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The Royal Society

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Rethinking the UK fiscal framework



Economic
and Social
Research Council



- Fiscal policy is hard, the world is complex, and trade-offs are unavoidable
 - No such thing as a perfect framework
 - No magic number or metric for assessing fiscal sustainability
- The UK fiscal framework has desirable features worth retaining
- But our current approach is not delivering good outcomes
 - We are in **a bad equilibrium**
- Plan for today:
 - Lay out the problems with our existing fiscal framework
 - Provide a constructive suggestion of an alternative approach



Part One: problems with our current approach

The UK's current framework, at a glance



- HM Treasury sets the fiscal rules; the independent Office for Budget Responsibility (OBR) assesses whether they're met under its central forecast
- This government has based its approach around two pass-fail rules:
 1. A 'flow' rule requiring a forecast for **current budget surplus** in 2029–30, then the third year of the rolling forecast period
 2. A 'stock' rule requiring (a particular measure of) **debt/GDP** to be falling by 2029–30, then the third year of the rolling forecast period
- *Since November:* performance against the rules formally assessed once per year, with a second forecast and 'interim update' in the spring
- Various other features, e.g. commitment to one major fiscal event per year (in theory); biennial Spending Reviews; an escape clause; a 'fiscal lock'; etc

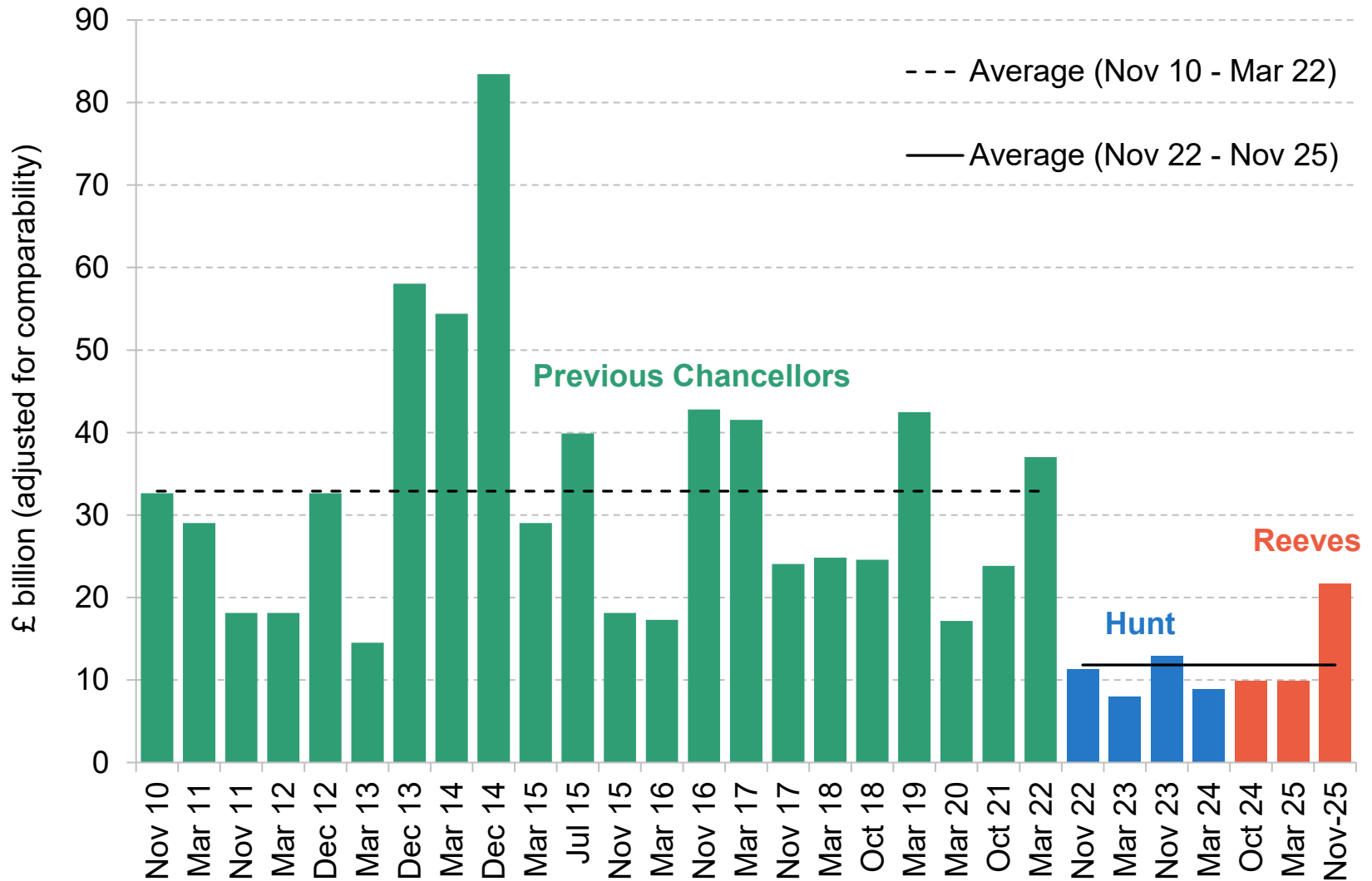
Thoughtfully designed, but producing dysfunction in practice

