4. The fiscal targets[1]

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Summary

- The Chancellor, George Osborne, has committed to complying with two fiscal targets, which constrain fiscal policy. The fiscal mandate states that the structural current budget must be forecast to be in balance or in surplus by the end of the rolling, five-year forecast horizon. The supplementary target states that public sector net debt as a share of national income should be falling at a fixed date of 2015–16.
- The latest forecasts from the Office for Budget Responsibility (OBR) show that Mr Osborne is complying with the fiscal mandate but the date at which the structural current budget is expected to return to surplus has been pushed back yet again.
- The fiscal mandate has much to recommend it and is preferable to the European Union's requirement to keep the deficit below 3% of GDP in every year. It constrains the government over the medium term to borrow only to finance investment spending, while allowing the flexibility to provide short-term stimulus in periods when the economy is underperforming and giving time for fiscal policy to adjust to shocks. But the role of the OBR and other independent commentators is crucial in ensuring that these flexibilities are not abused.
- The OBR's latest central forecast is that Mr Osborne is now on course to miss his supplementary target. However, since meeting the target would do little to ensure the sustainability of the UK's public finances, the fact that it looks set to be missed should not, on its own, cause significant concern about fiscal sustainability.
- Now would be a good time for Mr Osborne to consult on a better replacement for this rule, to complement the fiscal mandate. A rule that either targeted the total level of public debt (along the lines of the EU's debt ceiling) or in some way limited the fraction of future tax revenues that have been precommitted to meeting liabilities accrued by the current and previous governments would be better able to ensure long-run sustainability than the supplementary target.
- The Fiscal Responsibility Act 2010, legislated by the last Labour government, imposed legally binding constraints on borrowing and debt. Had the current government not repealed the Act, Mr Osborne would next year have more likely than not faced legal sanctions for failing to meet one of the Act's three provisions (that borrowing in 2013–14 should be half its 2009–10 level) – unless he were willing to announce tax increases or spending cuts of at least a further 0.5% of national income (£8 billion in today's terms) to be implemented next year.

[1] The Green Budget 2013 is funded by the Nuffield Foundation

4.1 Introduction

This year, public spending will exceed revenues by around 7.7% of national income (£120 billion). Borrowing at this level could not be sustained indefinitely by the UK economy. If the latest official estimates are correct, temporary economic weakness explains only a small part (2.1% of national income) of this gap.[2] Dealing with the structural deficit will require painful tax and spending choices, which will doubtless be politically difficult to implement. It can, therefore, be advantageous for politicians to tie their own hands somewhat – and, by doing so, possibly buy themselves valuable credibility with both voters and potential purchasers of UK government debt – by pledging to adhere to a set of fiscal goals that are consistent with long-run fiscal sustainability.

Such a strategy was employed by the last Labour government on coming to power in 1997. The then Chancellor Gordon Brown committed to complying with two fiscal rules – the golden rule and the sustainable investment rule – in part to convince voters that he would not repeat the perceived failings of previous Labour Chancellors. The golden rule stated that, over an economic cycle, total government receipts should equal or exceed total non-investment spending or, in other words, total government borrowing over an economic cycle should not exceed the amount spent on investment. The sustainable investment rule stated that public sector net debt should be kept below 40% of national income, which was slightly below the level Labour had inherited from the last Conservative government.[3]

The financial crisis and associated recession illustrated the limitations of such rules; in particular, they highlighted that rules that might be good guiding rules-of-thumb in most situations should sometimes be abandoned rather than slavishly adhered to. The damage done to the public finances by the financial crisis meant that it would barely have been possible – and certainly not sensible – to comply with either of the fiscal rules[4] that were in place in 2007 and so the previous government decided to 'depart temporarily from the fiscal rules'.[5] After this, it passed the Fiscal Responsibility Act in 2010, which imposed legally binding constraints on fiscal policy. Specifically, this Act stated that the Treasury must ensure that:

1. For each of the financial years ending in 2011 to 2016, public sector net borrowing expressed as a percentage of gross domestic product is less than it was for the preceding financial year.

[2] Although there is disagreement among independent forecasters about exactly how much of current public borrowing levels can be accounted for by purely temporary factors, most independent forecasts suggest a level of structural borrowing in the UK this year that could not be sustained indefinitely – see Chapters 2 and 5 for discussion of three alternative scenarios for the macroeconomy and public finances.

[3] A longer discussion of Mr Brown's fiscal rules, their strengths and weaknesses, and his success at complying with them is provided by R. Chote, C. Emmerson and G. Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, IFS Commentary 107, 2009 (http://www.ifs.org.uk/budgets/gb2009/09chap5.pdf).

[4] The Treasury's estimates of the output gap in 2008 indicated that an economic cycle ended and a new one began in the second half of 2006. Consequently, the 'upswing' of the new cycle (over which the golden rule would have to have been judged) would have run from late 2006 to early 2008, before a downswing that now looks set to last until at least 2018. Since the previous government had run current budget deficits throughout 2006 and 2007, the only way to comply with the golden rule would have been to run surpluses throughout the 'downswing' of the cycle.

[5] Paragraph 1.12 of HM Treasury, *Pre-Budget Report: November 2008*, Cm 7484 (http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

2. For the financial year ending in 2014, public sector net borrowing expressed as a percentage of gross domestic product is no more than half of what it was for the financial year ending in 2010. [The Treasury's forecast at the time of the March 2010 Budget was that public sector net borrowing (PSNB) would be 11.8% of national income in 2009–10, implying that borrowing would need to be reduced to 5.9% by the financial year ending in 2014.[6]]
3. Public sector net debt as at the end of the financial year ending in 2016 expressed as a percentage of gross domestic product (centred on 31 March 2016), is less than public sector net debt as at the end of the previous financial year expressed as a percentage of gross domestic product (centred on 31 March 2015).[7]

In addition to this, the government put before Parliament an additional Fiscal Responsibility Order, which imposed a more stringent limit (of 5.5% of national income) on borrowing in 2013–14 than was implied by the Fiscal Responsibility Act.[8]

These rules made no allowance for any temporary weakness resulting from a prolonged period of below-trend growth or a double-dip recession. Had the current government not repealed the Act on coming to power, it would have been required to implement an additional 0.5% of national income (or £8 billion in today's terms) of tax rises or spending cuts in the coming financial year, based on the latest forecasts from the Office for Budget Responsibility (OBR) for public borrowing.[9] This would be a significant fiscal tightening on top of the 1.1% of national income (or £17.5 billion) already planned for next year. Assuming the OBR's forecast is unbiased, this would still only give the Chancellor a 50:50 chance of not breaking the law. However, quite what the legal sanction on George Osborne for doing so would have been is hard to envisage.

Having repealed the Fiscal Responsibility Act, the coalition government replaced it with two fiscal targets:

- **fiscal mandate**: the structural current budget must be forecast to be in balance or in surplus by the end of the rolling, five-year forecast horizon;
- **supplementary target**: public sector net debt as a share of national income should be falling at a fixed date of 2015–16.

While the supplementary target – which the Chancellor is currently on course to miss – is identical to the third provision of the Fiscal Responsibility Act, the fiscal mandate is different; in particular, it provides much greater flexibility in the conduct of fiscal policy than the first two provisions of the Fiscal Responsibility Act would have. This more flexible fiscal framework has been accompanied by the introduction of the Office for Budget Responsibility. The OBR is an independent body that produces the UK's official economic and public finance forecasts, making use of full access to government data on tax revenues and spending. This set-up is intended to remove the possibility of politically motivated wishful thinking being introduced into official economic and fiscal forecasts.

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[6] HM Treasury, *Budget 2010*, March 2010 (http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/budget2010.htm).

[7] Fiscal Responsibility Act 2010 (http://www.legislation.gov.uk/ukpga/2010/3/section/1).

[8] Fiscal Responsibility Order 2010 (http://www.legislation.gov.uk/ukdsi/2010/9780111497418).

[9] This figure is calculated using the headline measures of borrowing in 2009–10 and 2013–14. If we instead adjust for the impact of the reclassification of the Asset Purchase Facility, Bradford & Bingley, and Northern Rock Asset Management, then additional tax rises or spending cuts amounting to 1.3% of national income (or £20 billion in today's terms) would be required in the coming financial year.

The OBR also has a remit to assess the government's compliance with the fiscal mandate and supplementary target and the long-run sustainability of the public finances and also to provide scrutiny of the official costings of budget measures.

Since 1997, the UK government has also – in theory, at least – been required to meet the fiscal objectives set out in the European Union's Stability and Growth Pact. These rules state that the government's deficit (specifically, the general government deficit) should not exceed 3% of national income and that debt (specifically, the gross debt of general government) should not exceed 60% of national income.

This chapter describes and assesses the UK's existing fiscal targets and suggests how they could be improved to help ensure long-run sustainability. We start by describing in more detail each of the fiscal rules that currently apply to the UK – the Chancellor's targets (in Section 4.2) and the Stability and Growth Pact commitments (in Section 4.3) – and the UK's current level of compliance with these. In light of general good principles of fiscal management (described in Section 4.4), we then discuss the merits and drawbacks of the Chancellor's fiscal targets (in Section 4.5). While the fiscal mandate has much to recommend it, the supplementary target has considerable weaknesses; in Section 4.6, we discuss what a better replacement for the latter might look like. Section 4.7 concludes.

4.2 The Chancellor's fiscal targets

Fiscal mandate

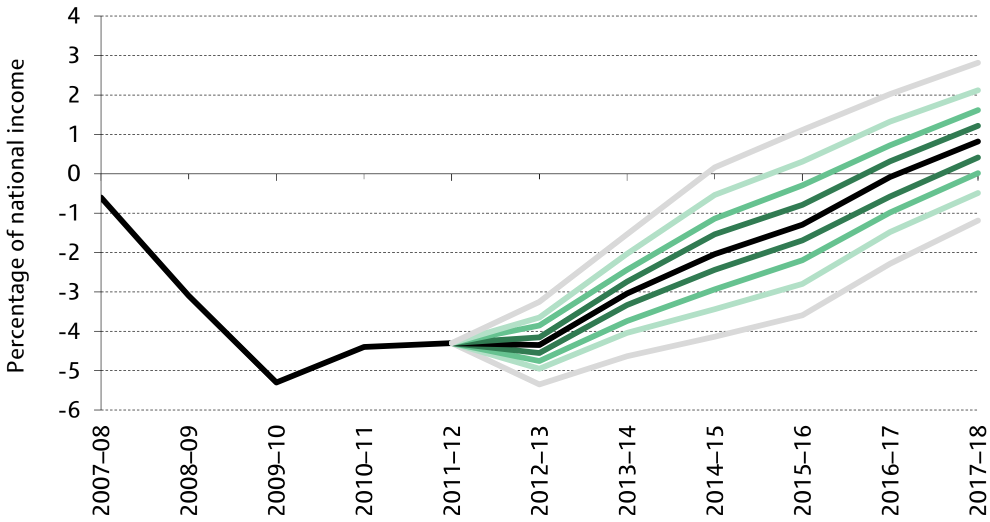
The Chancellor's first (and main) fiscal target is known as the fiscal mandate. The fiscal mandate states that the structural current budget must be forecast to be in balance or surplus by the end of the rolling, five-year forecast horizon. In other words, after taking into account the estimated impact of the ups-and-downs of the economic cycle on the public finances, government receipts should be projected to be equal to or greater than government non-investment spending.

