2. The fiscal policy framework

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Summary

- The Chancellor's tax and spending decisions are constrained by the golden rule (which states that the government should only borrow to invest on average over the economic cycle) and the sustainable investment rule (which states that public sector net debt should not rise above 40% of national income).
- The Treasury expects public sector net borrowing to fall from 3.2% of national income last year to 1.6% in 2008–09. If this is as accurate as past Treasury forecasts, there is a one-in-four chance the deficit will exceed 4% of national income in 2008–09 and a one-in-three chance it will have been eliminated.
- The Treasury assesses the golden rule over the current economic cycle, which it assumes to contain the seven financial years from 1999–2000 to 2005–06. In the Pre-Budget Report, it predicted a current budget surplus averaging 0.1% of national income over this period. If delivered, this would satisfy the rule.
- The expected surplus has declined steadily in successive Treasury forecasts. Based purely on the Treasury's forecasts and its past forecasting errors, the probability of meeting the rule fell from about 80% in Budget 2002 to about 60% in Budget 2004. If the Pre-Budget Report forecast for the current budget deficit in 2004–05 turns out to be correct, the probability would still be about 60%.
- But if trends in spending and revenues seen over the first nine months of the financial year persist over the last three, the probability of meeting the rule would be much lower, at 30–40%, depending on the extent to which the Treasury revises its current budget deficit forecast for next year to reflect any overshoot this year.
- The Treasury expects the current budget to move steadily into surplus after 2006–07. This relies on a strong pick-up in tax revenues, despite weaker economic growth and the absence of explicit tax-raising measures. The fortunes of the financial sector are central to this forecast.
- In recent years, the Treasury has progressively revised up its forecasts for public sector net debt. Based purely on current Treasury forecasts and its past forecasting errors, the chances of breaching the sustainable investment rule are very low over the next couple of years, but reach almost 30% in 2007–08.
- The Treasury could reform the golden rule to promote intergenerational fairness more effectively and to create better incentives for policymakers. Credibility might be enhanced by delegating more of fiscal policymaking to independent bodies outside government, but this is as much a political as an economic judgement.

2.1 Introduction

The purpose of this chapter is to discuss the policy framework within which the Chancellor takes his tax and spending decisions, and how his latest forecasts for the public finances compare with the requirements of that framework. In Chapter 3, we discuss the Treasury's assumptions regarding the long- and short-term outlook for the economy on which these forecasts are based, highlighting the risks to its central expectations. In Chapter 4, we give our own forecasts for the public finances and ask if they are consistent with the policy framework.

This chapter begins by describing the rules the government has set itself to help demonstrate that it will manage the public finances in a fair and responsible way (Section 2.2). It then discusses the need for a forward-looking assessment of the impact of current government tax and spending policy on key measures of fiscal performance and describes the uncertainties around the Treasury's forecasts of the public finances (Section 2.3). It then addresses how we should assess whether existing policies are consistent with meeting the rules now and in the future (Sections 2.4 and 2.5). Finally, it asks if the rules should be modified and whether institutional reforms are necessary to increase further the credibility of the government's fiscal policymaking (Section 2.6). Section 2.7 concludes.

2.2 Gordon Brown's fiscal rules

In 1998, Gordon Brown formally committed himself to two fiscal rules that – if adhered to – would potentially constrain his future tax and spending decisions: the 'golden rule' and the 'sustainable investment rule'.[1] His aim was to persuade both voters and financial market participants that the public finances would be kept on a sustainable path and that his tax and spending choices would not impose an unfair financial burden on future generations.[2]

The golden rule

The golden rule states that the government will only borrow to fund investment. This implies that tax revenues should equal or exceed current (or non-investment) spending. In other words, the so-called 'current budget' should be in balance or surplus.[3]

The rationale of the golden rule is broadly to ensure that future generations of taxpayers are only asked to repay debt that has financed spending from which they themselves are likely to benefit (see Section 2.6). It is also intended to reduce the incentive for policymakers to make disproportionate cuts in infrastructure spending, if and when total spending plans have to be cut. Cutting capital spending is more tempting as it takes longer for voters to feel the effects.[4]

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[1] A more detailed discussion of the government's fiscal rules can be found in C. Emmerson, C. Frayne and S. Love, *The Government's Fiscal Rules*, Briefing Note no. 16, Institute for Fiscal Studies, London, August 2004 (http://www.ifs.org.uk/bns/bn16.pdf).

[2] For more details, see HM Treasury, *Analysing UK Fiscal Policy*, London, 1999 (http://www.hm-treasury.gov.uk/media//89A63/90.pdf).

[3] The broadest measure of the budget balance – the difference between revenues and the sum of investment and current spending – is known as 'public sector net borrowing' or PSNB.

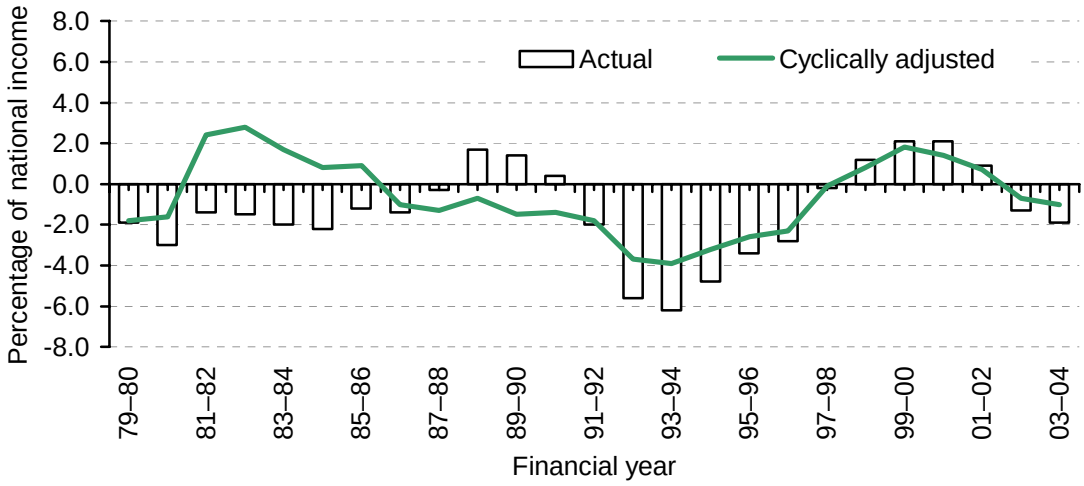
[4] For a discussion, see HM Treasury, *Fiscal Policy: Current and Capital Spending*, London, 1998 (http://www.hm-treasury.gov.uk/media/A97/77/530.pdf).

The golden rule only has to be met on average over the ups and downs of the economic cycle and not every year. This allows the 'automatic stabilisers' in the tax and benefit system to operate. When activity in the economy is below the level consistent with stable inflation, tax revenues are relatively subdued and spending on social security benefits relatively strong. This increases government borrowing and boosts total spending in the economy. The reverse happens in a boom: tax receipts are higher as a share of national income and spending on benefits is lower. If the rule had to be met every year, the government would be forced to respond to an increased current budget deficit arising from weak economic activity by raising taxes or cutting its expenditure plans. This could exacerbate the downturn by taking spending power out of the economy. By allowing the automatic stabilisers to operate, this feature of the golden rule helps lift some of the burden of stabilising the economy from monetary policy.[5]

The current budget balance in recent years

The current budget balance as a share of national income over the past 25 years is shown in Figure 2.1. Fluctuations in the current budget will in part be due to cyclical ups and downs in economic activity. So Figure 2.1 also shows the Treasury's 'cyclically adjusted' estimate of what the current budget balance would have been if economic activity had always been at a level consistent with stable inflation and therefore been sustainable in the long term.[6] This 'structural' balance gives a measure of the underlying strength of the current budget.

Figure 2.1. Current budget balance



Source: HM Treasury, *Public Finances Databank*, London, December 2004 (http://www.hm-treasury.gov.uk/media/F6C/7E/public_fin_databank_211204.xls).

The Treasury calculates that when national income rises by 1% relative to its sustainable level, current spending falls by about 0.5% of national income over the following two years

[5] While the automatic stabilisers operate in the desired direction, their strength is a function of the precise structure of the tax and benefit system and may not be optimal from the perspective of macroeconomic management. For more discussion, see section 2.3 of R. Chote, C. Emmerson and Z. Oldfield (eds), *The IFS Green Budget: January 2004*, Commentary no. 95, Institute for Fiscal Studies, London, January 2004 (http://www.ifs.org.uk/budgets/gb2004/04chap2.pdf).

[6] The Treasury estimates the 'potential' level of economic activity at which inflation would be stable at any given time by using a variety of indicators to identify points at which national output is actually at this level and then assuming that potential output grows at a constant 'trend' rate between them. As Chapter 3 discusses, potential output can also be estimated by running actual output through a statistical filter.

while current receipts rise by about 0.2% of national income. The net effect is to increase the current budget surplus (or shrink the deficit) by about 0.7% of national income.[7] Making this adjustment suggests that the swings in the current budget from deficit to surplus after 1993–94 and back into deficit after 2000–01 were partly the result of swings in economic activity, but more due to underlying movements in receipts and current spending. This is shown in Figure 2.1 by the fact that a substantial proportion of the improvement in the current budget balance over this period was due to an improvement in the cyclically adjusted current budget balance.

The sustainable investment rule

The sustainable investment rule states that the public sector's debt (net of its financial assets, which mostly comprise foreign exchange reserves) should be kept at a 'stable and prudent' level. The Chancellor currently defines this as no more than 40% of national income.

Despite its name, the sustainable investment rule does not give a straightforward answer to the question: 'How much can the government invest?'. This will depend on the current level of debt, the degree to which the golden rule is over- or under-achieved (which in turn partly depends on how much the government has to spend servicing its existing debt), the inflation rate and the real growth rate of the economy. If we assume that the golden rule is met exactly, that whole-economy inflation is 2.5% a year and that the economy grows in real terms by 2.5% a year, then the government could sustain public sector net investment of 2% of national income a year while keeping public sector net debt at 40% of national income.[8] If the debt ratio starts below 40%, the government can invest more temporarily until it gets there.

Applying the sustainable investment rule is slightly more complicated, because the Chancellor has said: 'To meet the target with confidence, at the end of every fiscal year of the current economic cycle, public sector net debt must be below 40% of GDP'.[9] This implies aiming for a debt ratio that is on average lower than 40% of national income, so that increases in the debt burden during periods when borrowing is inflated by an economic downturn can be accommodated. Next year, the Treasury predicts that the cyclical component of the debt ratio will be 2% of national income, on top of a cyclically adjusted 'core' debt of 33.4% of national income. If this is the maximum likely cyclical component of net debt, core debt would have to be kept below 38% of national income to keep net debt below the 40% ceiling.

In principle, it could be argued that the government should undertake any investment project for which the net social benefit exceeds the cost, whatever this implies for the debt ratio. But when a government increases the debt ratio, it is in effect imposing a tax increase on future generations (or requiring them to accept a lower level of public spending), whether or not those future generations believe that the spending financed by the extra debt was worthwhile. A ceiling on the debt ratio is in effect a self-imposed limit on the ability of today's

[7] See appendix A of HM Treasury, *End of Year Fiscal Report*, London, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352[1].pdf).

[8] Higher nominal growth in the economy, even if the result of higher inflation, would allow a higher level of real net investment.

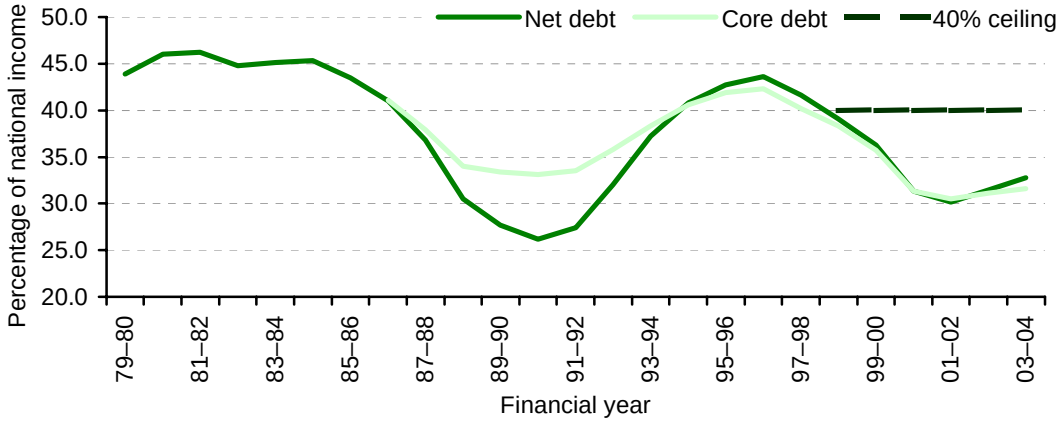
[9] HM Treasury, *Technical Note for the Treasury PSA 2005–2008*, London, 2004 (http://www.hm-treasury.gov.uk/media/EFF/68/julytechnicalnote_300704.pdf).

governments to tax tomorrow's taxpayers, which could be justified on fairness grounds or on the more practical basis that if future taxpayers feel they have been unreasonably overburdened, they may resort to inflation or default to reduce the debt burden – a possibility that can spook holders of government debt and prompt self-fulfilling expectations of a crisis.

Public sector net debt in recent years

Figure 2.2 shows that net debt dropped below 40% of national income early in Labour's period in office, reaching a trough of just over 30% in 2001–02. By last year, it had risen back to nearly 33%, in part because below-trend economic activity was pushing up borrowing. Figure 2.2 also shows that in the last decade, public sector net debt has never differed from core debt by more than 1.4% of national income. However, in the early 1990s, core debt was nearly 7% of national income above public sector net debt, reflecting the fact that swings in economic activity were much more pronounced in the late 1980s and early 1990s than in the past decade. A return to cyclical swings of this magnitude – and to big gaps between core and net debt – would make a commitment to keep net debt below 40% much more constraining.

Figure 2.2. Public sector net debt



Sources: HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm); HM Treasury, *End of Year Fiscal Report*, London, December 2004 (http://www.hm-treasury.gov.uk./media/8F5/65/pbr04end_year_456.pdf); HM Treasury, *Core Debt: An Approach to Monitoring the Sustainable Investment Rule*, London, April 2002 (http://www.hm-treasury.gov.uk./media/52F/5B/bud02_coredebt.pdf).

