Institute for Fiscal Studies

IFS Green Budget Chapter 4

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# Rewriting the fiscal rules

# 4. Rewriting the fiscal rules

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## Key findings

1 **In principle, well-designed fiscal rules could make it easier for governments to borrow for good reasons while making it hard to borrow for bad reasons.** Borrowing during periods of temporary weakness or to finance spending that delivers future benefits can be appropriate, but simply borrowing in order to defer announcing or implementing measures that involve difficult trade-offs is not.

2 **Successive Chancellors have been too quick to announce poorly designed fiscal targets: in total, 11 have been announced in the last seven years, with most of them being missed before being dropped.** The Chancellor was right to suspend and review the government's fiscal targets – and to allow borrowing to rise sharply – when the pandemic hit. The manifesto commitment to reduce debt over this parliament was always badly conceived and Rishi Sunak is right not to attempt to meet it.

3 **Indications are that both the Conservative Government and the Labour Opposition remain in favour of setting policy so that a current budget balance (or better) is forecast for the medium term.** This has much to commend it: it allows borrowing for investment purposes and gives some time for policy to adjust to shocks. But the split between capital and current spending will not always align with what spending does and does not benefit future generations. There is also a judgement to be made about the timescale over which a forecast current budget balance should be aimed for: too short and it could necessitate inappropriately sharp adjustments to policy; too long and governments may have more scope to promise future tax rises or spending cuts that they do not intend – or are perhaps unable – to implement.

4 The combined legacy of the COVID-19 pandemic and the global financial crisis (GFC) has been to elevate debt to levels not seen in recent UK history. Debt

interest payments are, however, lower than prior to the GFC as interest rates have fallen sharply. Indeed, they are lower as a share of revenue than at any time since 1700. This does not mean additional debt has been costless: the public finances are now much more exposed to increases in interest rates. This has been exacerbated by the fact that the increase in debt since the start of the pandemic has been effectively financed by increased deposits of commercial banks at the Bank of England. **There remains a strong case for gilt issuance to be tilted more towards long-dated index-linked gilts in order to lock in the current low real cost of more debt.**

5 There is a case for setting policy so that over the long term, debt is reduced as a share of national income. This could help reduce future debt interest spending and could create 'fiscal space' so that debt could be increased again when the next severe adverse shock strikes. Reducing debt from its newly elevated level will be made harder by known pressures facing the public finances. **The Office for Budget Responsibility estimates that the rising costs of healthcare, adult social care and state pensions will total 6.1% of national income by 2050–51, while costs associated with the transition to net zero are estimated to peak much sooner, in 2026–27, at 2.2% of national income.**

6 The International Monetary Fund estimates that UK general government net worth is the lowest of 24 advanced economies. **A clear risk with a narrow focus on debt is that public sector assets are inappropriately sold – or are not acquired – to help keep headline debt down.** Whatever its merits, measurement challenges mean that a formal target for public sector net worth may not be sensible. While there are advantages to reducing debt over the longer term, both the Treasury and the Labour Opposition should retain their welcome focus on the broader public sector balance sheet.

7 A clear lesson from the last 25 years is that, rather than having firm and fixed fiscal rules, it would be better for these to be considered rough rules of thumb that Chancellors should strive to keep to in most periods. This should be communicated from the outset. **We should not pretend that any fiscal target, however carefully designed, will be sacrosanct for evermore.**

# 4.1 Introduction

The COVID-19 pandemic led to UK government borrowing reaching its highest level since the Second World War and has pushed public sector net debt to a share of national income not seen since the early 1960s. Such a response is appropriate: governments should borrow more during periods of crisis in order to support households, businesses and public services.

To allow for borrowing on this scale in response to the crisis, the Chancellor Rishi Sunak sensibly suspended the government's fiscal rules. These rules were never designed for the current situation: it is hard to imagine any set of fiscal targets that would be usefully constraining during most periods but flexible enough to allow the increase in borrowing and debt that we have seen during the pandemic. Mr Sunak's first Budget in March 2020 initiated a review of the fiscal rules, stating that this would conclude by a Budget that following autumn. That Budget was then pushed back to the spring of this year, at which point it was announced that the review of the fiscal framework was continuing and that new fiscal rules would be set out in the Autumn 2021 Budget.

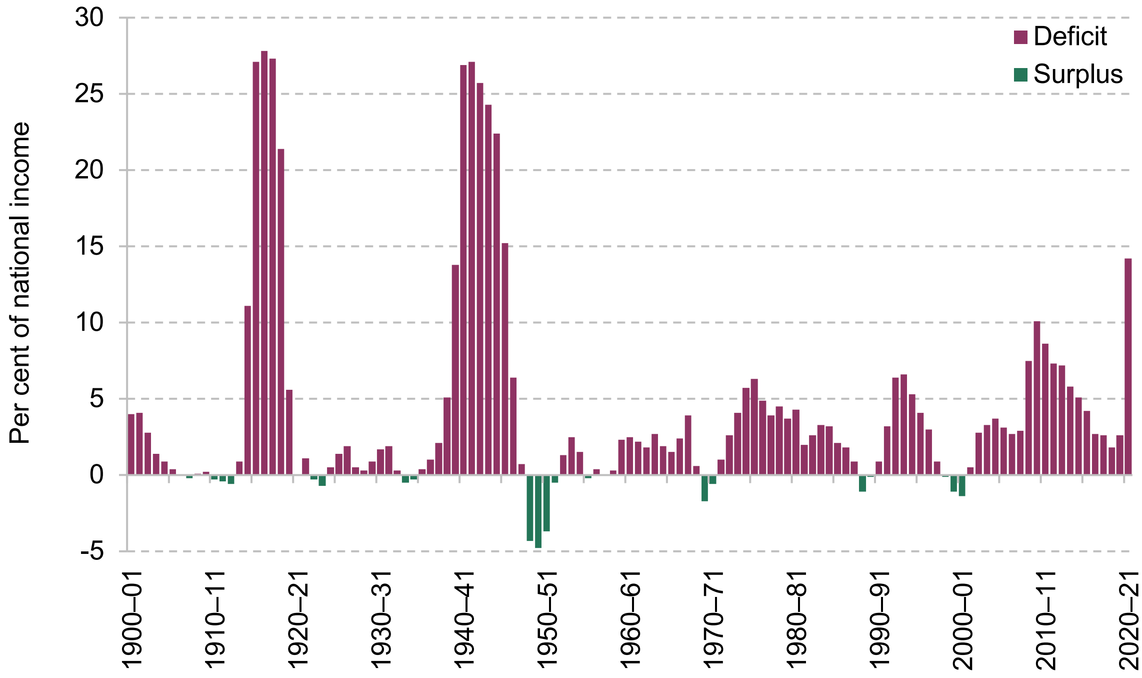
With this in mind, this chapter discusses the design of fiscal rules. It starts in Section 4.2 by asking why fiscal rules might be useful in helping the stewardship of the public finances in the first place. Section 4.3 provides a brief history of the experience of such rules in the UK over the last 25 years. Section 4.4 sets out the key features of a well-designed set of fiscal targets and makes some recommendations for the UK. Section 4.5 concludes.

# 4.2 Why fiscal targets at all?

It is common for governments – both in the UK and elsewhere – to raise less in revenue than they spend: in other words, to borrow. As shown in Figure 4.1, in the UK there has not been an overall budget surplus for over 20 years (the last one was in 2000–01), and since the start of the 20$^{th}$ century on average four out of every five years has seen spending exceed total revenues (98 out of 121 times).

There are often good reasons for governments to borrow, some of which apply in some temporary circumstances and some of which can justify planning to borrow on an ongoing basis. But governments might, at least in some circumstances, be tempted to borrow more than is appropriate from an economic point of view. And while debt can – and indeed should – grow faster than the size of the economy in some circumstances, it cannot continually increase as a share of national income forever; at some point, a combination of tax rises or spending cuts would be required to prevent debt interest costs and inflation from spiralling out of control. Excessive government borrowing can thus risk substantial costs. The key argument for fiscal

Figure 4.1. Public sector net borrowing since the start of the 20th century




Source: Office for Budget Responsibility, Public Finances Databank, www.obr.uk/data.

targets is therefore that they can make it harder for governments to borrow for inappropriate reasons, but still allow borrowing when it is felicitous.

## Good and bad reasons for governments to borrow

As has been discussed in previous Green Budgets (see, for example, Crawford et al. (2016)), there are at least five good principles for allowing governments to borrow:

- **Intergenerational fairness.** Where spending now delivers benefits in the future – either financial or non-financial – it is arguably fair that future generations share in the cost of financing this spending. The alternative, where such spending is financed from taxes levied on the current population, risks only doing spending that has reasonably immediate benefits. This could, for example, mean that investment projects with large up-front construction costs but more valuable benefits over a long period of time would not be commissioned. Such projects should go ahead where the benefits exceed the costs of financing them, even if the benefits only accrue slowly. This also has the implication that the lower the interest rate on government borrowing then, all else equal, the greater the amount of spending that delivers future benefits that should go ahead.
- **Output stabilisation.** When adverse shocks hit the economy, there will be temporary reductions in tax revenues and additional demands on spending, as indubitably demonstrated since the outbreak of the pandemic. The government should have the flexibility to increase borrowing (or to reduce any surplus) during adverse shocks in order to support households,

businesses and public services and to help stabilise the macroeconomy. Attempting to maintain borrowing at its previous level following an adverse economic shock would require a combination of tax rises and spending cuts, which would risk worsening the harm done and causing long-term economic damage. This is especially true when the role of monetary policy is limited, which could occur if it was not possible to reduce interest rates (e.g. because they are already near zero or if exchange rates are fixed and there is a non-common shock).

- **Gradual adjustment.** When tax rises or spending cuts are needed – for example, when the longer-term outlook for future economic performance is revised down – it may make sense to adjust taxes and spending gradually rather than all at once. Rapid adjustments could have unwanted impacts on aggregate demand in the economy that monetary policy may be unable to offset. Making changes quickly – in particular, cuts to day-to-day spending on public services – could also mean less efficient changes being made than would be possible over a longer timescale.
- **Tax-rate smoothing.** Rather than trying to smooth tax *revenues* over time, economic theory suggests that it is better to smooth tax *rates* over time. Stability in tax rates could also help individuals and businesses with saving and investment decisions.
- **Forecast errors.** Even in the very short run, there is considerable uncertainty around total public spending and total tax revenues (in fact, the estimated amount borrowed in a given recent year will be subsequently revised, and sometimes substantially so). This means that even if a government produced unbiased fiscal forecasts, there would be a (roughly) 50:50 chance of borrowing being greater than planned. But any unexpected borrowing should, over time, be balanced out by years in which borrowing turned out lower than had been planned.