At the time of the June 2010 Budget, the OBR's forecasts suggested that – if the government implemented all the policies that had been announced at that point – the structural current budget would reach a surplus of 0.3% of national income by 2014–15, one year before the end of the forecast horizon at that point. Since then, there has been further adverse economic news (in particular in the Autumn Statement of 2011 and the Autumn Statement of 2012) and the OBR's latest forecasts (from December 2012) now suggest that the structural current budget will not be back in balance until 2016–17, and only then because Mr Osborne has announced 2.4% of national income (or £38 billion in today's terms) of additional permanent tax increases and spending cuts since June 2010. But, since the five-year forecast horizon now extends to 2017–18 – by when the OBR is projecting a surplus on the structural current budget of 0.9% of national income – the fiscal mandate is being met.

The headline measure of the structural current budget that the OBR published in December 2012 was for a surplus of 0.4% of national income in 2016–17 – one year earlier than required by the mandate. However, this figure is flattered by the reclassification of a number of financial transactions that the OBR included for the first time in December – specifically, the transfer of the Asset Purchase Facility from the Bank of England to the Treasury and the reclassification of Bradford & Bingley and Northern Rock Asset Management to the public sector. Without these reclassifications, the structural current budget would be forecast still to be in deficit in 2016–17 (before returning to surplus in 2017–18).[10] Since the long-term strength of the public finances is not improved by these reclassifications,[11] if the Chancellor has not changed his view about the appropriate underlying fiscal stance, he should continue to aim to meet his fiscal mandate using a measure of the fiscal aggregates that excludes these classification changes. Therefore, in this chapter (except where explicitly noted), we cite figures for fiscal aggregates that exclude the impact of these classification changes.

Forecasting borrowing is – even in the best of times (which these certainly are not) – a difficult business. Figure 4.1 shows some indication of the degree of uncertainty around the OBR's latest central forecast (the black line). Based on past forecast accuracy, there is a 20% chance that the outcome will lie within the darkest green lines, a 40% chance that the outcome will lie within the next darkest bands, and so on. There is, therefore, about a 30% chance that the cyclically-adjusted current budget will actually be in deficit in 2017–18, assuming the OBR's latest forecast is as accurate as previous official forecasts have been over the last 30 years. However, on this basis, there is also a 30% chance that the surplus could be twice as large as currently forecast. Of course, past forecast errors may not be a good guide to the degree of uncertainty around the OBR's latest forecast. On the one hand, the current climate may be even more uncertain than normal – Chapter 5 discusses some specific risks facing the UK's public finances over the next few years. On the other hand, the OBR might be more accurate at forecasting the public finances than the Treasury was in the past.

Figure 4.1. Cyclically-adjusted current budget fan chart



Note: Figures shown exclude the impact of reclassifying on the public balance sheet Northern Rock Asset Management and Bradford & Bingley, as well as the financial transactions relating to the Asset Purchase Facility.
Source: Authors' calculations using chart 5.1 of OBR, *Economic and Fiscal Outlook*, December 2012, Cm 8481 (http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf).

[10] Paragraph 5.8 of OBR, *Economic and Fiscal Outlook*, December 2012, Cm 8481 (http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf).

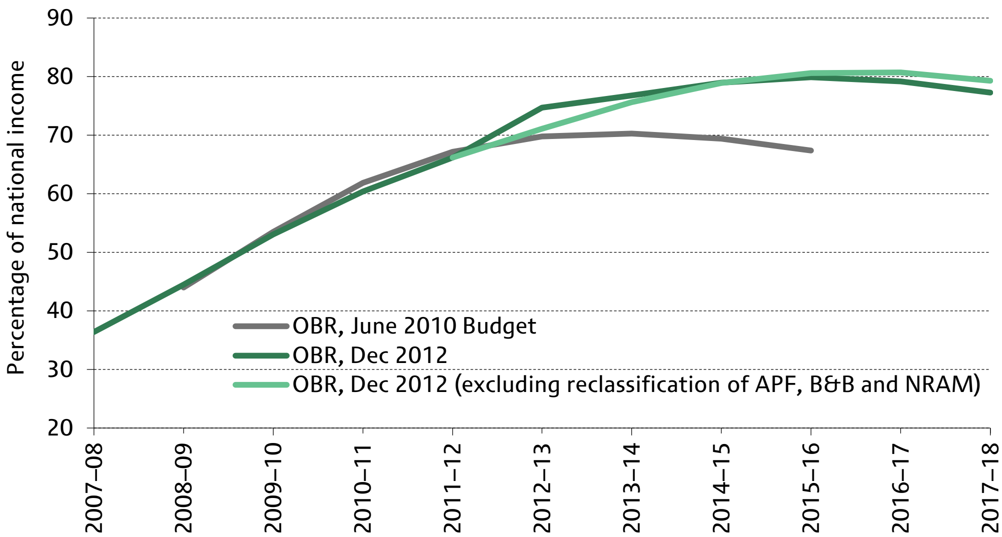
[11] For a full description of the impact on the UK's public finances in the short and long runs of the transfer of the Asset Purchase Facility from the Bank of England to the Treasury, see pages 101–106 of OBR, *Economic and Fiscal Outlook*, December 2012, Cm 8481 (http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf).

Supplementary target

The Chancellor's second fiscal target is known as the supplementary target and requires that public sector net debt as a share of national income should be falling at a fixed date of 2015–16.

At the time of the June 2010 Budget, the OBR's forecasts suggested that public sector net debt would actually start falling one year earlier – in 2014–15 – and would decline by 2.0% of national income between 2014–15 and 2015–16 (from 69.4% to 67.4%), as shown in Figure 4.2. However, since then, adverse economic developments have caused the OBR to revise up its forecasts for borrowing over the short and medium terms. As a result, the latest OBR forecasts, from December 2012, suggest that the Chancellor is on course to miss his supplementary target. The official forecast for headline public sector net debt is now that it will rise by 0.9% of national income (from 79.0% to 79.9%) in 2015–16. This is shown in Figure 4.2. If we strip out the impact of the reclassification of financial transactions, public sector net debt would instead be forecast to rise by even more over this period – from 78.9% to 80.6% of national income. On this basis, public sector net debt is not set to fall as a share of national income until 2017–18.

Figure 4.2. Debt not currently forecast to fall in 2015–16



Note: Figures for debt excluding the reclassification of the Asset Purchase Facility (APF), Bradford & Bingley (B&B) and Northern Rock Asset Management (NRAM) are authors' calculations using figures produced by the OBR.
Source: Authors' calculations using tables 4.4, 4.17, 4.26, 4.32 and 5.1 and box 4.1 of OBR, *Economic and Fiscal Outlook*, December 2012, Cm 8481 (http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf). Table C1 of HM Treasury, *Budget 2010*, June 2010 (http://cdn.hm-treasury.gov.uk/junebudget_complete.pdf). ONS series HF6X.

This raises the obvious question of whether it matters that the Chancellor is now on course to miss his supplementary target. There are three parts to the answer to this question:

- **Six of one, half a dozen of the other?** The supplementary target has not yet been missed. Given the significant uncertainty surrounding any forecasts for public borrowing and thus public debt (as discussed above), there is a non-trivial (although, assuming the OBR's forecasts are unbiased, less than 50%) chance that debt will actually be lower in 2015–16 than in 2014–15, even though the OBR's current central forecast is that it will be higher. Conversely, at the time of the March Budget, there was a slightly more than 50% chance of this outcome. A lot can happen in three years and there is a persuasive argument that – all other things being equal – we might want to wait and see how the economy develops before announcing hasty action now to try to restore a greater than 50% chance of meeting the target. Whether the supplementary target has been met will not be known until finalised data on debt as a share of national income in 2015–16 are available (the initial estimates of which will not be known until after September 2016).

- **A miss is as good as a mile?** However, all else might not be equal. One reason that the Chancellor has pledged to meet his fiscal targets is because he believes they buy him credibility with the UK government's creditors, which translates into lower borrowing costs. If his choice to remain on a course that suggests he will miss a target were to damage the perceived credibility of his commitment to fiscal sustainability, this could have real costs to the UK economy by increasing our cost of borrowing.
- **Not worth the paper it is written on?** But should the government's creditors really be concerned that it might miss the supplementary target or, equivalently, be reassured by a belief that it would be met? This is the most important element of the answer to the question we posed above. Although the supplementary target is clear, transparent and (in 2016) compliance will be easy to measure, it actually has little to recommend it in terms of ensuring long-run sustainability of the public finances, which is presumably what ought to concern potential creditors. Section 4.5 discusses the advantages and disadvantages of the supplementary target in more detail.

4.3 Ensuring fiscal sustainability in Europe? The Stability and Growth Pact

The UK government is also – in theory, at least – constrained by the fiscal objectives set out in the Stability and Growth Pact (SGP), signed by all European Union member states in 1997. The current law requires signatories to adhere to two fiscal rules:

- **deficit rule**: countries must deal with normal cyclical fluctuations while keeping the government deficit below 3% of national income;[12]
- **debt rule**: the ratio of government debt to national income must not exceed 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.[13]

The definitions of deficit and debt referred to by the SGP are narrower than those typically used to examine the health of the public finances in the UK: both relate to general government rather than the whole of the public sector (i.e. they ignore any

[12] Resolution of the European Council on the Stability and Growth Pact Amsterdam, 17 June 1997, *Official Journal C 236, 02/08/1997 P. 0001 - 0002* (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31997Y0802(01):EN:HTML).

