

## 5. Fiscal targets and policy: which way next?

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### Key findings

- **The current fiscal targets are no longer an anchor on fiscal policy.** All expire during the current forecast horizon. In any case, (cyclically adjusted) borrowing appears on course to exceed the 2% of national income ceiling supposedly imposed by the fiscal mandate. If a 'no deal' Brexit happens, it would be difficult to imagine the supplementary debt target not also being broken.
- **Labour's 2017 proposal for a rolling forward-looking target of current budget balance has much to commend it.** This would allow additional investment spending to be financed from borrowing when interest rates are low, and would also allow the chancellor some flexibility when responding to adverse shocks.
- **But Labour's 2017 proposal to have public sector net debt lower at the end of the parliament than at the start would be incompatible with its stated policies.** A large programme of nationalisation and substantial boost to investment spending would increase the size of the public sector balance sheet, increasing both its liabilities and its assets. Regardless of the merits of these policies, public sector net debt would rise, not fall.
- **Consideration could be given to targeting the projected path of public sector net debt over a longer horizon** and also to the feasibility of setting a target that takes account of a broader set of public sector assets.
- **If a 'no deal' Brexit occurred, fiscal policy would need to respond.** Over the longer term, the damage done to the economy would require some combination of tax rises and spending cuts. But in the near term, there could be a case for a temporary fiscal giveaway. This could target parts of the economy where the short-run dislocations were particularly painful, or particularly likely to have adverse long-term effects. But the overall giveaway should be temporary.
- **It is hard to imagine a set of short-term fiscal targets that would make sense both in the event of the UK leaving the EU with a deal and in the event of leaving without a deal.** Any rules that constrained behaviour at all in the first case would be broken in the second. Given heightened uncertainty, rather than setting a target for borrowing or debt, the chancellor could consider instead setting a fiscal anchor to limit the amount of permanent tax cuts or further increases in day-to-day spending that is announced. This would not limit the chancellor's options for borrowing to invest more or to deliver a temporary stimulus package. Well-designed fiscal rules could then be set out once at least some Brexit uncertainties have been resolved.

## 5.1 Introduction

In his 2019 Spending Round announcement, the new chancellor, Sajid Javid, claimed that ‘even with the extra spending we are still meeting the current fiscal rules’. As we will show, it now appears more likely than not that the government will breach its fiscal mandate. Perhaps relatedly, Mr Javid also announced that there would be a review of the current fiscal framework, noting ‘it is my judgement today that with a strong fiscal position and record low cost of borrowing, we can invest more in growing our economy’ but that ‘we’ll still need to make difficult choices about our national priorities, within a clear set of rules to anchor our fiscal policy and keep control of our national debt’.<sup>1</sup>

Historically low borrowing, coupled with very low interest rates, can justify a loosening of fiscal policy. All else equal, public investment spending will be more attractive when interest rates are low. And when very low interest rates are combined with periods of temporary weakness in the economy, there can be a stronger argument for implementing carefully designed discretionary fiscal giveaways in an attempt to stimulate demand. Measures of this type were implemented in many major economies – including the UK – in response to the financial crisis and Great Recession.

The Budget is an obvious opportunity for the new chancellor to set out the government’s thinking in these areas. This is particularly true for two reasons. First, the fiscal targets bequeathed by former chancellor Philip Hammond no longer provide much of a fiscal anchor. Second, the government has stated that it wants to keep open the possibility of a ‘no deal’ Brexit and, should this occur, an important decision would need to be made over how fiscal policy should adjust. These two issues interact since any new fiscal targets ought to be carefully designed so that they are robust to plausible scenarios for the UK economy, not least around Brexit.

This chapter begins by considering the case for having fiscal targets (Section 5.2). This is followed by two sections that look at the government’s current fiscal targets (Section 5.3) and the rules proposed by the opposition Labour party (Section 5.4). As well as critiquing these rules, we discuss how constraining they might prove to be under both current government policy and (in broad terms) under the policies that Labour set out in its 2017 general election manifesto. The chapter then turns in Section 5.5 to outline some of the important considerations when deciding upon the best fiscal policy response to an adverse economic shock and presents what a stylised fiscal stimulus might do to growth, borrowing and debt. Finally, Section 5.6 concludes by drawing together the discussion to recommend what a sensible course of action could be for Mr Javid – or his successor – to follow in terms of setting fiscal targets in the current climate.

## 5.2 Why set fiscal targets?

The recent history of UK governments adopting fiscal targets begins with the Labour party taking office in 1997. Keen to convince markets and voters that he would not repeat the perceived failings of former Labour chancellors, newly appointed chancellor Gordon Brown committed to keeping to his ‘golden rule’ and his ‘sustainable investment rule’.

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<sup>1</sup> ‘Spending Round 2019: Chancellor Sajid Javid’s speech’, 4 September 2019, <https://www.gov.uk/government/speeches/spending-round-2019-sajid-javids-speech>.

Since then, chancellors Alistair Darling, George Osborne and Philip Hammond have all followed Mr Brown's lead and set themselves fiscal targets.

There are a number of related potential advantages from having fiscal rules. These mainly stem from a concern that governments suffer from 'deficit bias' due to a desire to avoid taking difficult decisions, which would lead to spending being too high and taxes being too low. Fiscal targets can act as a self-commitment device constraining future behaviour in order to reduce this tendency.

