

# CHANGING THE FISCAL RULES

## UNLOCKING PUBLIC INVESTMENT FOR A GREEN NEW DEAL

**Written by:** Alfie Stirling, David Powell and Frank Van Lerven  
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New Economics Foundation  
[www.neweconomics.org](http://www.neweconomics.org)  
[info@neweconomics.org](mailto:info@neweconomics.org)  
+44 (0)20 7820 6300  
@NEF

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## EXECUTIVE SUMMARY

The physics of climate science are clear. We face irreversible shifts in weather, temperature and average sea levels that could ultimately prove fundamentally incompatible with a future in which human societies can flourish.

Perhaps for the first time in the UK, recognition of the sheer scale of change required has begun to go mainstream. The government has legislated for ‘net zero’ greenhouse gas emissions by 2050, following advice from its official advisors on emissions policy, the Committee on Climate Change (CCC). Meeting even this target – which is significantly less ambitious than the demands of many climate campaigners, and may need to be brought forward – will require transformation in every resource and energy intensive sector of the economy, from power generation to heat, construction, manufacturing industry and agriculture. It will require the largest peacetime mobilisation of resources in the country’s history.

Commercial finance and investment will be fundamental to a successful transition, but it will not be sufficient on its own. Nothing on this industrial scale and speed has ever been achieved before without direct state financial support. Even the UK Treasury has reportedly acknowledged that the CCC’s new targets would not be credible without plans for ‘increased government spending’.

The overall level of public investment required to fund such a transition is impossible to forecast accurately. The CCC estimates a total resource cost to transition of between 1-2% of GDP per year on average by 2050 – between around £20 billion and £40 billion in 2019/20 terms (although the Department for Business, Energy and Industry estimates are reportedly higher) – which will need to come from a mixture of public and private finance. The share of public finance will likely need to be especially significant, and front-loaded in the short-term, with the main benefits to the environment and therefore society increasing more steadily over the medium- to longer-term.

Given the speed and scale of transition required, the current fiscal rules (targets for government debt and borrowing) are a real limiting factor for sufficient public finance. In ‘normal’ times, public borrowing has historically been around 1.3% of GDP per year. Yet by the mid-2020s, even this baseline level of net borrowing would be precluded by the government’s current fiscal rules – let alone the level of additional borrowing required for a fair industrial transition. Sufficient public investment to support climate transition will therefore necessitate cuts elsewhere: requiring trade-offs between long-term societal health and wellbeing with those of a sustainable economy

and climate. In view of growing pressures on public resources from aging population, technological change and globalisation, such trade-offs are likely to prove intolerable.

**But how have we got here?** Essentially, the current fiscal rules assume that the best time to use so-called ‘fiscal space’ (the scope for further public borrowing before the amount of overall public debt presents significant risks to the economy) is always after a crisis has already taken place. But with respect to averting and mitigating a climate emergency this assumption is wholly inappropriate. In view of such a structural, rather than temporary problem, preventative investment to reduce current and future emissions today is many times more efficient than waiting to intervene until after the planet has warmed up. The current fiscal rules steer policy makers towards holding back space to borrow in reserve for the future, rather than borrowing for preventative investment today. This is despite the fact that being able to pay a little more unemployment benefit is an entirely inappropriate contingency when faced with food and land shortages caused by rises in global temperature and sea levels.

**In the UK, we propose the Treasury should begin work immediately on how to define new fiscal targets borne from a more sophisticated analysis of how and when to use fiscal space.** To do this effectively will require the development of two new analytic tools:

1. **The development of a framework for assessing, measuring and forecasting ‘fiscal space’:** defined in terms of the threshold beyond which there is a significant risk of adverse economic effects. Such a framework would allow the Treasury to more accurately (and more accountably) assess the level of fiscal space available to the UK at a given point in time.
2. **A method for conducting a form of cost-benefit analysis of how much fiscal space to use at a given point in time.** Such a tool would allow policymakers to accurately assess the implications of holding back fiscal space compared with the implications of borrowing for investment, and therefore allow politicians to come to an informed view on the best combination of fiscal intervention or fiscal prudence at a given point in time, including with respect to climate related risks.

We also propose more explicit cooperation between the Bank of England and the Treasury in managing, maximising and deploying fiscal space. Part of this arrangement could make use of a new public investment bank (or network of banks) – hereafter green national investment bank (GNIB) for shorthand – to increase commercial lending to green industries. The GNIB could be used as a backstop against political negligence from government in the form of underusing fiscal space for ideological reasons. In exceptional circumstances – such as government failing to provide sufficient stimulus

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during a large economic shock – the Bank of England could be given the power to delegate additional investment in green lending to the GNIB, while also buying up GNIB bonds on secondary markets to ensure this lending could always be financed.