[13] Consolidated version of the Treaty on the Functioning of the European Union – Part Three: Union Policies and Internal Actions – Title VIII: Economic and Monetary Policy – Chapter 1: Economic policy – Article 126 (ex Article 104 TEC), *OJ C 115, 9.5.2008, p. 99–102* (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008E126:EN:NOT). Consolidated version of the Treaty on European Union – Protocols – Protocol (No 12) on the excessive deficit procedure, *Official Journal 115, 09/05/2008 P. 0279 - 0280* (http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:12008M/PRO/12:EN:HTML).

borrowing or debts of public corporations) and the debt rule focuses on a measure of gross rather than net debt (i.e. it does not take into account as large a range of financial assets held by a government as public sector net debt). Not taking into account these short-term financial assets means that, for the UK, the narrower measure of debt targeted by the EU is higher than the broader measure of debt targeted by Mr Osborne (and previously Mr Brown).

Eurozone member countries that breach these rules can, in theory, face financial penalties and be required to comply with a programme of fiscal consolidation determined by the European Commission.[14] Countries that are signatories to the SGP but are not members of the eurozone (such as the UK) do not face financial penalties but can receive a judgment against them from the Commission if they fail to comply with the rules.

Deficit rule

In practice, the financial sanctions allowed for in the SGP have never been imposed – despite the fact that, even before the financial crisis, numerous countries had breached the 3% deficit ceiling. For example, Germany and France both exceeded the 3% limit in 2002, 2003 and 2004 and, although they were subject to excessive deficit procedures (EDPs), the time limits for correction were repeatedly extended until the problems were eventually corrected.[15] In total, out of 27 EU countries, only Estonia, Luxembourg and Sweden have never had an EDP launched against them, while the UK had an EDP in 2006 and has been subject to a second one since 2008. So it is far from clear whether the financial penalties have any impact as a deterrent.[16]

To some extent, this illustrates the problems associated with a supra-national entity such as the EU imposing and policing such limits on nation states. But these issues are not so dissimilar from those faced by the UK in isolation. Fiscal rules will never be kept to in all possible circumstances and so creating a combination of sufficient credibility alongside sufficient flexibility is an ongoing challenge for any such regime.

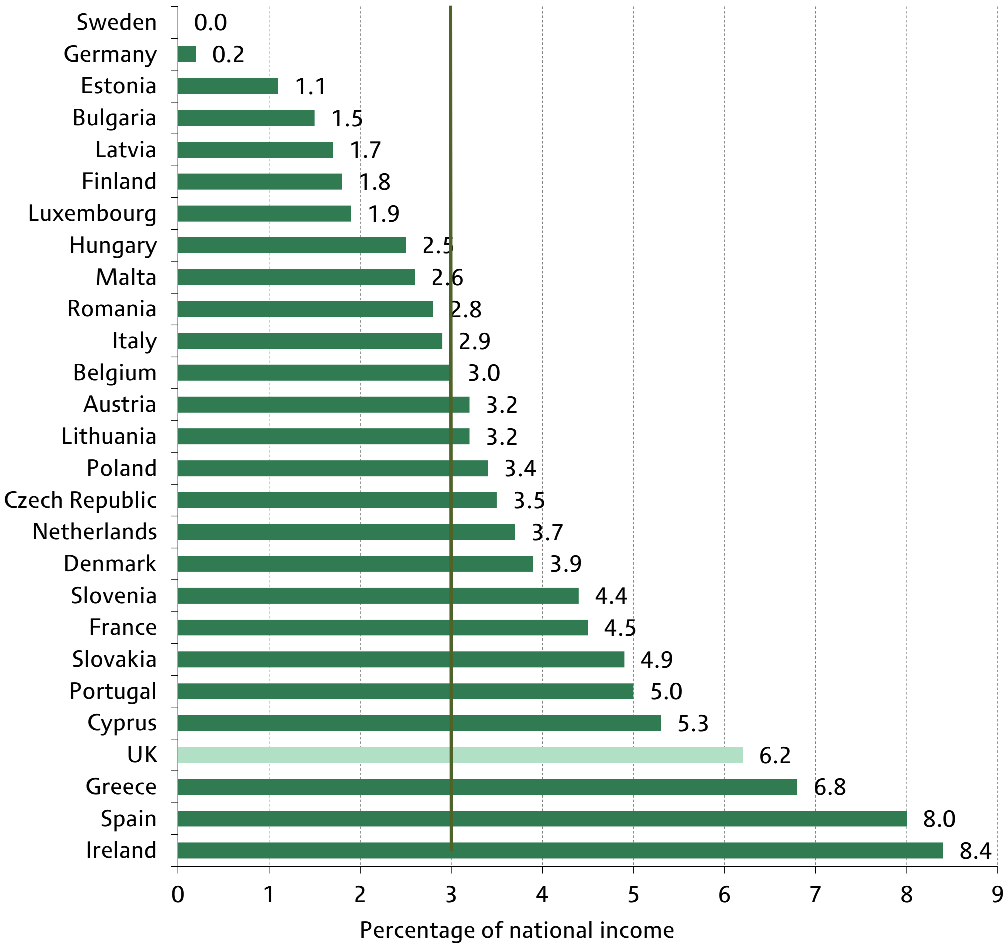
In 2012, as shown in Figure 4.3, 15 of the 27 EU countries had deficits exceeding 3% of national income, including the UK. Currently, most of these 15 EU member states – the exceptions are Greece, Ireland, Portugal, Spain and the UK – have been asked to return their deficits below 3% of national income by 2013 at the latest. While the latest forecasts suggest that not all countries are on course to comply with this programme, most look set either to achieve it or to come very close.

[14] Countries that are subject to an 'excessive deficit procedure' after breaching either of the limits can be fined a flat rate of 0.2% of national income, plus an amount equal to one-tenth of the difference between 3% and the actual level of their deficit as a share of national income (subject to an annual cap of 0.5% of national income). These fines are held in an account and returned to the country after the excessive deficit or debt problem has been 'corrected'.

[15] Council Decision of 5 June 2007 abrogating Decision 2003/89/EC on the existence of an excessive deficit in Germany (2007/490/EC), http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-12_council/2007-06-05_de_104-12_council_en.pdf. Council Decision of 30 January 2007 abrogating Decision 2003/487/EC on the existence of an excessive deficit in France (2007/154/EC), http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/30_edps/104-12_council/2007-01-30_fr_104-12_council_en.pdf.

[16] The 2011 amendment to the Stability and Growth Pact aimed to strengthen financial sanctions, by introducing 'Reverse Qualified Majority Voting', making it more difficult to overturn financial sanctions. It remains to be seen whether these would actually be used and whether they will act as a more effective deterrent.

Figure 4.3. Deficits across Europe in 2012



Note: Figures shown are for general government net borrowing.
Source: European Commission, *General Government Data: General Government Revenue, Expenditure, Balances and Gross Debt*, 2012 (http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/documents/2012/autumn2012_series_en.pdf).

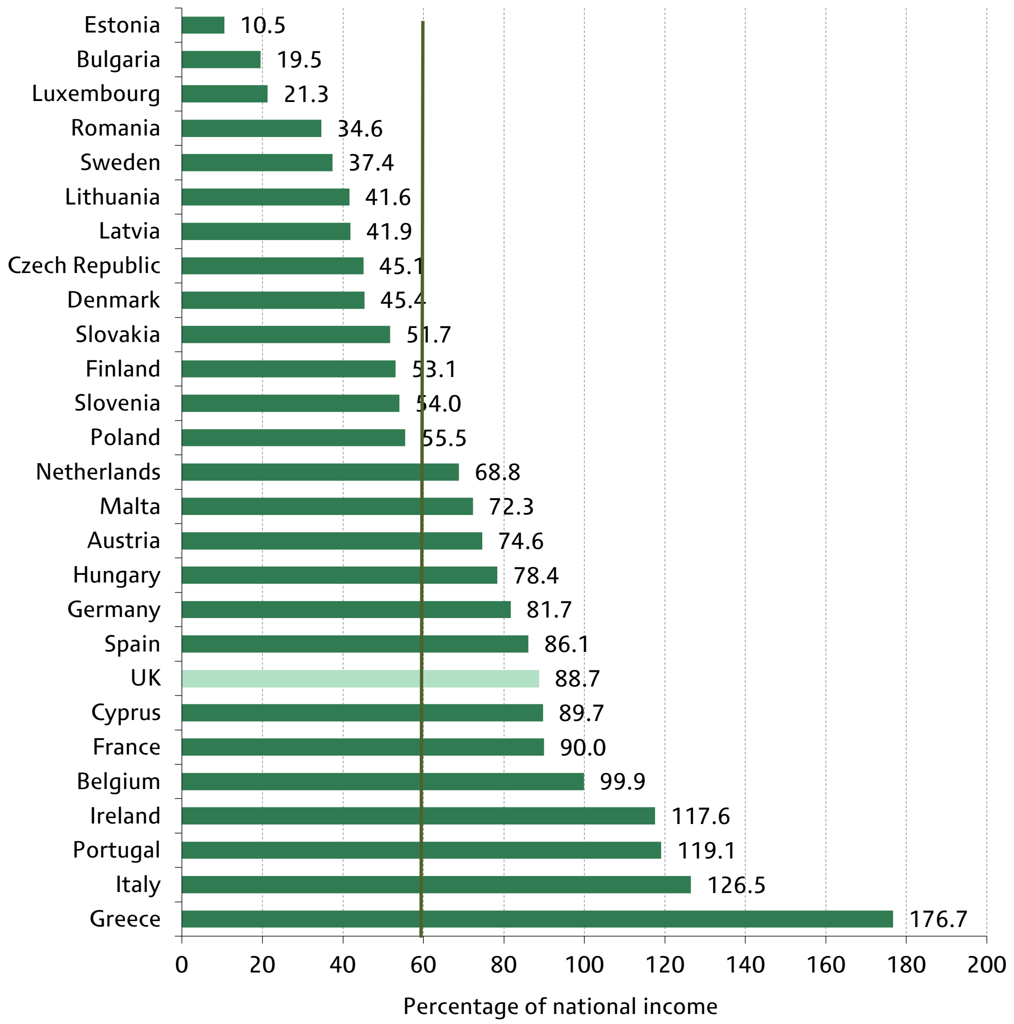
The European Commission has set out a plan for the UK that requires us to reduce our deficit to below 3% by 2014–15. However, these European targets have not appeared, and do not appear, significantly to constrain UK governments' behaviour. For example, the OBR's latest official forecasts are that the UK's deficit (measured using the Maastricht Treaty definition) will be 6.2% of national income in 2013–14, falling to 5.3% in 2014–15 and then to 2.8% by 2016–17. In other words, we are on course to fail to comply with the Commission's excessive deficit procedure and to do so by a reasonable distance.