Problems with the framework



- Fixation on amount of 'fiscal headroom' in debate and policy process
 - Exacerbated by recent tendency to operate with minimal 'headroom'

'Headroom' against successive fiscal targets

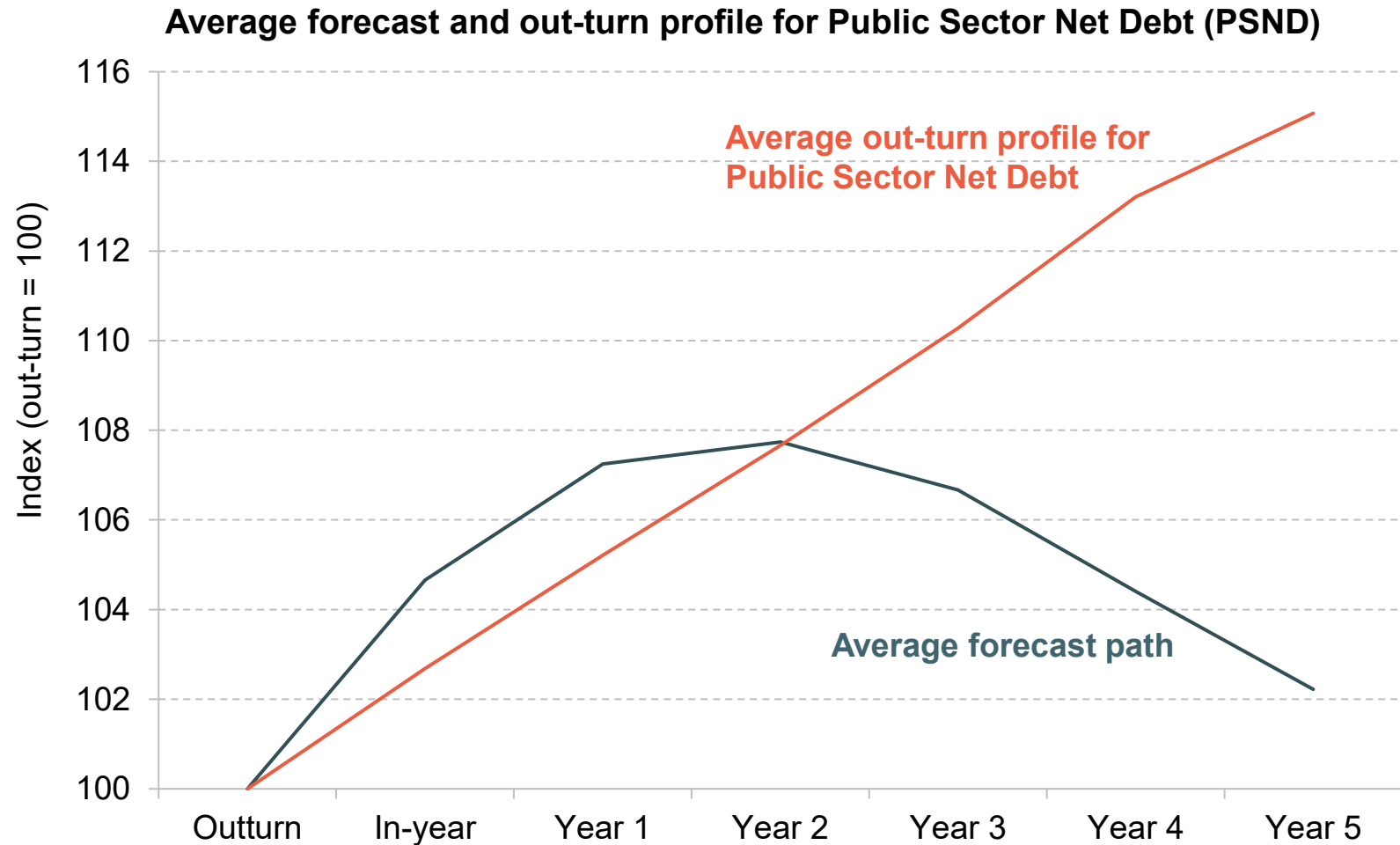


Problems with the framework



- Fixation on amount of ‘fiscal headroom’ in debate and policy process
 - Exacerbated by recent tendency to operate with minimal ‘headroom’
 - This means **volatility in macro forecast** → **policy volatility**
 - Adds to economic uncertainty and makes for worse policymaking
 - When the forecast improves, extra ‘headroom’ is seen as free money to be spent; when the forecast worsens, rules get abandoned or gamed
 - Huge and unhelpful amount of pressure on central point of OBR forecast
 - Not enough focus on *what we have ‘headroom’ against*
- Rolling targets means promised fiscal consolidations never arrive

Tax rises and spending cuts promised for the future don't tend to happen



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 - Not enough focus on *what we have ‘headroom’ against*
 - Rolling targets means promised fiscal consolidations never arrive
 - Excessive focus on a single metric for a single year means:
 - Other metrics and time periods are largely ignored
 - Policy decisions/design dictated by impact on metric used in fiscal rule
- **Dysfunctional policy, a poor debate, a lack of credibility, and ever-rising debt**



Part Two: a proposal for reform

The big picture

The new framework would have two pillars:

1. A Statement of Fiscal Strategy at the start of each parliament

- Outline high-level objectives and principles for fiscal policy
 - Expressed in narrative terms, as a direction of travel
 - Similar in spirit to the ‘fiscal standards’ proposed for the EU and the principles underpinning the New Zealand framework
- Should be a high profile set piece event, regular but infrequent

The big picture

The new framework would have two pillars:

1. A Statement of Fiscal Strategy at the start of each parliament

2. Monitoring via a set of ‘fiscal traffic lights’

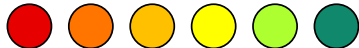
- HM Treasury to specify a set of economic indicators (perhaps 8 to 10) against which fiscal policy would be assessed and monitored
 - Published (and updated) alongside Statement of Fiscal Strategy
 - These will vary depending on context and government objectives, but some could be permanent or decided independently (e.g. by Treasury Select Committee)
- OBR produce forecasts/estimates for each indicator and describe the outlook for each using a gradated colour system (I suggest six-colour ‘traffic lights’)
 - HM Treasury, not OBR, to decide what constitutes red/amber/green, ideally after consulting externally – these thresholds would be fixed alongside the Statement
- This would be the centrepiece of the OBR assessment at fiscal events