# 1. INTRODUCTION

The physics of climate science are clear. The global economy must be re-embedded within sustainable limits – consciously and deliberately – within little more than a decade.<sup>1</sup> If not, we face irreversible shifts in weather, temperature and average sea levels that could ultimately prove fundamentally incompatible with a future in which all human societies can flourish.

Perhaps for the first time in the UK, recognition of the sheer scale of change required has begun to go mainstream. In May 2019, the UK government’s official advisors on emissions policy, the Committee on Climate Change (CCC), called on government to achieve ‘net-zero’ emissions by 2050.<sup>2</sup> The CCC acknowledge upfront this would require transformation in every resource and energy intensive sector of the economy, from power generation to heat, construction, manufacturing industry and agriculture. But perhaps even more significant was the CCC’s recognition that this could no longer be done sequentially, sector-by-sector.<sup>3</sup> In their view, the only remaining option for the UK is simultaneous, economy-wide transformation requiring the largest peacetime mobilisation of resources in the country’s history.

Climate emergency is very far from the only socio-environmental problem that we face. But it is perhaps the most urgent. It is now clear that a Green New Deal is needed to reorient economies towards the required investment, employment and redistribution of resources and opportunities that are essential to avoid its worst impacts.

## 2. THE CASE FOR PUBLIC BORROWING AND INVESTMENT

Nothing on the scale of a Green New Deal can be delivered in the UK without far more active and interventionist public finance and fiscal policy. But that is not to diminish the importance of reshaping and guiding private finance as well.

Monetary policy needs to evolve quickly. Lower comparative interest rates are needed in support of sustainable industry and could be achieved through modification to existing vehicles like the Bank of England's so-called 'term funding scheme'. The Bank of England also needs to take decisive action in reducing the carbon intensity of the financial 'assets' it is willing to buy and hold.<sup>4</sup> Financial regulation and prudential policy must shift focus as well. In particular, private banks should be instructed to hold back more reserves for loans to carbon intensive industry, reducing the overall attractiveness of dirty investments.<sup>5</sup> And most significant of all, the structure of the banking market itself needs to be shaken up with the creation of a new network of public purpose, green investment banks that operate at breadth and scale across the entire country.<sup>6</sup>

Vital though these measures are, focusing on reforms to private finance alone will not be sufficient. The reasons for this are twofold. The first is pure pragmatism and feasibility. Nothing on the scale and speed of required investment has ever been achieved before without direct state financial support. As research at the Breakthrough Institute has shown, the five most successful deliberate reductions in carbon – although modest by comparison to what needs to now be achieved – all came off the back of public sector led governance and investment.<sup>7</sup> In the UK, the CCC has also acknowledged explicitly that public subsidy and price signalling alone will not be enough,<sup>8</sup> while the Treasury have reportedly acknowledged that the CCC's new targets would not be credible without plans for 'increased government spending'.<sup>9</sup>

The second reason for financial reform is even more important: fairness. Alongside urgency, social and economic fairness must be a guiding principle of climate transition. Investment will be needed not just in the places where private markets (however guided) can make use of the profit motive of firms alone. Funds will also need to flow into projects and investments that yield the highest social returns for people and communities, and sometimes in the absence of direct commercial interests. This means supporting jobs, economic security and social wellbeing among places and industries that are already neglected by the UK's current economic model.<sup>10</sup> To this end, the funding for a green industrial strategy cannot be intermediated by private investors

alone. And many of the supporting measures that are essential to rebalance, reorient and rebuild the UK economy – from investing in skills, public transport, and a decent and humane social security system – will also require significant public funds.

Public investment on this scale requires an accompanying strategy for raising the necessary resources. Tax reform will be important in changing behaviour in industry and consumption. Making sure any tax reforms are progressive (those with the highest levels of income and asset-based wealth contributing the largest proportionate share) will also ensure the impacts of change are fairly distributed. The receipts generated from taxation will also provide much needed finance. But a key point is that economy-wide transformation is too big a task to be left for those in the present to finance alone.

Instead, public borrowing is needed to also pool resources across time. When a country builds a school or a hospital, public borrowing is invariably used by governments to ensure that all future pupils and patients who stand to benefit also contribute a fair share to the original investment, by helping to pay down future interest payments out of their future taxes. The green transition should be considered along similar lines.

