

## 3. The fiscal rules and policy framework

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### Summary

- Designing fiscal rules requires a trade-off between sophistication on the one hand and simplicity and transparency on the other. The golden rule and sustainable investment rule – like any fiscal rules that could be applied in practice – are not optimal, but they still have value as rules of thumb.
- Many economists outside government no longer see compliance with the fiscal rules as a good guide to the health of the public finances. This presumably reflects concern that the Chancellor ‘moved the goalposts’ to make the golden rule easier to meet when downward revisions to his public finance forecasts eroded the margin by which he expected to meet the rules after 2001.
- The Treasury could be argued to have pursued a rolling five-year target to achieve a current budget surplus of 0.7% of national income. This target was missed significantly in 2005–06 and is also set to be missed in coming years.
- The likely arrival of a new Chancellor later this year may be a golden opportunity to tweak the fiscal rules for the better. Sensible changes would include making the golden rule symmetric, forward-looking and less reliant on the ability to identify economic cycles. The Treasury’s fiscal forecasting could also be made more transparent or perhaps even delegated to an independent body.

### 3.1 Introduction

As we explained in Chapter 2, while in opposition, Gordon Brown attempted to persuade people that as Chancellor he would be a fair and prudent steward of the public finances by converting broad principles of good fiscal policymaking into specific operational rules that he promised to abide by and against which his performance could be judged:

- The **golden rule** requires the public sector to borrow only what it needs to pay for capital investment, and to finance its remaining current spending from tax and other revenues. In other words, the government has to keep the current budget (revenues minus current spending) in balance or in surplus. The rule has to be met on average over the ups and downs of the economic cycle rather than every year.
- The **sustainable investment rule** requires the government to keep the public sector’s debt (net of its financial assets) at a ‘stable and prudent’ level. The Treasury defines this as less than 40% of national income (GDP) at the end of every financial year of the current economic cycle, but has not yet announced how ‘stable and prudent’ is to be defined over subsequent economic cycles.

The government formally adopted these rules in the 1998 Finance Act. The Act also placed the rules in a statutory framework; this ‘Code for Fiscal Stability’ requires any government to

spell out how it intends to formulate and implement fiscal policy, and manage the national debt, and to publish twice-yearly forecasts illustrating how the setting of policy at any given time is consistent with its approach.

But the Code leaves the government to decide whether or not to set itself any operating rules and, if it does, to decide whether those rules have been kept to or not. There is no penalty (other than potential reaction of voters and financial market participants) if they are missed.<sup>1</sup> This has contributed to suspicions that the government has applied the rules in such a way as to make them easier to meet while avoiding having to make painful policy adjustments at politically inconvenient times. This in turn has prompted calls for greater independence in judging adherence to the rules so that the Treasury no longer ‘marks its own exam paper’.

This chapter describes the fiscal rules, assesses their operation to date and highlights ways in which assessment of adherence to them could be improved further. Section 3.2 examines the golden rule and Section 3.3 the sustainable investment rule. In Section 3.4, we describe a set of reforms that would improve the operation of the rules and might also help restore confidence that they truly reflect the underlying principles on which they were originally built.

## 3.2 The golden rule

The golden rule is designed to help achieve intergenerational fairness by ensuring that future taxpayers are not left to pay for public spending from which all the benefits have accrued to the current generation. It is also intended to remove a possible bias against investment if and when public spending has to be restrained, since it might be more tempting to cut capital rather than current spending because it normally takes longer for voters to feel the effects of cuts in capital spending in the quality of public services.<sup>2</sup> Requiring the golden rule to be met only on average over the economic cycle, rather than every year, allows it to ‘support monetary policy’ by ensuring that fiscal policy does not have to be tightened at the same time as monetary policy is being loosened. Section 2.7 discusses this issue in more detail.

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

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

We then examine how the golden rule has been applied in practice and whether the Treasury’s latest forecasts suggest it will be met over the current economic cycle.

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<sup>1</sup> For a detailed discussion, see C. Emmerson, C. Frayne and S. Love, ‘Updating the UK’s Code for Fiscal Stability’, IFS Working Paper W04/29, 2004 ([http://www.ifs.org.uk/publications.php?publication\\_id=3163](http://www.ifs.org.uk/publications.php?publication_id=3163)).

<sup>2</sup> For a discussion, see HM Treasury, *Fiscal Policy: Current and Capital Spending*, London, 1998 (<http://www.hm-treasury.gov.uk/media/A97/77/530.pdf>).

## Intergenerational fairness

For a number of reasons, balancing the current budget as defined for the purposes of the golden rule will not necessarily achieve intergenerational fairness:

- The golden rule is based on the distinction between capital and current spending used in the National Accounts, which is in turn based on international accounting standards as interpreted by the Office for National Statistics. These accounting definitions do not necessarily coincide with spending that does and does not benefit future taxpayers; for example, spending on the enhancement of skills can increase future economic growth but does not score as capital spending. £1 of 'current' spending on the training of teachers or doctors might benefit future taxpayers more than £1 of 'capital' spending on an Olympic venue of doubtful long-term use.

The Chancellor could distinguish spending that may and may not be covered by borrowing in a more sophisticated way, but there is likely to be a trade-off between the richness of the rule and its transparency. As Treasury officials have argued, 'It is difficult to agree on a robust definition of growth enhancing expenditure once generally accepted accounting standards are departed from'.<sup>3</sup> Observers might well suspect that a bespoke definition could be tweaked and spending reclassified if and when a breach of the rule looked likely. Even with the use of the National Accounts definitions, the current government has sometimes been accused of reclassifying current spending to ease the constraint of the golden rule.<sup>4</sup>

- To judge rigorously whether tax and spending decisions are intergenerationally fair, one would need to consider the overall impact of taxes and spending and take a 'general equilibrium' approach, analysing their knock-on impact throughout the economy and not just the formal incidence of a few policy instruments taken in isolation. One would need to understand who ultimately bears the costs of taxation and receives the benefits of public spending after taking into account the way in which all policies, and their interactions with each other, affect individuals.
- Furthermore, were a particular generation to lose from the introduction and financing of a new policy, this could still enhance intergenerational fairness if that generation would otherwise have been in a privileged position due to the effect of other policies.<sup>5</sup>
- Borrowing only to invest over a cycle does not directly link the time profile of debt repayments with the time profile of the benefits flowing from an investment project that the debt has financed.

A related issue is the servicing of debts that have arisen from past breaches of the rule (i.e. to finance some of past generations' current spending). It may be fairer to pass on some burden of this to the next generation (in the expectation that it and future

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<sup>3</sup> P. Toigo and R. Woods, 'Public investment in the UK', paper presented at the 7<sup>th</sup> Banca d'Italia Public Finance Workshop, 2005.

<sup>4</sup> 'Brown faces "fiddle" claim after U-turn on the roads', *The Times*, 19 February 2005 (<http://www.timesonline.co.uk/article/0,,19809-1490602,00.html>).

<sup>5</sup> W. Buiter, 'Notes on "A Code for Fiscal Stability"', *Oxford Economic Papers*, 53(1), 1–19, 2001.

generations will in turn continue to do so ad infinitum) rather than to be the ‘transition’ generation that selflessly pays for its own and all outstanding past current spending.

- Fairness considerations might lead us to argue that future generations should pay for some of today’s current spending, as productivity growth arising from technological progress should make future generations financially better off on average and therefore give them greater ability to pay. In other words, running a current budget deficit would achieve progressive redistribution across the generations.

Even if a balanced current budget could be relied upon to deliver intergenerational fairness, that is not what Labour’s variant of the rule requires. Instead, it says the current budget should be in balance *or in surplus*. But the concept of intergenerational fairness underpinning the golden rule suggests that we should be as concerned if today’s taxpayers pay too much for current spending as if they pay too little.

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

## Taking account of the economic cycle

Now to our second question regarding Labour’s interpretation of the golden rule: does it make sense to aim to achieve it over a specific economic cycle with defined start and end dates?

There is certainly a powerful case for taking some account of the condition of the economy in assessing the appropriate level of the current budget balance (or any other measure of borrowing or debt) at any given time. Government revenues and spending are both influenced directly by fluctuations in income, spending, transactions and employment. Economic activity can be thought of as fluctuating around a rising sustainable level consistent with stable inflation. When the economy is weak and activity is below the sustainable level (i.e. there is a negative output gap), tax revenues will be depressed temporarily and the government is likely to have to spend more on transfer payments for the low-paid and out-of-work. This will tend to push the current budget towards deficit. Conversely, when the economy is above trend output, the budget will tend towards surplus.

Changes in national income affect current spending and taxes collected, with higher national income leading to lower spending and higher receipts. According to Treasury estimates, if national income were to rise by 1% relative to its sustainable level, current spending would be expected to fall by about 0.5% of national income while current receipts rise by about 0.2% of national income over the following two years. The net effect is to increase the current budget surplus by about 0.7% of national income.<sup>6</sup>

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<sup>6</sup> As taxes and spending both equal roughly 40% of the economy, if national income were to rise by 1%, both revenues and spending would fall by about 0.4% of national income when compared with the size of the economy (assuming there was no change in their cash value). Treasury estimates suggest that, in addition to this ‘denominator’ effect, over the following two years we would see spending on transfer payments and debt interest payments drop by 0.1% of national income and revenues rise by 0.6% of national income. Adding the two effects together, after a 1% rise in national income relative to its sustainable level, we would see current spending fall by about 0.5% of national income while current receipts rise by about 0.2% of national income over the following two years. The net effect is to increase the current budget surplus by about 0.7% of national income. (HM Treasury, *End*

The Bank of England is tasked with using interest rates to pursue an inflation target, which implies that once inflation is on target, it will try to keep activity as close as possible to its sustainable level. Over time and on average, monetary policy should therefore tend to erode any cyclical component of the budget surplus or deficit (even if shocks, policy errors and any other factors not associated with the economic cycle mean that it is not eliminated *ex post*). This implies that fiscal policy decisions should focus on the structural budget position. Broadly speaking, it is reasonable to expect cyclical deficits and surpluses to sum to zero over the course of a single symmetric economic cycle. So, if tax and spending decisions also succeed in keeping the structural position in balance on average, the golden rule will be met.