Governments might be tempted to borrow more than is appropriate, a phenomenon known as deficit bias. This could occur because governments (unsurprisingly) find it easier to increase spending and to cut taxes than to cut spending and to increase taxes. Particularly in the run-up to a general election, a Chancellor might be tempted to defer difficult decisions to a later Budget when either they have been returned to office and may not face a general election for a number of years or, in the event of an election defeat, the challenges can become the problem of a political opponent. Indeed, the history of recent UK fiscal events has shown a tendency for large tax increases to be much more likely to be announced in the 12 months following a general election than in other years (with the year following the 1992, 1997, 2001, 2005, 2010 and 2015 general elections all showing this pattern).

The fact that politicians might be tempted to borrow more than is appropriate has implications for the design of the fiscal framework and associated fiscal rules. It means that there needs to be a political cost to an unjustified breach of fiscal rules: otherwise the rules will be, and will be seen to be, meaningless. Similarly, the rules need to be carefully designed so that they cannot be easily gamed: otherwise, rather than trying to comply with the principles behind a rule, there may in some circumstances be a temptation for a Chancellor to attempt to meet the letter of the rules – for example, by inappropriately distorting policy, delivery or measurement.

## Potential benefits of well-designed fiscal rules

There are a number of related reasons why a Chancellor might decide to implement a fiscal framework and fiscal rules that constrain their behaviour. Most obviously, and as stated above, a fiscal framework and fiscal rules that are well designed, credible and understood by policymakers, voters and others who are trying to hold the government to account can lead to better policy outcomes as they make it easier for governments to borrow for good reasons and harder for governments to borrow for bad ones. Second, fiscal rules might help the government explain to voters and to those lending the government money what it is trying to achieve. This could help persuade voters and financial market participants that the public finances are going to be kept on a sustainable path and that tax and spending choices would not impose an unfair financial burden on future generations. This could help keep the UK risk premium low and therefore debt financing costs down. Third, one potential benefit – from the perspective of the Treasury or finance ministry, at least – is that fiscal rules that are constraining might help the Chancellor win arguments with cabinet colleagues in Spending Review negotiations.

## Features of well-designed fiscal rules

The good reasons for government borrowing set out above have several implications for any fiscal rules that we might wish to adopt.

- First, we should certainly not want to constrain the government to running an overall budget surplus in each and every year, which was a mistaken commitment made by George Osborne when he was Chancellor. But in most circumstances, and certainly in 'good' economic times, we might think tax revenues paid by the current generation should cover all spending from which it benefits.
- Second, higher borrowing (or lower surpluses) should be allowed during periods of crisis, when the economy is temporarily underperforming. This will be particularly important when it is not possible, or not appropriate, for monetary policy to be loosened further. Conversely, borrowing should be lower (or surpluses larger) during unsustainable economic booms. But even outside of a boom, we may want lower borrowing in order to create the fiscal space to allow borrowing to rise when future adverse shocks occur.
- Third, borrowing should be allowed to finance spending that benefits future generations. For example, borrowing increased enormously during the Second World War and it might be considered right that subsequent generations share in this cost. But we might also want to put a limit on the extent to which we pre-commit the spending of future generations as they might value greater flexibility, not least as their preferences might be different. Therefore we might want to borrow more for purposes that deliver future benefits when the interest rate on

government borrowing is low and when future growth is expected to be high. We should also bear in mind that if borrowing is done at short durations then future increases in interest rates would lead to higher debt interest costs when borrowing is refinanced.

- Fourth, revenue streams or spending pressures will vary over time and, where changes are known in advance, governments should consider adjusting before they happen. For example, there is a case for increasing taxes and/or cutting spending, and therefore reducing debt relative to what it otherwise would have been, ahead of future spending pressures from demographic change. Equivalently, were a new revenue source – for example, from the discovery of a new tax-rich natural resource – to be on the horizon, this could justify cutting taxes and/or increasing spending, and therefore increasing debt relative to what it would have been, in advance of the new revenues actually materialising. Doing this will help to smooth tax rates over time and should aid the efficient implementation of decisions.

These implications make designing a good set of fiscal rules extremely challenging. Rules need to be flexible enough to allow more borrowing in temporary periods of economic weakness and especially so when monetary policy is constrained. They need to distinguish between whether or not borrowing is being used to finance spending that will benefit future generations. They need to look forwards, considering not just known future pressures on revenue and spending but also unexpected crises that will – at some point – doubtlessly occur (as the global financial crisis and the COVID-19 pandemic have comprehensively demonstrated). Yet to have the benefits of fiscal rules set out above, they need to be widely known and understood, which suggests a need for simple rules and – ideally – rules that are relatively stable over time.

In many cases, there is a trade-off between introducing greater flexibility to allow additional borrowing for good reasons in particular circumstances (most obviously temporary weakness in the economy or the financing of spending that benefits future generations) and the increased cost of opening the rules up to the possibility that they will be gamed. More flexible rules may also be more complicated and therefore harder to communicate and to be understood.

With these considerations in mind, we now turn to look at the UK's experience of fiscal rules over the period since 1997.

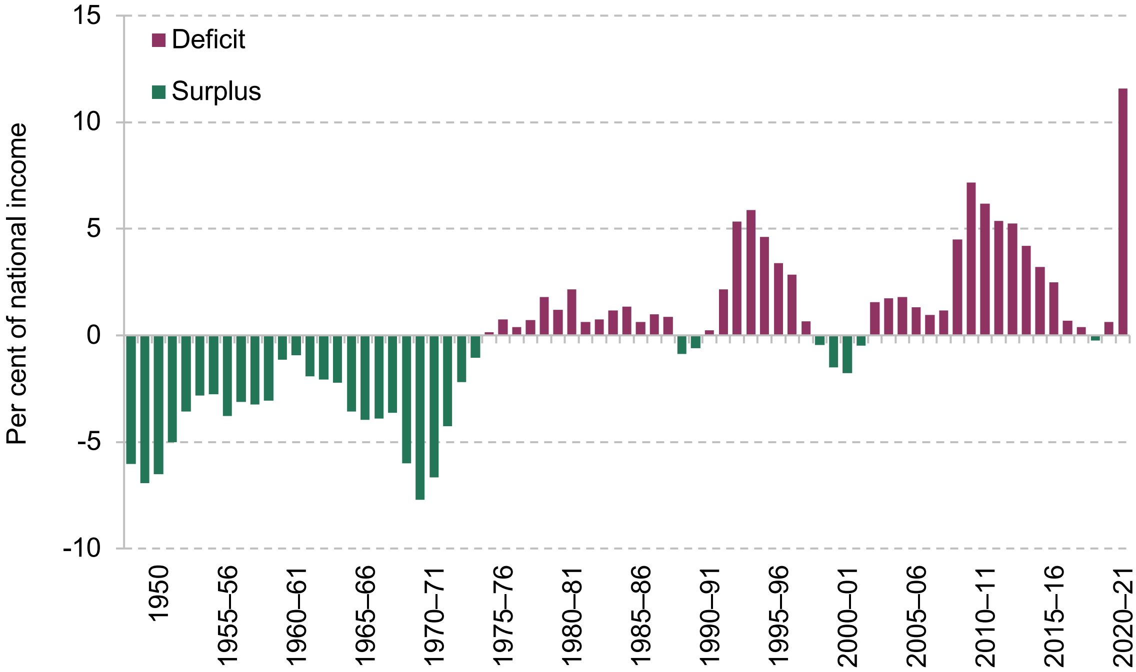
# 4.3 A brief history of UK fiscal targets

## The pre-COVID targets

The Conservative Party's 2019 general election manifesto – and associated policy costings document – committed to three fiscal rules (Conservative Party, 2019a, 2019b). These are:

- to have the current budget in balance no later than the third year of the forecast period;

Figure 4.2. Current budget deficit since 1948




Source: Office for Budget Responsibility, Public Finances Databank, www.obr.uk/data.

- to limit public sector net investment to 3% of national income; and
- to reassess plans in the event of a pronounced rise in interest rates taking interest costs above 6% of government revenue.

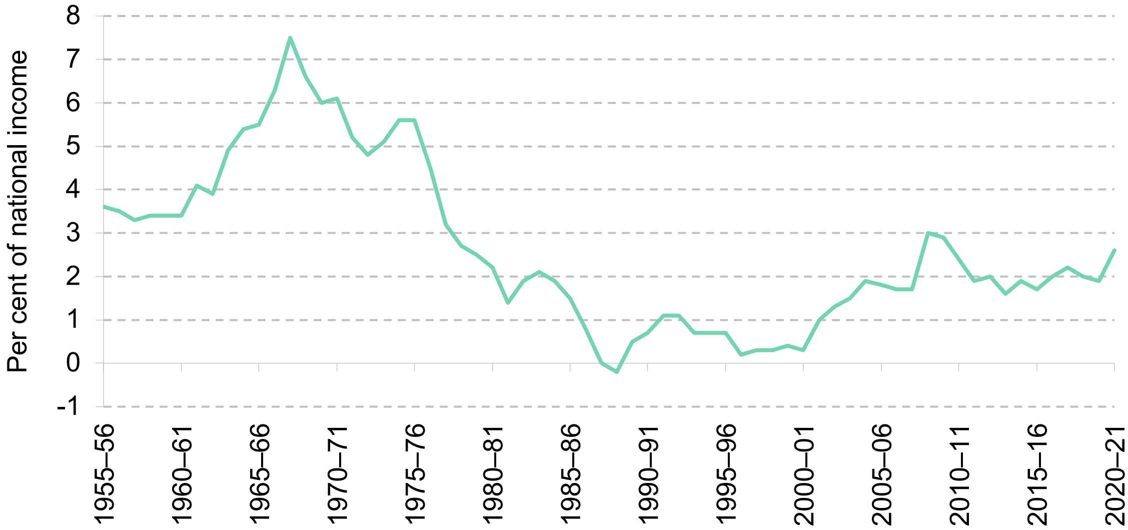
The manifesto also confidently asserted that 'debt will be lower at the end of the Parliament'.

The three fiscal rules relate closely to many of the features of well-designed rules set out in the previous section. The first – aiming for a current budget balance within three years – commits to collecting sufficient revenue from the current generation to pay for all non-investment spending. As shown in Figure 4.2, over the period since 1975 it has been more common for there to be a deficit than a surplus on the current budget, or in other words for the government to borrow more in a year than it spends on public sector net investment. The average current budget deficit over this period has been 2% of national income.

