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Designing fiscal targets for the UK

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This presentation draws heavily on C. Emmerson, S. Keynes and G. Tetlow “The fiscal targets”, Chapter 4 of the *IFS Green Budget: February 2013* (http://www.ifs.org.uk/publications/6562)

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Outline

- Principles of good fiscal management
- Design issues
- Fiscal targets in practice
- Conclusions

Why strive to have low debt?

- Advantages of having lower government debt
  - less national income needs to be devoted to debt finance
  - lower cost of borrowing so less crowding out of private investment
  - public finances less dependent on the cost of government borrowing
  - more scope to increase debt dramatically if needed
  - easier to ensure fiscal sustainability

- Trade-off between the benefits of low debt and the cost of higher taxes/lower spending needed to bring low debt about

Why should governments borrow…

- Investment spending
- Output stabilisation
  - if/when fiscal policy better instrument than monetary policy (or in a fixed exchange rate regime)
- Adjusting gradually to shocks
- Forecast errors
- Smooth tax rates and consumption when time profiles of revenue streams and spending needs do not match
  - most obviously with revenues from North Sea oil and the public finance costs of an ageing population
- Possible desire to redistribute from (richer) future generations
- Certainly do not want revenues to equal spending in all periods

…but we might think that…

- Within cycles:
  – if borrowing rises during a period of temporary weakness it should fall again once the problem has passed
  – if the economy experiences an unsustainable boom the government should save any additional revenues
- Across cycles spending that only benefits the current generation should be covered by tax revenues paid by the current generation
  – normative, but note that both Gordon Brown's "golden rule" and George Osborne's "fiscal mandate" had this in mind
- Amount of debt-financed investment should be greater when the cost of borrowing is lower (and vice-versa)
- There should be a limit on how much we pre-commit future taxpayers' money

… and that without some additional constraints too much borrowing might occur

- Incentives faced by politicians
  - for example by heavily discounting periods beyond the next election
  - (but incoming governments might want to be too pessimistic)
- Time inconsistency (either by politicians or the public)
- Lobbing from those who want higher spending/lower taxes
  - insufficient lobbying for lower borrowing from those not yet born
- Tendency to be over confident about both future prospects and our ability to forecast accurately
  - next time it really will be different?
- These phenomena might also lead to too little spending on investment projects
  - Labour in 1997 argued that there was a tendency for fiscal tightening to come disproportionately from cuts to public sector net investment

Why might fiscal targets help?

- Make explicit what the government views as desirable policy
- Pre-commitment device to help align policymakers' incentives with the optimal outcome
  - change payoff structure to increase the cost to the government of deviating from desirable policy

- Example: Gordon Brown's fiscal rules were an attempt to persuade voters and market actors that he would not succumb to the perceived failings of previous Labour Chancellors

Why might fiscal targets hinder?

- Good management of public finances requires good fiscal policy
  - fiscal targets are not necessary or sufficient for this
- Slavish adherence with fiscal targets won't be optimal in all periods
- Fiscal targets could help endorse inappropriate fiscal policy
  - if compliance is too easy could allow borrowing to be increased inappropriately
- Fiscal targets could help enforce inappropriate fiscal policy
  - last Government right to suspend its own rules in late 2008, rather than taking action to try to ensure debt remained below 40% of GDP
- Not possible to eliminate these risks
  - but well designed fiscal targets should be a reasonable rule-of-thumb in most periods
  - need to remember that sometimes rules should be broken

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An optimal fiscal target?