Having identified and looked at the recent performance of the Treasury's target measures for government borrowing and debt, we now turn to the difficulties involved in forecasting them.

2.3 Forecasting the public finances

Facing up to uncertainty

When the government takes tax and spending decisions, it estimates their impact on borrowing and debt a number of years into the future, to assess whether they are consistent with meeting the fiscal rules. This forward-looking approach reflects the fact that changing tax and spending plans too often and too abruptly is undesirable. It can harm the economy and the efficiency of the public sector by imposing administrative costs, as well as by creating

uncertainty that leads to short-termist decision-making by individuals, firms, investors and spending departments within government. Voters may also be unsettled by frequent changes.

Unfortunately, the public finances are hard for anyone – even the Treasury, with privileged access to data on government spending and revenues – to predict with accuracy. In part, this simply reflects the fact that borrowing is typically a small difference between two very big numbers. For example, in the December 2004 Pre-Budget Report, the Chancellor predicted that current spending would total £493.9 billion in 2005–06 (including depreciation) and current receipts £487.0 billion, giving a current budget deficit of £6.9 billion. If spending were just 1% higher and receipts 1% lower, the deficit, at £16.7 billion, would overshoot its forecast by over 140%.

The Chancellor should try to avoid getting himself into the position where he has to make sudden large policy changes to meet his rules. He should therefore decide, when taking policy decisions, how important it is to him that the rules be met and, in light of that, how much room for manoeuvre he should allow himself in meeting them, in case the public finances evolve differently from his central expectation. Similarly, outside commentators need to take the vagaries of public finance forecasting into account when predicting whether the rules will be met and recommending what (if anything) should be done if they expect them to be missed.

The Chancellor has repeatedly argued that his forecasts are cautious and that the rules will be kept to without the need to change his tax and spending plans.[10] But, unlike the Bank of England in its pursuit of the inflation target, he shies away from explicit discussion of the confidence that can be attached to his forecasts and the implications that has for his decisions.

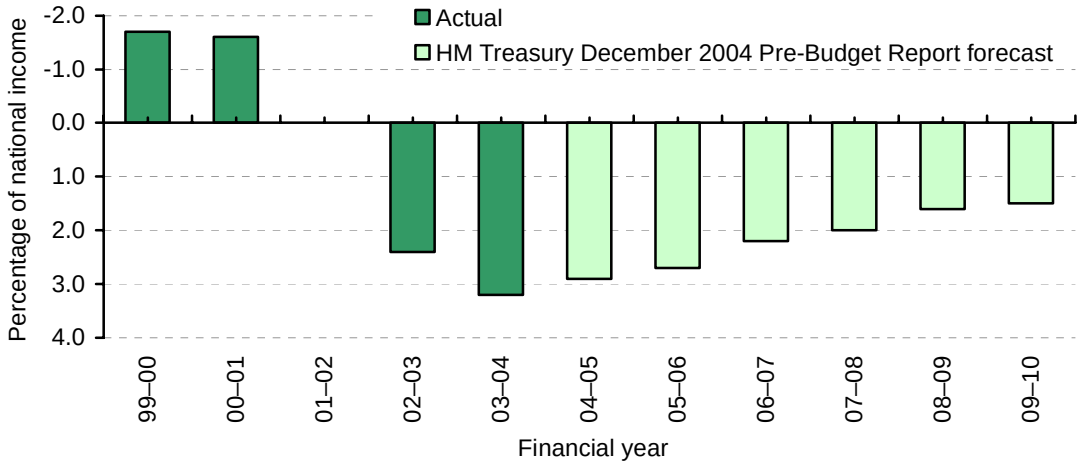
Lessons from past experience

The Treasury's past forecasting errors are a good place to start in assessing the confidence we should have in its current predictions. If we have no reason to believe that forecasting performance in the future will differ from the past, we can calculate the probability that the outcome will differ by a given amount in one direction or the other from the central forecast. We can then determine what policy will deliver a given probability of meeting the rules. The desired probability will depend on the Chancellor's assessment of the economic and political costs of breaking the rule and of the scope for countervailing policy adjustments to avoid it.

Figure 2.3 shows the Treasury's latest forecasts for public sector net borrowing – the current budget balance plus net investment – taken from the December 2004 Pre-Budget Report. It shows that there has been a sharp swing from surplus to deficit since 1999–2000, but that from this year onwards, the deficit is expected to shrink gradually as an improvement in the current budget balance outweighs a modest planned rise in public sector net investment.

[10] For example, in his evidence to the HM Treasury Select Committee on 16 December 2004, Gordon Brown stated: 'There are no circumstances I see coming before this Committee today that mean I believe we will not meet our fiscal rules' (http://www.publications.parliament.uk/pa/cm200405/cmselect/cmtreasy/uc138-iii/uc13802.htm).

Figure 2.3. Public sector net borrowing



Sources: HM Treasury, *Public Finances Databank*, London, December 2004 (http://www.hm-treasury.gov.uk/media/F6C/7E/public_fin_databank_211204.xls); HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm).

But how confident can we be that this improvement will take place? The Treasury's average absolute error in forecasting public sector net borrowing one, two, three and four years ahead for the period from 1977–78 to 2002–03 is shown in Table 2.1. This shows that even one year ahead, the average absolute error is £12.1 billion in today's prices.[11]

Table 2.1. Treasury errors in forecasting public sector net borrowing

Time period	Average absolute error (% of national income)	Average absolute error (£ billion)
One year ahead	1.0	12.1
Two years ahead	1.7	19.4
Three years ahead	2.2	26.1
Four years ahead	3.0	34.7

Notes: Figures in £ billion are calculated assuming HM Treasury forecast for national income in 2004–05 of £1,176 billion. Average error corresponds to the average absolute error over the period 1977–78 to 2002–03 for one year ahead, 1981–82 to 2002–03 for two years ahead, 1982–83 to 2002–03 (excluding 1996–97 to 1999–2000) for three years ahead, and 1983–84 to 2002–03 (excluding 1984–85 to 1986–87 and 1997–98 to 2000–01) for four years ahead.
Sources: Table 2.8 of HM Treasury, *End of Year Fiscal Report*, London, December 2003 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/assoc_docs/prebud_pbr03_adend.cfm); authors' calculations.

Errors in forecasting public sector net borrowing can arise either from errors in forecasting the strength and composition of economic growth (and therefore the impact of the automatic stabilisers) or from errors in predicting tax revenues and spending for any given level and composition of national income. Errors in forecasting economic growth have been relatively unimportant in explaining the Treasury's errors in forecasting the budget balance over a horizon of at least up to four years.[12] Last year's current budget deficit, for example, was £12.7 billion larger than the Treasury predicted at the time of the April 2003 Budget even

[11] IFS forecasts show errors of similar magnitude. See C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective', *Fiscal Studies*, February 1998, vol. 19, pp. 83–100 (http://www.ifs.org.uk/publications.php?publication_id=2250).

[12] See table B13 of HM Treasury, *Pre-Budget Report*, London, November 1998 (archive.treasury.gov.uk/pub/html/prebudgetNov98/index.html).

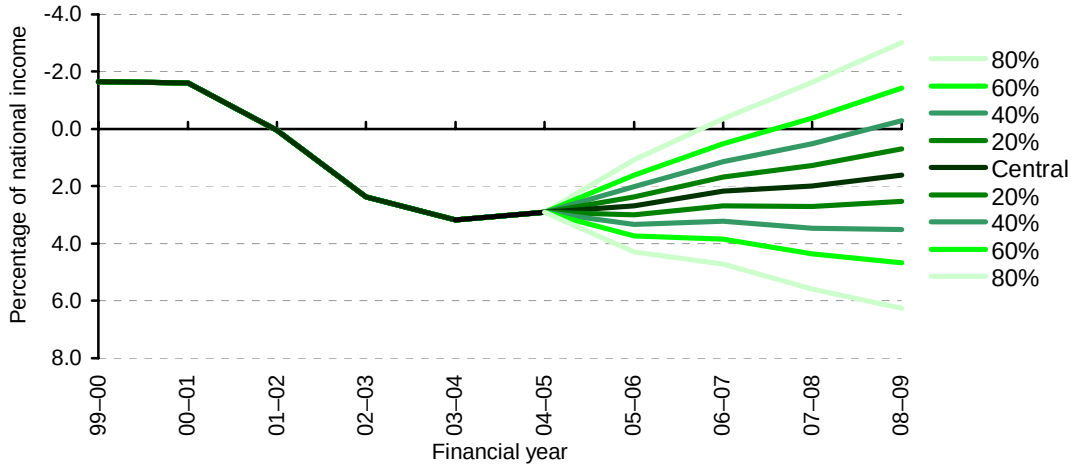
though the Treasury's forecasts for economic growth turned out to be relatively accurate. This was due to a £9.6 billion overestimate of government revenues and a £3.2 billion underestimate of current spending.[13]

Reflecting uncertainty in published forecasts

If we assume that the Treasury's latest forecasts will be as accurate as its past ones, that overestimates of borrowing are as likely as underestimates and that errors are normally distributed, we can put confidence intervals around the projections.

Figure 2.4 shows the probabilities of different outcomes for public sector net borrowing, based purely on the Treasury's latest forecasts and its past forecasting performance. We assume that the Treasury's projection for 2004–05 is correct, but that there is uncertainty thereafter. The presentation is analogous to the Bank of England's inflation and growth forecasts in its quarterly *Inflation Report*.[14] The 'central' estimate is the forecast shown in Figure 2.3. Figure 2.4 shows that there is a 20% probability that the outcome will lie within the darkest bands either side of the central forecast, a 40% probability that it will lie between the next darkest bands, and so on. It shows, for example, that in 2008–09, there is a one-in-four chance that the deficit will be greater than 4% of national income and a one-in-three chance that the deficit will have been eliminated.

Figure 2.4. Probabilities of public sector net borrowing outcomes



Sources: Central projections are taken from HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm), and assume that the forecast for 2004–05 is correct; methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

The estimates of previous Treasury forecasting errors used in this analysis are likely to be underestimates of the true forecasting error. This is because the forecasts for borrowing have not been adjusted for subsequent tax and spending decisions. In practice during periods where

[13] Table 2.7 of HM Treasury, *End of Year Fiscal Report*, London, December 2004 (http://www.hm-treasury.gov.uk/media/8F5/65/pbr04end_year_456.pdf).

[14] See, for example, Bank of England, *Inflation Report*, London, November 2004 (http://www.bankofengland.co.uk/inflationreport/ir04nov.pdf).

(underlying) borrowing was exceeding expectations, Chancellors would have been more likely to engage in a fiscal tightening than a fiscal loosening. For example, the two Budgets of 1993 contained significant tax-raising measures aimed at bringing revenues closer to previous expectations. This suggests that, if anything, the probability bands shown in Figure 2.4 should be wider. It would be very useful if the Treasury published information on previous forecasting errors that have been adjusted for subsequent policy announcements.

The other key assumption implicit in the estimates contained in the fan chart is that the Treasury's forecasts are as likely to be too optimistic as too pessimistic. Looking at the Treasury's one-year- and two-year-ahead forecasts back to 1970, the overly optimistic predictions do indeed offset the overly pessimistic ones, giving an average error of 0.0% of national income. But in the period since the current government introduced its fiscal rules, the Treasury claims that its forecasts have been deliberately cautious. This is consistent with the results we have seen over that period: forecasts for public sector net borrowing have been on average 0.4% of national income too pessimistic one year ahead and 0.2% of national income too pessimistic two years ahead.[15]

The main source of caution in the public finance forecasts is the assumption that the trend growth rate of the economy is a quarter of a percentage point lower than the Treasury's central view. Hence the assumption for economic growth between 2005–06 and 2009–10 used to forecast the public finances averages less than 2½% a year rather than the Treasury's true estimate of nearly 2¾% a year. This means that the level of national income assumed for 2009–10 is 1.4% lower than the Treasury's true expectation.[16] If the Treasury's central view of trend growth is correct, this would lead us to expect its borrowing forecasts to become increasingly pessimistic over time relative to the true outcome – reaching an expected difference of around 1% of national income by 2009–10. It would be more transparent if the Treasury dealt with the need for caution explicitly when explaining its policy decisions rather than trying to incorporate deliberate bias in its forecasts. As we have yet to see whether the supposedly cautious growth assumption will produce unduly pessimistic forecasts on average over a long period, we assume for the time being, in calculating the probability distribution of future outcomes, that future Treasury forecasts will be unbiased.

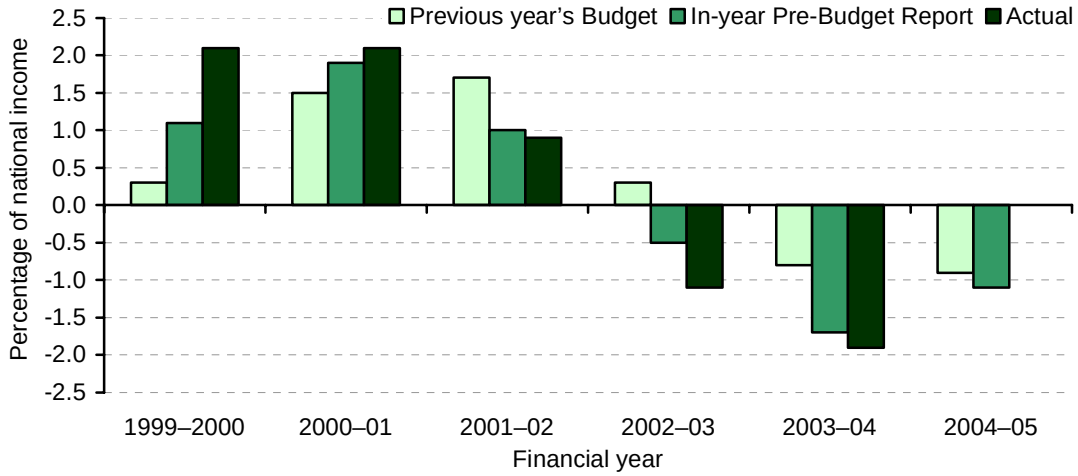
It is also important to remember that the direction of forecasting errors tends to be correlated from one year to the next: in other words, an overoptimistic forecast tends to be followed by another overoptimistic one and a pessimistic forecast by another pessimistic one. We can see this in Figure 2.5. In the Budget of March 1999, the Treasury forecast a current budget surplus in 1999–2000 of 0.3% of national income. The eventual out-turn was 2.1% of national income. Hence the Treasury's year-ahead Budget forecast for the current budget balance was about 1¾% of national income too pessimistic in 1999–2000. In subsequent years, it was about ½% of national income too pessimistic in 2000–01, ¾% too optimistic in 2001–02, 1½% too optimistic in 2002–03 and 1% too optimistic in 2003–04. If the December 2004 Pre-Budget Report prediction turns out to be accurate, the equivalent forecast for 2004–05 will have been less than ¼% of national income too optimistic. But Pre-Budget Report forecasts

[15] Table 2.2 of HM Treasury, *End of Year Fiscal Report*, London, December 2004 (http://www.hm-treasury.gov.uk/media/8F5/65/pbr04end_year_456.pdf).

