

CALLING TIME

REPLACING THE FISCAL RULES WITH FISCAL REFEREES

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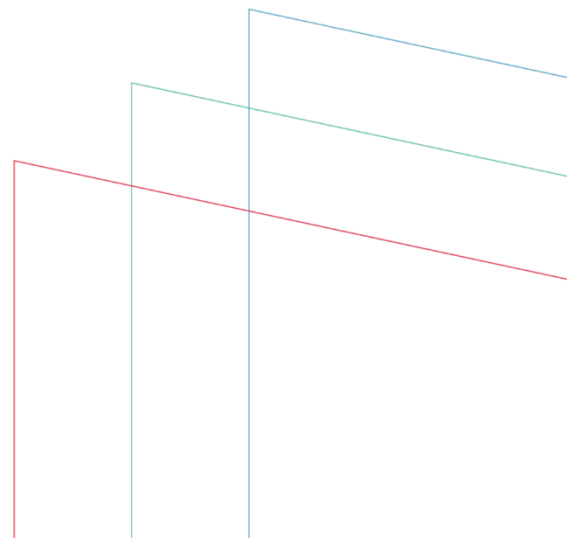
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EXECUTIVE SUMMARY

As the UK emerges from the largest peacetime economic shock since modern records began, the Treasury is preparing to publish the latest iteration of the government's new fiscal framework – the arrangements, targets and institutions governing the implementation of public budgets. With monetary policy sitting at its so-called effective lower bound – the point beyond which further reductions in interest rates have a negligible impact on the economy – for more than a decade, the design of fiscal frameworks has rarely been so important. They must equip governments with the rationale and scope to navigate not only the recovery from unprecedented economic and public health crises, but also far greater existential challenges, such as averting, mitigating and adapting to the climate crisis and environmental breakdown. Given the scale and nature of the challenges facing the UK economy, fresh thinking around the government's fiscal frameworks is required.

Under the bonnet: what's wrong with fiscal rules?

In this paper, we argue that the conventional approach to designing the UK's fiscal rules – targets for public debt and borrowing over a medium-term horizon – suffers from at least three major design flaws.

First, fiscal rules lack institutional bite and consistently fail on their own terms in holding chancellors to their targets, damaging the credibility of UK fiscal policy and undermining democratic accountability. Chancellors simply change their fiscal rules when they become too difficult to meet – they are a political tennis ball, not a tool of effective policy.

Second, based on an over-simplistic and politically expedient approach to macroeconomics, the fiscal rules have been guided by a narrow focus on the wrong targets and weak indicators of so called 'fiscal space'. Instead, we argue that fiscal space – the scope for further public borrowing before the amount of overall public debt presents a significant risk to the economy – is determined by a more complex set of macroeconomic dynamics than simple ratios between parts of the government's balance sheet and gross domestic product (GDP).

Third, the conventional approach to designing fiscal frameworks assumes that all of the policy risk sits with the possibility of over-borrowing, or exceeding fiscal space. While this is important concern, we argue that in fact the risks have far greater symmetry than this. Too little borrowing – such as when needed to respond to recession

or adapting to future shocks like climate change or health crises - should be considered as equally irresponsible and harmful to the economy as borrowing too much.

Towards a new approach

To help better optimise the use of fiscal space, better understand its constraints, and offer institutional bite, we propose replacing the fiscal rules with the establishment of *fiscal referees* – or *Fiscal Policy Committee (FPC)*, *appointed by government and parliament and guided by a set of fiscal principles*. The fiscal referees would act as an independent advisory committee housed at the Office for Budget Responsibility (OBR) or another third-party institution. They would estimate a target range for the optimal primary balance – the difference between government spending and revenue before taking into account debt interest – over a rolling forecast period, and given wider macroeconomic dynamics. The process of translating these assessments over fiscal space and prevailing risk into a target range for the optimal primary balance would need to follow a set of fiscal principles (eg based on resource constraints, full capacity utilisation, the private sector balance sheet position, public sector net worth, and more) set out in the committee's mandate.

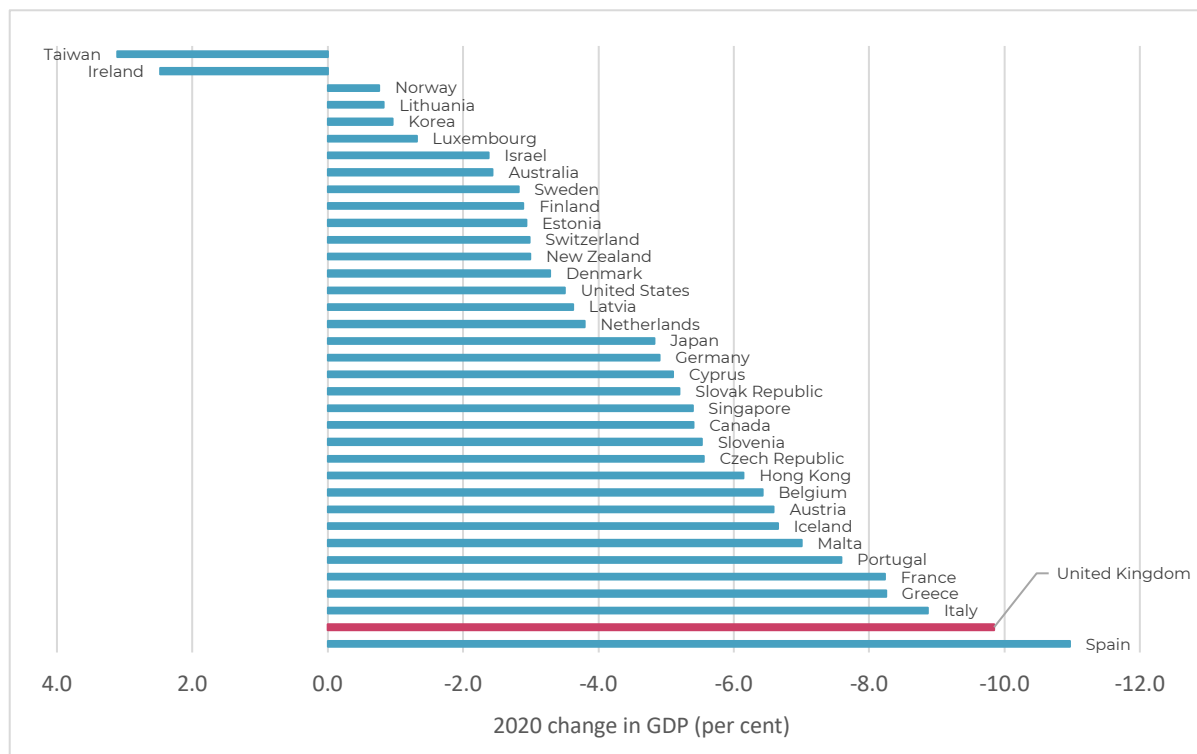
Decisions over the level and nature of tax and spending would remain solely with the Chancellor and wider government, but they would no longer set and mark their own homework. Either undershooting or overshooting the range would constitute a missed target, and the Chancellor would be required to write a letter of explanation and give verbal evidence to a body of parliament if ever the target range was missed in this way.

1. INTRODUCTION

In the March 2020 budget, HM Treasury committed to reviewing the government’s fiscal framework. With interest rates at historical lows and expected to stay that way over the medium to long term, the chancellor announced that the economic context had changed and a rethink was needed.¹ The consultation, initially intended to report by autumn 2020, was supposed to review the following areas: the low-interest-rate environment, macroeconomic stabilisation, incentives for value for money prioritisation, developments in the management and measurement of the balance sheet, building on the strength of UK institutions (ie Office for Budget Responsibility (OBR) and the Office for National Statistics (ONS)), and mitigating fiscal risks and pressures – including actions needed to achieve net zero by 2030.²

However, the Covid-19 pandemic then struck, which completely changed the economic and fiscal outlook. Notwithstanding the devastating impact on public health, the pandemic resulted in the most significant reduction in UK output in three centuries – and one of the worst recessions relative to other high-income economies (even after adjusting for statistical differences in calculating real gross domestic product (GDP)), with real GDP dropping by almost 10% (in 2020) (Figure 1).³

Figure 1: UK Economy suffers from one of the most severe recessions
Change in real GDP in 2020 in advanced economies (IMF definition)