- Economics 101 does provide a rule to stick to in all periods:
  - increase borrowing until expected marginal benefit from the borrowing is equal to the expected marginal cost of that borrowing
- Unfortunately this is useless as a guide to policymakers
  - but useful to bear in mind since encouraging or enforcing any deviation away from it has a cost
  - trade-off between precision on one hand and simplicity and transparency on the other
- Can we reduce opportunities for naughtiness by politicians without encouraging or enforcing bad policy outcomes?
  - answer will depend on how bad you think politicians can be relative to the costs of a sub-optimal fiscal rule
  - an independent fiscal authority can help by reducing scope for bad behaviour

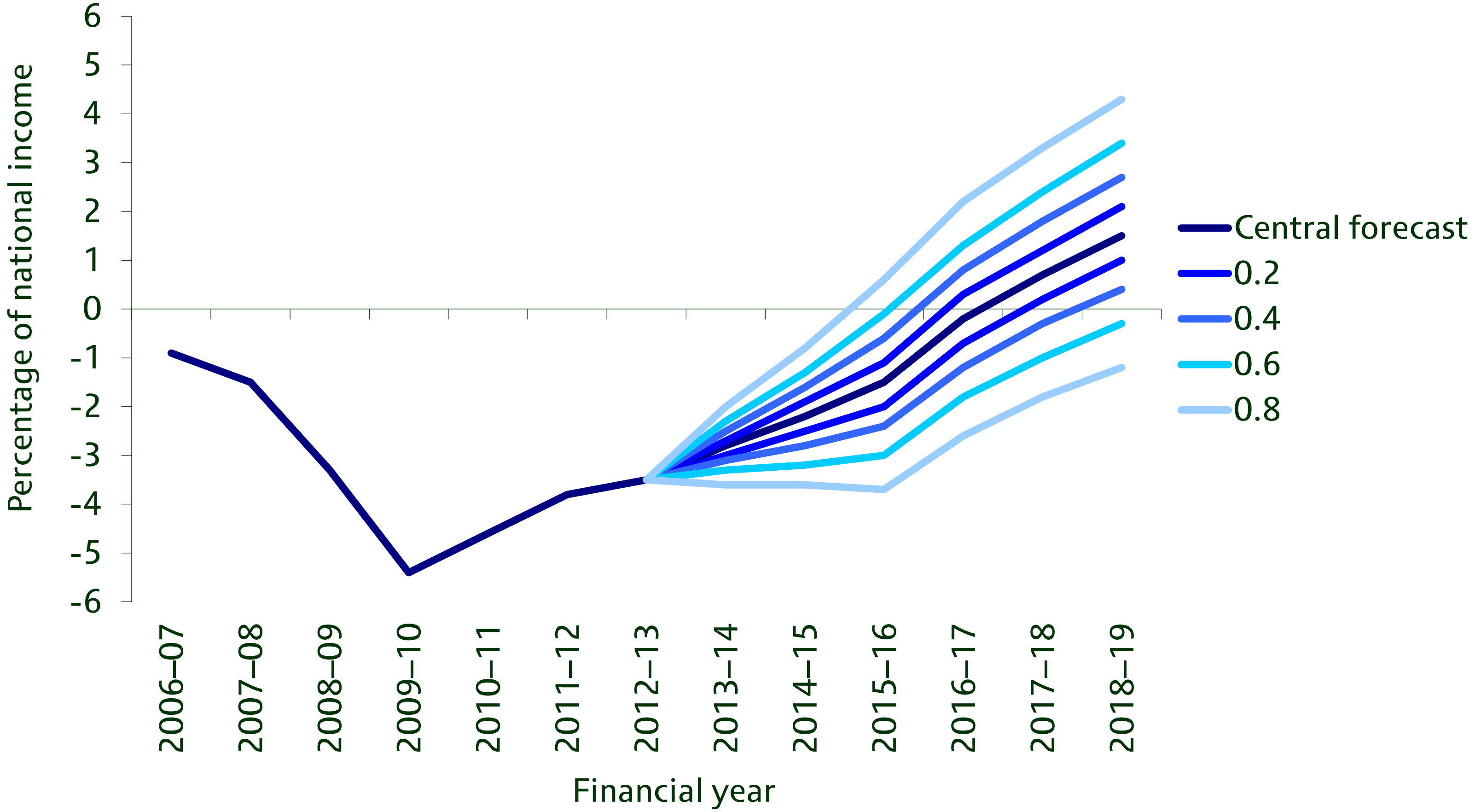
Design issues

- Should
  - we have fiscal targets at all, or are independent forecasts enough?
  - targets apply to the deficit, the debt or the cost of debt (or some combination of these things)?
  - we have a fixed date or a rolling target?
  - investment spending be treated differently?
  - we adjust for the cycle (and other temporary shocks)?
  - how should we take into account expected changes in revenue streams / spending needs?
  - there be automatic mechanisms for suspending the rules?
  - the role of the OBR be changed in any way?