[16] Paragraph B23, page 196 of HM Treasury, *Pre Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm).

have been overoptimistic three years running (although less so than the preceding Budget forecast). If trends in receipts and spending seen over the first nine months of this financial year persist, the Budget forecast will again turn out around 1% of national income too optimistic.

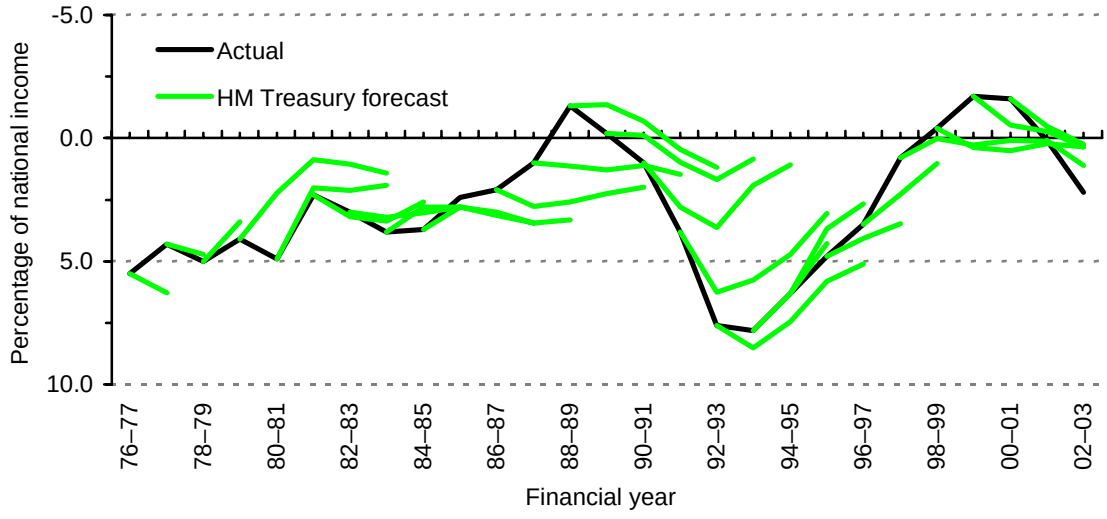
Figure 2.5. Treasury current budget balance forecasts



Sources: HM Treasury, various Budgets and Pre-Budget Reports.

It is also the case that if a forecast made for one year ahead turns out to be too optimistic or pessimistic, then forecasts made further ahead tend to have errors in the same direction. This is demonstrated by the fact that the forecast lines tend not to cross the actual borrowing line in Figure 2.6, which shows the longer run of Treasury forecasts.

Figure 2.6. Treasury public sector net borrowing forecasts



Source: Authors' calculations, from data contained in HM Treasury, *End of Year Fiscal Report*, London, December 2003 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/assoc_docs/prebud_pbr03_adend.cfm).

Table 2.2 shows the correlations between the errors in successive Treasury forecasts over time horizons of up to four years as far back as the late 1970s. They confirm that even successive forecasts looking four years ahead tend to err in the same direction from one forecast to the next.

Table 2.2. Correlations of forecasting errors for public sector net borrowing

Years ahead:	1	2	3	4
1	1.00			
2	0.76	1.00		
3	0.53	0.89	1.00	
4	0.38	0.70	0.90	1.00

Note: Statistics on the one-year-ahead errors are constructed using all years' out-turns from 1977–78 to 2002–03; statistics on the two-year-ahead errors use out-turns from 1981–82 to 2002–03; statistics on the three-year-ahead errors use out-turns from 1982–83 to 2002–03 except the years 1996–97 to 1999–2000; and statistics on the four-year-ahead errors use out-turns from 1983–84 to 2002–03 except the years 1984–85 to 1986–87 and 1997–98 to 2000–01.
Source: C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

The Treasury should seriously consider presenting its forecasts in a fan chart or a similar form that incorporates confidence intervals. Referring to the Bank of England's inflation forecasts, Andrew Haldane believes 'a quantified distribution allows policy to be exercised in an explicitly probabilistic fashion'.[17] It would make it clear that no reasonable safety margin could ever guarantee that a fiscal rule will be met with 100% certainty. The best one can do is decide how large a probability of breaking the rule is tolerable and plan accordingly. Rather than focusing on whether the Chancellor is likely to 'hit' or 'miss' a rule, it would be more productive to analyse where the Chancellor chooses to aim within the probability distribution and to reach a judgement on whether he is pursuing the target with appropriate caution. So, for example, the Chancellor could publish a forecast based on central rather than cautious assumptions and then show the extent to which he was being cautious by demonstrating that there was a reasonable probability that borrowing would exceed a given amount.

The Treasury Committee of the House of Commons recommended such an approach in its report on the November 2002 Pre-Budget Report:[18]

> From the forthcoming Budget onwards, we recommend that the Treasury should present the projections of the public sector net borrowing, the current budget and the cyclically-adjusted current budget in the style of a 'fan chart', similar in style to those published by the MPC and the US Congressional Budget Office … We believe the adoption of fan charts would greatly enhance the presentation and transparency of the public finance projections.

But the Chancellor did not agree.

Having assessed the confidence that we should place in the Treasury's forecasts for borrowing, we now ask what this implies for assessing the chances of meeting the fiscal rules.

[17] A. Haldane, 'Ghostbusting: the UK experience of inflation targeting', International Monetary Fund seminar paper, March 2000 (http://www.imf.org/external/pubs/ft/seminar/2000/targets/Haldane.pdf).

[18] The report (HC 159) is available at http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtreasy/159/159.pdf and the government response (HC 528) can be found at http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtreasy/528/528.pdf.

2.4 Meeting the golden rule

Identifying the economic cycle

To judge whether the golden rule has been met, we need to calculate the cumulative or average current budget balance over a complete economic cycle – the rule is met if the current budget is in balance or surplus over this period. Obviously, this requires us to identify when a particular cycle starts and finishes. Cycles are, by definition, a never-ending process, and any point in time is the end of one and the beginning of the next. But the Treasury assumes for these purposes that the current cycle began when economic activity had just reached the 'potential' level consistent with stable inflation. This has been followed by a period of above-trend economic growth, a peak in activity, a slowdown creating spare capacity in the economy, and then finally a recovery that will bring output back to its sustainable level.

To identify where we are in the cycle at any given moment, we need to estimate the 'output gap', a measure of the distance between actual national income and the potential level thought to be consistent with stable inflation. Unfortunately, the level of potential output cannot be observed directly. It can, though, be estimated by looking at the past relationship between output and inflation, and projecting how it will change in the future.[19] To predict whether the golden rule will be met over the current cycle, we also need to estimate when the cycle will end. To do that, we need to know the size of the current output gap and the rates at which potential output[20] and actual economic activity are likely to grow.

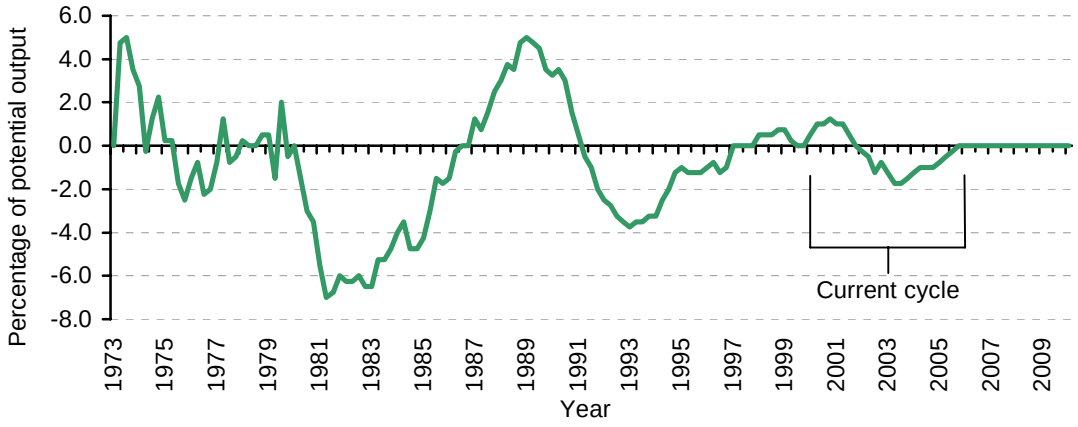
Figure 2.7 shows the Treasury's estimate of the output gap from the first quarter of 1973 to the first quarter of 2010. The Treasury said in the Pre-Budget Report that economic activity would be around 0.8% below potential on average this financial year.[21] Potential output is estimated to grow by 2¾% a year, mostly trend productivity growth, plus contributions from a rising employment rate and a rising population of working age, partly offset by a trend decline in average hours worked. With the economy forecast to grow by 3¼% this year and 3% in 2005–06, the output gap is expected to close in early 2006. The current cycle is assumed to have begun in 1999–2000, following a mini-cycle between the first half of 1997 and mid-1999. So, as an approximation, the Treasury assumes that the current economic cycle consists of the seven financial years running from April 1999 to March 2006.

[19] As we discuss in Chapter 3, potential output can also be estimated by running actual output data through a statistical filter or by estimating a production function.

[20] For information about the Treasury's view on the sustainable level of economic growth, see HM Treasury, *Trend Growth: Recent Developments and Prospects*, London, April 2002 (http://www.hm-treasury.gov.uk/media//D6678/ACF521.pdf).

[21] The Pre-Budget Report (PBR) indicated that output was around 1% below potential in the third quarter of 2004 (to the nearest quarter of a percentage point). But revisions published after the PBR in the latest quarterly national accounts (23 December 2004 – http://www.nationalstatistics.gov.uk/pdfdir/qna1204.pdf) suggest that actual output was somewhat higher than previously estimated. If the Treasury sticks to its view in the PBR that output was at potential in the third quarter of 2001 and that potential output has been growing by 2¾% a year, this would reduce the size of the negative output gap in 2004Q3 to ¾% (or 0.6% to one decimal place). But if the Treasury concludes that the revision affects potential as well as actual output and revises down its estimate of trend growth, the output gap estimate need not change.

Figure 2.7. HM Treasury estimates of the output gap



Note: Actual output less trend output as a percentage of trend output (non-oil basis).
Source: HM Treasury (consistent with December 2004 Pre-Budget Report).

The Treasury conceded in the Pre-Budget Report that its estimate of the output gap is larger than that of many independent forecasters. The Bank of England does not publish a formal estimate of the output gap, but Mervyn King, the Governor, argued in October that there was 'little if any spare capacity' left in the economy.[22] The OECD estimates that output was already 0.4% above potential in 2004.[23] Chapter 3 discusses the uncertainty surrounding the shape of the economic cycle and the size of the output gap in detail. Using a statistical technique that generates a similar start date for the cycle to that used by the Treasury, it is estimated that the output gap closed in the first half of 2004 and that the economy is now running at or slightly above potential. This suggests that there was a six-financial-year cycle running from 1999–2000 to 2004–05. Given the uncertainty surrounding the size of the output gap, it would be helpful if the Treasury could attach confidence intervals to its estimates and discuss the implications for the possible dating of the cycle.

The golden rule and the current cycle

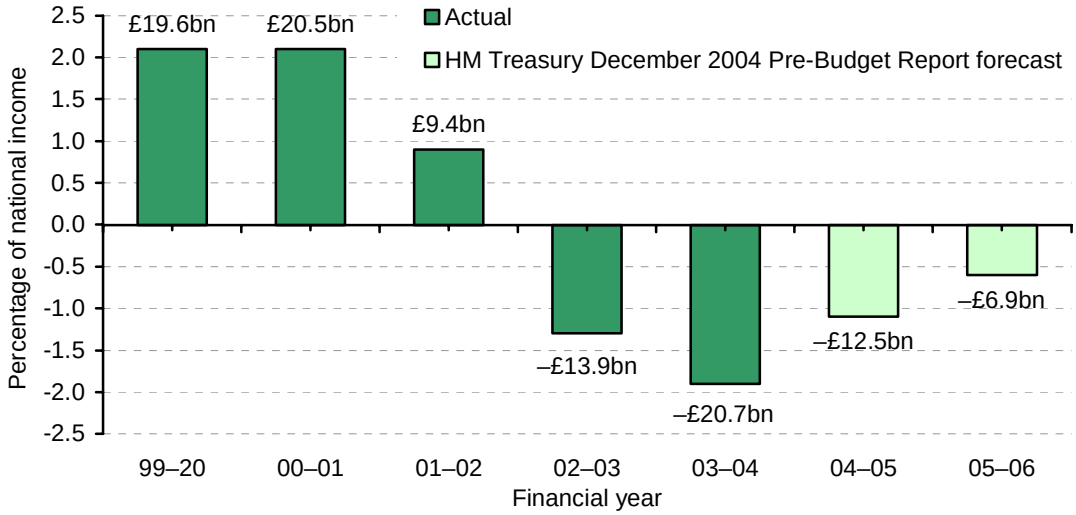
Let us assume the Treasury is correctly dating the current cycle and that it covers the seven years from 1999–2000 to 2005–06. Do its forecasts suggest the golden rule will be met?

Over the first five years of the cycle, the current budget has averaged a surplus of 0.4% of national income. As we can see in Figure 2.8, in the latest Pre-Budget Report, the Treasury predicted deficits of 1.1% of national income this year and 0.6% in 2005–06. This would reduce but not eliminate the surplus, leaving the rule to be met by an average of less than 0.1% of national income or a cumulative £5 billion in today's money. The Treasury argues that its true room for manoeuvre is slightly larger, at around £8 billion, because its non-investment spending plans for this year and next include an as-yet unallocated £3.5 billion contingency reserve for unexpected needs. But even £8 billion is still smaller than the average forecasting error for the current budget balance one year ahead.