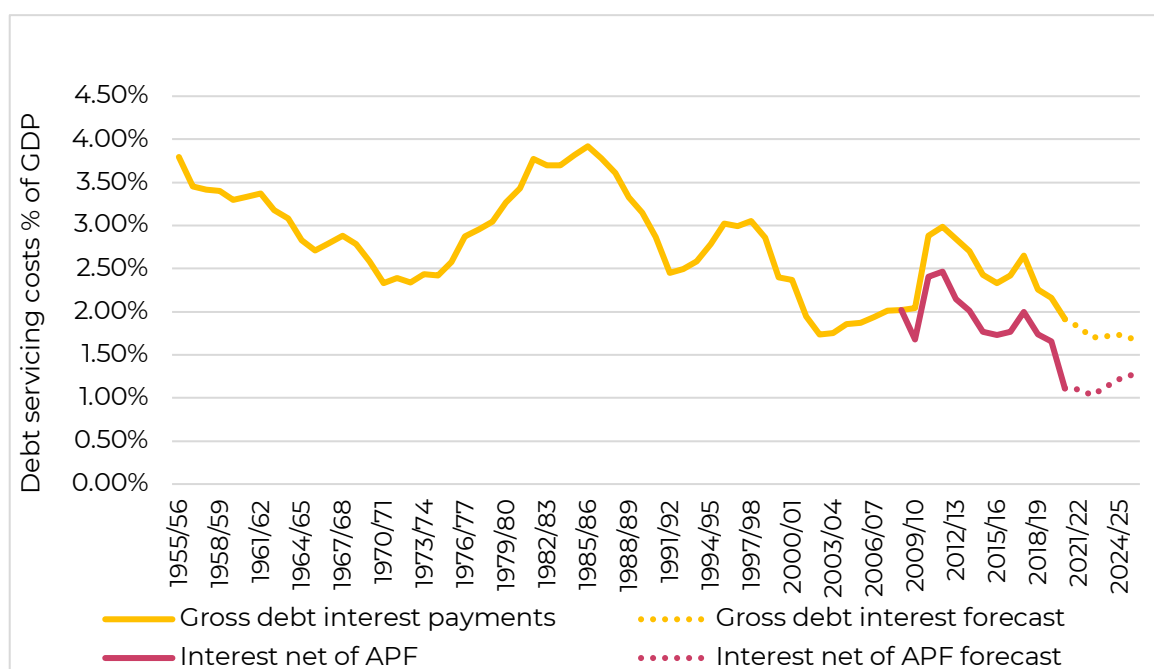


Source: OECD (2021)

In an effort to protect households, businesses, and public services from the most severe peacetime economic shock the global economy has seen since the 1930s, the UK government borrowed 14.2% of GDP in 2020/2021 – its largest deficit since 1944/1945. With higher levels of borrowing, the public-debt-to-GDP ratio is forecast to increase by more than 20%, peaking at 109.7% in 2023/2024 – the highest level since 1958/1959. At the same time, notwithstanding a recent modest rise government interest payments are at historical lows, largely thanks to unprecedented monetary easing by the Bank of England. Despite ongoing deficits and a growing stock of debt, these payments are currently forecast to rise to only 1.3% by 2025/2026 (Figure 2).

Figure 2: Government debt-servicing costs at historical lows

Government interest payments: gross and net of asset purchase facility (APF), 1955–2026



Source: OBR (2021)

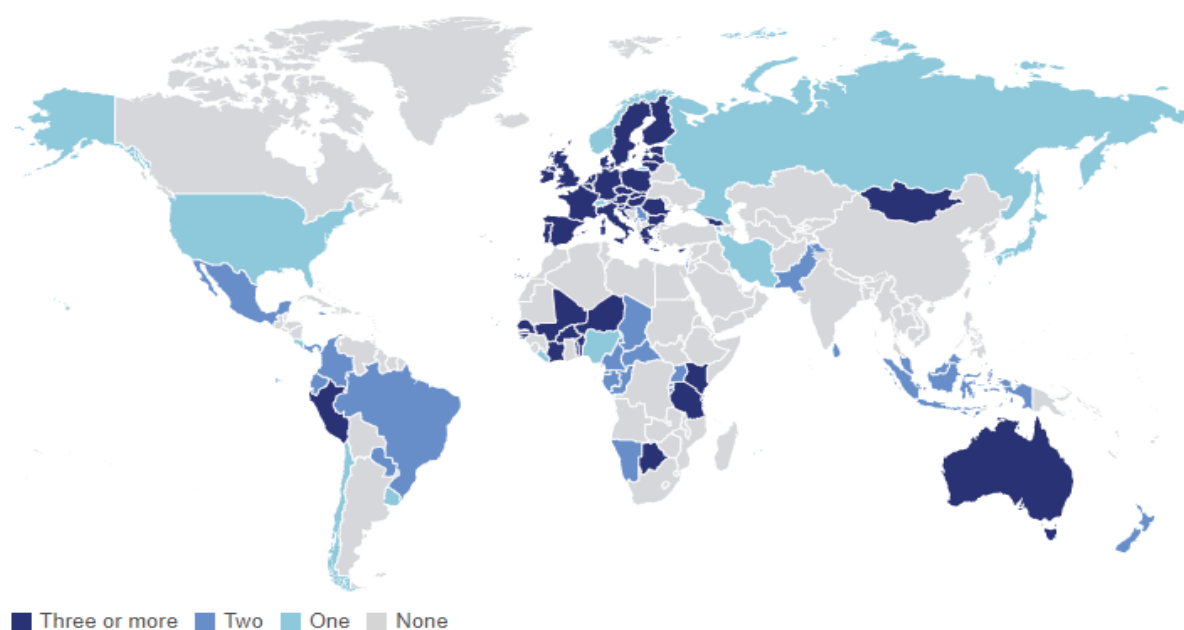
In the upcoming autumn 2021 spending review, the government is looking to finally publish its new fiscal framework. In the wake of the havoc wrought by the Covid-19 pandemic, the economic and fiscal context has drastically changed. Despite moderate commitments to raise public capital expenditure, the chancellor is set on balancing the books and has targeted a declining debt level over the medium term.⁴ With the economic recovery barely underway, structural imbalances that have long plagued the UK economy, and an impending environmental emergency, it is critical that the new fiscal framework does not repeat the same mistakes of the past. Some fresh thinking is urgently needed.

2. MOVING THE GOALPOSTS: FISCAL RULES FAIL ON THEIR OWN TERMS

In conventional macroeconomic policymaking circles (ie HM Treasury, the International Monetary Fund (IMF), and the Organisation for Economic Co-operation and Development (OECD)),⁵ fiscal rules are considered constraints on public debt and borrowing over a medium-term horizon, often in the form of numerical targets or limits on one or more fiscal aggregates (like public sector net debt as a proportion of gross domestic product (GDP)). According to the most recent dataset made available by the IMF (2017), across the globe, there were 291 fiscal rules in place throughout 92 different countries in 2015.⁶ In fact, just under half (48%) of all countries in the world had a fiscal rule in place. The proliferation of such rules has grown over time, starting with just nine countries in 1990. In all cases, these rules were explicitly designed to be simple numerical targets for debt and borrowing, and so centred on one or more elements of the government's balance sheet.⁷ According to an IMF (2021) study, fiscal rules were successful in reducing the debt burden in many countries because they offered: 1) The simplicity to be publicly credible and enforceable, 2) the flexibility to respond to economic shocks, and 3) effective mechanisms for monitoring compliance.⁸