By relating to the third year of the forecast horizon, the rule has a forward-looking element. This allows forecast errors or periods of economic weakness to lead to current budget deficits as long as these are not too long-lived. However, as can be seen in Figure 4.2, the big increases in the current budget deficit that were seen in the early 1990s and the late 2000s took much longer than three years to unwind.

The second rule places a limit on public sector net investment. As shown in Figure 4.3, allowing investment spending to run at 3% of national income is consistent with a level of investment spending that had not been sustained in the UK since the late 1970s. This rule therefore gave the government scope, which it said it wanted, to increase investment spending quite substantially. When combined with the target for current budget balance, it also provided a ceiling on the amount of total borrowing the government could aim for by the third year of the forecast horizon, of 3% of national income. By UK historical standards, this would not be a particularly low level of borrowing: on average over the 74 years from 1946–47 to 2019–20, UK government borrowing averaged 2.5% of national income (see Figure 4.1).

**Figure 4.3. Public sector net investment**




Source: Office for Budget Responsibility, Public Finances Databank, www.obr.uk/data

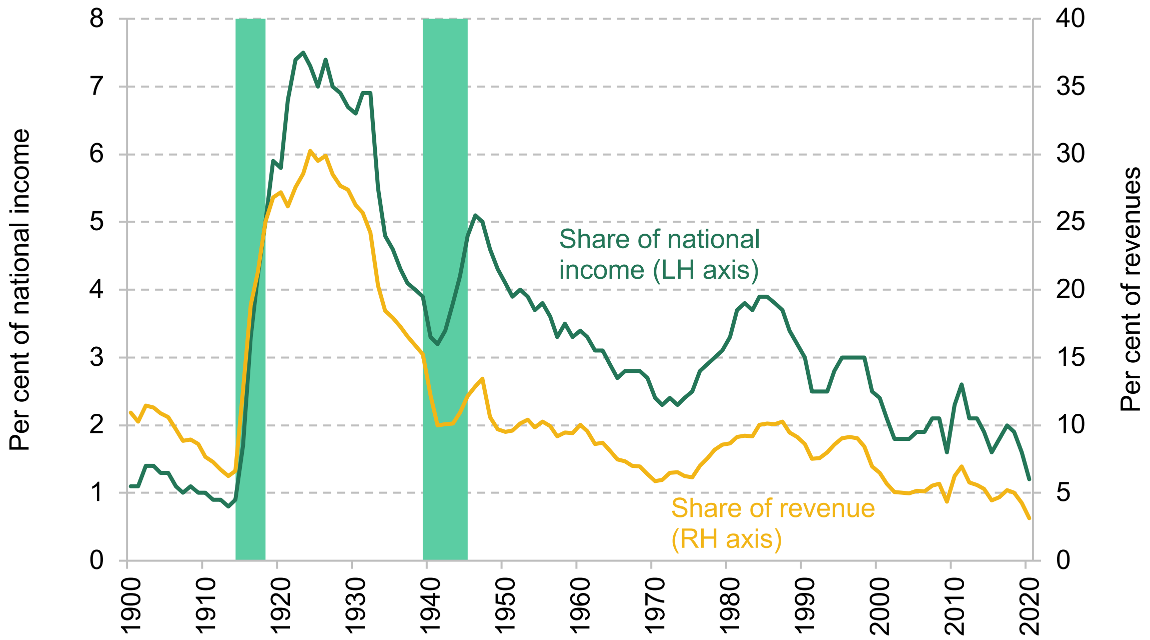
The third rule states that the rules would be re-evaluated were debt interest costs to rise above 6% of government revenues. A logic behind this was that the 3% ceiling on investment spending had been chosen in the light of the low cost of government borrowing. As stated above, there is a case for doing more investment spending if it can be done well and can be financed more cheaply. Equivalently, were debt interest costs to rise, this would justify investment plans being revisited and projects with lower benefits potentially being abandoned.

A ceiling on debt interest payments alongside a ceiling on total borrowing also (at least in part) provides a limit on the extent to which the national income of future generations is being pre-committed which, again as stated above, might be considered desirable. However, it would have been more appropriate to state the cap on debt interest spending as a share of national income rather than as a share of government revenues. While the latter is sometimes used in assessing the fiscal sustainability of developing countries, this is justified by concerns about their capacity to tax.

A measure of debt interest spending, both as a share of national income (left-hand axis) and as a share of government revenues (right-hand axis) is shown in Figure 4.4. Relative to both national income and government revenues, debt interest spending has tended to fall since the mid 1980s. The Conservative manifesto target, as interpreted by the Office for Budget Responsibility (OBR), uses a wider measure of debt interest, which includes interest payments by and to the wider public sector.[1] This measure is typically lower than the measure shown in Figure 4.4, and is less closely related to the cost of financing the national debt. When the Conservatives set their fiscal rules, debt interest spending was running at 4.6% of revenues (or 4.1% on their own measure) in 2018–19, again suggesting the fiscal target provided a bit of flexibility against the 6% ceiling. In fact, debt interest spending fell further as a share of revenues over the next two years as the effective interest rate on government borrowing fell sharply – although recent months have seen this start to reverse.

The three rules set out by the Conservatives therefore did share many of the features of well-designed fiscal rules. They also appeared to give the government some flexibility. One striking thing about them is, taken together, they did not place any limit on public sector net debt. With

**Figure 4.4. Spending on debt interest**




Note: Central government debt interest net of income from the Asset Purchase Facility shown; 'revenues' are total public sector revenues. This differs slightly from the Conservative target, which is for public sector net debt interest as a share of non-debt-interest revenues.

Source: Office for National Statistics, series NMFX, MU74, JW2O and YBHA; Bank of England, A Millennium of Macroeconomic Data, tables A9, A27 and A28.

[1] The target is for public sector net debt interest as a share of non-interest receipts, whereas we focus on central government debt interest net of interest income from the Asset Purchase Facility measured as a share of total receipts. Since fiscal targets are intended to constrain central government borrowing, it is arguable whether interest income of the wider public sector should be netted off the numerator.

debt at around 80% of national income prior to the pandemic, borrowing of 3% of national income would lead to debt rising as a share of national income unless nominal growth in the economy was more than 3¾%. For comparison, the OBR's March 2020 (i.e. pre-pandemic) Budget forecast was for growth to average 3½% a year over the six years from 2018–19 to 2024–25.

Despite this, the manifesto was firm that 'debt will be lower at the end of the Parliament'. This is a very poorly designed fiscal target. While there are good reasons to want, over the longer term, to reduce debt from the level it was at in 2019, the target gave very little flexibility in the event of an adverse shock – as illustrated by the pandemic, but a much smaller and more mundane event could equally have made it unachievable, depending on when it occurred. Were a government to be on course to miss the target marginally, it could provide a temptation to sell assets purely to reduce debt at the time of the next general election (see Section 4.4 for further discussion of balance sheet issues). It is also the case that by stating that debt at the time of the next general election should be lower than at the start of the parliament, it raised the possibility that how hard the target would be to meet would depend on the timing of the next general election.

In his first Budget speech in March 2020, as the implications of the COVID-19 pandemic for the UK were only starting to become clear, Mr Sunak stressed that he was meeting these fiscal rules and that debt was forecast to fall over the parliament. But he also announced that the fiscal framework was to be reviewed – despite the rules having only just been committed to in the December 2019 general election manifesto – with a wide consultation of experts, and that he would report back in the autumn.

The Autumn 2020 Budget was then cancelled. The following March 2021 Budget document stated:

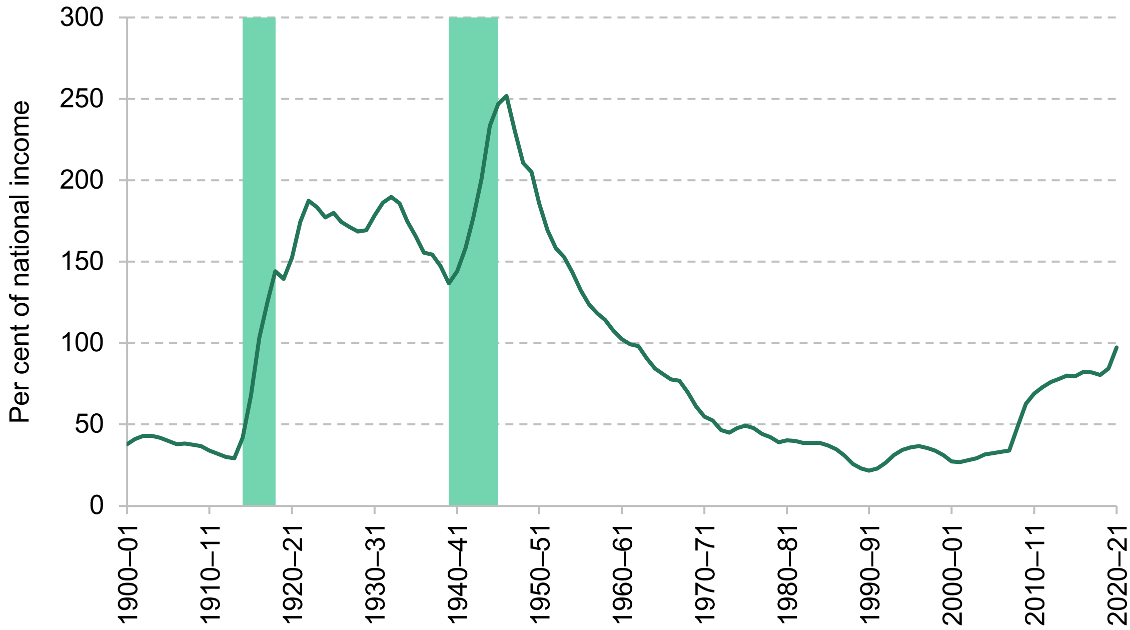
> **The current level of uncertainty means it is not yet the right time to set new medium-term fiscal rules and many countries around the world have suspended their fiscal rules. The fiscal framework remains under review, and the government intends to set out new fiscal rules later in the year, providing economic uncertainty recedes further.**
>
> HM Treasury, 2021a

Suspending the rules was the right decision by Mr Sunak. They were not designed with a crisis like the pandemic in mind. Had these rules not been suspended at this point then the requirement to have a current budget balance by at least the third year of the forecast horizon would have been breached (the Budget 2021 forecast for the current budget in 2023–24 is for a deficit of

0.6% of national income). However, the 3% of national income ceiling for public sector net investment would not have been breached, and debt interest spending remained – and was forecast to remain – well below 6% of government revenues.