An example set of traffic lights

In-year	Year 1	Year 3	Year 5
2025–26	2026–27	2028–29	2030–31

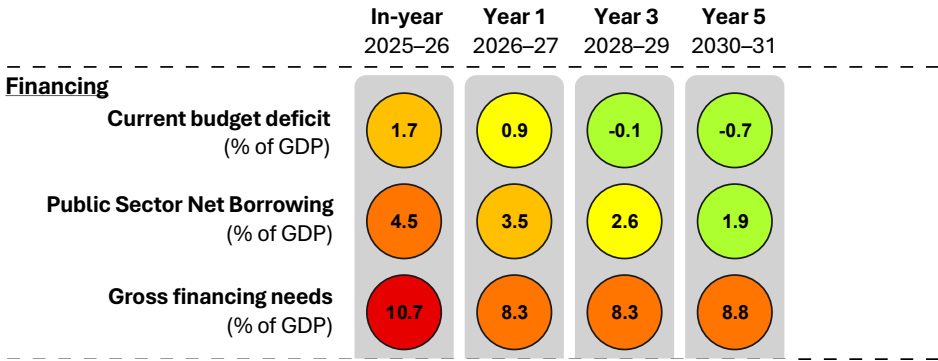
Summary

More vulnerable
(red)

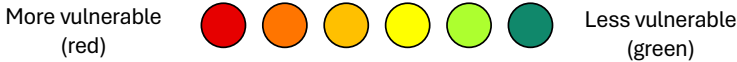


Less vulnerable
(green)