Figure 3: Nearly half of all countries in the world have a fiscal rule in place

Countries with fiscal rules 2015



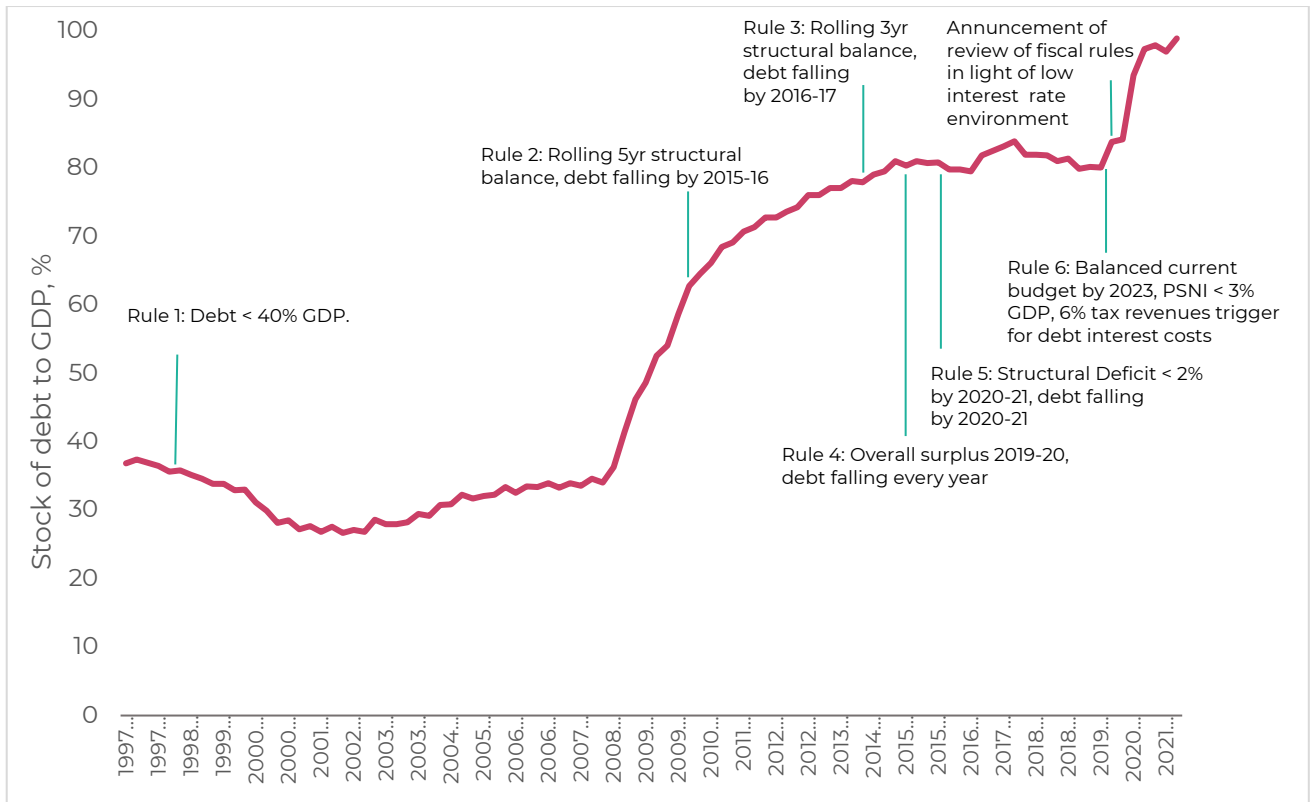
Source: Based on IMF Fiscal Database (2015)

Of the countries with fiscal rules, 85% had a budget balance rule (aimed at balancing expenditure and income over a given time frame) and 83% had a debt rule (a target for public debt relative to GDP). This compares to 49% with an expenditure rule (limits on total or primary spending over a given period), and 15% with a revenue rule (aimed at boosting revenue collection or preventing an excessive tax burden). In total, 97% of countries with fiscal rules had either a budget balance or debt rule in place.

The UK's recent experience of fiscal rules has been far from settled. After helping to pioneer fiscal rules in the late 1990s, the UK experienced six different sets of rules, with eleven rules coming in the past seven years. In the last decade, a new set of rules has, on average, lasted for just two years.⁹ At best, such a frequent turnover of rules represents a gross design failure to build in even the minimum required flexibility to manage a single business cycle – let alone multiple booms and busts. At worst, such turnover is reflective of deliberate reengineering for political advantage; such as by a chancellor seeking to outmanoeuvre their opposite number, a permanent secretary seeking to constrain policy from their ministers, or for interdepartmental advantage between the Treasury and other parts of Whitehall. According to senior individuals interviewed for this report, including those directly involved in the setting of fiscal rules at the highest level, all three political dynamics had some bearing on the process.

Whether or not political rules have routinely served one or more short-term political purposes in the UK, taken at face value it is clear that they have largely failed on their own terms. All UK fiscal rules have contained a combination of debt stock targets as well as targets for annual budget balance. But, as Figure 4 shows, despite some modest declines, debt has for the most part risen consistently since the early 2000s. Meanwhile, a variety of targets for reducing annual borrowing were also consistently missed.

Figure 4: Fiscal rules changing over time
Public sector net debt to GDP, quarterly, 1997–2021



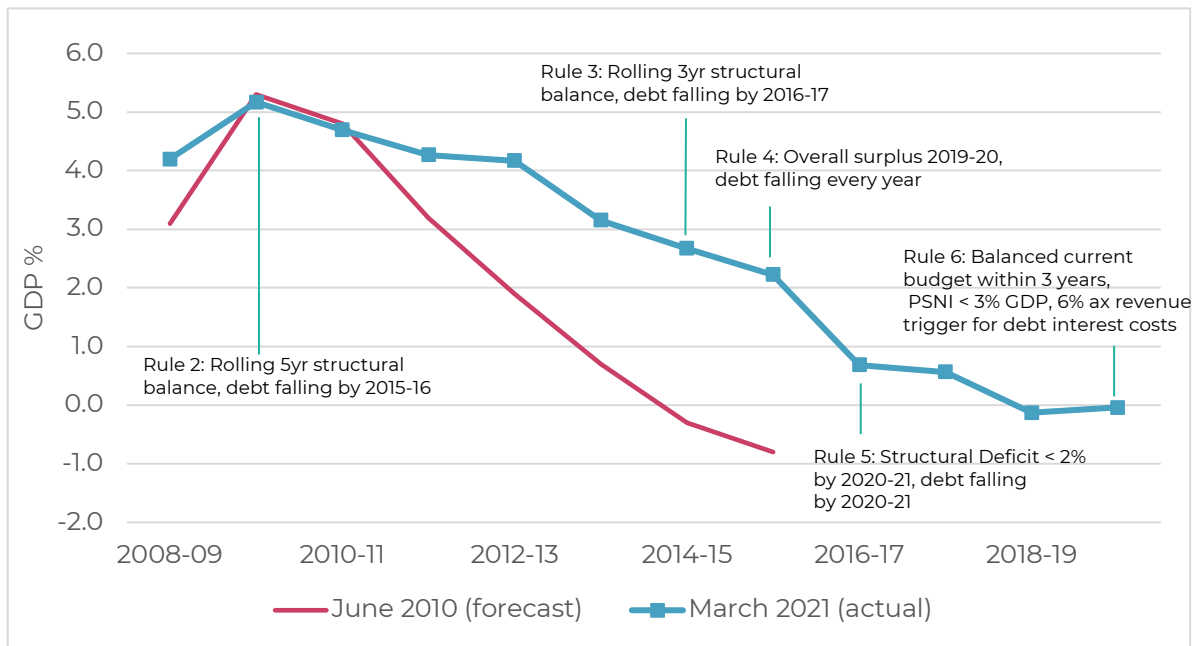
Source: Updated - Harries and Zuccolo (2015); and Bell et al. (2019).

Notes: Structural balance is defined as follows: "The structural or underlying fiscal balance is the difference between government revenues and expenditures corrected by the effects that could be attributed to the economic cycle and one-off events."¹⁰

As Figures 5 and 6 show, from June 2010 the government’s current budget deficit was intended to reach a surplus by 2015, but this was only reached in 2018/2019 – taking almost twice as long to reach the forecasted balance. Meanwhile, public sector net borrowing was supposed to reach £470 bn over 2010/2011 to 2015/2016 (29.8% of GDP), with borrowing hitting zero in 2016/2017. However, net borrowing reached £670 bn for this period (38.2% of GDP), and rather than balancing out to zero, borrowing continued reaching £871 billion in 2019/2020 (47.8% of GDP), nearly double the expected amount.