Targets also help communicate this to voters and market actors and may add transparency over government intentions. They may also help the Treasury with the internal management of government. In the run-up to Budgets, chancellors can expect to receive far more submissions calling for tax cuts than ones calling for tax rises. Similarly, spending departments will put in bids for additional spending that exceed the total amount of spending available. For example, it was recently reported that bids to the September 2019 Spending Round totalled £55 billion;<sup>2</sup> these were whittled down to an eventual £13 billion of additional spending in what was still one of the most generous spending giveaways since 2010 (see Chapter 6).

Good fiscal targets, which appropriately constrain the government, can therefore lead to lower borrowing, and debt over the longer term, than would otherwise be the case. This can have obvious advantages, such as reducing debt interest spending (which in turn means the desire to keep future debt down will depend on what interest rates are expected to be) and ensuring that the public finances are able to respond to adverse shocks while remaining sustainable in the longer run.

Lower debt achieved through implementing higher taxes or lower day-to-day spending today would typically benefit future generations and improve fiscal sustainability. But if lower future debt is achieved by reducing investment spending (which should improve either the productive capacity of the economy or the future quality of public services), then it is less clear that this is desirable in the longer term. Future generations might also be less concerned about higher debt that was associated with the public sector acquiring marketable assets: not least because, assuming they are managed well, they would always have the option of selling those assets.

All of these arguments underscore that it is the longer-term path of debt which matters, rather than the precise level of debt (or its change) in the near term.

Finally, one of the key challenges with designing fiscal targets is ensuring that they allow a chancellor the flexibility to respond appropriately to new fiscal developments. Allowing borrowing to fall and rise over the ups-and-downs of the economic cycle is sensible: it facilitates a smoother path for tax rates and spending and helps support the economy when it is underperforming. When structural public finance problems emerge, such as those following the global financial crisis and Great Recession, it can be sensible to implement the necessary fiscal tightening gradually rather than all at once.

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<sup>2</sup> <https://www.theguardian.com/politics/2019/sep/18/it-has-got-worse-boris-johnson-hamstrung-by-rift-with-sajid-javid>.

In the end, there is a tension between having clear and measurable short-term targets which impose real constraints and allowing chancellors full discretion to make appropriate decisions. Were governments fully rational and trustworthy – and this widely seen to be the case – rules would not be needed. The rules themselves will always be second-best. The less trust and confidence there is in a government’s handling of the economy, the greater the benefits from having a transparent, measurable and constraining set of rules.

With these considerations in mind, the next section critiques the government’s current fiscal targets, while the subsequent section examines Labour’s proposed fiscal rules.

### 5.3 The government’s current fiscal targets

The government’s formal – and current – fiscal targets were announced by the then chancellor Philip Hammond in the 2016 Autumn Statement. They were then legislated in the Charter for Budget Responsibility, which was last updated prior to the 2017 general election.<sup>3</sup> The targets are:

- **the fiscal mandate:** cyclically adjusted public sector net borrowing – that is, headline borrowing adjusted for the estimated impact of the ups-and-downs of the economic cycle – to be less than 2% of national income in 2020–21;
- **the supplementary debt target:** public sector net debt to be lower as a share of GDP in 2020–21 than in 2019–20;
- **the welfare cap:** spending on ‘welfare-in-scope’ in 2022–23 to be below the cap set in November 2017, with compliance assessed in the first fiscal event of the next parliament.

There is no perfect fiscal target as there is no one measure that is best suited to guide policy in all time periods and all circumstances. But all of the above targets have some reasonably obvious flaws.<sup>4</sup> One issue they have in common is that they are all time-limited: the fiscal mandate constrains borrowing but only in 2020–21; the supplementary debt target constrains the growth in debt but only between March 2020 and March 2021; and the welfare cap constrains welfare spending only in 2022–23.

The Charter for Budget Responsibility also says that the government’s overall fiscal objective is to ‘return the public finances to balance at the earliest possible date in the next Parliament’. This was legislated prior to the 2017 general election, but the government is clearly not focusing on meeting this target: we are not going to have an

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<sup>3</sup> HM Treasury, ‘Charter for Budget Responsibility: Autumn 2016 update’, legislated January 2017, <https://www.gov.uk/government/publications/charter-for-budget-responsibility-autumn-2016-update>.

<sup>4</sup> As stated in C. Emmerson and T. Pope, ‘Risks to the UK public finances’, in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, <https://www.ifs.org.uk/publications/13516>, ‘There are sensible reasons to attempt to adjust for the economic cycle when looking at borrowing, but what about borrowing caused by other factors that are known to be temporary, such as one-off revenues or spending items? There are good reasons to want debt to fall as a share of national income over the longer term, but how can we be sure that there won’t be good reasons why it should be higher in March 2021 than in March 2020? The government should carefully consider how best to respond to unintended increases in social security spending but, rather than wait until the next parliament, why not retain annual assessments as was the case with Mr Osborne’s version of this fiscal target?’.

overall budget balance early in the current parliament since, regardless of the date of the next general election, we will soon be in the second half of this parliament.

