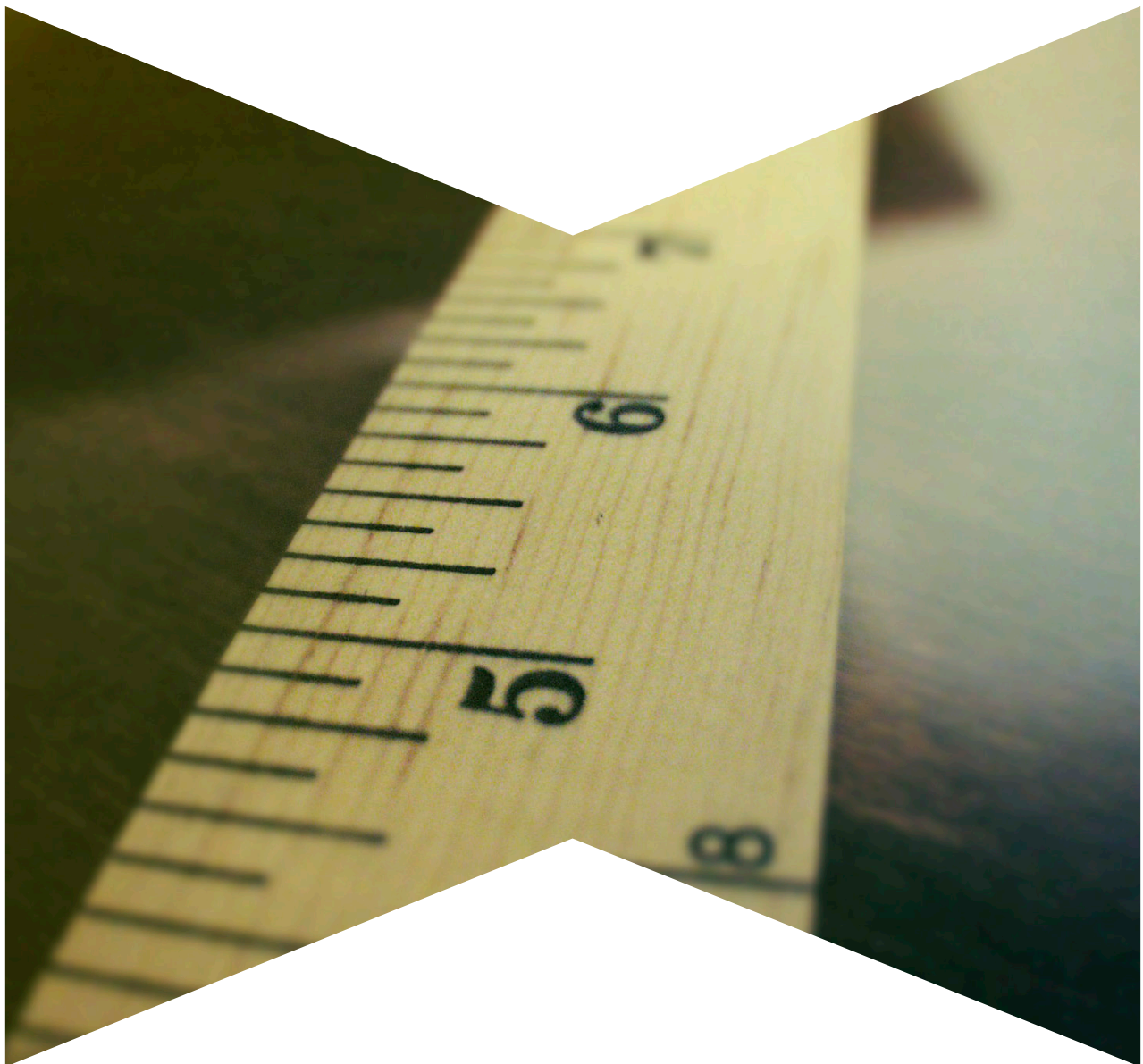


Totally (net) worth it

The next generation of UK fiscal rules

Richard Hughes, Jack Leslie, Cara Pacitti & James Smith

Oct 2019



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Executive Summary

The UK needs a new and different fiscal framework

The UK is currently operating without a fiscal framework. Two of the government's three fiscal rules were already set to expire next year, but the combination of economic and fiscal deteriorations since the Spring Statement and the new set of spending commitments set out in the 2019 Spending Round mean that all three fiscal rules have effectively been abandoned. Specifically, the government looks set to miss its target of reducing the structural deficit below 2 per cent of GDP next year by around £16 billion (0.7 per cent of GDP). That means it will also struggle to keep underlying debt (excluding the temporary effects of the Bank of England) falling beyond next year, particularly if it wants to follow through on its as-yet-unfunded promises around increased capital spending and tax cuts. And the longer-term objective of balancing the budget by the mid-2020s looks even more unattainable today than when it was first set.

The UK was a pioneer in the development of fiscal rules in the late 1990s and needs fiscal rules just as much today. Both the stop-go fiscal policies that characterised the decades before the advent of rules, and the flurry of tax promises and spending commitments made in recent months, illustrate the risks of returning to unfettered short-term discretion in fiscal policy. And such risks are magnified by continued political and

economic uncertainty and the looming prospect of another general election. With that in mind, the review of the fiscal rules announced by the Chancellor at the Spending Round is critical to re-establishing a credible policy framework for future budget decisions.

However, it is not enough to simply tweak or extend the existing rules. The UK needs a new and different set of fiscal rules that reflect the lessons of the past, seize the opportunities of the present, and respond to the challenges of the future. Over the past two decades, the UK has had fiscal regimes designed either to constrain fiscal profligacy during a period of economic stability (1998-2008) or consolidate the fiscal position following a period of economic turbulence (2010 to the present). The next generation of rules will need to guide fiscal policy through a period of unprecedented near-term uncertainty, but also enable it to address looming long-term economic, social, and environmental pressures.

This requires a set of rules that are both more robust and more flexible, safeguarding fiscal sustainability in the long run while allowing policy to respond to a range of potential economic scenarios over the medium term. It also requires a fiscal framework that enables the government to seize the opportunities presented by historically low interest rates to invest in tackling long-term challenges. However, the framework should also take advantage of recent improvements in fiscal reporting to hold governments to account for the value of the assets created by that investment. To do all this, the new rules need to move beyond the familiar borrowing and debt aggregates that have formed the building blocks of previous fiscal frameworks.

The new rules need to learn from past successes and failures

In designing the next generation of fiscal rules, it is important that we learn the lessons of past successes and failures in the UK and internationally. Fiscal rules have been adopted by all UK governments since 1998, and rules are now in place in three-

quarters of advanced economies. Two decades of experience with fiscal rules at home and abroad highlight five key lessons.

First, what gets excluded gets exploited. For example, the focus on government debt that has characterised all UK fiscal rules to date has encouraged the creation of off-balance sheet liabilities (such as Private Finance Initiative contracts) and led to the steady accumulation of non-debt liabilities (such as from unfunded public sector pensions) being overlooked. Avoiding such temptations and blind spots requires the adoption of rules that are as comprehensive as possible in their coverage of public sector institutions, stocks, and flows.

Second, rules can be either too focused on the past or on the future to effectively guide today's fiscal decisions. For example, the 1997 Labour government's definition of its golden rule 'over the cycle' allowed the government to run an increasingly procyclical fiscal policy from 2002 onwards thanks to the current surpluses it built up in the late 1990s. The 2010 Coalition government's rolling five-year structural current balance rule allowed the deadline for meeting that target to retreat into the distance with each successive forecast. This points to the benefits of fixed time horizons for fiscal targets which are binding on outturn values.

Third, point targets lead to perverse incentives as deadlines loom. Targeting specific numerical values for borrowing can lead to disruptive, inefficient and opaque fiscal decisions. Examples of these include HM Treasury's redefining of the start and end dates of the cycle over which Labour's golden rule was applied. Likewise, changes to the timing of corporation tax payments and the top-slicing of departmental budgets were utilised in a failed attempt to meet the 2015 Conservative government's overall balance target in 2019-20. Rules specified as target *ranges* better reflect the risks and uncertainties inherent in fiscal forecasting and provide greater flexibility to accommodate and respond to any negative shocks if and when they crystallise.

Fourth, rules should build in greater headroom to deal with uncertainty and include escape clauses which allow for the temporary suspension of some rules without abandoning of the

framework altogether. Previous Chancellors have typically given themselves less than 1 per cent of GDP in headroom against their medium-term fiscal targets, despite the average five-year-ahead forecast error for borrowing being around 3 per cent of GDP since 1997-98. And while past UK fiscal frameworks have incorporated escape clauses, the rules themselves have never survived the onset of a shock. As the next set of rules will be guiding fiscal policy through a period of sustained economic uncertainty, they will need to cater for a range of different economic scenarios and incorporate a more workable and realistic combination of targets, headroom, and escape clauses.

Finally, rules need to reflect a broad and durable political consensus about the objectives of fiscal policy and be rooted firmly in legislation. From their inception, fiscal rules in the UK have been closely associated with the government of the day, and no set of rules has outlasted the Chancellor that authored them. Given the risk that today's political fragmentation persists into the next decade, governments need to find ways to build greater cross-party consensus on the objectives of fiscal policy. This calls for greater consultation on the government's proposed fiscal rules and a firmer grounding of those rules in primary legislation, so they can more formally constrain future tax and spending decisions.

The new rules also need to reflect new economic realities

In addition to learning from the past, any new fiscal rules must also take into account the major changes in the macroeconomic environment in recent years. Most importantly, they should recognise that the lack of monetary policy space associated with today's low interest rates means that fiscal policy needs to play a more active stabilisation role than it has in the past. Interest rates have been cut by an average of 5 percentage points in past UK recessions. But with policy rates currently below 1 per cent and longer-term rates close to all-time lows, there is limited further scope for monetary policy to support activity in a future downturn. This means fiscal policy will need to bear more of the burden of supporting the economy in future recessions. It also means that budgets need to be tighter in good times to

rebuild fiscal policy space and stop successive downturns from ratcheting up public debt levels and eroding net worth. Both the flexibility to respond to economic shocks and incentives to rebuild fiscal resilience in their aftermath need to be hardwired into the new fiscal framework.

The new rules also need to take account of the changes in the way we think, talk, and go about making fiscal policy. Historically low interest rates have made rules which focus on the volume of debt but ignore significant and potentially lasting changes in its cost, obsolete. The limitations of an exclusive focus on debt as the only relevant stock in the fiscal framework have been reinforced by government's growing use of the wider public balance sheet to pursue a range of public policy objectives – from bailing out banks at the height of the crisis to helping first-time buyers get a foot on the housing ladder and supporting students with the cost of university. Today, both main parties are arguing that government needs to borrow to invest in meeting a range of economic, social, and environmental challenges. Therefore, fiscal rules need to take account of not only the level of debt, but also what it costs to borrow. They also need to recognise the value, quality, and performance of the assets created or acquired on the other side of the public ledger. Recent improvements in fiscal reporting mean that balance sheet targeting in fiscal policy is a practical proposition for the first time in our history.

This report proposes three new fiscal rules

Reflecting both the lessons of the past and the challenges and opportunities facing policy makers in the decade to come, we propose a suite of three fiscal rules:

1. A **net worth 'objective'** to deliver an improvement in public sector net worth as a share of GDP over a fixed five-year term from 2020-21 to 2024-25. This means that the growth in the value of the government's total financial and fixed assets needs to exceed that of its debt and other liabilities over the next five years as a share of GDP;
2. A **structural current balance 'target'** to aim to achieve a cyclically adjusted public sector current balance of +1 per cent of GDP and no less than -1 per cent of GDP in outturn by the end of the fixed five-year period ending

in 2024-25. This would allow the government to borrow to invest (subject to the other two rules) but would require it to keep current receipts and current spending (including depreciation on its assets) in broad balance. To build in sufficient margin for error against breaching the lower end of the +/- 1 per cent of GDP target range, the government would be expected to target a current surplus of 1 per cent of GDP in each Budget up until the target year; and

3. A **debt interest 'ceiling'** to ensure the share of total public sector revenue spent on debt interest does not exceed 10 per cent at any time. This would ensure that the overall debt burden remains sustainable by taking account of not only the volume of debt, but also its cost and the government's ability to service it.

Our proposed framework also includes an **escape clause**, under which the net worth objective and structural current balance target would both be suspended in any years in which the Office for Budget Responsibility's (OBR's) pre-measures forecast showed spare capacity in excess of 1 per cent *and* Bank Rate below 1.5 per cent. Both rules would be reinstated in the year in which the OBR estimated that the output gap would decrease below 1 per cent, with the window for meeting the rules reset to five years ahead at that point.

These new rules have considerable advantages over previous ones

Such a suite of rules has at least four advantages relative to previous fiscal frameworks.

First, the net worth objective would allow the government to take advantage of historically low interest rates to borrow in order to invest in meeting the long-term challenges of restarting productivity growth, tackling climate change, and modernising our public service infrastructure. Yet it would also hold them accountable for doing so in a way that increases net public value for this and future generations. Where some past fiscal frameworks entirely excluded the results of investment, this approach explicitly recognises the value of the assets created, acquired, or sold using the Office for National Statistics' new statistical data on the public sector balance sheet. It thereby encourages government to invest where there is a compelling

economic case and the value of the assets generated exceeds the cost of financing. It would also eliminate the fiscal illusions associated with concessional loans or asset fire sales under the current borrowing and debt rules. Likewise, it would force the government to confront its significant and growing non-debt liabilities, including unfunded public sector pensions.

Second, targeting the structural current balance would ensure that tax revenues are broadly sufficient cover the government's day-to-day running costs. The target range of +/- 1 per cent of GDP for assessing the rule militates against disruptive fiscal fine-tuning associated with pure point targets. The cyclically adjusted nature of the target would also allow for the full operation of automatic stabilisers to help smooth the ups and downs of the economic cycle. And adopting the precautionary principle of always aiming for a 1 per cent current surplus when the rule is in force would incorporate a level of headroom against the lower end of the target range commensurate with the UK's historic fiscal forecast errors. It would also help compensate for the tendency for debt to increase and net worth to deteriorate during economic downturns, especially with fiscal policy playing a more active macroeconomic stabilisation role.

Third, limiting debt interest costs to 10 per cent of revenue would ensure that the actual burden that debt places on the public finances is sustainable while giving fiscal policy time to adjust to any permanent changes in the interest rate, inflation, or growth outlook in a gradual and measured way. It would also facilitate fiscal-monetary coordination, by allowing looser fiscal policy when interest rates are low but requiring tighter fiscal policy as rates rise.

Fourth, the escape clause would allow greater scope for discretionary fiscal policy to provide active and sustained support to households and businesses during economic downturns without abandoning the rules altogether. The subsequent resetting of the five-year timeframes for the net worth objective and current balance target once the output gap falls below 1 per cent would have the advantage of allowing fiscal policy to return to a neutral setting gradually, without undermining any economic recovery. The sustained operation of

the debt interest ceiling throughout the downturn period would safeguard sustainability and provide additional continuity within the framework of rules.

The rules are robust to a wide range of possible economic futures

This new framework is designed to cope with a range of potential economic scenarios for the coming decade, including in:

- the **baseline forecast**: If economic conditions develop broadly in line with the OBR's most recent (March 2019) forecast, the new framework would give the UK government the ability to lead the world in investments in climate change mitigation and adaptation – subject to those investments delivering long-term public value;
- **secular stagnation**: Were the economy to become mired in a period of persistent low growth, inflation, and interest rates, the proposed rules would provide the government with the flexibility to borrow to invest in the infrastructure, research and development, and new technologies needed to kick-start future growth, while also requiring current spending and tax levels to adjust to potentially diminished medium-term economic prospects;
- a **cyclical recession**: Under a typical demand-led economic downturn, the new rules would enable fiscal policy to play a leading role in supporting economic activity while monetary policy is constrained, before gradually adjusting back to a neutral setting as the economy returns to trend; and
- a **no deal Brexit**: In response to the economic disruption associated with a no deal Brexit, the rules would allow fiscal policy to play an active role in supporting both supply and demand in the near term. But they would also require fiscal policy to adjust to a smaller and slower-growing economy in the long run.

In all of these scenarios, the debt interest ceiling would ensure that the government's debt burden remained affordable at all times.

Building consensus for a new approach to fiscal policy making

A number of elements in our proposed new fiscal framework are novel and untested in this or any other country. At the same time, the UK has long been a pioneer in the design of rules and development of leading-edge practices in fiscal policy making. Indeed, if established practices in the design and implementation of fiscal rules were adequate, we would not be on our fourth set of fiscal rules in five years.

However, there is a strong case for consulting on the proposed fiscal rules, both to better understand their practical implications and to build a broader and more durable consensus in favour of their objectives. This would also provide some time to resolve some of the current uncertainty around the UK's future economic relationship with Europe and the rest of the world and understand its implications for our country's economic prospects. Once that consultation and debate on the country's fiscal objectives has taken place, the resulting new set of rules should be codified in primary legislation which commands broad and lasting parliamentary support.

Section 1

Introduction

The UK was a pioneer in the development of fiscal rules but does not currently have an effective framework for fiscal policy. Fiscal rules aim to constrain the behaviour of policy makers to pursue sustainable fiscal policies in the face of short-term incentives toward tax and spending giveaways. Fiscal rules are in place in the vast majority of advanced economies, and no UK government since 1998 has gone without them. The current fiscal rules are on track to be broken and, in any case, are set to expire next year. The current review of the fiscal rules provides an opportunity to design a new and different framework for the decade ahead. This next generation of rules needs to learn the lessons from UK and international experience, take advantage of recent innovations in fiscal policymaking, and respond to significant changes in the macroeconomic environment in recent years.

The UK has been a pioneer in the development of fiscal rules

Fiscal rules, durable numerical constraints on fiscal policy decisions, are in place in around half of the countries in the world and more than three-quarters of advanced economies.¹ Like inflation targets in monetary policy, fiscal rules are designed to solve the time-inconsistency problem inherent in fiscal policy making: while it is in a government's long-term interest to keep government borrowing and debt at sustainable levels, taxing less or spending more can secure them a short-term political advantage over their opponents.

Unlike in monetary policy, government cannot cede responsibility for fiscal policy to an independent body without compromising one of the fundamental tenets of any democracy – accountability to citizens for the stewardship of their resources. But by requiring elected governments to set clear, medium-term, and sometimes legally binding objectives for fiscal policy, rules try to counteract deficit bias by raising the political cost of opportunistic fiscal behaviour.²

The UK was a pioneer in the development of fiscal rules in the late 1990s, and no government or major political party has since felt they could go without a fiscal rule as an expression of their fiscal philosophy and demonstration of their commitment to

¹ G Kopits and S Symansky, *Fiscal Policy Rules*, IMF Occasional Paper No. 162, July 1998; and IMF Fiscal Rules Database, 2015

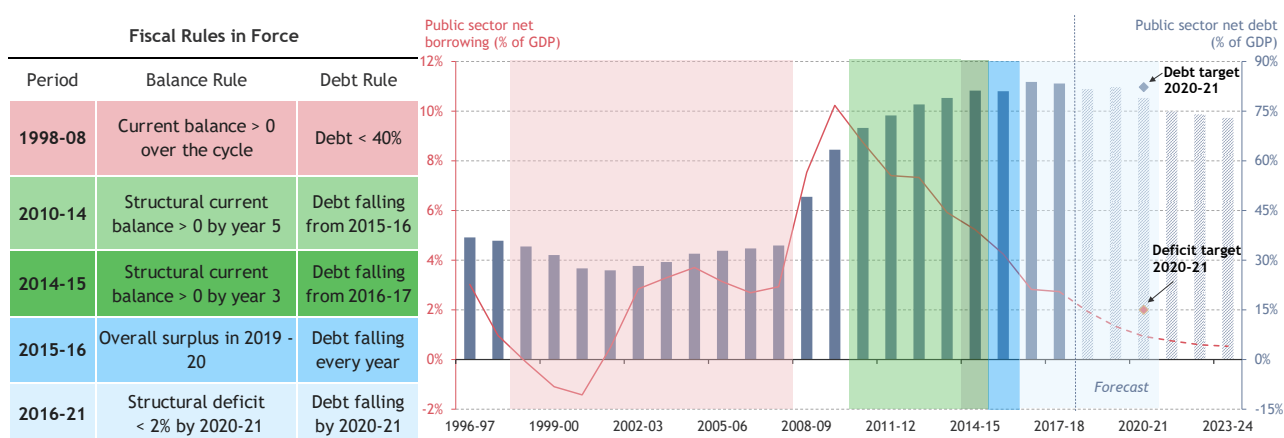
² For a discussion of the multiple sources of deficit bias, see L Calmfors & S Wren-Lewis, 'What Should Fiscal Councils Do?', *Economic Policy*, vol. 26, pages 649-695, 2011.

responsible management of the public finances. Their track record of living up to those commitments has been more mixed.

Five different Chancellors have operated five different fiscal rules over the past two decades, with life spans ranging from ten years to barely one (Figure 1). The UK's rules have always included objectives for public sector net debt (PSND) and some variant of public sector net borrowing (PSNB) depending on the economic priorities of the government of the day.

FIGURE 1: The UK has had five different fiscal rules over the past 20 years

UK fiscal rules in force (1998-Present)



NOTES: All figures relate to the UK, unless otherwise specified.
SOURCE: RF analysis of OBR, *Public finances databank*

The UK's rules have generally kept pace with global developments in fiscal frameworks. That has included being comprehensive in their coverage of public sector institutions, generally medium-term in orientation, grounded in some form of legislation, usually adjusted for the economic cycle and, since 2010, evaluated based on economic and fiscal forecasts produced by the independent Office for Budget Responsibility (OBR).

The UK needs a new and different fiscal framework

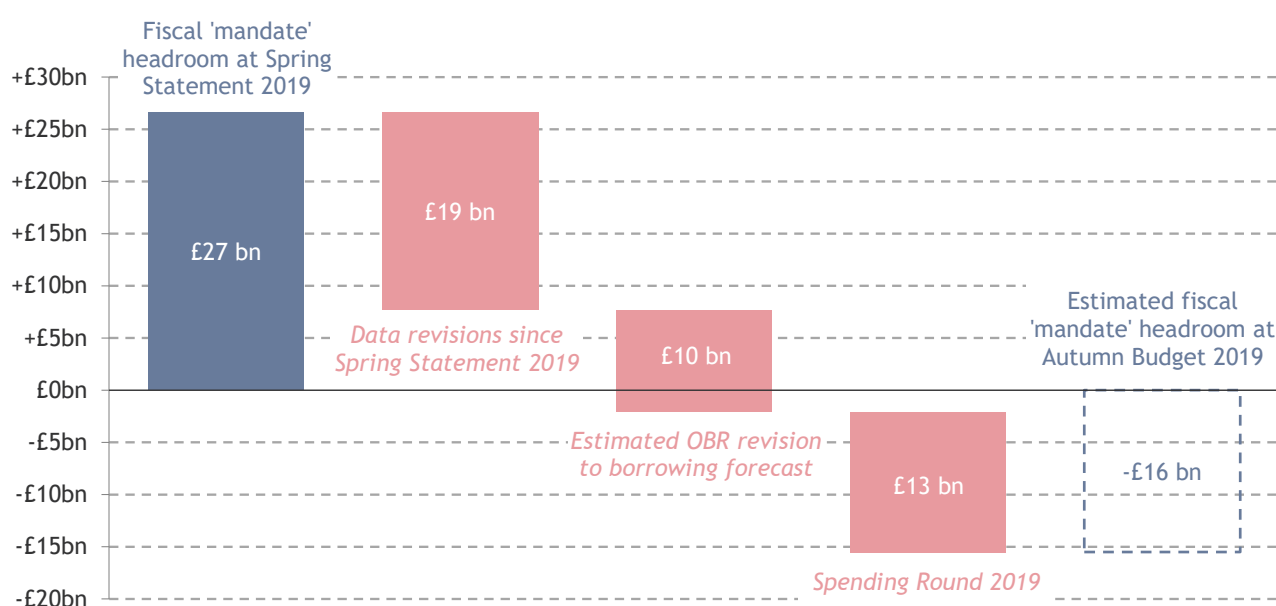
The UK's current fiscal rules are set to expire in 2020-21³ and are almost certainly on track to be broken. Following ONS revisions to the accounting treatment of student loans, disappointing economic and fiscal outturns since March, and the addition of £13 billion to departmental spending plans for 2020-21 as part of the 2019 Spending Round, it appears that the current 'fiscal mandate' (which aims to reduce cyclically adjusted

3 See 'Charter for Budget Responsibility', HM Treasury, January 2017. There are currently four fiscal rules: i) a 'fiscal objective' which specifies that public sector net borrowing should be brought into balance early in the next Parliament (taken to be 2025-26); ii) a 'fiscal mandate' which involves returning the cyclically-adjusted public sector net borrowing to less than 2 per cent of GDP by 2020-21; iii) a 'supplementary target' which specifies that public sector net debt should be falling as a percentage of GDP by 2020-21; and iv) a cap on welfare spending by 2022-23.