Figure 5: Budget deficits miss forecasted targets

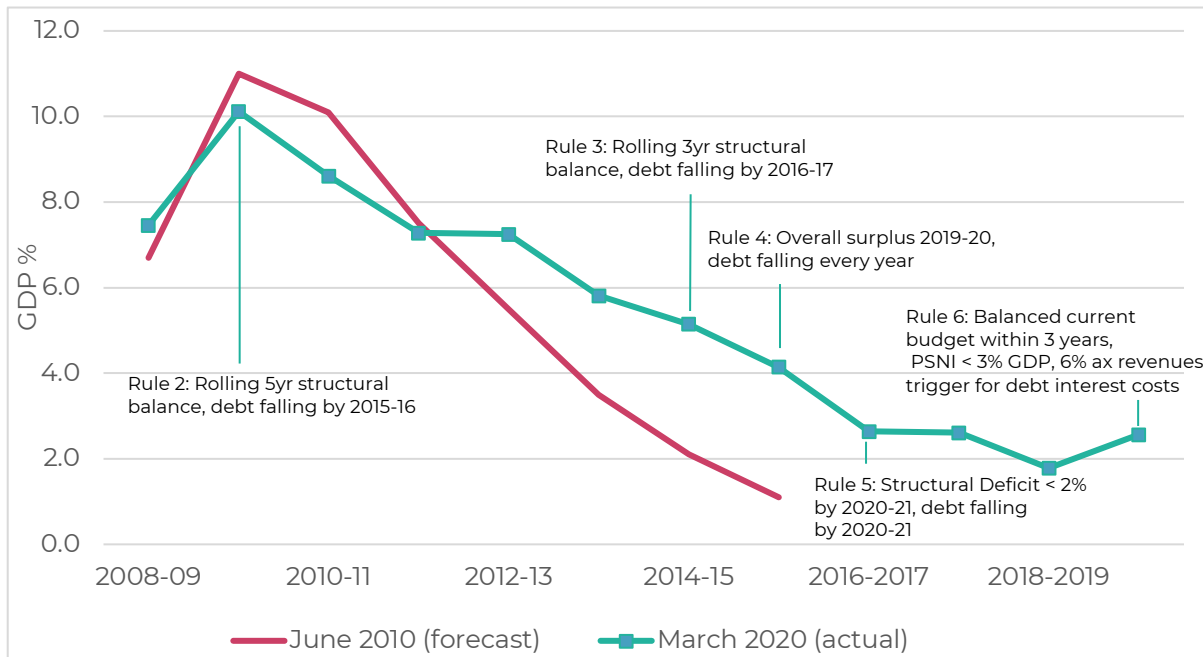
Cyclically adjusted current budget deficit June 2010 forecast versus actual overrun, % GDP, yearly, 2008–2020



Source: OBR (2021)

Figure 6: Public sector borrowing misses forecasted targets

Public sector net borrowing, % GDP



Source: OBR (2021)

Recent analyses, such as IMF (2021) for emerging and advanced economies and Browne and Mulheirn (2021) for the UK, suggest that, in the absence of fiscal rules, the public sector's financial position may have been much worse.^{11,12} However, as we explain further in Chapter 5, in line with Fatás and Summers (2018), the endeavour to prematurely and excessively consolidate the public finances, before full capacity utilisation of the economy had been reached, leads to a fall in aggregate demand, a decline in economic output, and permanent economic scarring.¹³ Along the lines of De Grauwe and Ji (2016)¹⁴ and the IMF (2012), we show that that the depressed economic activity, resulting from the fiscal rules, likely led to a reduction in the tax take and so an increase in the deficit, while a reduction in GDP led to greater government borrowing and a higher debt-to-GDP ratio.^{15,16} Indeed, new evidence presented by Canale et al. (2021) suggests that fiscal retrenchments, as prescribed by EU fiscal rules, can lead to a decline in market confidence.¹⁷ The underlying irony is that the debt and deficit target prescribed by fiscal rules, and associated 'credibility', may have been more easily hit if fiscal rules had been different or looser.

By the IMF's standards and that of conventional policymaking circles, UK fiscal rules have proven neither credible nor enforceable, have failed when faced with economic shocks, and lack effective mechanisms to compel compliance. Chancellors have simply changed their fiscal rules when they became too hard to meet, leaving a supposed cornerstone of hardnosed macroeconomic policymaking vulnerable to political gaming and appropriation.

3. METRICS AND THE STREETLIGHT EFFECT

Chapter 2 shows how the UK's fiscal rules have failed on their own terms over the course of the previous business cycle, and have had to churn through numerous iterations. In this chapter, we explain why the problems run deeper than the design of any one rule or set of rules, and are rather linked to a macroeconomic policy that is too reliant on targets centred narrowly on the government's balance sheet.

In social sciences, the *streetlight effect* is used to describe a related observational bias, where analysts only search for answers in the places they find easiest to look. The metaphor depicts the proverbial person looking under a streetlight for their wallet because it is the only place they can see clearly, despite knowing that it was more likely dropped on the other side of the road.

Macroeconomic policy's reliance on fiscal rules is analogous to this problem. The application of fiscal rules relies on a notion of so-called *fiscal space* – the scope for further public borrowing before the amount of overall public debt presents intolerable risk or harm to the wider economy. At present, fiscal space indicators are aimed at solely measuring some aspect of the public sector's balance sheet – such as the ratio of public sector net debt to gross domestic product (GDP), or public sector net borrowing as a proportion of GDP. This approach neglects that how fiscal space is used can shape the long-term trajectory of the economy; and vice versa, that the state of the economy will have important implications for how much the public sector can and should borrow.

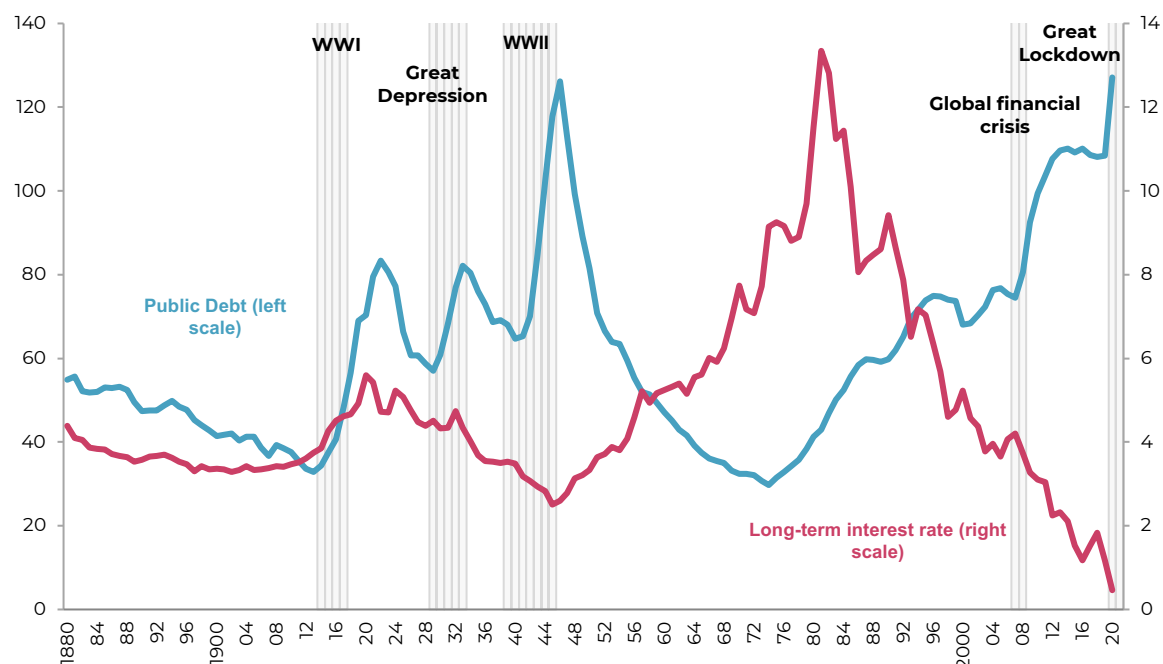
Fiscal space is determined by a complex set of macroeconomic dynamics,¹⁸ such as the resource constraints of a domestic economy – the full capacity utilisation of the economy,¹⁹ underlying inflation, the current account balance, the private sector's willingness to spend/save, and institutional credibility and resilience. Not only are ratios between the public balance sheet and national income known to be (at best) weak proxies for these dynamics, but as NEF (2021) analysis has shown, they are often linked to ill-conceived, if not randomly determined thresholds and targets.²⁰ This problem means fiscal rules are largely arbitrary targets for their goal to help manage fiscal space. Not only is the appropriate level or trajectory for a given fiscal aggregate – like public debt or borrowing – entirely conditional on prevailing macroeconomic dynamics, but fiscal rules do not attempt to measure or target these conditions.²¹

The neglect of complex macro dynamics means at least half the puzzle is missed; hence, the analytical frameworks currently used to assess the sustainability of a fiscal expansion

are unable to accurately measure fiscal space. Without a more holistic and empirically grounded understanding of fiscal sustainability, we risk imposing arbitrary constraints on the government's borrowing capacity. Put differently, how do we know what a low and sustainable level of debt is if we are not measuring the right thing?