Public sector net debt, however, is forecast to rise over the course of the parliament. As shown in Figure 4.5, having been 84.4% of national income in 2019–20 (the year in which the December 2019 general election fell), it climbed sharply to 97.2% of national income in 2020–21. While the future path of public sector net debt is highly uncertain, we can be extremely confident that it will not fall back below 84.4% of national income before the date of the next general election. So the manifesto commitment to reduce debt will be broken.

**Figure 4.5. Public sector net debt**




Note: Shaded areas are the two World Wars.

Source: Office for Budget Responsibility, Public Finances Databank, www.obr.uk/data.

## And before that there was …

Over the last 25 years, it has been common for UK Chancellors to set themselves fiscal rules. This is in line with the trend seen across advanced economies. The IMF's Fiscal Rules Database suggests that out of 33 advanced economies, the number with a fiscal rule in place rose from 4 to 31 between 1985 and 2015.[2] On taking office in 1997, the then Chancellor Gordon Brown committed to meet his 'golden rule' (to ensure revenues covered day-to-day spending over the

[2] Authors' calculations using International Monetary Fund (2017). A fiscal rule is defined there as having in place a numerical limit on a budgetary aggregate.

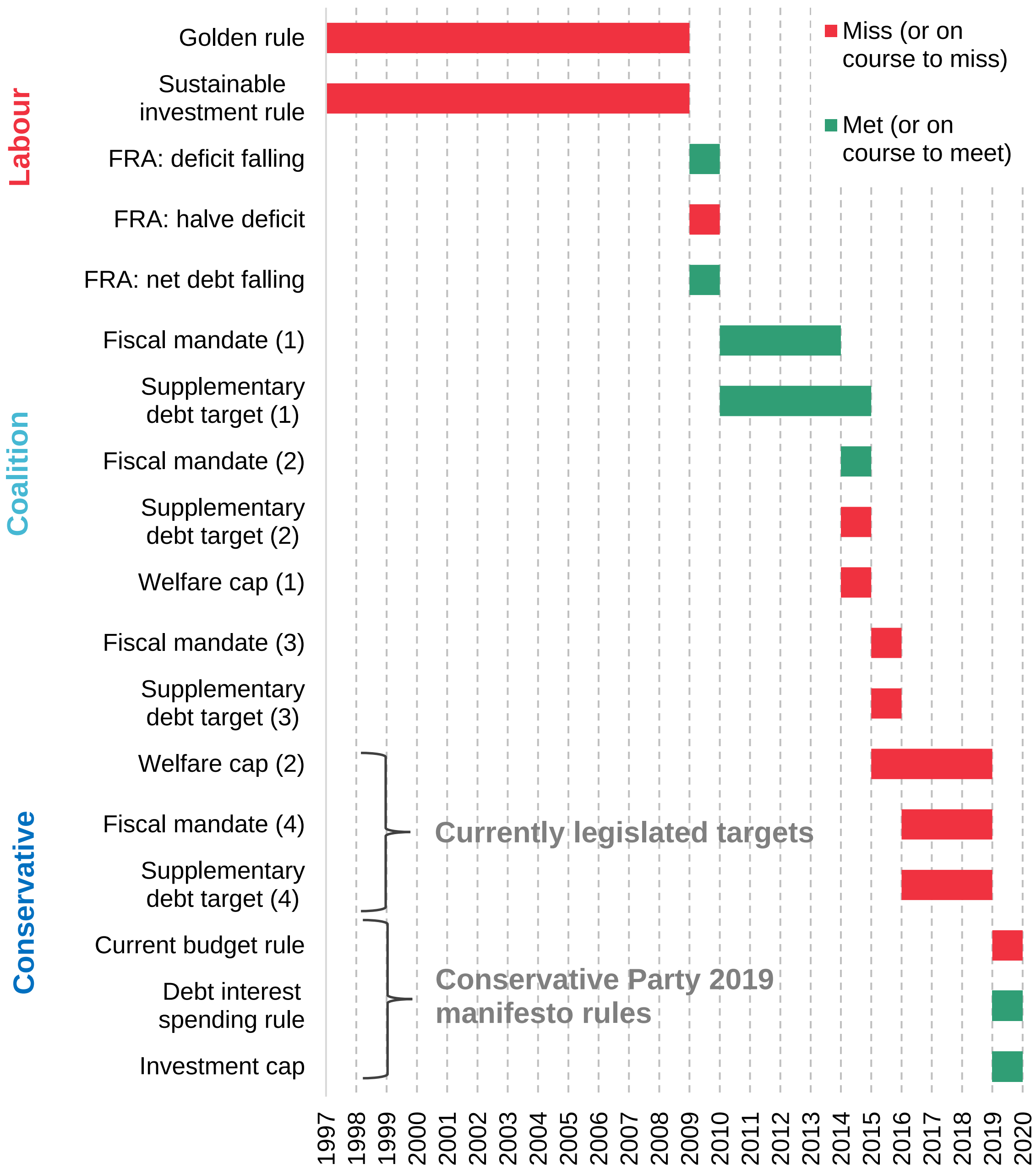
economic cycle) and his 'sustainable investment rule' (to keep public sector net debt below 40% of national income). Successive Chancellors – Alistair Darling, George Osborne, Philip Hammond and Sajid Javid – have all implemented new fiscal targets. So they have now been a feature of Labour, Coalition and Conservative Governments. But while Mr Brown's two fiscal targets lasted for 12 years before the financial crisis led to them sensibly being dropped, the period since 2009 has seen rapid churn in new fiscal targets. In particular, since Mr Osborne set out his second set of three fiscal targets in 2014, we have seen a total of 11 fiscal targets announced in just 7 years, as shown in Figure 4.6.

Many of these fiscal targets were not well designed and many have been missed; and in many cases the poor design means that missing them was the appropriate thing to do. The latest set of fiscal targets have even been announced, and then dropped, before they were formally legislated. This means that the Office for Budget Responsibility remains legally required to assess whether the Budget plans are compliant with Mr Hammond's chosen fiscal targets as set out in the January 2017 Charter for Budget Responsibility (HM Treasury, 2017). These relate to borrowing in 2020–21 (missed), debt in 2020–21 (missed) and a measure of welfare spending (missed).

Of course, extreme adverse shocks – such as the global financial crisis and the COVID-19 pandemic – are likely to lead to fiscal rules being suspended and, in many cases, abandoned. It would be very difficult to design a set of fiscal rules that were suitably constraining in the run-up to those events but flexible enough to allow the increase in borrowing that was appropriate once they arrived. And simply reactivating the previous set of fiscal rules once a crisis has passed may often not be appropriate either. Most obviously, the legacy of a crisis will affect the appropriate path of debt going forwards. Other changes – for example, to long-run interest rates – might also lead to fiscal rules needing to be reconsidered.

Changing fiscal rules is not, however, costless, as many of the benefits of fiscal rules are unlikely to materialise if they are not consistent over time. The high frequency with which the UK has gone through successive sets of fiscal rules since the financial crisis – and in particular since 2014 – makes it far more difficult for them to be understood or for their presence to be taken seriously as an indicator of the government's commitment to the careful stewardship of the public finances. It seems unlikely that many voters – or even, for that matter, gilt traders and foreign investors who lend to the UK government – have been keeping up with the changing details of fiscal targets. Even if a well-designed set of fiscal rules were now implemented, one would have to question whether it was likely they would actually prevent borrowing from being inappropriately high, or whether it is more likely that the Chancellor would simply choose to fudge or abandon them.

**Figure 4.6. A history of UK fiscal rules in one graph**




Note: FRA stands for the Fiscal Responsibility Act 2010, https://bills.parliament.uk/bills/565.

Source: Authors' calculations.

One potential reason so many rules have been abandoned in recent years is that they were too quickly announced and, as a result, badly designed, and therefore dropping them swiftly then became the best course of action. For example, Mr Osborne's legal commitment to run an overall budget surplus in 2019–20 (and beyond) was inflexible and abandoned immediately after the 2016 EU referendum result. The eventual deficit in that year was £57 billion. But his successor, Mr Hammond, failed to learn sufficiently from this experience: while his commitment to keep borrowing below 2% of national income in 2020–21 did allow an adjustment for the economic cycle, it was still extremely inflexible and was swiftly scrapped by his successor, Mr Javid, even before the pandemic hit. The latest OBR estimate is that (cyclically adjusted) borrowing in that year exceeded Mr Hammond's 2% of national income ceiling in 2020–21 by almost £250 billion. One clear lesson from this is that setting rules that refer to a fixed near-term year risks being very inflexible. Another is that we should not rush to implement a new set of fiscal targets.

Despite these clear lessons, in his 2020 Party Conference Speech Mr Sunak said 'this Conservative government will always balance the books'. This risked yet another swiftly implemented and poorly designed fiscal target. And if by 'always balance the books' the Chancellor was referring to an overall budget surplus being run every year by the current Conservative Government, then a more likely accurate statement would be that the current Conservative Government will 'never balance the books'.

## A new hope?

Much more sensibly, in his March 2021 Budget Speech Mr Sunak stated:

> **This Budget is not the time to set detailed fiscal rules, with precise targets and dates to achieve them by – I don't believe that would be sensible. But I do want to be honest about what I mean by sustainable public finances, and how I plan to achieve them. Our fiscal decisions are guided by three principles.**
>
> **First, while it is right to help people and businesses through an acute crisis like this one, in normal times the state should not be borrowing to pay for everyday public spending. Second, over the medium term, we cannot allow our debt to keep rising, and, given how high our debt now is, we need to pay close attention to its affordability. And third, it is sensible to take advantage of lower interest rates to invest in capital projects that can drive our future growth.**
>
> HM Treasury, 2021b

Waiting before setting a new set of fiscal rules is a good call by the Chancellor. The previous set of rules (aside from the supposed commitment to have debt lower as a share of national income at the end of the parliament than at the start) had much to commend them. It could be that returning to those targets would make sense. If a further delay until beyond the coming Budget resulted in a better-designed set of rules ultimately emerging, then this too would be welcome. As well as allowing more time to refine the rules, a delay would also mean that more of the heightened uncertainty in the outlook for the public finances arising from the pandemic should have dissipated. This means that further delay could well make it easier to set rules that strike a good balance between being suitably constraining while allowing sufficient flexibility to borrow more when that is appropriate. There is no rush.

The quote from the Chancellor above also reveals quite a lot about his fiscal principles which, presumably, will underpin any fiscal targets that he ultimately announces and commits to. These principles have much in common with the good and bad reasons for borrowing set out in previous Green Budgets and summarised in Section 4.2. They also have much in common with the fiscal targets that Mr Sunak inherited from Mr Javid, and actually have a reasonable amount of common ground with fiscal targets introduced by Mr Brown and Mr Osborne – and those committed to by the then shadow Chancellor, John McDonnell, in the Labour Party manifestos of 2017 and 2019.