Debt rule

The Treaty on Stability, Coordination and Governance – signed by all EU countries except the UK in March 2012 – states that, if a country's debt exceeds 60% of national income, it is required to reduce debt as a share of national income each year by an average of at least one-twentieth of the gap between the actual debt level when the EDP is launched and the 60% ceiling. If signing countries fail to comply with this, the European Court of Justice can impose a fine of 0.1% of national income.[17]

The UK is currently on course to have debt remaining well above the 60% target level for the foreseeable future. The OBR's latest forecast is that the Treaty definition of debt will be 90.3% of national income in 2012–13, rising to 97.4% by 2015–16 before beginning to fall. Figure 4.4 shows that, in 2012, the UK had the 8th highest level of debt in the EU.

Figure 4.4. Debt across Europe in 2012



Note: Figures shown are for general government consolidated gross debt.
Source: European Commission, *General Government Data: General Government Revenue, Expenditure, Balances and Gross Debt*, 2012 (http://ec.europa.eu/economy_finance/db_indicators/gen_gov_data/documents/2012/autumn2012_series_en.pdf).

Summary

While the Chancellor has demonstrated his willingness to announce fiscal policies that enable him to meet his own fiscal mandate, he appears to place little weight (just as Mr Brown did) on the potential reputational cost of missing the European targets. So, in

[17] Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, 2012, http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf.

practice, this second set of fiscal objectives – policed by the European Commission – seems to have little impact on the stance of fiscal policy in the UK. At least in part this can be justified by the fact that the European rules (in particular, the deficit rule) are poorly designed for the UK.

4.4 Principles of good fiscal management

The Chancellor has placed considerable store by his fiscal targets as statements and indicators of his commitment to restoring the long-run sustainability of the UK's public finances. But how appropriate are the Chancellor's rules and the wider fiscal framework (including the existence and role of the OBR) in fulfilling the objective of restoring long-run fiscal sustainability? This section sets out some general principles of good fiscal management (and some barriers to achieving this in practice) before the next section examines the Chancellor's current rules in this light.

There are clear advantages to having a low level of public sector net debt. Most obviously, it means that less national income needs to be devoted to financing that debt and the strength of the public finances is less dependent on the rate of interest at which the government can borrow. Having a low level of debt also increases the scope for an economy to increase its debt dramatically in the event of a large adverse shock, as the UK did during the Second World War and the recent financial crisis.

In principle, there are also a number of additional circumstances in which it may be advantageous to an economy for its government to borrow rather than to balance its books in every year. Understanding these circumstances is key to understanding what good fiscal objectives should look like. Broadly speaking, there are at least five legitimate reasons for governments to borrow:

1. **Investment spending**: The benefits of many forms of investment spending are spread across time – for example, a new road will deliver benefits to future generations and not just to the one that built it. It therefore seems fair that the cost should also be spread over current and future generations by borrowing money to cover some of the initial construction costs and thus requiring future generations to service this debt.
2. **Output stabilisation**: There will inevitably be times when shocks hit the economy, temporarily affecting tax revenues and/or placing demands on spending. The level of government borrowing should be able to respond to these output shocks in order to help stabilise the macroeconomy. For example, during a recession, it is likely to be advantageous for the government to be able to run a deficit in order to help stimulate the economy, rather than attempting to balance its books immediately, which would risk worsening the recession. (Conversely, during a temporary boom, the government may want to accrue a surplus in order to somewhat dampen an overheated economy.) This argument is particularly strong when the role of monetary policy is limited – for example, if nominal interest rates are close to zero or if the exchange rate is fixed and therefore unable to depreciate.
3. **Adjusting gradually to shocks**: When a fiscal adjustment does need to be made – for example, due to a revised outlook for the economy – it makes sense to adjust taxes and spending gradually rather than to make changes immediately. First, quick adjustments might have unwanted impacts on aggregate demand in the economy, which changes to monetary policy are unable to offset. Second, making changes too

quickly might lead to less efficient changes being made than would be possible over a longer timescale.

4. **Forecast errors**: Forecasts for total public spending and total taxes are subject to considerable uncertainty, even in the short run. However, if forecasts are unbiased, forecast errors should balance out over time. In such a situation, governments should be able to borrow in years that turn out to be worse than expected and repay debt in the unexpectedly good years.
5. **Tax rate smoothing**: Economic theory suggests that smoothing tax rates over time is better for welfare than having tax rates that change over time (for example, in order to smooth tax revenues). Reducing variation in tax rates over time might also help individuals making (in particular) saving and investment decisions.

These reasons suggest that – other things being equal – we would certainly not want to constrain a government to balancing its books in each and every year. However, we might also want to ensure the following:

1. In periods of economic stability, spending that benefits only the current generation should be covered by tax revenues paid by the current generation.
2. If borrowing rises during periods of temporary economic weakness, it should fall again once the problems have passed. If the economy experiences an unsustainable boom, the government should save the additional revenues.
3. Although borrowing to fund investment spending or to provide temporary support to the economy can be justified, there should be a limit on how much of future taxpayers' money we precommit to meeting these debt repayment obligations. Future generations may have different priorities from those we impose upon them.
4. If the time profiles of an economy's production capabilities and consumption needs differ substantially from one another – for example, because of demographic transitions or the exploitation of finite natural resources – governments might also want to consider explicitly pre-funding future high consumption needs or explicitly allowing borrowing to be higher in the short term, with the intention of running surpluses later on, if they anticipate revenue-raising capacity increasing in future.

Politicians might also be tempted (or pressured) to borrow for less appropriate reasons – such as to fund additional short-term spending promises in their priority areas or to offer tax cuts to favoured groups. That is why it can be useful for governments to tie their own hands by imposing fiscal targets, which attempt to ensure that they operate the public finances in a way that is good for the economy in the long run. The principles discussed above imply that both the annual flow of new borrowing and the accumulated stock of debt need to be considered when assessing the appropriateness of fiscal policy; politicians may want to consider complementary rules that govern each of these.

Such rules range along a spectrum from simple ones that impose tight constraints on government borrowing but allow little flexibility to accommodate the good motives for borrowing, to more flexible rules that allow a greater role for discretion to be used sensibly but also run the risk of being open to inappropriate manipulation. The broader fiscal framework and political context in which a country operates will be important in determining what sorts of fiscal targets are implementable and most appropriate. For example, a country that publishes detailed, transparent information on the fiscal position and has a strong, independent arbiter of fiscal policy may be able to impose a more flexible set of rules than a country where there is little capacity for commentators outside the government to scrutinise its plans.

There are a number of different fiscal rules in operation around the world and yet others that could, in principle, be used. In the next section, we discuss the merits and shortfalls of the Chancellor's two fiscal targets in adhering to these general principles. Then, in Section 4.6, we discuss what improvements could be made to the Chancellor's fiscal framework – in particular, to ensure the long-run sustainability of UK indebtedness.

4.5 How good are the Chancellor's fiscal rules?

Critique of the fiscal mandate

Advantages of the fiscal mandate

The fiscal mandate has a number of features that facilitate the general principles of good fiscal management set out in the previous section – indeed, in our 2005 Green Budget (and every other Green Budget thereafter, until 2010), we recommended a forward-looking fiscal rule along very similar lines, precisely because it would have these desirable features:[18]

1. **Investment spending**: The fiscal mandate relates to the 'current budget' rather than total borrowing – that is, the government can invest as much as it chooses (and pay for this entirely from borrowed funds) without falling foul of the fiscal mandate.
2. **Output stabilisation**: The fiscal mandate relates to the 'structural' current budget – that is, a measure of borrowing that strips out the estimated impact of any temporary economic weakness – which allows the government to borrow in the short run if this borrowing is thought purely to reflect shocks causing the economy *temporarily* to perform below its expected level.
3. **Adjusting gradually to shocks**: The fiscal mandate requires only that there must be balance or surplus 'by the end of the rolling, five-year forecast horizon' – this allows the government to adjust gradually to *permanent* shocks to the public finances.
4. **Forecast errors**: The fiscal mandate requires that the current budget is *forecast* to be in balance or surplus. Therefore, even if borrowing turns out to be somewhat higher than forecast, this would not breach the mandate, as it is purely forward-looking.
5. **Tax rate smoothing**: The fiscal mandate allows the government to borrow during periods of economic weakness or to cover unexpected shocks such that tax rates can be made smoother than if they had to adjust every year in response to temporary changes to borrowing.

The fiscal mandate is quite close in spirit to Mr Brown's golden rule. Sensibly, both would allow the government to borrow to cover investment spending and both allow borrowing to take into account the ups-and-downs of the economic cycle. The key difference is that Mr Brown's golden rule required the start and end of an economic cycle to be dated and borrowing to adjust to any shocks over that period. There were two clear criticisms of this, which do not apply to the fiscal mandate:

1. The start and end dates of an economic cycle are not easily verifiable in real time (if ever). This raised suspicions when, just after the 2005 general election and when the public finances appeared to be on course to breach rather than meet the golden rule,

[18] R. Chote and C. Emmerson, 'The fiscal policy framework', in R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS Commentary 97, 2005 (http://www.ifs.org.uk/publications/3250).

Mr Brown decided to push back the start of the then current economic cycle from 1999 to 1997, making it easier to meet the rule.[19]

2. During the last year of an economic cycle – unless a large margin of error has been accumulated – even a negative forecast error or revisions to past data could necessitate a large tax rise or spending cut to be implemented in-year in order to comply with the rule over the current economic cycle. This could make fiscal policy changes inappropriately backward-looking – for example, requiring a fiscal tightening in order to comply with the rule over the current economic cycle, which could be reversed the following year as it was not needed to comply with the rule in the next economic cycle.