[22] Speech at the Eden Project, Cornwall, 12 October 2004 (http://www.bankofengland.co.uk/speeches/speech229.pdf).

[23] *OECD Economic Outlook*, November 2004 (http://www.oecd.org/document/18/0,2340,en_2825_293564_20347538_1_1_1_1,00.html).

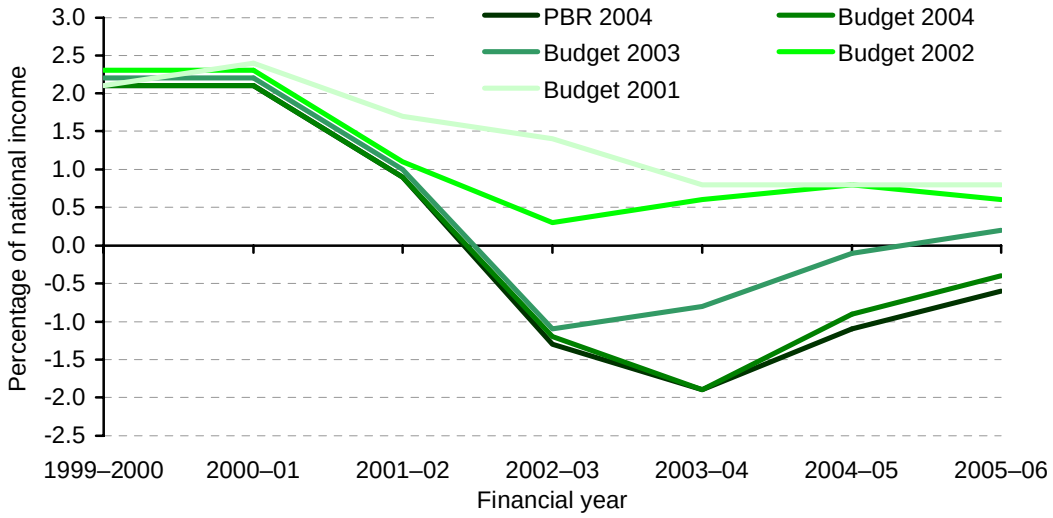
Figure 2.8. Current budget surplus



Source: HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm).

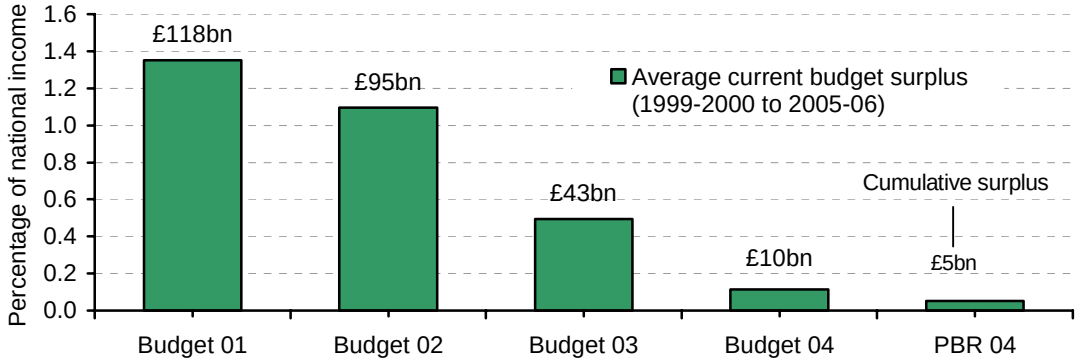
The Chancellor has steadily downgraded his forecasts for the current budget balance in recent years (Figure 2.9). This has significantly reduced the room for manoeuvre with which he expects to meet the golden rule (Figure 2.10). Three-and-a-half years ago, the Chancellor forecast that the golden rule would be overachieved by a margin of £118 billion, assuming that the contingency reserve is spent, as it has often been in the past. Just under a quarter of the decline to the current estimate of £5 billion is due to policy measures (mostly increases in current spending), with the rest due to unfavourable forecast revisions (mostly disappointing tax revenues).

Figure 2.9. Treasury current budget forecasts over present cycle



Sources: Successive Budgets and Pre-Budget Reports.

Figure 2.10. Treasury forecast overachievement of golden rule



Notes: Average percentage of national income estimated by taking the nominal projections for the current budget balance over the Treasury's latest forecast for national income. Figures in £ billion are the cumulative surplus multiplied by the Treasury's latest forecast for GDP in 2005–06, which is £1,243 billion.
Sources: Successive Budgets and Pre-Budget Reports; authors' calculations.

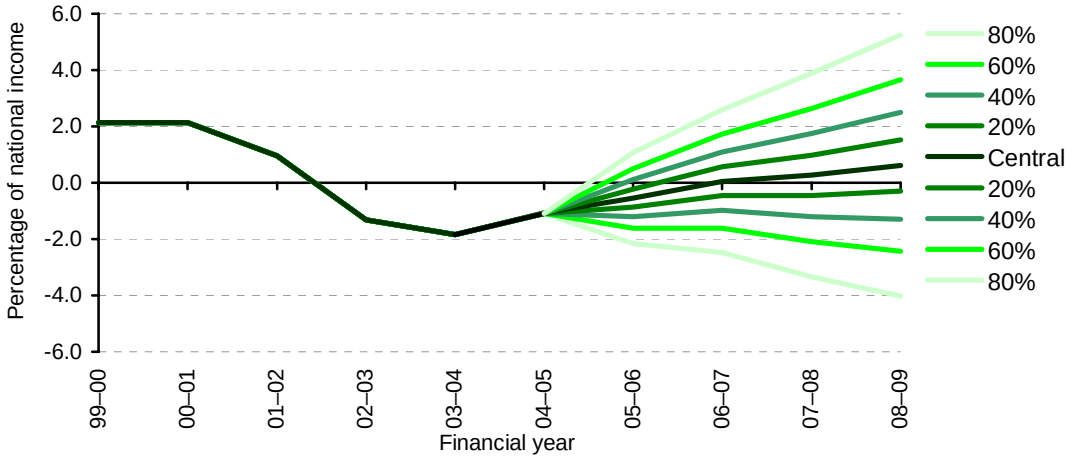
In some Budget and Pre-Budget Report speeches, the Chancellor has calculated whether he will meet the golden rule by summing the cash value of the current budget balances rather than the shares of national income. On that basis, he would now expect to break the rule by a total of £4.9 billion. Summing shares of national income gives a more favourable result because the economic cycle begins with surpluses and ends with deficits, and £1 at the start is a larger share of national income than £1 at the end due to inflation and real growth in the economy. If we are concerned that the government should not add to the value of its debt as a result of current spending and revenue decisions, summing cash values would be more sensible.

There is no reason why the Treasury should wish to overachieve the golden rule significantly *ex post*, unless public sector net debt were at or near the 40% of national income ceiling and the government wished to create room for more investment. It is therefore reasonable that the forecast overachievement of the golden rule should decline as the end of the cycle draws nearer and as the uncertainties surrounding the out-turn over the remainder of the cycle diminish. But has the Chancellor used up too much room for manoeuvre too quickly?

To answer this question, we need to translate the expected average surplus over the cycle into a probability that the rule will be met, given the likely forecasting errors over the remainder of the cycle. We can do this by using the data in Tables 2.1 and 2.2, and assuming that Treasury forecasts for the current budget are as accurate as those for public sector net borrowing.

Figure 2.11 shows the probabilities of different outcomes for the current budget balance, based purely on the Treasury's latest Pre-Budget Report forecasts and on its past forecasting performance. It is in the same format as Figure 2.4, which shows the probabilities for public sector net borrowing. We assume that the Treasury's projection for 2004–05 is correct, but that there is uncertainty thereafter. Figure 2.11 shows that there is a 20% probability that the outcome will lie within the darkest bands either side of the central forecast, a 40% probability that it will lie between the next darkest bands, and so on. It shows, for example, that in 2008–09, there is a one-in-ten chance that the deficit will be greater than 4% of national income and a three-in-five chance that the deficit will have been eliminated.

Figure 2.11 Probabilities of current budget balance outcomes



Source: Central projections are taken from HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm), and assume that the forecast for 2004–05 is correct; methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

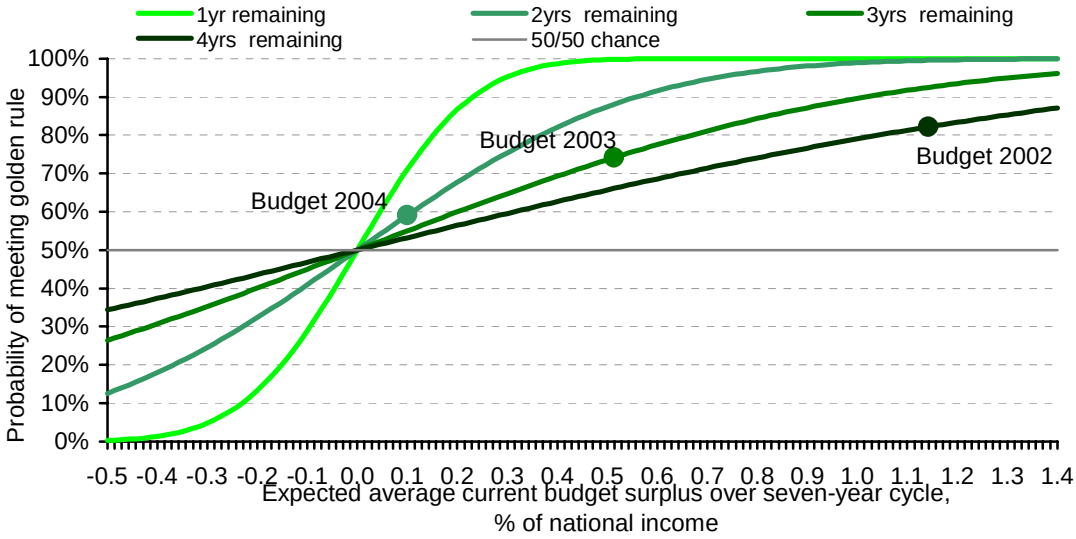
Figure 2.12 uses this method to show how the probability of meeting the golden rule over the current economic cycle has changed in recent Budgets. The horizontal axis shows the expected average current budget surplus over the present economic cycle as a share of national income, namely the average of the actual or expected current budget surpluses as shares of national income for the seven years from 1999–2000 to 2005–06. The vertical axis then gives the probability that the golden rule will actually be met if forecasting performance in the future mirrors the past. In other words, given the number of years of the economic cycle remaining and the expected size of the cumulative surplus, the vertical axis shows the likelihood that the final cumulative budget balance will be zero or positive. Because we assume that the forecast errors are not biased in either direction and that the distribution of errors is symmetrical, a forecast cumulative surplus of exactly zero means a probability of meeting the golden rule of exactly 50%: underachievement is as likely as overachievement. This is the case regardless of the number of years remaining when the forecast is made. We also exclude the possibility that the Chancellor will choose to implement new measures to increase the cumulative surplus in the event of disappointing out-turns. So the probabilities on Figure 2.12 show the likelihood of meeting the rule without policy changes.

With four years of out-turns to come, the Budget 2002 prediction of an average surplus of 1.1% of national income implied an 82% probability of the expected average surplus remaining positive or zero and of the rule being met. As the expected average surplus fell to 0.5% of national income in Budget 2003 and 0.1% in Budget 2004, so the probability of meeting the rule fell to 74% and then to 59%. Interestingly, although the cash margin by which the rule was expected to be met fell more sharply in Budget 2003 than in Budget 2004, the probability of meeting the rule fell more sharply in Budget 2004 than in Budget 2003.

To reiterate, these probabilities are based entirely on the uncertainty that the Treasury might place around its own forecasts if it were to assume that its forecasting performance will be the same in the future as in the past. The probabilities would be different if a different view was taken from the Treasury's about the evolution of the economy or about the likely size of

revenues and spending for any given state of the economy. We discuss the outlook for the economy in Chapter 3 and generate our own forecasts for the public finances in Chapter 4.

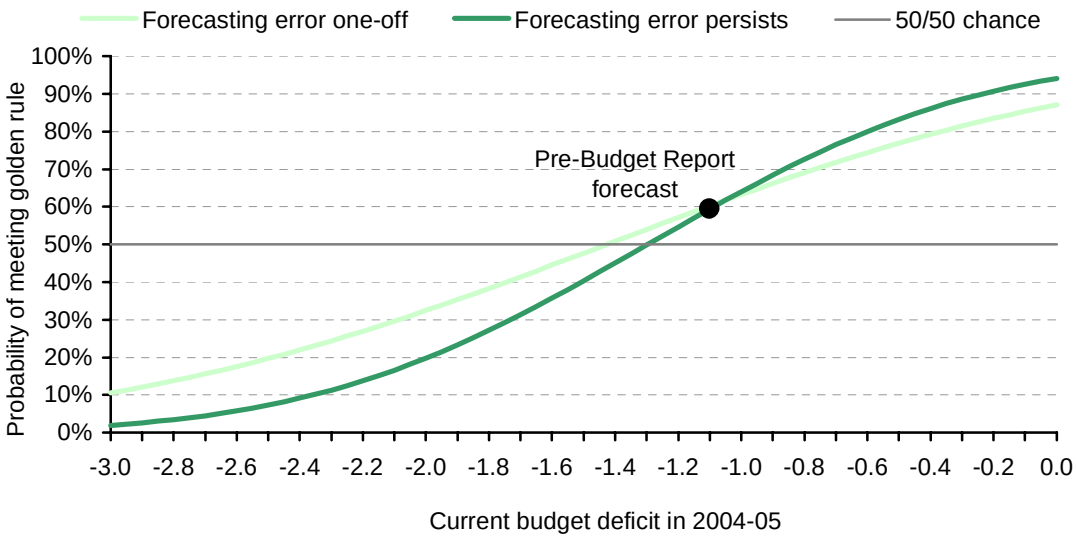
Figure 2.12. Probabilities of meeting the golden rule in recent Budgets



Source: The Budget projections marked on the graph are taken from various HM Treasury Budgets. Methodology for computing probabilities taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

The cumulative surplus (or deficit) over the cycle expected in Budget 2005 – and the implied probability of meeting the golden rule with just a year to go – will depend on the out-turn for the current budget deficit this year, plus any revisions to past data and next year's forecast. Figure 2.13 shows the probability of meeting the rule for different values of the current budget deficit this year, first assuming that the Treasury leaves the 2005–06 forecast as it was in the latest Pre-Budget Report ('forecasting error one-off') and second assuming that the Pre-Budget Report prediction for next year's deficit is revised proportionately with any forecast error this year ('forecasting error persists').