Allowing borrowing to rise and fall through the cycle acts as an ‘automatic stabiliser’. If the government tried to keep the current budget balanced in every year of the cycle, it would need continuously to offset cyclical surpluses and deficits with structural deficits and surpluses respectively. This would typically mean raising taxes and/or cutting spending when a negative output gap leads to a cyclical deficit. Conversely, it would mean cutting taxes and/or increasing spending when a positive output gap leads to a cyclical surplus. This would place a greater burden on monetary policy to stabilise the economy. It would also require temporary changes in tax rates that might well be more costly in economic terms than holding tax rates steady and allowing the current budget balance to fluctuate instead. It should be borne in mind that the strength of the automatic stabilisers will depend on the size of the public sector and the progressiveness of the tax and benefit system, so it may not be optimal from a stabilisation perspective. However, there would be nothing to stop the Treasury from making additional discretionary policy changes in either direction, as long as they balanced out on average over the cycle, or from making changes to the tax and benefit system so that the automatic stabilisers are of a different magnitude.

But it is one thing to argue that the government should aim to balance the structural current budget at some appropriate time horizon in the future; it is another to argue that it should explicitly date a particular cycle and aim for a structural balance or surplus on average over that period. The Treasury identifies cycles by estimating from a variety of economic indicators points in time when economic activity was at its sustainable level and the output gap was zero (i.e. when there was neither upward nor downward pressure on inflation). It then assumes that the sustainable level of activity grows at a constant rate between these ‘on-trend’ points, allowing it to estimate the output gap at any other point. To date, it has chosen to define a cycle as a period of above-trend activity followed by a period of below-trend activity, although it could equally have opted for a below-trend one followed by an above-trend one.

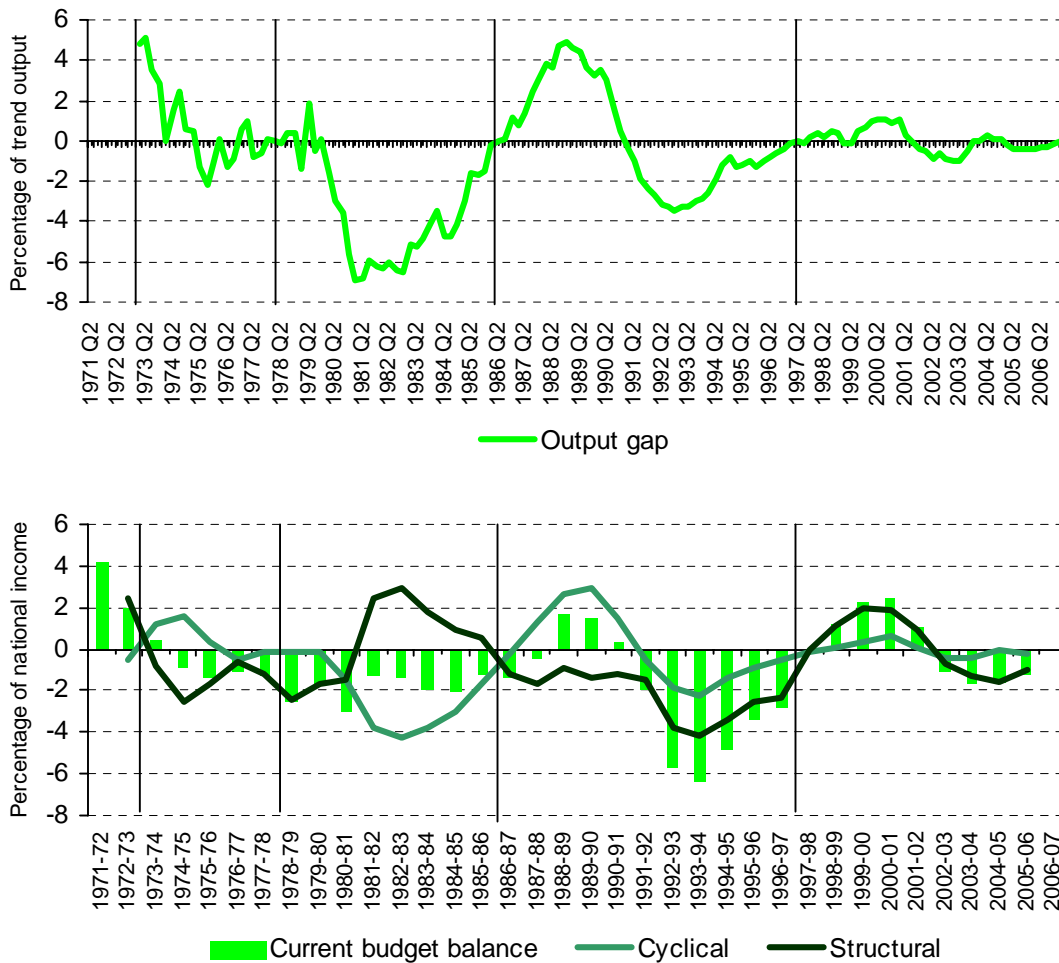
Figure 3.1 shows the Treasury’s estimates of the output gap<sup>7</sup> and the periods that it defines as economic cycles. It then shows the current budget balance, divided into its estimated ‘structural component’ (the level that would have occurred had the output gap been zero throughout) and the estimated remaining ‘cyclical’ element that reflects deviations in economic activity from its trend. This is based on the Treasury’s estimates of the average output gap in each financial year.

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of Year Fiscal Report, December 2003 ([http://www.hm-treasury.gov.uk/media/324/70/end\\_of\\_year\\_352%5B1%5D.pdf](http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf).)

<sup>7</sup> The output gap shown in Figure 3.1 is measured using ‘non-oil gross value added’ as the measure of output, in line with Treasury practice.

Figure 3.1. Current budget balance: cyclical and structural



Source: HM Treasury, *Public Sector Finances Databank*, London, December 2006 ([http://www.hm-treasury.gov.uk/media/A5B/FD/pfd\\_dec06.xls](http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls)).

One disadvantage of picking any fixed period over which to judge the rule is that the amount the government can borrow towards the end of the period is determined by what it has borrowed earlier on. Policy becomes backward-looking as the Chancellor is potentially constrained to compensate for the policy and forecasting errors of the past rather than setting what is necessarily the most sensible policy looking forward.

This is significantly different from the approach Labour has taken with monetary policy, where the Chancellor is happy for the Bank of England to set interest rates to try to achieve the inflation target at roughly a two-year time horizon but without requiring it to offset actual deviations from the target in the past or expected deviations from the target in the very near term (i.e. the Bank of England’s Monetary Policy Committee (MPC) targets inflation rather than a particular price level – higher-than-target inflation in period 1 would not lead to the MPC trying to achieve lower-than-target inflation in period 2). An analogous approach for fiscal policy would be to set a rolling forward-looking target for the cyclically adjusted current budget balance (or just the total current budget balance if the policy horizon were sufficient to expect the output gap to have returned to zero). We argue below that the present government’s approach can actually be interpreted in this way, given its published forecasts.

All this assumes that we can identify ‘on-trend’ points and the output gap at any given time. But, according to Barry Eichengreen of the University of California (Berkeley), ‘The one thing economists know about cyclical adjustments is that we do not know how to do them’.<sup>8</sup>

Using the Treasury’s own technique, identifying the start and end points of the cycle is in large part a matter of judgement. But there are also other methods of identifying the cycle – including statistical filters and production function techniques – that can yield very different answers (as shown in Table 4.3 of Chapter 4). Typically, the Treasury technique identifies fewer cycles than the filters do.

Given the lack of consensus over the dating of the cycle from different methods, if the Treasury re-dates the cycle in a way that increases the average current budget surplus for the period over which the golden rule is being judged (as it did in 2005, as we shall see below), it will not be surprising if people suspect that this has been done to make the golden rule easier to meet.

An obvious alternative would be for the Treasury to present forecasts based on output gap estimates produced by an independent body or bodies, such as the soon-to-be-independent Office for National Statistics, perhaps advised by an external panel.

But, more fundamentally, does it make sense to base policy on a clearly defined economic cycle at all? In a stable environment in which monetary policy is well run and credible, we might expect deviations in economic activity from its sustainable level to be relatively small. Economic activity might show high-frequency noise around its trend rather than protracted periods with significantly positive or negative output gaps. This would make cycles increasingly hard to identify and prone to re-dating as the National Accounts are revised.