Better to target debt or the deficit?

- Ultimate objective is to have appropriate debt in the long-run
  - so might seem more sensible to target that
- What measure of debt:
  - what about commitments to PFI providers, promises to pay public-service pensions, and other contingent liabilities, etc.?
  - allow for more if the cost is lower?
- But:
  - debt is much more volatile: the impact of a recession on the deficit should be short-lived relative to its impact on debt
  - adjusting debt for impact of temporary shocks difficult
  - and want policy to adjust slowly to shocks
- Case for a deficit target as well?

Public finance forecasts are very inaccurate…



Source: Chart 5.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2014*.

…and this causes problems for debt targets and for fixed date targets

- Suppose committed to a CA current budget balance or better in coming year and the Budget forecasts a 1% of GDP surplus
  - 10% chance that an in-year fiscal tightening of more than 0.4% of GDP would be needed to comply with the rule
  - even if the year-end Budget projected a surplus of 0.8% of GDP there would still be a 10% chance that the rule would be breached
  - errors on forecasting headline PSNB even greater
- Problem worse for targets that add borrowing over several years
  - such as Gordon Brown's "golden rule", or any debt target
- So either need to allow for lots of wiggle-room, or have a forward-looking target
- Case for forward-looking target stronger the more honest the forecasts are thought to be

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Treat investment spending differently?

- Ideally should consider which generations ultimately receive the benefits from spending and bear the costs of taxation
  - might current generation underinvest if they have to pay fully for it?
- Only borrow to pay for things that future generations benefit from?
- Okay to borrow to invest using a national accounts definition?
  - spending on teacher training not investment, but spending on the London Olympics is?
  - increased pension promises to current public sector workers is not current spending, but payment of pensions to former employees is?
  - will time profile of benefits from investment spending match the time profile of debt repayments?
  - transparency suggests we should stick with the National Accounts definition (or treat public service pensions differently?)

To cyclically adjust or not?

- Temporary shocks to the public finances should not lead to large changes in taxes or spending
  - for example: don't want large temporary tightening in a recession
- But adjusting borrowing for the impact of the ups-and-downs of the economic cycle is not straightforward
  - requires contemporaneous assessment of the size of the output gap and an assessment of how that is affecting public finances
- And the economic cycle is not the only source of temporary shocks: housing market, financial sector profits, etc.
- Big problem for fixed-year targets: not adjusting moves further from optimality, but adjusting reduces transparency
- Rolling targets don't escape the problem entirely
  - current spare capacity in economy will affect outlook for revenues

Fiscal targets in practice

- Targets for borrowing
  - Gordon Brown's "golden rule"
  - George Osborne's "fiscal mandate" and his September 2013 conference announcement
- Targets for debt
  - Gordon Brown's "sustainable investment rule"
  - George Osborne's "supplementary target"
  - solvency targets
  - IFS Green Budget proposal for a "sustainable commitments rule"

Gordon Brown’s “golden rule”

- Current budget should be at least in balance over an economic cycle
- Good:
  - allows borrowing for investment
  - allows borrowing to be smoothed over the ups-and-downs of a cycle
- Bad:
  - target is asymmetric: need to aim for sizeable surplus if want to be confident of success without further policy action and therefore will tend to redistribute to future generations
  - permissible surplus/deficit in the last year of a cycle depends only on behaviour since cycle began: rule becomes entirely backwards looking
- Ugly:
  - not possible to date the start and end of a cycle in real-time (if ever)
  - current budget in last year of cycle also scored as first year of next cycle: some years’ borrowing double-counted!