Figure 7: No meaningful correlation between debt levels and interest rates across advanced economies

Public debt and long-term interest rates, in advanced economies, 1880–2020, %GDP



Source: IMF (2021)

This point can be illustrated by examining just one such dynamic – *affordability*, or debt-financing costs. Despite running a sizeable deficit in response to the Covid-19 pandemic at the end of November 2020, long-term interest rates were lower than the year before and significantly lower than five and ten years before that (Figure 8). Indeed, there has been a trend, which is not UK specific (Figure 7), of yields declining over the past 30–40 years, despite the increase in the government's stock of debt over the past decade. With negative real yields, investors are now effectively paying to lend to the government. This suggests another issue with the assumption that higher levels of debt raise government debt-financing costs – in bad times (when governments typically borrow more), investors tend to flee towards safe assets (like UK government debt), which reduces rather than raises government borrowing costs.²²

There is a vast, but controversial, empirical literature indicating that deficits and growing debt levels positively increase risk premia and bond yields.^{23,24,25,26, 27} For example, as noted by former chief economist of the IMF, Olivier Blanchard (2020), the more

pessimistic empirical studies indicate that a one percentage point increase in a country's government-debt-to-GDP ratio could increase long-term borrowing costs by 0.04%.²⁸ Meanwhile, IMF economists Salvatore Dell'Erba and Sergio Sola (2016) find that when simply considering domestic variables (not controlling for international factors) a fiscal deficit leads to an increase in long-term interest rate by 8–11 basis points.²⁹

At the same time, as highlighted by Figures 7 and 8, and by professors of economics at Harvard University, Jason Furman and Larry Summers (2020), over the last 40 years debt levels across advanced economies went from being extremely low by historical standards to being extremely high while borrowing costs inversely fell from being very high by historical standards to record lows.³⁰ Along the lines of De Grauwe and Ji (2016), the conventional policymaking approach would have predicted that, as deficits and debt levels increased, interest rates should have increased instead of decreased.³¹

Meanwhile, several more recent studies, Benmelech and Tzur-Ilan (2020),³² Apeti et al. (2021),³³ and Chen et al. (2021),³⁴ have found that existing public debt levels as a share of GDP did not determine the size of the fiscal stimulus in response to the Covid-19 pandemic.^{35,36,37} In fact, contrary to conventional policy assumption, a most recent study by Aizenman et. al (2021) found that "it was governments with bigger debt loads that announced bigger programs, but that sovereign spreads were not so clearly associated with the size of these program plans...It seems reasonable to argue that in an emergency situation such as the emergence of a global pandemic, the longer-term considerations of debt sustainability – usually proxied by debt/GDP averages – do not matter much." (p. 15).³⁸

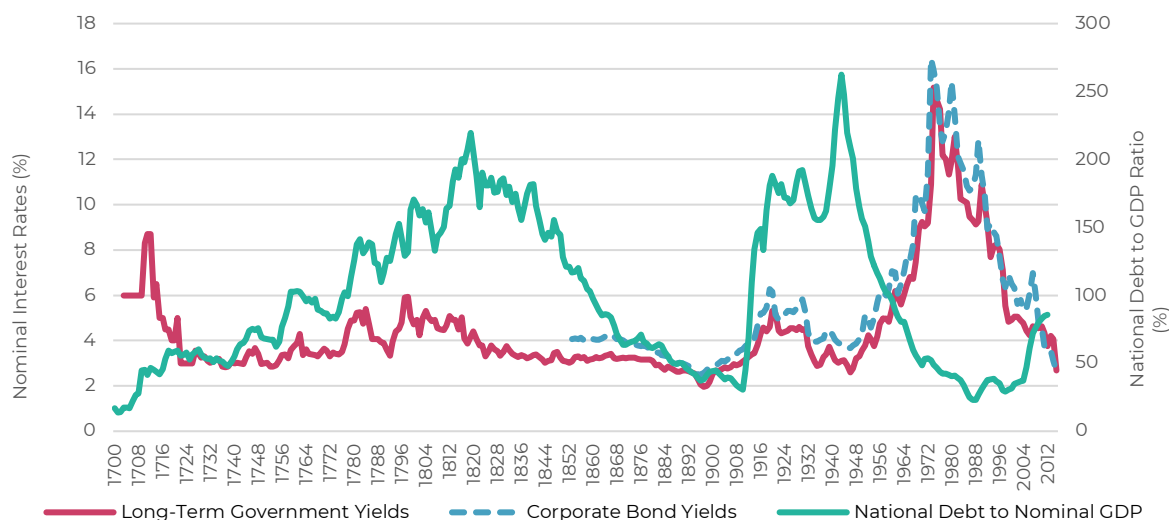
At this stage, we take no position on whether higher debt and deficit levels lead to an increase in interest rates – all other things being equal. Our point here is that, as noted by Blanchard (2020), as well as by Summers and Rachel (2019), other factors can play a significant role.^{39,40} Indeed, despite their initial findings that deficit levels are correlated with higher interest rates, when controlling for global fiscal and monetary factors, IMF economists Dell'Erba and Sola (2016) find that the estimated effect of budget deficits on long-term interest rates vanishes and becomes insignificant.⁴¹ At the very least, other macroeconomic dynamics have more than offset any impacts from deficits or growing debt levels on borrowing costs.

For example, applying a similar methodology to Tymoigne (2020)⁴² to the UK context, we find that higher levels of public debt do not meaningfully correlate with higher borrowing costs, nor with new annual borrowing and borrowing costs. In fact, for more than a century, the apparent relationship has been essentially the reverse (Figures 8 and

9) suggesting other factors have more than offset any impacts from debt levels or the deficit on yields.

Figure 8: UK stock of debt has no meaningful relationship with long-term yields

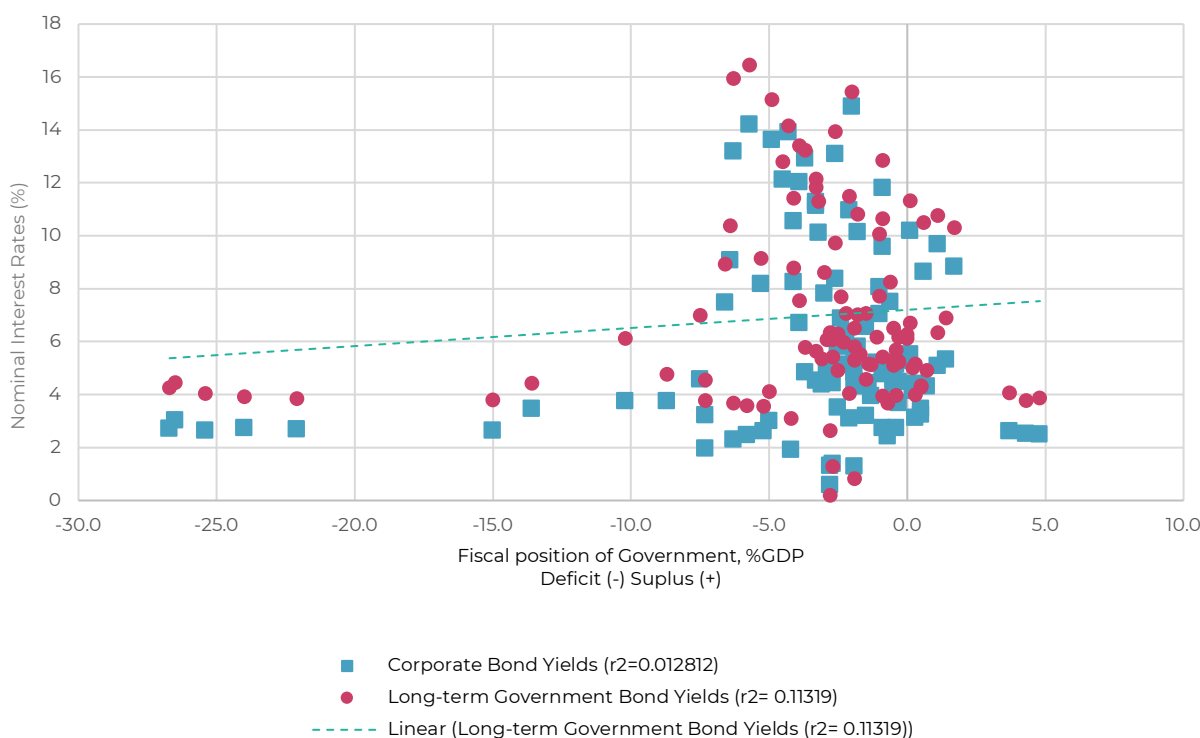
UK stock of debt as a percentage of nominal GDP [RHS], long-term government yields -10 years - as (%), corporate bond yields – 10 years – as (%) [LHS], 1700-2015