As Mervyn King, Governor of the Bank of England, has argued:

I am not even sure if the output gap is terribly well defined. To put precise numbers on it is pushing beyond the bounds of the plausible. The Bank and the Treasury have a very different view of how to think about the cycle. We don’t like this sort of fixed dating and we have a different way of thinking about the productive potential of the economy and how it evolves. I am not even sure it makes sense to think about a cycle as if it is a well-defined phenomenon.<sup>9</sup>

An alternative might be for the Treasury to set a target for the current budget in the medium term and constrain itself to present forecasts of revenues and spending based on some average of independent forecasts for growth and other macroeconomic variables. Or it could use the forecasts used by the Bank of England, which would mean that the same projections would be used for both fiscal and monetary policy. One pitfall of this approach is that it could increase the political importance of the Bank of England’s projections, which, over time, might risk reducing public confidence in their neutrality.

An even more dramatic option would be for more of the fiscal forecasting process to be delegated to an independent body, following the precedent of the Bank of England’s

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<sup>8</sup> B. Eichengreen, ‘Comment on “The political economy of fiscal adjustments”’, *Brookings Papers on Economic Activity*, 1, 255–62, 1998.

<sup>9</sup> M. King, *Inflation Report* press conference, August 2005 (<http://www.bankofengland.co.uk/publications/inflationreport/2005.htm>).

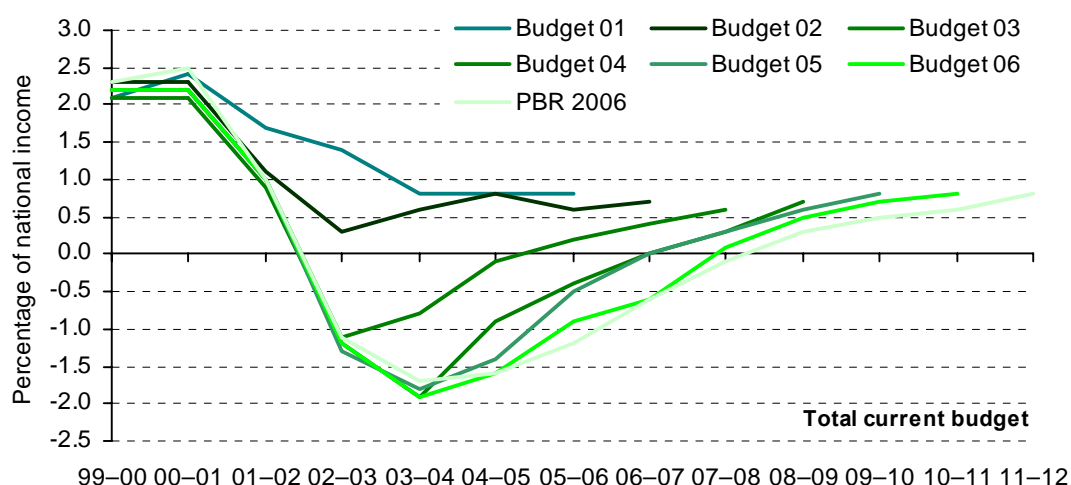
Monetary Policy Committee. For example, an independent body could be asked to provide official tax revenue forecasts, helped by access to information from HM Revenue & Customs. However, the Treasury has traditionally argued that it is impossible to separate responsibility for public finance forecasts or the economic inputs into them from the responsibility for making policy. We discuss this further in Section 3.4.

### The golden rule in practice

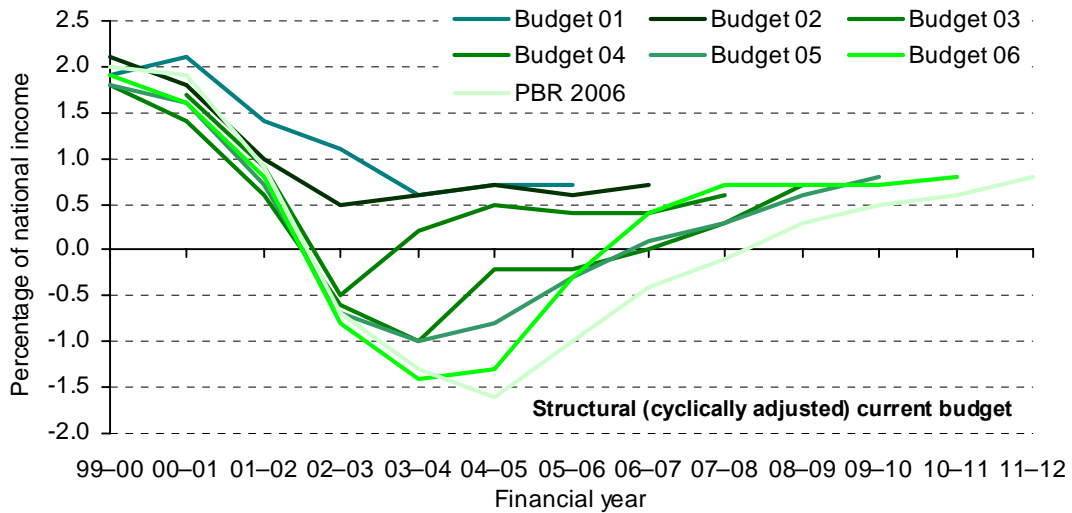
In understanding how Mr Brown has interpreted and applied the golden rule in practice over recent years, it is important to remember that the Treasury’s forecasts for the public finances have been consistently over-optimistic since 2001 and have hence been revised down in successive Budgets and Pre-Budget Reports. In particular, there has been a persistent unexpected weakness of tax revenues from the financial sector after the stock market decline between 2000 and 2002. The latest downward revisions, in the 2006 Pre-Budget Report, reflect a weaker outlook for North Sea oil revenues and higher-than-expected inflation.

Figure 3.2 shows the Treasury’s forecasts for the current budget balance in each Budget since 2001 and the latest Pre-Budget Report. It shows that in 2001 and 2002, the Treasury expected current budget surpluses over the medium-term forecasting horizon, clearly implying that the golden rule would be met over any economic cycle of plausible duration. But in 2002–03, the current budget moved into deficit and the Treasury’s expectations of a swift return to the black were repeatedly frustrated. As the second chart in Figure 3.2 shows, the unexpectedly weak fiscal performance was not explained in any large part by temporary weakness in the economy – Treasury forecasts for the structural current budget balance were revised downwards in similar fashion.

Figure 3.2. Treasury current budget balance forecasts





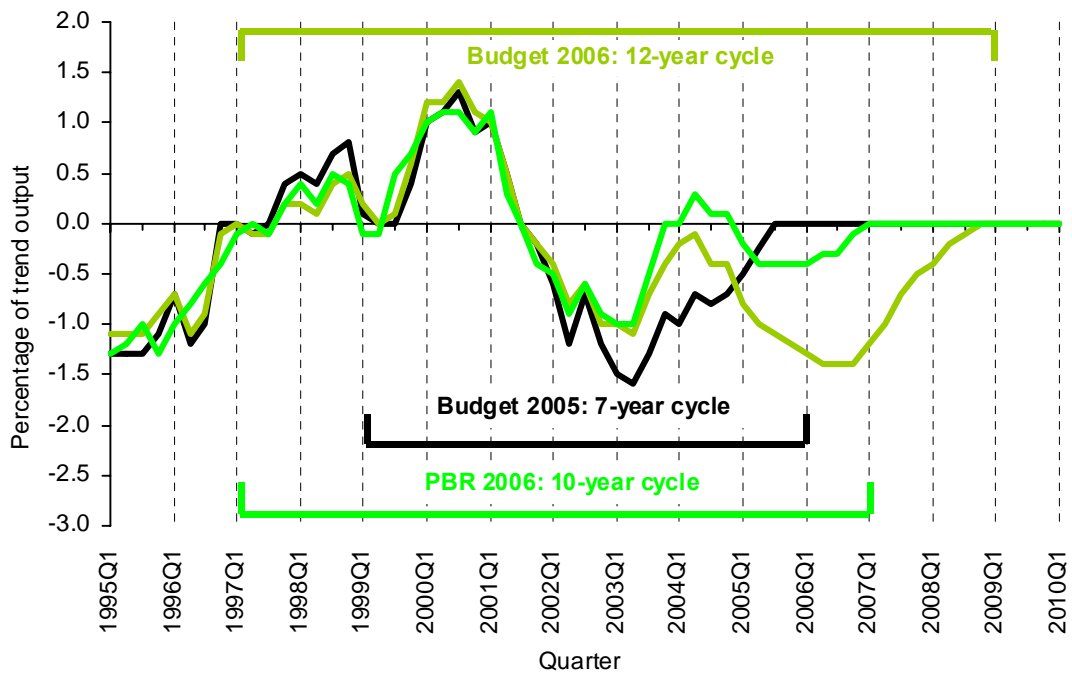


Sources: Successive Budgets and 2006 Pre-Budget Report.

As Mr Brown’s hopes of continued surpluses were dashed and deficits began to mount up, the precise dating of the economic cycle became increasingly important in determining whether the golden rule was on course to be met – and, if so, with what degree of comfort.

In Budget 2000, the Treasury had reached the ‘provisional conclusion’ that the present economic cycle began in financial year 1999–2000, a view it maintained up to and including the pre-election Budget in 2005. In that Budget, the Treasury argued the economy was running about 0.7% below full capacity and that above-trend economic activity would close the output gap ‘around the end of 2005’. For the purposes of the golden rule, this meant that there was one financial year still to come (2005–06) in a cycle spanning a total of seven years, as shown in Figure 3.3.

Figure 3.3. The output gap and the economic cycle: Treasury estimates



Note: Actual output less trend output as a percentage of trend output (non-oil basis).  
Source: HM Treasury.