Transition needs to happen now, but just as it would be unjust to allow future generations to suffer the climate consequences of today's unsustainable economy, so too is it unfair that those who happen to be paying their taxes today are forced to meet the bill – whether in higher taxes or consumer prices, or lower wages and profits. The financing of a Green New Deal should be borne equally across present and future generations and long-term public borrowing is the fairest and most efficient way to achieve this aim.



## **3. UNLOCKING TRANSFORMATIONAL PUBLIC FINANCE**

Paradigm-shifting policy change doesn't happen overnight. Realising a green transformation across the economy will require the mobilisation of ideas and political leverage on a scale rarely seen in modern UK history. Such a paradigm shift has only happened twice in the past 70 years – with the creation of the welfare state in the 1940s and the deregulation of industry and finance in the 1980s. But delivering a Green New Deal that is democratic, fair and effective requires deep and comparable institutional change once again.

Developing the right reforms to unlock and deploy public investment at sufficient scale represents a monumental challenge in and of itself. To meet this challenge, the very rules for managing the public finances need to be recast. But doing this with rather than against existing institutions will be key, whether the Treasury and its independent watchdog (the Office for Budget Responsibility) or the Bank of England itself. History suggests that for this to succeed, the case for evolution needs to begin within and between institutions themselves, and by tackling the logic of incumbent rationales head on.<sup>12</sup>

### **3.1 PROPOSAL 1: MODERNISING THE FISCAL RULES**

Most advanced economies manage their public balance sheets through 'fiscal rules': targets for public debt and borrowing over a medium-term horizon. But these rules are ill-equipped for either the enormity, or urgency, of the present climate challenge. Such targets are therefore a key limiting factor to transformational public finance.

The precise details of the fiscal rules themselves in the UK have been written and rewritten over the past two decades, often revised to suit short-term political expediency. But the broad overall prescription – to limit public debt and borrowing – has remained unchanged. Gordon Brown's so called 'golden rule' stated that borrowing for day-to-day spending should never exceed average tax receipts over a full economic cycle. And its counterpart, the 'sustainable investment rule', prevented public debt from rising above 40% of GDP. Today, the government's 'charter for budget responsibility' limits public sector net borrowing to less than 2% of GDP by 2020-21 and states that net debt must also be falling in 2020-21. Within the UK's current fiscal rules, the maximum level of additional public borrowing (compared with the current forecast) possible at the start of the 2020s would be around 1% of GDP.<sup>13</sup> But if the current commitment in the

government's fiscal rules to "return the public finances to balance at the earliest possible date in the next Parliament" is retained, the scope for additional borrowing for investment would be expected to fall to zero (if not negative) by the mid-2020s at the latest.

The overall level of public investment required to fund a Green New Deal is impossible to forecast accurately. This is partly because it is a function of technological and economic uncertainty. But also because it is dependent on the outcome of legitimate democratic debate over questions of fairness and social justice. But what is clear is that current limits to public borrowing are demonstrably in tension with a just climate transition. The CCC estimates a total resource cost to transition of between 1-2% of GDP by 2050 (although the Department for Business, Energy and Industry reportedly estimates a higher cost) which could come from a mixture of public and private finance.<sup>14</sup> However, the CCC's estimates are narrow in scope. For example, they do not include the additional resources needed to help ensure the benefits and opportunities of green transition are broadly shared (for example in the form of social security, skills training and social housing). Furthermore, they do not reflect the fact that much of the required public investment may be need to be frontloaded. Estimates for capital costs – such as for new infrastructure – are presented as average annualised contributions to resource costs in the CCC's estimates. But where publicly financed, these investments would feature as larger upfront increases in public debt and borrowing.

Outside of major transition or recession, public borrowing in 'normal' times has historically been around 1.3% of GDP per year.<sup>15</sup> Yet by the mid-2020s, even this baseline level of net borrowing would be precluded by the current fiscal rules – let alone the level of additional borrowing required for an effective and fair Green New Deal. As such, and under current fiscal rules, sufficient public investment in climate transition would necessitate cuts elsewhere, requiring trade-offs between long-term societal health and wellbeing and those of a sustainable economy and climate. This would be harmful at the best of times. But in view of growing pressure on public resources from other structural changes like an aging population, technological change and globalisation, such trade-offs are likely to prove intolerable.

But how have we got to a place where our fiscal rules are an active impediment to tackling one of the greatest existential risks to both economy and society? At least three basic assumptions from mainstream macroeconomics underpin the current broad design of UK fiscal rules:

- First, that a country's economy operates on a medium-term cycle of modest boom and bust – in apparent isolation from the environmental systems (or

indeed other structural changes such as globalisation or demographic change) within which it is embedded.