Figure 2.13. Probabilities of meeting the golden rule with one year to go



Source: Authors' calculations.

Should the Treasury's Pre-Budget Report forecast for a current budget deficit of 1.1% of national income (£12.5 billion) be correct, then, as shown in Figure 2.13, there will be a 62% chance that the golden rule will be met over the current economic cycle. Should the current budget deficit in 2004–05 be larger than 1.1% of national income, the likelihood that the golden rule will be met will be less than 62%. To go into the last year of the cycle with the golden rule more likely to be met than missed, the current budget deficit this year would have to be no larger than 1.4% of national income (£16.9 billion) if the overshoot from the Pre-Budget Report forecast is a one-off, or no larger than 1.3% of national income (£15.4 billion) if the Treasury forecasts an overshoot next year proportionate to any this year.

We can certainly conclude from this analysis that the Chancellor's prospects of meeting the golden rule (without new policy announcements) during this cycle are considerably lower now than they were three-and-a-half years ago. But we cannot say whether they are 'too low' because the Chancellor has not been explicit about what he regards as an acceptable probability of breaking the rule, even though he must realise it can never be zero. It certainly seems hard to square the sorts of probabilities calculated above with the certainty with which the Chancellor typically claims the rule will be met in his public pronouncements.

To sum up, if we take the Treasury's Pre-Budget Report forecasts at face value, the chances of meeting the golden rule over the current cycle are approximately 60-40, given its past forecasting performance. If the trends in spending and revenues we have seen over the first nine months of the financial year persist over the last three, the chances are 40-60 even if none of the shortfall persists into 2005–06, and just 30-70 if the Treasury's forecast for 2005–06 is revised proportionately.

So there is clearly a significant possibility that the golden rule will be missed. If the Treasury's forecasts again prove overoptimistic, the Chancellor could have to announce immediate tax-raising measures of a significant magnitude in Budget 2005 to get back on course. But it is not clear that the costs of missing the rule by a few billion pounds over this period would in themselves be sufficient to justify this action (and we certainly would not expect him to take such action). It might be embarrassing for the Chancellor to break the rule at his first attempt, especially in light of the certainty he has claimed in his public statements. But, fundamentally, it would be more important for the credibility of the fiscal framework to convince people that the government is making sufficient efforts to meet the rule in the future. Analogously, the Bank of England consistently sets interest rates to hit the inflation target about two years ahead, arguing and explaining that it is too late to do anything sensible about a divergence from the target in the nearer term. So what do the Treasury's forecasts imply about the chances of meeting the golden rule beyond the current cycle?

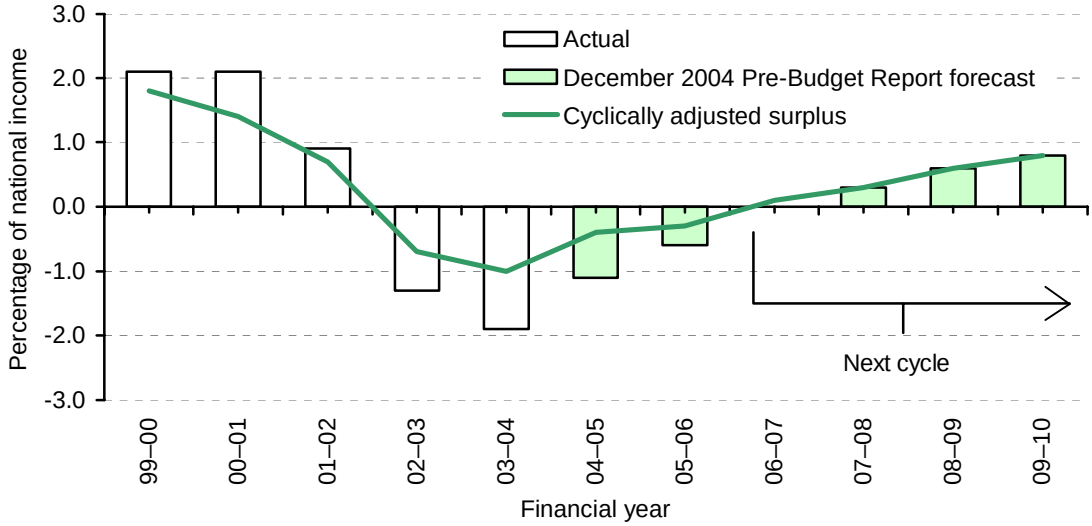
The golden rule and the next cycle

The Treasury said in the December 2004 Pre-Budget Report that 'based on cautious assumptions, the Government is … on course to meet the golden rule after the end of this economic cycle'.[24] It reaches this judgement on the basis of the forecasts shown in Figure 2.14. The Treasury assumes for the purposes of forecasting the public finances that it will

[24] Paragraph B8, page 192 of HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm).

indeed abolish 'boom and bust' and that this economic cycle will be the last (see Figure 2.7). It therefore assumes that the output gap will be zero in 2006–07 and beyond. As a result, the cyclically adjusted current budget balance will be equal to the actual balance from 2007–08 (since both the current and lagged output gap affect the current budget balance).

Figure 2.14. Current budget surplus



Sources: HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm); HM Treasury.

We can see that the Treasury expects the current budget balance to swing back into the black over the next five years – above and beyond any improvement that occurs automatically as the economy temporarily enjoys above-trend growth while remaining spare capacity is used up. The Treasury expects us to move from a cyclically adjusted deficit last year of 1% of national income (the largest since Labour came to power, although still less than the 2.4% of national income that it inherited in 1996–97) to a surplus of 0.8% of national income in 2009–10. If this fiscal tightening occurs, then it is clear that the government will meet the golden rule in the next cycle as it starts with the current budget in balance and then builds up surpluses that get bigger every year.

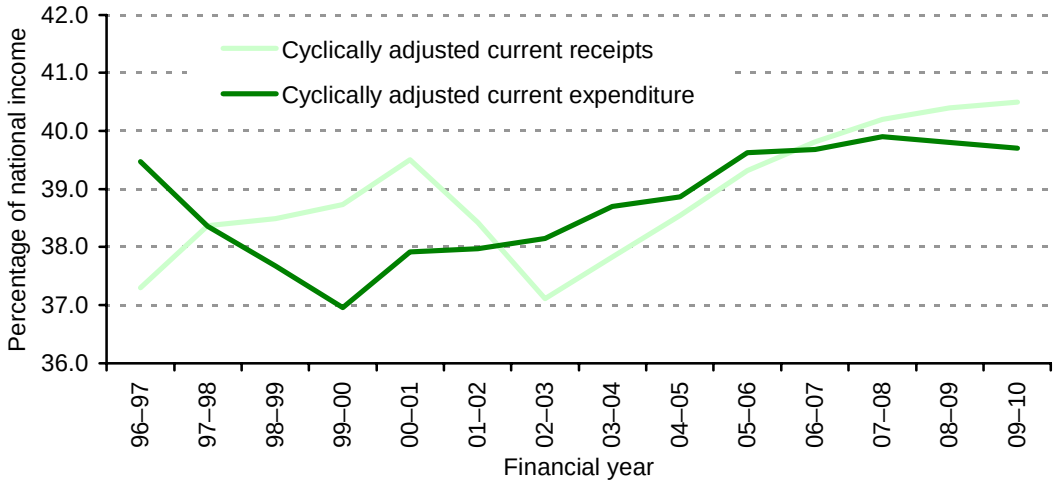
But, of course, these forecasts could turn out to be wrong. We can in principle use the Treasury's past forecasting record to determine the probability that the rule will be met, but this will depend on the expected length of the next economic cycle. This is clearly uncertain – on Treasury estimates, the current cycle is expected to last seven years, the previous one two years and the one before that 11 years. The analysis in Chapter 3 suggests that it is reasonable to expect a cycle to last six years, broadly in line with the recent average. Unfortunately, we only have information on the Treasury's forecasting performance up to four years ahead, which means we can only assess the probability of meeting the golden rule over that period. If we assume that any cyclical impact on the current budget deficit washes out over the cycle – which should broadly be the case if the Bank of England keeps the inflation rate roughly stable and if the magnitude of any above-trend activity is similar to the magnitude of any below-trend activity – the Treasury would expect to record a surplus averaging 0.4% of national income in a cycle running from 2006–07 to 2009–10. On past performance, the probability of meeting the golden rule over this period would be 57%.

Explaining the return to surplus

But where do the mounting surpluses that the Treasury expects beyond 2006–07 come from?

Not from cuts in public spending, although the rapid increases of recent years are coming to an end. The Pre-Budget Report estimates that current spending (including depreciation) stood at 39.4% of national income last year. It is expected to edge up to 39.9% in 2007–08, which is the final year covered by the last spending review, before dropping back to 39.7% in 2009–10. Adjusted for the expected strengthening in economic activity, cyclically adjusted current spending is set to rise by 1.0% of national income between 2003–04 and 2009–10, contributing a small net loosening of fiscal policy (Figure 2.15).

Figure 2.15. Cyclically adjusted current receipts and current expenditure



Notes: Current expenditure includes spending to offset depreciation. The cyclically adjusted figures for public sector current expenditure and current receipts were obtained using the 'ready reckoner' formula in table A5 of HM Treasury, *End of Year Fiscal Report*, London, December 2003 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/assoc_docs/prebud_pbr03_adend.cfm).
Sources: HM Treasury; authors' calculations.

With spending broadly static as a share of national income, after adjusting for the cycle, the fiscal tightening intended by the Treasury has to be taking place on the tax side. Following a sharp drop in the share of national income taken in tax between 2000–01 and 2002–03, the government is now expecting current receipts to rise from 37.5% of national income in 2003–04 to 40.5% in 2009–10, their highest level since the late 1980s. Adjusted for the economic cycle, current receipts are projected to rise by 2.7% of national income over this period, more than accounting for the planned 1.7% of national income net fiscal tightening. As discussed in Chapter 6, this is not due to any explicit tax-raising measures, unlike a large part of the increase in tax revenues seen since 1996–97.

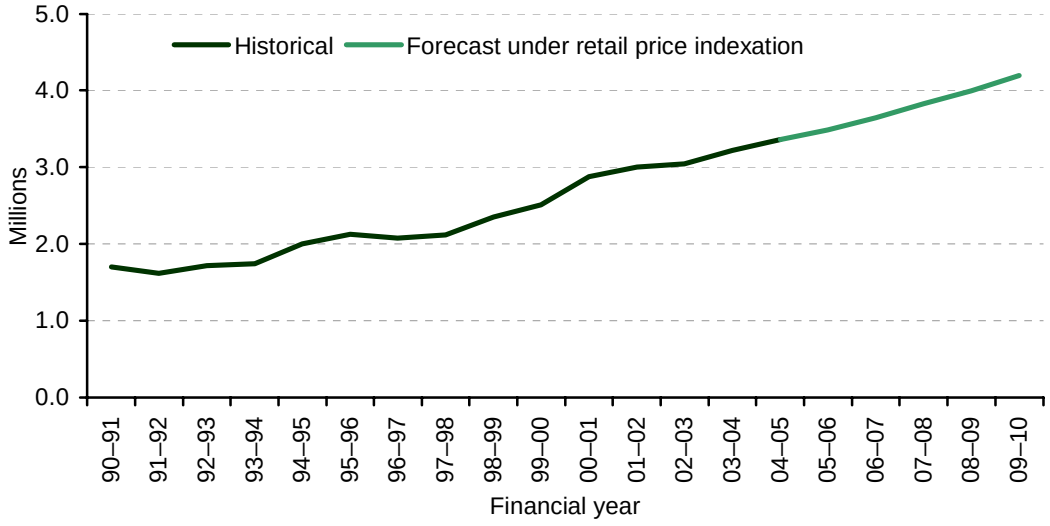
The Treasury says that this rise in the underlying tax burden is in part the result of economic factors that are not captured in conventional cyclical adjustment, notably a rebound in tax revenues from companies and employees in the financial sector. The structural increase in current receipts may also reflect the government's efforts to collect more of the tax that it believes it is due – for example, by cracking down on VAT fraud and avoidance. For instance, the government estimates that it failed to collect 15.8% of the £80.7 billion in VAT it was

owed in 2002–03. It believes it reduced the estimated 'VAT gap' to 12.9% in 2003–04 and plans a further cut to 12% by 2006–07.[25]

Fiscal drag

An important source of increased future revenue is 'fiscal drag'. The Treasury assumes, when forecasting the public finances, that tax allowances and thresholds rise in line with retail prices. But earnings typically rise more quickly, which means that this assumption implies a continuous rise in the share taken in income tax as more people find larger proportions of their income being taxed at higher rates. The impact of this is shown in the Pre-Budget Report: the Treasury forecasts that gross income tax receipts will increase from 11.1% of national income in 2005–06 to 11.8% of national income in 2009–10, despite economic activity remaining at potential and there being no discretionary income tax increase in the pipeline. Left unchecked, fiscal drag would see the share of national income taken in income tax rise steadily for a considerable time. We would see a similar phenomenon for taxes such as inheritance tax, capital gains tax and stamp duty, where the tax base tends to grow more quickly than the rise in thresholds assumed for the purposes of forecasting the public finances. The Treasury estimates that fiscal drag increases current receipts by 0.2% of national income a year in total, about £2.4 billion in today's terms.[26]

Figure 2.16. Number of higher-rate taxpayers



Note: Assumes 2% real annual growth in private incomes.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the Family Resources Survey 2002–03.

Fiscal drag manifests itself in part by leading to a steady increase in the number of people paying income tax at the higher rate of 40%, as Figure 2.16 illustrates. The effective higher-rate threshold has fallen from 165% of average earnings in April 1997 to 146% (£36,145) in

[25] HM Customs and Excise, *Measuring and Tackling Indirect Tax Losses – 2004: An Update on the Government's Strategic Approach*, London, December 2004 (http://www.hmce.gov.uk/channelsPortalWebApp/downloadFile?contentID=HMCE_PROD_011582).

[26] Paragraph A24 of HM Treasury, *End of Year Fiscal Report*, London, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf).

April 2004. As a result, there will be an extra 1.3 million people paying higher-rate tax in 2004–05 compared with 1996–97. If the threshold is raised in line with inflation over the next five years – as the Pre-Budget Report assumes – and earnings grow in real terms by a plausible 2% a year, the effective higher-rate threshold will drop to 133% of average earnings in April 2009, increasing the number of higher-rate taxpayers from 3.4 million in 2004–05 to 4.2 million in 2009–10.