Source: Authors' calculations, Bank of England (2021) and Tymoigne (2020)

Figure 9: UK deficits have no strong correlation with long-term yields

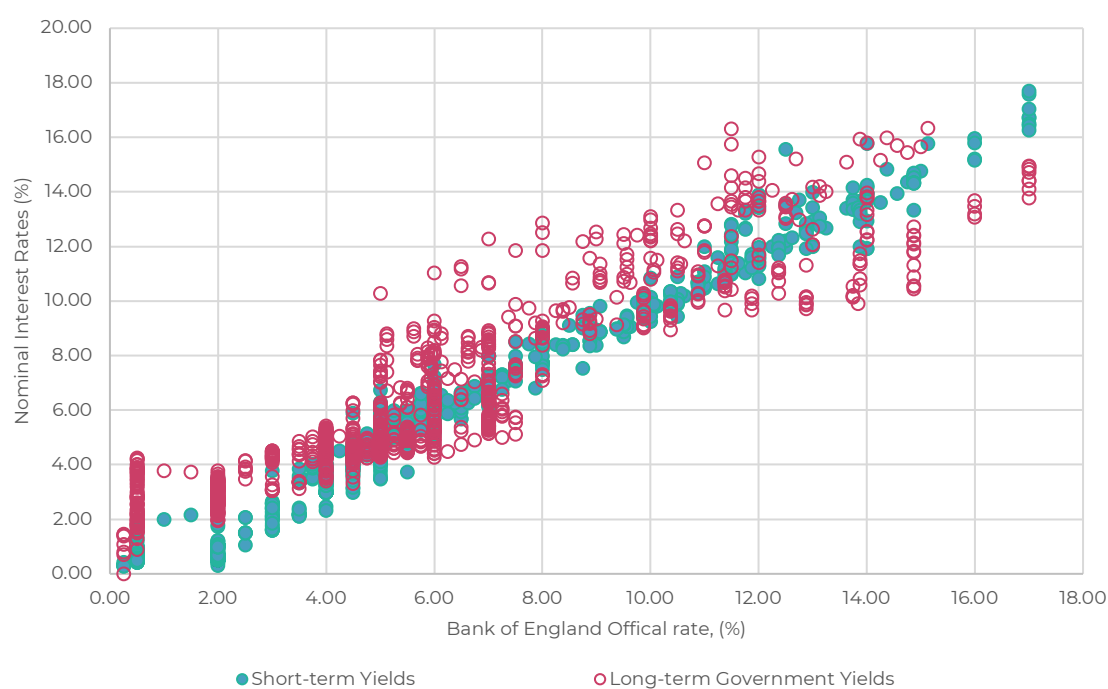
Public sector net borrowing as a percentage of nominal GDP, long-term yields -10 years – as (%), corporate bond yields – 10 years – as %, 1920-2019



Source: Authors' calculations, Bank of England (2021) and Tymoigne (2020)

At face value, there appears instead to be a much stronger positive correlation between the policy interest rate set by the Bank of England and the government's borrowing costs, than between the level of government borrowing or debt and borrowing costs (Figure 10). Of course, different factors contribute to this relationship, and causality may run in several directions. But descriptive observations, such as these, generally support contemporary macroeconomic literature; that is, that numerous macro-dynamics typically counterbalance any effects borrowing or debt levels may have on interest rates.^{43,44, 45}

Figure 10: Significant positive relationship between Bank Rate and government yields
Bank of England's official policy rate, short-term and long-term yields, 1920-2019



Source: Authors' calculations, Bank of England (2021) and Tymoigne (2020)

At the very least, the conventional policymaking approach to fiscal space overlooks or downplays the role of central banks, such as the Bank of England. The UK can borrow money in its own currency and, if needed, finance it through the Bank of England's money-creating powers. As such, unlike households, the UK government cannot default on its debt, because such debt is merely a promise to pay more of its own liabilities in the form of central bank reserves. The Bank of England can always create new money to repay the government, as such debt is issued in the currency the Bank creates. This does not mean there are no unintended side effects and constraints to government borrowing and printing money in one's own currency. The subject of a forthcoming NEF paper, certain constraints can come in the form of resource constraints in the domestic economy, environmental and biosphere limitations, currency fluctuations, and private

sector confidence; while unintended consequences (absent mitigating policy interventions) could include asset price inflation and an associated rise in inequality. It does, however, demonstrate that the simplistic recent targets for debt or borrowing failed to capture even elementary institutional realities.

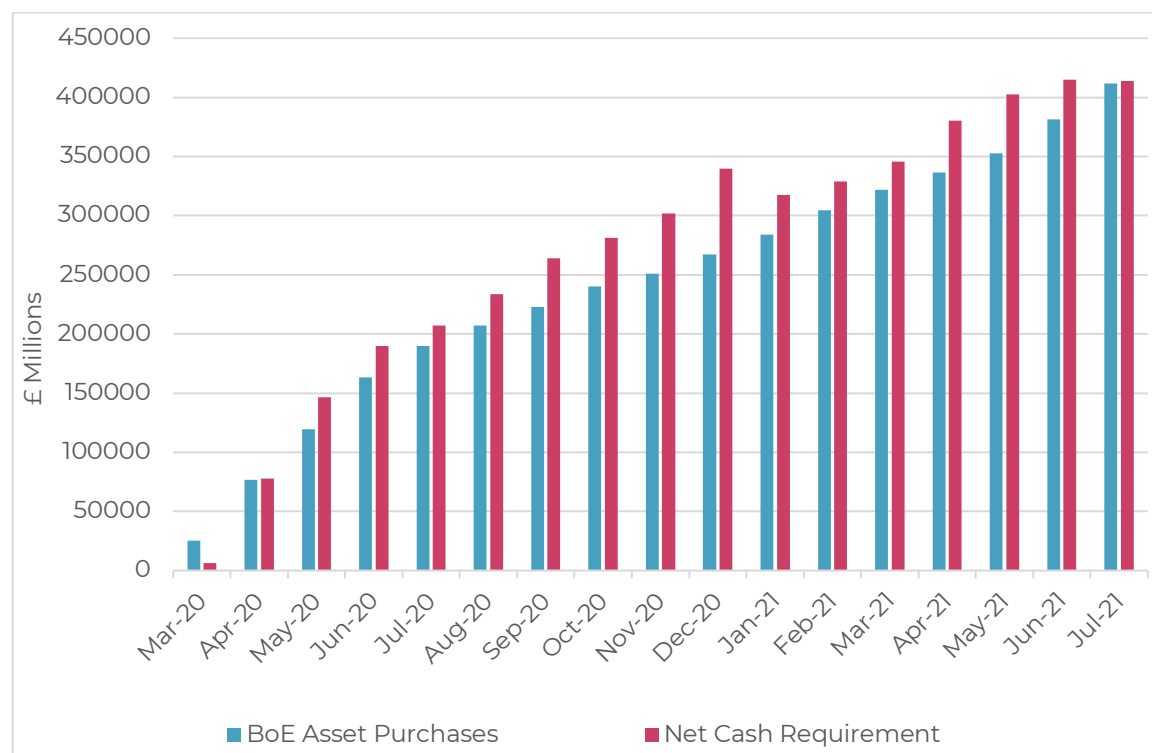
In some ways, the response to Covid-19 brought the importance of this limitation from theory into reality, albeit without official or formal acknowledgement from policymakers. This is because the Bank of England's asset purchases have consistently tracked the government's borrowing needs throughout the pandemic (Figure 11). For example, NEF calculations suggest that while government borrowing in FYE 2021 was 14.9% of GDP or £320.5 bn (the highest since the second world war), the Bank of England's net purchase of government bonds was 15.3% of GDP or £328 bn over the same period. Put differently, all the public sector borrowing in FYE 2021 was indirectly financed by money newly created by the Bank of England. Of the £2.5 tn worth of debt (107.4% of GDP) the government is forecasted to owe by the next financial year, the Bank of England will own £895 bn (ie around 36% of total government debt). In effect, this replaces the cost to the Treasury of paying interest rates on gilts with the much lower cost to the Bank of England of paying interest on reserves to commercial banks (because the difference between the two rates is paid back to the Treasury).