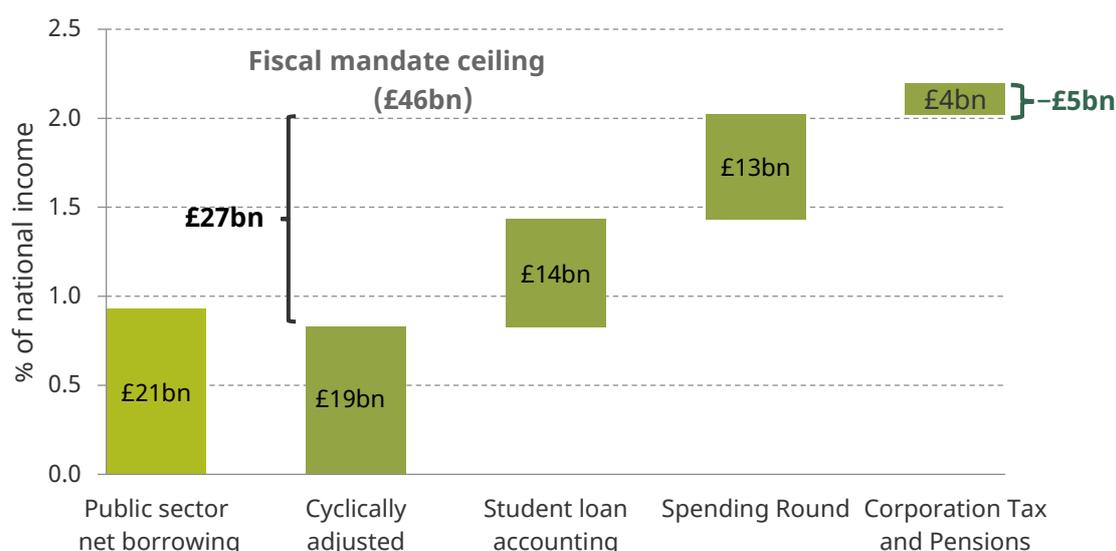
The Conservative party's 2017 general election manifesto stated, less ambitiously, that the objective was instead 'a balanced budget by the middle of the next decade'. But it is also far from clear that Mr Hammond was striving to meet this target: the March 2019 Spring Statement forecasts are for the government to run a deficit of 0.5% of national income in 2023–24. In Chapter 4, we update this forecast for developments since March and estimate that the deficit might, under current government policy and still assuming a 'smooth and orderly' Brexit process, now be on course to be 1.7% of national income in 2023–24 (see Table 4.2).

### The fiscal mandate

The most constraining target in the current parliament appears to be the fiscal mandate. The OBR's March 2019 Spring Statement forecasts were for cyclically adjusted borrowing in 2020–21 to be 0.8% of national income, which would be 1.2% of national income – or £27 billion – below the 2% ceiling on this measure of borrowing in that year. This headroom against the government's fiscal mandate has become known as the 'Brexit war chest'. This is shown in Figure 5.1.

As described in Chapter 4, a number of things have changed since March that will push up public sector net borrowing. First, a welcome change has been made to the accounting treatment of student loans, which we estimate will add £14 billion to borrowing in 2020–21. Second, the boost to day-to-day spending announced by Mr Javid in the September 2019 Spending Round will add another £13 billion. Third, changes to the accounting of public sector pensions and the correction of an error in estimated corporation tax receipts will push up borrowing by £4 billion more. Taken together, these three changes appear set to add over £30 billion to borrowing (and to cyclically adjusted borrowing) in 2020–21. On these estimates, cyclically adjusted borrowing next year is set to be above the 2% of

**Figure 5.1. Changes to the outlook for cyclically adjusted borrowing in 2020–21**



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2019*, <https://obr.uk/efo/economic-fiscal-outlook-march-2019/>. Student loan accounting change is authors' calculation, as set out in Box 4.1.

national income ceiling. Indeed, our ‘adjusted baseline forecast’, presented in Table 4.1, was for headline borrowing in 2020–21 to be 2.2% of national income.

Of course, borrowing could turn out to be lower (or higher) than our forecast. But on current policy (and assuming a smooth and orderly Brexit process), these estimates suggest that there is a slightly more than 50% chance that the fiscal mandate will in fact be breached.<sup>5</sup> Other developments since March might suggest that borrowing is actually more likely to be revised upwards rather than downwards. As described in Chapter 4, the Bank of England’s latest forecasts are for near-term growth to be weaker than the OBR forecasts. Under this forecast, borrowing in 2020–21 would be expected to be higher, although to the extent that weaker growth was deemed to represent only temporary weakness in the economy it would not increase the structural deficit. Mr Javid will doubtless be hoping for a positive shock to lead to borrowing coming in below the 2% ceiling imposed under the fiscal mandate. But the fact that the government has chosen not to preserve any degree of ‘headroom’ shows that (for better or for worse) it is not taking this fiscal target that seriously.

### The supplementary debt target

The chancellor does remain on course to meet the supplementary debt target to have debt falling as a share of national income. In part, this is because the change to student loan accounting, which pushes up headline borrowing, does not affect the measure of debt. This is also true after including the estimated impact of the downgrade to the Bank of England’s growth forecasts (which might not push up cyclically adjusted borrowing but would add to headline borrowing and therefore debt). Under our ‘adjusted baseline forecast with Bank of England near-term downgrade’, public sector net debt (excluding the Bank of England) would be on course to fall, slightly, from 74.8% of national income in 2019–20 to 74.3% of national income in 2020–21 (middle panel of Table 4.2). The headline measure of debt – which includes the Bank of England, and is the measure targeted by the supplementary debt target – would fall faster as loans made under the Term Funding Scheme are repaid.