The Treasury estimated in Budget 2005 that it would meet the golden rule over this period with around £5 billion to spare,<sup>10</sup> far lower than the margins implied over the same period by previous forecasts. But as 2005–06 got under way, it soon became clear that the current budget deficit was not shrinking as rapidly as planned. In June 2005, the Treasury published figures showing that the deficit in the first two months of the financial year was only about 10% smaller than in the same period of 2004–05. If this persisted, it would come in at around £15 billion rather than the £5.7 billion forecast in Budget 2005. The golden rule would be breached.

Then, a month later, the Treasury published a detailed analysis arguing that the period from mid-1997 to mid-1999 should be regarded as part of the up-phase of the current cycle rather than as a complete mini-cycle in its own right. This would add two additional financial years to the beginning of the cycle and extend it from seven to nine years. The Treasury justified this change largely on the grounds that revisions to National Accounts data showed that economic growth in 1999 had been stronger than hitherto thought. In Budget 2000, the Treasury had identified a ‘mini-cycle’ in 1997–98 and 1998–99, the down-phase of which was estimated to last for two quarters with an average negative output gap of 0.3% of potential output. But, following the revisions up to 2005, output appeared to have fallen below potential only in 1999Q1 and then by less than 0.1% of potential output. The Treasury concluded: ‘There is now no evidence of a clear dip below trend in early 1999. So the below trend phase of the previously identified 1997H1 to mid-1999 “cycle” now looks non-existent’.<sup>11</sup>

At a stroke, adding the two extra years to the beginning of the cycle put the Treasury back on course to meet the golden rule, thanks to the current budget surplus of 1.2% of national income recorded in 1998–99 (which outweighed the 0.1% of national income deficit in the previous year). The fortuitous timing of the Treasury’s decision inevitably fuelled speculation that it had been motivated by the desire to make the golden rule easier to meet.

We have argued in the past that if one were to accept the Treasury’s methodology and estimates for the output gap, it would be quite plausible to suggest that the cycle began in 1997 rather than 1999.<sup>12</sup> In most recent Budgets and Pre-Budget Reports, casual observation of the output gap chart would suggest that 1997 to 2001 was a single up-phase with a pause in the middle, rather than one-and-a-half cycles. But the case for making this judgement in the summer of 2005 seemed little stronger than at any time in the previous five years.<sup>13</sup> So it is hardly surprising that extending the cycle at precisely the point at which it meant the government would suddenly be on course to meet the rule rather than to break it should undermine the credibility of the policy framework and create suspicion that the Chancellor was simply ‘moving the goalposts’ to avoid the embarrassment of missing his target.

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<sup>10</sup> Cash value of cumulative current budget surpluses across the cycle, with surpluses in each year measured as shares of national income and then converted to cash terms using 2005–06 money GDP.

<sup>11</sup> HM Treasury, *Evidence on the UK Economic Cycle*, July 2005 ([http://www.hm-treasury.gov.uk/media/2E6/A5/economic\\_cycles190705.pdf](http://www.hm-treasury.gov.uk/media/2E6/A5/economic_cycles190705.pdf)).

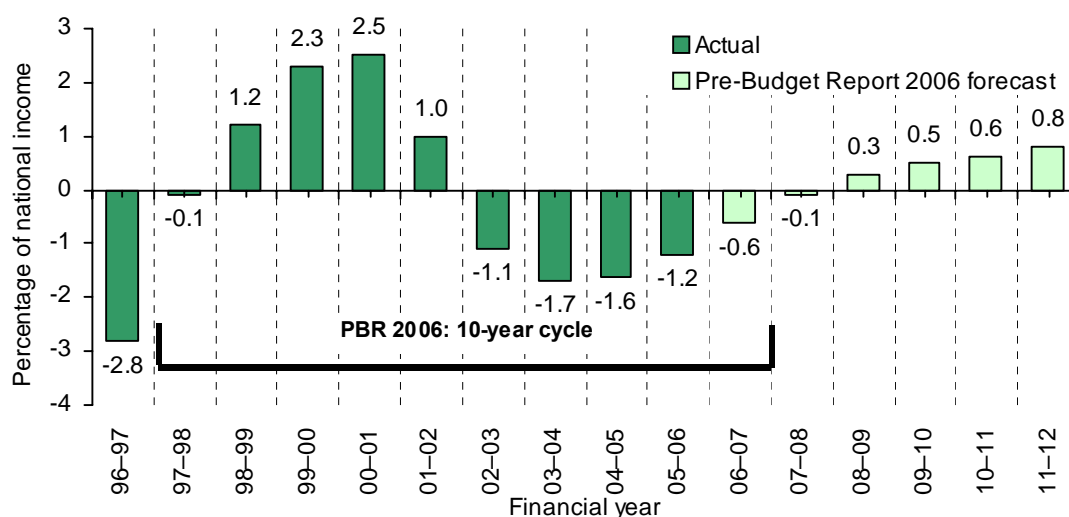
<sup>12</sup> C. Emmerson, ‘Bending the rules?’, *Public Finance Magazine*, 5 August 2005 ([http://www.cipfa.org.uk/publicfinance/features\\_details.cfm?News\\_id=24755](http://www.cipfa.org.uk/publicfinance/features_details.cfm?News_id=24755)).

<sup>13</sup> See pages 20–26 of chapter 2 of R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, London (<http://www.ifs.org.uk/budgets/gb2006/index.php>).

The Chancellor also announced in the 2005 Pre-Budget Report that he expected the cycle to end in 2008–09 rather than 2005–06. The Treasury estimated that economic activity was at that time running around 1½% below potential, its weakest cyclical position since 1994. The Treasury expected the output gap to remain at a similar level in 2006–07 and only to close in 2008–09 after two years of above-trend growth. Given the forecasts for the current budget balance over the three additional years, this marginally increased the comfort with which the Treasury expected to meet the rule, but with greater uncertainty around the central forecast because of the longer time horizon.

In last year’s Pre-Budget Report, the Treasury yet again changed the dating of the cycle. Revisions to the National Accounts and stronger-than-expected growth prompted the Treasury to revise its estimate of the negative output gap at the end of 2006 to just ¼% of national income from the 1¼% implied by its forecasts in the 2006 Budget. With growth remaining above trend, the Treasury said that the cycle would close in early 2007, implying that the final financial year of the cycle would be 2006–07 rather than 2008–09, cutting it to 10 years.

Figure 3.4. Current budget balance in the 2006 Pre-Budget Report



Source: HM Treasury, *Public Sector Finances Databank*, December 2006 ([http://www.hm-treasury.gov.uk/media/A5B/FD/pfd\\_dec06.xls](http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls)).

Figure 3.4 shows recent out-turns and Treasury forecasts for the current budget balance from the 2006 Pre-Budget Report. If the Treasury is correct in its forecast that the current budget deficit this year will be £7.9 billion (0.6% of national income), then the rule will be met with £8.4 billion to spare. If trends in spending and revenues over the first nine months of the financial year continue over the remaining three, the current budget deficit would come in at £12.0 billion and the Chancellor would meet the golden rule with £4.3 billion to spare. But we might well expect spending growth to slow and the margin to be larger (see Chapter 5). This suggests that the golden rule is very likely to be met if the cycle dates do not change again.

As Table 3.1 shows, if the Treasury forecasts and latest estimated out-turns are accurate, then the rule would also be met on the cycle as defined in the 2005 Budget, 2005 Pre-Budget Report and 2006 Budget and is expected to be met under the 2006 Pre-Budget Report

Table 3.1. Meeting the golden rule?

	<b>Average surplus over cycle</b> (% of GDP)	<b>Cumulative surplus</b> (£ billion, 2006–07 GDP terms)	<b>Current budget balance in first year of next cycle</b> (% of GDP)
<b>Budget 2005 cycle:</b> 1999–2000 to 2005–06	+0.0%	+£2.4bn	-1.2%
<b>PBR 2005 &amp; Budget 2006 cycle:</b> 1997–98 to 2008–09	+0.1%	+£10.8bn	+0.3%
<b>PBR 2006 cycle:</b> 1997–98 to 2006–07	+0.1%	+£8.4bn	-0.6%
<b>PBR 2006 cycle end with later start:</b> 1999–2000 to 2006–07	-0.1%	-£5.5bn	-0.6%

Sources: HM Treasury, *Public Sector Finances Databank*, December 2006 ([http://www.hm-treasury.gov.uk/media/A5B/FD/pfd\\_dec06.xls](http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls)); authors' calculations.

projections. However, assuming that the cycle closes in 2006–07 – as the Treasury now expects – the golden rule would have been missed had the Treasury not added the extra two years at the beginning of the cycle.

What about the prospects for meeting the golden rule in the next economic cycle?

One problem in judging this is that although the Treasury has reached a provisional judgement that the current economic cycle will end in 2006–07, it has not decided, in that event, which year would be the first of the next cycle. Paul Boateng, the then Chief Secretary to the Treasury, said in 2003 that 'Progress against the golden rule is measured by the average surplus on the current budget over the period from the financial year in which the economic cycle starts up to and including the financial year in which it ends'.<sup>14</sup> This would seem to imply that if 2006–07 is treated as the last year of one economic cycle, it should also be treated as the first year of the next. But, in response to questioning by the Treasury Select Committee in December, Mr Brown's officials left open the option of dropping this approach:

**David Gauke MP:** But whenever it does end, whichever year it is, will that year count for both the old cycle and the new cycle?