Disadvantages of the fiscal mandate

The fiscal mandate looks, in many ways, better than the rules it replaced. However, it is not without some problems – all of which are essentially direct corollaries of the desirable features of the rule just outlined:

1. **Definitions of investment and current spending**: The fiscal mandate requires that all 'current spending' should be paid for by taxes levied on the current population, while investment spending can be funded through borrowing, which will in part be paid for by future generations of taxpayers. For understandable reasons of simplicity and transparency, the Chancellor (like Mr Brown with his golden rule) chose to use the National Accounts definitions of current and investment spending when defining the mandate. However, there are three reasons why this might deviate from being entirely in line with the first theoretical justification described in Section 4.4. First, there are some items of investment spending that may not confer great benefits on future generations (such as, arguably, the Millennium Dome or the London Olympics) and, in any case, it is far from clear why the time profile of benefits from investment spending would match the time profile of the interest payments arising from servicing the associated debt. Second, there are some items of current spending that arguably do benefit future generations (such as paying teachers to provide education to today's children, who will be tomorrow's taxpayers). Third, there are some liabilities that the government is incurring – for the benefit of today's taxpayers – that are counted as neither investment nor current spending today. For example, the government remunerates public sector workers partly by offering them a defined benefit occupational pension; most of these pensions are unfunded and thus the additional pension promises made each year (unlike additional current pay given to the same workers) does not count as current spending. This potentially provides an incentive for the current government to remunerate public sector workers more through pensions and less through current pay, since the cost of the latter has to be met by current taxpayers while liability for the former will be passed on to future taxpayers.
2. **Measuring the output gap**: While it is difficult to forecast total borrowing, it is even harder to decompose what portion of this is 'structural' as opposed to 'cyclical' – as is required by the fiscal mandate. Doing so requires an assessment of the current and likely future size of the 'output gap' – that is, the gap between the actual level of economic activity in the economy and the level that could be sustained without implying accelerating inflation or growing unemployment – and an assessment of its

[19] For a discussion, see C. Emmerson, 'Bending the rules?', *Public Finance Magazine*, August 2005 (http://www.publicfinance.co.uk/features/2005/bending-the-rules-by-carl-emmerson/).

impact on the public finances. As discussed in Chapter 5, different commentators have different views on the size of the current output gap, with the OBR's assessment being somewhere in the middle of other independent forecasters' estimates. The lack of transparency that estimating the output gap confers on judging the fiscal mandate is mitigated by the existence of the OBR, which is able to produce economic and fiscal forecasts that contain all relevant, available information about the UK economy, tax revenues and government spending but should – crucially – not be influenced by political considerations. While commentators may disagree with the OBR's view on the exact size of the output gap, they should at least be reasonably confident that the choice has not been politically motivated. However, the OBR is required to make some subjective judgements in coming to its view on the likely level of borrowing and the size of the output gap; to improve transparency and credibility, its judgements should be acknowledged and explained in as much detail as possible, which the OBR has done in its publications to date.

3. **Length of the horizon over which the mandate must be met**: Aiming for a surplus at the end of the forecast horizon (rather than more immediately) sensibly allows the government to adjust gradually to permanent shocks to the economy, such as the ones that have occurred around the recent financial crisis and associated recession. However, it does run the risk that politicians are perceived to be inappropriately delaying the implementation of politically painful decisions. Furthermore, at times when the economy had not recently experienced large adverse structural shocks, it would not be clear why a government should need five years to get the public finances back into balance. (Conversely, immediately after very large permanent shocks, a government may be better advised to plan to take longer than five years to rebalance the public finances.)

The first of these factors limits the ability of the fiscal mandate to constrain the government to borrowing only for 'legitimate' reasons (and was also an issue with Mr Brown's golden rule). The latter two potentially undermine the credibility of the rule.

Comparing the fiscal mandate and the EU's deficit rule

The fiscal mandate is more flexible than the EU's deficit rule and thus has clear advantages over it. In particular, the EU's deficit rule relates to total borrowing, which allows less flexibility to borrow for investment that benefits future generations and does not make any additional allowance for borrowing related purely to temporary economic weakness. In practice, some flexibility has been built into the way the EU rule is implemented. In particular, a 2005 amendment specified that 'excessive deficit procedures' will not be launched against countries if a breach of the deficit ceiling is associated with a period of weak economic performance – in particular, 'a negative annual GDP volume growth rate or … an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential'.[20] The same amendment allowed the Council to extend the time limit for correcting an excessive deficit by one year. However, these ad hoc allowances are less transparent than targeting a cyclically-adjusted measure of borrowing, as the fiscal mandate does, even though the latter is not without its problems (as just discussed). It might be more important for the UK than for some other EU countries to have flexibility to borrow during times of

[20] Council regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1997R1467:20111213:EN:PDF.

temporary economic weakness because the UK has tended to experience relatively large economic cycles and there is evidence that the UK's public finances are particularly sensitive to economic cycles.[21]

Potential improvements to the fiscal mandate

There are some changes that could be made to the fiscal mandate to address the first and third 'disadvantages' outlined above. Measuring the output gap (the second difficulty mentioned above) is inherently difficult and to some extent subjective. Any fiscal rule that wants to allow flexibility for the government to operate counter-cyclical fiscal policy – for which there are strong arguments – would need to incorporate some judgement about how the level of economic activity compares with its potential level and how this has impacted on the public finances. Therefore, the problem of measuring the output gap is technically unavoidable (unless one does not want borrowing to vary over an economic cycle) and the potential loss of credibility this implies is well mitigated in the UK by the existence of the OBR.

Enhancing intergenerational fairness

In principle, it would be possible to have a more sophisticated definition of spending that solely benefits the current generation than the National Accounts measure of current spending which is used in judging the fiscal mandate. Items that are not already included, but which are deemed to be of benefit to the current rather than future generations, could be added in – for example, accrual of unfunded public service pension liabilities and spending on 'investment' projects mainly of benefit to the current generation. Similarly, items currently included in the National Accounts measure of current spending but which are mainly of benefit to either past or future generations could be taken out. These could include the element of spending on teachers' pay that represents an investment in human capital and the payment of public service pensions accrued in earlier years. A more detailed discussion of the treatment of public service pensions is provided in Box 4.1.

However, there would be costs to using a non-standard definition of current spending for the purposes of the fiscal mandate. While National Accounts measures of spending are defined, measured and published by the independent Office for National Statistics, any alternative measure could be seen as being less transparent and potentially open to greater manipulation. Therefore, the benefits of using a definition that is more in line with the theoretical arguments would need to be weighed against this potential loss of transparency and predictability.

Adjusting the length of the horizon

Over the last two years, the government has each year chosen to take longer to get the structural current budget back into surplus than had previously been planned – that is, it has made use of the 'extra year' that is added to the end of the forecasting horizon at the time of each Autumn Statement. This is demonstrated in Figure 4.5, which shows the forecasts for the structural current budget surplus from each official fiscal statement since the June 2010 Budget, as well as the forecast published in the March 2010 Budget (the last official forecast produced by the Treasury before the introduction of the OBR).

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[21] Evidence that the UK has experienced greater fluctuations over the business cycle is presented in table 4.1 of M. Artis, *Analysis of European and UK Business Cycles and Shocks*, HM Treasury, London, 2003 (http://www.hm-treasury.gov.uk/d/addevon03_316.pdf). There is evidence that the impact of asset price movements on the public finances is particularly marked in the UK: F. Eschenbach and L. Schuknecht, 'Asset prices and fiscal balances', European Central Bank, Working Paper 141, 2002 (http://www.ecb.int/pub/pdf/scpwps/ecbwp141.pdf).

Box 4.1. Incorporating unfunded public sector pensions into a borrowing rule

New pension promises made to public sector workers in the current year could be incorporated into the fiscal mandate by expanding the definition of 'current spending'. Similarly, we might want to narrow the definition of current spending to exclude payments that are being made to retired former public sector employees, which 'should' have been covered by a former generation but were not. This would ensure that the current generation pays for the services of public sector employees that it benefits from, while allowing the cost of past employees (which was not fully paid for by previous generations) to be spread over future generations as well through borrowing.

The (discounted present) value of public sector pension liabilities changes from year to year for a number of reasons – including changes to assumed longevity of existing members, changes to the discount rate used to value future payment streams, and because additional promises are made to current workers. Many of these do not actually reflect additional benefit accruing to the current generation – for example, changes to previously assumed longevity could more accurately be classed as 'forecasting errors'. However, changes in the liabilities that reflect the fact that the government has made new pension promises to current employees in return for them working this year are akin to current spending and could be incorporated into the fiscal mandate.

The latest figures show that estimated public sector pension liabilities fell from £1,135 billion as of 31 March 2010 to £960 billion at 31 March 2011.[a] This decrease was driven by two main factors: an increase in the discount rate used to value the future stream of pension payments – from 1.8% to 2.9%[b] – and a decrease in the value of past accrued liabilities as a result of the decision, in Spending Review 2010, to index pensions in payment (and to deferred members) to growth in the consumer price index (CPI) rather than the retail price index (RPI). However, this decline was somewhat offset by new unfunded pension promises made to current public sector workers over that period, which amounted to £33.1 billion (or 2.2% of national income).[a]

In the same year, payments of public service pensions totalled £26.0 billion (1.8% of national income).[c] This suggests that the measure of current spending that the current generation would need to cover in order to finance the spending from which it benefits might be £7.1 billion[d] (or 0.5% of national income) higher than the £652.7 billion of traditionally defined current spending by the public sector in 2010–11.[e] The OBR's latest forecasts suggest that the government is on course to achieve a structural current budget surplus of 0.8% of national income by 2017–18.[f] Therefore, if the cost of new pension promises (net of pensions paid) in 2017–18 were equivalent to what they were in 2010–11 (which they might not be – for example, because the reduced size of the public sector workforce should reduce the accrual of new public service pension liabilities), the currently forecast surplus would be reduced from 0.8% of national income to 0.3% of national income (and the fiscal mandate would still be met).

[a] Note 27, pp. 159–164 of HM Treasury, *Whole of Government Accounts 2010–11*, 2012 (http://www.hm-treasury.gov.uk/psr_government_accounts.htm).

[b] The present value of public sector pension liabilities is calculated using a discount rate based on the yield on high quality corporate bonds. This rose from 1.8% (in excess of RPI) on 31 March 2010 to 2.9% (in excess of CPI) on 31 March 2011. Source: paragraph 3.67 of HM Treasury, *Whole of Government Accounts 2010–11*.