One scenario in which this rule could be breached is if the UK economy enters a recession. For example, under the no-deal Brexit scenario presented in Table 4.4, public sector net debt excluding the Bank of England would be forecast to rise from 73.7% of national income in 2019–20 to 75.4% of national income in 2020–21. Under such a scenario, it is plausible that the Monetary Policy Committee (MPC) of the Bank of England would choose to extend the Term Funding Scheme (or to introduce a new, similar scheme), which could lead to headline debt (i.e. including the Bank of England) also rising as a share of national income.

### Summary

The government’s fiscal targets will soon cease to provide any kind of fiscal anchor. In any case, the government’s actions are not consistent with it being committed to keeping

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<sup>5</sup> The chancellor could reasonably argue that the 2% ceiling was chosen with reference to a different measure of borrowing, and that now student loans are being accounted for differently, it would be reasonable to raise the ceiling by a corresponding amount. But were the chancellor minded to make such a change, he would presumably have communicated this in his spending round announcement.

borrowing within a ceiling of 2% of national income in 2020–21. The supplementary debt target would also be likely to be breached were a no-deal Brexit to occur.

## 5.4 Labour’s proposed fiscal rules

At the last election, the Labour party proposed a ‘fiscal credibility rule’<sup>6</sup> (FCR), which included two targets:

- a rolling forward-looking target to run a current budget balance five years out;
- to have public sector net debt as a proportion of national income (adjusted for what are deemed to be the ups-and-downs of the economic cycle) lower at the end of the parliament than it was at the start.

Sensibly, compliance with the FCR would be judged by the OBR (whose mandate would be changed so that it reported solely to parliament rather than to both the executive and to parliament). Furthermore, were the MPC to deem that monetary policy was at its effective lower bound – a situation where the MPC would like to loosen monetary policy but, due to short- and long-term interest rates being so low, it feels that it does not have an effective policy lever to do this – then the FCR would be suspended. This would give the independent MPC a direct say over fiscal policy since only on its say-so could the fiscal rules be suspended. Having an independent judgement on this has much to commend it. It would mean that (if deemed appropriate) further fiscal loosening could be implemented to support the economy (which we discuss in Section 5.5) without the FCR being breached.

### Rolling forward-looking target for the current budget

This component of Labour’s FCR has many sensible features: indeed, it has been recommended in successive IFS Green Budgets.<sup>7</sup> It was also actually adopted as a fiscal target by George Osborne as chancellor in 2010 and by Ed Balls as shadow chancellor in 2015. The forward-looking nature of the target has much to commend it, allowing a chancellor time to respond flexibly to shocks while still returning the current budget to its planned path over the medium term.<sup>8</sup> By targeting a current budget balance, the target would allow for borrowing to fund investment spending – permitting the government to invest more if, for example, new opportunities arise or interest rates fall. This feature could be attractive to Mr Javid as it would be consistent with his stated desire to invest more when borrowing costs are low.

If the government did adopt this rule then it would, under current economic forecasts, be met.<sup>9</sup> However, continuing to meet this target would – again, on current economic

<sup>6</sup> See <https://labour.org.uk/wp-content/uploads/2017/10/Fiscal-Credibility-Rule.pdf>.

<sup>7</sup> See, for example, R. Chote, C. Emmerson and C. Frayne, ‘The fiscal policy framework’, in R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, <https://www.ifs.org.uk/green-budget/2006>.

<sup>8</sup> Of course, the extra flexibility in this target also means it would be less constraining on the chancellor; for example, a chancellor could attempt to game the target by announcing tax rises for the end of the forecast horizon and then repeatedly pushing them back. Effective scrutiny by the OBR, IFS and others would be an important part of ensuring that chancellors kept to the spirit, not just the letter, of this target.

<sup>9</sup> In 2018–19, government receipts exceeded current spending (including depreciation) by £5.4 billion or 0.3% of national income. While the September 2019 Spending Round added £13.4 billion (0.6% of national income) to

forecasts – not allow any further substantial permanent net giveaways (outside of investment spending). This would mean that any large tax cuts would need to be financed, at least primarily, either through tax rises elsewhere or through cuts to day-to-day spending. So were the government to sign up to such a target, it would (given the recent decision to increase day-to-day spending) require the tax proposals put forward by Boris Johnson (see Chapter 8) either to be put on ice, or to be financed through tax rises elsewhere. Furthermore, the economic forecasts could change – most obviously in the event of a no-deal-Brexit scenario. Even a relatively benign no-deal Brexit would leave this target on course to be missed (although under such a scenario the rule could be suspended as the MPC might deem monetary policy at its effective lower bound).

The target would also be constraining for a Labour government. At the time of the 2017 general election, the Labour party's stated intention was for a substantial increase in day-to-day spending to be covered by a substantial increase in taxes. This could be sufficient to maintain a forecast current budget surplus. But at the time of the last election, analysis by IFS researchers suggested that Labour's proposed tax-raising measures would, most likely, raise significantly less than Labour had assumed (and that its day-to-day spending increase would cost more than it had allowed).<sup>10</sup> Overall, the impact of Labour's proposals was estimated to add over 0.4% of national income to the current budget deficit. While at the time this would still have been consistent with meeting this rule, it might no longer be possible to accommodate a similar shortfall now.

### **Debt to be a lower share of national income at the end of the parliament**

A commitment to aim to run a surplus on the current budget would not, on its own, place any constraint on public sector net debt. Under Labour, this would come from the second component of its FCR, which requires that the net-debt-to-(trend)-GDP ratio is lower at the end of the next parliament than at the beginning. This suffers from two of the same problems as the government's debt target. First, defining targets based on the length of parliament means that the effective period to which the target applies can change in an unusually short parliament. Second, depending on circumstances, it may be better for debt to be a greater share of national income at the end of the period than at the start. There are good reasons to want to ensure that policy is consistent with public sector net debt as a share of national income trending decisively downwards, but this should be measured by looking over the longer term rather than just comparing what happens to be the first and last financial years of a parliament.