**Jon Cunliffe (HM Treasury):** That is what we have done in the past.

**David Gauke MP:** Is that what you are going to do in the future?

**Jon Cunliffe (HM Treasury):** I do not know what we are going to do in the future.<sup>15</sup>

If the Treasury were to count 2006–07 as the first year of the next cycle, it would begin with a current budget deficit of 0.6% of national income that would need to be offset by a surplus of at least the same size later in the cycle (as shown in Table 3.1). On the Treasury's December 2006 Pre-Budget Report forecast, the golden rule would be more likely to be met than not on this basis as long as the next cycle lasted at least four years. By contrast, if the Treasury counted 2007–08 as the first year of the next cycle, it would start with a deficit of just 0.1% of

<sup>14</sup> *Hansard*, 4 November 2003, column 630w.

<sup>15</sup> <http://www.publications.parliament.uk/pa/cm200607/cmselect/cmtreasy/uc115-ii/uc11501.htm>.

national income in that year, and the golden rule would be more likely than not to be met after two years.

We noted earlier in this section that one alternative to meeting the golden rule over a specifically dated economic cycle would be to aim for a particular target level for the current budget balance over an appropriate time horizon. As Figure 3.2 illustrates, we could argue that in practice the government has in fact been pursuing just such a target in recent years; it has made tax and spending decisions that it expects will deliver a current budget surplus (total or cyclically adjusted) of around 0.7% of national income after five years.

How has the Treasury performed relative to these notional targets?

Table 3.2 shows that the five-year-ahead target set in Budget 2001 was undershot by 2.0% of national income last year, of which 0.3% reflects the fact that the economy was running below potential. Budget 2002 loosened the target for this year by 0.1% of national income, but the Treasury still expects it to be undershot by 1.5% of national income, of which 0.4% reflects a weak economy. Budget 2003 loosened the target again by 0.1% of national income, and the Treasury now expects to undershoot this by 0.7% of national income. In the next two Budgets, the target was tightened back to the level set in Budget 2001, with the Treasury now expecting to miss these targets by 0.4% of national income in 2008–09 and 0.3% of national income in 2009–10. Budget 2006 set a five-year-ahead target of 0.8% of national income for 2010–11, and the Treasury already expects to be 0.2% of national income adrift from that.

Table 3.2. Performance against notional five-year rolling target

Current budget balance (% of national income)	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11
<b>Target set 5 years previously</b> <i>(total &amp; structural)</i>	0.8%	0.7%	0.6%	0.7%	0.8%	0.8%
<b>Total</b>						
<i>Actual deviation</i>	–2.0%	-	-	-	-	-
<i>Forecast deviation</i>		–1.5%	–0.7%	–0.4%	–0.3%	–0.2%
<b>Structural</b>						
<i>Actual deviation</i>	–1.7%	-	-	-	-	-
<i>Forecast deviation</i>		–1.1%	–0.7%	–0.4%	–0.3%	–0.2%

Source: Projections from various HM Treasury Budgets. Latest out-turns from HM Treasury, *Public Sector Finances Databank*, December 2006 ([http://www.hm-treasury.gov.uk/media/A5B/FD/pfd\\_dec06.xls](http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls)).

The current budget underperformed the Treasury’s notional Budget 2001 target for 2005–06 largely because of the unexpected fall in tax revenue from the financial sector in 2000–01 and 2001–02 failing to rebound as quickly as it hoped and because of decisions to spend more on health, education and tax credits. Since 2002, IFS Green Budgets have been less optimistic than the Treasury about tax revenues. To achieve the sort of improvement in the public finances that the Chancellor was looking for, we said there would be need for tax increases and/or spending cuts worth roughly 0.6% of national income in the 2002 Green Budget, and roughly 1% of national income in the Green Budgets of 2003, 2004 and 2005.

The Chancellor consistently rejected this advice in the run-up to the 2005 election, but then followed it at the first opportunity once polling day was safely out of the way – he announced tax increases and signalled cuts in spending plans worth in total around 1% of national

income in the 2005 Pre-Budget Report. We argued for a further tightening of 0.2% of national income in Green Budget 2006, and tax increases worth roughly this amount have been delivered in the 2006 Budget and Pre-Budget Report. Looking back over this period, if the Chancellor had made some of the tightening that we and other commentators had said would be necessary to fulfil his forecasts during most of Labour's second term, rather than waiting until after the 2005 election, the Treasury would not now be expecting to undershoot its notional rolling target for the current budget balance over the next few years to the extent that it is.

### 3.3 The sustainable investment rule

The sustainable investment rule states that the public sector's debt (net of its financial assets, which mostly comprise foreign exchange reserves) should be kept at a 'stable and prudent' level. More precisely, 'To meet the target with confidence, at the end of every fiscal year of the current economic cycle, public sector net debt must be below 40% of GDP'.<sup>16</sup>

#### Why impose a debt ceiling?

Governments take on debt for much the same reason that individuals and firms do – to smooth their spending. Whilst the biggest changes in government debt levels in this country have been driven by the need to finance the two World Wars, in more normal circumstances there are three main reasons why governments might take on debt:

- First, it can be both fair and efficient to smooth the cost to taxpayers of public spending that yields a flow of (typically non-financial) benefits into the future.
- Second, it may make sense to smooth payments for current spending over the ups and downs of the economic cycle to help stabilise activity and alleviate pressure on monetary policy.
- Finally, and less commendably, governments may seek to push the costs of current spending onto future taxpayers for political advantage, because they believe that voters are short-sighted.

But when does debt – taken on for any or all these reasons – become 'unsustainable'? As the Treasury argues, 'There are many possible definitions of sustainability. One definition is that a government should be able to meet its obligations if and when they arise in the future'.<sup>17</sup> As debt increases, the cost of servicing it also increases. In principle, the cost could rise so high that the economy produces too little to meet it. But in practice, long before then, sustainability becomes a political judgement: the ability of a government to meet the obligations it undertakes or inherits will depend on the willingness of future taxpayers to provide the revenue or to sacrifice other spending.

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<sup>16</sup> HM Treasury, *Analysing UK Fiscal Policy*, 1999 ([http://www.hm-treasury.gov.uk/Documents/UK\\_Economy/Fiscal\\_Policy/ukecon\\_fisc\\_policy99.cfm?](http://www.hm-treasury.gov.uk/Documents/UK_Economy/Fiscal_Policy/ukecon_fisc_policy99.cfm?)).

<sup>17</sup> Page 19 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/assoc\\_docs/prebud\\_pbr06\\_adlongterm.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm)).

As experience in various emerging market countries has shown over the decades, *in extremis* governments may find it more attractive to lift the burden of meeting their financial obligations from taxpayers and concentrate it instead on their domestic and/or international creditors through rescheduling, default or inflation. Conscious of this danger, investors will become more reluctant to lend to a government if its policies look likely to impose a politically unacceptable burden on future taxpayers. By increasing interest rates and reducing economic growth, such investor fears can become self-fulfilling by further increasing the government's obligations and simultaneously shrinking the resources available to meet them. Even in the absence of a significant default risk, interest rates may rise as government debts increase, weakening growth by 'crowding out' private investment. (This market discipline has been relatively weak in recent years, with most industrial countries seeing their borrowing costs fall even as their debts have risen, as discussed in Chapter 4.)

Given these dangers, it may be sensible for a government to make a clear public commitment to limit its obligations to some level that would not (under plausible economic circumstances) impose an unacceptable burden on future taxpayers. As Treasury officials have argued, 'Committing to a clear benchmark level of debt helps to anchor expectations and helps avoid self-fulfilling losses of credibility in fiscal policy'.<sup>18</sup>

## The height of the debt ceiling

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

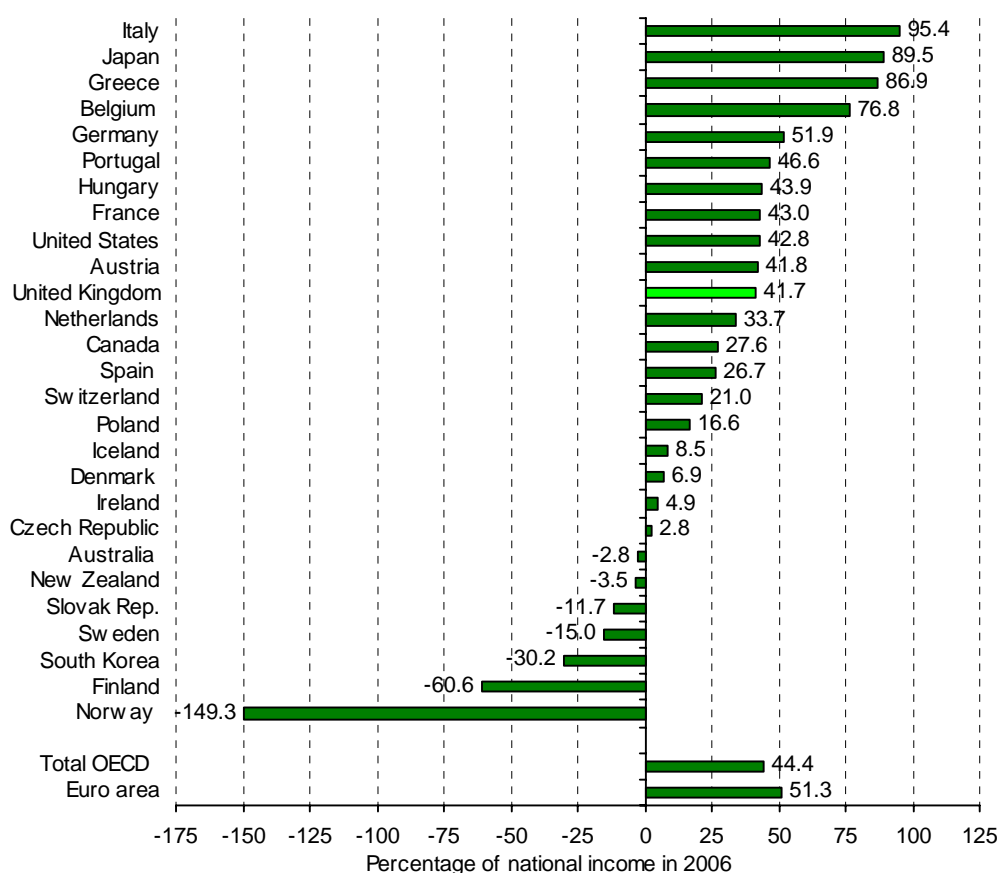
It certainly seems implausible to suggest that a debt ratio of up to 40% of national income would be sufficient to trigger a sovereign debt crisis, especially for a developed country such as the UK that has long been able to borrow in its own currency with relative ease. The current government appears to have chosen this ratio in effect as a commitment not to allow debt to rise above the level it inherited. Assuming that the golden rule was met, a debt ceiling of 40% of national income is also sufficiently high to permit a higher level of public sector net investment in the long term than Labour inherited.