So, there is much here that does not appear to be economically or politically controversial. In line with this, recent reports suggest that the government's new fiscal targets and the ones that Labour will commit to may well have much in common. On 16 September, the *Financial Times* reported that Mr Sunak's new rules will 'commit him to stop borrowing to fund day-to-day spending within three years …. [and] also require underlying debt to start falling by 2024–25'.[3] The first of these would be identical to the rule set out in the Conservatives' 2019 General Election manifesto.

Ten days later, on 26 September, the same paper reported that Rachel Reeves, the Shadow Chancellor, will 'pledge to balance the current budget in the medium term, ensuring that tax revenues at least match day-to-day public expenditure, and that the burden of public debt is on a downward trajectory of national income'.[4] The piece on Labour's rules reported that alongside a set of rules, there would also be a number of principles, including an intention to 'look at public sector assets as well as liabilities' and a 'mechanism for suspending the rules if the economy was hit by an exceptional shock' – we turn to these issues in Section 4.4. There are close similarities between Ms Reeves's reported rules (which are themselves similar to those proposed by the Conservatives) and those in Labour's 2019 General Election manifesto. This pledged 'to eliminate the current budget deficit by the end of the rolling five-year forecast period' and 'to improve the strength of the Government's balance sheet (Public Sector Net Worth)' and also

[3] https://www.ft.com/content/eb23375d-7219-4b22-a8a7-3060cd848163.
[4] https://www.ft.com/content/5dcfa73d-5a39-4f95-b8b3-b706bf9239ce.

proposed a ‘knock-out’ when monetary policy was unable to support demand sufficiently (Labour Party, 2019).

This might make us hopeful that a new set of fiscal targets could emerge that have some attractive features, have broad political support, and are able to last a reasonable amount of time – at least to make it to the two-year mark that most of those rules announced since 2014 have failed to do. We now turn to examine what a well-designed set of targets could look like.

# 4.4 What should new fiscal targets be?

The principles set out in Section 4.2 suggest that to be well designed, fiscal rules need to:

- be forward-looking;
- look through temporary factors that can depress or flatter headline measures of the public finances;
- help ensure fairness for different generations;
- be credible; and
- be communicable and, ideally, stable.

This section sets out what a well-designed target for borrowing might look like. It then turns to debt, where the task of balancing appropriate flexibility with a target that is constraining is more challenging. It then considers whether the Chancellor should set out in advance circumstances under which the rules would be suspended and whether, given all these challenges, the Chancellor should be setting formal fiscal targets at all.

## A fiscal rule for borrowing

As argued in Section 4.2, it might be considered fair that the costs of financing spending should be shared across the generations that benefit from it, and that this might also help to improve the efficiency of spending decisions. A reasonable proxy for this might be considered to be to aim for a current budget surplus. This would ensure that revenues were expected to be at least as great as day-to-day spending and it could allow borrowing to finance investment spending. Mr Sunak’s first fiscal principle, stated above – that ‘in normal times the state should not be borrowing to pay for everyday public spending’ – would suggest that he agrees.

Precisely this type of target would have much to commend it, and as such it has been advocated in past editions of the IFS Green Budget.[5] By setting policy to ensure a forecast current budget

[5] This was first proposed by IFS researchers in section 2.6 of Chote and Emmerson (2005), with the argument refined and repeated in subsequent Green Budgets.

surplus a few years into the future, this allows time for the public finances to recover from any temporary adverse shocks, such as those caused by a cyclical downturn. (For this reason it makes more sense to target the headline current budget, rather than one that attempts to adjust for the estimated impact of the ups and downs of the economic cycle, which is extremely difficult to do with any accuracy in real time.) And it would avoid the situation where a one-off forecast error could lead to the rule bring breached.

## What spending should count as 'everyday'?

Targeting the current budget would not be a perfect proxy for ensuring each generation pays for itself. There is no guarantee that the timing of the stream of interest payments resulting from a decision to borrow to invest will match the timing of the stream of benefits from that investment having occurred. More fundamentally, some day-to-day spending – most obviously, spending on education and training – will be expected to deliver future benefits. Similarly, it is arguable whether the cost of day-to-day spending that mitigates past carbon emissions going back multiple generations should be borne entirely by the current generation. Working in the other direction, payment of pay-as-you-go public sector pensions, while benefiting recipients now, would better be considered as a payment for services delivered to previous taxpayers rather than being day-to-day spending benefiting the current generation. And while investment spending should deliver benefits to future taxpayers, some poorly chosen and/or badly managed investment projects could fail to do that.

In principle, though, one could imagine attempting to define comprehensively which spending was benefiting the current generation. The risk with such approach is that it would then doubtless divert attention of spending departments towards arguing that their activities should not be classified as being for the current generation – most likely on the basis that they deliver future benefits – in the hope that this would make it easier to secure a more generous budget settlement. A Chancellor might also be tempted to indulge in such reclassifications in order to make a fiscal target defined in this way easier to meet. While far from perfect, using the distinction of 'current spending' and 'public sector net investment' spending as defined by the Office for National Statistics (ONS) has the advantage of being based on an independent body's assessment of how spending should be classified on the basis of international accounting rules.

## What is the right time horizon?

A key decision would need to be made over how many years into the future to aim to deliver a current budget balance. The right answer to this will depend in part on how far from current budget balance we are at any point in time – in situations where there was a sizeable structural current budget deficit, it would seem reasonable to take longer to get back to balance than when there was only a modest deficit to begin with. This has perhaps been seen in practice. Mr Osborne's version of this rule – which came into force in 2010 when there was a sizeable, and structural, current budget deficit – targeted the current budget five years out. In contrast, Mr

Javid's rule, which was in the Conservative Party's 2019 general election manifesto, was set when there was already a surplus on the current budget and instead targeted the current budget three years out. Indeed, official forecasts from December 2014 until March 2020 (inclusive) were for a current budget surplus by the third year of the forecast horizon. The COVID-19 pandemic led to the two most recent official forecasts (November 2020 and March 2021) forecasting a current budget deficit three years hence (2023–24). However, the improved outlook for the economy (see Chapter 2), and the rolling nature of the target, are very likely to lead to a current budget surplus being forecast for three years hence (now 2024–25) in the October 2021 Budget (see Chapter 3).

The right time frame will also depend on the likely frequency and scale of adverse shocks that might hit the economy and the extent to which these lead to – or necessitate – an increase in government borrowing. If sizeable adverse shocks are common then this would point to having a longer time horizon than if adverse shocks typically only had a modest and short-lived impact on the public finances.

Taken together, in most periods, it could be deemed appropriate to target the current budget three years hence. During particularly adverse situations, it will be appropriate to extend the period; the Chancellor should make clear in advance that there is nothing economically sacrosanct about three years and that the horizon would be extended in the event of that being deemed the right response to the occurrence of another severe and somewhat persistent adverse economic shock.

## Changing defaults to strengthen the automatic stabilisers?

The extent to which periods of temporary economic weakness automatically lead to higher borrowing will depend in part on the automatic stabilisers, i.e. the extent to which tax revenues are reduced – for example, from taxes on incomes, spending and profits – and public spending is increased – for example, on benefits paid to low-income working-age families.

These stabilisers have not been optimised so as to best manage the needs of the economy over the ups and downs of the economic cycle. Rather, they result from decisions made by successive governments over the progressivity of the tax and benefit system and, specifically, a trade-off between a desire to redistribute to those on lower incomes, a desire to preserve financial incentives to increase income and a desire to keep public spending down. But this may not be a problem: if deemed appropriate, discretionary fiscal policy giveaways could be implemented to provide greater support to the economy.

Within the UK's current macroeconomic framework, such discretionary fiscal stimulus packages will be more likely in downturns where it is deemed that a response solely through looser monetary policy is poorly suited to, or unable to meet, the task at hand. Indeed, discretionary temporary tax cuts and spending increases were made by the then Labour Government in the financial crisis and to a much greater extent by the current Conservative Government in the COVID-19 crisis (Emmerson, 2021). Some have called for these automatic stabilisers to be strengthened so that borrowing is automatically more counter-cyclical: for example, by economists at the OECD (Caldera et al., 2021) and, for the United States, by Orszag, Rubin and Stiglitz (2021) and, for the United Kingdom, by the Resolution Foundation (Smith et al., 2019).

One challenge with this approach is that no two recessions will be the same and therefore the size of the policy response should differ. But we might think that the costs of too big a stimulus are smaller than the costs of too small a stimulus. While the former could lead to an overheating economy and high inflation, this could be calmed with tighter monetary policy. Having too small a stimulus could lead to the economy underperforming for longer than necessary and risk greater harmful economic scarring, particularly when monetary policy cannot effectively be loosened.

The type of economic stabilisation policies that should be adopted in response will also vary by the type of downturn. In principle, a given set of automatic stabilisers could be too weak for some downturns and too strong for others. In terms of the policy mix, a cut to the main rate of VAT to boost consumer spending might be a good policy in a financial crisis (as was implemented for 13 months from December 2008) but a bad one during a pandemic lockdown where the cause of the recession is the need to reduce virus transmission and where job furlough schemes would instead make more sense (as were implemented during COVID-19).

The trade-off between redistribution and incentives will vary over the economic cycle, with reduced concerns over the impact of diminished work incentives during periods of weak labour demand. This is one argument in support of the temporary £20 per week boost to universal credit that was in place between April 2020 and September 2021. We could imagine setting a system where universal credit was *automatically* set at a higher level during periods when vacancies are scarce and set at a less generous level in other periods. This would be primarily for reasons of efficient redistribution, but may also promote macroeconomic stabilisation.

In the US context where the system of government and resulting political structure makes legislating swift changes to fiscal policy difficult, there may be a particularly strong case for increasing the extent to which economic downturns automatically boost spending and/or reduce government revenues. While swiftly implementing measures that were precisely targeted at the specific nature of the downturn would in principle be a better outcome, in practice it may be preferable to have a stronger automatic response than the possibility of only a limited discretionary package that might not be implemented in a timely way.