We would not recommend the current government adopts this target, though current policy appears consistent with remaining on course to meet it. After adjusting the 2019 Spring Statement OBR fiscal forecasts for changes since March, including the estimated impact of the downgrade to the Bank of England's growth forecasts, debt would still be forecast to fall as a share of national income over the next four years (as was shown in the middle panel of Table 4.2). But a substantial fiscal loosening – or indeed even a relatively benign no-deal-Brexit scenario – would put compliance in doubt. So, as with the first component of Labour's FCR, the current government would be on course to comply with this target as long as any new tax cuts or spending increases were (largely) covered by

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day-to-day spending in 2020–21, the surplus on the current budget was forecast by the OBR in the March 2019 Spring Statement to increase by a further 0.6% of national income between 2018–19 and 2023–24.

<sup>10</sup> See C. Emmerson, 'General election 2017, manifesto analysis: the outlook for the public finances', <https://www.ifs.org.uk/publications/9256>.

new tax rises and as long as a no-deal Brexit was avoided. (Although again, in practice, depending on the view of the MPC, it is possible the FCR would be suspended under such a no-deal-Brexit scenario.)

In contrast, a Labour government would not, at least under the policies set out in its 2017 general election manifesto, be able to expect to see debt falling as a share of national income. A rise in the net-debt-to-GDP ratio would seem much more likely than a fall. This arises because the 'net' in public sector net debt only reduces gross debt by the value of any short-term financial assets, such as cash, held by the public sector, while the Labour party's 2017 manifesto contained two sets of policies that would add substantially to both the liabilities and the physical assets of the public sector:

- First, the party's proposed nationalisation of Royal Mail and publicly owned companies operating in rail, energy and water. The liabilities of these organisations would add to public sector net debt. Of course, their assets would also become part of the public sector balance sheet, and economically what matters is whether these assets would be better managed by the public or the private sector. But the net-debt-to-GDP ratio would rise, not fall.
- Second, even if the additional liabilities acquired from the newly nationalised bodies were ignored (perhaps on the basis that the assets acquired at the same time could generate a flow of substantial revenues), Labour's other stated policies could be enough to see debt on a rising path. Specifically, it proposed a £250 billion boost to infrastructure spending over a 10-year period, to be financed from additional borrowing. If spent well, this would boost the productive capacity of the economy. But this also implies borrowing an additional £25 billion a year – which is slightly more than 1% of national income. If we assume that Labour's tax plans would be sufficient to cover its planned increase in day-to-day spending, this much extra borrowing would be sufficient to leave the net-debt-to-GDP ratio broadly flat over the next four years, so even a modest worsening of the fiscal outlook would leave the fiscal target breached.<sup>11</sup>

Given the desire of the Labour party to pursue policies that would substantially expand the balance sheet of the public sector, it is odd that it also claims to be committed to reducing public sector net debt as a share of national income over the course of a parliament. Given its policies, it might make more sense for Labour to target a measure of debt that takes better account of the longer-term assets, as well as the liabilities, of the public sector. This could involve netting off the estimated value of the public sector's long-term financial assets (such as loans made) and its physical assets (which are substantial and, crucially in this context, would increase under Labour's proposed nationalisation and investment plans). Indeed, the potential benefits of such an approach were acknowledged by the Treasury last year: 'Taking a more comprehensive view of the government balance sheet can help to provide a more complete picture of the sustainability of the public finances and promote greater accountability for the management of public wealth'.<sup>12</sup>

<sup>11</sup> Taking the scenario set out in the bottom panel of Table 4.2, but instead having a £25 billion a year boost to investment spending (assumed to be 1.1% of national income), this would see the debt-to-GDP ratio being projected to fall from 74.8% in 2019–20 to 74.1% in 2020–21 but then to rise gradually over time, reaching 74.3% in 2023–24.

<sup>12</sup> Paragraph 6.2 of HM Treasury, 'Managing fiscal risks: government response to the 2017 fiscal risks report', July 2018,

An argument for increased investment spending and a new target along these lines was recently made by Chris Giles in the *Financial Times*.<sup>13</sup> Such a measure already exists: public sector net worth. In principle, targeting a broader measure of debt (one that encompasses as many of the liabilities and the assets of the public sector as possible), such as public sector net worth, is preferable.

However, caution is needed. Valuing the public sector assets is difficult: how much is the UK road network worth, for example? And one could easily imagine estimates moving dramatically over time in ways that did not reflect the true situation. Indeed, as noted by the OBR in its recent Fiscal Risks Report, 'the ONS [Office for National Statistics] has not published PSNW [public sector net worth] data since 2012 due to concerns about the quality of the public corporations' non-financial assets data. It aims to address these concerns later in 2019.'<sup>14</sup>

Keeping an eye on public sector net worth certainly makes sense. Targeting it as the key element of your fiscal framework may lack the sort of transparency and credibility required of such a framework. It would need to be combined with a commitment to ensure that policy was consistent with public sector net debt being on a decisively downwards path over the longer term (rather than over a parliament).

