

3. Fiscal targets: committing to a path of budget responsibility?

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Summary

- At 80% of national income, the UK's public sector net debt is high by recent standards and relative to most advanced economies, although not particularly high in a longer-term historical context or relative to most of the largest economies.
- The Chancellor's new fiscal mandate requires a budget surplus to be achieved in all years from 2019–20 unless growth drops below 1%. Running a surplus is not necessary to bring debt down as a share of national income – that can be achieved so long as cash debt grows less quickly than national income. But, all else equal, a bigger surplus would reduce debt as a share of national income more quickly. This might provide more fiscal flexibility in the face of another recession and therefore could reduce the (perhaps remote) risk that the UK could suffer the dire consequences attendant on losing access to international capital markets.
- The first official figures showing whether or not Mr Osborne has met his target of running a surplus in 2019–20 should be published days ahead of the 2020 general election. Achieving and maintaining a consistent surplus is challenging. The UK has not had more than three years of consecutive budget surpluses since 1952. Surpluses have not been common in other large advanced economies.
- Flexibility comes from the provision to suspend the mandate if growth drops below 1%. This should be enough to accommodate most negative shocks to output. The mandate also has the advantages of being simple and transparent.
- But this simplicity comes at a significant potential cost. It can be sensible to borrow to finance beneficial investment projects that would otherwise not be undertaken; this will be especially true when interest rates are lower. Because it applies to a relatively narrow measure of borrowing, the rule may also lead politicians inappropriately to favour policies that temporarily flatter headline measures of the public finances.
- Unless a large surplus is planned, small forecasting changes could require sudden in-year tax rises or spending cuts to ensure the mandate is met. Even if we start 2019–20 with an expectation of a £10 billion surplus, previous experience suggests there would be a more than one-in-four chance that in-year tax rises or spending cuts would be needed to ensure an out-turn of any surplus at all.
- The Chancellor has also set a requirement for debt to fall as a share of national income in every year through to 2019–20, but is meeting it through selling assets. These asset sales might be sensible, but meeting the rule in this way would be contrary to its underlying principle.
- The welfare cap was intended to constrain the bulk of spending on benefits and tax credits but, less than two years after its introduction, it is already being breached. This brings into question whether it is really any constraint on policy.

3.1 Introduction

In 2010, the Labour government introduced a bill to legislate for rules to constrain the level of government borrowing and the path of debt. At the time, the then Conservative shadow Chancellor George Osborne was scathing of the idea that any government should need to tie its own hands by legislating targets for fiscal prudence:¹

We have to debate this vacuous and irrelevant legislation, but why did the Chancellor feel the compelling need to introduce it? Why is he the first Chancellor in history to feel that he needs an Act of Parliament on top of a Budget statement? There can be only two explanations: either he does not trust himself to secure sound public finances, or he knows that the public do not trust him to secure them.

But five years is a long time in politics and one of Mr Osborne's first acts as Chancellor of the first Conservative government in 18 years was to pass his own Fiscal Charter in July 2015. In presenting this to parliament, he commented:²

We should always fix the roof while the sun is shining. Today I publish the new Fiscal Charter that commits our country to that path of budget responsibility. ... It is sensible, pragmatic and it keeps Britain secure.

In this chapter, we describe the three rules that – in theory, at least – will now constrain Mr Osborne's fiscal plans. These are: the fiscal mandate, which governs the level of public borrowing; the supplementary debt rule, which governs the path of public debt over the next few years; and the welfare cap, which is designed to limit the level of spending on most spending on social security benefits and tax credits over the next five years. The supplementary debt rule and the welfare cap were both introduced in the last parliament and were discussed in the IFS Green Budgets of 2013 and 2015, respectively. We therefore devote most attention in this chapter to the newly-implemented fiscal mandate.

The fiscal mandate requires that in 'normal times' the government should always run a budget surplus. Section 3.2 discusses possible motivations for such a rule and also outlines why, in principle, a government might want to run looser fiscal policy. Section 3.3 then examines the details of the fiscal mandate more closely and considers whether it provides the flexibility to deal with the circumstances described in Section 3.2. Section 3.4 discusses the supplementary debt rule and the welfare cap. Section 3.5 concludes.