In the UK context, the argument seems far less clear-cut. The UK system of government and resulting political structure means that decisions can be made and legislated very quickly – as with the temporary boost to universal credit described above. So a better approach to macroeconomic management in the UK context might well be to manage the public finances so that there should be scope to loosen policy substantially if needed – that is, to create fiscal space to react. As the OBR puts it, ‘In the absence of perfect foresight, fiscal space may be the single most valuable risk management tool’ (Office for Budget Responsibility, 2021). Alongside this, operational conditions need to be in place so that, once legislated, well-targeted policies can be swiftly implemented. These could include having:

- Information databases that are kept up to date so policies can be well targeted. This was a particular challenge when designing a furlough scheme for the self-employed (Cribb, Delestre and Johnson, 2021).
- Flexible computer systems so that cuts to taxes or increases in the generosity of working-age benefits can be done quickly. The March 2020 decision to boost working-age benefits led very impressively to universal credit increasing just two weeks later. But equivalent increases to legacy benefits were not made, with both the Permanent Secretary and the Secretary of State at the Department for Work and Pensions suggesting that a key reason was that it was simply not possible to increase those benefits that quickly (Mackley, Hobson and McInnes, 2021).
- Investment projects ready-to-roll for when a downturn hits, to ensure that any injection of stimulus via this channel is timely.

One place where changing policy defaults in the UK could lead to better fiscal policy outcomes could be around how the public finances adjust to long-run pressures such as an ageing population. One such measure that has already been put in place is that the state pension age is linked to rises in life expectancy. Rises in the state pension age help offset the pressures of an ageing population through reduced spending on state and public service pensions and increased tax receipts. There may be other parameters in the tax and benefit system that could be explicitly related, by default, to pressures on the public finances, easing the management of these pressures.

## Vulnerable to a St Augustinian approach?

A final concern over a forward-looking target for the current budget (or indeed for any measure of borrowing) is that it could be met by stating that policies would be pursued, despite a government not having the willingness or (perhaps) ability to implement them in practice. This might be considered St Augustine’s approach to the public finances – ‘Lord, make me pure but not yet’. For example, just as an individual might promise to improve their health by quitting smoking, improving their diet and frequently going to the gym from next month and never actually do it, a Chancellor could claim that they would reduce borrowing in future years through spending plans or tax changes that, in reality, they would not implement when the moment came. Provisional spending totals are often revised up before a Spending Review is actually conducted – as we saw in Mr Javid's Spending Round 2019 (HM Treasury, 2019) and frequently during Mr Brown's time as Chancellor (Crawford, Johnson and Zaranko, 2018). And on the tax side, every year since 2011 has seen a freeze or cut in the rates of fuel duties despite formal policy remaining that, in future years, rates will increase in line with the Retail Prices Index (RPI). As it is the formal policy position, the OBR continues to incorporate the assumption of RPI indexation into its supposedly 'central' revenue forecasts, despite also acknowledging it considers there to be a less than 10% chance that this will actually happen (see figure 1 of Office for Budget Responsibility (2021)).

Preventing such gaming is difficult. But the fact that the fiscal forecasts are produced by the OBR means Chancellors have to be explicit about the policy settings that underpin the official forecasts, and the OBR is admirably transparent about these. This allows bodies outside of government – such as IFS – to point out clearly when they consider policy settings to be unrealistic, to quantify the impact of a perhaps more realistic scenario and also to highlight when previously announced spending cuts or tax rises are repeatedly deferred. For example, if – as seems more plausible than continued RPI indexation – rates of fuel duties are frozen for a further four years, this would reduce revenues by around £3 billion a year relative to the latest forecast and bring the total cost of cuts and freezes to fuel duties since 2010, relative to an alternative of RPI indexation, up to £14 billion a year.

## A fiscal rule for debt

By not restricting borrowing for investment purposes, a target for the current budget would not, on its own, place any constraint on the debt that can be accumulated. Prior to the financial crisis, Mr Brown's sustainable investment rule made the commitment that public sector net debt would be below 40% of national income which was, very roughly speaking, the level of debt bequeathed to him by the previous Conservative Government.[6] As was shown in Figure 4.5, both the global financial crisis and the COVID-19 pandemic have pushed debt up considerably and it is now running close to 100% of national income. This is a level not seen in the UK since the early 1960s. But while high by recent historical standards, it is not high relative to a longer swathe of history: over the 263 years from 1699 to 1961 (inclusive), debt was higher than 100% of national income in more years than it was below it (142 years above it, 121 years below it).

### Debt high, but debt interest not high?

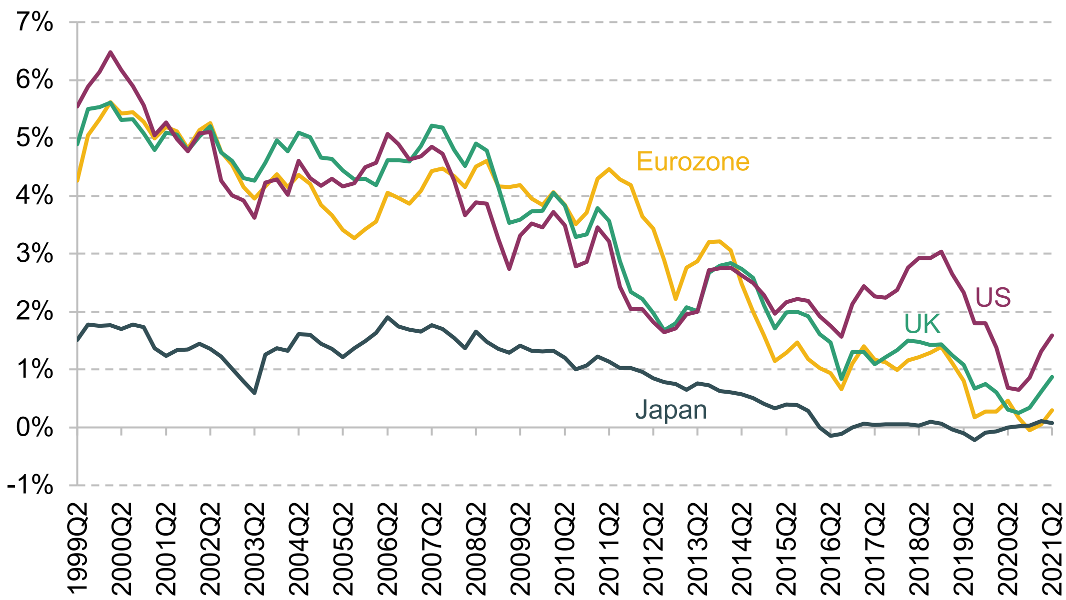
There is no consensus over the right level of debt, or the levels at which it would become particularly problematic. These will depend on many factors, some of which will change over

6 Public sector net debt in 1996–97 is now estimated to have been 36.7% of national income. Earlier estimates were higher, as methodological changes have increased measured GDP. For example, in the March 1999 Budget, public sector net debt in 1996–97 was estimated to have been 44.3% and falling over time.

time. The continued fall in interest rates – including long-term interest rates – over the last decade has led to a general view that advanced economies can live with more debt than was previously thought (see, for example, Blanchard (2019)). Figure 4.7 shows how the yields on 10-year government bonds in the UK compare with those in the Eurozone, Japan and the US over the period from 1999 to 2021. For all these currency zones, yields on government debt have fallen over most of this period, although there have been some increases – most notably in the UK and US – since the end of 2020. Despite this, rates in the UK, the Eurozone and the US are now closer to the extremely low rates that have become typical for Japan. At the same time, over the period from 1999 to 2019, debt rose by 103% of national income in Japan, 59% in the US, and between 7% and 49% in Germany, Italy and France, major Eurozone economies.[7] This combination of falling interest rates and rising debt suggests that lenders were not very concerned that these higher debt levels were unsustainable.

Where countries are borrowing at low long-term interest rates, they can indeed use this as a good justification for having more debt. There are two obvious reasons for this. First, it could mean that more policies offer a return greater than the cost of financing them. The obvious candidates

**Figure 4.7. Yields on 10-year government bonds for selected economic areas**




Note: Rates on 10-year government bonds. 'Eurozone' refers to the evolving composition of the monetary union, i.e. including Greece from 2001 and including Slovenia from 2007. National rates are weighted by the nominal amounts outstanding in the maturity band.

Source: OECD monthly monetary and financial statistics (Main Economic Indicators).

[7] General government debt, a measure which is available on an internationally comparable basis. It is different from the broader public sector net debt measure, which we focus on in our UK analysis.

will include potential investment projects. Figure 4.3 showed that the current government's previous ceiling on investment spending of 3% of national income gave scope for a much higher level of investment than has been sustained over the last 40 years. But doing this investment spending well requires policymakers to:

- have access to well-done cost–benefit analyses that consider all relevant factors – including the extent to which private sector spending may be crowded out or leveraged in by the project;
- be able to choose the right projects to pursue; and
- be able to ensure that they are delivered well.

A second reason for choosing to have higher debt when borrowing at low interest rates is that more debt could be accumulated before the same share of future national income was pre-committed to debt interest spending, alleviating concerns that we were inappropriately pre-committing the spending decisions of future generations. For example, the March 2008 Budget, produced prior to the global financial crisis, forecast that public sector net debt would remain below 40% of national income and that public sector net debt interest payments would be running at 1.7% of national income in 2012–13. Thirteen years later, the March 2021 Budget forecasts public sector net debt running at around 100% of national income but that by 2025–26 public sector net debt interest payments will be just 0.9% of national income. So, at least for now, lower interest rates have meant that, despite much higher debt, there is a much lower share of national income being devoted to spending on debt interest.

## Debt interest spending more exposed to increased interest rates

That is not to say that the increase in debt since March 2008 has been costless. Higher debt also increases the sensitivity of debt interest spending to the average interest rate that is paid on that debt. This will be less of an issue when those interest rates have been locked in for a long time. However, the additional borrowing done since the start of the pandemic is of a similar scale to the expansion of the Bank of England's programme of quantitative easing over the same period. This means that elevated public sector debt has effectively been financed through increased deposits of commercial banks at the Bank of England, on which interest is paid at the contemporaneous Bank Rate.[8] Overall quantitative easing now reduces the average overall duration of government borrowing from 15 years to 10 years (see Figure 3.10). So debt interest spending over the next few years, while lower in 2020–21 than had been forecast prior to the pandemic despite debt being much higher, is now more exposed to increases in interest rates (see Figure 3.9).

8 Chapter 5 of last year's Green Budget contains a more detailed explanation (Emmerson, Miles and Stockton, 2020).

Last year's Green Budget argued that there was a strong case for tilting gilt issuance more towards long-dated index-linked debt (Emmerson, Miles and Stockton, 2020). Since then, long-run interest rates on RPI-indexed UK government bonds have remained extraordinarily low. For example, on 22 September the Debt Management Office auctioned £350 million of gilts that run to 2056 at a yield of RPI *minus* 2.3%.[9] The case for a greater share of government financing to be done on long-term inflation-linked terms to lock in the real cost of debt servicing remains strong. Though there will be limits to the extent to which this will reduce the sensitivity of debt interest spending to interest rate changes.