PSNB below 2 per cent of GDP by next year) is set to be broken. As Figure 2 shows, the overshoot could amount to as much as £16bn.⁴ This, plus stated government objectives to cut taxes and increase capital spending further, would take the public finances even further away from the government’s longer-term ‘fiscal objective’ of balancing the overall budget by the mid-2020s. It also endangers the delivery of the ‘supplementary target’ to have debt falling as a proportion of GDP after the target year, when the temporary effects of the Bank of England’s Term Funding Scheme on debt are fully unwound.

FIGURE 2: The government’s fiscal rules are on course to be broken

Estimated changes since March 2019 to fiscal mandate ‘headroom’ in 2020-21



NOTES: Headroom calculated as the difference between cyclically adjusted net borrowing in 2020-21 and two per cent of GDP in 2020-21. Values are shown at 2020-21 prices.
 SOURCE: RF analysis of HM Treasury, Spending Round 2019; Office for Budget Responsibility, Economic and Fiscal Outlook, March 2019

With no effective fiscal framework currently in operation, the UK needs a new and different set of fiscal rules from the ones that have shaped, though not always bound, fiscal policy in this country since the turn of the century. And the significant tax promises and spending commitments made over the last few months, outside the normal fiscal event cycle and without the benefit of an up-to-date economic and fiscal forecast, illustrate the dangers of a return to unfettered discretion in fiscal policy.

The review of the UK’s fiscal regime announced by the Chancellor at the conclusion of the 2019 Spending Round therefore provides a welcome and timely opportunity to reflect on our own experience with fiscal rules and well as the lessons from the successes and failures of fiscal regimes in other countries. It also gives us a chance to take advantage

⁴ For a discussion, see T Bell and D Tomlinson, *Breaking the rules*, Resolution Foundation, August 2019.

of recent innovations in fiscal reporting and analysis, including the publication of comprehensive and timely data on the public sector balance sheet by the ONS and ground-breaking analysis of fiscal risks by the OBR, in the design of the new rules.⁵

However, the current economic and political context also presents a new set of challenges for fiscal policymakers. The next generation of fiscal rules needs to be more effective in constraining fiscal decisions in a potentially more fragmented political environment. At the same time, the framework needs to provide scope for greater fiscal activism under a broad range of possible economic scenarios and against a backdrop of an elevated recession risk.⁶ Finally, the rules need to enable the government to take advantage of the currently favourable financing conditions to tackle major economic, environmental, and social challenges without endangering long-term fiscal sustainability.⁷

This paper sets out our proposal for a new fiscal framework

This report sets out the Resolution Foundation's proposals for a new and different fiscal framework that learns the lessons of the past, seizes the opportunities of the present, and responds to the challenges of the future. To that end, the rest of the paper is organised as follows:

- **Section 2** discusses the context for the next generation of fiscal rules by exploring the objectives that shape their design, the lessons from UK and international experience with the operation of fiscal rules, and the changes in the macroeconomic and institutional environment for fiscal policy making;
- **Section 3** details our proposal for a new suite of three fiscal rules which collectively provide a basis for effective fiscal policymaking in the decade ahead;
- **Section 4** illustrates the key design features of our proposed rules, by stress testing them against a range of potential economic scenarios and considering how fiscal policy would respond to the incentives they create; and
- **Section 5** concludes by summarising our proposed rules, their key features, and their advantages with respect to the current rules and possible alternatives.

⁵ F Khatun, *International Monetary Fund's Government Finance Statistics framework in the public sector finances*, ONS public sector finances, 22 October 2019; and OBR, *Fiscal Risks Report*, July 2019.

⁶ For a discussion of such risks, see J Smith, J Leslie, C Pacitti, and F Rahman, *Recession Ready?*, Resolution Foundation, September 2019.

⁷ See HM Treasury, *Spending Round 2019*, 4 September 2019.

Section 2

Context for the UK's next fiscal rules

Updating the UK's fiscal rules should not simply be a case of rolling forward the previous set. While the fundamental objectives of fiscal policy remain timeless, each new set of rules has to make a set of trade-offs between them. And with over twenty years of experience with fiscal rules around the world, the next fiscal framework needs to learn from the successes and failures of rules in the UK and abroad. At the same time, the next set of rules need to reflect dramatic changes in the macroeconomic policy landscape in recent years.

Fiscal policy must balance three fundamental objectives

In all countries at all times, fiscal policy makers are generally trying to achieve a number of competing objectives. And in a world of scarce resources, there is an inherent need to make choices between them. How governments trade-off between the competing aims of fiscal policy shapes their fiscal frameworks and has driven a growing sophistication in the design of fiscal rules around the world (Figure 13).

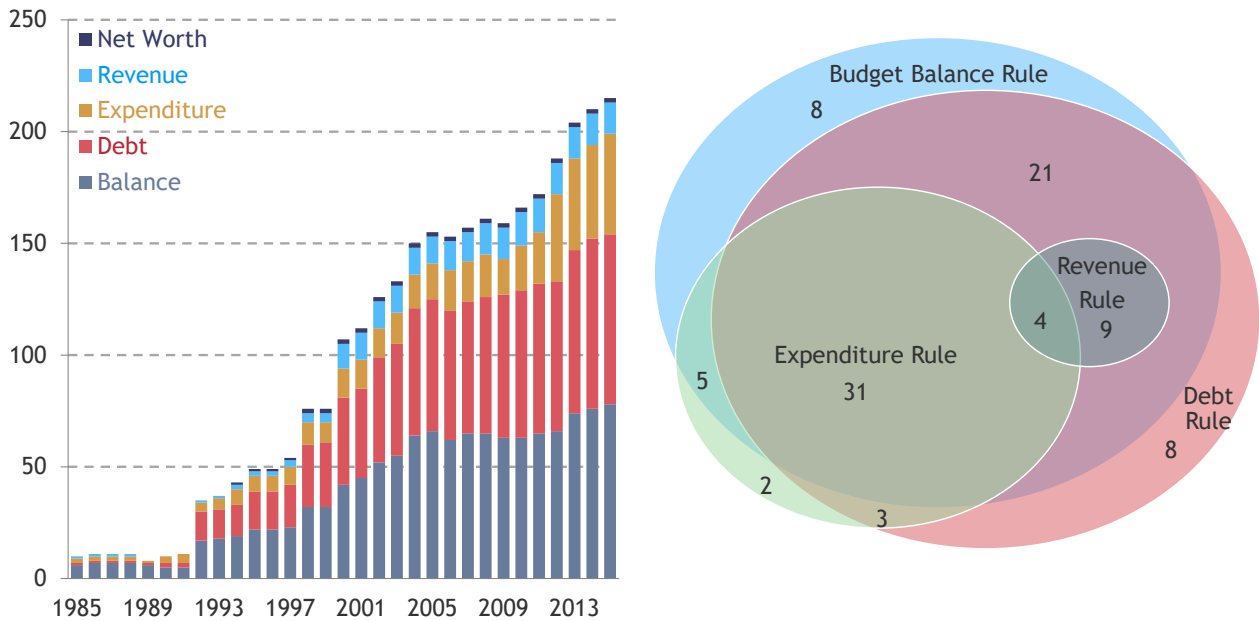
Ensuring fiscal sustainability

A first and fundamental objective for fiscal rules is to ensure that the public finances are sustainable in the long term. For this reason, most fiscal rules are anchored in the preservation or restoration of a particular level of public debt (Figure 3). However, conceptions and definitions of fiscal sustainability have evolved over time as both the scope of government liabilities and range of assets taken into consideration has expanded and the cost of government debt itself has declined. The broadest possible definition of fiscal sustainability, public sector net worth (PSNW), includes all assets and liabilities held by government and all the entities it owns or controls.⁸

⁸ This section focuses on sustainability in terms of ensuring the public finances remain on an affordable path. Broader definitions of sustainability include whether fiscal policies place fair burden on current and future generations and whether they create incentives for the stewardship of environmental resources and other public goods.

FIGURE 3: Most countries' fiscal frameworks include debt and balance rules

Number of countries with different types of fiscal rules, 2015

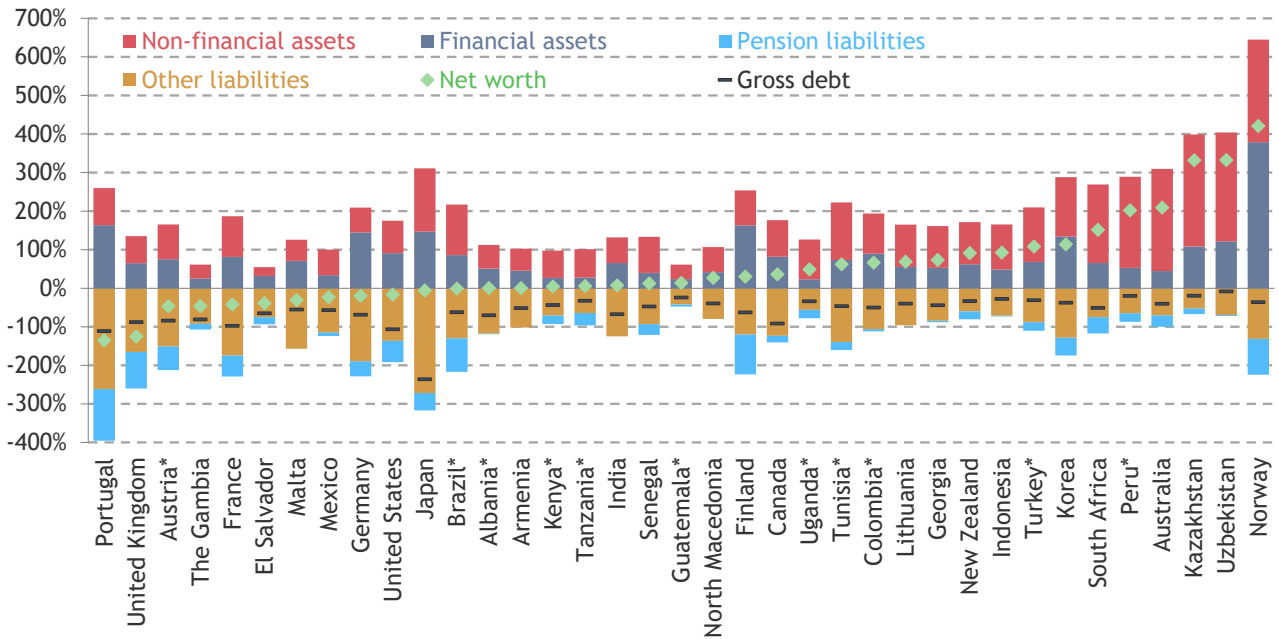


NOTES: Includes both national and supranational fiscal rules. Venn diagram excludes Iran, which only has a revenue rule and the two net worth targets that are held by Australia and New Zealand.
SOURCE: RF analysis of IMF, Fiscal Rules Database, 2015

Under this definition of sustainability, the UK compares poorly with other countries (Figure 4). The UK's relatively large negative public sector net worth position is due in part to its elevated post-crisis level of debt. But it is also partly an artefact of the incentives created by the fiscal policy frameworks of the 1980s and early 1990s which focused on reducing the volume of debt and minimising the public sector cash requirement. This encouraged privatisations of state-owned companies and sales of fixed assets such as social housing, even when these assets were sold below their retention value. This, together with the current deficits run over much of this period, drove a steady deterioration in public sector net worth between the early 1980 and mid 1990s (Figure 5). It also diverted the government's focus away from its steady accumulation of non-debt liabilities, including in the form of unfunded public sector pension liabilities and environmental clean-up costs. *Reversing this legacy and restoring long-term sustainability argues for the new fiscal framework to be anchored in an objective for improving public sector net worth and increasing public value for future generations.*

FIGURE 4: The UK has a relatively low level of public sector net worth

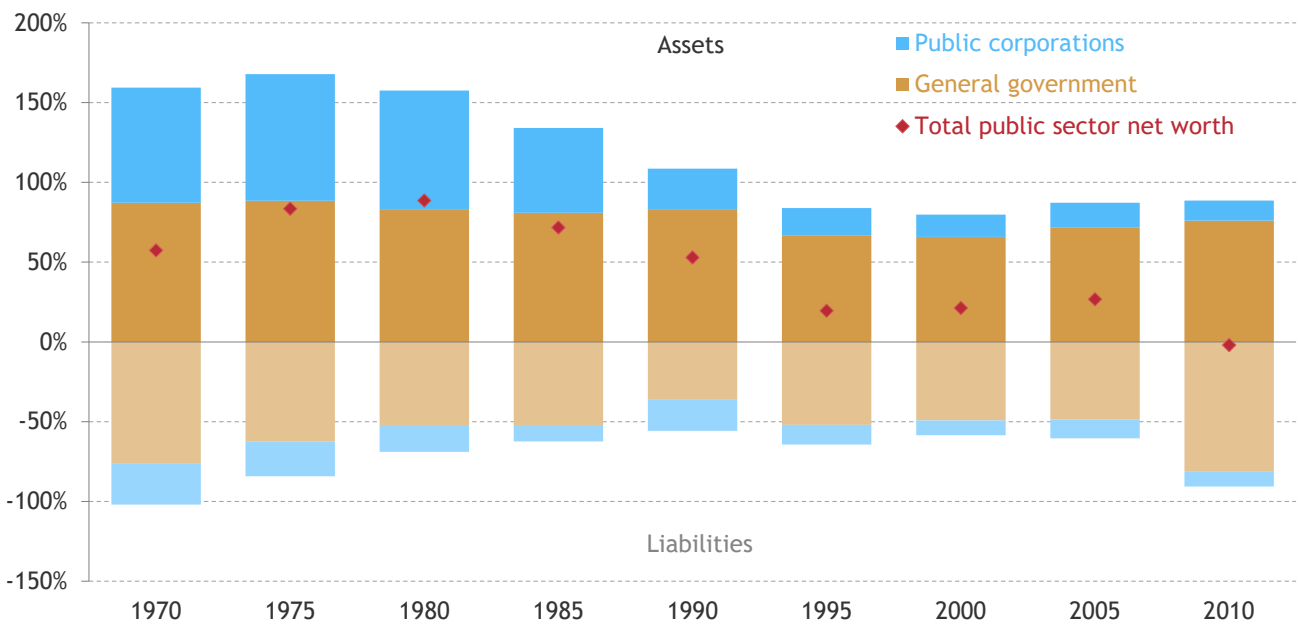
Public sector balance sheets by country, and asset and liability type, proportion of GDP



NOTES: Missing data on gross debt position for The Gambia, El Salvador, Albania, Armenia, Guatemala, North Macedonia, Tunisia and Georgia. *Based on 2016 data, exceptions: Austria, 2014, Brazil, 2014, Albania, 2013, Kenya 2013 Tanzania 2014, Guatemala, 2014, Uganda, 2015, Tunisia, 2013, Colombia, 2015, Turkey, 2013, Peru, 2013, Portugal, 2012.
SOURCE: RF analysis of IMF, Public Sector Balance Sheet Database

FIGURE 5: UK net worth declined in the 1980s, early 1990s, and late 2000s

Public sector net worth as a proportion of GDP



NOTES: In order to construct a back series for net worth, the data here relate to a historic series of net worth published by the ONS until 2012, which excludes unfunded public sector pensions.
SOURCE: OBR, *Fiscal Risks Report*, 2017

Stabilising the macroeconomy

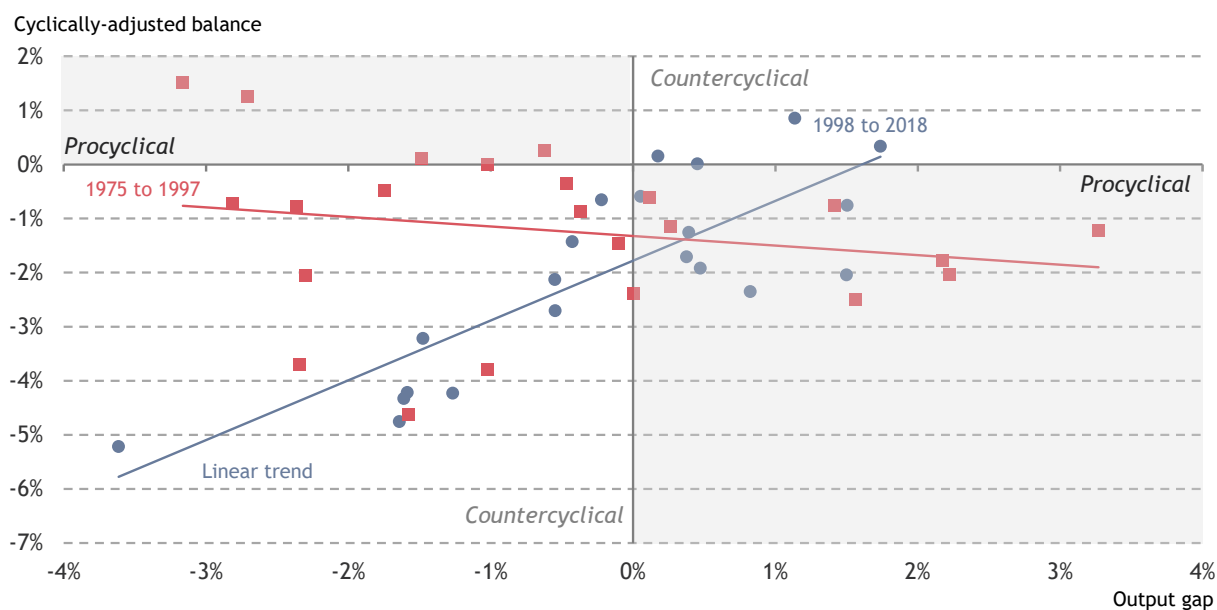
A second objective of fiscal policy is the stabilisation of the macroeconomy. As governments grew in size during and after the Second World War, fiscal policy became a powerful potential instrument for smoothing out cyclical economic fluctuations by supporting demand in downturns and softening it in upswings.⁹ Fiscal rules can play an important role in either inhibiting or enabling the operation of automatic fiscal stabilisers and the use of discretionary fiscal policy to influence economic activity. Rules can facilitate counter-cyclical policy either through fiscal rules that are expressed in cyclically adjusted terms or through the use of escape clauses which suspend the rules during times of economic instability.

All UK fiscal rules since 1998 have made use of one or both of these features, as do a growing number of fiscal rules around the world (Figure 13). Fiscal policy in the UK has been more evidently countercyclical since the adoption of fiscal rules in 1998 than in the previous two decades (Figure 6). As discussed below, it will need to be even more so in future. However, if fiscal policy responds asymmetrically between economic booms and busts, successive economic downturns can lead to a ratcheting up in public sector net debt and a deterioration in net worth. This ratchet effect can lead to the public finances becoming unsustainable and thereby undermines the ability for fiscal policy to respond to future downturns. *This implies that the new fiscal rules should continue to take account of the cyclical position of the economy but also incentivise policy makers to build in structural headroom that can be used as a cushion if and when negative shocks crystallise.*

⁹ Some economists have argued that the welfare gains from stabilising the economy in the face of cyclical fluctuations are relatively small (see, for example: R E Lucas, 'Macroeconomic Priorities', *American Economic Review*, vol. 93, pages 1-14, 2003) and that governments should prioritise measures which increase the average growth rate of the economy. But the distributional effects of recessions provide an additional rationale for undertaking cyclical macroeconomic policy because the effects for some groups may be very large. For a discussion of these issues, see: G de Giorgi & L Gambetti, 'Business Cycle Fluctuations and the Distribution of Consumption', *Review of Economic Dynamics*, vol. 23, pages 19-41, 2017.

FIGURE 6: UK fiscal policy has been more countercyclical in the fiscal rule era

Cyclically adjusted balance versus output gap: proportion of GDP



SOURCE: RF analysis of OBR, public finances databank

Supporting long-run growth and social welfare

A third objective of fiscal policy is to incentivise specific tax and spending policies that promote long-run growth and social welfare. UK fiscal rules have often excluded public investment from near-term borrowing limits for this reason. For example, Labour's golden rule was effective in helping to rebuild public investment in the early 2000s, coming off the back of sharp cuts made by the previous government in an effort to reduce headline borrowing in the mid-1990s (Figure 7). New Zealand has gone further still, by attempting to incorporate wider measures of national wellbeing in the country's set of fiscal objectives.¹⁰

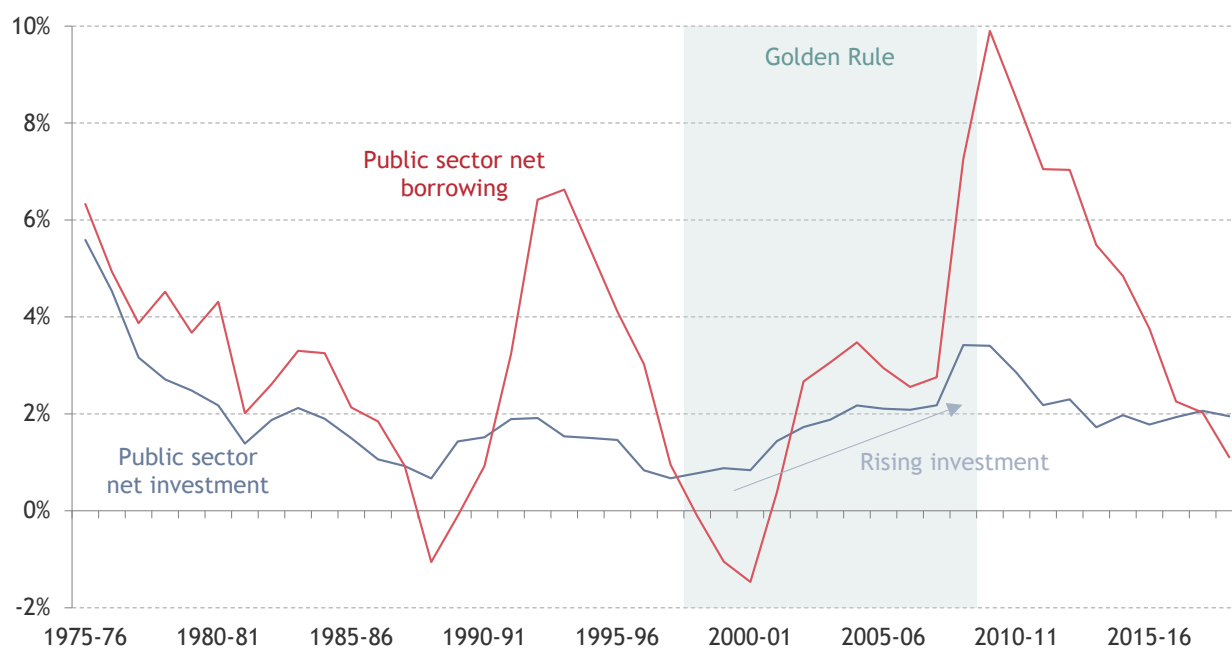
However, there are again trade-offs to be made between this objective and the others. The more items of expenditure that are excluded from the rule, the more long-term sustainability is put at risk (as in the case of private finance initiatives or unfunded public sector pensions obligations which both fell outside past fiscal frameworks). And the more actively fiscal policy is used as a tool of demand management, the more likely that sharp movements in tax rates or government spending plans distort or disrupt the economic decisions of firms and households and so reduce overall welfare.¹¹ *This implies that fiscal rules need to limit any exclusions and set medium-term constraints on government borrowing that allow policy to adjust gradually to shocks.*

¹⁰ See: The Treasury New Zealand, 'The Wellbeing Budget', May 2019.