3.2 Fiscal policy principles

The Chancellor George Osborne has clearly stated that he considers public sector debt too high and that it should be reduced. In his most recent Mansion House speech, in June 2015,³ he said:

¹ Source: Hansard, 5 January 2010, column 75, <http://www.publications.parliament.uk/pa/cm200910/cmhansrd/cm100105/debtext/100105-0012.htm>.

² Chancellor George Osborne's July 2015 Budget Speech, <https://www.gov.uk/government/speeches/chancellor-george-osbornes-summer-budget-2015-speech>.

³ Mansion House Speech, 10 June 2015, <https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer>.

With our national debt unsustainably high, and with the uncertainty about what the world economy will throw at us in the coming years, we must act now to fix the roof while the sun is shining.

Rather than the cash level of public sector debt, what matters for the sustainability of the public finances is the size of debt relative to national income. This certainly cannot be allowed to increase indefinitely. But it is important to remember that it will fall as long as the cash level of debt held increases less quickly than national income: in other words, as long as the economy is growing, continuing to run deficits – and therefore continuing to add to the stock of debt in cash terms – can still be consistent with a sustainable fiscal position.

The Chancellor is, however, aiming to run overall budget surpluses, implying that he believes public sector net debt relative to the size of the economy should be reduced more quickly than would be the case if deficits were still being run. This section first asks whether the UK should be aiming to reduce public sector net debt as a share of national income and then goes on to consider whether this should be done through aiming to run overall budget surpluses.

Should the UK aim to reduce public sector net debt?

Public sector net debt is the total debt of central government and local authorities plus that of organisations deemed to be under public sector control, such as the BBC and Network Rail. It is measured net of any short-term financial assets. This means that it does not take into account the value of physical assets held by the public sector – such as buildings and the UK road network – nor does it take into account any long-term financial assets that the public sector may hold – such as repayments due on books of student loans still held by the public sector.

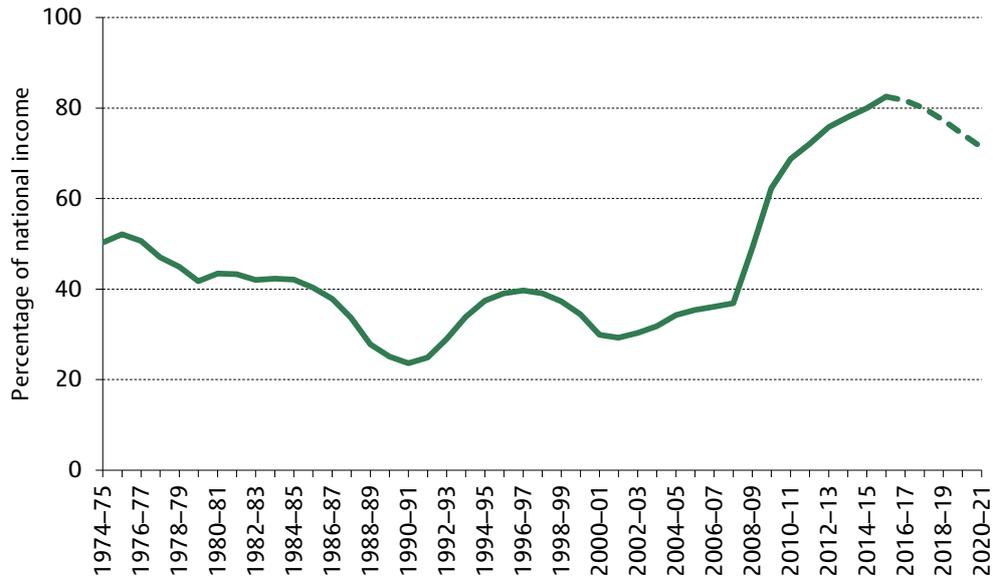
When thinking about the right level of ‘debt’ (or, related, the deficit), one should consider what a particular measure includes or excludes. Concern with the indebtedness of the public sector would ideally focus on as broad a measure of debt as possible. In practice, there is no well-defined concept of the correct broad measure of debt. However, focusing on a specific narrow definition of debt runs the risk that it might encourage the government to engage in questionable strategies that reduce the target measure of debt without actually reducing the country’s underlying indebtedness. For example, a strategy of selling off physical assets or long-term financial assets would reduce the measure of debt that the UK government typically focuses on (i.e. public sector net debt) but might not deliver the best set of outcomes for society because it would not necessarily be driven by consideration of whether public or private ownership of the assets was more desirable.