## Summary

Labour's FCR has two key targets. The first – a rolling forward-looking target for the current budget – has much to commend it. Under a smooth and orderly Brexit, it would not allow substantial tax cuts or further increases in day-to-day spending to be financed through greater borrowing. Given the strong case against a substantial permanent fiscal loosening – as set out in Chapter 4 – there would be merits in such a target being adopted by the current government or by an incoming Labour administration. Such a target might well not prove robust to a no-deal Brexit: it is possible that a no-deal Brexit might mean that it is no longer an appropriate (or effective) constraint.

Labour's second target – to have public sector net debt lower as a share of national income at the end of the parliament than at the start – has less to commend it. It is also incompatible with the programme of nationalisation and boost to investment spending proposed in Labour's 2017 general election manifesto. Consideration should be put to the feasibility of targeting a broader measure of the public sector balance sheet and to targeting the projected path of public sector net debt over a longer time.

## 5.5 Case for – and design of – a fiscal stimulus

During the recent Conservative party leadership election, it was widely reported that Boris Johnson would implement an emergency 'no deal' Budget that would ensure the

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[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/725913/Managing\\_Fiscal\\_Risks\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/725913/Managing_Fiscal_Risks_web.pdf).

<sup>13</sup> 'Britain can afford to loosen its fiscal rules', *Financial Times*, 19 September 2019, <https://www.ft.com/content/65825520-d483-11e9-8367-807ebd53ab77>.

<sup>14</sup> Paragraph 6.2 of Office for Budget Responsibility, *Fiscal Risks Report: July 2019*, <https://obr.uk/docs/dlm/uploads/Fiscalrisksreport2019.pdf>.

economy was going ‘gangbusters’ by 31 October.<sup>15</sup> A giveaway Budget – either through tax cuts or further spending increases – could boost demand in the near term, although any such measures would at best have only a very limited impact before the end of October.

More recently, in his spending round announcement, Mr Javid stated: ‘I’ve tasked the Treasury with preparing a comprehensive economic response to support the economy if needed. And we’ll work closely with the independent Bank of England to coordinate fiscal and monetary policy’.<sup>16</sup> This section looks at the case for such measures and, if they are to be implemented, sets out some principles for how they should be designed. It also shows what impact an illustrative fiscal stimulus might be expected to have on the path of growth, borrowing and debt. The chancellor should consider scenarios such as these, alongside how likely he deems them, as part of deciding which, if any, fiscal targets to set himself.

### The case for a stimulus

At the moment, most economic forecasters – including the OBR in the March Spring Statement – estimate that the UK economy is operating around full capacity.<sup>17</sup> If correct, this would suggest that any stimulus could only have a very limited impact on boosting demand before it led to inflationary pressures. Of course, the prime minister has specifically referred to a stimulus to assist in a no-deal Brexit. Such a situation would see the UK leaving the EU single market and customs union and trading with EU countries on non-preferential World Trade Organisation (WTO) terms.

How economically harmful such an outcome would be is, to say the least, highly uncertain. The previous government’s central assessment was that the resulting reduction in trade with the EU would, after 15 years, leave GDP 7.7% lower than under a scenario where the UK had remained in the EU.<sup>18</sup> This was forecast to add 2.4% of national income to the deficit, equivalent to about £50 billion in today’s terms. Chapter 3 underscores the economic damage a no-deal Brexit would do. A fall in net migration would depress GDP, and weaken the public finances, even further. Over the long term, it would be necessary for fiscal policy to adjust to offset this increase in the deficit – it is not possible for the government to simply borrow 2.4% of national income more each year indefinitely. So the long-run response to an economically bad Brexit would be some combination of further tax rises and a return to austerity for at least some public services.

But in the short run there could be a case for a different approach. This could be particularly true since, with short- and long-term interest rates already so low, looser monetary policy might not be an effective way to help stimulate demand in the economy. Some fiscal policy response would come by default through the ‘automatic stabilisers’: weaker economic performance leads to more spending on working-age benefits and lower receipts of taxes on income, spending and profits, both of which act to push up

<sup>15</sup> See, for example, C. Giles, ‘Here is what awaits the next UK chancellor’, *Financial Times*, 18 July 2019, <https://www.ft.com/content/c46ebbf6-a8ae-11e9-984c-fac8325aaa04>.

<sup>16</sup> <https://www.gov.uk/government/speeches/spending-round-2019-sajid-javids-speech>.

<sup>17</sup> HM Treasury, ‘Forecasts for the UK economy: August 2019’, <https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-august-2019>.

<sup>18</sup> HM Government, *EU Exit: Long-Term Economic Analysis: November 2018*, [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/760484/28\\_November\\_EU\\_Exit\\_-\\_Long-term\\_economic\\_analysis\\_1\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760484/28_November_EU_Exit_-_Long-term_economic_analysis_1_.pdf).

borrowing.<sup>19</sup> But the automatic stabilisers have not been designed in order to support the economy through all periods of weakness: rather, they largely arise from government's choice of progressivity for the tax and benefit system.

Therefore, there may be a case for an additional short-term fiscal policy response. In deciding whether and how to intervene, the government should consider carefully the nature of the shock. In particular, it must assess the extent to which there is *temporary* weakness in demand and/or supply in excess of the expected *permanent* hit to the economy. It can then decide whether a discretionary, short-term fiscal giveaway could be an effective way of addressing the former.