With elevated debt – and in particular elevated debt financed on a short duration – it becomes much more important that interest rates remain low (or, more precisely, the relationship between interest rates and growth in the economy remains benign). The interest rate at which the UK government can borrow at will be determined by the international interest rate on safe assets – which has been falling for many years – and the risk premium that investors attach to the UK relative to other governments. The former is outside the control of anything that the UK does.[10] But the latter is not. Specifically, this highlights the importance of maintaining the confidence of international investors who are lending to the UK government but often have alternative governments they could lend to instead were the UK to start to look relatively less attractive. Ensuring confidence in the UK's institutions – the independent OBR producing the economic and fiscal forecasts, and the independent Monetary Policy Committee of the Bank of England setting monetary policy to meet the publicly stated target for inflation – is an important component of this, as is the rest of the fiscal and monetary framework. Carefully communicating the fiscal strategy and having well-designed fiscal targets that are clearly explained may help to support this. Having badly designed, poorly understood, non-credible fiscal targets could make maintaining this confidence more difficult.

## What to target?

Setting a fiscal target for debt is difficult as the lack of consensus over the right level of debt, and the fact that it is a stock rather than a flow variable, mean that it does not lend itself easily to a forward-looking target. There is a very strong case for allowing debt to rise during periods of economic weakness – and indeed it would often prove futile to attempt to prevent this. But, as set out in Section 4.2, there is a good case for the debt to national income ratio to be reduced at least over the very long run – it certainly cannot be allowed to increase for evermore. Reducing debt in advance of the next severe adverse shock would be advantageous, and there are known sizeable future pressures on spending on health and social care, including from the ageing

9 https://www.dmo.gov.uk/data/gilt-market/.

10 For a recent summary of academic studies into the factors behind the fall in global real interest rates see Chart 4.7 of Office for Budget Responsibility (2021).

population, for which smaller tax rises (or spending cuts) in place for longer might be preferable to having larger ones in place for less long.

One concern with debt targets is that they can inappropriately incentivise governments to sell assets solely to reduce debt. For example, in its recent Balance Sheet Review, the Treasury admits that the accounting treatment of student loans was a driver of its earlier attempt to sell the student loan book (HM Treasury, 2020). The broader concern is that any target for public sector net debt will inappropriately incentivise asset sales to reduce debt at particular points in time. Equivalently, it could discourage the public sector from issuing debt to purchase assets even when doing so would lead to the nation's assets being better managed. For example, regardless of the merits – or otherwise – of the programme of nationalisation proposed in the 2019 Labour Party manifesto, this would not have been consistent with a desire to reduce headline debt (Crossman, Emmerson and Kraftman, 2019). Both public sector assets and public sector debt would have been increased substantially as the substantial assets and liabilities of those organisations being nationalised became part of the public sector's balance sheet.

This has led to some – including Richard Hughes, Chair of the OBR, in his former role at the Resolution Foundation – arguing that rather than targeting public sector net debt, there should instead be a target for public sector net worth (Hughes et al., 2019). Public sector net worth is essentially an estimate of the value of all of the assets of government (both financial and physical) net of the value of all its liabilities (such as gilts in issuance). In principle, this would be attractive since while, for example, purchasing or selling a physical asset for what it is worth would have an impact on public sector net debt, it would leave public sector net worth unchanged. This would allow proposals such as nationalisation programmes to be considered under more appropriate tests – most obviously whether society would be better off if the assets in question were managed by the public or private sector – rather than by looking at the impact on just one side of the public sector balance sheet.

The idea of measuring public sector net worth is not new. Arguably, an early attempt was made by William the Conqueror in the Domesday Book of 1086. A more recent example came after the Labour Government took office in 1997:

> **On arrival in office in 1997 the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth. Urgent action was needed.**
>
> HM Treasury, 1999

This led to the Treasury publishing estimates of, and forecasts for, public sector net worth. This was never formally targeted – at the time, there were concerns about the reliability of the measure – but figures were contained in Budget documents for several years. These showed public sector net worth rising as debt was falling while additional investment spending increased the valuation of public sector assets. The financial crisis then led to forecast debt rising sharply and part of the then Labour Government's medium-term fiscal response was to cut back on planned investment spending. Combined, this led to forecast public sector net worth falling and turning negative, and the measure was quickly – and quietly – dropped.

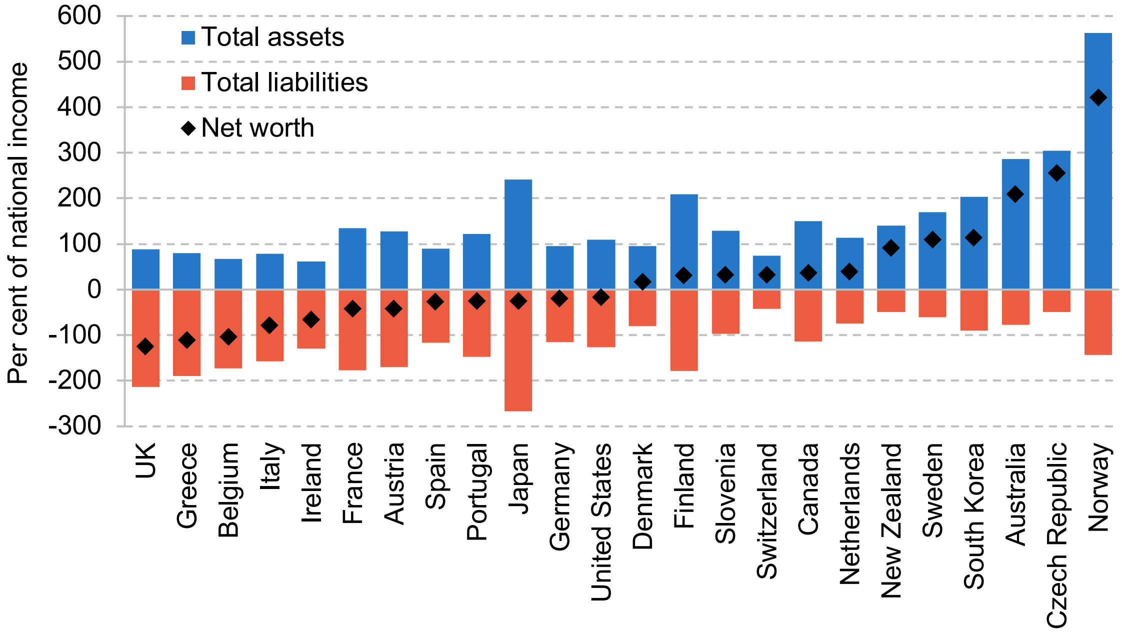
Interest in the measure has reignited recently. The ONS produced two separate estimates of public sector net worth, using different methodologies, and is currently working on a new measure that will be fully consistent with the other public finance statistics that it produces (Office for National Statistics, 2021). Alongside its forecasts for public sector net debt, the OBR now routinely produces forecasts for public sector net financial liabilities, which nets off not just short-term financial assets but also long-term financial assets (such as the value of the student loan book) from public sector net debt. The OBR has also said that it will explore methodologies for forecasting public sector net worth in future.

There are, however, big measurement challenges with valuing the public sector's assets – for example, what is the value of the UK road network? On the other side of the public sector's balance sheet, the valuation of long-run liabilities – such as the costs of meeting obligations made to pay public sector pensions and nuclear decommissioning costs – is both uncertain and hugely sensitive to the discount rate used. For example, nuclear decommissioning costs are projected to run until 2137 and the scale and timing of these costs are understandably uncertain. The government's Whole of Government Accounts include a provision for these costs. Between 2017–18 and 2018–19, it fell from £263.4 billion to £152.2 billion, with £96.0 billion of the £111.2 billion drop being attributed to a rise in the assumed discount rate.

Improvements to the measurement of the public sector balance sheet, an increased focus by the government, and the commitment from Ms Reeves to 'look at public sector assets as well as liabilities'[11] are welcome, and especially so if they lead to better management of public sector assets and liabilities and a more consistent approach across the public sector. This is particularly the case given that while the UK's debt is certainly not the highest among advanced economies, the International Monetary Fund estimates that its general government net worth is the lowest of 24 advanced economies. This is shown in Figure 4.8. The Office for Budget Responsibility (2021) puts this down to the UK having 'relatively high debt stock, significant public sector pension liabilities, and paucity of financial and non-financial assets'.

[11] https://www.ft.com/content/5dcfa73d-5a39-4f95-b8b3-b706bf9239ce.

Figure 4.8. General government net worth for selected advanced economies




Source: Chart 4.17 of Office for Budget Responsibility (2021) using data from the IMF.

Rather than striving for a consistent approach to managing public sector assets and liabilities, the Treasury Balance Sheet Review unfortunately seems to embed status quo bias by favouring gilt financing unless assets are currently held. Specifically, on page 34 it celebrates the funding of the local government pension scheme being 'in a strong position ... with a 98% funding level … Long term investment performance has been generally good with thirty year returns at 8.4%'. In contrast, on the very next page, it rejects funding the Nuclear Liabilities Fund (NLF): 'investing funds in the private sector in order to meet future liabilities is deemed to be an unnecessary risk and not a financially efficient use of funds'. There may be good arguments for having a different funding approach to the two sets of liabilities, but the fact that increasing the extent to which the liabilities of the NLF were backed by holdings of private sector assets would have 'worsened PSND [public sector net debt]' is not a good one.

The substantial measurement challenges around public sector net worth are important for the appropriateness of setting a fiscal target based on it. Changes to the methodology, or changes to assumptions about (for example) discount rates, could lead to big movements in public sector net worth. In some cases the right response might be to adjust fiscal policy, while in others the right response might be to leave policy unchanged. But would a symmetric fiscal response be followed? A clear risk is that a Chancellor could respond to a technical change that increased measured net worth with a set of tax cuts or spending rises whereas, had they been faced with the equivalent change in the opposite direction, they might have chosen not to adjust policy. In isolation, either response might (depending on the details) be justifiable – and even the right thing to do – but an asymmetric response would mean that, over time, methodical changes could lead to a weakening of the public finances.

One partial remedy might be to target public sector net financial liabilities, rather than public sector net debt. This would have the advantage of considering the value of long-term financial assets of government where the measurement issues are likely less severe. But it would not be going anywhere near as far as including the value of the public sector's non-financial assets.