¹¹ The concept of tax smoothing was originally due to J R Barro, 'On the Determination of Public Debt', *Journal of Political Economy*, vol. 87, pages 940-971, 1979.

FIGURE 7: Labour's golden rule helped rebuild public investment in the 2000s

Public sector net borrowing and investment as a proportion of GDP



NOTES: Data is based on government fiscal years rather than calendar years.

SOURCE: OBR, Public Finances Databank

The new rules should learn from experience in UK and abroad¹²

While the UK was a pioneer in adopting fiscal rules in the late 1990s, it is not alone in facing these trade-offs and attempting to design the 'optimal' fiscal framework. It is important that we learn both from our own experience (summarised below) and that of other countries over the past two decades (summarised in Box 1). Over the past twenty years, five different Chancellors have operated five different sets of fiscal rules, albeit with a two-year hiatus in the wake of the 2008 financial crisis. The UK's track record in adhering to its stated fiscal objectives has been mixed, with the life spans of different fiscal rules ranging from ten years to barely one. This experience has highlighted five key lessons that should inform the design of any new rules.

What gets excluded gets exploited

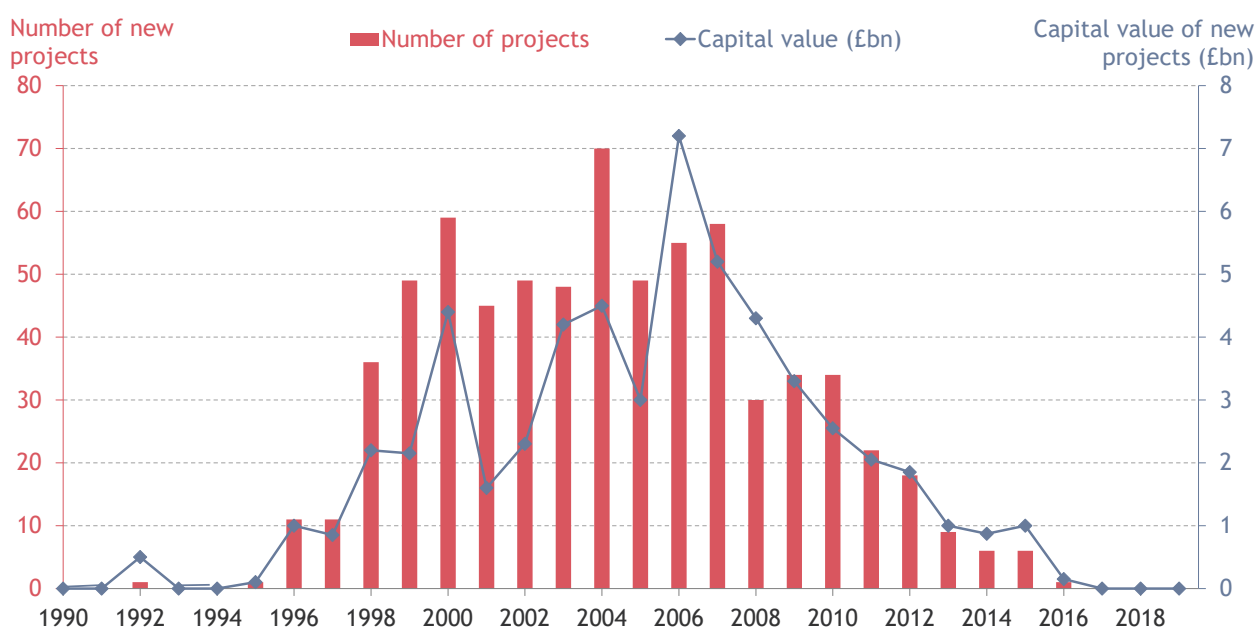
The first lesson is that what gets excluded gets exploited. Limitations in the scope of the targets under past rules have created incentives to channel fiscal activity into areas outside the rules. This can have deliberately positive effects, as in the aforementioned case of the recovery in public investment associated with Labour's golden rule. But it can also have more distortionary consequences. This was the case with the growth in private finance initiative (PFI) liabilities which did not fall within public sector net debt (PSND) up until recently. As a result, the number of new PFI projects signed annually went from 11

¹² For more on what we can learn from the past use of fiscal rules, see: R Hughes, J Leslie and C Pacitti, *Britannia waives the rules?*, Resolution Foundation, October 2019.

in 1996 up to a peak of 70 in 2004 with the total annual service charges on the contracts peaking at over £10 billion in 2017-18.¹³ Many PFI obligations have since been reclassified into PSND by the Office for National Statistics (ONS), contributing to a rapid decline in this mode of financing public projects (Figure 8).

FIGURE 8: PFI projects increased rapidly after 1997, when the government adopted a ceiling on public sector net debt

Number of new PFI and PF2 projects and their capital value, by year



SOURCE: Infrastructure and Projects Authority, 'Private Finance Initiative and Private Finance 2 projects: 2018 summary data', May 2019

Another example of this phenomenon is the growth in the size and generosity of student loans over the 1990s and 2000s. In this instance, the subsidised interest rate on, and expected write-offs of, student loans did not count against the definition of borrowing targeted by both Labour and Conservative governments. The volume of student loan assets has grown steadily since the 1990s to around £120 billion (6 per cent of GDP) today and is set to reach 20 percent of GDP by 2040.¹⁴ To take account of the costs associated with these unrecognised assets, the ONS has this year decided to reclassify their concessional elements into borrowing in the year the loans are contracted, contributing to the government missing one of its current fiscal rules.¹⁵ *This implies that fiscal rules should be as comprehensive as possible in their coverage of public sector institutions, stocks, and flows which should be valued according to internationally recognised standards.*

¹³ National Audit Office, *PFI and PF2*, 18 January 2018.

¹⁴ Jim Ebdon & Reece Waite (2018), *Student loans and fiscal illusions*, Office for Budget Responsibility, Working Paper No. 12, July.

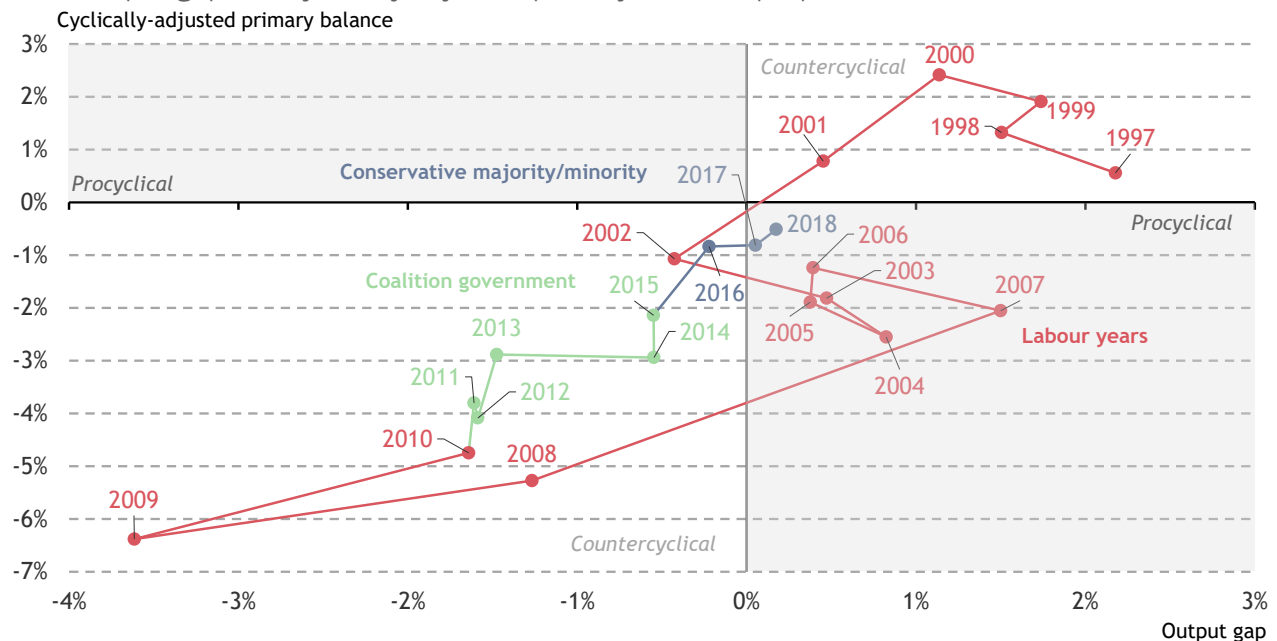
¹⁵ ONS (2018), *New treatment of student loans in the public sector finances and national accounts*, December.

Rules can be too focused on the past or the future to guide the present

The second lesson from UK experience is that rules can be both too focused on the past or the future to effectively guide today’s fiscal decisions. For example, the Labour government’s golden rule, which was measured as the current balance ‘over the economic cycle’, allowed the government to run an increasingly pro-cyclical fiscal policy from 2002 onwards thanks to the current surpluses it built up in the late 1990s (Figure 9).

FIGURE 9: Measuring the golden rule over the cycle allowed Labour to run an increasingly pro-cyclical fiscal policy in the mid-2000s

Output gap and cyclically adjusted primary balance: proportion of GDP, 1997 to 2018

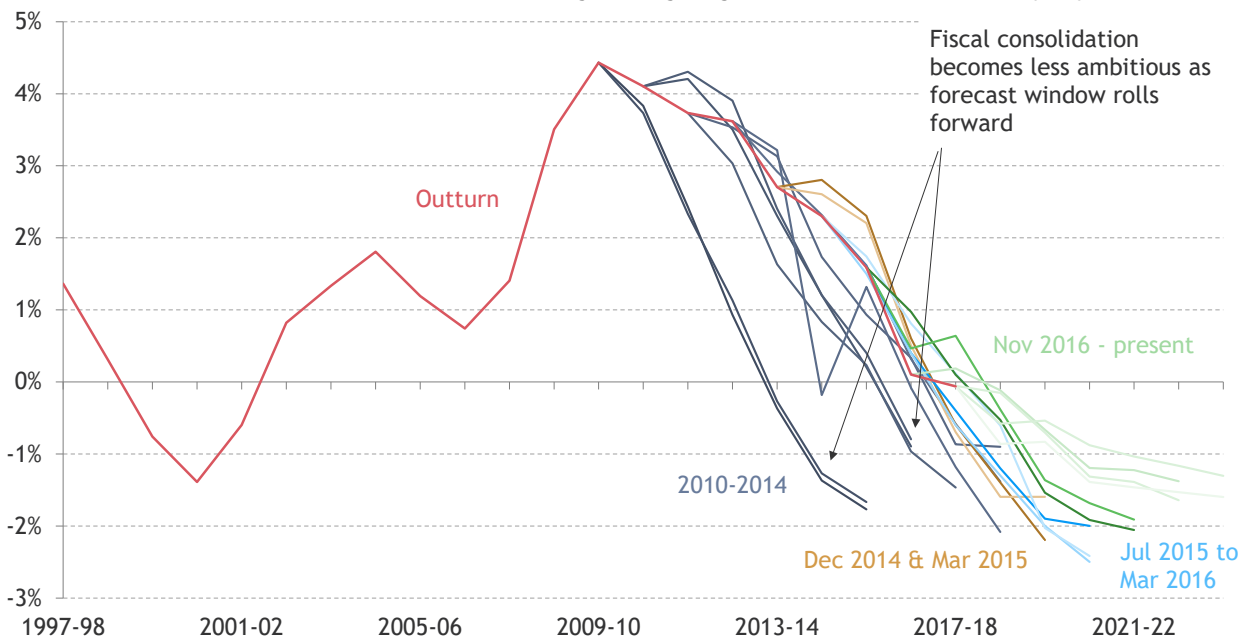


NOTES: Years refer to the first part of the government financial year (i.e. 1997 is the 1997-98 financial year).
SOURCE: OBR, *Public finances databank*

By contrast, the 2010 Coalition government’s rolling five-year structural current balance rule, in place between 2010 and 2014, allowed the deadline for meeting the target to retreat into the distance with each successive forecast (Figure 10). *This points to the benefits of fixed time horizons for fiscal targets which are binding on outturn values.*

FIGURE 10: The Coalition’s rolling debt targets in operation from 2010 to 2014 resulted in the serial postponement of fiscal adjustment

Outturns and successive forecasts of cyclically-adjusted current balance: prop. of GDP

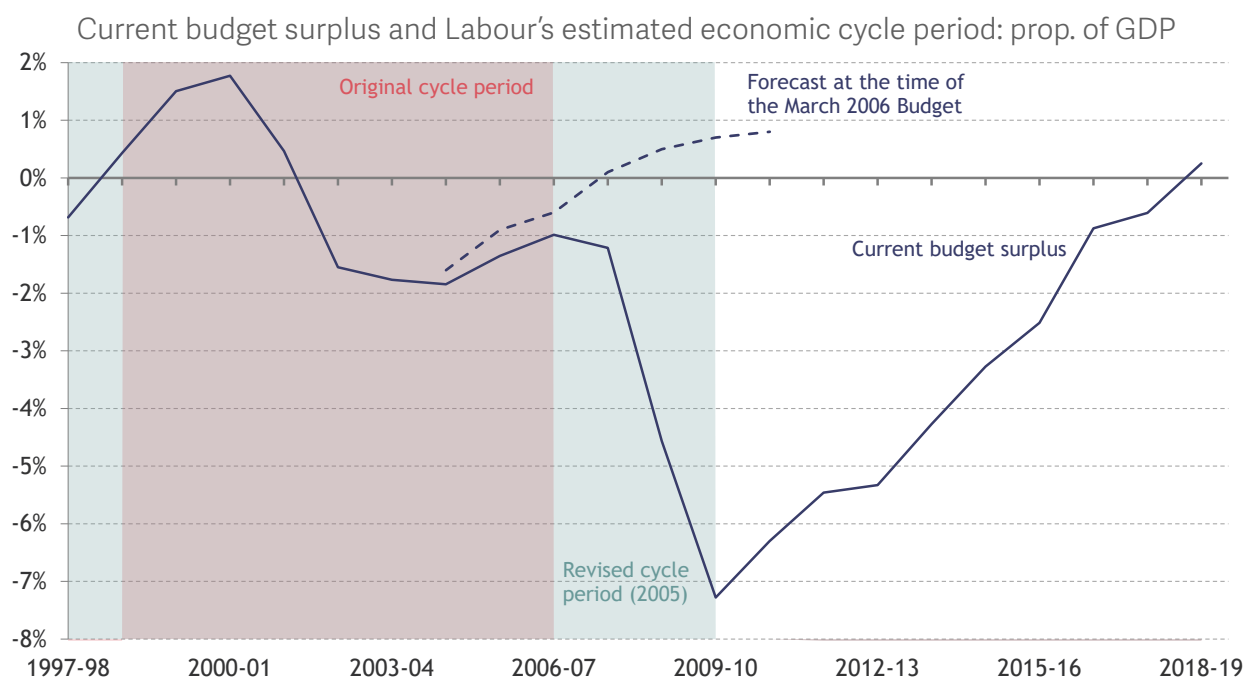


NOTES: Forecasts are adjusted to reflect subsequent reclassifications in the underlying series.
SOURCE: RF analysis of OBR, Historical official forecasts database

Point targets can drive disruptive, inefficient, and opaque practices

A third lesson is that point targets can lead to disruptive, inefficient, and opaque policy as deadlines loom. In the case of Labour’s golden rule, the requirement to balance the current budget on average between the first and the last day of the economic cycle prompted HM Treasury to redefine the start and end dates of the cycle to bring in more surplus years as the deadline for assessing the rule approached (Figure 11). In the case of the Conservatives’ 2015 surplus target, attempts to deliver a small overall surplus in 2019-20 prompted the Treasury to make purely cosmetic changes to the timing of quarterly corporation tax payments and impose an unallocated top-slice on departmental budgets in that year (which ultimately proved impossible to deliver). *This argues for fiscal rules expressed in terms of target ranges rather than specific numerical values to account for the errors inherent in fiscal forecasting.*

FIGURE 11: Labour’s golden rule prompted opportunistic changes to the timing of the cycle

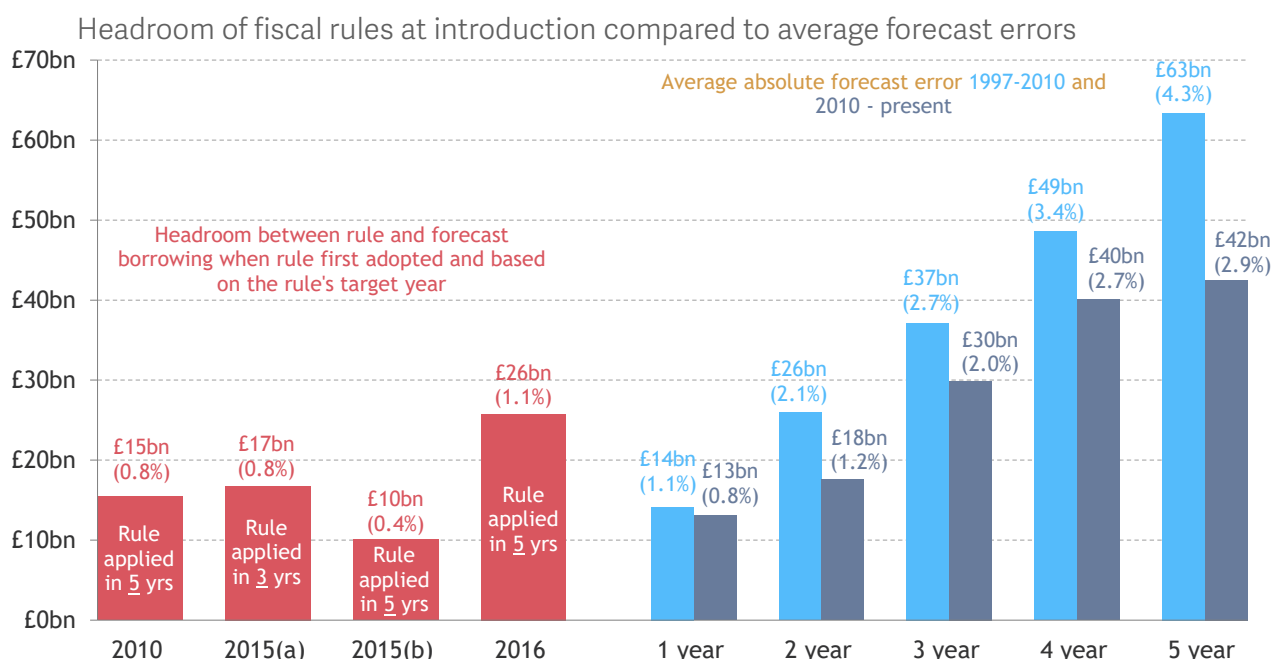


NOTES: Forecasts are adjusted to reflect subsequent reclassifications in the underlying series.
 SOURCE: RF analysis of OBR, Historical official forecasts database; March 2006 Budget

Rules need to build in greater headroom against uncertainty

The fourth lesson is that fiscal rules need to build in a greater headroom to deal with uncertainty. Governments have typically run the public finances ‘close to the wire’ and failed to build sufficient buffers into their forecasts to meet their fiscal rules with a high degree of confidence. When first setting their rules, the Labour, Coalition, and Conservative Chancellors typically gave themselves less than 1 per cent of GDP in headroom against their targets despite the fact that the average five-year-ahead forecast error for borrowing has been around 3 per cent of GDP since 1997-98 (Figure 12). Given the optimism bias inherent in fiscal forecasting, it is therefore not surprising that all of the UK’s time-bound headline fiscal rules have been, or are likely to be, missed in the target year. *This implies that fiscal frameworks need to encourage the build-up of larger fiscal buffers at the outset to cope with uncertainty and compensate for downside risks.*

FIGURE 12: Chancellors never build in enough headroom against their rules



NOTES: Headroom is defined as the difference between the fiscal rule limit and forecast borrowing at the point the rule is introduced. Forecast errors are calculated as the deviation between the forecast value and the outturn. Errors are adjusted to be net of the estimated impact of reclassifications between the forecast period and the current headline historic data. Numbers in brackets are the nominal values as a proportion of GDP (GDP for the denominator is from the year the rule is set for headroom and current GDP for errors). SOURCE: RF analysis of OBR, *Fiscal Risks Report* (July 2019) and *Historical official forecasts database*

Escape clauses need to provide for greater survivability

A fifth and final lesson is that escape clauses included in fiscal frameworks have been more like self-destruct switches. In the face of significant negative shocks to the outlook which cannot be addressed using the headroom available against the fiscal rules, the framework should allow for temporary suspension of the rule under well-defined circumstances. While all past fiscal frameworks have incorporated such clauses, the rules themselves have never survived the onset of an economic shock. Instead in each case the rules were abandoned and replaced with new targets. This reflected the fact that rules have tended to be designed either for ‘normal times’ (as in the period 1998-2008) or for periods of fiscal adjustment (as in 2010-15), but never both.

The next set of rules will need to guide policy through a period of sustained economic uncertainty, with greater reliance on fiscal policy to cope with shocks. The rules will thus need to cater for a range of possible economic scenarios and incorporate a more workable combination of targets and escape clauses. Absent that, there is a risk that worries about fiscal sustainability could surface following a suspension of the rules, forcing a premature tightening in policy. *This implies that the new fiscal framework should incorporate an escape clause that allows for more active fiscal policy during economic shocks, but which continues anchoring expectations regarding the long-term direction of fiscal policy.*

BOX 1: Lessons from international experience with fiscal rules

The UK is not alone in trying to operate fiscal policy within a set of numerical limits. Over 90 countries have some sort of rule in place, with the most common combination being a long-term objective for the stock of debt coupled with a medium-term target for borrowing, which together account for 70 per cent of rules in force in 2015.¹⁶

Over time, these rules have become more sophisticated in their design by: (i) making adjustments for the cyclical position of the economy; (ii) including escape clauses to cope with exceptional economic shocks; (iii) carving out expenditure with long-term benefits such as infrastructure investment; and (iv) being codified in legislation, constitutions, or international treaties. Rules have also been increasingly accompanied by institutional reforms in the form of independent fiscal councils, binding multi-year budget frameworks, and regular analysis of near and long-term fiscal risks which help bolster compliance with the rules.

While the mere adoption of a fiscal rule does not guarantee better fiscal performance, the latest cross-country analysis finds that well-designed fiscal rules are associated with lower government deficits, debts, and

borrowing costs.¹⁷ Three decades of international experience with fiscal rules has highlighted a number of design characteristics of successful rules. These include:

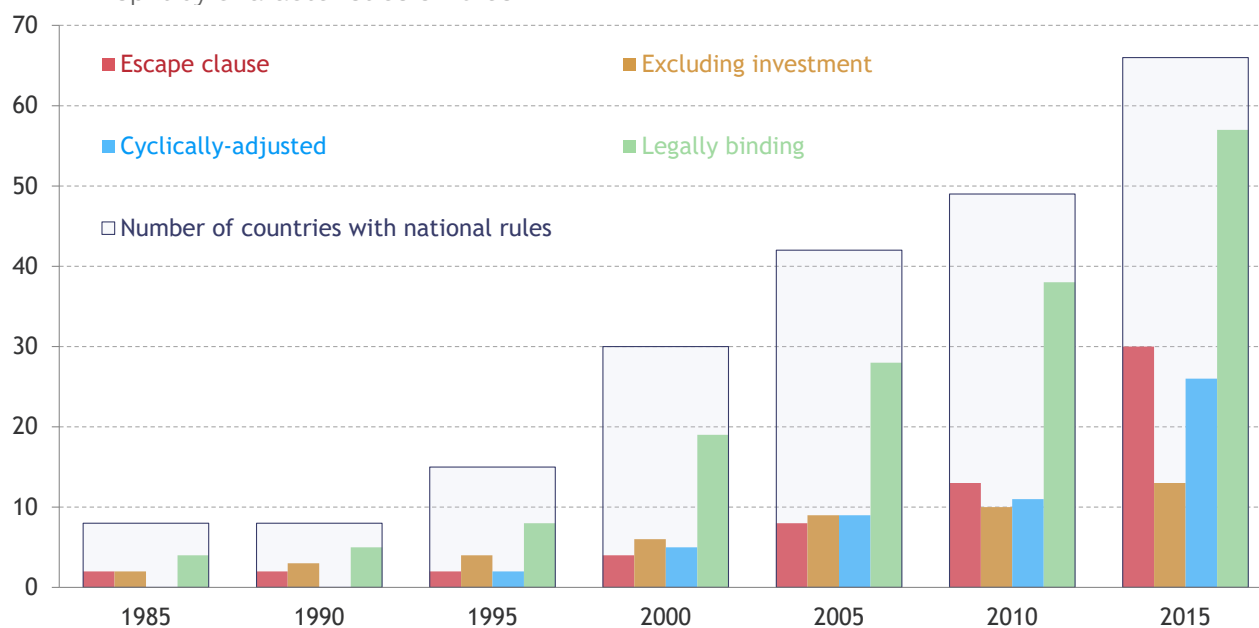
- having a firm basis in legislation which reflects a broad and durable political consensus about the objectives for fiscal policy;
- being comprehensive in coverage of public sector institutions and financial activities and measured according to internationally recognised accounting concepts;
- being medium-term in orientation and calibrated to ensure that the public finances are robust to a range of plausible macroeconomic scenarios;
- incorporating features that enable fiscal policy to play an active role in stabilising the macroeconomy in both booms and busts, such as cyclical adjustment, escape clauses, and self-correction mechanisms; and
- being supported by sound fiscal management arrangements which facilitate the preparation, execution, and monitoring of government budgets in a manner consistent with the rules.