### The design of a fiscal stimulus

If a discretionary fiscal stimulus package is deemed appropriate, then the key is – as set out by the International Monetary Fund (IMF) at the height of the global financial crisis just over a decade ago – to ensure that it is timely, targeted and temporary.<sup>20</sup> Timely so that it helps the economy at the right moment; targeted so that it boosts activity where the costs of lost output would otherwise have been greatest; and temporary so that it does not make restoring the long-run health of the public finances harder to achieve. A package of permanent tax cuts and spending increases does not meet these tests.

One option for the government would be to use existing fiscal policy levers. There are in fact at least two policies already in place that should have the impact of boosting demand this year and next. First, public sector net investment is forecast to grow in real terms by 10.5% between 2018–19 and 2019–20. Second, the government has increased the amount of investment that can be entirely offset against corporation tax from £200,000 a year to £1 million a year temporarily for the period between January 2019 and December 2020.

One could go further with existing policy levers: for example, temporary cuts to income tax or National Insurance contributions or a reduction in the main rate of VAT or an increase in benefits. One issue is ensuring these do not end up being a permanent giveaway, as was successfully done by the UK during the financial crisis when the main rate of VAT was lowered from 17½% to 15% for 13 months.

If a no-deal Brexit created specific, localised disruptions that were deemed to be especially costly, then specially tailored measures could be more effective at mitigating them. These could attempt to target very closely parts of the economy where the short-run dislocations were thought to be particularly painful in the short term, or to be particularly likely to have adverse long-term effects.

Work by IFS researchers that was summarised in last year's Green Budget suggests that the industries that are most exposed to the risk of trade barriers being created by a no-deal Brexit are: transport equipment; chemicals, pharmaceuticals and refining; and

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<sup>19</sup> A cyclical drop in national income of 1% (around £22 billion in today's terms) would, according to the OBR's ready reckoner, add around 0.7% of national income (£15 billion) to public sector net borrowing. Source: ready reckoners published alongside the 2017 fiscal risks report: <https://obr.uk/download/july-2017-fiscal-risks-report-ready-reckoners/>.

<sup>20</sup> A. Scott, 'IMF survey: making fiscal stimulus effective during downturns', 2008, <https://www.imf.org/en/News/Articles/2015/09/28/04/53/sores100208b>.

clothing and textiles.<sup>21</sup> So there may be a case for post-Brexit industrial policy to target temporary support at these industries, in order to help them through the adjustment to a new trading environment outside of the EU. This could be either to achieve a (more) managed decline in industries that might be less economically viable once the UK has left the EU, or to prevent particularly costly short-term disruptions having undesirable long-term effects.

The impact of a no-deal Brexit will also vary across the UK. For example, The UK in a Changing Europe<sup>22</sup> highlighted that industries such as vehicles and parts, whose highly integrated European supply chains would be severely disrupted by trade barriers, were also regionally concentrated in areas such as the West Midlands. Northern Ireland, with its close links to the Irish economy, might also be particularly adversely affected by an economically bad Brexit, so consideration could be given to providing additional support to activity there.

### The impact of a stylised stimulus on growth, borrowing and debt

The actual impact of a fiscal stimulus will depend on many factors, including its scale, duration and precise design. Here we illustrate the extent to which a stylised giveaway of 1% of national income, in place for two years, could boost growth and what the resulting impact could be on public sector borrowing and debt. This is shown in Table 5.1. The top panel repeats the relatively benign no-deal scenario that was presented in Table 4.4, with no further fiscal giveaway in place. Under this scenario, the economy contracts by 1% in 2020–21 and grows by just 1.4% in 2021–22. Public sector net borrowing would peak at 4% of national income in 2021–22, while public sector net debt would rise as a share of national income over the next four years to reach 83.4% in 2023–24.

The bottom panel of Table 5.1 incorporates the impact of the stylised stimulus package. For simplicity, we take the largest OBR fiscal multiplier, of +1, which relates to public sector net investment<sup>23</sup> – and, like the OBR has done in the past, we assume this fades away completely over the subsequent four years. In practice, the actual multiplier would depend on the particular policies being delivered; spending an additional 1% of national income on investment next year, and delivering it well, might not be possible. Furthermore, the economic climate will affect the size of the multiplier, which might be larger in periods when the economy is underperforming, though perhaps reduced in periods of much heightened uncertainty.

Under our stylised example, the stimulus is successful in delivering a much smoother profile for growth. The economy is forecast to stand still rather than contract in 2020–21,

<sup>21</sup> P. Levell and A. Norris Keiller, 'The exposure of different workers to potential trade barriers between the UK and the EU', in C. Emmerson, C. Farquharson and P. Johnson (eds), *The IFS Green Budget: October 2018*, <https://www.ifs.org.uk/publications/13463>. This was similar to the later study by the former UK government that highlighted chemicals, pharmaceuticals, rubber and plastics, and motor vehicles and parts, as the sectors that would be hardest hit by a no-deal Brexit. Source: HM Government, *EU Exit: Long-Term Economic Analysis: November 2018*, [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/760484/28\\_November\\_EU\\_Exit\\_-\\_Long-term\\_economic\\_analysis\\_1\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/760484/28_November_EU_Exit_-_Long-term_economic_analysis_1_.pdf).

<sup>22</sup> <https://ukandeu.ac.uk/research-papers/cost-of-no-deal-revisited/>.

<sup>23</sup> Multipliers measure how much of a giveaway feeds through into national income. A multiplier of +1 means that national income is expected to rise by the same amount as the giveaway in the first year. Multipliers can be lower than 1 if the giveaway increases inflation or if some of it is saved or spent on imports.