In a trivial sense, fiscal drag means that the golden rule is bound to be met eventually on 'existing' policies because it increases the tax burden year after year. But, as the *Long-Term Public Finance Report* that accompanies the Pre-Budget Report acknowledges, assuming that the tax burden continues to increase would be unrealistic. The Treasury therefore assumes that revenues and their composition remain broadly unchanged as shares of national income over the longer term.[27] This implies 'a comprehensive form of "real indexation"',[28] which presumably means tax allowances and thresholds rising in line with growth in the relevant tax base, i.e. often faster than prices. The Treasury may indeed believe that, over the short to medium term, exploiting fiscal drag is the most sensible way to raise the extra revenues that it requires to meet the golden rule looking forward. But we should be clear that this would be a policy choice and not an economically neutral assumption. There are other ways that the public finances could be strengthened.

Why the tax burden needs to rise

Bringing together the trends in spending and receipts, the big picture – somewhat simplified – looks like this. When Labour came to office, it inherited a position in which the Conservatives had to borrow to pay for investment and some current spending, while Mr Brown promised he would only borrow to pay for investment. During Labour's first term, the Chancellor reduced spending and increased revenues as a share of national income, strengthening the fiscal position and wiping out the structural deficit. During the second term, he increased current spending back towards its initial level, while tax revenues weakened unexpectedly in the wake of the stock market decline. So the fiscal position worsened and the public finances moved back into structural deficit as the spending increases were paid for through higher borrowing. Over the current economic cycle, the surpluses recorded late in the first term should roughly offset the deficits in the second, so the golden rule will probably be met or missed only by a small margin. But the Chancellor now finds himself in a similar position to that which he inherited: tax revenues are not sufficient to cover current spending on an ongoing basis. With spending now expected to be broadly stable as a share of national income, he therefore needs a significant rise in the tax burden to wipe out the structural deficit again and get back on course to meet the golden rule looking forward with a reasonable margin for error. Currently, his intended end point is a level of spending similar to that which he inherited and a tax burden somewhat higher.

The crucial question now is whether government revenues will rebound sufficiently (helped by increased tax revenues from fiscal drag) to achieve this without the Chancellor having to

[27] Paragraph 5.20, page 50 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, London, December 2004 (http://www.hm-treasury.gov.uk/media/8F5/85/pbr04long-term_473.pdf).

[28] Footnote 13, page 51 of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, London, December 2004 (http://www.hm-treasury.gov.uk/media/8F5/85/pbr04long-term_473.pdf).

announce fresh tax-raising measures (or a reduction in spending). Mr Brown is convinced that they will, but, as our own forecasts suggest in Chapter 4, we are not so sure.

Misjudging the cycle

In judging whether the government is on course to meet the golden rule, much depends on whether it has correctly assessed the cyclical position of the economy.[29] In the late 1980s, the Treasury and many other forecasters misinterpreted a move into budget surplus as a structural improvement in the public finances, when in fact it was the temporary result of an unsustainable economic boom. The present government is keen not to make the same mistake.

As we noted earlier, one way the Chancellor tries to guard against this possibility is by assuming that the underlying growth rate of the economy is a quarter of a percentage point below what he believes to be the true figure. The Treasury estimates that economic activity was last at the level consistent with stable inflation in the third quarter of 2001. It expects potential output to grow by 2¾% a year until the fourth quarter of 2006 and then by 2½% a year thereafter; but for the purposes of forecasting the public finances, it assumes trend growth of 2½% to 2006–07 and 2¼% thereafter. This in effect builds in a safety margin that mounts each year, averaging around ½% of national income a year over a seven-year cycle.

But the Treasury concedes that it sees more spare capacity in the economy than other forecasters: it estimates that activity is running around 0.8% below potential in 2004–05 while the OECD, for example, sees output 0.4–0.5% above potential. The analysis of statistical filters in Chapter 3 also suggests spare capacity in the economy has now been exhausted. If this is right, less of the present current budget deficit should be blamed on temporarily depressed economic activity and more on the underlying weakness of the public finances.

Stress-testing the public finances

In past Budgets and Pre-Budget Reports, the Treasury 'stress-tested' the public finance projections against a 'cautious case' in which the level of potential output was 1% lower than the central estimate. This increased the share of past budget surpluses attributable to the cyclical strength of economic activity by about 0.7% of national income and reduced the share attributable to the underlying health of the public finances by the same amount. Figure 2.17 shows this scenario from the December 2004 Pre-Budget Report.

Having predicted in every Pre-Budget Report and Budget since November 1998[30] that the golden rule would still be met on this basis, the Treasury conceded in the December 2003 Pre-Budget Report that 'the average surplus on the current budget in the cautious case is no longer positive', arguing in mitigation that this caution was no longer necessary with the end of the cycle drawing closer.[31]

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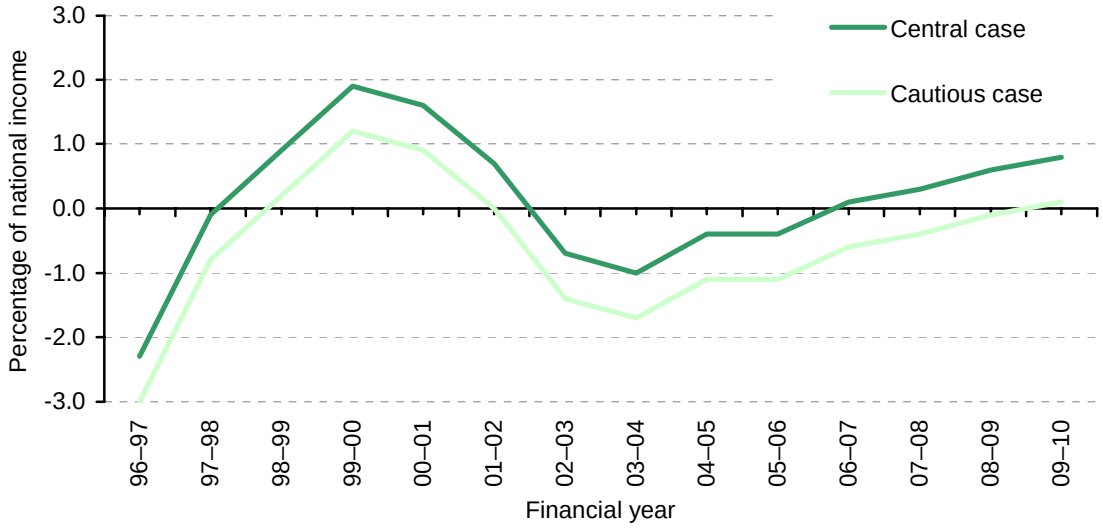
[29] We discuss the problems of doing so in greater detail in Chapter 3.

[30] See, for example, chart 2.3, page 25 of HM Treasury, *Pre-Budget Report*, Cm. 4076, London, November 1998.

[31] Paragraphs 2.71–2.74, pages 38–39 of HM Treasury, *Pre-Budget Report*, London, December 2003 (http://www.hm-treasury.gov.uk/media/5FB/2A/pbr03chap2_267.pdf).

Figure 2.17. Cyclically adjusted current budget surplus



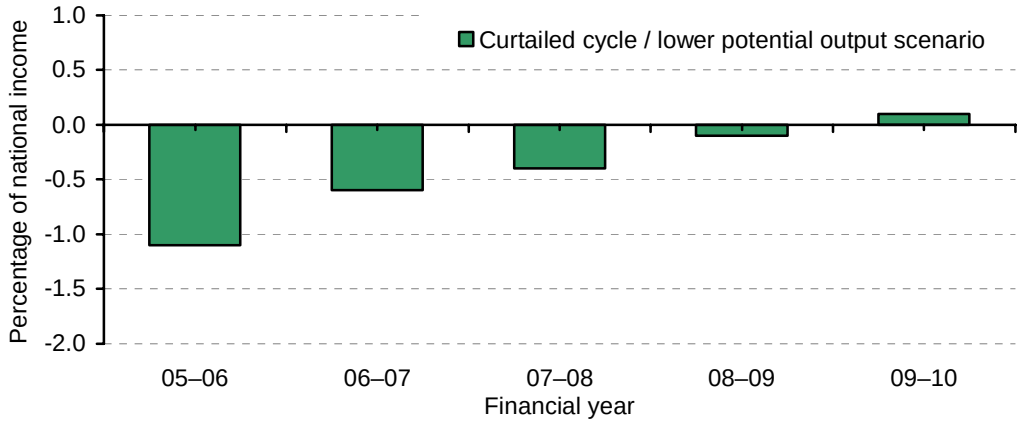
Sources: HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm); HM Treasury.

But is this particular 'cautious case' very plausible? If potential output has consistently been 1% lower than the Treasury's central estimate – which implies it has been right about the growth rate of potential output – the start and end points of the cycle would be different from the Treasury's current estimate. There would probably have been a cycle running from 1996–97 to 2004–05, a period over which the golden rule would have been missed by 0.1% of national income on average. This is shown by the 'HMT cautious case' column in Table 2.3. The golden rule would only have been missed relatively narrowly because the economy would have moved further above potential (and for longer) at the beginning of the cycle than it fell below it at the end. The cyclically adjusted balance would have been significantly negative through the cycle, but almost offset by a net cyclical surplus. However, in a cycle of this sort, we should have seen a step upward shift in the rate of inflation over the course of the cycle, which clearly did not occur.

If there is less spare capacity in the economy than the Treasury thinks, a more plausible explanation is that the trend growth rate of potential output has been lower since the beginning of the current cycle than the Treasury estimates. The trend growth rate of potential output would only need to have been 0.17 percentage points lower than the Treasury's central estimate since April 1999 for the level to be 1% lower by March 2005. If this is the case, then it curtails the current cycle by a year and means that it will end in March this year. This makes the golden rule easier to meet in the short term because we do not have to worry about the current budget deficit pencilled in for 2005–06. The rule will be met as long as the current budget deficit this year does not exceed 2.0% of national income or £23½ billion. The Pre-Budget Report forecast that it would be 1.1% of national income, although if the trends in spending and revenues seen in the first nine months of the financial year continue over the next three, it will come in at £20.5 billion (1.8% of national income). To meet the rule on a curtailed cycle, we would need current budget surpluses averaging £1.2 billion over the next three months compared with an average of £2.2 billion over the same three months last year.

Although a curtailed cycle would make the golden rule more likely to be met in the short term, it would make it harder to meet in the longer term because the next cycle would begin with the current budget in deficit. Let us assume: (1) that potential output is 1% lower than the Treasury thinks; (2) that the present cycle ends a year early; (3) that the Treasury is right about the growth of potential output in the next cycle; and (4) that the Treasury expects the same profile of fiscal tightening over the next few years as in the Pre-Budget Report. We would then find ourselves moving along the Treasury's scenario, where trend output is 1% lower, and beginning the cycle in 2005–06 as in Figure 2.18.

Figure 2.18. Cyclically adjusted current budget surplus



Source: HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm).

Were this to happen, the government would begin the cycle in structural deficit. This is shown by 'cautious case II' in Table 2.3. An atypically long cycle with uninterrupted fiscal drag would have to be expected to have even a 50-50 chance of meeting the golden rule. To have the public finances in as strong a position as the Chancellor was looking for in the last Budget, policy would need to be tightened by 0.4% of national income (£5 billion) in the forthcoming Budget. The longer the tightening is left, the more ground there is to make up and the more abrupt it would have to be.

Table 2.3. Average current budget surpluses over cycle

% of national income	Central case (99–00 to 05–06)	HMT Cautious Case (96–97 to 04–05)	Cautious Case II (99–00 to 04–05)
Cyclical	–0.2	0.6	–0.0
Structural	0.2	–0.7	0.2
Total	0.1	–0.1	0.2
Structural balance in first year of next cycle	0.1	–1.0	–1.0

Source: Authors' calculations.

Table 2.3 provides a summary of whether the golden rule would be met over the current economic cycle and the strength of the starting position as we move into the next economic cycle under each of the three scenarios considered in this section. In all of these cases, the golden rule is likely to be met or missed by a relatively small margin over the current

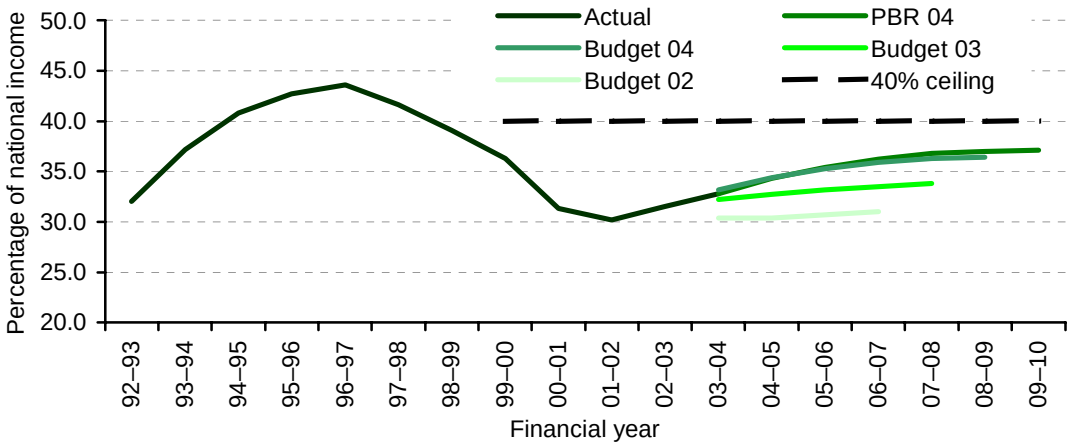
economic cycle. However, the strength of the position in which we start the next economic cycle is very sensitive to whether we reach trend output in 2004–05 or in 2005–06.

To sum up, even if one does not quarrel with the Chancellor's underlying forecasts for spending and revenues, fresh tax increases or spending cuts may be necessary if the Treasury is overestimating the amount of spare capacity in the economy. If the economy is already running above potential, this may make it slightly easier to meet the golden rule in the short term (depending on the dating of the current cycle), but will certainly make it more difficult looking forward. If a tightening in policy is required as a result, the sooner it happens the less abrupt it needs to be to expect to meet the golden rule over the next economic cycle. This is a key issue, and one to which we return in Chapter 4.