¹⁶ See: R Hughes, J Leslie and C Pacitti, *Britannia waives the rules?* Resolution Foundation, October 2019.

¹⁷ Luc Eyraud et al (2018), *Second Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability*, IMF Staff Discussion Note, April; and Antonio Afonso and João Tovar Jalles (2019), 'Fiscal Rules and Government Financing Costs', *Fiscal Studies*, Vol 40, No 1, March.

FIGURE 13: Fiscal rules have increased in sophistication over time

Number of advanced economies with fiscal rules adopted at a national level by year, split by characteristics of rules



NOTES: Supranational-only rules are excluded. Rules are shown from implementation date rather than announcement date.

SOURCE: RF analysis of IMF, *Fiscal Rules database*, 2015

The new rules need to adapt to a changed macroeconomic environment

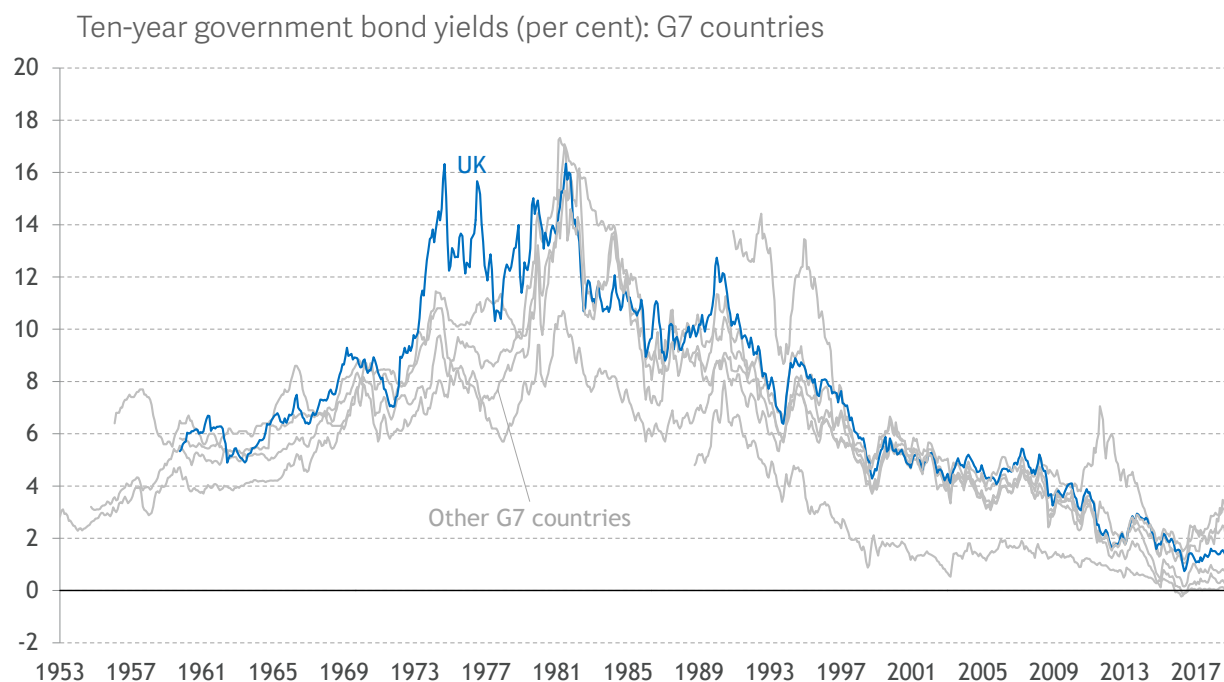
In addition to learning the lessons of history, the UK's new fiscal rules must also take account of changes in the economic landscape which means the future environment for fiscal policymaking will not be like the past. Specifically, three major macroeconomic developments in recent years present both challenges and opportunities for fiscal policy which need to be reflected in the design of the new rules.

Interest rates at historic lows

First, interest rates have fallen to historic lows. The post-crisis period has been marked by falls in longer-term interest rates around the world. The fact that these falls pre-date the crisis and have been synchronous across advanced economies points to the idea that these developments will be with us for some time to come (Figure 14).¹⁸ The low interest rate environment significantly constrains the ability of monetary policy to support the economy during a downturn, and implies the need for more active fiscal policy. Bank of England rate cuts have averaged around 5 percentage points in post-war recessions. But with its policy rate below 1 per cent, it is clear that the capacity for conventional monetary policy to support the economy in a recession is severely diminished.

¹⁸ For a discussion, see Box 3, page 50 of: J Leslie, C Pacitti, F Rahman and J Smith, *Recession Ready?*, Resolution Foundation, September 2019.

FIGURE 14: Longer-term interest rates have been in secular decline over the last four decades



NOTES: Averages of daily interest rates implied by the prices at which the government bonds traded in financial markets.

SOURCE: OECD

While quantitative easing (QE) can provide some additional capacity for monetary policy to support the economy, the fact that longer-term interest rates are close to all time lows, and so are unlikely to be driven much lower by further QE, means that the scope for further stimulus from QE will also be limited. In previous work we concluded that monetary policy would be hard pushed to provide support of more than 1 per cent of GDP, around a quarter of the support needed to offset the fall in GDP in the average post-war recession.

In addition, the automatic fiscal stabilisers – that is, the part of the tax and benefit system that fluctuates automatically over the economic cycle – also appear to have weakened in recent years.¹⁹ This means discretionary fiscal policy needs to carry more of the burden of stabilising the economy in future downturns. If this is not hardwired into the fiscal framework there is a risk that future downturns could be more severe and painful. But it also means tighter policy in good times to stop debt levels ratcheting up. *It is therefore important that the new rules allow fiscal policy to play a larger, more active, and more sustained role in stabilising the economy than previous fiscal frameworks.*

¹⁹ For a discussion of evidence of this, see: J Leslie, C Pacitti, F Rahman and J Smith, *Recession Ready?*, Resolution Foundation, September 2019.

Opportunities for investment

Second, the prospect of a sustained period of lower interest rates also creates new opportunities for governments to address some of today's most pressing economic, environment and social challenges. Despite the more than doubling of public debt since the financial crisis, simultaneous falls in UK government borrowing costs mean that the cost of servicing that debt remains close to all-time lows (Figure 20). This calls into question the value of using the *volume* of public sector net debt as an indicator of fiscal sustainability. It also presents an opportunity for government to take advantage of what may be a limited window to borrow to address significant long-term structural challenges facing society.²⁰

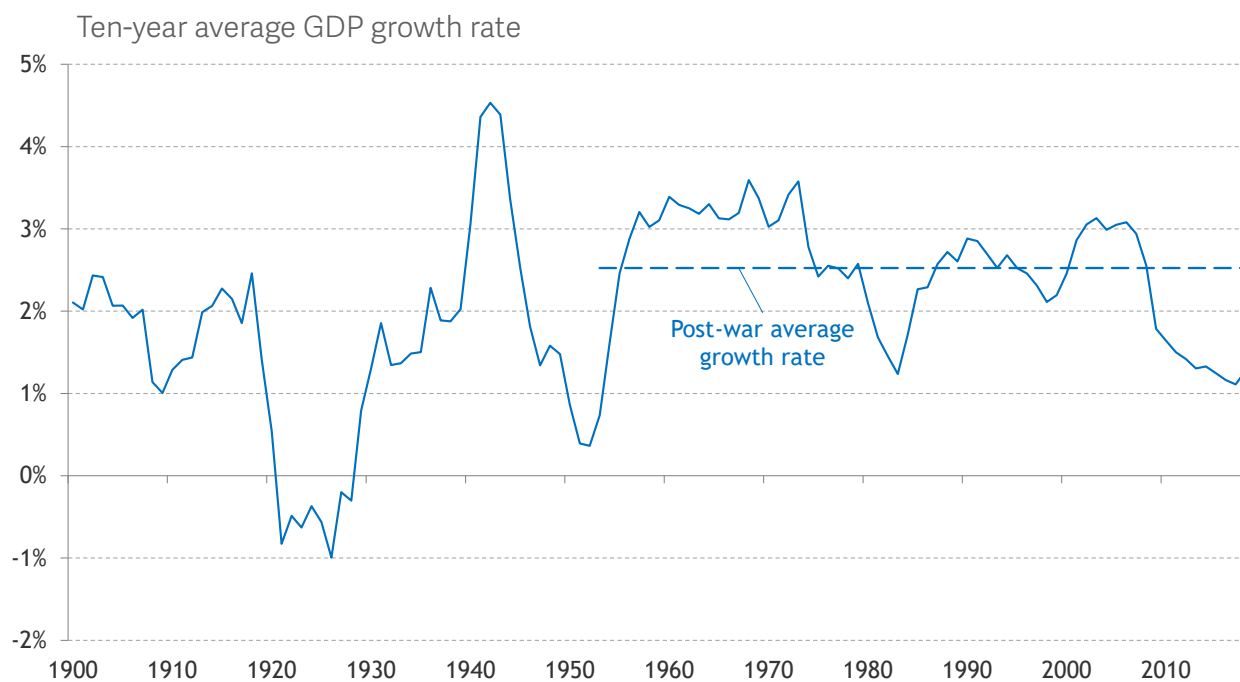
One such challenge which appears to be closely linked to the fall in interest rates is the sustained weak growth in productivity since 2008. Indeed, as shown in Figure 15, in the aftermath of the financial crisis the UK has experienced the slowest decade of peacetime growth since 1929. Ten-year average growth fell to just 1.1 per cent by 2017, compared to a post-war average growth rate of around 2.5 per cent. This has led to a widespread view that there has been a structural slowing in growth, implying a slower rate of productivity growth in future.²¹

Another, and no less daunting, structural challenge is mitigating the impact of, and adapting to, climate change. As discussed in Section 4, meeting both of these challenges is likely to require substantial and sustained public investment on a level not seen in a generation. *This argues for a fiscal framework which allows government to borrow to invest but places more emphasis on the quality of that investment. It also calls for the long-run affordability constraint within that framework to focus not solely on the volume of debt but on the burden that servicing it places on the public finances.*

²⁰ For a discussion of the impact of low interest rates on fiscal policy, see: O J Blanchard, 'Public Debt and Low Interest Rates', *American Economic Review*, vol. 109, pages 1197-1229, April 2019.

²¹ See, for example, the arguments set out in: R J Gordon, *The Rise and Fall of American Growth: The U.S. Standard of Living Since the Civil War*, Princeton University Press, 2016. For a discussion in the UK context, see: S Tenreyro, *The fall in productivity growth: causes and implications*, Speech, Peston Lecture Theatre, Queen Mary University of London, 15 January 2018.

FIGURE 15: UK productivity has endured its weakest decade of peacetime growth since the Great Depression



NOTES: Ten-year moving average of annual GDP growth rates. Post-war average is 1945 to 2007.
SOURCE: RF analysis of ONS and Bank of England

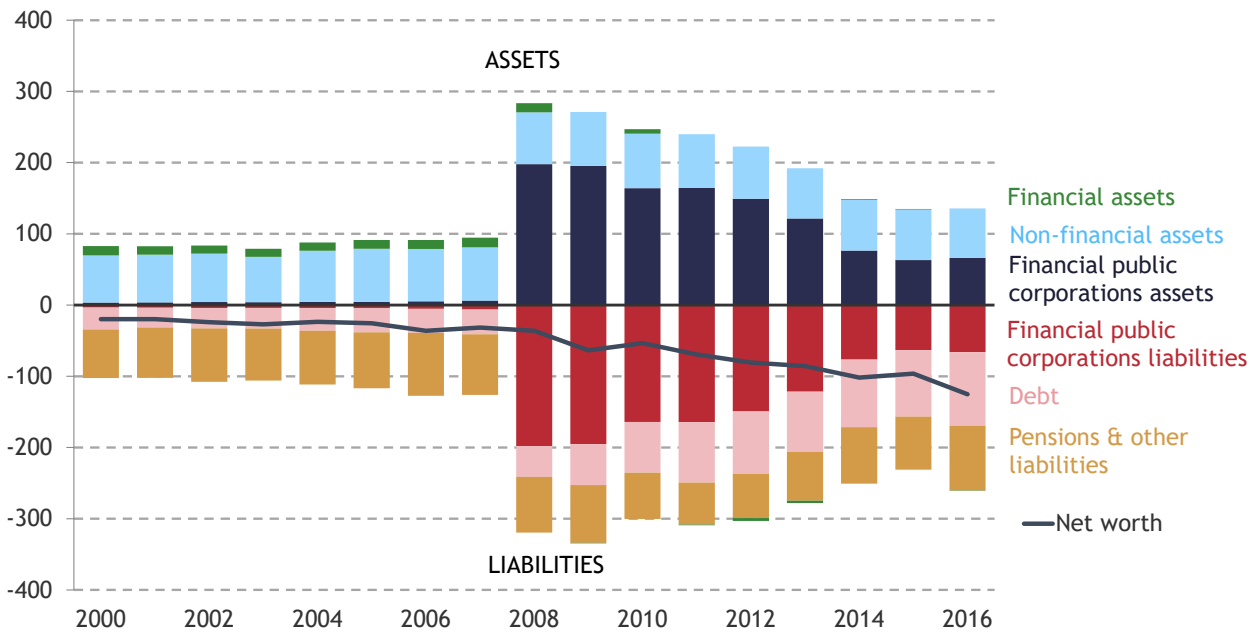
The growing importance, use, and understanding of government balance sheets

A third recent macroeconomic development has been the growing emphasis on the whole public sector balance sheet as the focus of fiscal policymaking. Governments across the advanced world made unprecedented use of their balance sheets to bail out financial firms and support businesses and households in the wake of the 2008 financial crisis. The UK public sector balance sheet ballooned during this period, with assets trebling from 95 per cent of GDP in 2007 to 285 per cent of GDP in 2008 (Figure 16). This was driven initially by measures to support the financial sector (including the acquisition of RBS, Lloyds and Northern Rock). But it has also reflected growing use of loans, guarantees, and other financial instruments to pursue a range of other policy objectives including increasing access to higher education, helping first time buyers get a foot on the housing ladder, financing infrastructure projects, and managing the cost of healthcare.

Until recently, the full consequences of these transactions in assets and liabilities were obscured by the fact that the government lacked information on the state of its balance sheet. However, after more than a decade of preparatory work, the UK now has some of the most comprehensive, timely, and reliable public sector balance sheet data in the world. And over the past three years, the OBR has begun forecasting the future evolution of public sector assets and liabilities.

FIGURE 16: The UK public sector balance sheet exploded following the financial crisis in 2008

Evolution of the UK public sector balance sheet, 2000-16 (% of GDP)



SOURCE: RF analysis of IMF

With both main political parties promising to borrow to invest in everything from infrastructure to the acquisition of public utilities and other strategic industries, this requires a fiscal framework that captures both sides of the transaction and ensures that the value of the assets created exceeds the cost of their financing. And understanding the public sector balance sheet is important not only for sustainability, but also for the other objectives of fiscal policy. Countries with higher net worth face lower debt service costs and are better able to use discretionary fiscal policy to respond to economic shocks.²² This argues for the new fiscal rules to take account of the value of both assets and liabilities.

²² See: S R Yousefi, 'Public Sector Balance Sheet Strength and the Macro Economy', IMF Working Paper WP/19/170, 2019. According to the author, a 10 per cent improvement in a government's net worth position reduces government bond yields by around 15 basis points.

Section 3

The proposed fiscal rules

In light of the timeless objectives of fiscal policy, lessons from experience with fiscal rules, and changes in the macroeconomic environment discussed above, this section sets out a suite of three fiscal rules for the UK in the coming decade. It discusses the advantages of these rules relative to the current and past UK fiscal targets. It also describes the circumstances under which those rules might be partially and temporarily suspended.

A proposal for a new UK fiscal framework

Reflecting the objectives for fiscal policy in any country at any time, the lessons from UK and international experience with fiscal rules over the last twenty years, and the challenges and opportunities facing fiscal policymakers in the UK over the next decade, we propose a suite of three fiscal rules:

- A **net worth 'objective'** to deliver an improvement in public sector net worth as a share of GDP over a fixed five-year term from 2020-21 to 2024-25. This means that the growth in the value of the government's total financial and fixed assets needs to exceed that of its debt and other liabilities over the next five years as a share of GDP;
- A **structural current balance 'target'** to aim to achieve a cyclically adjusted public sector current balance of +1 per cent of GDP and no less than -1 per cent of GDP in outturn by the end of the fixed five-year period ending in 2024-25. This would allow the government to borrow to invest (subject to the other two rules) but would require it to keep current receipts and current spending (including depreciation on its assets) in broad balance. To build in sufficient margin for error against breaching the lower end of the target range, the government would be expected to target a current surplus of 1 per cent of GDP in each Budget up until the target year; and
- A **debt interest 'ceiling'** to ensure the share of total public sector revenue spent on debt interest does not exceed 10 per cent at any time. This would ensure that the overall debt burden remains sustainable by taking account of not only the volume of debt, but also its cost and the government's ability to service it.

The precise specification of these three rules, their advantages over what has come before, and the circumstances under which some of them can be temporarily suspended are discussed in turn below.

The net worth objective

The long-term anchor for the fiscal framework would be an objective to improve public sector net worth (PSNW) as a share of GDP over the five years from 2020-21 to 2024-25. This would be the ‘stock’ rule in the fiscal framework, replacing the role that public sector net debt (PSND) has played in all previous UK fiscal regimes. Unlike PSND, which includes only debt on the liability side and liquid financial instruments (such as gold and foreign currencies) on the asset side, PSNW provides a summary measure of the entire public sector balance sheet covering all financial and non-financial assets and liabilities. Figure 17 summarises the differences in coverage between PSND, PSNW, and other statistical and accounting measures of the balance sheet including public sector net financial liabilities (PSNFL) and the IFRS measure of PSNW found in Whole of Government Accounts.

FIGURE 17: Public sector net worth provides a summary of the whole public-sector balance sheet

Coverage of alternative balance sheet metrics

	National Accounts Measures			IFRS Measures
	Public Sector Net Debt (PSND)	Public Sector Net Financial Liabilities (PSNFL)	Public Sector Net Worth (PSNW)	Public Sector Net Worth (PSNW)
Assets		Illiquid financial assets*	Non-financial assets	Non-financial assets
		Liquid financial assets	Illiquid financial assets	Illiquid financial assets
	Liquid financial assets		Liquid financial assets	Liquid financial assets
Liabilities	Government borrowing	Government borrowing	Government borrowing	Government borrowing
		Other financial liabilities*	Other financial liabilities	Other financial liabilities
			Unfunded public sector pensions**	Unfunded public sector pensions
			PFI contracts**	PFI contracts
				Provisions

*Including funded public sector pensions

**Included in IMF GFSM2014 but not ESA2010

SOURCE: RF analysis of HM Treasury, ‘Managing Fiscal Risks’, July 2018

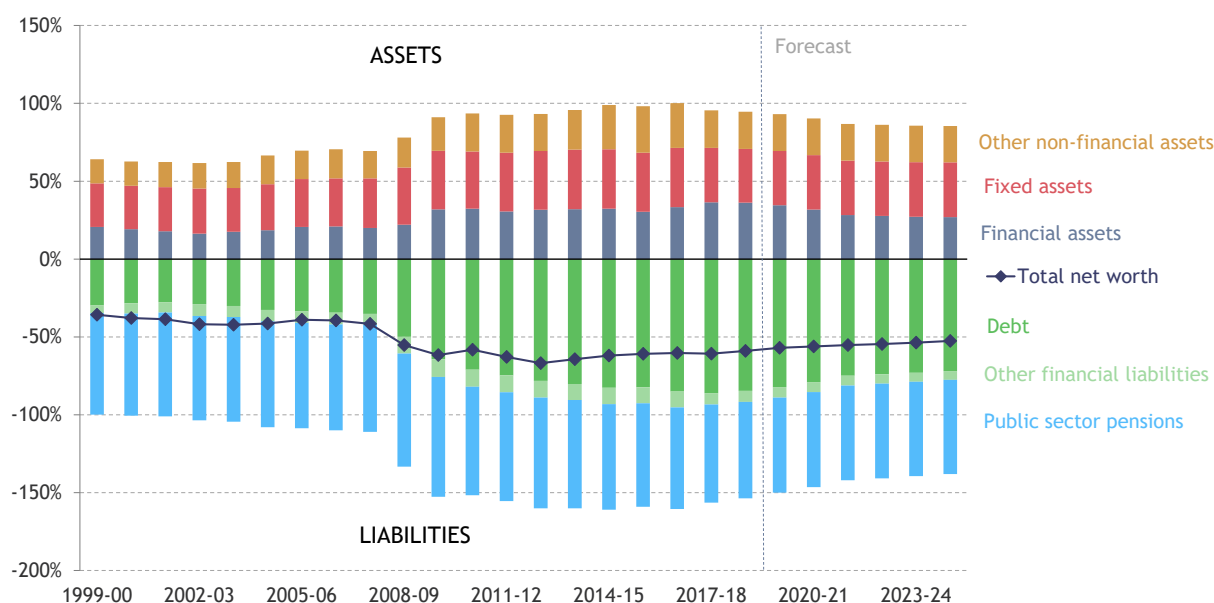
Based on the new ONS balance sheet data released on 22 October 2019, PSNW has fallen from -42 per cent of GDP in 2007-08 to -59 per cent of GDP this year (Figure 18).²³ Based

²³ ONS, *September 2019 public sector finances*, 22 October 2019

on our own projections, using the OBR's March 2019 *Economic and Fiscal Outlook* (EFO) as a base, PSNW looks set to improve by around 3.6 per cent of GDP over the period specified by the rule from minus 57.1 per cent of GDP in 2020-21 to minus 53.5 per cent in 2024-25. It would nevertheless remain lower than in the immediate pre-crisis period.

FIGURE 18: **Public sector net worth has deteriorated in recent years**

Net worth as a proportion of GDP, by types of asset and liability



NOTES: Other non-financial assets include non-produced assets, such as land, and inventories. Other financial liabilities include loans, special drawing rights, financial derivatives and other accounts payable.
SOURCE: RF analysis of ONS, *Public sector finances*; OBR, March EFO

Advantages of public sector net worth over net debt

As discussed in the companion paper *Seeking public value*,²⁴ PSNW has a number of advantages over PSND as the long-term anchor of the fiscal framework. Specifically:

- PSNW provides a more comprehensive measure of the long-term sustainability of the public finances than PSND because it includes all assets and liabilities of the public sector. This includes financial assets such as student loans, fixed assets such as social housing and the road network, and non-debt liabilities such as public sector pensions and standardised guarantees. By contrast, PSND which includes only £2 trillion (95 per cent of GDP) in debt on the liabilities side and £245 billion (12 per cent of GDP) in liquid financial instruments,²⁵ neglects both significant public wealth in financial assets (worth £770 billion or 36 per cent of GDP) and non-financial assets (worth £1.25 trillion or 58 per cent of GDP) as well as substantial non-debt liabilities of £1.5 trillion (69 per cent of GDP).