George Osborne's "fiscal mandate"

- A forecast balance (or surplus) on the cyclically-adjusted current budget by end of forecast horizon
- Good:
  - allows borrowing for investment and for temporary reasons, and allows policy time to adjust gradually to permanent shocks
  - rolling-target means don't need to aim to overachieve by large margin
- Bad:
  - target is still asymmetric: will tend to redistribute to future generations
  - a government that continually promised to tighten in future, but never delivered on those promises, would not break the rule
- Ugly:
  - complaints about targeting cyclically-adjusted current budget as this is never observed (but the forecast is observed)

George Osborne’s conference announcement

- Aim to achieve an overall balance, provided growth continues
  - combined with a pledge to maintain investment spending as a share of national income
  - more detail to come in 2014
- Sounds similar to the present fiscal mandate
  - but aiming for a current budget surplus of at least the present level of investment spending, rather than of at least a balance
  - not cyclically-adjusted, although with caveat about the state of the economy

Gordon Brown's "sustainable investment rule"

- Net public sector debt should be kept at a 'stable and prudent' level
  - for the economic cycle that started in the late 1990s this was defined as 40% of national income
  - assuming a current budget balance, and nominal GDP growth of 5% p.a., 40% ceiling implied a cap on investment spending of 2% of national income
- Good
  - broader measure of debt than used by European targets
- Bad
  - why cap public sector net debt but not other commitments?
- Ugly
  - 40% ceiling arbitrary: seemingly picked on the basis of what Labour inherited from the Conservatives (but this not necessarily wrong)

George Osborne’s “supplementary target”

- Public sector net debt should be falling as a share of national income in 2015–16
  - retained from the previous Labour government’s Fiscal Responsibility Act 2010
- Good
  - very little, though it is clear and transparent and, in 2016, it should be easy to measure compliance (currently on course to breach this target)
- Bad
  - debt rising in every year up to 2014–15, then falling in 2015–16, before rising in every year thereafter would be compliant with this rule

- Goes too far in being simple and transparent at expense of being suboptimal

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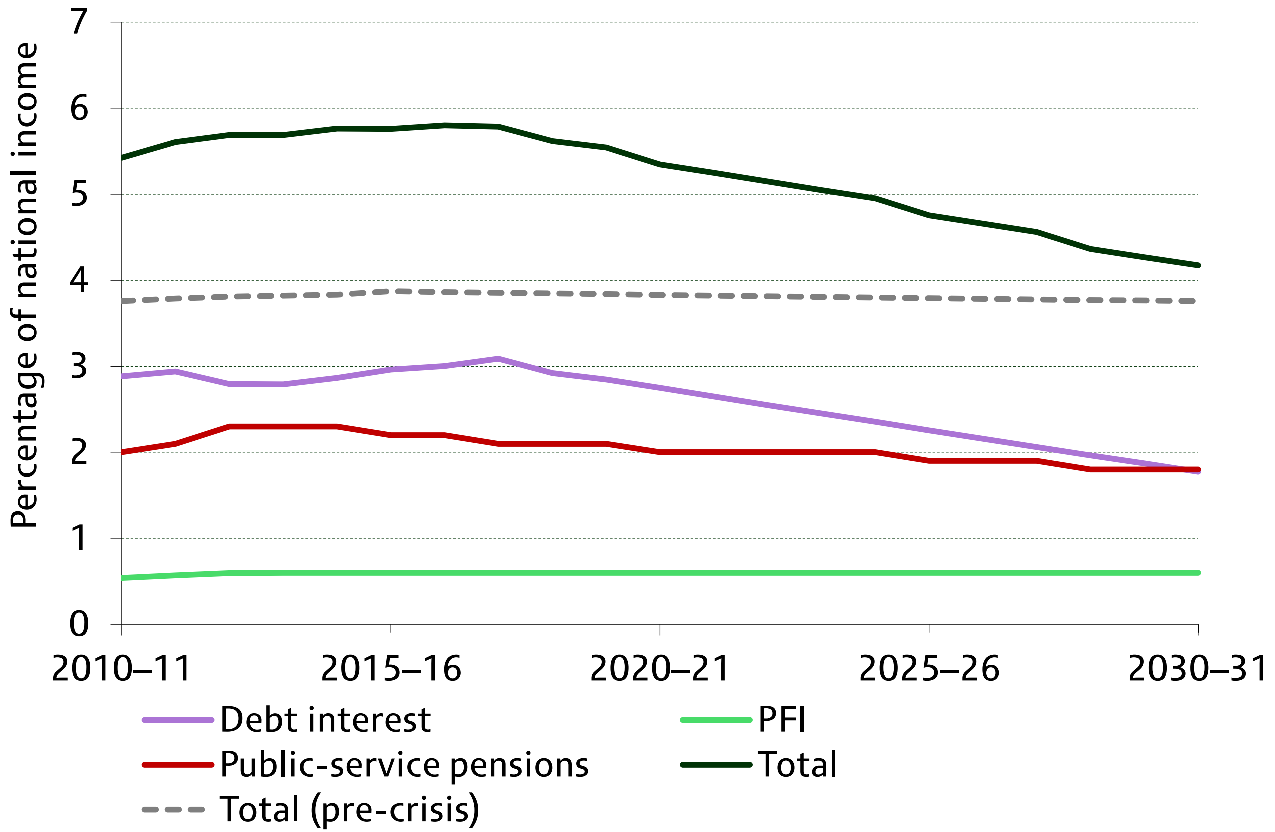
Solvency targets