2.5 Meeting the sustainable investment rule

In recent Budgets and Pre-Budget Reports, the Treasury has gradually revised up its forecasts for public sector net debt, as shown in Figure 2.19. In Budget 2002, the Treasury was predicting a debt ratio around 31% of national income at the end of the then forecasting period in 2006–07. In the 2004 Pre-Budget Report, it predicted that the debt ratio would stabilise at around 37% of national income at the end of the current forecasting period in 2009–10. If this forecast is accurate, the government will continue to meet the sustainable investment rule, as the ratio will remain below the permitted ceiling of 40% of national income. But the Chancellor clearly has less room for manoeuvre than in recent years.

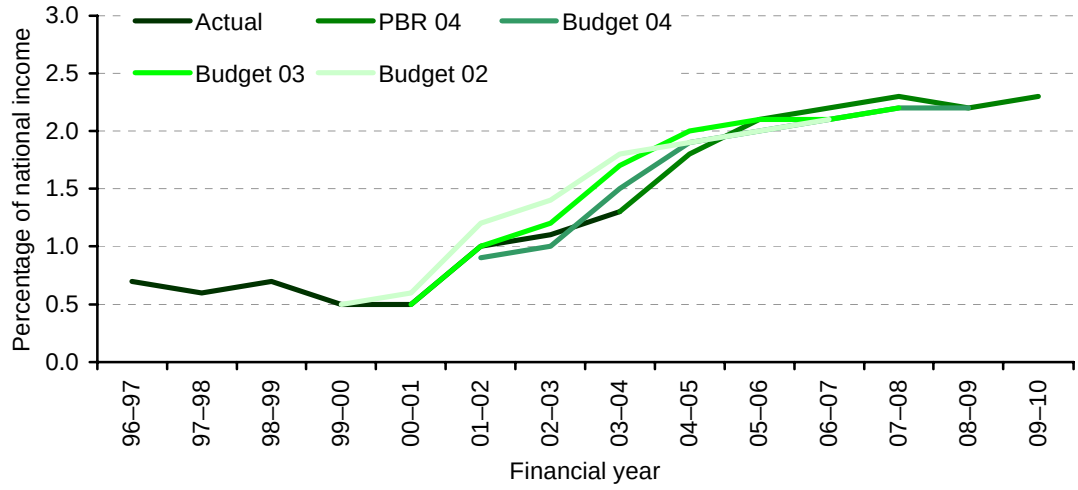
Figure 2.19. Treasury public sector net debt forecasts



Sources: Various Budgets and Pre-Budget Reports.

The rise in the Treasury's debt forecasts reflects unexpectedly large current budget deficits rather than more ambitious plans for public sector net investment. As Figure 2.20 shows, the government has repeatedly failed to increase investment as quickly as it would like.

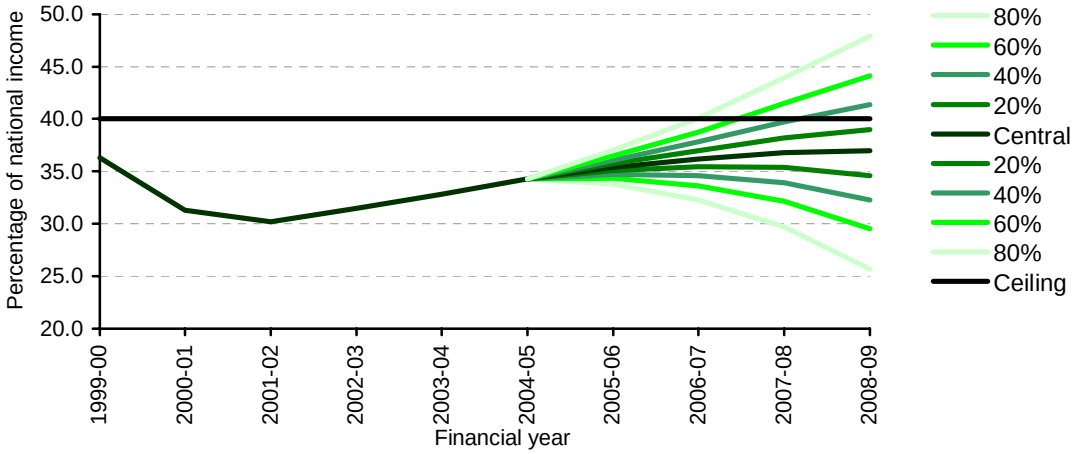
Figure 2.20. Treasury public sector net investment forecasts



Sources: Various Budgets and Pre-Budget Reports.

If the Treasury's latest forecasts for public sector net debt are correct, the government could make an additional one-off public sector net investment of just under 3% of national income before breaching the sustainable investment rule. But, as we noted earlier, there is no guarantee that the forecasts will be correct, based on past experience.

Figure 2.21. Probabilities of public sector net debt outcomes



Note: Assumes that any cumulative variation in public sector net borrowing from that forecast by the Treasury directly adds to public sector net debt. The second-order impact of changes in debt interest is ignored.
Source: Central projections are taken from HM Treasury, *Pre-Budget Report*, London, December 2004 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr04/prebud_pbr04_index.cfm); methodology for computing fan charts adapted from that set out in C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

We can translate the probability distribution for public sector net borrowing in Figure 2.4 into a probability distribution for public sector net debt (Figure 2.21). Again, this assumes that the Pre-Budget Report forecast for 2004–05 is accurate. The chances of breaching the 40% ceiling are extremely low in the next couple of years, but then increase quickly as the forecasting horizon extends. This is due to the relatively strong historical correlations between

errors in successive forecasts, and the fact that any differences in borrowing have a cumulative impact on net debt.

In 2005–06, we estimate that, on the basis of the Treasury's forecasts, there is a negligible chance that the sustainable investment rule will be breached. However, the probability of a breach increases to 11% in 2006–07, 28% in 2007–08 and 36% in 2008–09.

2.6 Reforming the fiscal framework

It is more than seven years since the current government began to put in place its fiscal policy framework. The Chancellor said that the golden rule would be judged over a full economic cycle; the first such cycle under the new regime is now drawing to – or may already have drawn to – a close; and the Treasury has yet to publish an estimate of the duration of the next cycle. So this seems a good point at which to ask whether the framework should be applied in exactly the same way looking forward or whether changes would be desirable.[32]

The fiscal rules

There is always a trade-off, when publishing policy targets, between precision on the one hand and simplicity and transparency on the other.

In a number of respects, the existing fiscal rules are defined and applied in ways that mean that, even if they are formally adhered to, they are unlikely to achieve exactly the goals that have been used to justify them. But reforming the rules to achieve these goals more precisely may make them harder to understand and police, and thus less effective as a means of holding policymakers to account for their actions.

In addition, the rules are not applied in a way that takes explicit account of the uncertainty around forecasts of the measures being targeted, which could lead to poor policy decisions. But taking this uncertainty into account more formally could create a perception that the government is simply trying to make it easier to move the goalposts if policy goes off track.

Bearing these points in mind, how might the design and operation of the rules be reformed?

The golden rule

The current/capital distinction

The golden rule is designed to help achieve intergenerational fairness, by ensuring that future taxpayers only have to repay debts that have financed spending from which they benefit. The rule is based on the distinction between capital and current spending in the national accounts, which in turn is based on international accounting standards as interpreted by the Office for National Statistics. The decision to use the national accounts definition was presumably taken, in large part, on grounds of transparency (and also because it would achieve the additional objective of protecting infrastructure spending if and when spending plans need to be cut).

[32] For further discussion see C. Emmerson, C. Frayne and S. Love, *Updating the UK's Code for Fiscal Stability*, IFS Working Paper W04/29, November 2004, (http://www.ifs.org.uk/publications.php?publication_id=3163).

The distinction between capital and current spending in the national accounts does not necessarily coincide with spending that does and does not benefit future taxpayers. For example, £1 of 'current' spending on teacher training might be of greater benefit to future taxpayers than £1 of 'capital' spending on the Millennium Dome. The rule could in principle be redefined on the basis of a more sophisticated categorisation of spending. But, as this would inevitably be a matter of judgement, it might raise suspicions that the government would tweak the definition or reclassify spending when a breach of the rules looked likely.

Even if the golden rule did distinguish perfectly between spending that does and does not benefit future taxpayers, it does not necessarily distribute the burden of paying for spending in a 'fair' way. For example, there is no guarantee that the time profile of debt repayments will match the time profile of the benefits flowing from the investment project that the additional debt has funded. Neither would different members of a particular generation necessarily pay in proportion to the benefits they receive. (Indeed, that might well not be thought desirable, as one of the purposes of public spending and taxation is to redistribute resources within generations on equity grounds.) Equity considerations might also lead us to believe that future generations should pay for some of today's current spending, as productivity growth should make future generations on average better off and therefore give them greater ability to pay.

Symmetry versus asymmetry

But let us assume that the golden rule is a reasonable rule of thumb. Other questions remain. For example, why should the rule be asymmetric? If we are simply seeking intergenerational fairness, we should presumably care as much if today's taxpayers pay too much for current spending as if they pay too little.

The combination of an asymmetric target and large forecasting errors for the target measure can create unhelpful incentives for policymakers. Under the current formulation, the Chancellor appears to be gambling his credibility on avoiding even a tiny current budget deficit over a multi-year period. This means either that he has to build in a large margin for error, in which case the most likely outcome is a current budget surplus, or that he has to aim for balance or a small surplus, in which case the chances of meeting the golden rule will be only 50-50 or a little better, making a loss of credibility quite likely.

Alternatively, the rule could be made symmetric and the Chancellor could approach it in much the same way that the Bank of England approaches the inflation target. He would aim for a current budget balance, with everyone aware that the chances of meeting it exactly are negligible. Instead, credibility would rest on his ability to convince voters and investors that policy was being set with the genuine aim of getting as close to the target as possible, and – to that end – on his willingness to explain why the current budget may be deviating from target and what he intends to do about it over a sensible time horizon.

The Chancellor presumably prefers an asymmetric target because running a current budget deficit would make it more difficult to meet the sustainable investment rule by adding to the debt burden. (There would be a similar conflict if the government had a target for the price level as well as for inflation.) But if past current budget deficits made it desirable to overachieve the golden rule for a while to avoid an undesirable squeeze on investment, the government could temporarily adopt a symmetric target to achieve an appropriate current budget surplus. Retaining symmetry in this way would avoid the need either for big margins

for error or for credibility to be dependent on unrealistic hopes of forecasting the current budget balance very accurately. Alternatively, the Chancellor could retain the formal target of a current budget balance, but in fact aim for a surplus. However, this would be untransparent.

If we want to retain an asymmetric target for the current budget, then it might be sensible for the Chancellor to explain what he regards as an acceptable probability of breaking the rule, given the inevitable uncertainties around even the most short-term forecast for government borrowing. He could, for example, promise always to set policy so as to give him a 70% chance of meeting the rule, given past forecast uncertainty and the length of time remaining before the expected end of the current economic cycle.[33] But this is clearly more complicated than the current formulation and might appear to be a weaker commitment.

A rolling forward-looking target

The attraction of demanding that the golden rule only has to be met on average over an economic cycle – not every year – is that it allows the automatic stabilisers to operate. But the choice of exactly which cycle over which to judge the rule is arbitrary. Instead of the current formulation, for example, we could define a cycle as running from peak to peak or trough to trough, or beginning with activity falling below potential rather than rising above it.

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

It is also difficult to set policy credibly to achieve the golden rule at the beginning of a cycle of unknown duration, especially if the current budget starts out in structural deficit. Let us say you begin with a deficit of 1% of national income in the first year of the cycle and that you aim to tighten policy by the same amount each year to meet the golden rule. You need to tighten by 2% of national income a year if you expect a two-year cycle, ⅔% of national income a year for a four-year cycle and ⅓% of national income a year for a seven-year cycle. Given recent history, each of these durations is plausible and it might take some time before there is general agreement on even the approximate likely length of the cycle.

An alternative would be to set a rolling forward-looking target for the cyclically adjusted budget balance at the end of a suitable medium-term time horizon – say, four or five years. This would allow the automatic stabilisers to operate and would parallel the operation of the inflation target: the Bank does not have to achieve an average inflation rate of 2% over a particular period, but rather sets interest rates to achieve it two or so years ahead.

Risks include the fact that it would be harder to explain than the existing target and that the Treasury might be suspected of fiddling the cyclical adjustment (although this could be handed to an independent body, as we discuss below). Again, it looks a weaker and less verifiable commitment, bringing to mind Labour's criticisms of the previous government for its vague goal of 'balancing the budget over the medium term'. The stronger the Treasury's (and the Chancellor's) credibility, the less important these concerns would be.

[33] The desired probability need not be constant, but it should perhaps at least be explicit.

The sustainable investment rule

As we discussed in Section 2.2, leaving aside the question of which investment projects the government should undertake, the principle of setting some self-imposed ceiling on the ratio of debt to national income has intuitive appeal: it would be unfair on future generations and dangerous in terms of the likely response of financial markets for public sector debt to be on an explosive upward path. It is less obvious how high the ceiling should be set or what liabilities to include in the definition of public sector debt.

Off-balance-sheet liabilities

The definition of public sector net debt is based on international accounting standards, as interpreted by the Office for National Statistics (ONS). The issue has become controversial in part because of the increasing use, under governments of both parties, of partnerships with the private sector to help deliver investments the government deems desirable. This creates payment commitments and potential liabilities for the government that may be off the public sector's balance sheet. This in turn creates the suspicion that such mechanisms will be used not because they deliver greater value for money than conventional debt financing, but because they allow the government to spend more on investment without breaking its rules.

Private firms undertake some capital spending on behalf of the public sector by means of the Private Finance Initiative (PFI). Under the PFI, the public sector pays private firms a rental price for use of a capital asset that the private sector delivers. It is estimated that around 43% of the investment carried out through the PFI is 'off balance sheet', in the sense that future payments due to private contractors do not constitute current public sector debt.[34]

The Treasury estimates that PFI deals signed to April 2004 will deliver a total of £40.0 billion of investment in public services.[35] If all of this spending is carried out by March 2009 and no additional capital spending is carried out on any further PFI deals not yet signed, then this would equate to 2.8% of national income in 2008–09. Public sector net debt would be 1.2% of national income higher as a result of including on the public sector's balance sheet the 43% of this PFI investment spending that is currently on the private sector's balance sheet. This would raise the expected public sector net debt ratio to 38.2% of national income in 2008–09 and increase the probability of breaching the debt ceiling by then from 36% to 42%. But the Chancellor might reasonably argue that if he had intended to include PFI spending in the targeted debt ratio, he would have set the ceiling higher.[36]

Private Finance Initiative payments are not the only off-balance-sheet liabilities that might be faced by the government. For example, borrowing carried out by Network Rail could be considered similar to conventional government borrowing, even though the ONS defines it as a private sector company and therefore off the public sector's balance sheet. After all, the government in effect determines Network Rail's income by controlling the prices that train operators have to pay the company to use the track and associated infrastructure, as well as

[34] Speech by the Chief Secretary to the Treasury, Paul Boateng, to the PFI Congress, 10 June 2003 (http://www.pppforum.com/government/cst10_06_03_2003.html).