²⁴ R Hughes, *Seeking public value*, Resolution Foundation, 29 September 2019.

²⁵ ONS, *Public Sector Finances*, September 2019. Excludes public sector banks, Bank of England, and Asset Purchase Facility.

- PSNW also offers a more honest picture of the fiscal implications of financial transactions which play an increasingly important role in meeting the government's micro and macroeconomic objectives. Transactions in financial assets and liabilities including asset purchases and bank nationalisations played a key role in socialising risk at the height of the 2008 financial crisis. And since then the government has made active use of loans, guarantees, and other financial instruments to increase access to higher education, help first time buyers get a foot on the housing ladder, and finance infrastructure projects. All of these transactions are excluded from PSND but captured in PSNW. Moreover, policy changes that affect the value of these assets – such as changes in the interest rate or repayment threshold for student loans – have no impact on PSND but would have an immediate impact on the value of those assets in PSNW.
- Additionally, PSNW offers a transparent accounting framework for holding governments to account for their promises to 'borrow to invest'.²⁶ Policy makers in both main political parties argue that, as the exigency of deficit reduction has receded post-crisis, fiscal policy needs to take advantage of permanently lower interest rates to borrow to finance growth or welfare-enhancing investments.²⁷ Some political parties are even making the case for direct government investment in the reacquisition of public utilities and other strategic industries.²⁸ Implicit in these strategies is the assumption that these investments will pay for themselves either directly (in the form of dividends on shares acquired in nationalised companies)²⁹ or indirectly (in the form of a higher tax take from a larger economy).³⁰ Unlike previous rules, some of which allowed government to borrow to invest by entirely excluding investment from the fiscal framework (with potential consequences for the quality of that investment), targeting PSNW would show both sides of the transaction and how the value of the assets acquired through government investment compare with the cost of the debt incurred to create or purchase them.
- Finally, PSNW provides stronger incentives to manage public assets and liabilities for the benefit of current and future generations than PSND. By recognising the value of the assets created by government investment, PSNW would bring a greater focus on the quality of that investment and the maintenance of the resulting public infrastructure. Actions which reduced the £49 billion (2.2 per cent of GDP) annual

²⁶ For a discussion of the fiscal rules in this context, see: A Hantzsche & G Young, 'Light at the end of the fiscal tunnel?' National Institute Economic Review No. 244, May 2018.

²⁷ Sajid Javid Signals Borrow to-Invest Budget, Says BOE Search on Track, Bloomberg News, 17 October 2019; Jeremy Corbyn's plan to rewrite the rules of the UK economy, Financial Times, 1 September 2019

²⁸ Labour Party September 2018 Consultation Paper on Democratic Public Ownership.

²⁹ Speech by Rt Hon John McDonnell to the 2018 Labour Party Conference, 24 September 2018;

³⁰ Rt Hon Boris Johnson Interview with Sky News, 30 June 2019.

cost associated with the depreciation of those assets would support PSNW (and improve the current balance), while neglect of those assets would detract from net worth over time. It would also remove the incentives under PSND to resort to ‘fire sales’ of assets or opportunistic privatisations to reduce reported debt, as the sale of any assets or institutions at below their retention value would appear as a net reduction in PSNW by the amount of the loss on disposal. Finally, targeting PSNW would force policymakers to face up to its significant and growing non-debt liabilities including £1.3 trillion (62 per cent of GDP) of public sector pensions liabilities.

Progress in public sector balance sheet reporting

A decade of work on the part of HM Treasury and Office for National Statistics (ONS) to improve the comprehensiveness, reliability, and timeliness of public sector balance sheet data has also made targeting PSNW a practical proposition for the first time. The UK has published Whole of Government Accounts (WGA), which include a comprehensive balance sheet prepared in line with International Financial Reporting Standards (IFRS), for over a decade. However, the current 12-month delay in the consolidation and publication of this comprehensive set of accounting data limits its usefulness as a guide for real-time fiscal decision-making.

Fortunately, in the past three years, the ONS has started publishing more frequent and timely *statistical* data on the public sector balance sheet in line with the IMF’s Government Finance Statistics Manual 2014 (GFMS2014) standard. Beginning in Autumn 2018, the ONS began publishing quarterly statistics on public sector net financial liabilities (PSNFL) which covers all *financial* assets and liabilities of the public sector. In June 2019, the ONS published its first quarterly statistics on the *entire* public sector balance sheet, including both financial and non-financial assets and liabilities. Further improvements to the data were made in the September 2019 *Public Sector Finances* release, including more refined estimates of fixed assets and the inclusion of unfunded public sector pension liabilities.

Crucially for fiscal policymaking and budgeting purposes, the OBR has also begun forecasting the evolution of the public sector balance sheet. The OBR began forecasting the government’s *financial* balance sheet in its Autumn 2016 *Economic and Fiscal Outlook*. Forecasting the *entire* balance sheet, which would require estimating the evolution of fixed assets and non-debt liabilities over the next five years would be a reasonably straightforward exercise which we have attempted for the first time in this paper (Figure 18).

Real-time monitoring of PSNW trends in-year would require an increase in the frequency of reporting from quarterly to monthly, but this should not present any insurmountable methodological problems either. Moreover, were the government to accept the recommendation later in this paper to consult publicly on its proposed fiscal rules before legislating for them, this would give both the ONS and OBR time to develop their PSNW compilation and forecasting methods.

The structural current balance target

To ensure that the paths of revenue and expenditure are consistent with increasing PSNW/GDP even after taking account of potential shocks, the second element of our proposed fiscal framework is an objective to deliver a structural current balance of +1 per cent of GDP and no less than -1 per cent of GDP by 2024-25. As with the Coalition government's two rules between 2010-14, the structural current balance would represent the difference between public sector current receipts and current expenditure *including* depreciation. The target would, therefore, permit the government to borrow to invest within the strictures of the other two rules: the net worth objective and debt interest ceiling.

Targeting a structural current balance of between +1 and -1 percent of GDP would again have a number of advantages over the traditional limit on public sector net borrowing (PSNB) included in past fiscal regimes, including:

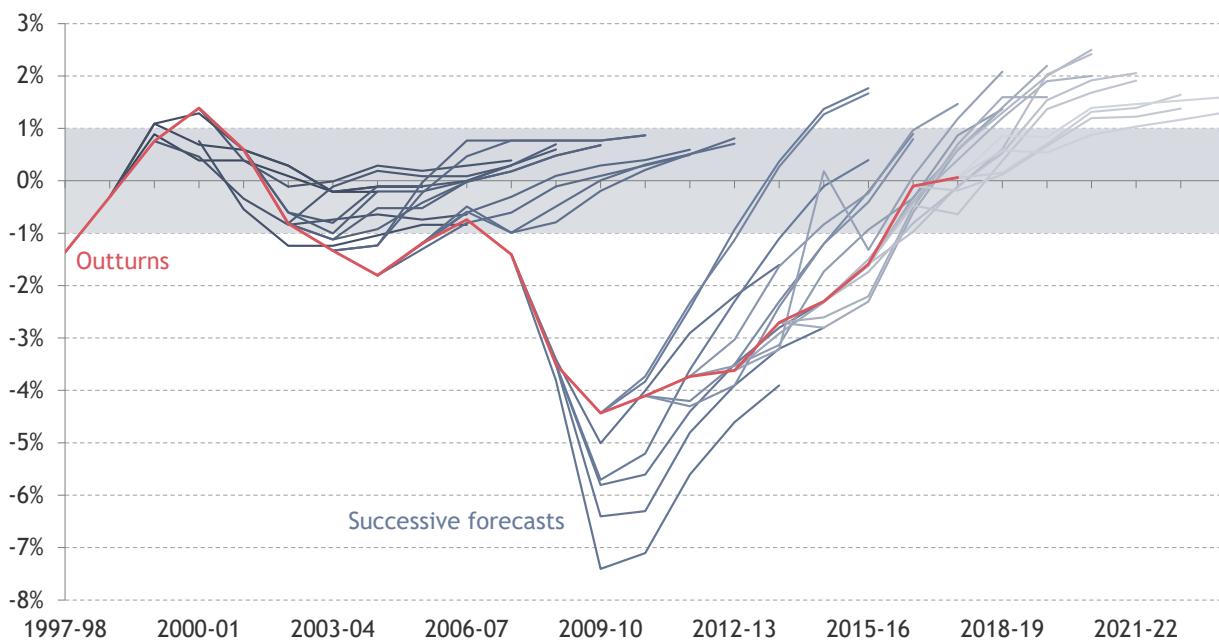
- With interest rates and productivity growth at historic lows, targeting the structural current balance would enable the government to borrow to invest in infrastructure and other assets that support the long-run growth potential of the economy. However, unlike past UK fiscal frameworks that have included current balance targets, the other two rules (the net worth objective and debt service ceiling) ensure that the resulting investment creates assets of equal or greater value than the cost of borrowing and that the total liabilities accumulated are affordable;
- By including depreciation as an expense in measuring the current balance, our proposed target requires the government to raise sufficient revenue to cover not only current expenditure but also the ongoing cost of maintaining these assets;
- By adjusting for the cyclical position of the economy, the target allows for the automatic fiscal stabilisers to smooth out the ups and down of the economic cycle without jeopardising the achievement of the rule or encouraging procyclical tightening or loosening of fiscal policy;³¹

³¹ For a discussion of the use of cyclical adjustment in fiscal rules, see: M Lopresto & G Young, 'Measuring the cycle and structural shocks', The National Institute Economic and Social Review, Vol. 50, No. 1, Spring 2019.

- Targeting a range between +1 and -1 per cent of GDP reduces the perverse incentives created by past point targets as the deadline approaches.³² This depends, of course, on government not simply aiming for the bottom, or indeed middle, of the range, an issue which is addressed in Box 2 on calibrating fiscal headroom; and
- As discussed further below, targeting the top end of the +/-1 per cent of GDP range on the current balance during normal times helps to compensate for deteriorations in the current balance and net worth during economic downturns (Figure 19). By pursuing a tighter fiscal policy during good times than under previous rules, this allows fiscal policy to be more active during downturns. It also ensures net worth continues to improve over the economic cycle as a whole.

FIGURE 19: To keep the structural current balance above -1 per cent of GDP, you have to aim for a surplus of +1 per cent of GDP

Cyclically adjusted current balance, proportion of GDP



NOTES: Historic forecasts are adjusted for the estimated effect of reclassifications.

SOURCE: RF analysis of OBR, *Historical official forecasts database*.

Based on the OBR's March 2019 *Economic and Fiscal Outlook* projections, adjusted to include September revisions to student loan treatment and depreciation published by the ONS,³³ the government appeared to be on course to achieve a structural current

³² For a discussion of the importance of data uncertainty in a fiscal context, see: J Chadha, A Hantzsche, A Pabst, T Lazarowicz & G Young, 'Understanding and Confronting Uncertainty: Revisions to UK Government Expenditure Plans', National Institute of Economic and Social Research Discussion Papers No. 495, 2018.

³³ For the sake of maintaining comparability with the latest EFO projections, the forecast has not been revised to take account of the additional discretionary DEL spending announced in the 2019 Spending Round.

surplus of 1.1 per cent of GDP in 2024-25. That would exceed the top of our target range by 0.1 per cent of GDP, or £3.3bn. As discussed in Box 2, explicitly aiming for 1 per cent structural current surplus in each Autumn Budget between now and the target year would recognise the degree of uncertainty and optimism bias inherent in fiscal forecasting and improve the government's chances of keeping the outturn with the target range. It would also help to ensure that PSNW continues to improve over the period.

BOX 2: Building in sufficient headroom against the rule

As discussed in the companion paper *Britannia waives the rules?*³⁴ on the lessons from two decades of experience with fiscal rules, one serial error made by all Chancellors over this period was the failure to build in a sufficient margin of error against their rules when setting fiscal policy. Since the establishment of the OBR in 2010, the average forecast error for borrowing five years ahead was around 2.1 per cent of GDP (or around £45bn), highlighting the tendency for fiscal forecast errors to be both large and biased toward underestimating future levels of borrowing (Figure 12). Yet, the most amount of headroom any Chancellor has retained against any rule during this period was the 1.2 per cent of GDP (£27bn) set aside by Philip Hammond against his 2 per cent of GDP structural deficit target.

Aiming for a 1 per cent of GDP structural current surplus in 2024-25 would build in 2 per cent of GDP (£43 billion) in headroom against the bottom end of the target range of +1 to -1 per cent of GDP. This would, therefore, be roughly equal to the average five-year ahead absolute forecast error for

borrowing since the establishment of the OBR. And it would be more than double the average amount of headroom retained by previous Chancellors against their borrowing rules.

Aiming for a 1 per cent of GDP structural current surplus would also ensure that the net worth objective would be met with confidence. All else equal, the annual nominal change in net worth should be equal to the current balance for that year. This means that government could run a current deficit of up to 1.8 per cent of GDP before net worth begins to decline as a share of GDP, based on the average rate of economic growth assumed by the OBR. So, securing a 1 per cent of GDP structural current surplus ensures that PSNW improves by around 2.8 per cent per year as a share of GDP. This improvement is broadly equal to the OBR's average absolute forecast error of 2.9 per cent of GDP in forecasting public sector net debt five-years ahead (although the sample size is small with only eight observations).

³⁴ R Hughes, J Leslie and C Pacitti, *Britannia waives the rules?* Resolution Foundation, October 2019.

Aiming for a 1 per cent of GDP current surplus in the target year, rather than some previous rules' focus on current balance, also serves as a counterweight to the increases in debt and declines in net worth which are inevitable during periods in which escape clauses, discussed below, have been triggered.

As shown in Figure 23, the average annual increase in debt (the main driver of changes in net worth) during periods where the output gap is larger than -1 per cent is around 3.5 per cent. With the average downturn lasting three years, this means that an average economic downturn adds roughly 10 per cent to the debt-to-GDP ratio, an observation borne out by a recent OBR and IMF analysis of sources and scale of fiscal risks in the UK and elsewhere.³⁵

Aiming for a 1 per cent current surplus enables the government to make sufficient progress in improving net worth during 'normal times' to accommodate the typical declines in net worth that accompany economic downturns. As such, this built-in overachievement against the structural current balance targets acts as a kind of 'self-correction mechanism' for net worth. It also helps to ensure that fiscal policy builds up adequate buffers in normal times to be able to support the economy without endangering sustainability during economic slowdowns. Targeting a current balance of zero 'head on' would fail to recognise the need to create the fiscal policy space needed to support the economy in future recessions, given the constraints on monetary policy discussed above.

The debt interest ceiling

The third rule in our proposed fiscal framework requires the government to keep public sector debt interest costs below 10 per cent of public sector current receipts (PSCR) at all times. This rule would ensure that the cost of servicing the government's total stock of debt remains sustainable and does not place an undue burden on current or future generations. The rationale for the choice of 10 per cent as the limit is discussed in Box 3.

BOX 3: Why limit debt interest to 10 per cent of revenue?

While rules for the ratio of debt interest/revenue are common at the subnational level, they are a novelty among national governments.³⁶ Our choice of a 10 per cent ceiling in this instance was based on three considerations.

³⁵ IMF, *Analysing and Managing Fiscal Risks Analysis: Best Practices*, June 2015; and Office for Budget Responsibility, *Fiscal Risks Report 2019*, July 2019

³⁶ D Sutherland, R Price & I Joumard, 'Fiscal rules for sub-central governments: Design and impact', OECD Working Papers on Fiscal Federalism, No. 01, OECD Publishing, Paris, 2018

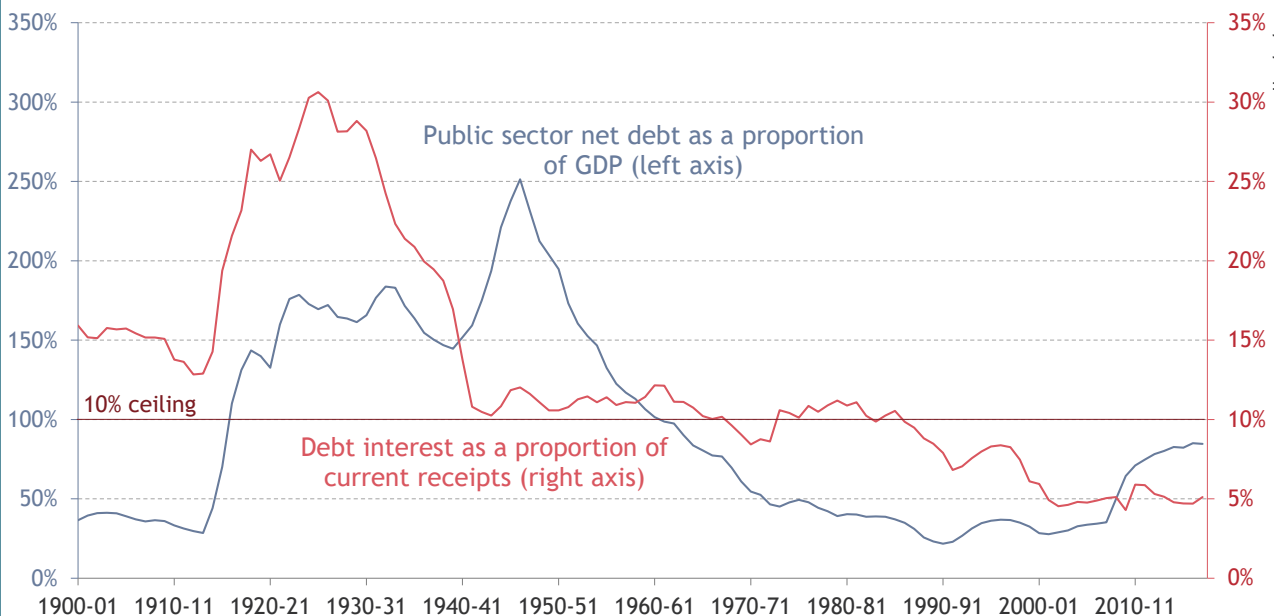
UK historical comparisons

The average debt interest/revenue ratio in the UK has been 7.8 per cent since 1945, during which time it has ranged from a high of around 13.4 per cent in the immediate aftermath of the war to a low of 4.6 per cent in 2009-10 (Figure 20). However, the ratio was as high as 9.2 per cent as recently as 1996-97

when PSND stood at 36.9 per cent, and the effective interest rate on that debt was 8.3 per cent. It was at this point that the then Labour government set a debt-to-GDP limit of 40 per cent suggesting that, as recently as 20 years ago, governments were prepared to accept debt interest costs accounting for around 10 per cent of their total resources.

FIGURE 20: The debt interest burden has remained stable over the last 15 years despite higher debt levels, reflecting low interest rates

Public sector net debt and debt interest payments as a proportion of tax receipts



SOURCE: RF analysis of OBR

UK interest rate scenarios

The 10 per cent ceiling on the debt interest/revenue ratio was also calibrated to accommodate both a sudden shock to, or gradual normalisation of, interest rates. In the near-term, a two standard deviation positive shock to interest rates (to 4.5

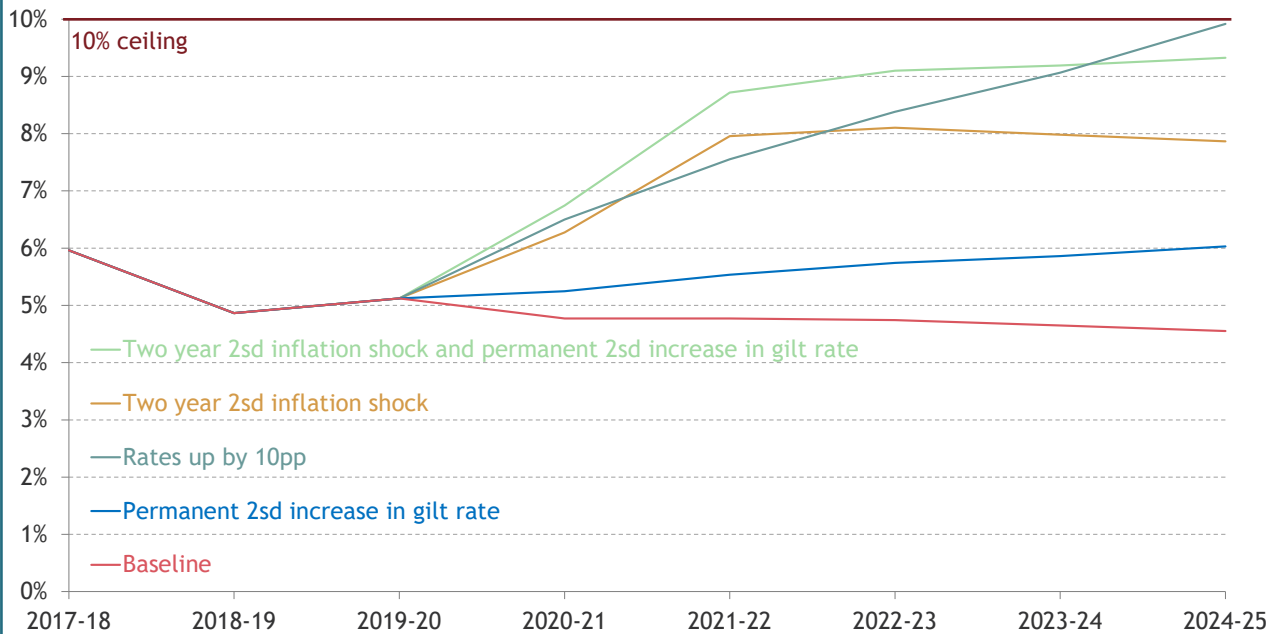
per cent permanently) and RPI inflation (to 5.5 per cent for two years) would increase the ratio above 9 per cent by 2022-23. As shown in Figure 21, much of this increase is due to the immediate impact of higher RPI inflation on the cost of index-linked gilts, highlighting the importance of the government's efforts to reduce their exposure to

these instruments.³⁷ In the very long-term (more than a decade), a return of 10-year gilt rates to their 1998-2008 average level of around 4.8 per cent

would also be enough to return this ratio to 10 per cent, assuming debt and receipts remain the same share of GDP.