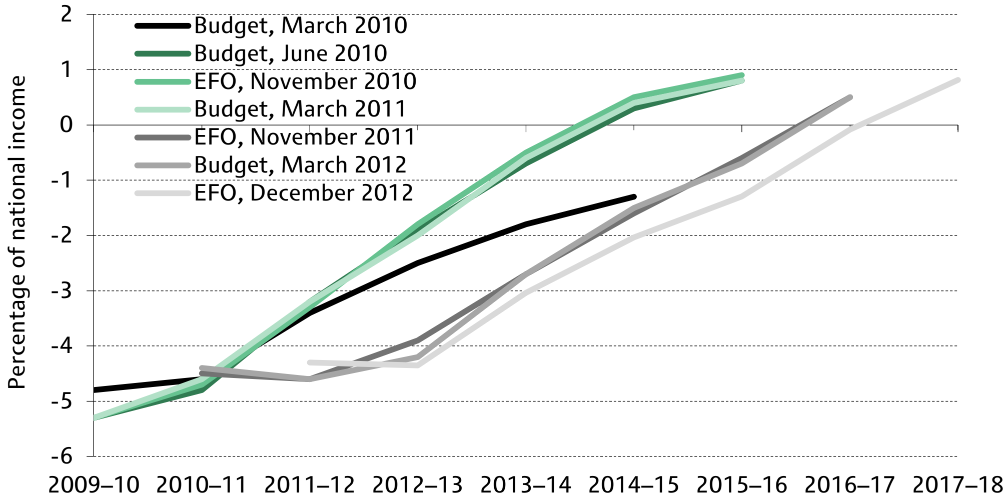
[c] Table D.1 of HM Treasury, *Public Expenditure Statistical Analyses 2012* (http://www.hm-treasury.gov.uk/d/pesa_complete_2012.pdf).

[d] Calculated as £33.1 billion less £26.0 billion.

[e] Calculated as public sector current expenditure plus public sector depreciation (ONS series JW2Q and JW2S).

[f] The OBR's headline forecast for the structural current budget deficit in 2017–18 is 0.9% of national income; excluding the impact of financial reclassifications, this figure is 0.8%.

Figure 4.5. Historic forecasts for the structural current budget



Notes: EFO stands for *Economic and Fiscal Outlook* – the publication produced by the OBR describing its latest official economic and public finances forecasts, which is released alongside each Budget and Autumn Statement. The December 2012 figures shown exclude the impact of reclassifying on the public balance sheet Northern Rock Asset Management and Bradford & Bingley, as well as the financial transactions relating to the Asset Purchase Facility.
Source: Table C2 of HM Treasury, *Budget: March 2010*, HC451. Table C1 of HM Treasury, *Budget: June 2010*, HC 61. Table 4.23 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2010*, Cm 7979. Table 4.23 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2011*, Cm 8036. Table 4.27 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011*, Cm 8218. Table 4.29 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2012*, Cm 8303. Authors' calculations using chart 5.1 of OBR, *Economic and Fiscal Outlook: December 2012*, Cm 8481. (Budgets available at http://hm-treasury.gov.uk/ and EFOs available at http://budgetresponsibility.independent.gov.uk/.)

The extensions to the length of the consolidation have come in response to additional adverse economic news that has caused the OBR to increase its estimate of the permanent damage that was done to the UK economy by the financial crisis and recession. As discussed in Chapter 5, this worse economic news has increased the apparent size of the hole in the public finances. In these circumstances, taking longer to deal with a larger fiscal problem might be entirely appropriate and it might well be better to plan to continue to cut public spending in the next parliament than to attempt even greater spending cuts in this parliament (see Chapter 7).

That the Chancellor had the flexibility to extend the timescale for dealing with the fiscal problems in the light of additional adverse economic news is arguably a strength of the fiscal framework. But one could imagine other circumstances in which the OBR had not changed its view on the size of the economic damage over the last two years. If the size of the problem had stayed the same but the Chancellor had continually decided to delay the point at which he would deal with it, this might have justifiably led to concern that he was inappropriately taking advantage of the flexibility afforded by his fiscal mandate.

Unfortunately, this problem is not ameliorated by the existence of the OBR because it is constrained to assessing compliance only with the *letter* of the mandate. In particular, were we in a situation where the economic damage remained the same size (or even got smaller) but the Chancellor continued to delay dealing with it, the OBR would nonetheless continue to confirm that he was complying with the mandate. Of course, there would not (and should not) be anything to stop it pointing out that public sector net borrowing had been revised upwards as a direct result of a policy response rather than due to a worsening underlying situation.

The size of this problem could be addressed by – at some point – shortening the horizon over which the mandate must be met. When the cyclically-adjusted current budget has moved closer to balance – that is, we are nearer to where we want to get to – it might be sensible to shorten the length of time allowed by the mandate to finish closing the gap. Similarly, if another large, permanent adverse shock were to hit the UK economy, we might want to lengthen the horizon. However, such adjustments to the length of the horizon could still appear opaque to the general public and so would not eliminate the problem. Independent commentators outside the OBR would need to continue to monitor whether inappropriate use was being made of the flexibility provided by the horizon over which the mandate has to be met.

Critique of the supplementary target

Although, as discussed above, the fiscal mandate is relatively well designed, it is not sufficient on its own to ensure long-term fiscal sustainability. It does not constrain the total level of borrowing in any year and therefore it does not constrain how much debt is accumulated in total. This is because it does not limit the amount the government can (in theory) borrow each year. As a result, a government could adhere to the mandate, and still be on a path towards increasing and unsustainable debt levels. Therefore, a secondary rule constraining the level of overall public indebtedness is also required – both to ensure financial sustainability and potentially also on the grounds of fairness to future generations. The supplementary target plays this role within the current fiscal architecture.

Advantages of the supplementary target

The supplementary target has the advantage of being easy to measure, clear and transparent. It will be possible to look back and assess whether the target was met or missed, although we will have to wait until after September 2016.

Disadvantages of the supplementary target

However, the supplementary target is a very crude tool for ensuring long-run fiscal sustainability as it does not actually constrain the public finances to be on a sustainable long-run path. Debt could fall between 2014–15 and 2015–16 and yet still be set to increase thereafter. It would be preferable to have a rule phrased in terms of the path for long-run indebtedness, rather than one that describes only a tiny, fixed segment of that path.

A second problem is that the supplementary target relates to the National Accounts measure of public sector net debt, which does not cover all forms of liabilities that are racked up by the government and passed on to future generations.

Comparing the supplementary target and the EU's debt rule

The EU's debt ceiling is different from the Chancellor's supplementary target, in that it imposes a permanent cap on the level of indebtedness (rather than a target for a small portion of the path of future debt) and sets out how quickly debt should be returned below the threshold if it is breached. This type of rule has considerable advantages – in terms of ensuring long-run fiscal sustainability – over the supplementary target.

The next section discusses some possible replacements for the supplementary target, including a debt ceiling along the lines of that imposed by the Stability and Growth Pact.

4.6 A better debt rule?

What would a better debt rule look like? At what point does debt become 'unsustainable'?

There are many possible definitions of sustainability but, as the OBR states, 'most are built on the concept of solvency – the ability of the government to meet its future obligations'.[22] In this section, we discuss three options for a second fiscal target, each of which is grounded in an assessment of the sustainability of the UK's long-term public finance position.

Option 1: Solvency criterion

In theory, for a government to be solvent, it must be able – over an infinite time horizon – to raise sufficient revenue to cover all its non-debt-interest spending and also to service and eventually pay off its outstanding debt. Satisfying this 'intertemporal budget constraint' takes into account all debt accrued to date and all future spending and revenue streams that the government has. Each year in its *Fiscal Sustainability Report*, the OBR assesses the government's intertemporal budget constraint and publishes an estimate of the 'intertemporal budget gap' – that is, the immediate and permanent increase in taxes or cut in spending as a share of national income that would be required for the government to satisfy the constraint. The European Commission also calculates a similar figure for each country in the European Union, which it refers to as the S2 indicator.[23]

One possibility would be to impose a second fiscal rule that required the government to comply with this intertemporal budget constraint. The OBR's estimate in July 2012 was that the UK's intertemporal budget gap currently stands at 2.6% of national income from 2017–18 onwards – in other words, tax increases or spending cuts amounting to around £40 billion in today's terms in every year from 2017–18 onwards would be required to meet the solvency condition in such a way that the fiscal tightening is smoothed out over all future years.[24] However, this figure is sensitive to a range of assumptions that are required to calculate it – for example, assumed future population changes and economic growth. (The European Commission's latest estimate is a gap of 5.2% of national income. This is higher than the OBR's figure largely because it does not take into account the spending cuts that have already been announced for the period 2015–16 to 2017–18, which are included in the OBR's assessment.[25])

A sustainability rule could be envisaged that required a government to implement a fiscal tightening sufficient to comply with this intertemporal budget constraint at some reasonable time horizon – with the OBR reporting each year on how large a gap (if any) there was. How long the horizon for implementing any required tightening should be

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[22] Paragraph 5.3 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/).

[23] European Commission, *Fiscal Sustainability Report 2012*, 2012 (http://ec.europa.eu/economy_finance/publications/european_economy/2012/fiscal-sustainability-report_en.htm).

[24] Paragraph 5.7 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/).

[25] Table 3.5 of European Commission, *Fiscal Sustainability Report 2012* (http://ec.europa.eu/economy_finance/publications/european_economy/2012/fiscal-sustainability-report_en.htm).

would likely have to depend on the size of the hole that needed to be filled; similar considerations to those discussed above for the fiscal mandate would apply.

The advantage of using this type of measure to judge debt sustainability – rather than more commonly-used debt ceilings, which we discuss below – is that it factors in predictable future spending and revenue pressures, including some government liabilities that are not included in National Accounts measures of public indebtedness in the UK, such as the commitment to pay (unfunded) pensions to public sector workers and to make contractual payments to Private Finance Initiative (PFI) providers. Meeting the intertemporal budget constraint will be harder for countries that face growing pressure on public spending (as the UK faces as the ageing population increases demand for public spending on the NHS, state pensions and long-term care) or declining revenue streams.[26] All of this can be factored into the solvency condition.

However, while judging sustainability using this solvency criterion has some theoretical appeal, it suffers from practical difficulties. First, depending on the time profiles of a country's revenue and spending, complying with the solvency criterion could nonetheless imply debt being at a very high level for a long period. If investors are not as far-sighted, they may not be willing to accept this without charging higher interest rates. Second, because judging the solvency criterion requires adding up revenue and spending streams over an infinite horizon, whether or not a country is judged to meet it will be sensitive to the assumptions used – including the projected size and structure of the population, the rate of economic growth, and the rate of productivity growth in public service provision.[27] For these reasons, it would be hard to implement a sufficiently credible solvency rule.