- Second, and partly given that the economy apparently operates within its isolated, uninterrupted cycle, it is assumed that the right level of public debt and borrowing for public good should on average remain largely unchanged across time.<sup>16</sup> Moving above this average is thought to raise market interest rates above their 'efficient' level, thus disincentivising profitable and productive private investment that could otherwise have taken place.<sup>17</sup> At worst it can cause a crisis of confidence in the domestic economy, leading to crippling high interest rates and inflation.
- Finally, in order to minimise these risks, it is assumed that increases in net borrowing beyond the long-term average are only ever temporary, and in response to economic shock (for example through higher social security payments going to the unemployed, the costs of which would then fall automatically as the economy recovers).<sup>18</sup>

Collectively these assumptions lead to a relatively simple policy prescription which is absorbed into the very culture of Treasury administration: public debt and borrowing must always be minimised during the 'boom' years in order to create 'fiscal space' – room for further borrowing – during and after the bad years. Hence the current limits to debt and borrowing in the present fiscal rules can only be 'review[ed]' once, and only if, the UK economy experiences 'significant negative shock'.<sup>19</sup>

Even when assessed on its own terms, this approach to managing the public finances suffers from a logical oversight. Essentially, the current fiscal rules assume that the best time to use fiscal space is always after a crisis has already taken place. But with respect to addressing the economic and social crises that would be brought about by climate emergency and global heating, this assumption is wholly inappropriate. In view of such a structural, rather than cyclical problem, preventative investment to reduce current and future emissions today would be many times more efficient at delivering public wellbeing than waiting to intervene until after a changing climate has caused a 'significant economic shock'. Instead, the rules steer policy makers towards holding back space to borrow in the future, rather than borrowing for preventative investment today. This is despite the fact that being able to pay a little more unemployment benefit is an entirely inappropriate contingency when faced with food and land shortages caused by rises in global temperature and sea levels.

In short, the current fiscal rules embed 20th century ideas of fiscal responsibility, where the greatest risks to a country were deemed to be the market's reaction to the public

balance sheet, rather than genuinely existential threats to the economic system and societal wellbeing. But in view of what we know must now be done to avert irreversible climate chaos, the current fiscal rules represent the definition of irresponsibility for the 21st century.

The first step to solving this problem can nonetheless be achieved through evolution rather than revolution, in the current rationale underpinning fiscal rules. Even within mainstream economic literature, the validity of using the existing stock of debt as a proxy for responsible future borrowing has been discredited.<sup>20</sup> In the UK, the Treasury should begin work immediately on how to define new fiscal targets borne from a more sophisticated analysis of how and when to use fiscal space. To do this effectively will require the development of two new analytic tools:

1. **First, development of a framework for assessing, measuring and forecasting 'fiscal space'.** Fiscal space should be defined in terms of the threshold beyond which there is a significant risk of adverse economic effects (for example, the risk of causing a crisis in private investment, treasury bond issuance or a collapse in the value of sterling). New research at the International Monetary Fund (IMF) has set out the beginnings of a framework to measure a given country's 'fiscal space' through an assessment of: exposure to shock, access to finance, and present economic and institutional structures.<sup>21</sup> Building on the work at the IMF and elsewhere, a systematic approach to measuring fiscal space should be modified, trialled and formalised for a UK context. Such a framework would allow the Treasury to more accurately (and more accountably) assess the level of fiscal space available to the UK at a given point in time.
2. **Second, a framework for conducting cost-benefit analysis of how to use fiscal space (through higher or lower levels of debt and public borrowing).** The Treasury should look to adapt and develop existing cost-benefit methodologies to assess the comparative effects of different uses of fiscal space with respect to either averting or responding to future economic shocks. Assessing scenarios in response to climate related risks should predominate, but risks related to demography and the financial system should also be included. Such a tool would allow policymakers to accurately assess the implications of holding back fiscal space compared with the implications of borrowing for investment, and therefore allow politicians to come to an informed view on the best combination of fiscal intervention or fiscal prudence at a given point in time.

Development of such tools would allow fiscal policy to operate with at least a similar level of sophistication as present day monetary policy. **Just as it is considered equally harmful to overshoot or undershoot the inflation target, so too should it be**

considered just as irresponsible to underuse fiscal space as it is to overuse it. This principle is true at all times, but the stakes are especially high today in view of the climate consequences of failing to re-embed the economy within safe limits on time.