FIGURE 21: Significant headroom is needed to accommodate an inflation shock

Debt interest/revenue ratio under different scenarios



SOURCE: RF fiscal forecasting model and OBR Economic and Fiscal Outlook

Credit Rating Agencies

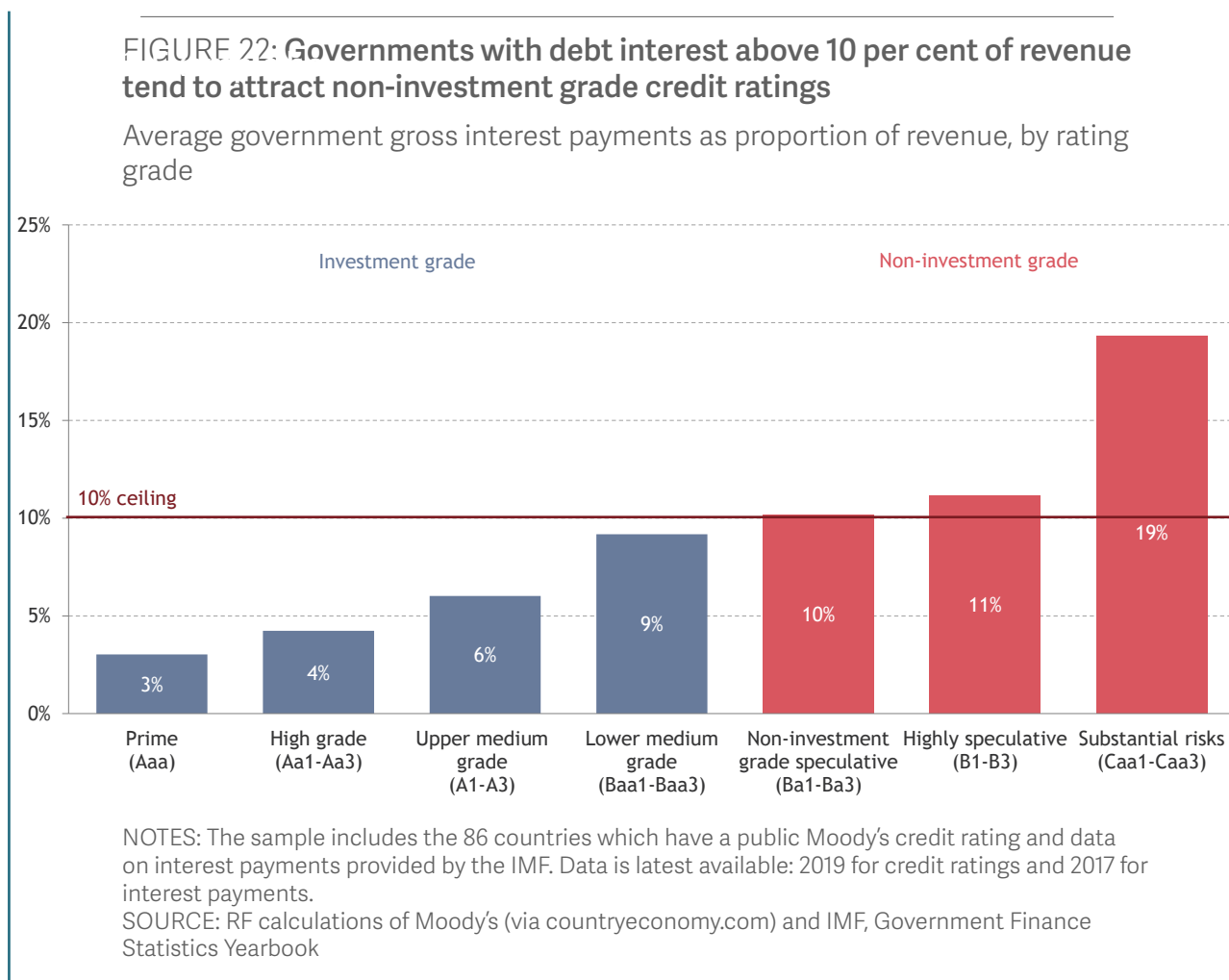
The debt interest/revenue ratio is commonly used by credit rating agencies in assessing the creditworthiness of sovereign borrowers. A debt interest/revenue ratio of 10 per cent or higher is considered to be towards the ‘weaker’ end of the Standard and Poor’s six point scale (depending on a country’s level of

debt).³⁸ In Moody’s ratings of sovereigns, a debt interest/revenue ratio above 10 percent currently appears to be one of the key factors that is associated with a typical country’s sovereign rating going from an investment-grade (Baa or above) to non-investment grade (Ba or below), as shown in Figure 22.³⁹

³⁷ HM Treasury, Debt management report 2019-10, March 2019.

³⁸ Standard & Poor’s Global, Sovereign Rating Methodology, December 2018.

³⁹ Moody’s Investors Service, Sovereign Defaults Series - The Aftermath of Sovereign Defaults, October 2013.



Our proposed ceiling on debt interest costs has a number of advantages over the more conventional limits or targets for the debt-to-GDP ratio that have featured in all previous UK fiscal frameworks and those of many other advanced economies. Specifically:

- The debt interest/revenue ratio is a better measure of the actual *burden* of debt on taxpayers as it takes account of not only the volume of debt but also its cost and the government's ability to service it. Over the past two decades, the debt/GDP ratio in the UK has trebled from 28 per cent in 2000-01 to 85 per cent at its peak in 2016-17. However, during this same period the effective interest rate that the government has paid on that debt has fallen by more than three-quarters from 8.5 per cent to 2.1 per cent. The net effect of these two changes has been to keep the burden of debt interest on the public finances (i.e. revenues) within a narrow range of 4.6 to 6.6 per cent over this period. With uncertainty over the future path of interest rates, it makes sense for the sustainability constraint to take account not only the level, but also the cost, of government debt, as the sustainable level of the former depends upon the latter. Moreover, government revenue is a better proxy for the affordability of the government's debt than GDP, which is only available to service that debt if the government is prepared to tax it at sufficiently high rates.

- The debt interest/revenue ratio is more *manageable* than the debt/GDP ratio. As a stock which is prone to dramatic increases during recessions (especially when combined with financial crises), limits on the stock of debt seldom prove effective in constraining fiscal policy once the level of debt approaches the limit, as discussed in *Britannia waves the rules?*⁴⁰ Once such limits are breached, they tend to lose their value as a constraint given the difficulties in reversing the trajectory of debt even over a five-year forecast period. Even worse, in some cases, governments have resorted to sub-optimal fiscal policy decisions, like ‘fire sales’ of assets, poor value for money PFI contracts, or questionable privatisations in order to keep the profile of debt within the limit set by the rule. By contrast, the long (roughly 14 year) average maturity of the UK government debt means that sharp falls or increases in conventional interest rates take a number of years to work through the debt stock.⁴¹ This gives governments time to adjust fiscal policy settings gradually to the new financing environment and avoid the limit being breached.
- Moreover, the fact that debt levels and interest rates have tended to move in opposite directions in the UK, as monetary policy is eased and investors flee to safety during economic shocks, the debt interest/revenue ratio tends to respond much less violently and more gradually to shocks than the debt/GDP ratio. However, as discussed in Box 3, this is less the case for the quarter of the government’s outstanding debt stock which is indexed to inflation which is much more sensitive to inflation shocks. This means that it is important to start with significant headroom under any such target as long as these inflation-linked instruments remain a substantial proportion of government debt.
- The debt interest/revenue ratio can take account of not only interest paid on debt but also interest *received* from financial investments. The *net* interest burden is a good proxy for the overall financing cost of government because it reflects interest income on its holdings of student loans, housing loans, central bank deposits and other financial assets. Decisions to reduce the interest rate on these instruments would show up as an increase in this ratio relative to previous forecasts, and thereby highlight the costs of lending on concessional (below market) terms.
- The debt interest/revenue ratio also provides the right incentives for fiscal-monetary coordination. It does so by enabling fiscal policy to support monetary policy when interest rates are falling, while requiring it to tighten fiscal policy when interest rates are rising. By removing the limit on the debt/GDP ratio, this also ensures that any

⁴⁰ R Hughes, J Leslie and C Pacitti, *Britannia waives the rules?* Resolution Foundation, October 2019.

⁴¹ As illustrated in Box 3, the relatively long average debt maturity insulates the conventional debt stock from sudden increases in gilt rates. However, this is not the case for the 25 per cent of debt in the form of index-linked gilts whose interest rate and principle is highly sensitive to changes in the Retail Price Index (RPI).

Monetary Policy Committee decisions regarding further rounds of financial asset purchases would not be constrained by the fact that the Bank of England reserves used to finance those purchases add to PSND pound-for-pound while the financial assets purchased do not.

Based on the March 2019 *Economic and Fiscal Outlook*, the proposed debt interest ceiling would be respected with the share of revenue never rising above 4.8 per cent in any year of the forecast. It is therefore unlikely to be the binding constraint on fiscal policy based on current policies and macroeconomic conditions, as one might expect given highly favourable forecast financing conditions over the next five years. However, as discussed in Box 3, a significant shock to inflation, change in the interest rate outlook, or increase in debt could see the government approach the 10 per cent limit. In these circumstances, a gradual adjustment to fiscal policy settings to alter the trajectory of debt would be required, and appropriate, to ensure that overall interest costs remain affordable.

The escape clause

Our proposed fiscal framework would also include an escape clause to allow the government to use discretionary fiscal policy during an economic downturn that cannot be sufficiently mitigated through a combination of monetary policy action and the flexibilities provided within the fiscal rules (the five-year horizon for meeting both rules and the cyclical adjustment and 2 per cent of GDP target range for the structural current balance target).

With policy interest rates stuck close to the zero lower bound, and the low level of longer-term interest rates constraining the scope for further unconventional monetary policy stimulus, the ability of monetary policy to cushion the impact of negative economic shocks on households and businesses is likely to be constrained for some time. Faster, larger, and longer stimulus from discretionary fiscal policy is therefore likely to be needed to support demand in any future recession.

Under the escape clause, the structural current balance and net worth targets would be suspended in any years in which the OBR's pre-measures forecast showed that the outlook had deteriorated significantly, and monetary policy is likely to be constrained. Specifically, the escape clause would be triggered when spare capacity exceeded 1 per cent (i.e. an output gap of less than -1 per cent) and Bank Rate was below 1.5 per cent.⁴²

⁴² The choice of an output gap of 1 per cent reflects an assessment of the amount of monetary policy space – see: J Leslie, C Pacitti, F Rahman and J Smith, *Recession Ready?*, Resolution Foundation, September 2019; and 1.5 per cent for Bank Rate reflects the average interest rate cut during an interest rate cycle which has been highlighted by the Monetary Policy Committee as the level at which it can act to provide material stabilisation in the face of shocks to the economy – see: M Carney, '[New Economy, New Finance, New Bank](#)', speech given at The Mansion House, June 2018.

Both rules would be reinstated in the year in which the OBR estimated that the amount of spare capacity would drop below 1 per cent, at which point the window for meeting the rules would be reset to five years ahead. This gives the government a more realistic timescale following an adverse shock to return the public finances to a neutral stance than previous fiscal frameworks which required fiscal policy to begin tightening even in the face of a persistent and sizable output gap. To ensure that the public finances remain sustainable throughout this period, the third rule limiting debt interest to no more than 10 per cent of revenue would continue to apply at all times.

Such an escape clause would have a considerable advantage over those included in previous UK fiscal frameworks which entirely suspended the rules in the face of an economic shock. As discussed in *Britannia waives the rules?*,⁴³ no previous set of fiscal rules has survived the invoking of an escape clause, because it suspended the operation of the rules until further notice. This means that the UK was without an anchor for expectations of future fiscal policy during these periods.

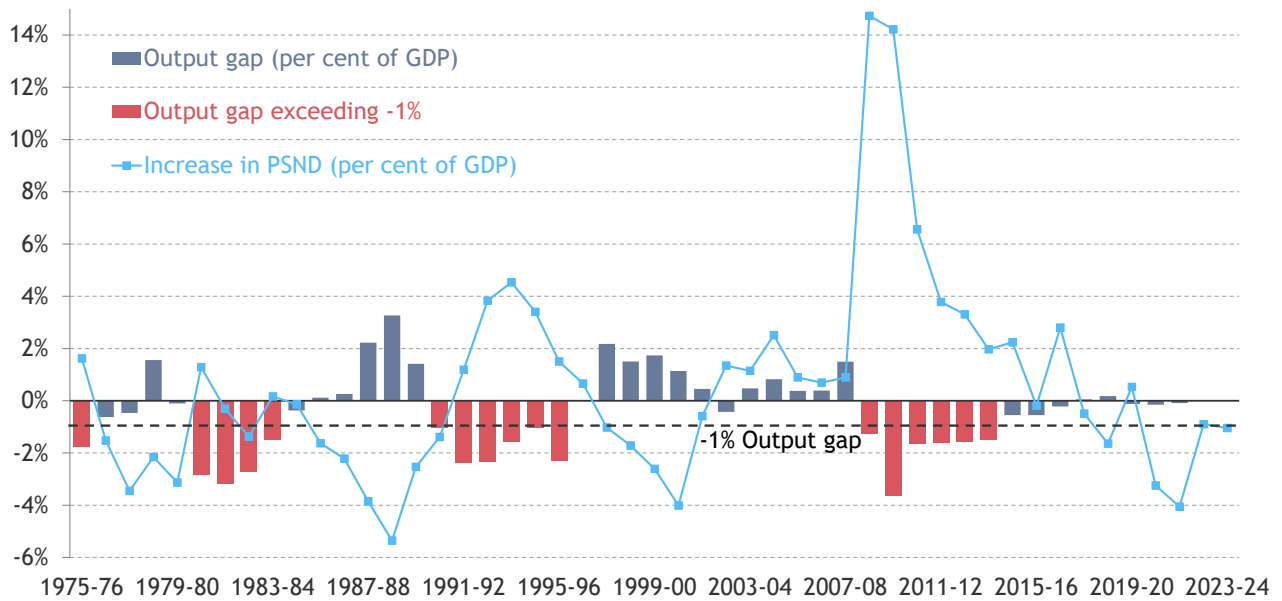
By contrast, our proposed escape clause would suspend only two of the three rules and only in the years for which the output gap exceeded -1 per cent of GDP. In the other years of the forecast period, the rules remain in force, and the government would be expected to begin making progress back towards the net worth and structural current balance objectives, albeit with more time to reach them. As such, all the rules would remain in force for the years after the shock has abated.

Taken together, this escape clause provides reassurance that a prudent fiscal framework remains in place even in a severe downturn. As shown in Figure 23, had this escape clause been in place over the past three-and-a-half decades, it would have been triggered in 17 out of 49 years and for as long as six years on two occasions.

⁴³ R Hughes, J Leslie and C Pacitti, *Britannia waives the rules?* Resolution Foundation, October 2019.

FIGURE 23: The escape clause would have been triggered in 17 years since 1975

Output gap and public sector net debt as a proportion of GDP, output gaps of lower than -1 in red



SOURCE: RF analysis of OBR

Building wider and more durable political commitment

While the UK’s fiscal rules have played a prominent role in the fiscal policy debate and had some grounding in legislation since they were first introduced in the late 1990s, collective and sustained political commitment to a set of objectives for fiscal policy has been lacking. Labour’s golden and sustainable investment rules were never enshrined in legislation, but the requirement to state and report on its fiscal objectives in each Budget was one of a number of obligations placed on the government by the Code for Fiscal Stability which was approved by parliament as part of the *1998 Finance Act*. More recently, the Coalition government’s *2010 Budget Responsibility Act* did require the government’s fiscal rules to be debated and approved by parliament in the form of a secondary instrument, the Charter for Budget Responsibility.

Despite these efforts to garner greater parliamentary commitment to the fiscal rules, they have still tended to be closely associated with the Chancellor of the day. To date, no set of rules has outlasted the Chancellor that authored them. This stands in contrast to the growing tendency in other countries to seek to enshrine their fiscal rules in national constitutions or higher (framework or ‘organic’) laws. With the UK facing the prospect of a potentially sustained period of political fragmentation and minority or coalition governments, policy makers need to find ways to build greater cross-party and wider social consensus on the objectives of fiscal policy.

This calls for greater consultation and debate on the government's proposed fiscal rules than has traditionally been the case in this country. With both main political parties calling for government to take advantage of low interest rates to borrow to invest, there appears to be at least some common ground on the objectives of fiscal policy. Once a shared position on the government's fiscal objectives is reached, there is a need to embed it more firmly in primary legislation so that the rules can constrain parliament's tax and spending decisions in future Budgets.

Section 4

Stress testing the proposed rules

While there is a strong conceptual case for our proposed framework, it is important that the rules themselves are robust to a variety of possible macroeconomic futures. This section therefore examines how the rules perform, and the policy incentives they create, under four different macroeconomic scenarios. The baseline scenario looks at whether the rules are met if economic conditions develop broadly in line with the OBR's March 2019 Economic and Fiscal Outlook. The secular stagnation scenario considers what flexibilities and constraints the rules provide were the economy to become mired in prolonged period of low growth and low inflation. The 'cyclical recession' scenario explores what scope the rules provide for countercyclical support to the economy in the event of a typical demand-led economic downturn. Finally, the 'no deal' Brexit scenario looks at how the rules cope with a combined supply and demand shock to the economy.

Four economic scenarios

In order to assess the proposed fiscal rules, this section looks at their performance under four different economic scenarios. These are not projections; rather they represent plausible economic case studies that allow us to test the characteristics of our proposed fiscal rules in different circumstances. Importantly, these scenarios represent economic shocks to both the supply and demand side of the economy. Effective fiscal rules should provide an appropriate balance of flexibility and constraint on governments depending on the economic circumstances. These scenarios demonstrate that our proposed rules strike the right balance between these goals.

The analysis tests the rules under four economic scenarios:

- a 'baseline' scenario based on the OBR's latest *Economic and Fiscal Outlook*;
- a 'secular stagnation' scenario assuming persistent low real GDP growth and interest rates;
- a 'cyclical recession' scenario representing a typical demand-led UK recession; and
- a 'no deal' Brexit scenario assuming the UK leaves the EU without a Withdrawal Agreement.

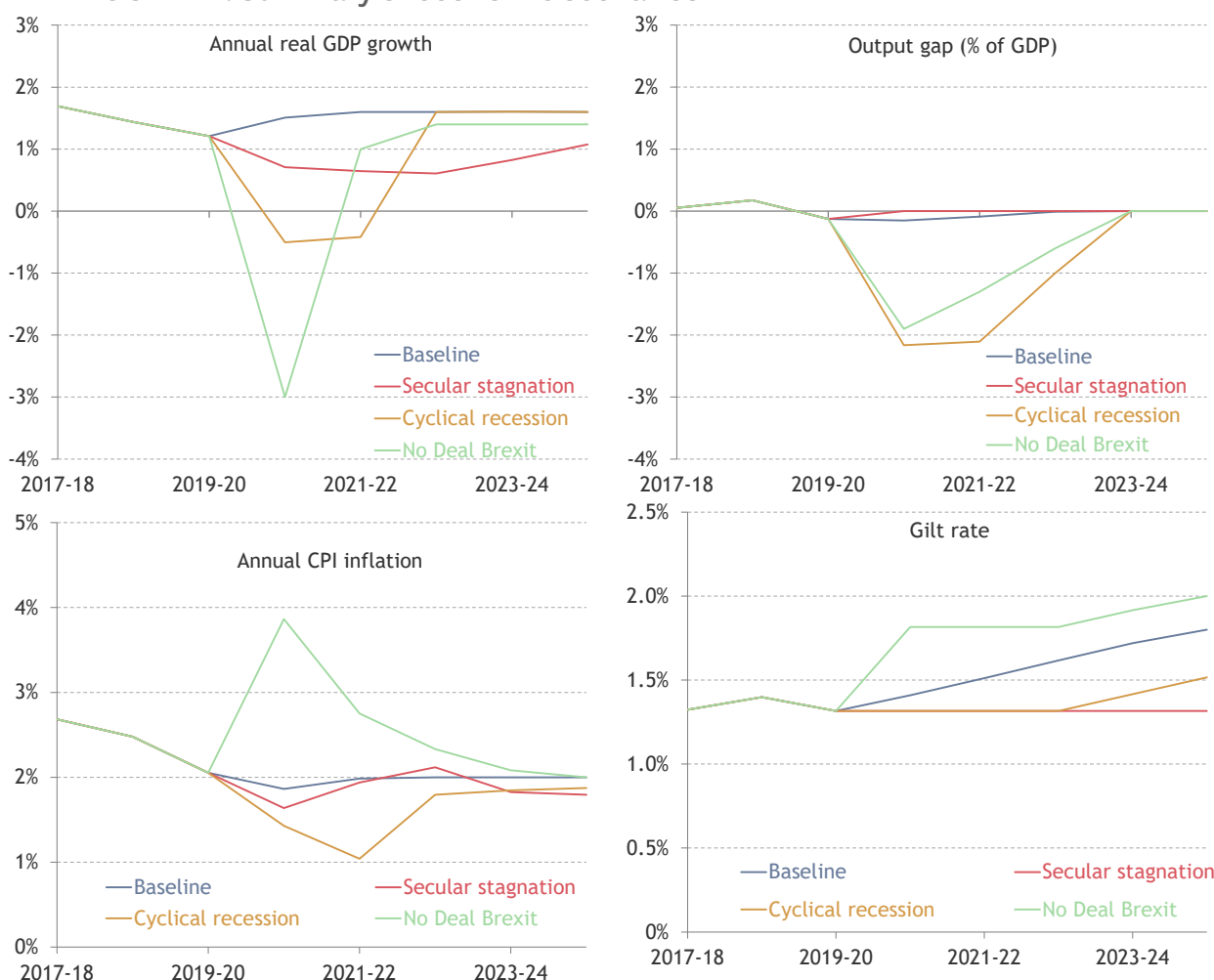
Table 1 and Figure 24 provide a summary of the key economic parameters in each scenario, and we consider how our rules perform in each instance in turn below.

TABLE 1: Summary of economic outturns for scenarios

	Baseline	Scenario outturn (2020-21)		
	forecast	Secular stagnation	Cyclical recession	No Deal Brexit
Real GDP growth	1.5%	0.7%	-0.5%	-3%
Output gap (% of GDP)	-0.2%	0%	-2.2%	-1.9%
Consumer price inflation	1.9%	1.6%	1.4%	3.9%
Unemployment (thousands)	1,350	1,360	1,810	1,950
Average effective gilt rate	1.4%	1.3%	1.3%	1.8%
Exchange rate (\$/£)	1.3	1.3	1.2	1.1

NOTES: Scenario outturns are either taken directly from original sources or are based on RF calculations designed to ensure consistency with the source scenario data and narrative.
SOURCE: RF calculations based on ONS, Bank of England, and OBR.

FIGURE 24: Summary of economic scenarios



NOTES: Scenario outturns are either taken directly from the original sources or are based on RF calculations designed to ensure consistency with the scenario data and narrative. Gilt rate is defined as the effective average gilt rate of the outstanding government debt. Years correspond to gov. financial year.
SOURCE: RF calculations based on ONS, Bank of England, and OBR

Baseline scenario

The baseline scenario is taken from the OBR's most recent forecast – the March 2019 *Economic and Fiscal Outlook*. This forecast assumes that the trading relationship between the UK and EU remains unchanged until the end of 2020, and that there is then an 'orderly' transition to the new post-Brexit long-term relationship. Near-term growth is forecast to be below its long-run average of 1.2 per cent in 2019, leading to a small output gap in 2020. Employment growth is expected to be broadly in line with population growth, and the unemployment rate to stay close to 4 per cent. This is all consistent with the economy continuing to operate at around capacity with weak global growth, investment uncertainty and continued slow productivity growth representing the main economic headwinds.

The fiscal forecasts used to illustrate the proposed fiscal rules are based on the same economic forecasts, but have been updated to include three sets of supplementary information that have since been published:

- Changes to the accounting treatment of student loans, published in September 2019 by the ONS. Principally, this approach recognises that a proportion of student loan debt will not be repaid, adding £12.4bn to public sector borrowing in 2018-19.
- Improvements to estimations of depreciation also published by the ONS in September 2019. This resulted in an increase in depreciation and to small (single digit £ billions) reductions in the current balance and net worth.
- New ONS public sector balance sheet data released for the first time on 22 October 2019. This breakdown of public sector assets and liabilities has been used below to forecast net worth; though debt projections are based on those in the March 2019 *Economic and Fiscal Outlook* to maintain consistency and comparability.

The forecasts do not take into account the fiscal impact of the additional departmental spending announced in the September 2019 Spending Round or any other policy announcements since the March 2019 Spring Statement.