There are important concerns that interest rates could rise in the future, which would increase debt-servicing costs. In the worst-case scenario, this could lead to a dynamic where interest rates are higher than the growth rate (the renowned $R > G$ dynamic) – putting debt levels on an unsustainable pathway in the absence of an adequate primary surplus.⁴⁶ Importantly, while we are not necessarily against raising certain taxes to run a primary surplus, we note that the interest rate on central bank reserves is a policy decision. At present, it is the same as the Bank Rate, and so could rise with a strengthening of the economy (although, from the Treasury's perspective, a rise in debt-financing costs of this kind would also be offset, at least partially, by increased tax receipts from a stronger economy).

However, as noted by professor of economics at University College of Dublin, Karl Whelan (2021), following the precedent set by the Bank of Japan and the European Central Bank, the Bank of England could move towards a 'tiered reserve system'.⁴⁷ The Bank of England could then stop paying interest on the majority of these short-term liabilities, which could reduce the government's debt-to-GDP ratio from the forecasted 103% to 70% by the year 2025/2026 (a future NEF paper will discuss how such an operation could happen in practice). Alternatively, if desirable, the Bank could simply target a specific yield that keeps debt-servicing costs low or below the economy's

growth rate.⁴⁸ The Bank of Japan currently takes this approach, and this policy measure was also historically deployed by many central banks in the aftermath of World War 2, including the Bank of England and the US Federal Reserve.⁴⁹

Figure 11: Bank of England asset purchases track the government's borrowing needs
Net cash requirement (exc PS Banks) (PSNCR exc): £m CPNSA and BoE asset; Purchases total allocation (nominal £mn), both cumulative, March 2020-July 2021.



Source: ONS and BoE, authors' calculations updated from Giles and Stubbington (2020)

4. AN UNLEVEL PLAYING FIELD: ASYMMETRY IN FISCAL RULES

Like inflation targets in monetary policy, fiscal rules are designed to mitigate time-inconsistency problems. According to the IMF (2018), building up fiscal space is ‘like having money in the bank for a rainy day’.⁵⁰ The best and only time to use fiscal space, so the argument goes, is after an economic shock has taken place.⁵¹ Unlike monetary policy targets, however, this means that fiscal rules display an apparently inexplicable asymmetry. Whereas in monetary policy, it is considered equally costly for inflation to either overshoot or undershoot the inflation target, fiscal rules only attempt to guard against excessive use of fiscal space (or *deficit bias*), rather than underuse it (something that might be described as *surplus bias*).

This asymmetry in fiscal rules is well captured in a statement by professor of economics at Harvard University, Jason Furman (2021):

I used to think that policymakers only made errors in one direction, which is irresponsibly large increases in deficits, and so that rules could play a useful role in constraining discretion. Over the last twenty-five years, however, one has seen many errors in the opposite direction. [...] So the entire premise of rules is wrong for many countries.⁵²

A surplus bias gives the impression that the government’s financial position is the key barometer for measuring a country’s economic welfare. However, when addressing longer-term structural issues, as opposed to cyclical ones, an overly narrow focus on reducing the size and risks to the government’s financial balance sheet can mean accumulating numerous risks and vulnerabilities elsewhere in society and the wider economy (such as environmental breakdown, weaker private sector balance sheets, and inadequate public services). The build-up of these risks and vulnerabilities weakens our capacity to cope and respond to future crises, and so undermines the resilience of our socio-economic system.⁵³

For example, previous public spending cuts substantially weakened our health and social care before Covid-19, making the effects of the pandemic much worse, despite no observable limits to the government’s fiscal space to respond during and after the pandemic (thanks in part to the Bank of England’s additional gilt purchases, Chapter 3).^{54,55,56} The same can be said for the welfare system, where going into the pandemic relied on one of the weakest safety nets in advanced economies as well as in the UK’s post-war history.⁵⁷ For example, in 2019, total out-of-work payments claimed by UK

workers was 34% lower than their pre-existing employment earnings – the third lowest of 35 Organization for Economic Co-operation and Development (OECD) economies.⁵⁸ Similarly, the primary adult out-of-work payment stood at 15% of average earning – the lowest since the establishment of the welfare state in 1948.⁵⁹ While the government definitely merits a certain level of praise for the establishment of the furlough scheme, it is likely that many people and families still fell through the cracks.⁶⁰ As the government discovered, you cannot erode public provision for a decade and then rebuild it in a day.⁶¹

A surplus bias can also lead to missed opportunities to avert, mitigate, or adapt to crises before they happen. Preventative investment to avoid or mitigate an environmental breakdown, for example, would be many times more efficient at reducing future costs (including to the Treasury) than waiting to respond to extreme weather events or high sea-level rises after they have already happened. At the macroeconomic level, the OBR (2021), for example, has recently warned that delaying decisive action by roughly ten years would double the overall cost of the transition to net zero, while leading to certain permanent losses.⁶² In an unmitigated scenario, progressively more frequent and costly shocks would mean that debt ratchets up to more than 289% of gross domestic product (GDP) by the end of the century, accompanied by the incalculable social and environmental costs of a 4°C temperature rise. Even in the delayed action scenario, debt in 2050/2051 is 23% of GDP higher than in the early action scenario.⁶³

Deficit bias is also a problem for narrow economic and fiscal outcomes. This is because fiscal consolidation – withdrawing public spending from the economy as a proportion of overall income – following an increase in debt, can contract aggregate demand when it is most needed. This reduction in spending and investment can worsen the productive capacity of the economy, that is, the difference between actual economic output and the economy's potential, meaning the economy performs below its possible capacity.⁶⁴ It can also increase company bankruptcies and lead to less investment in research and development, hurting the supply side of our economy, and potentially exacerbating inflationary pressures. In short, it can have hugely negative knock-on effects for the future path of GDP, employment, and disposable household incomes.

Several renowned mainstream economists have concluded that a variety of major advanced economies, including the UK, are economically worse off because they attempted to run a fiscal surplus in inappropriate macroeconomic conditions.^{65,66} Economics professors Antonio Fatás and Laurence Summers (2018), for example, suggest that austerity has more than a short-run negative impact on GDP; it also has a permanent long-term effect on GDP, so that austerity's "effects on (fiscal) sustainability are exactly the opposite than its original goals".⁶⁷ Similarly, for a sample of 20 large

advanced economies, professors of economics at the University of Berkeley Auerbach and Gorodnichenko (2017) found that:

Government spending shocks do not lead to persistent increases in debt-to-GDP ratios or costs of borrowing, especially during periods of economic weakness. Indeed, fiscal stimulus in a weak economy can improve fiscal sustainability along the metrics we study.⁶⁸

Other empirical studies, controlling for a host of confounding variables, have found that fiscal consolidation measures taken irrespective of the macroeconomic context have largely delivered higher measures of public debt instead of substantial reductions.^{69,70,71,72,73}

In 'normal times' (when the economy is close to operating at its full capacity), some of the adverse economic effects of fiscal contraction might be offset by, for example, looser monetary and credit policy measures (eg the Bank of England could lower interest rates).⁷⁴ But with interest rates thought to have reached their effective lower bound – the point beyond which further reductions in interest rates have a negligible impact on the economy – since 2009, and a prevailing private sector environment characterised by high debt-to-earnings ratios, weak balance sheets, and pessimistic expectations of future profits – the effectiveness of monetary and credit policy at boosting further spending in the economy diminishes.

This situation is what economists call a *liquidity trap*, and this dynamic has plagued the UK economy for at least a decade.^{75,76} Trying to stimulate a sustained increase in aggregate demand by trying to encourage more private sector borrowing is like pushing on a string. As the IMF chief economist Gita Gopinath (2020) recently put it, "for the many countries that find themselves at the effective lower bound of interest rates, fiscal stimulus is not just economically sound policy but also the fiscally responsible thing to do."⁷⁷

5. CALLING TIME: TOWARDS A NEW FISCAL FRAMEWORK

As the previous chapters have shown, the range of scenarios where fiscal expansion – involving high medium-term debt and borrowing – is closer to optimal policy than fiscal contraction is wide. Furthermore, proxies for fiscal space that rely almost solely on aggregates from public accounts suffer from gross oversimplification. Frameworks that rely on such proxies are unlikely to succeed on their own terms, and leave themselves vulnerable to institutional dominance and political gaming.