Even if challenges related to the measurement of the value of assets owned by the public sector could eventually be overcome, it should be remembered that the most substantial public sector asset is its ability to levy taxes. And its biggest liabilities will be the implicit promise to provide public services, social security benefits and state pensions in future years. None of these will be included in the public sector balance sheet – but obviously the good management of both taxes and spending is crucial to the country's well-being. The New Zealand Treasury now incorporates estimates of 'fiscal net worth' – that is, the present value of expected future revenues less expected future spending – in its measure of 'comprehensive net worth'. The broadness of public sector net worth as a summary measure of the overall health of the public finances should therefore not be overstated.

Considering the substantial methodological challenges, it might well be better for any fiscal rule to remain related to public sector net debt (or potentially public sector net financial liabilities) – while being aware of its limitations in judging decisions around buying or selling assets. Specifically, a forward-looking desired path for public sector net debt could be stated. Under a given outlook for nominal growth in the economy, this would translate into a forward-looking desired average level of borrowing. When combined with a forward-looking target for the current budget – as suggested earlier – this would also translate into a forward-looking target for public sector net investment.

The trade-off between borrowing and the eventual debt level is illustrated in Table 4.1. This shows the projected ratio of debt to national income under different scenarios for average nominal growth in the economy and for the average deficit. For example, if public sector net borrowing runs at an average of 2% a year, and nominal growth averages the OBR's long-run projection of 3.9% a year, then in 2050 the UK's debt would fall to 69% of national income, i.e. below the share it was at before the outbreak of the pandemic.

Were borrowing instead to average 3% a year – the maximum consistent with the government's previous set of fiscal rules (current budget balance and spending 3% of national income on public sector net investment) – then public sector net debt would still fall as a share of national income from its current elevated level. So Mr Sunak might be able to run deficits of this size and still meet his reported desire to have debt falling as a share of national income. Labour has set out plans to spend an additional £28 billion a year over the next eight years on green investments (Reeves, 2021) – our calculations suggest that, at least over the next few years, it might be possible to do this and still just about meet its reported objective to have debt on a downward path. However, as Table 4.1 shows, continuing to borrow an average of 3% of national income each year would, at least under the OBR's central growth assumption, still have debt in 2050 above its pre-pandemic (2018–19) share of 80%.

Even under this scenario, while debt would remain elevated as a share of national income, were the average effective interest rate on government debt to remain low at its forecast level for 2025–26 the share of national income that would have to be devoted to debt interest spending in 2050 would be just 1.3%. This is lower than the 1.6% of national income spent prior to the pandemic in 2018–19.

The table also highlights how – for a given size of average deficit – higher growth would contribute to a faster fall in the ratio of debt to national income, while lower growth would lead to it being higher.

The challenge of running deficits of a given average size will be made harder by known pressures on – and adverse shocks that hit – the public finances. The known pressures include the rising cost of healthcare, adult social care and state pensions in an ageing society, which is estimated by the OBR to build over time to an additional 6.1% of national income between now and 2050–51. Other expected costs include those associated with the transition to net zero which, at its peak in 2026–27, the OBR puts at 2.2% of national income.[12]

**Table 4.1. Debt in 2050–51 as a share of national income under different assumptions for average deficit and for growth**

| Debt | | Average deficit beyond 2025–26 | | | |
|---|---|---|---|---|---|
| 2018–19<br>80.4% | 2025–26<br>97.9% | 0% | 1% | 2% | 3% |
| Nominal growth rate beyond 2025–26 | 2.9% | 47% | 65% | 83% | 101% |
| | 3.4% | 42% | 59% | 76% | 93% |
| | 3.9% (OBR) | 37% | 53% | 69% | 86% |
| | 4.4% | 33% | 48% | 64% | 79% |
| | 4.9% | 29% | 44% | 59% | 73% |

Note: Long-run nominal growth rate from 2025–26 to 2050–51. 3.9% is the OBR's long-run growth assumption in its Fiscal Sustainability Report (Office for Budget Responsibility, 2020). Debt in 2025–26 is assumed to be at 97.9% of national income from our 'central' scenario in Chapter 3.

[12] This is based on the OBR's 'central' government share scenario. The government may decide it is appropriate for the private sector to instead shoulder a greater or a smaller share of the cost of the transition.

Given the lack of consensus over what the right level of public sector net debt should be, it is not possible to say what path of debt, or equivalently (for a given growth path) what level of borrowing, we should be aiming for. The right path will depend on the importance placed on a number of factors, including:

- building 'fiscal space' in advance of the next adverse shock;
- the risk that higher borrowing costs push up debt interest spending without a corresponding boost to the outlook for revenues (though, as described above, this is a risk that could also be reduced by issuing a greater proportion of long-dated index-linked debt);
- whether investment spending – or any other spending that is intended to deliver benefits to future generations – will actually be able to deliver the hoped-for returns.

A similar trade-off would result were we instead to target public sector net financial liabilities, as might be preferable.

## When should rules be broken?

A clear lesson from the UK's recent history of fiscal rules is that there will be periods of time when they will need to be broken or suspended or both. This will be particularly true of badly designed rules or – to be kinder – rules that have attempted to be more constraining and, as a result, less flexible (such as those that prescribe a particular level of borrowing or debt in a single specific year). This indicates that any rules should be more flexible than many of those seen in recent years. It has also been argued that, when setting rules, the Chancellor should go further and explicitly set out in advance the situations in which they would automatically suspend or abandon their rule.

This was a feature of Mr Osborne's commitment to eliminate the overall budget deficit from 2019–20: the rule had a clause stating it would be suspended were growth over four quarters to be less than 1% (either in out-turn or forecast; HM Treasury, 2015). It has also been reported that Labour's fiscal targets would include a 'mechanism for suspending the rules if the economy was hit by an exceptional shock'.[13] This raises the question of how such a mechanism might be designed. In their proposals for UK fiscal targets, Portes and Wren-Lewis (2015) propose that fiscal rules should contain a 'knock-out' where the rules are immediately suspended when interest rates hit their zero lower bound (ZLB) and that debt should instead be increased at that point so that interest rates can rise. They then add that:

[13] https://www.ft.com/content/5dcfa73d-5a39-4f95-b8b3-b706bf9239ce.

> **This increase in debt will almost certainly mean that previous fiscal targets will become outdated, and so it makes sense for the government to say at the same time how they think the fiscal rule will change once the ZLB constraint no longer operates. Indeed it would be positively desirable for it to do so. Raising the level of debt to help counteract a recession must imply that taxes will be higher and/or government spending will be lower once the recession is over.**
>
> Portes and Wren-Lewis, 2015

So this would explicitly be allowing more borrowing and debt during downturns where interest rates reach their zero lower bound than might otherwise be allowed by a set of fiscal rules. And it also makes clear that if the economy is supported through lower taxes and higher spending then it implies that taxes will be higher or spending lower at some subsequent point.

This type of knock-out makes sense. Since there will not always be a consensus as to whether or not we are at the ZLB, one could imagine the Monetary Policy Committee of the Bank of England being asked to rule when the scope for interest rate cuts, or looser monetary policy, was exhausted. This mechanism was proposed by Labour in its 2019 General Election manifesto, alongside an additional knock-out whenever 'unconventional monetary policy operations' are expanded by the Bank of England. But there might well be other circumstances in which the right thing to do would be to jettison the fiscal targets that were in place, and other situations where fiscal targets should be refined rather than abandoned altogether. For the example, in the event of a severe adverse shock, from which recovery is expected to take several years, the right response might be to extend the time frame for getting forecast borrowing back on track from, say, three years to five years hence. This would be the case regardless of whether or not the scope for looser monetary policy was exhausted at this time.

This suggests that rather than having fiscal rules that are to be firm and fixed unless specific circumstances are met, it might be better for the Chancellor to consider fiscal targets to be rough rules of thumb that they should be keeping to in most periods. The Chancellor should be clear from the outset that this is the case, and that effective and appropriate scrutiny through the parliamentary process, by the OBR and by credible outside institutions cannot be easily substituted by comprehensive 'knock-out' clauses. Carefully communicated, this could allow flexibility to achieve better policy outcomes and avoid the pitfall of fiscal rules being inappropriately followed or great efforts of policymakers being inappropriately put to ensuring the letter of a specific fiscal rule is being met regardless of the underlying principle behind the rule.

## 4.5 Conclusion

A well-designed set of fiscal targets could help to improve policy outcomes. But this is not easy to achieve. Targets need to be forward-looking, they need to account for any temporary factors that may be depressing or flattering the public finances, and they should help ensure fairness across generations. This might point to some rather complex measures that consider many factors. But they also need to be communicable, credible and, ideally, stable. The Chancellor was right to suspend the current set of fiscal targets during the pandemic, and he is also right to take time to consider what a good set of post-pandemic targets will look like. Having announced 11 fiscal targets in the last seven years, there is no point in rushing to implement another set of poorly designed targets.

There appears to be a reasonable amount of consensus across several Chancellors and Shadow Chancellors in their chosen fiscal targets. Specifically, several – Mr Brown, Mr Osborne prior to 2014, Mr McDonnell, Mr Javid, Mr Sunak and Ms Reeves – have set rules with the desire to raise sufficient revenues to pay for spending that is of benefit now, while being content to borrow to finance spending that delivers future benefits. And, with the exception of Mr Brown, all have followed the advice of previous IFS Green Budgets and operationalised this with a target for the forecast current budget. Such a target is far from perfect, but it does have many desirable features and, unlike many of the targets set in the last decade, was flexible enough to cope with the shocks hitting the public finances until the onset of COVID-19.

Far harder is setting an appropriate target for debt. While a near-term target for debt would risk being insufficiently flexible, there are good reasons to set fiscal policy so that debt will decline as a share of national income over the longer term. Achieving this could help keep future debt interest payments down and could create ‘fiscal space’ so that, if appropriate, debt can be increased again when the next severe adverse shock strikes. But reducing debt will not be easy in the face of growing pressures from the rising costs of healthcare, social care, state pensions and the transition to net zero. And it will be important for policymakers not to respond to a debt target by selling public sector assets, or not acquiring them even when they would be better managed in the public sector.

A clear lesson from the last 25 years is that, rather than having firm and fixed fiscal rules, it would be better for these to be considered rough rules of thumb that Chancellors should strive to keep to in most periods. The Chancellor should be clear from the outset that this is the case, and that effective and appropriate scrutiny through the parliamentary process, by the OBR and by credible outside institutions cannot be easily substituted by ‘knock-out’ clauses that would risk being insufficiently comprehensive. What we should not do is pretend that any fiscal target, however carefully designed, will be sacrosanct for evermore.

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