The Treasury estimates that public sector net debt will be 37.5% of national income this year, slightly below the 40% ceiling. Figure 3.5, which uses a slightly different definition of debt to aid international comparison, shows that even if public sector debt in the UK did rise by the 2.5% of national income or so necessary to hit the ceiling, it would still be low relative to that of most other G7 countries. But there are other industrial countries with much stronger net debt positions, including Australia, New Zealand and the Scandinavian countries. Some OECD countries have more financial assets than debt – for example, Norway (to smooth the

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<sup>18</sup> R. Woods, 'The role of public debt in the UK fiscal rules', paper presented at the 6<sup>th</sup> Banca d'Italia Public Finance Workshop, 2004.

Figure 3.5. General government debt ratios in OECD countries in 2006



Source: Annex table 33 of OECD, *Economic Outlook No. 80*, November 2006  
[http://www.oecd.org/document/18/0,2340,en\\_2649\\_201185\\_20347538\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/18/0,2340,en_2649_201185_20347538_1_1_1_1,00.html).

consumption of its oil revenues) and South Korea (which has built up enormous foreign exchange reserves to limit the rise in its exchange rate).

So why might the UK wish to aim for a debt ratio higher or lower than 40%?

First, the desired debt ratio will depend on the desired level of public sector net investment over the long term. The amount the government can invest while adhering to a particular debt ceiling will depend on: (a) the current level of debt; (b) the degree to which the golden rule is over- or under-achieved (which in turn partly depends on how much the government has to spend servicing its existing debt); and (c) the growth of the cash value of the economy.

If we assume that the golden rule is met exactly, that whole-economy inflation is 2.5% a year and that the economy grows in real terms by 2.5% a year, then the government could sustain public sector net investment of 2% of national income a year while keeping public sector net debt at 40% of national income. If we believe that public sector net investment should be higher than 2% of national income in the long term, this argues for raising the debt ceiling above 40% unless the golden rule is consistently overachieved or unless cash growth in the economy exceeds 5% a year. Conversely, if we wish to invest less than 2% of national income, the debt ceiling could be lowered.



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

As we discuss in more detail in Section 7.4, the Treasury estimates that, on existing policies, public spending in the UK will, as a result of changing demographics, rise from 40.9% of national income last year to 44.7% in 2055–56 – an increase of 3.8% of national income or £50 billion in today's terms.<sup>19</sup> Individuals are likely to wish to smooth their consumption in the face of an expected rise in tax rates to pay for these increases in spending, but some will be more aware of the necessary adjustments and better placed to make them at low cost than others. On these grounds, it may be thought preferable for the state to help make the adjustment by increasing tax rates now (aiming for a lower debt-to-national-income target) to reduce the increase required in the future (when the debt ratio would be allowed to rise again).

## **Other liabilities**

As well as future debt repayments due to current borrowing, the government has made promises of other future payments in a number of ways. These include payments arising from the Private Finance Initiative and the pensions of public sector workers, plus possible contingent liabilities (notably the debt of Network Rail). The treatment of these future payments is important since, despite not appearing in the headline figures for debt, they could reduce the amount of income that future generations will be able to spend as they choose.

The opposition Conservative Party,<sup>20</sup> among others, has expressed concern at the size of the liabilities that are not counted in public sector net debt, and therefore are not constrained (at least in the short and medium term) by the sustainable investment rule. Arguably more important than the level of these liabilities is whether or not the total indebtedness of the public sector is increasing and the appropriateness of the financing tool used. Financing this spending through means that do not immediately score against public sector net debt would be inappropriate if it is done in order to keep the headline net debt figure low rather than for reasons of economic efficiency.

But how large are these commitments that are not included in public sector net debt (PSND)? Due to intrinsic differences in their nature, comparable figures (based on consistent underlying assumptions) for different components of public sector indebtedness are not

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<sup>19</sup> Source: Table 5.1, page 40, of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/assoc\\_docs/prebud\\_pbr06\\_adlongterm.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm)).

<sup>20</sup> See, for example, Conservative Party, *Developing a Conservative Macroeconomic Framework*, 2005 (<http://www.conservatives.com/pdf/Macroeconomicframework-Dec2005.pdf>).

available. Bearing in mind this important caveat, Table 3.3 compares the size of PSND with official estimates of public sector pension liabilities, an estimate of the value of the future flow of payments to PFI providers under contracts already signed, and the latest figure on the debt of Network Rail. Quantitatively speaking, the PFI and Network Rail obligations appear to be relatively small compared with the official measure of PSND, while public sector pension liabilities are particularly significant in size. They are estimated by the government to be larger than net debt itself. Taken all together, these estimates of public sector pension liabilities, future PFI payments and the debt of Network Rail are around £650 billion, which is 40% larger than PSND. This gives an estimate of total liabilities of the public sector standing at around £1,100 billion, just under 90% of national income.

A number of issues arise with each of these components of the indebtedness of the public sector, and we now discuss each in turn.

**Table 3.3. Estimated value of various future public sector obligations based on official estimates**

	£ billion	% of GDP
Public sector net debt, March 2006	462.7	36.4
Estimated public sector pension liabilities, March 2005	530	≈42
Estimated future PFI payments, signed deals December 2006	100	≈8
Network Rail debt, September 2006	18	≈1
<b>Total</b>	<b>≈1,100</b>	<b>≈87</b>

Sources: Public sector net debt from table A4 of HM Treasury, *Public Sector Finances Databank*, December 2006 ([http://www.hm-treasury.gov.uk/media/A5B/FD/pfd\\_dec06.xls](http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls)); public sector pension liabilities from answer to parliamentary question by Des Browne, then Chief Secretary to the Treasury, 2 March 2006, *Hansard*, column 388W ([http://www.publications.parliament.uk/pa/cm200506/cmhansrd/cm060302/debtext/60302-03.htm#60302-03\\_spm1n0](http://www.publications.parliament.uk/pa/cm200506/cmhansrd/cm060302/debtext/60302-03.htm#60302-03_spm1n0)); estimated future PFI payments from table B24 of HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/prebud\\_pbr06\\_index.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm)) with payments discounted to 2006–07 by future nominal GDP (assuming growth of 5% p.a. from April 2012 onwards); Network Rail debt from table 9, page 20, of Network Rail Limited, *Interim Financial Statements, six months ended 30 September 2006* (<http://www.networkrail.co.uk/browse%20documents/interim%20results/2006-07%20network%20rail%20limited%20interim%20financial%20statements.pdf>).

### **Network Rail (net debt of £18 billion, September 2006)**

Borrowing carried out by Network Rail could be considered similar to conventional government borrowing as the government guarantees to repay its debt if the company collapses, though the Office for National Statistics defines it as a private sector company and therefore off the public sector's balance sheet. In order to avoid a collapse, if the company got into serious trouble, it is likely that the government would take greater control and the ONS would reclassify it as part of the public sector for the purposes of the National Accounts, even if Network Rail had not been formally renationalised. This would further reduce the Chancellor's room for manoeuvre in remaining below the current debt ceiling.

The latest Network Rail accounts, at September 2006, report net debt of £18 billion.

### ***Private Finance Initiative (future payments totalling £100 billion, December 2006)***

Under PFI arrangements, private firms undertake some capital spending on behalf of the public sector, with the public sector paying private firms a rental price for use of a capital asset, in addition to payments for any current goods and services, that the private sector delivers. While the use of the PFI began in 1987 (with the Queen Elizabeth II Bridge built over the Thames at Dartford/Thurrock), it has been much more widely used since 1998.<sup>21</sup>

In total, PFI deals signed up to December 2006 will finance a total of £55 billion (4.2% of national income in 2006–07) of capital spending. This will only be incorporated in public sector net debt to the extent to which payments have already been made by the public sector to the private sector, or where debt has been undertaken by the private sector under PFI and accountants judge (and the National Audit Office agrees) that the public sector has taken on the risks and rewards of owning the asset concerned (e.g. a hospital), and where the new asset – or a phase of improvement work on an existing asset – is operational.