### **3.2 PROPOSAL 2: GREATER MONETARY AND FISCAL COORDINATION AROUND FISCAL SPACE**

In view of a crisis such as that presented by climate breakdown, policy makers could also use the management of fiscal space as a focal point for tighter coordination between monetary and fiscal policy – and in support of a common objective for economy-wide, green transformation. Indeed, both throughout history and even among advanced economies today, central banks and treasuries have successfully used such coordination to tackle some of the biggest socioeconomic challenges of their time, from recovering from war to supporting ambitious industrial or socioeconomic transformation.<sup>22</sup>

Besides the stated objectives of current policies like so called ‘quantitative easing’ (QE) – reducing long-term interest rates by buying up debt in the marketplace – buying up public debt in particular also has powerful spillover effects for fiscal space. In the UK, the Bank of England continues to hold £435 billion of government debt. In doing so, the Bank ensures demand for this debt remains strong, pushing down the interest rate that government is expected to pay. In the UK’s case, this has contributed to a decade of record low borrowing costs for the Treasury. The direct effect of this is to significantly increase the government’s fiscal space beyond what it would otherwise have been. The Bank’s QE programme therefore significantly increased the scope for productive public spending, but this opportunity was largely wasted by economically harmful austerity politics and the accompanying tightening of the fiscal rules under Coalition and Conservative governments. Failure to make the most of this fiscal space also made it harder for the Bank of England to deliver on its own objectives as well, since after 2009 the Bank of England could not cut interest rates any further directly to stimulate economic recovery.<sup>23</sup>

Besides a new framework for managing fiscal space at the Treasury (see previous proposal), a Green New Deal may also require a revised institutional arrangement for more explicit cooperation between the Bank of England and the Treasury. Such an arrangement would allow the Bank to support the Treasury in maximising its fiscal space so that it can be deployed in the interests of both institutions. One way to achieve this could be to introduce new supplementary targets in the Bank’s mandate. A further option could also be to introduce a third institution – such as a public investment bank (or network of banks), hereafter green investment bank (GNIB) for shorthand – to

increase commercial lending to green industries, housing, and technological innovation.<sup>24</sup> Such a GNIB would need a democratic mandate or ‘mission’ from government (for example, from the Department for Business, Energy and Industrial Strategy as well as local authorities) to support a Green New Deal.

The advantage of the latter approach is that it would also help to provide a backstop against short-term political negligence from government in the form of underusing fiscal space for ideological reasons: or ‘surplus bias’.<sup>25</sup> In exceptional circumstances – such as government demonstrably failing to provide sufficient stimulus during a large economic shock – the Bank of England could be given the power to delegate additional investment in green infrastructure to the GNIB. To ensure the extra lending could always be funded, the Bank of England could accompany such a delegation in lending with additional purchases of GNIB bonds from third party private investors. The demand for these bonds would help ensure that the GNIB always had fiscal space within which to operate when required.<sup>26</sup>

## CONCLUSION

Given the speed and scale of transition required, the current fiscal rules (targets for government debt and borrowing) are a real limiting factor for sufficient public finance. The current fiscal rules steer policy makers towards holding back space to borrow in reserve for the future, rather than borrowing for preventative investment today. This is despite the fact that being able to pay a little more unemployment benefit is an entirely inappropriate contingency when faced with food and land shortages caused by rises in global temperature and sea levels.

**In the UK, we propose the Treasury should begin work immediately on how to define new fiscal targets borne from a more sophisticated analysis of how and when to use fiscal space.** To do this effectively will require the development of two new analytic tools:

1. **The development of a framework for assessing, measuring and forecasting ‘fiscal space’:** defined in terms of the threshold beyond which there is a significant risk of adverse economic effects. Such a framework would allow the Treasury to more accurately (and more accountably) assess the level of fiscal space available to the UK at a given point in time.
2. **A method for conducting a form of cost-benefit analysis of how much fiscal space to use at a given point in time.** Such a tool would allow policymakers to accurately assess the implications of holding back fiscal space compared with the implications of borrowing for investment, and therefore allow politicians to come to an informed view on the best combination of fiscal intervention or fiscal prudence at a given point in time, including with respect to climate related risks.

We also propose more explicit cooperation between the Bank of England and the Treasury in managing, maximising and deploying fiscal space. Part of this arrangement could make use of a new green national investment bank (GNIB) to increase commercial lending to green industries. The GNIB could be used as a backstop against political negligence from government in the form of underusing fiscal space for ideological reasons. In exceptional circumstances – such as government failing to provide sufficient stimulus during a large economic shock – the Bank of England could be given the power to delegate additional investment in green lending to the GNIB, while also buying up GNIB bonds on secondary markets to ensure this lending could always be financed.

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