Option 2: Debt ceiling

A simpler and more transparent rule might instead focus simply on the level of public debt in the short to medium term. Such a rule would be cruder in many ways than the solvency criterion but would have the advantage of being more easily judged. The ceiling would need to be set at a level that would not – under plausible economic circumstances – impose what was judged to be an unacceptable burden on future generations. The OBR's latest official forecasts suggest that debt will peak as a share of national income in 2016–17 at 80.7%. A debt ceiling could either be set at or above this level or, as is more likely, if this level were deemed to be above the sensible long-run debt ceiling for the UK, a fiscal rule could be designed that imposed a lower debt target in the medium run, with a requirement that short- and medium-term fiscal policy be consistent with reducing debt towards that target at a 'sensible' pace.

A number of other countries operate debt ceilings. As mentioned in Section 4.3, this includes EU countries (although less than half of the EU countries actually currently have debt below the 60% ceiling). A 2009 IMF survey of fiscal rules found that, overall, around

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[26] The UK faces downward pressure on some revenue streams – for example, greener transportation is likely to reduce revenues raised from fuel duties and the depletion of North Sea oil and gas reserves will diminish revenues from that source. However, these revenue changes are not included in the OBR's modelling when it estimates the intertemporal budget gap. See chapter 4 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/).

[27] Sensitivity to the assumed rate of growth of productivity in the health sector is demonstrated in annex B of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/).

80% of advanced economies (including Australia, Canada and New Zealand) operated some form of debt ceiling.[28]

The height of the debt ceiling

Choosing where to set a debt ceiling is not straightforward. Previous studies have used data on levels of government debt and economic growth rates from a range of countries over time to attempt to ascertain at what point increases in debt start adversely to affect growth.[29] These studies have typically concluded that there is a non-linear relationship between debt levels and growth, with higher debt resulting in a particularly strong drag on growth above a threshold of between 80% and 100% of national income. However, there are a number of weaknesses in the methodologies employed in these studies and exactly where the threshold lies – if indeed there is a threshold effect of this kind – for any one country at any particular point in time will depend on a wide range of country-specific factors.

Mr Brown's sustainable investment rule required that public sector net debt should not exceed 40% of national income. It seems unlikely that 40% was the level at which a sovereign debt crisis would have been triggered – as was fairly clearly demonstrated by the ability of the UK government to nearly double the level of public debt over the last four years. In practice, the 40% ceiling really reflected a commitment by the previous Labour government that debt would remain below the level that it was bequeathed by the last Conservative government.

In setting the ceiling, to facilitate tax smoothing, policymakers could take into account the type of future pressures mentioned above – higher age-related spending from an ageing population, lower tax revenues coming from the exploitation of finite natural resources, and downwards pressure on some other revenue streams (such as fuel duties). They might also want to factor in some scope to absorb future shocks. The financial crisis and recession of 2008 and 2009 amply demonstrated the need for countries to have the scope to increase debt levels in response to adverse shocks. Over only a five-year period – between March 2008 and March 2013 – public sector net debt is expected to increase by about 40% of national income in the UK. Had the UK government not been in a position to raise this additional financing on the open market, we could have been forced by the markets into implementing the fiscal consolidation package sooner. That the UK has been able to continue borrowing on the open market was no doubt aided by the fact that the UK entered the crisis with a mid-table level of debt by international standards.[30] Looking forward, even if one were to judge that debt at 80% of national income were sustainable year-on-year, one might worry that having debt at that level might make accommodating another large, adverse shock difficult.

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[28] International Monetary Fund, *Fiscal Rules: Anchoring Expectations for Sustainable Public Finances*, 2009 (http://www.imf.org/external/np/pp/eng/2009/121609.pdf).

[29] M. Kumar and J. Woo, 'Public debt and growth', IMF, Working Paper 10/174, 2010 (http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf). S. Cecchetti, M. Mohanty and F. Zampolli, 'The real effects of debt', Bank for International Settlements, Working Paper 352, 2011 (http://www.bis.org/publ/work352.htm). C. Checherita-Westphal, and P. Rother, 'The impact of high government debt on economic growth and its channels: an empirical investigation for the euro area', *European Economic Review*, 2012, 56, 1392–405.

[30] For a comparison of UK debt levels and those of other industrialised countries prior to the financial crisis, see table 2.2 of R. Crawford, C. Emmerson and G. Tetlow, 'The new fiscal framework: an assessment', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011*, IFS Commentary 117, 2011 (http://www.ifs.org.uk/budgets/gb2011/11chap2.pdf).

A further consideration when setting the ceiling should be liabilities that are not included in public sector net debt. Details of these can be found in the Whole of Government Accounts;[31] they include provisions, which are future payments that are likely to occur but are of uncertain value, and contingent liabilities, which are future liabilities that have only a remote likelihood of occurring. The former includes nuclear decommissioning and clinical negligence claims assessed to have a greater-than-evens chance of materialising. The Treasury estimates that (as of March 2011) the present value of these future payment streams amounts to £60.9 billion for nuclear decommissioning and £17.5 billion for clinical negligence claims. The larger these values are assessed to be – and, in the case of contingent liabilities, the greater the likelihood with which they are deemed to materialise – the lower the ceiling on public sector net debt that we will want to aim for.

Exactly where the ceiling should be set will also depend on the measure of debt that is targeted. Mr Brown's sustainable investment rule and Mr Osborne's supplementary target both relate to public sector net debt. Meanwhile, the European Union's Stability and Growth Pact, as discussed in Section 4.3, imposes a ceiling (of 60% of national income) on general government debt, which is a different measure of debt. In terms of the choice between these two measures, there are clear advantages to using public sector net debt (which Mr Brown chose to target) rather than general government gross debt (which the EU focuses on) since the latter could easily be inappropriately manipulated by selling off liquid financial assets or by moving debt from general government to public corporations.

There are advantages – in terms of transparency and predictability – of policymakers choosing to target a standard National Accounts measure of debt. The disadvantage of using such a measure is that it is more difficult to take account of liabilities that do not score in such measures, such as PFI and public service pension commitments. Policymakers could still take these into account when deciding exactly where to set the debt ceiling. But this would be rather opaque, would probably not fully constrain these other elements of indebtedness and could still create an incentive for governments to seek to fund spending in ways that are not counted within public sector net debt.

Reducing debt towards the target level

The optimal level of the debt ceiling for the UK might well be below the current level of debt. If this is the case, then any fiscal rule that imposed a debt ceiling would also need to include provision for how quickly the level of debt should decline towards the target – just as the EU fiscal framework specifies how quickly debt should move back towards the target level if this is breached. Deciding on the speed of this convergence would require a trade-off between creating greater scope for absorbing future shocks (and possibly boosting the credibility of the rule) by aiming to reduce debt towards the target more quickly, and taking account of the strength of the economy and its capacity to absorb a faster debt reduction.

As an example, if it were decided that Mr Brown's ceiling on public sector net debt at 40% of national income remained an appropriate one to aim for, policy would have to be set so that we remained on course to return to below that level by some appropriate date. Our calculations suggest that the current planned fiscal tightening will be sufficient to return debt below this level by 2032–33, as shown in Chapter 5). If it were decided that the

[31] HM Treasury, *Whole of Government Accounts: 2010–11*, HC 687, 2012 (http://www.hm-treasury.gov.uk/d/whole_of_government_accounts_31-03-2011.pdf).

target should be approached more quickly, the debt rule would impose more stringent conditions on the amount of consolidation required.

Summary

A second fiscal rule phrased in terms of a debt ceiling would have considerable advantages over the existing supplementary target – not least because it would be operable beyond 2015–16 and would impose a permanent, rather than temporary, constraint on debt levels. It would be a somewhat cruder indicator of long-run fiscal sustainability than the solvency measure discussed above but it would be easier to judge, more transparent and possibly more credible to investors – advantages that probably outweigh that disadvantage.

However, a debt ceiling would not completely negate the problems identified above for the solvency condition; in particular, in deciding what an appropriate debt target should be and how quickly debt should fall to that level, policymakers would still have to make a (less explicit but no less important) judgement about how spending demands and revenue-raising capacity are likely to evolve in future. A further disadvantage of a debt target compared with a solvency condition is that it would be harder to take account of liabilities that are not counted within National Accounts measures of debt.

Option 3: Sustainable commitments rule

Rather than targeting the stock of accumulated debt, an alternative way of constraining the burden that is imposed on future taxpayers would be to limit the amount of future tax revenues that are precommitted (in each future year) to meeting the liabilities accrued by previous governments. That is, set a target that no more than some particular percentage of future national income is committed to meeting debt servicing obligations and any other liabilities accrued by the current and previous governments. Such a rule would have a number of advantages over a debt ceiling:

1. **Allowing flexibility to borrow more when interest rates are low**: Focusing on the cost of servicing debt, rather than on the debt stock itself, would have the advantage of directly targeting the burden of debt (i.e. the cost of servicing it) rather than the headline debt. It would allow governments to borrow more when interest rates were low, while constraining them more when interest rates were high. This seems a desirable feature since, for example, it would encourage (and allow) governments to optimise the point at which they invest in infrastructure by borrowing money when interest rates are low and not when they are high. It would also reward governments that were able to bring about lower interest rates (for example, by choosing to maintain and, where possible, improve the credibility of the operation of monetary policy) – such governments would be able to borrow more (for example, to increase public sector net investment) without breaching the rule.
2. **Broader definition of future liabilities**: Focusing on the stream of payments that we are committing future taxpayers to making also allows us to incorporate other public sector liabilities that are not scored in public sector net debt more easily within the same rule. For example, future public service pension payments could be incorporated in this way,[32] as could commitments to make payments to PFI providers in future.

[32] Although, as discussed in Section 4.5, it might seem most consistent to incorporate new pension commitments within the fiscal mandate (treating these in the same way as public sector workers' current pay,

Designing a sustainable commitments rule

There would, of course, be some difficulties in designing such a rule. First, one would need to decide exactly which liabilities should be included. We mentioned PFI payments and unfunded public sector pensions above. Both of these are expenditures that future governments will be contractually obliged to make – although it might be possible for governments to renegotiate these or in some other way reduce the payments that have to be made. One can imagine other liabilities that future governments are more or less firmly committed to making. All the main UK political parties are committed to state pensions and the NHS and spending on these items will most likely continue to dwarf the cost of public service pensions or payments to PFI providers. But the distinction is that future generations can choose at what level (and cost) things such as the state pension and spending on the NHS should be set, whereas the current generation is contractually committing future generations to honouring public service pensions and PFI deals.