- Each year OBR estimates the ‘intertemporal budget gap’
  - size of the permanent and immediate fiscal tightening needed to satisfy the intertemporal budget constraint
  - July 2013 estimate is 1.9% of GDP from 2018–19 onwards
- Could commit to meeting this over some timescale
  - appropriate timescale could depend on the size of the gap
  - could factor in unfunded public-service pensions and PFI commitments, plus estimated public finance costs of ageing population and declining North Sea Oil production
- But
  - could be consistent with relatively high levels of debt
  - very sensitive to assumptions used: OBR judgments over (for example) forecast population size and structure, and public-service productivity growth, would be crucial

‘Sustainable commitments rule’

- Limit the amount annual flow of future tax revenues that are precommitted to meeting the liabilities already accrued
  - first proposed in the January 2009 IFS Green Budget
- Would allow greater borrowing when interest rates were low
- Could incorporate a broader definition of liabilities
  - debt interest plus, potentially, payments to PFI-providers, public-service pensioners, etc.
- But which liabilities to include
  - is it sensible to include PFI and public service pension payments but ignore the larger implicit commitments to state pensions and the NHS?
- And what level of ceiling?
  - should it be lower in periods when taxable capacity is lower, when risks around projections deemed greater, or when likely cost of contingent liabilities thought to be higher?

A possible ‘sustainable commitments rule’



Source: Figure 4.6 of C. Emmerson, S. Keynes and G. Tetlow (2013), ‘The fiscal targets’, Chapter 4 of *The IFS Green Budget: February 2013* (http://www.ifs.org.uk/publications/6562).

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The Office for Budget Responsibility

- Welcome improvement in the presentation, transparency and credibility of official forecasts
  - judgements made by three independent experts should be better than having them made by the Chancellor
- Role of OBR – and other independent commentators – more important with targets based on rolling measures
- Also important role to play in describing what the impact of a fiscal event was
  - a longer-term giveaway or takeaway?
  - did it increase or reduce the overall risks in the public finances?
- OBR should be retained: but should its scope remain relatively narrow or should it be increased?

Conclusions

- Fiscal mandate has many attractive features
  - pretty much what has been proposed in Green Budgets since 2005
  - case for shorter timescale in normal times
  - should timescale automatically be changed in certain times (for example depending on size of output gap or structural deficit?)
- Doesn't ensure long-run financial sustainability and might want to limit the extent to which future national income is pre-committed
  - long-run debt target: set policy to aim for 40% of GDP in, say, 2035?
  - or perhaps long-run ceiling for path of debt interest payments (and potentially other commitments)
  - ceiling could incorporate expected changes to revenue sources and spending needs?
  - how should these targets be modified if large shocks occur?
- Retain the OBR

Design issues for discussion

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