**Table 5.1. Scenarios for growth and the public finances under a relatively benign no-deal Brexit, with and without a stylised two-year stimulus package**

	2019–20	2020–21	2021–22	2022–23	2023–24
<b>Adjusted baseline forecast</b>					
Public sector net borrowing (£bn)	43.7	67.8	92.0	85.0	71.2
Public sector net borrowing (% of GDP)	2.0%	3.1%	4.0%	3.6%	2.9%
Net debt (excl. BoE, % of GDP)	73.7%	75.4%	80.8%	83.3%	83.4%
<i>Memo: growth</i>	0.4%	-1.0%	1.4%	2.7%	2.8%
<b>With additional giveaway (% of GDP)</b>	<b>0%</b>	<b>1%</b>	<b>1%</b>	<b>0%</b>	<b>0%</b>
Public sector net borrowing (£bn)	43.7	79.6	101.9	81.2	71.2
Public sector net borrowing (% of GDP)	2.0%	3.6%	4.4%	3.4%	2.9%
Net debt (excl. BoE, % of GDP)	73.7%	75.9%	81.8%	84.0%	84.1%
<i>Memo: growth</i>	0.4%	0.0%	2.2%	2.7%	2.8%

Note: As Table 4.4 but here the additional 1% giveaway is implemented in full immediately and is only left in place for two years, and we assume a higher multiplier (of 1, which is what the OBR uses for investment spending) which fades over time to zero.

Source: Office for Budget Responsibility, *Fiscal Risks Report*, July 2019; authors' calculations using OBR estimates of transfers between the UK and the EU (*Economic and Fiscal Outlook*, March 2018 and March 2019); Office for National Statistics.

and then to grow by 2.2% in 2021–22. Public sector net borrowing would rise further, reaching 4.4% of national income in 2021–22 before returning to the level it would have been at without the stimulus in 2023–24. Overall, by the end of the period, public sector net debt is left slightly higher at 84.1% of national income instead of 83.4% of national income. In other words, of the increase in public sector net debt between 2019–20 and 2023–24, relatively little would be the direct result of the stimulus; the vast majority would have occurred anyway.

There are at least two key questions raised by this analysis: first, whether the smoother path for GDP growth would justify the slightly higher debt level at the end of the period; and second, whether there are good reasons to believe that the fiscal giveaway would have more enduring positive impacts on the level of activity than is assumed here. One reason why both answers could be yes is if avoiding the contraction in the economy meant fewer households endured the potentially scarring impact of a period of unemployment. But given the complexity of what a no-deal Brexit would do to the economy, answering either question would be far from straightforward.

There are challenges with managing a stimulus package though. One is ensuring that it is well targeted and effective. It is easy to waste money if the spending taps are turned on

too quickly. The other key challenge lies in unwinding the stimulus. If that means putting taxes back up or cutting spending, it may prove politically difficult to achieve.

## 5.6 Conclusion: so what should the chancellor do?

The current fiscal targets all expire within the current forecast period. In any case, the government is currently not taking its own fiscal mandate seriously. A new set of targets are needed, but this is a difficult time to set them. Setting targets that would be suitably constraining under a smooth and orderly Brexit process (let alone under a remain scenario), but that would also allow the chancellor to respond appropriately under a no-deal scenario, is no easy task.

The last two decades have seen the implementation of numerous fiscal targets. Some have been quite well designed (most notably Mr Osborne's 2010 fiscal mandate, which has much in common with the first half of Labour's proposed fiscal rule). But many have been poorly designed; and many have been committed to, only subsequently to be missed or abandoned. Indeed, it looks as if the government's self-imposed ceiling on borrowing next year will be breached. Were the UK to enter a recession now, then the forecasts made next spring could be for debt in 2020–21 to rise rather than fall as a share of national income, thereby missing the debt target as well. In this scenario, the chancellor would be best advised to abandon the supplementary debt target rather than to implement immediate tax rises or spending cuts.

Given current uncertainties, the chancellor should wait before implementing a new set of fiscal targets. This would also allow the Treasury to take more time in designing its fiscal targets, which could also lead to smarter targets that are more appropriate in a wider range of situations. When it does undertake this process, the government should consider returning to a rolling forward-looking target for the current budget; whether it would be sensible to target a measure of public sector net debt that takes account of a broader set of public sector assets; and focusing its commitment to downward-trending debt on a longer time horizon, rather than an arbitrary fixed date (which both the current government and the Labour opposition share an odd enthusiasm for).

In the meantime, some fiscal anchor could be useful – not least given the prime minister's desire to cut taxes, and next year's spending review. Given current heightened uncertainty, rather than targeting measures of borrowing or debt, one short-term option could instead be to set a maximum amount of permanent discretionary fiscal loosening that the chancellor would be prepared to implement. If an increase in investment spending financed by borrowing was thought to be appropriate, such an anchor could apply just to the current budget. For example, the chancellor could commit to ensuring that any permanent tax cuts or further permanent increases in day-to-day spending would be entirely financed through tax rises or cuts to other spending. But because it would not constrain actual borrowing or debt, these could still increase if the underlying fiscal outlook deteriorates, or if the chancellor chooses to raise investment spending or deliver a temporary fiscal stimulus package – flexibility that might be particularly important in the event of an adverse economic scenario, such as a no-deal Brexit. Well-designed fiscal rules could then be set out once at least some Brexit uncertainties have been resolved.