Second, having decided on the coverage, one would need to decide what ceiling to set and whether this should be constant over time or whether it should increase or decline. As a starting point, one could examine how large the included elements of spending have been and currently are in the UK. Figure 4.6 combines the latest estimates for total future public spending commitments on debt interest payments, public service pensions and payments to PFI providers. The total of these payments is estimated to have been 5.6% of national income in 2011–12, falling to 4.2% by 2030–31. This is significantly higher than the level that the same commitments were forecast to be before the crisis (as shown by the dotted black line).

There are a number of other factors that might potentially need to be considered when setting a ceiling:

- First, one might want to take into consideration what risks there are to future spending levels. For example, debt interest payments would increase if interest rates were higher than assumed in the projections in Figure 4.6. Therefore, just as with setting a debt ceiling, a ceiling on the flow of future commitments would need to consider the risks around the central projection.
- Second, one could decide that it would be appropriate for the ceiling to be lower for years when the taxable capacity of the country was expected to be lower – for example, due to having a relatively larger older population or not having tax-rich resources such as North Sea oil and gas. This would have required a lower level of government borrowing during the 1980s and 1990s than would otherwise have been the case in order to ensure that the commitments made for periods after the baby boomers had retired and the North Sea oil and gas fields had been depleted were sufficiently low.
- Third, as with a debt ceiling, the greater the value of contingent liabilities, or the likelihood that they would materialise, the lower the appropriate ceiling on the commitments covered by any sustainable commitments rule.

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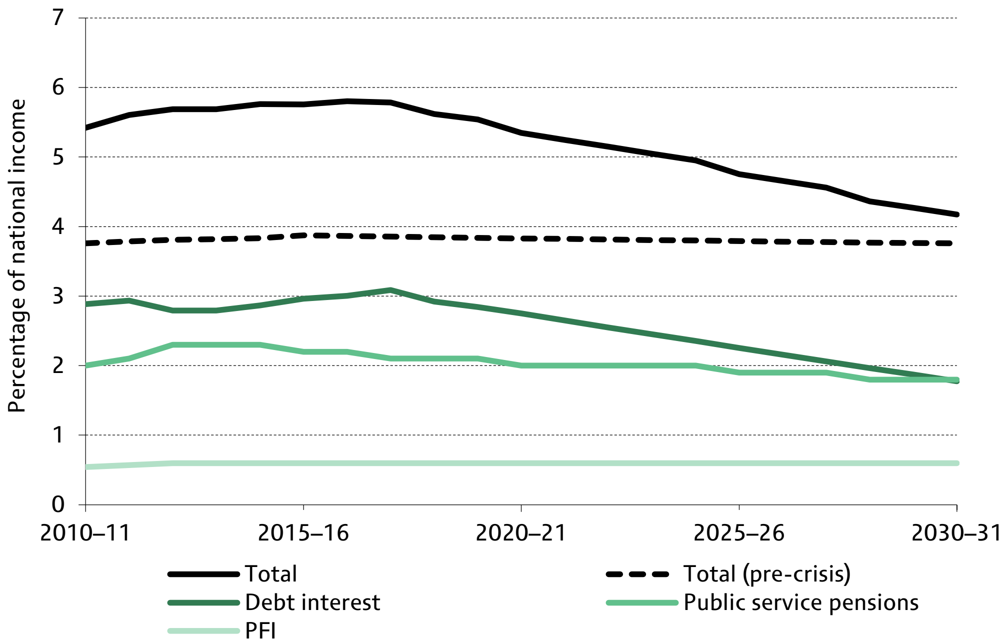
and also to exclude the pension payments when they are made), rather than within a debt sustainability target, there are disadvantages from deviating from the National Accounts measure of the current budget when assessing compliance with the fiscal mandate. Therefore, an alternative option – which would also avoid the problematic sensitivity of the current estimated value of these payments to the choice of discount rate – would be to include the flow of payments within a sustainable commitments rule instead.

Figure 4.6. A possible 'sustainable commitments rule': some projected future public spending obligations



Note: Figures shown for the Private Finance Initiative (PFI) are for total unitary payments on PFI contracts signed up to and including 31 March 2012.
Sources: Historic figures for public sector net debt interest payments are calculated using ONS series JW2L and JW2P. Forecasts for net debt interest spending and public sector net debt are authors' calculations based on OBR, *Economic and Fiscal Outlook*: December 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/). Figures for public sector pension spending are from chart A.1 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/). Figures for PFI payments are from *PFI current projects list: March 2012*, downloaded from HM Treasury website on 18 December 2012 (http://www.hm-treasury.gov.uk/d/pfi_current_projects_list_march_2012.xls). We assume that PFI commitments remain constant at their peak (2013–14) level. Debt interest projections beyond 2017–18 are calculated on the same basis as the debt figures shown in Figure 5.11; they assume that, over the medium term, structural revenues and non-debt-interest spending stabilise as a share of national income at the level for 2017–18 indicated by the OBR at the time of Autumn Statement 2012. The figures also assume that the effective interest rate on government debt remains at its 2017–18 level. Pre-crisis estimates are taken from the 'Budget 2007' line in figure 5.9 of R. Chote, C. Emmerson and G.Tetlow, 'The fiscal rules and policy framework', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, IFS Commentary 107, 2009 (http://www.ifs.org.uk/budgets/gb2009/09chap5.pdf).

The idea of a 'sustainable commitments rule' would need further investigation before being put forward as a firm policy proposal. But it would seem to have the strengths of Mr Brown's sustainable investment rule objective of targeting public sector net debt (rather than Mr Osborne's rule, which, like Labour's Fiscal Responsibility Act, targeted the change in debt between two years), along with the additional advantages of allowing higher government borrowing when such finance was cheaper and of taking into account a more comprehensive set of commitments affecting future taxpayers. Which commitments should be encompassed by such a rule would need to be considered carefully, as would the choice over the appropriate level (or path) of the ceiling on these commitments. Were the government to move towards such a target, official forecasts for public sector net debt as well as other measures of the state of the public finances such as 'net worth' and the 'primary balance' should, nonetheless, continue to be published.

Summary

Since the fiscal mandate is not sufficient on its own to ensure long-run fiscal sustainability, some secondary rule is required to constrain overall public sector indebtedness. The supplementary target is poorly designed to serve this purpose and the government should consult on a suitable replacement.

In theory, what ultimately matters is the solvency of the UK. Assessing the UK's intertemporal budget constraint takes into account all accrued debts and all future revenues and spending commitments. However, while such a forward-looking rule has attractions, imposing a solvency criterion judged over an infinite horizon poses a number of practical problems and may not have sufficient credibility with potential creditors. Therefore, there are attractions of adopting a cruder target for indebtedness. However, one would nonetheless like to take into account future commitments and pressures on revenues and spending when setting such a rule.

One candidate rule is a debt ceiling, along the lines of Mr Brown's sustainable investment rule or the EU's debt rule. Such a rule would be similar to a solvency criterion but would be judged over a finite horizon and might consider a narrower range of liabilities and impose a non-zero target for this measure of debt. In deciding what measure of debt to use and what level to set the ceiling at, the government should take into account all accrued liabilities and an assessment of the future risks to the UK's public finances.

An alternative candidate would be a 'sustainable commitments rule', which would impose a limit on the annual flow of future payments that can be precommitted. Relative to a simple debt ceiling, this would enable more borrowing when the rate of interest was lower (and vice versa). Exactly what level the limit was set at should depend on what payments were included and, as above, what other pressures there were on future spending and revenues. Whether the advantages of such a rule would outweigh its novelty relative to a simple target for a National Accounts measure of debt is something that the government should consider and consult on.

4.7 Conclusions

Mr Osborne has committed to meeting two fiscal targets – the fiscal mandate and the supplementary target. The fiscal mandate has several desirable properties that make it well placed to guide the government's borrowing while allowing the flexibility to borrow to address short-term economic weakness and to adjust gradually to the large, adverse shock to the UK economy that occurred in 2008. Indeed, the fiscal mandate is very similar to the 'forward-looking golden rule' that we advocated in previous Green Budgets, starting in 2005. The flexibility allowed by this rule has been made possible, in large part, by the welcome establishment of the Office for Budget Responsibility, which now produces the UK's official economic and fiscal forecasts, free from political pressure – thus reducing the risk that market players feel that the official forecasts for the UK's public finances reflect politically-motivated wishful thinking in the underlying assumptions.

However, the fiscal mandate on its own is not sufficient to ensure that the public finances are on a sustainable path in the long run. It therefore needs to be complemented by an additional rule that sets out an ambition for and constrains the path of public indebtedness in the longer run. The supplementary target is poorly designed to achieve this objective, since it refers only to a tiny segment of the path for future public debt. There are a number of other possible rules that could replace the supplementary target.

One option would be a debt ceiling, along the lines of Mr Brown's sustainable investment rule or of the debt ceiling included in the European Union's Stability and Growth Pact (with the measure of debt targeted by Mr Brown being broader, and therefore better, than that targeted by the SGP). The disadvantage of such a rule is that it would be hard to incorporate within it government liabilities that are not scored in National Accounts measures of debt.

Another alternative the government could consider is a 'sustainable commitments rule'. Instead of focusing on the total stock of debt, this rule would constrain the level of future flows of precommitted spending. Such a rule would have the advantage of allowing us to incorporate a range of liabilities that do not score in National Accounts measures of debt – such as unfunded public sector pension liabilities – without being sensitive to the precise choice of discount rate used in valuing these liabilities. To our knowledge, no other countries currently operate a rule of this type and so a number of practical issues would need to be considered in deciding how to implement such a rule.

We have looked in detail at the current fiscal rules and a range of alternatives but no rule will be perfect. Therefore, probably the most important element of any fiscal framework is an absolute commitment to transparency, which allows markets and commentators to judge fiscal sustainability. Government should use the wealth of information produced by the OBR in its annual *Fiscal Sustainability Report* in setting policy, as should external commentators when considering and judging the sustainability of those policies.