Therefore, in the short run, a conventionally financed investment project would typically add more to public sector net debt than a project financed via PFI or public private partnerships (PPPs). As long as this remains the case, there may be a suspicion that investment projects are undertaken via PFI (rather than conventionally) to help meet the sustainable investment rule rather than on value-for-money grounds. Had conventional finance been used instead of the PFI then public sector net debt would have been increased by the total amount of capital spending that has taken place under the PFI so far (which will be less than the £55 billion that will eventually be done from all contracts signed to date). Instead, the only amount that has so far been included in public sector net debt is the payments that have so far been made to PFI providers and the finance-lease component (which in September 2006 were estimated by the ONS to total £4.95 billion). Under a no-PFI scenario, public sector net debt – in the absence of compensating changes to taxes or other spending – is likely to have been around, and possibly above, the 40% of national income level. However, the Chancellor might reasonably argue that if he had not intended to use the PFI, he would have set the ceiling higher.

The future indebtedness of the public sector relates not to the capital value of PFI deals, but instead to the value of the payments that have been agreed contractually. In total, under deals signed up to December 2006, the value of future payments under PFI contracts is £100 billion (after discounting future payments by assumed nominal growth in national income of 5% a year). However, one key difference between these payments and the amounts owed to the holders of national debt is that in many cases these payments are in return for the receipt of future delivery of public service provision. Therefore a future government might well be able to negotiate a lower payment from the public purse in return for a reduction in services provided, in particular where these are for current rather than capital goods.

### ***Public sector pensions (estimated liabilities of £530 billion, March 2005)***

The future liabilities of unfunded public sector workers' pension schemes are not included in public sector net debt. Estimating the value of these liabilities is extremely difficult as it will

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<sup>21</sup> Capital spending financed through the PFI averaged 0.1% of national income a year under deals signed over the 10-year period from 1987 to 1996, but averaged 0.5% a year over deals signed during the 10 years from 1997 to 2006 (with the three London Underground Tube deals being particularly significant in terms of the contracted capital spend (£16.3 billion, 1.2% of national income).

depend on individuals' pension tenure, their final salaries, how their pension benefits are indexed and the longevity of public sector workers. Nonetheless, these liabilities appear to be substantial: the most recent official estimate is that at March 2005, they were worth £530 billion. The estimate of this liability is extremely sensitive to how future payments are discounted. Under these official estimates, calculated by the Government Actuary's Department, future payments are discounted at a rate of 3½% per year after inflation, but in future these will be discounted by a lower rate of 2.8% per year. Reducing the discount rate will increase the estimated liabilities, with a recent study projecting that this change would increase the liability from £530 billion to £639 billion.<sup>22</sup> Given that the state can use future national income to cover its liabilities, it would seem more appropriate to deflate by expected economic growth, which would be around 2½% a year and (since it is below 2.8%) would increase the estimated liabilities further. Other studies propose using the discount rate implied by government bonds, which is currently significantly below 2½% a year and would increase the estimated liability even further.<sup>23</sup>

One key difference between public sector pension liabilities and public sector net debt is that governments are able to reduce the generosity of the future accrual of public sector workers' pension rights, though this could have implications for other components of the remuneration package required to attract and retain public sector workers of the desired quality and motivation.

The treatment of public sector pensions also deserves more thought under the golden rule. On grounds of intergenerational fairness, it seems reasonable that today's taxpayers should pick up the tab for the future pension costs of workers employed to deliver current services today. Leaving aside the liability for longevity and other risks, this would happen automatically if public sector pension schemes were funded rather than pay-as-you-go. But as most are not, it seems reasonable that if the government increases the number of public sector workers (or increases their expected tenures or expected final salaries, both of which would increase the expected value of their final salary pension arrangements), it should run a current budget surplus on average so that the increased cost of pension payments faced by tomorrow's taxpayers is offset by lower debt interest payments.

Of course, in thinking about whether and how to set such a target, we have to remember that we are not starting with a blank sheet of paper – today's taxpayers are already paying the pensions of past public sector workers despite receiving no services from them. On these grounds, it might be thought reasonable to pass a similar burden onto future generations. So while it is true that today's public sector pension commitments are expected to cost 2.0% of national income in 2055–56, past public sector pension commitments were already costing

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<sup>22</sup> See table 11, page 72, of N. Record, *Sir Humphrey's Legacy Facing Up to the Cost of Public Sector Pensions*, Institute of Economic Affairs, 2006 (<http://www.iea.org.uk/files/upld-release114pdf?.pdf>).

<sup>23</sup> Deflating by expected GDP growth was proposed by J. Hawksworth, *Public Service Pension Liabilities and the Fiscal Rules*, PriceWaterhouseCoopers, London, 2006. Alternative estimates for public sector liabilities have made less optimistic (in terms of pension liabilities) assumptions over mortality improvements, salary growth and also the discount rate. For example, estimates produced by Neil Record and Stephen Yeo are that the liabilities stand at £1,025 billion and £960 billion respectively. The largest component of the difference between these estimates and those of the Government Actuary's Department is the chosen discount rate. See N. Record, *Sir Humphrey's Legacy: Facing Up to the Cost of Public Sector Pensions*, Institute of Economic Affairs, 2006 (<http://www.iea.org.uk/files/upld-release114pdf?.pdf>), and S. Yeo, 'Unfunded public sector pension liabilities now close to £1,000 billion', Watson Wyatt Press Release, 8 March 2006 (<http://www.watsonwyatt.com/news/press.asp?ID=15784>).

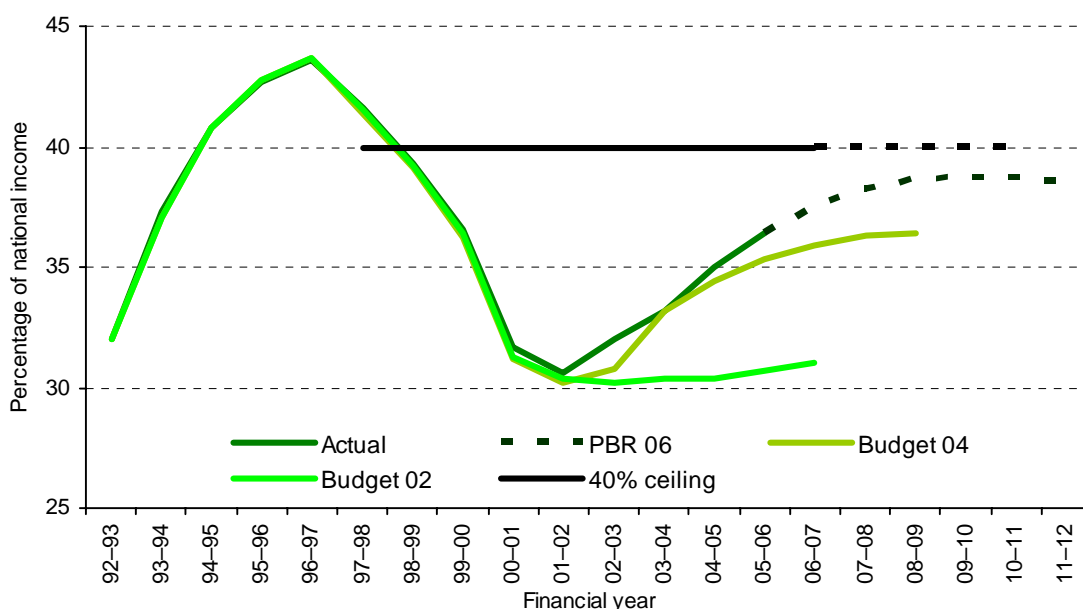
1.5% of national income in 2005–06.<sup>24</sup> It is the increase in the servicing burden over time that implies an additional intergenerational transfer, not the total debt burden.

Returning to the justification for the sustainable investment rule, we should presumably favour targeting a measure of public sector liabilities that reflects the expected impact of policy commitments made today on the revenue needs of governments tomorrow – not least because this is what investors in government debt will ultimately worry about. That suggests that we should not ignore commitments where the precise timing and amount of the revenue required in the future is uncertain, but rather take explicit account of the uncertainties in deciding what obligations are safe to undertake. The completion of the Whole of Government Accounts<sup>25</sup> would be a good opportunity for the incoming Chancellor to think about widening the scope of the existing sustainable investment rule at least to include provisions (including public sector pensions), and possibly the expected cost of contingent liabilities.

### The sustainable investment rule in practice

The same errors that have required the Chancellor to increase his forecasts of public sector borrowing repeatedly since 2001 have also required him to increase his forecasts for public sector net debt. As Figure 3.6 shows, the headroom beneath the 40% of national income ceiling over the forecast period has dropped from 9.0% of national income in the Budget 2002 forecasts to less than 1.5% in the December 2006 Pre-Budget Report. But the Treasury has only promised to keep the ratio below 40% in every year of the current cycle, so we do not know yet if the same will apply during the next cycle.

Figure 3.6. Treasury public sector net debt forecasts



Sources: Various Budgets and Pre-Budget Reports.

<sup>24</sup> Source: Table 5.1, page 40, of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2006 ([http://www.hm-treasury.gov.uk/pre\\_budget\\_report/prebud\\_pbr06/assoc\\_docs/prebud\\_pbr06\\_adlongterm.cfm](http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adlongterm.cfm)).

<sup>25</sup> For more information, see [www.wga.gov.uk](http://www.wga.gov.uk).

Table 3.4. Meeting the sustainable investment rule?

Financial year	Central estimate for net debt in PBR 2006	Probability net debt exceeds 40%
2007–08	38.2%	8%
2008–09	38.6%	32%
2009–10	38.7%	41%
2010–11	38.7%	44%

Notes: As Figure 2.8.