Secular stagnation scenario

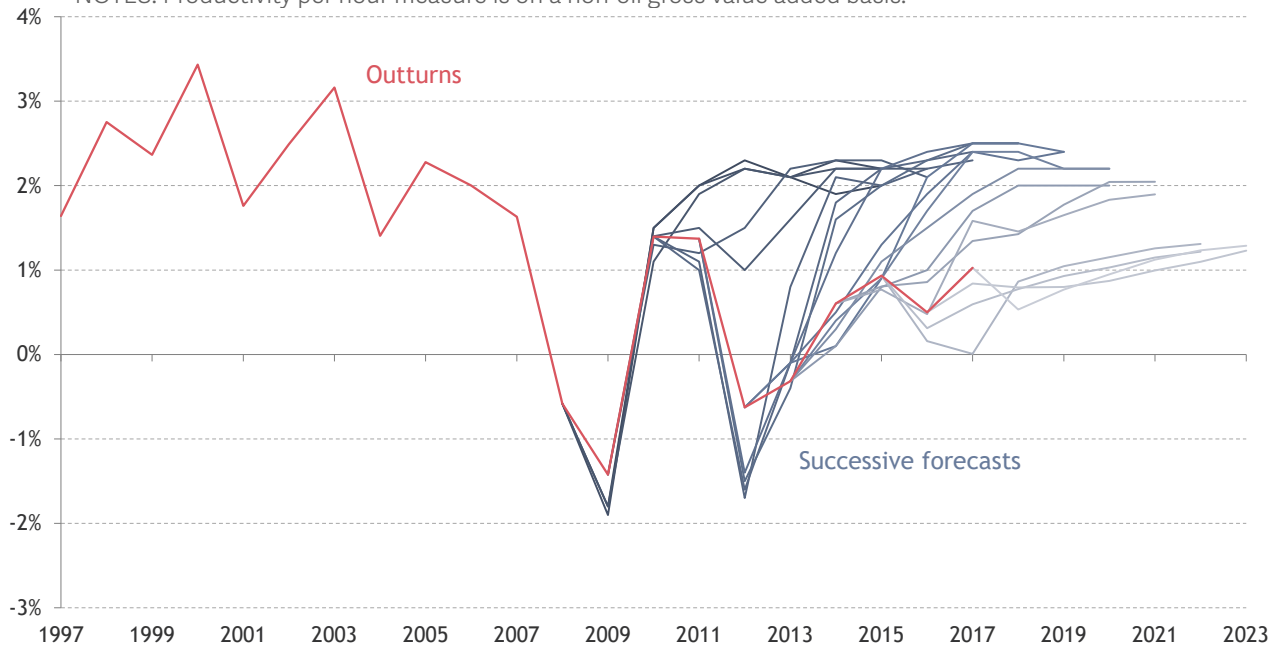
The secular stagnation scenario analyses the dynamics of the UK's public finances under a continuation of the recent low-growth, low-productivity and low interest environment. Economic forecasters, including the OBR, have repeatedly revised down growth in output and productivity since the financial crisis but continue to assume productivity growth eventually recovers albeit to levels well below its pre-crisis average (Figure 25). This scenario takes the pessimistic view that the pattern of low productivity, GDP growth,

and interest rates recorded over the past few years continues, with average annual GDP growth over the next five years of just half of the rate since 2010 (at 0.8 per cent per year). Inflation dips slightly below target in the first year, before stabilising at closer to 2 per cent. Interest rates are left unchanged, with monetary policy close to the effective lower bound.

FIGURE 25: Productivity has consistently disappointed since 2009

Annual growth in productivity per hour

NOTES: Productivity per hour measure is on a non-oil gross value added basis.



SOURCE: OBR, Historical official forecasts database

This scenario is based on the Bank of England *Biennial Exploratory Scenario* stress test in 2017, which was used to assess the viability of the UK banking system in a long-term low-growth, low-rates environment. This exercise provides a baseline for our scenario to which adjustments are applied to bring the start date of the scenario forward to 2020-21, and to add additional variables not published by the Bank of England, including employment and unemployment, consumption, and the output gap.

Cyclical recession scenario

The cyclical recession scenario captures a demand-led fall in output and is calibrated to reflect the UK’s experience of a typical cyclical downturn. The scenario assumes a shallow two-year recession before a bounce back to trend growth, but with no catch-up of the lost potential output. Inflation falls somewhat as an output gap opens up but is supported by a simultaneous fall in the exchange rate. Gilt rates fall slightly but are constrained by the zero lower bound on Bank Rate.

This scenario uses as its base the ‘real GDP growth shock’ scenario employed in the *Debt Sustainability Analysis (DSA)* included in the IMF’s 2018 Article IV report for the UK, as well as recent Resolution Foundation work on the experience of the UK economy during previous recessions.⁴⁴ Variable paths were either taken directly from the DSA, or were calculated based on the average experience in UK recessions since 1980.

The scenario is adjusted to reflect structural shifts in the UK economy over time. For example, the UK labour market has become more flexible since the 1980s and we would therefore expect to see smaller and less persistent increases in unemployment than implied by historical averages. Overall, this is a relatively mild scenario, especially when directly compared to the 2008-09 recession, not least because it also includes the comparatively shallow recession in the early 1990s.

No deal Brexit scenario

The final scenario models a recession driven by an immediate negative supply and demand shock, a plausible representation of a no deal Brexit. With the terms of the UK’s future trading relationship with the European Union subject to the outcome of ongoing Parliamentary deliberations on the Withdrawal Agreement and subsequent negotiation of a free trade agreement with the EU, the risk of a no deal exit from the EU on World Trade Organisation terms remains material. A disruptive Brexit scenario therefore remains a useful ‘stress test’ for the proposed fiscal rules.

This Brexit scenario is based on the Bank of England’s November 2018 *Report to the Treasury Select Committee on EU withdrawal scenarios and monetary and financial stability* under various Brexit outcomes. We have chosen to use the less severe of the Bank’s two ‘no deal, no transition’ scenarios, termed a ‘disruptive’ no deal Brexit. The Bank of England did not publish complete variable paths for every economic determinant needed for our forecasting model. We have therefore augmented the published data with additional variables, while maintaining consistency with the main economic aggregates.⁴⁵

In the scenario, the combined demand and supply shocks drive a large one-year contraction in output, a moderate increase in the output gap, and a longer-term slowdown in output growth. Sterling falls by 15 per cent against the US dollar, slightly larger than the fall around the EU referendum date, contributing to a material increase in consumer price inflation to 3.9 per cent at its peak in 2020-21.

The scenario used in this paper, which has real GDP falling by 3 per cent in 2020-21, is more severe than the no deal Brexit scenario used by the OBR in its 2019 Fiscal Risks Report but less severe than the ‘disorderly no deal’ scenario included in the Bank of

⁴⁴ Resolution Foundation, *Failing to plan = planning to fail*, July 2019; and Resolution Foundation, *A problem shared?*, August 2019.

⁴⁵ See Bank of England, *EU withdrawal scenarios and monetary and financial stability*, November 2018.

England's November 2018 analysis. The OBR's scenario – which itself was based on a no deal Brexit scenario included in the IMF's April 2019 *World Economic Outlook* – has real GDP falling by 2 per cent, while the Bank's 'disorderly' Brexit assumed a fall in real GDP of 8 per cent in 2020-21.

Performance of the rules under alternative scenarios

Baseline scenario

Under the baseline scenario, the structural current balance target is met and there is considerable scope for additional investment compared with the existing fiscal rules. The structural current balance reaches 1.1 per cent and net worth improves by 3.7 per cent of GDP by 2024-25, while the debt interest/revenue ratio falls slightly from 4.8 to 4.6 per cent.

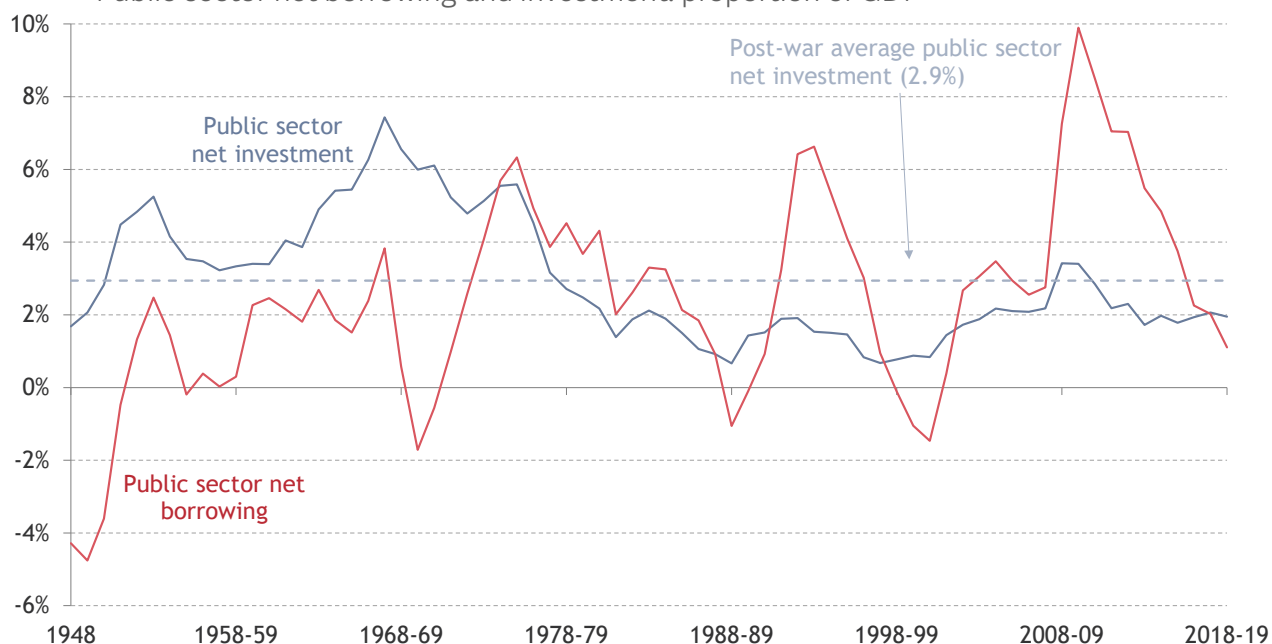
Were the government to follow the precautionary principle proposed in Box 2 and target a 1 per cent of GDP structural current surplus by 2024-25, this would offer little scope (£3.3 billion) to increase current spending or reduce taxes in 2024-25.⁴⁶ This relatively limited headroom on the current side of the budget reflects the need to retain sufficient fiscal buffers in the relatively benign current economic environment with high employment, low unemployment and moderate growth in GDP and wages. As fiscal policy will need to be more active in the next downturn, it is appropriate for the government to 'keep its powder dry' to cope with a potential negative economic shock (e.g. from a global recession).

However, the structural balance rule, net worth objective and debt interest/revenue ceiling would all allow for a significant increase in public investment as a share of GDP. There is a clear case for the government to increase investment in the current environment, especially as: (i) interest rates are low and forecast to remain so for the foreseeable future; (ii) crowding out of private investment is less likely as the current level of net private investment is so weak; and (iii) investment needs are high, as discussed below. The proposed rules would allow the government to increase net investment to the post-war average of around 3 per cent of GDP, a level not maintained since the 1970s when a number of capital-intensive industries were in government hands (Figure 26).

⁴⁶ Were the government to set fiscal policy to achieve a structural current balance in 2024-25, this would provide scope for £30 billion (1.1 per cent of GDP) in additional current spending or tax cuts. However, this would not be consistent with the need to preserve sufficient headroom to cope with future shocks.

FIGURE 26: Government investment is below the post-war average

Public sector net borrowing and investment: proportion of GDP



NOTES: Data is based on government fiscal years rather than calendar years, except before 1955.

SOURCE: OBR, *Public Finances Databank*

By contrast, the government's current fiscal rules offer some fiscal space for investment in the near-term but limited and potentially negative fiscal space in the medium-term. Following the recent changes to the accounting treatment of student loans, headroom against the 2 per cent of GDP target for cyclically adjusted borrowing in 2020-21 stands at £8 billion (0.4 per cent of GDP). As shown in Figure 2, accounting for additional borrowing above forecast since March this year and the additional spending commitments in the 2019 Spending Round, leaves no headroom against this target.

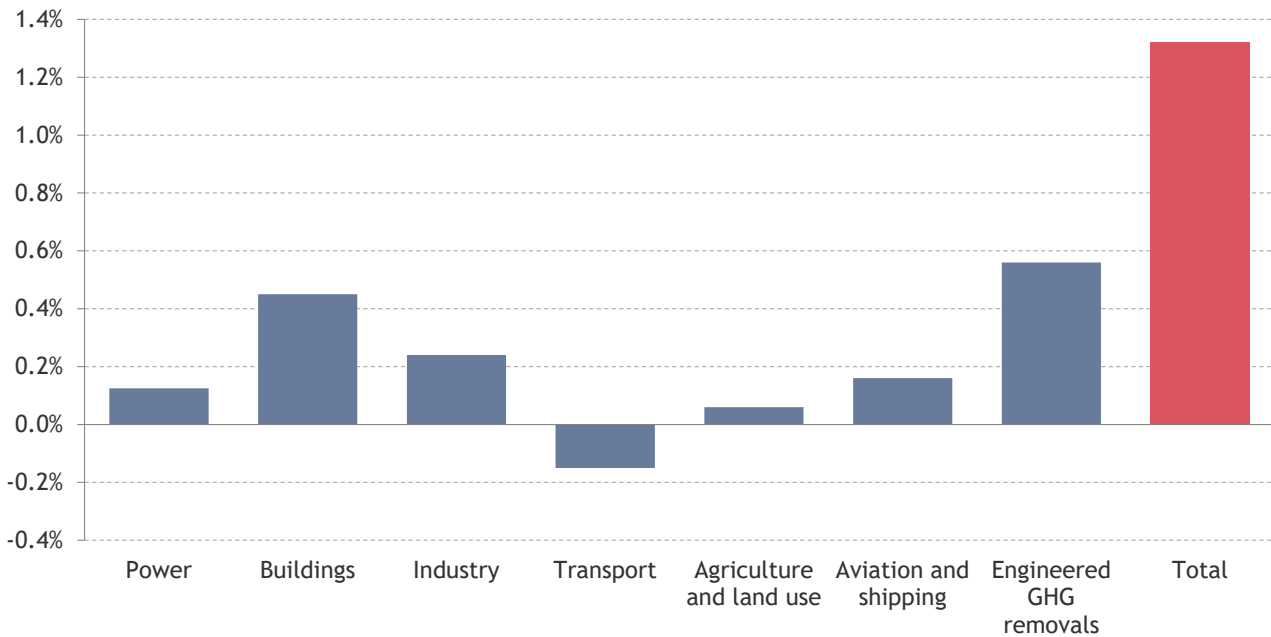
Headroom against debt falling as a proportion of GDP, the government's second fiscal rule, is much larger at £75bn in 2020-21. However, nearly two-thirds of the fall in debt in that year is attributable to the one-off redemption of illiquid assets held in the Bank of England's Term Funding Scheme, which raises £51.1bn in cash in 2020-21 and £70.3bn in 2021-22. After 2021-22, keeping debt on a declining trajectory becomes much more challenging, with the debt-to-GDP ratio falling by only around 1 percentage point (£24-26 billion) per year. And the government has negative headroom against its longer-term fiscal objective of balancing the budget by the mid-2020s, with a projected deficit of £29 billion (1.1 per cent of GDP) in 2024-25.

The fiscal space afforded by the proposed rules would enable the government to use fiscal policy to tackle a number of the most important economic, environmental, and social challenges facing the UK and other advanced economies over the next decade. This could include, for example, additional investment to address the issue of climate

change. Estimates of the annual (public and private) cost of avoiding catastrophic climate change range from 1 to 2 per cent of global GDP per year, depending on the level of ambition in reducing greenhouse gas emissions (Figure 27).⁴⁷

FIGURE 27: Achieving net zero carbon emissions will require investment across the economy

Central estimates for annual resource cost of meeting a net-zero greenhouse gas (GHG) emissions target by sector in the UK: proportion of GDP, 2050



NOTES: Estimates shown are based on the investment costs plus ongoing upkeep net of the savings (for example as a result of increased full efficiency) from the emissions reduction technology/approach. This means that these do not represent costs to the government, rather an estimate of the resources required in the economy to reach net-zero emissions. These estimates are also gross of the economic costs of climate change. See the source report for full details.

SOURCE: Committee on Climate Change, *Net Zero: The UK's contribution to stopping global warming*, May 2019

While these costs sound daunting, they need to be compared against an estimated ½ per cent to 2 per cent of global GDP per year in economic costs of taking no further action to reduce greenhouse gas emissions.⁴⁸ The proposed fiscal framework could accommodate an additional 2 per of GDP in investment in environmental research, rollout of energy-efficient technologies, and low-carbon energy generation which would also be broadly neutral for the structural current balance and net worth, and only increase the debt interest/revenue ratio from 4.8 per cent to 5.0 per cent of GDP by 2024-25.

As discussed above, the rules build-in significant flexibility in the form of target ranges, cyclical adjustment, and an escape clause in the event of a significant economic downturn. A serial weakness of past UK fiscal policy has been a failure to retain sufficient

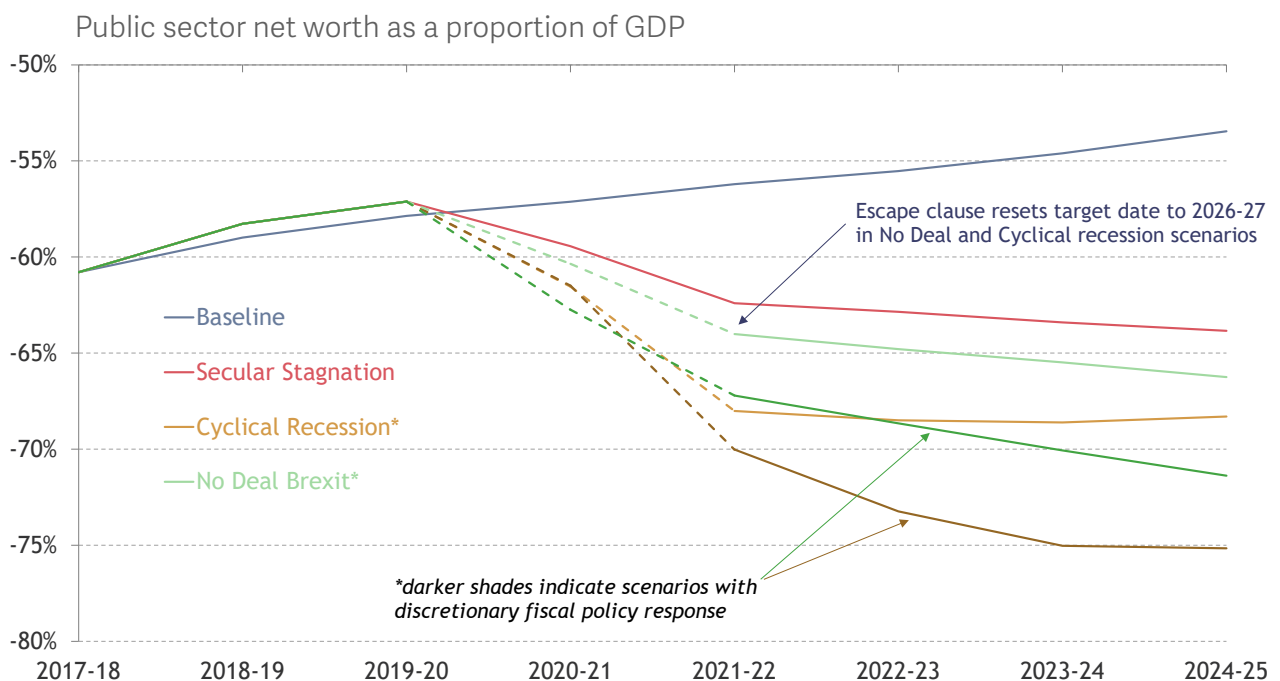
⁴⁷ Stern Review and Committee on Climate Change

⁴⁸ OBR *Fiscal Risks Report 2019*

fiscal space to both absorb but also counteract the inevitable shocks to the UK macro-economy and public finances. This flexibility to provide support to the economy in these circumstances is all the more important today, given the limited scope for further monetary stimulus, weakening of the automatic fiscal stabilisers, and heightened vulnerability of low-income households.⁴⁹

The three ‘stress test’ scenarios explore the implications of the different kinds of economic shocks for the performance of the rules and illustrate the scope for fiscal activism afforded by the proposed rules by comparison with the current rules under each of these scenarios. Depending on the scenarios, these responses can include both a loosening of the fiscal stance to cope with temporary shocks to demand and supply or a tightening of the fiscal stance to cope with permanent shocks to potential GDP growth. The impact of the shocks themselves and the fiscal policy response for the three proposed fiscal rules over the next five years are shown in Figure 28, Figure 29, and Figure 30. The fiscal policy responses envisaged under each scenario are discussed below.

FIGURE 28: Net worth declines in the first years of all scenarios

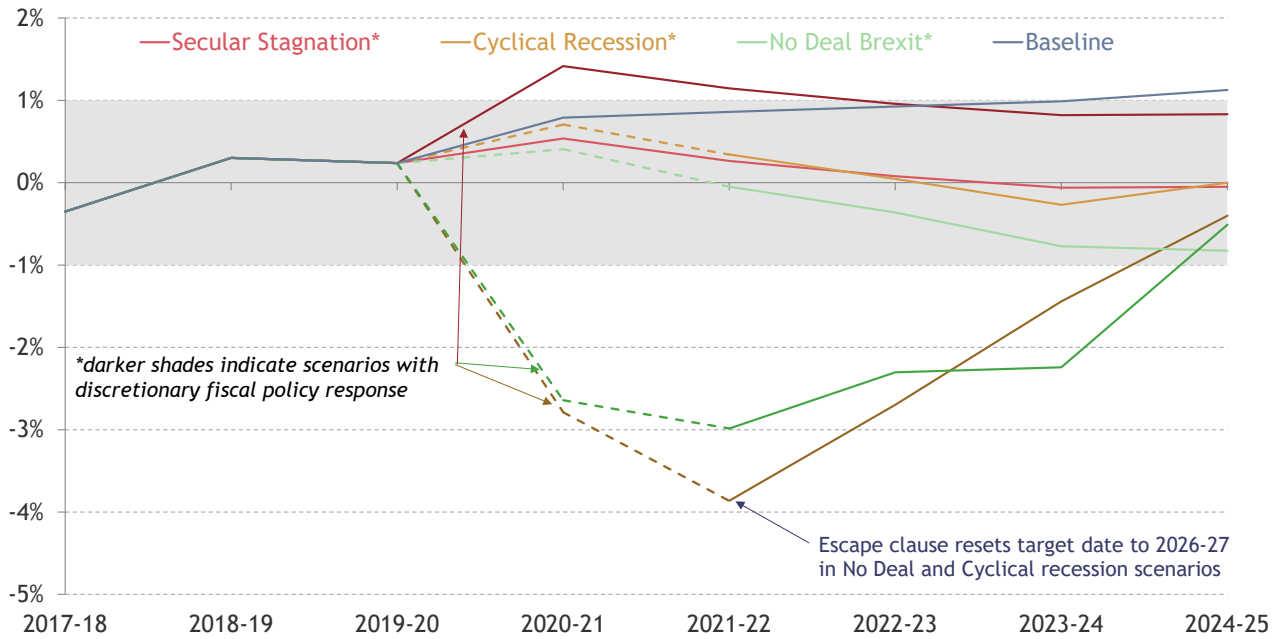


SOURCE: RF fiscal forecasting model and OBR *Economic and Fiscal Outlook*

⁴⁹ For more detail on the constraints faced by monetary policy, see: J Smith, J Leslie, C Pacitti & F Rahman, ‘Recession ready?: Assessing the UK’s macroeconomic framework, Resolution Foundation’, September 2019

FIGURE 29: Fiscal stimulus packages require additional borrowing in the aftermath of shocks

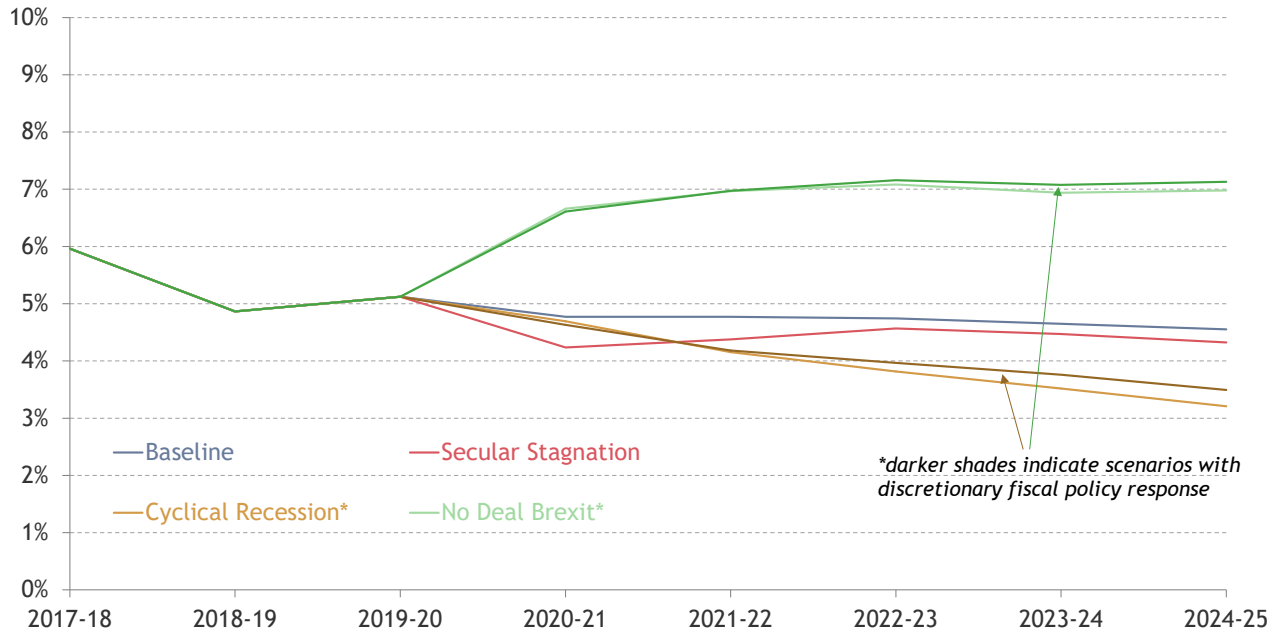
Cyclically adjusted operating balance as a proportion of GDP



NOTES: The secular stagnation discretionary fiscal policy response is a simple non-dynamic estimate of the operating balance needed in each year to achieve a growing net worth over the five year horizon.
 SOURCE: RF fiscal forecasting model and OBR *Economic and Fiscal Outlook*

FIGURE 30: Debt service rule is not broken in any scenario

Debt service to revenue ratio



SOURCE: RF fiscal forecasting model and OBR *Economic and Fiscal Outlook*

Secular stagnation scenario

In a scenario of continued secular stagnation, with slow real GDP growth and Bank Rate remaining at 0.75 per cent, all of the existing rules and one of the three proposed fiscal rules would be broken in the absence of a policy change. Lower tax receipts cause cyclically adjusted borrowing and debt to rise as a proportion of stagnating GDP, breaking both of the government's current fiscal rules by 2022-23 and causing net worth to decline by 4.4 per cent of GDP between 2020-21 and 2024-25. However, the structural current balance target and debt interest/revenue ceiling continue to be met with £24 billion of headroom and £54 billion of headroom respectively in 2024-25. Moreover, debt interest/revenue decreases against the baseline as conditions of low growth and low rates keep debt servicing costs low. Given the output gap in the secular stagnation scenario remains around zero, the escape clause is not triggered in this scenario.