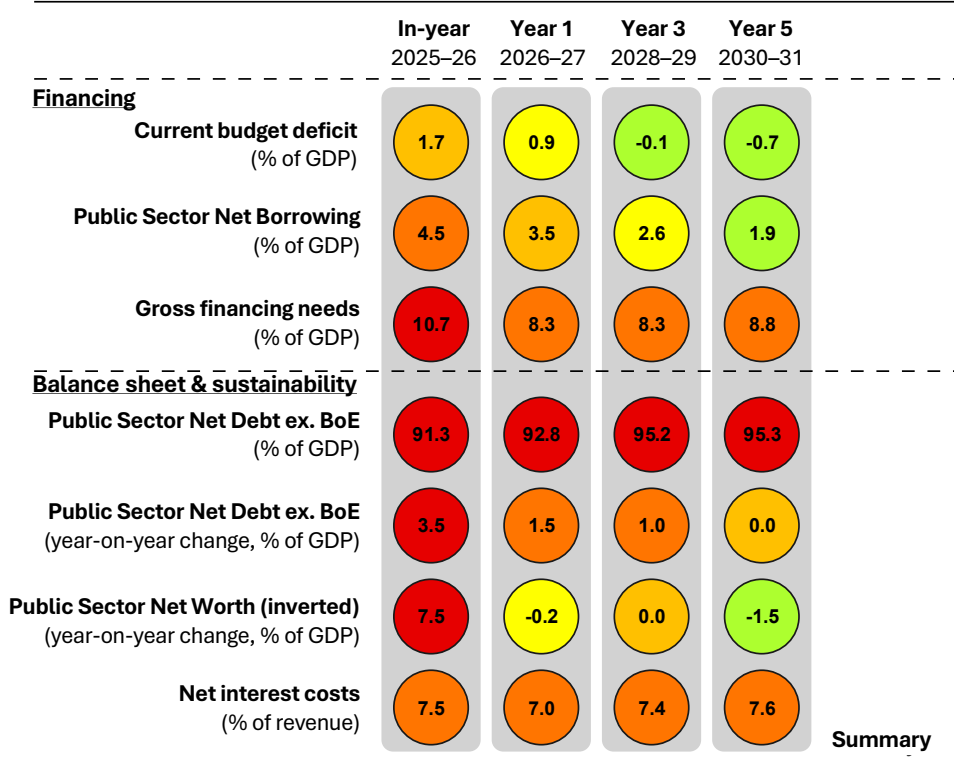
An example set of traffic lights

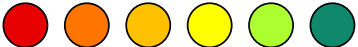


Summary

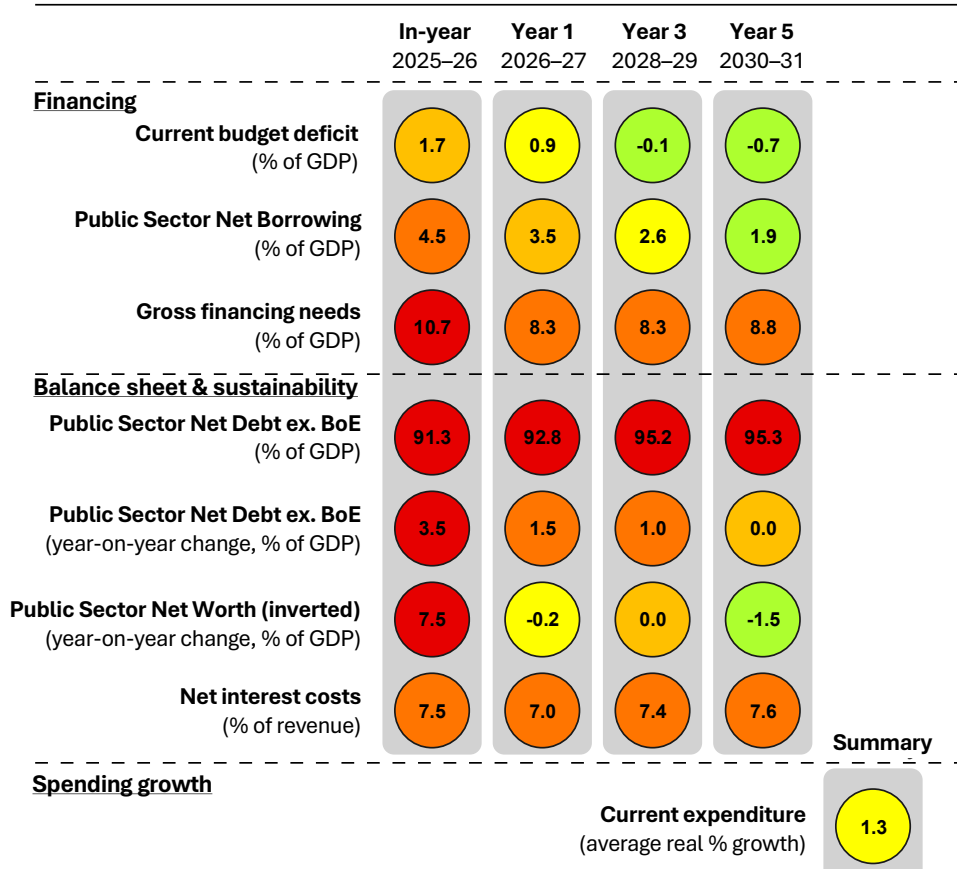


An example set of traffic lights



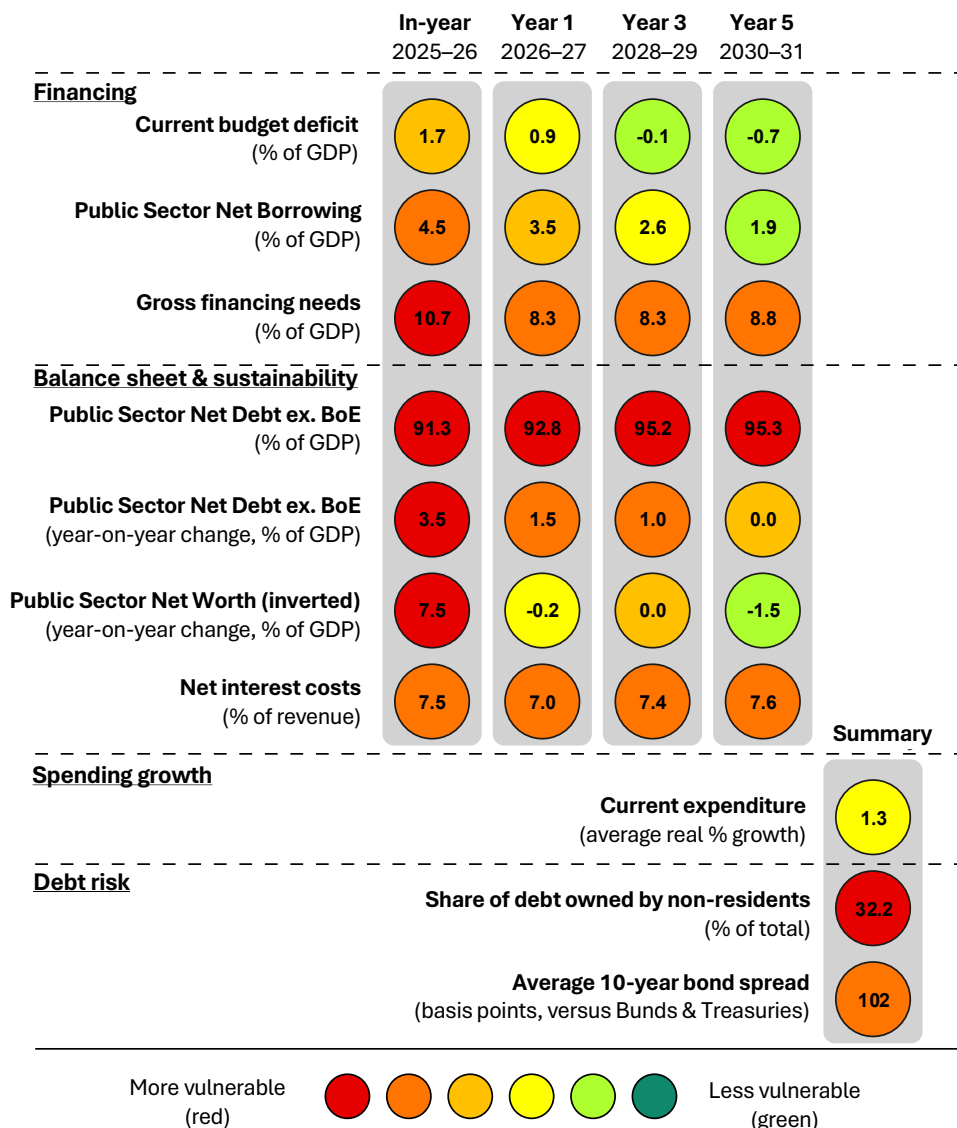
More vulnerable (red)  Less vulnerable (green)

An example set of traffic lights



More vulnerable (red) Less vulnerable (green)

An example set of traffic lights



Key aims of this approach:

- Move beyond ‘fiscal headroom’
- Broader assessment of fiscal position
- Make multiple objectives explicit
- Intuitively understandable
- Reduced incentive to contort policy
- A more nuanced debate
- Take pressure off central OBR forecast
- Help stick to one fiscal event per year

A summary and a caveat

In sum: use ‘fiscal traffic lights’ to monitor performance against broad fiscal objectives and principles set out at the start of each parliament