Sources: As Figure 2.8.

Applying the probability distribution implied by past Treasury forecasting performance to its central estimate in the Pre-Budget Report (see Section 2.6 of Chapter 2), we can derive the probabilities that net debt would, on unchanged policies, breach 40% in each of the next four years. These are shown in Table 3.4. Unless the Chancellor relaxes the sustainable investment rule in the next cycle, the Treasury's own forecasting abilities give him a less than 60% chance of sticking to it (without further spending cuts or tax increases) based on past performance. This suggests that the sustainable investment rule may now be more binding than the golden rule.

### 3.4 Reforming the rules: a golden opportunity?

Gordon Brown has transformed the machinery of macroeconomic policymaking in the UK – by giving the Bank of England control of interest rates in pursuit of an inflation target, and by setting himself two high-profile pass/fail tests for fiscal policy in the shape of the golden rule and sustainable investment rule. His monetary reforms are widely regarded as a triumph, while his fiscal reforms are regarded with scepticism at best and cynicism at worst.

Judging from the inflation expectations implicit in gilts prices, the Chancellor's monetary policy framework has convinced financial market participants that interest rates will be driven by the inflation target rather than by short-term political considerations. When it comes to fiscal policy, we do not have an objective measure of the credibility of the rules analogous to financial market inflation expectations. When government borrowing (and the supply of gilts) is expected to increase, we might expect the yield on government debt to increase as well and fulfil a similar function. But, as discussed in Chapter 4, other factors are at play and the relationship between the amounts industrial country governments borrow and the interest rates they pay has not been particularly close in recent years.

Economists outside government have little faith in the rules as a decisive factor determining Mr Brown's tax and spending decisions. In its New Year survey of the views of independent economists, the *Financial Times* concluded earlier this month that 'Almost none use the chancellor's fiscal rules any more as an indication of the health of the public finances'.<sup>26</sup>

This probably reflects the belief that the Chancellor has 'moved the goalposts' as downward revisions to his public finance forecasts eroded the margin by which he expected to meet the

<sup>26</sup> 'Cut spending to reduce borrowing', *Financial Times*, 2 January 2007 (<http://www.ft.com/cms/s/683400d2-9a05-11db-8b6d-0000779e2340.html>).

rules after 2001. Suspicions were raised initially when he changed the way in which he calculated the cumulative current budget surplus over the cycle in a way that gave a more flattering picture (although the Treasury claimed that the less flattering method was only a ‘shorthand’ for use in speeches). The most controversial decision was to add two years, during which there had been on average a net current budget surplus, to the beginning of the economic cycle at precisely the point when it became necessary to get the government back on course to meet the golden rule. The Chancellor’s decision repeatedly to delay the announcement of a fiscal tightening that most independent observers thought necessary until just after the 2005 election has also suggested that the rules have not depoliticised budget judgements to anything like the degree that the monetary policy framework has depoliticised interest rate decisions. The Treasury’s current reluctance to say whether the year in which the current economic cycle ends will also be counted as the first in the next cycle – which would be consistent with past practice, but would mean beginning the next cycle with the current budget in deficit by 0.6% of national income – risks further accusations of goalpost-moving.

On the face of it, this seems like a lot of fuss over nothing. As we saw in Section 3.2, the golden rule is at best a rule of thumb and there is little direct economic significance if it is met or missed by a few billion pounds either way. It can also be argued that the rules have acted as a constraint on tax and spending decisions – as we note in Chapter 2, Mr Brown is likely to leave the Treasury with the public finances in stronger shape than when he arrived there.

But Mr Brown has from the outset staked his credibility on achieving the rules exactly, creating conditions in which meeting them by £1 would be a political triumph and missing them by £1 a disaster. This approach did not look very risky four or five years ago, when the rules were expected to be met with tens of billions of pounds to spare. But the Chancellor has fallen victim to the characteristic serial correlation of the Treasury’s fiscal forecasting errors: things turned out better than expected early in the cycle, and Mr Brown used the proceeds to top up his spending plans; but when the forecasts took a turn for the worse, his room for manoeuvre evaporated and time ran out to take countervailing measures. It is between the Chancellor and his conscience whether he instructed the Treasury to add two years to the beginning of the cycle primarily because it appeared necessary to meet the golden rule. But there is a widespread suspicion that he did, and that he has preferred to affront fiscal aficionados by moving the goalposts in a way that will be obscure to the general public, rather than read headlines saying the rule has been broken. This suspicion has eroded credibility.

Whatever the reality, if the Treasury sticks with its current dates for the cycle, Mr Brown will presumably declare the golden rule successfully met over a full cycle when March’s public finance data are published on 23 April. This may leave close observers of the fiscal goalposts unimpressed, but the combination of this opportunity to declare ‘victory’ and the arrival of a new Chancellor later in the year may be a golden opportunity to tweak the fiscal framework for the better. This could legitimately be presented as adhering to the spirit of Mr Brown’s original vision, and indeed could be said to apply lessons learned from the widely hailed success of his monetary policy regime.

If so, what should be done?

- First, it seems reasonable to stick with the golden rule and sustainable investment rule as rules of thumb, but they should be presented as such rather than as an exact science. A new Chancellor might ponder a more sophisticated distinction between spending that

does and does not benefit future taxpayers, but the benefits may well not exceed the costs in terms of transparency and predictability from abandoning the familiar National Accounts distinction between current and capital spending. It may be more worthwhile to rethink the treatment of public sector pension liabilities, using the introduction of Whole of Government Accounts to widen the range of obligations to which the sustainable investment rule applies and to require today's taxpayers to finance the difference between the future costs of public sector pension commitments that arise simply because they wish to consume more current spending today and the public sector pensions being paid by today's taxpayers for services delivered to previous generations.

- Second, like the inflation target, the golden rule should be made symmetric, requiring the government to pursue a point target for the current budget balance rather than 'balance or surplus'. Symmetry seems a more appropriate way to pursue intergenerational fairness. And it also avoids the problem of the Chancellor needing to decide – implicitly or explicitly – what safety margin to aim for to give an acceptable probability of falling the right side of the pass/fail line.
- Third, the Treasury should present its forecasts for the fiscal aggregates in such a way that they explicitly quantify the uncertainties around the central estimate – for example, with a 'fan chart' similar to that which the Bank places around its inflation target. The baseline forecast should also be a genuinely 'central' forecast, rather than one based on 'cautious' economic assumptions that inject deliberate bias.
- Fourth, the Treasury should no longer seek to meet the golden rule over a specific dated economic cycle. Instead, it should say that it is aiming for a target level for the total or cyclically adjusted current budget balance over an appropriate time horizon. (The former has the added attraction of avoiding the need to calculate an estimate of the output gap that may be suspected of political manipulation.) It can be argued that the Treasury has in effect been doing this implicitly in recent years, with a rolling target (now being missed) to achieve a current budget surplus of around 0.7% of national income after five years.

Table 3.5. Cycles and Chancellorships

	Mean length (years)	Median length (years)
<b>Chancellors of the 20<sup>th</sup> century</b>		
Years as Chancellor		
Excluding Mr Brown	2.83	2.38
Including Mr Brown	3.02	2.42
Years as Chancellor plus consecutive period as Prime Minister (where applicable)	3.45	2.54
<b>Economic cycles</b>		
HM Treasury estimate (1972Q4 – 2007Q1)	8.56	9.13
Morgan Stanley (2005) estimate (1957Q2 – 2004Q1)	6.75	7.00

Notes: All figures for lengths of Chancellorships exclude Iain Macleod's Chancellorship as he died after just one month in office. Morgan Stanley estimates of business-cycle lengths since 1957 are based on detrending using an HP filter with  $\lambda = 1,600$ .

Source: Table 3.5 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS Commentary 97, 2005; authors' calculations.



The use of a fixed, dated cycle means that policy is unnecessarily and unhelpfully backward-looking, with tax and spending decisions today in principle depending on past policy and forecast errors and on changing assessments of the start date of the cycle, rather than on the most appropriate path looking forward. It is also worth bearing in mind that Mr Brown's Chancellorship has been unusually long and that in more normal circumstances it may not be particularly convincing to promise to meet a rule over a period typically lasting seven or more years when most Chancellors spend less than three years in the job and four-year parliaments seem to have become the norm (Table 3.5). Interestingly, before Mr Brown, Dennis Healey is the only Chancellor in the last 50 years to have served for a full cycle.

- Fifth, if possible, an independent body or bodies should be given access to the same information on the evolution of spending and tax revenues that the Treasury receives to make forecasts of fiscal aggregates. The Treasury has long argued that this would be impossible, and there are certainly serious legal issues of taxpayer confidentiality that would need to be addressed. However, it would be helpful for the Treasury or for the Treasury Select Committee to ask former senior officials of the Treasury and HM Revenue & Customs to assess independently whether this would be possible and how it might be achieved. One model would be for an official forecasting body to be responsible to Parliament rather than to ministers. The Treasury might even agree to abide by the net fiscal policy adjustment recommended by this body to achieve the fiscal targets that would appropriately still be set by the government.

The argument is not that reforms of this sort would necessarily produce more accurate forecasts, but that it would reassure voters and investors that the forecasts were not being massaged to delay politically inconvenient policy adjustments. This would also leave the choice of individual tax and spending decisions – and the political trade-offs they involve – with ministers, where they belong. At the very least, the Treasury could continue to enhance transparency further by publishing a more in-depth explanation of the assumptions that underpin its revenue and spending projections.