In this briefing paper, we argue that the UK government’s consultation on fiscal frameworks should recommend a wholesale departure from fiscal rules. In this chapter, we set out our proposals for an alternative, based on two key principles for reform borne from the preceding analysis:

1. Symmetry of risk: Where there are risks to both underusing and breaching fiscal space, the fiscal framework should attempt to guard against either eventuality.
2. Accuracy over spurious precision: Where the key determinants of fiscal space cannot be measured easily close to real-time, institutional checks and balances and informed debate over the known parameters should replace overly narrow and partially arbitrary targets.

Interest in fiscal rules and frameworks has increased in recent years, with several alternative frameworks undergoing initial development. Our thinking is indebted to many of the insights borne out of this work. However, in our view, none of these proposals satisfies the two principles above to the required degree.

Some of the main proposals are discussed in turn.

Targeting public sector net worth: One proposal gaining increasing credence is to move beyond the overly narrow focus on public sector net debt to the wider government balance sheet by targeting public sector net worth (PSNW) as a share of gross domestic product (GDP) (as proposed by the Resolution Foundation).⁷⁸ Instead of only capturing debt on the liability side and certain financial instruments on the asset side, a PSNW objective would offer a more holistic indication of the public sector balance sheet by reviewing all financial and non-financial assets and liabilities.

This option would better capture the benefits of public sector interventions in the economy, supporting borrowing for growth-enhancing investment, while additionally taking account of crucial financial transactions and forcing policymakers to account for non-debt-based liabilities. It is worth noting though that PSNW still omits a range of

other assets and liabilities that can affect both the public sector balance sheet (and the wider economic outlook), such as depreciation in natural assets and associated liabilities and investment requirements.

Green golden rule: This fiscal rule is being increasingly discussed at the EU level, and is a revised form of a golden rule.⁷⁹ Here deficit borrowing for capital investment would be excluded from any fiscal rules; however, such borrowing would still be constrained by an overlap with a fiscal rule on the current account and/or overall debt issuance. This rule acknowledges that certain public investment projects, even with a high risk-adjusted social rate of return, will yield low or zero financial returns (eg roads, bridges, investment in climate change mitigation).

The negative financial returns (and cost of depreciation) would have to be covered by the current account. Capital investments with lower financial returns infer higher future transfers from the current account, requiring restrictions on the current account or overall debt issuance. This rule would thus allow for deficit borrowing in investments that would effectively pay for themselves, but still be constrained if the investment has a low financial return. While this proposal would allow for higher levels of net investment, it would still be very difficult to make important investments that don't yield immediate financial returns.

Interest rate rule: Another option, proposed by macro hedge fund manager Eric Lonergan and Professor Mark Blyth (2020), is to tie fiscal rules to long-term market rates of interest and GDP.⁸⁰ As long as the long-term costs of government debt are below nominal GDP, the government can issue debt. This is not a yield-targeting exercise; this simply allows for the government to target a stable debt-to-GDP ratio – if bond yields are close to or higher than GDP growth, this would act as a constraint on deficits. This is a very strong proposal that will allow for significant flexibility in the size of the deficit and debt-to-GDP ratio – while allowing the central bank to target inflation (with tools such as dual interest rates). A possible issue here is that interest rates might be subject to volatility when borrowing is most needed, and, more importantly, whether public good can be adequately captured by GDP.

Replacing 'fiscal rules' with 'fiscal referees'

In this briefing paper, we make initial proposals for more fundamental reform of the UK's fiscal rules. Our proposals include the following two key features:

- **Replace narrow targets for debt and borrowing with a target range for the government's primary balance** – the difference between government revenue

and non-interest expenditure – as a proportion of GDP and over a rolling medium-term forecast horizon. The target range would be based on a set of fiscal principles (Box 1). Such a range would better reflect both inherent uncertainty and the symmetry of possible cost to sub-optimal fiscal policy. The range itself could at any one time straddle either or both a reflationary or deflationary position for aggregate fiscal policy, but, more importantly, falling outside of the range at either extreme would constitute missing the target.

- **Delegate the process of setting the target range to a third party institution outside of the Treasury or the chancellor’s direct control.** Such an independent third party could take the form of a new fiscal policy committee (FPC) at the Office for Budget Responsibility (OBR). This advisory committee could be tasked with updating their target range for the optimal primary balance twice a year, before fiscal events such as the spring budget and autumn statement. The committee would establish their target range based on a detailed analysis of fiscal space. The range would also reflect a judgement over the extent of exposure to known and unknown, economic, societal, and environmental risks that could otherwise benefit from prior avoidance, mitigation, or adaptation through fiscal policy.

In essence, such a reform could be **characterised as replacing *fiscal rules* with *fiscal referees* guided by a set of fiscal principles** and would represent an important shift in institutional power away from the chancellor and the Treasury, as part of better satisfying our two principles.

The new FPC could in some respects operate similarly to the Bank of England’s monetary policy committee (MPC), or the Low Pay Commission (LPC) an independent body that advises the government about the national minimum wage. Like the MPC, membership of the FPC would be appointment-based, with eligibility limited based on expertise and professional experience. A fixed number of FPC appointments could be made by the government, for example including the chair of the OBR, with the remainder appointed via a parliamentary process, for example via the House of Commons Treasury Committee. The FPC could also follow a transparent, minuted process in arriving at its target range for the optimal primary balance, similar to the MPC’s process for setting interest rate policy. Outside of the two key reporting periods before fiscal events, members of the FPC could also be permitted to contribute to the wider debate through speeches and public articles.

Unlike the MPC, however, the FPC would have no delegated policymaking power – with the UK’s fiscal position remaining the responsibility of the government and the chancellor as it is today. In this sense, the FPC would be an independent advisory body in a similar vein as the LPC. But the chancellor would no longer set or mark their own homework concerning fiscal targets. Any divergence from the target range for the optimal balance could elicit a letter of explanation from the Chancellor to parliament. In addition, the Chancellor could make time to meet a specifically designed House of Commons Parliamentary Committee to explain policy choices. These are simply illustrative examples of accountability mechanisms that we believe would significantly enhance the process of holding the government to account over its economic responsibilities, compared to the current status quo.

A primary function of the FPC would be to come to an analytic view on the availability of fiscal space over a medium-term horizon. This would be based on an analysis of macroeconomic variables and dynamics, such as different elements of the public sector balance sheet, the availability of real resources in the wider economy, the balance sheet position of the private sector, the balance sheet and activities of the Bank of England, and the maturity and ownership profiles of government debt – similar to exercises currently undertaken by the IMF (2018). The FPC would also need to come to a view on prevailing economic and societal risks, informed by sister bodies such as the Committee on Climate Change. The process of translating these assessments over fiscal space and prevailing risk into a target range for the optimal primary balance would need to follow a set of principles set out in the FPC’s mandate from the government. Both this process, and the relevant principles, will be the focus of a future NEF paper, but an illustrative example is presented in Box 1.

Box 1. Illustrative examples of a set of fiscal principles

I. General fiscal principles:

- a. With debts denominated in its own currency and a floating exchange rate, the UK government's fiscal space is constrained by the availability of resources and idle inputs in the economy.
- b. When making decisions regarding its spending, the government should consider the long-term impact of these decisions on society as a whole – both in a strict economic sense and more broadly in terms of the positive benefits that stem from investments in public goods – rather than just on its own debt and deficit.

II. Criteria for meeting these principles:

- a. The UK government shall not borrow in excess of the availability of resources and idle input of the economy, such that nominal aggregate demand outstrips the productive capacity of the economy.
- b. The UK government shall not under-borrow when there are clear available resources and idle inputs in the economy, such that nominal aggregate demand is permitted to fall and the productive capacity of the economy wane.

III. Secondary legislation or commonly agreed positions for meeting whether criteria are satisfied:

- c. Methods and metrics to assess whether principles and criteria are being met would include monitoring inflation, output gap and productive capacity, balance sheet position of the private sector, the current account deficit, balance sheet of the Bank of England, interest rates, PSNW, green finance gap, etc.

We believe such a reform would deliver superior performance against our principles than either conventional fiscal rules of the kind used in the UK or comparable advanced economies, as well as all alternative proposals that we are aware of. We believe it strikes the right balance between retaining measurable accuracy without descending into spurious precision and arbitrary decision-making. It also better reflects the symmetry of risk, costs, and opportunity costs of suboptimal fiscal policy and it would make the chancellor and the Treasury most robustly accountable, as they are currently free to write and re-write their own fiscal targets multiple times a parliament.

ENDNOTES

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