- More detail in the full paper for the fiscal nerds

The overarching aim: create the conditions for better fiscal policymaking and debate while maintaining discipline and credibility

Crucial caveat: this is not a proposal for immediate reform

- Now is not the time for a(nother) change to the fiscal rules
- Only from a position of strength should such reform be enacted
- Could run traffic lights in parallel with existing system over rest of the parliament, ahead of full transition in future (next parliament?)

One of several reasonable objections



No such thing as an ‘optimal’ framework: there are potential downsides

One objection: the absence of a hard numerical limit means the system would provide (even) less of a bulwark against demands for extra borrowing

The response:

1. The framework would still act to constrain policy and counteract deficit bias
 - Inclusion of in-year borrowing totals → harder to ignore short-term excess
 - Could encourage greater prudence, to be ‘safe’ on multiple indicators
 - Could lessen ‘magnet effect’ (i.e. reduce incentive to borrow up to the limit)
2. HM Treasury has other means of maintaining spending control
3. The bond market would remain as the ultimate constraint on policy
4. Any costs need to be weighed against benefits – I’d make the trade-off

Ultimately, there’s no substitute for good governance

Conclusion

- Any reform to the framework comes with trade-offs
 - The question is whether they are worth making
- Government can change the terms of the debate
 - When fiscal rules change, previous ones are forgotten
- This is not an argument for immediate reform, but an attempt to provide a credible alternative for the medium term

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