As might be expected in the face of a permanent shock to potential GDP, the proposed fiscal rules require policy makers to adjust fiscal policy to the conditions of secular stagnation to preserve net worth over the medium-term. Reductions in current spending or increases in taxes of £20 billion (0.9 per cent of GDP) per year by 2024-25 would likely be needed in the absence of a recovery in growth prospects. However, the proposed framework would also allow and encourage increases in investment which could both increase net worth (thanks to lower costs of borrowing) as well as bolster growth and productivity. This is in contrast to previous debt rules which have incentivised cuts to investment spending during times of acute or chronic economic and fiscal stress.

By way of illustration, the proposed fiscal framework would allow for a step-change in investment in the infrastructure that could support the long-term productive potential of the UK economy. The G-20's Global Infrastructure Hub estimated the country's additional long-run infrastructure needs at £148 billion over the next 24 years, or around £6 billion (0.3 per cent) annually.⁵⁰ A recent McKinsey report estimated that closing the gap between the UK's current levels of public and private infrastructure investment of 2.2 per cent and the global average of 3.5 per cent of GDP would cost around £30 billion (1.3 per cent of GDP) per year.⁵¹

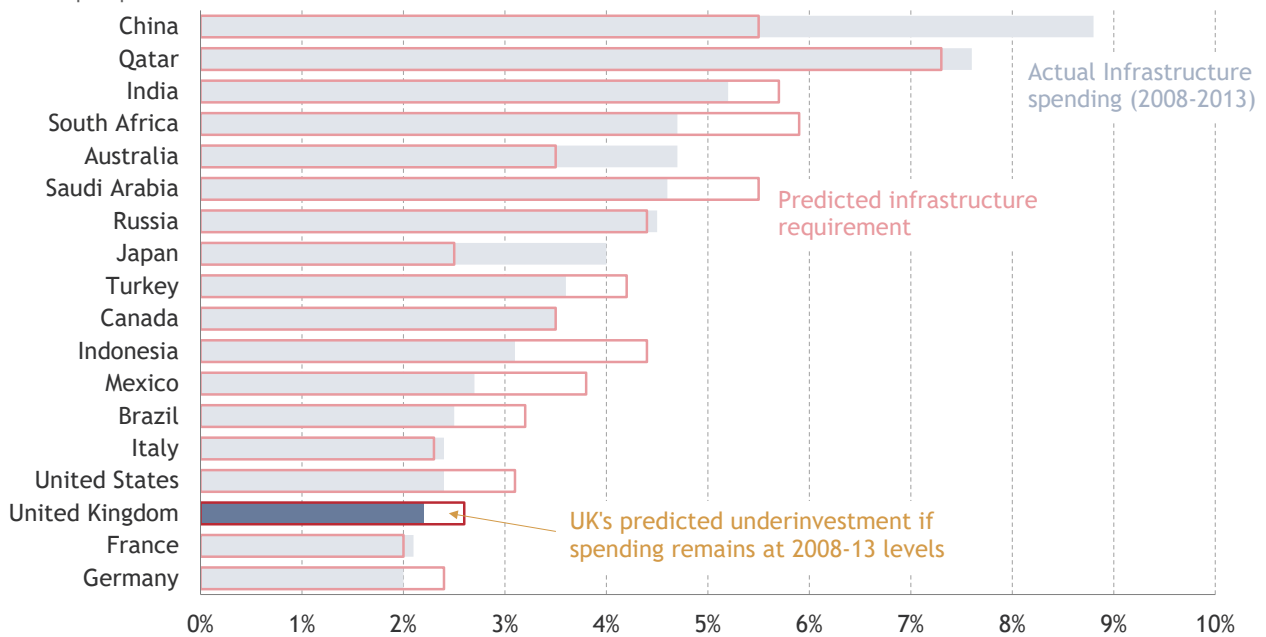
Closing either of these sizeable infrastructure gaps through greater public investment would be possible within the proposed fiscal frameworks because the borrowing required to finance the additional investment would not increase the structural current balance, be broadly neutral for net worth, and increase the debt interest to revenue ratio marginally from 4.3 to 4.6 per cent of GDP by 2024-25.

⁵⁰ United Kingdom Country Profile, Global Infrastructure Outlook, Global Infrastructure Hub, 2016.

⁵¹ McKinsey Global Institute (2016), *Bridging Global Infrastructure Gaps*, June

FIGURE 31: The UK needs to increase infrastructure in the coming decades

Infrastructure spending versus estimated infrastructure needs (2016–30) as a proportion of GDP



SOURCE: McKinsey Global Institute, Bridging Global Infrastructure Gaps, June 2016

Cyclical recession scenario

In the cyclical recession scenario, all three of the government’s current fiscal rules would be broken, leaving the government’s fiscal policy unmoored. PSND rises in every year from 2020-21, and cyclically adjusted PSNB approaches the 2 per cent of GDP target in 2021-22 before rising above it for the rest of the forecast. The prospect of returning the public finances to overall balance becomes even more remote. While the escape clause in the current Charter might be invoked, it is unlikely that any of the rules could be reinstated during the forecast period.

By contrast, the escape clause and built-in flexibility of our proposed rules provide significant scope for fiscal policy to support the economy during the downturn before guiding fiscal policy back to a more balanced position. Under our proposed rules, the escape clause would be triggered for two years from 2020-21, with the output gap reaching -2.2 per cent in 2020-21 and staying at -2.1 per cent in 2021-22.

In the absence of any discretionary policy response, the output gap would fall below -1 per cent of GDP and both the net worth and structural current balance rules re-introduced in 2022-23 would be met by the end of the forecast horizon in 2024-25. That would be two years earlier than the new deadlines set by the reinstated rules. Net worth rises as a proportion of GDP by 0.2 per cent from 2022-23 to 2024-25, while the cyclically adjusted current balance remains between £17.5 and £25 billion (0.7 per cent to 1 per cent

of GDP) above the lower end of the range of the rule in every year from 2022-23 to 2024-25.

However, as Bank rate is also below 1.5 per cent, both the structural current balance and net worth rules would be suspended, offering significant scope for discretionary fiscal policy to support demand. While the debt interest/revenue rule remains in place, headroom against the 10 per cent ceiling actually increases as falling interest rates reduce the ratio from 5.1 per cent in 2019-20 to 3.2 per cent by 2024-25. This results in headroom of £44 billion in the first year of the recession, rising to £63 billion (£10 billion more than in the baseline scenario) by 2024-25.

This provides considerable fiscal space to implement a discretionary fiscal stimulus package in 2020-21 and 2021-22. For illustrative purposes, we assume a 'textbook' fiscal stimulus combining a timely, targeted, and temporary increase in public investment, support for households exposed to falls in their income through increased welfare payments, a small cut in VAT, and other typical demand stimulus measures.

This package, illustrated in Figure 28, Figure 29 and Figure 30, is designed to fill the output gap in the first year of the shock and then smooth the path of GDP growth in subsequent years – taking advantage of the five-year horizon for meeting the rules after the shock has abated. The package would require additional borrowing of around £50 billion in each of the first two years, which is then gradually withdrawn to an additional £10 billion of borrowing in the final year of the forecast.

Naturally, this additional borrowing for tax cuts and current spending worsens both PSNW and the cyclically adjusted current balance in the near-term, as allowed under the escape clause. As the rules come back into force in 2022-23, they provide a guide to the appropriate rate of fiscal consolidation, particularly the constraint that net worth must be increasing over the following five years. The consolidation required to meet the net worth target would be equal to £24 billion (1 per cent of GDP) in 2025-26 and 2026-27.

The clear advantage of this approach is that five-year horizon for meeting the rules once they are reintroduced ensures that the government maintains a credible and responsible long-term fiscal position while recognising the potential need for fiscal policy to support economic activity for an extended period while monetary policy is constrained.

No deal Brexit scenario

In a no deal Brexit based on the Bank of England's November 2018 'disruptive' scenario, both of the current fiscal rules are broken by the end of the forecast period. The debt falling rule is immediately broken as PSND rises by 2.1 percent of GDP in 2020-21 and then oscillates around 84 to 88 per cent of GDP for the remainder of the forecast. The

fact that much of the initial shock is to aggregate demand preserves £2.8 billion of the government's £26 billion of headroom against its 2 per cent of GDP structural deficit target in 2020-21. However, as the supply shock works its way through the economy, cyclically adjusted borrowing increases above 2 per cent from 2021-22 onwards as lower domestic receipts and higher interest costs more than offset the additional customs revenues collected on EU and global trade.

Under our proposed fiscal rules, the escape clause would be triggered for two years as the output gap widens to -1.9 per cent in 2020-21 and -1.3 percent of GDP in 2021-22. Net worth falls as a proportion of GDP from 2020-21 onwards, primarily due to the impact of imported inflation on index-linked debt. The structural current balance falls to -0.8 per cent of GDP but never breaches the lower bound of -1 per cent of GDP. The debt interest/revenue rule remains in force and would continue to be met despite the ratio rising by 2 per cent to stabilise at 7 per cent from 2021-22 onwards, leaving around £26 to £29 billion of headroom in each year of the forecast.

Taking account of the two-year suspension of the first two rules in the aftermath of a no deal Brexit, all three rules are therefore on track to be met under this scenario in the absence of any policy response. Moreover, the triggering of the escape clause offers the government significant but temporary scope to use discretionary fiscal policy space to smooth the transition to a no deal Brexit. At the same time, the steady deterioration in the current balance and only marginal improvement in net worth point to a need for fiscal policy to adjust to a permanently smaller and slower growing economy and higher long-run interest rates.

A previous report from the Resolution Foundation's Macroeconomic Policy Unit, *Dealing with no deal*, provided in-depth analysis of how the government should respond to the unique scenario of a no deal Brexit, and included an indicative targeted fiscal stimulus package.⁵² The proposed stimulus package amounted to £60 billion of additional borrowing in 2020-21, broken down into: £40 billion of direct demand stimulus (VAT cut, benefit uprating and additional capital investment); £20 billion of government guaranteed emergency loans to firms affected by border disruption; and a further £50 billion in government guaranteed loans to firms to facilitate the economy's transition to its new trading position.⁵³

The package is phased out as growth returns to the economy in 2021-22. This is done gradually, so as to prevent the withdrawal of fiscal stimulus inhibiting the economic recovery. The final year of the forecast incorporates a further fiscal consolidation which

⁵² See R Hughes, J Leslie, C Pacitti & J Smith, 'Dealing with no deal: Understanding the policy response to leaving the EU without a formal agreement', Resolution Foundation, September 2019

⁵³ A conservative default rate of 30% is assumed for both loan packages. This means the 'cost' to government finances is estimated at around £5 billion for the emergency loans and around £15 billion for the transitional loans.

brings the cyclically adjusted current balance back to close to zero. Once the shock has abated, further consolidation of £70 billion over the subsequent five years (only three of which appear in the forecast) is needed to meet the net worth objective.⁵⁴ This is needed because a negative supply shock like a disruptive Brexit reduces both the size and potential growth rate of the economy, requiring a long-term reduction in borrowing to ensure fiscal sustainability.

⁵⁴ £30 billion of this consolidation is included in the final year of the scenario. The additional £40 billion adjustment would be needed over the subsequent two years.

Section 5

Conclusion

Over the past two decades, the UK used fiscal rules to try to constrain fiscal profligacy during a period of unprecedented economic stability and to consolidate the fiscal position following a period of unprecedented economic turbulence. The next generation of rules will need to guide fiscal policy through a period of unprecedented economic uncertainty and challenges. This requires a new and different set of rules which build in greater scope for fiscal policy to respond actively to economic shocks without undermining the framework as a whole or jeopardising long-term fiscal sustainability. It also calls for a set of rules which take advantage of historically low borrowing costs and improvements in our understanding of the government balance sheet to enable fiscal policy to respond to the long-term challenges of slow growth, climate change, and a changing economic relationship with Europe and the rest of the world.

The three fiscal rules and wider framework proposed in this paper respond to these requirements, opportunities, and challenges while also learning the lessons from UK and international experience. Taking each in turn:

- the **net worth objective** allows the government to borrow to invest in meeting the long-term challenges of restarting productivity growth, tackling climate change, and modernising our public service infrastructure while increasing public value over the next five years. However, unlike past fiscal frameworks which entirely excluded investment from the rules, it holds governments to account for the value of the assets created using ONS's latest statistical data on public sector assets and liabilities. It also eliminates the fiscal illusions associated with concessional loans or asset sales under the current borrowing and debt rules and forces the government to confront its significant and growing non-debt liabilities in the form of unfunded public sector pensions;
- the **structural current balance target** of +/-1 per cent of GDP ensures that tax revenues are sufficient to broadly cover the government day-to-day running costs over the next five years without resort to the disruptive fiscal fine-tuning associated with point targets. The cyclically adjusted nature of the target would allow the full operation of the automatic stabilisers to smooth the ups and downs of the economic cycle. And adopting the precautionary principle of always aiming for a 1 per cent of GDP current surplus when the rule is in force would incorporate a level of headroom against the lower end of the target range commensurate with

the UK's historic fiscal forecast errors. It would also compensate for the tendency for debt to increase and net worth to deteriorate during economic downturns and create policy space for fiscal policy to play a lead role in cushioning their impact on households and firms.

- the **debt interest ceiling** equal to 10 per cent of government revenue ensures that the burden that any additional borrowing places on the public finances is sustainable while requiring government to gradually adjust to any permanent changes in the interest rate, debt stock, inflation, or growth outlook. It also facilitates fiscal-monetary coordination by allowing looser fiscal policy when interest rates are low and requiring tighter fiscal policy as rates rise.
- the **escape clause**, which suspends the net worth and current balance rules while economic slack is greater than 1 per cent of GDP and Bank Rate below 1.5 per cent allows discretionary fiscal policy to provide more active and sustained support to households and businesses during economic downturns without abandoning the rules altogether. This is reinforced by the continuous operation of the debt interest ceiling even when the net worth and structural balance targets are suspended. And resetting the 5-year timeframe of the two rules once the output gap falls below 1 per cent allows fiscal policy to return gradually to a neutral setting without undermining the economic recovery.

This new fiscal framework is robust to a range of possible economic futures for the UK over the next decade.

- If economic conditions develop broadly in line with a **baseline scenario** of the OBR's most recent forecast, it gives the government the flexibility to match the global average in infrastructure spending or lead the world in investments in climate change mitigation and adaptation.
- If the economy becomes mired in a period of **secular stagnation**, it provides the same flexibility to borrow to invest in restarting growth while also requiring current spending and tax levels to adjust to diminished medium-term economic prospects.
- Under a typical **cyclical recession**, the rules enable fiscal policy to take a lead role in supporting demand while monetary policy is constrained and gradually adjust back to neutral settings as the economy returns to trend.
- In the event of a **no deal Brexit**, the rules also allow fiscal policy to play an active role in supporting both supply and demand in the near-term but require fiscal policy to adjust to a smaller and slower-growing economy in the long-run.

- In **all scenarios**, the debt interest limit ensures that the government's debt burden remains affordable at all times.

A number of elements in the proposed fiscal rules are novel and untested in this or any other country. However, the UK has long been a pioneer in the design of rules and development of leading-edge practices in fiscal policy. And if established practices in the design and implementation of fiscal rules were sufficient, we would not be on our fourth set of fiscal rules in five years.

However, there is a strong case for consulting on the proposed fiscal rules both to better understand their practical implications and build a broader and more durable consensus in favour of their objectives. This would also provide some time to resolve some of the current uncertainty around the UK's future economic relationship with Europe and the rest of the world and understand its implications for our country's economic and fiscal prospects. Once that consultation and debate on the country's fiscal objectives has taken place, the resulting rules could then be codified in legislation which commands broad and lasting parliamentary support.

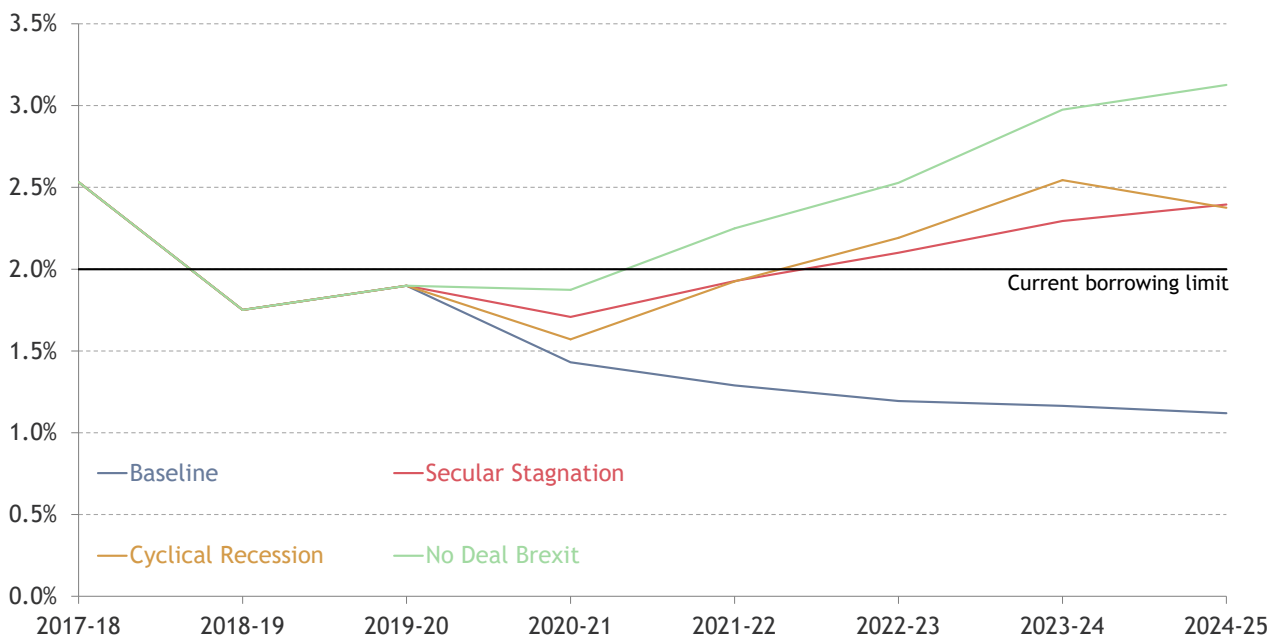
Annex

Performance of current fiscal rules under economic scenarios

Figure 32 and Figure 33 show the forecast path of cyclically-adjusted net borrowing and public sector net debt, the metrics that are used for the current set of fiscal rules, under the economic scenarios discussed in the main body of the paper.

FIGURE 32: Borrowing would rise above 2 per cent in all downturn scenarios

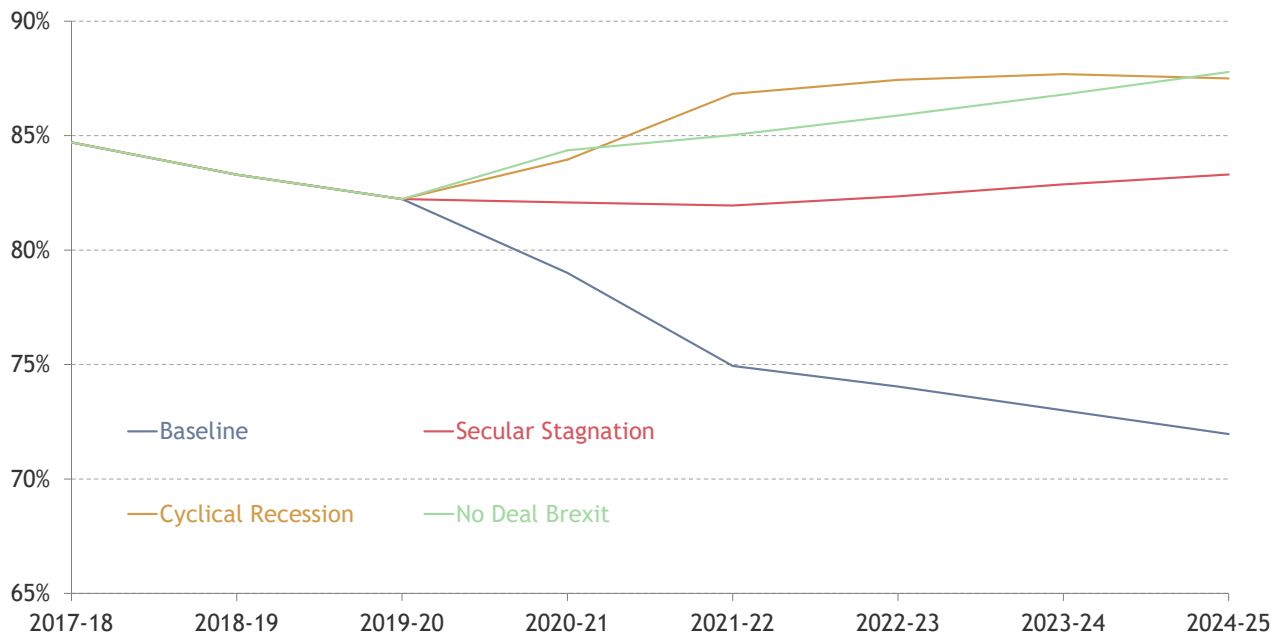
Cyclically-adjusted public sector net borrowing: proportion of GDP



SOURCE: RF fiscal forecasting model and OBR Economic and Fiscal Outlook

FIGURE 33: Debt rises from current levels in all downturn scenarios

Public sector net debt: proportion of GDP



SOURCE: RF fiscal forecasting model and OBR Economic and Fiscal Outlook

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged.

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