[35] HM Treasury, *PFI Signed Projects List – April 2004*, 2004 (http://www.hm-treasury.gov.uk/media/F20/9F/ACF12A5.xls).

[36] For a more detailed discussion, see chapter 2, pages 13–17 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, Commentary no. 92, Institute for Fiscal Studies, London, January 2003 (http://www.ifs.org.uk/budgets/gb2003/ch2.pdf).

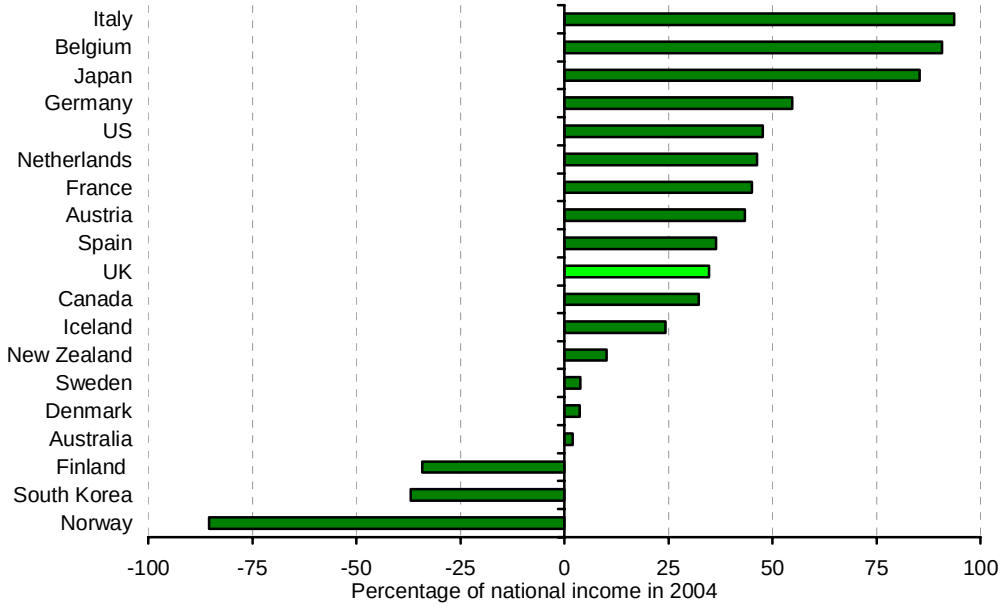
guaranteeing to repay its debt if the company collapses. More likely, if the company got into serious trouble, the government would take greater control and the ONS would reclassify it as part of the public sector for the purposes of the national accounts, even if Network Rail had not been formally renationalised. This would further reduce the Chancellor's room for manoeuvre in remaining below the current debt ceiling.

Given the suspicions raised by the growth of the off-balance-sheet liabilities, it might be thought desirable on grounds of transparency to widen the definition of public sector debt and increase the ceiling in the sustainable investment rule correspondingly. But it is hard to know where to stop in deciding which future payments or revenue streams we might in principle want to bring onto the balance sheet. For example, the government probably has greater scope to renegotiate future payments to PFI providers than to reduce significantly the amount it will have to pay to run the NHS over the next few years. And, unlike a private company, the government has future revenue guaranteed by its ability to levy taxes. A fully comprehensive treatment of the public sector balance sheet would presumably take these into account.

The height of the debt ceiling

If we stick with the existing definition of public sector net debt, does the current ceiling of 40% make sense? It is hard to argue from economic theory that a 40% ceiling is any more sensible than, say, a 30% or 50% ceiling. Attempts have been made to infer an optimal debt ratio from comparisons with the debt/equity ratios prevailing in the private sector and from theoretical and empirical analyses of the relationship between interest rates and economic growth rates. None gives a particularly precise or robust result.[37] The 40% ratio appears to have been chosen in effect as a commitment not to allow debt to rise again to the levels inherited from the Conservatives (under whom it had risen to 43.6% in 1996–97).

Figure 2.22. General government debt ratios in OECD countries



Source: OECD.

[37] Pages 174–5 of E. Balls and G. O'Donnell (eds), *Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability*, Palgrave, Houndmills, 2001.

As Figure 2.22 shows, even if it reached the 40% ceiling, the UK's public sector debt would be low relative to those of most other G7 countries.[38] But there are comparable countries with much stronger debt positions, including Australia, New Zealand and the Scandinavian countries. Some OECD countries have more financial assets than debt – for example, Norway (which is aiming to smooth the consumption of its oil revenues) and South Korea (which has built up enormous foreign exchange reserves to limit the rise in its exchange rate).

The UK might not wish to go this far, but, given the pressures of an ageing population on the costs of the pension system, a lower debt target to be raised again later could help smooth future tax rates. But this is likely to be an imprecise and poorly targeted means to the desired end. Public sector net investment could be protected if any reduction in the debt burden were brought about by overachieving the golden rule, but a lower debt ceiling would reduce the amount of debt-financed investment that could be undertaken in the steady state.

Institutional reform

On taking office in 1997, Labour swiftly established new frameworks for both monetary and fiscal policy. In both cases, it created transparent operational targets: the inflation target for monetary policy, and the golden rule and sustainable investment rule for fiscal policy.

To convince voters and financial market participants that the government was serious about achieving the inflation target, responsibility for setting interest rates in pursuit of that target was handed to an independent monetary policy committee at the Bank of England. Similar arguments could be made for the need to persuade people that the government is serious about meeting its fiscal targets, yet there has been no equivalent delegation of fiscal policy. Responsibility for both tax and spending decisions remains with the Chancellor.

A number of academics and commentators have argued that at least some aspects of fiscal policy should be delegated to an independent body, analogous to the Monetary Policy Committee.[39] The Treasury has discussed this possibility in the context of adopting a more active fiscal policy if the UK adopts the euro. It concluded:

> Taxation and expenditure decisions are complex and fundamentally collective political and social choices, requiring strong democratic accountability to provide adequate legitimacy. The establishment of an independent fiscal policy committee would be inconsistent with the parliamentary tradition in the UK, which gives the House of Commons 'financial privilege' with respect to tax decisions. Making even a subset of fiscal policy decisions independent of scrutiny would thus challenge parliamentary sovereignty and it is therefore not considered further.[40]

Given the government's willingness to diverge from parliamentary tradition in other policy areas, it seems hard to imagine that the technical prerogatives of the House of Commons would be an insurmountable barrier if ministers decided that delegating fiscal policy was fundamentally desirable. More important is the question of whether tax and spending

[38] General government debt is a slightly narrower definition than the public sector debt measure used in the sustainable investment rule, but it facilitates international comparison.

[39] Box 6.7, page 74 of HM Treasury, Fiscal Stabilisation and EMU: A Discussion Paper, London, 2003 (http://www.hm-treasury.gov.uk/media/D9C/48/adhereford03_4567ra_324.pdf).

[40] Paragraph 6.37, page 73 of HM Treasury, ibid.

decisions are inherently and necessarily more 'political' than interest rate decisions and whether the legitimacy of those decisions therefore requires them to remain under the direct control of elected representatives. The answer would presumably depend in part on the fiscal policy decisions to be delegated. We can imagine a range of options, such as those set out in Table 2.4.

Table 2.4. Options for fiscal delegation

Option	Government	Independent body
I (complete delegation)	• No role	• Determines fiscal rules • Decides spending plans • Decides detailed tax measures
II	• Decides spending plans	• Determines fiscal rules • Decides detailed tax measures
III	• Determines fiscal rules • Decides spending plans	• Decides detailed tax measures to deliver revenue thought necessary to meet rules
IV	• Determines fiscal rules • Decides spending plans • Sets most tax parameters	• Varies limited number of tax parameters to deliver revenue thought necessary to meet rules
V	• Determines fiscal rules • Decides spending plans • Suggests detailed tax measures	• Estimates revenue required to meet rules • Approves tax proposals if revenue thought to be sufficient
VI	• Determines fiscal rules • Decides spending plans • Decides detailed tax measures	• Makes official revenue forecasts • Judges if rules (likely to be) met
VII (status quo)	• Determines fiscal rules • Decides spending plans • Decides detailed tax measures	• Judges if subset of forecasting assumptions are 'reasonable' (National Audit Office)
VIII	• Determines fiscal rules • Decides spending plans • Decides detailed tax measures	• No role

It seems highly implausible to suggest that an independent body would be given responsibility for deciding the size and/or composition of government spending (Option I). It is (slightly) more plausible to suggest that it would be given responsibility for setting fiscal rules to ensure that the spending was paid for in a fair and sustainable way, and for setting taxes to meet them (Option II). Analogously, within the euro-zone, the European Central Bank has responsibility for deciding the operational target for monetary policy ('goal independence') as well as setting interest rates to meet it. The UK government has also delegated the setting of interest rates, but retained the right to set the monetary policy target ('instrument independence'). An equivalent structure for fiscal policy would leave open the question of which instruments to delegate – the design of the entire tax system could be handed over (Option III) or a limited

number of parameters, such as the main rates of income tax and VAT, could be (Option IV). Confining an independent fiscal authority's decisions to a single tax parameter might make its actions less controversial, but it would not necessarily make for the most efficient tax system.

If – as seems likely – it were decided that even limited delegation of the power to set tax rates was politically unacceptable (for example, because different choices would imply different sets of winners and losers), the independent fiscal body could be given the power to veto a set of Budget measures that it believed inconsistent with meeting the fiscal rules with a reasonable probability (Option V). Or its role could be purely advisory (Option VI). The Conservative Party has suggested creating an independent fiscal policy committee that would be responsible for official fiscal forecasts and judging whether the rules have been met or not.[41]

Under the status quo, an independent body (in the shape of the National Audit Office) has responsibility for pronouncing on whether a subset of the economic assumptions that underlie the Treasury's public finance forecasts are 'reasonable' or not. This model could be extended – for example, by giving an independent body the task of identifying the start and end points of the economic cycle over which the golden rule is judged (or of estimating the size of the output gap if the government decided to set a rolling target for the cyclically adjusted current budget). One candidate would be the Bank of England, which would mean that the same judgement about the degree of spare capacity in the economy would be used for both monetary and fiscal policy. But the Bank is wary of the output gap as a guide to the outlook for inflation, and the Monetary Policy Committee does not reach a collective view on it.

Ultimately, the acceptable extent of delegation has to be a matter of judgement on which reasonable people will disagree and on which the balance of opinion might change over time. After all, most people would not have thought central bank independence politically acceptable 25 years ago and it might not be thought politically acceptable in 25 years' time.

Delegating the levers of fiscal policy is inevitably more complicated and controversial than delegating the levers of monetary policy because tax and spending decisions involve more politically contentious trade-offs. Tax and spending policies interact to achieve a number of sometimes conflicting policy objectives: supplying public goods; replacing missing insurance and credit markets; influencing individual and firm behaviour; and redistributing resources within and across generations. In the monetary policy sphere, it is widely accepted: (1) that inflation should be low and stable; (2) that short-term interest rates are the most sensible tool with which to target it; and (3) that there is no trade-off between higher inflation and lower employment or economic growth in the long term. The main trade-off the Bank of England has to make is between the variability of growth and inflation – in other words, how quickly to correct any deviation of inflation from target and what temporary consequences for growth and employment to accept in doing so.

Creating an independent fiscal body with a purely advisory forecasting role would be akin to the monetary policy regime established under Kenneth Clarke's Chancellorship in the mid-1990s, when the Bank of England made public its view on the outlook for inflation but responsibility for setting interest rates was left with the Chancellor. Such a body might have

[41] http://www.conservatives.com/tile.do?def=news.story.page&obj_id=117992.

some advantage over existing independent forecasters in terms of accuracy if it were better resourced and/or enjoyed the privileged access to information on government spending and tax payments that the Treasury currently enjoys.

2.7 Conclusions

At best, the golden rule and sustainable investment rule are rough yardsticks to help ensure that tax and spending decisions are sustainable and fair.

The golden rule might promote intergenerational fairness more effectively if it distinguished better between spending that does and does not benefit future generations, if it unambiguously encouraged policymakers to aim for a balanced current budget, and if it was forward-looking rather than requiring policymakers to average desirable outcomes over arbitrary time periods.

Whether the sustainable investment rule sets too high or too low a ceiling for public sector net debt is less clear. This depends on the level of public sector net investment that it is thought desirable to maintain and on the extent to which it is thought appropriate for today's governments to determine – for good or ill – the tax burden faced by future generations of taxpayers who may have had no say in the matter. The definition of public sector net debt could also in principle be widened to bring more liabilities onto the public sector balance sheet, but the definition could quite easily be widened so far as to make the rule of little practical use.

Whether the precise formulation of the rules is modified or not, debate over the appropriate setting of fiscal policy would benefit from more explicit consideration of the uncertainty that surrounds forecasts of government borrowing and debt. Judging purely from its past forecasting errors, the Treasury's latest forecasts suggest that it is touch-and-go whether the golden rule will be met over the current cycle, and that there is a non-negligible possibility both that the golden rule will be missed over the next cycle (especially if it is short) and that public sector net debt will breach the sustainable investment rule in the next few years. On the other hand, it is quite possible that the outcomes will be better than the Treasury expects. As we discuss in Chapter 4, our own forecasts suggest that the outlook is less favourable.

If the government were to amend the definition of the fiscal rules and/or take greater formal account of the uncertainty around its forecasts, the public might find them harder to understand and suspect that the Treasury was trying to make life easier for itself. One response could be to delegate more of the fiscal policymaking process to an independent body outside government. But the degree to which it is appropriate to do so is as much a political judgement as an economic one. Either way, the more open and transparent the Treasury is in its fiscal forecasting and policymaking, the more credible its actions are likely to be.