For now we focus on the official measure of public sector net debt, but Section 3.4 looks at the impact of recent and planned asset sales for the path of public sector net debt in this parliament and Chapter 4 provides a discussion of the Whole of Government Accounts, which include the public sector’s balance sheet.

Context: historical UK practice

At the end of 2014–15, public sector net debt stood at 80.0% of national income. It is forecast by the OBR to rise to 82.5% of national income by the end of 2015–16 before starting to decline so that at the end of 2019–20 it is forecast to be 74.3% of national income. As shown in Figure 3.1, this is a high level of public

Figure 3.1. Public sector net debt high by recent historical standards

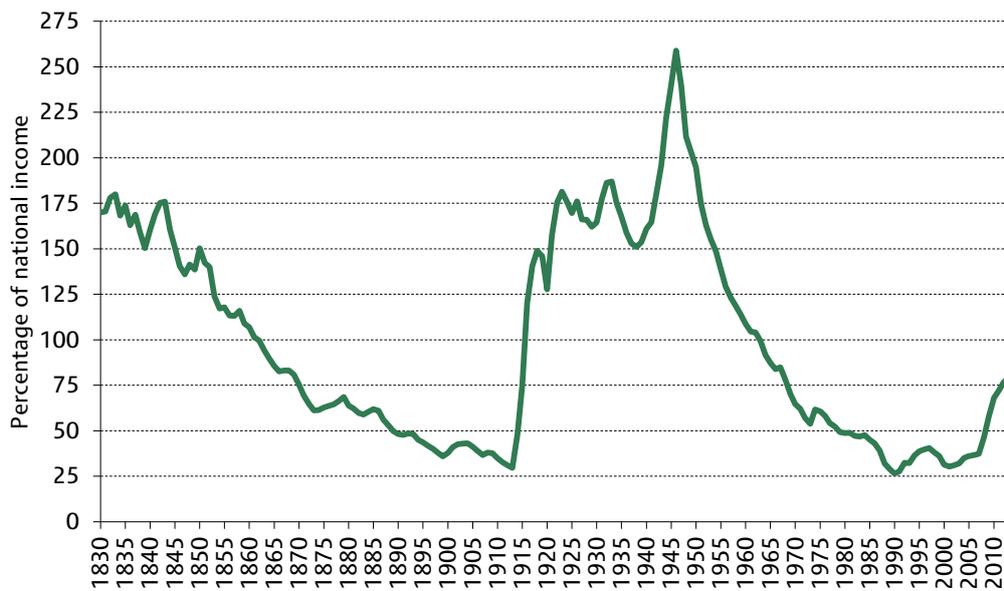


Source: Office for Budget Responsibility, 'Public finances databank', 15 January 2016, <http://budgetresponsibility.org.uk/data/>.

sector net debt relative to recent UK historical standards. The Labour governments between 1997 and 2010 had a limit on public sector net debt of 40% of national income, which they complied with until the end of 2007-08. However, the recent financial crisis and its aftermath approximately doubled debt as a share of national income, leading to this ceiling being shattered and public sector net debt in 2010 reaching its highest level for over 35 years.

However, this is not by any means the highest level of debt that the UK public sector has held. As Figure 3.2 shows (for a very slightly different measure of

Figure 3.2. Public sector net debt not that high by historical standards



Source: Figure 9 of A. Jowett and M. Hardie, 'Longer-term trends: public sector finance', November 2014, http://www.ons.gov.uk/ons/dcp171766_386187.pdf.

public sector net debt as a share of national income to enable consistent historical comparisons), debt was above 80% of national income throughout the period from 1916 to 1967, and also for all years from (at least) 1830 to 1869. Over the whole period from 1830 to 2013, UK public sector net debt has been above 80% of national income half of the time.

There are good reasons for governments to hold a positive stock of debt – for example, the borrowing may have financed productive investment projects – and a government being in debt is not in itself a cause for concern. Nonetheless, there are reasons why governments may want to limit how much debt they hold.

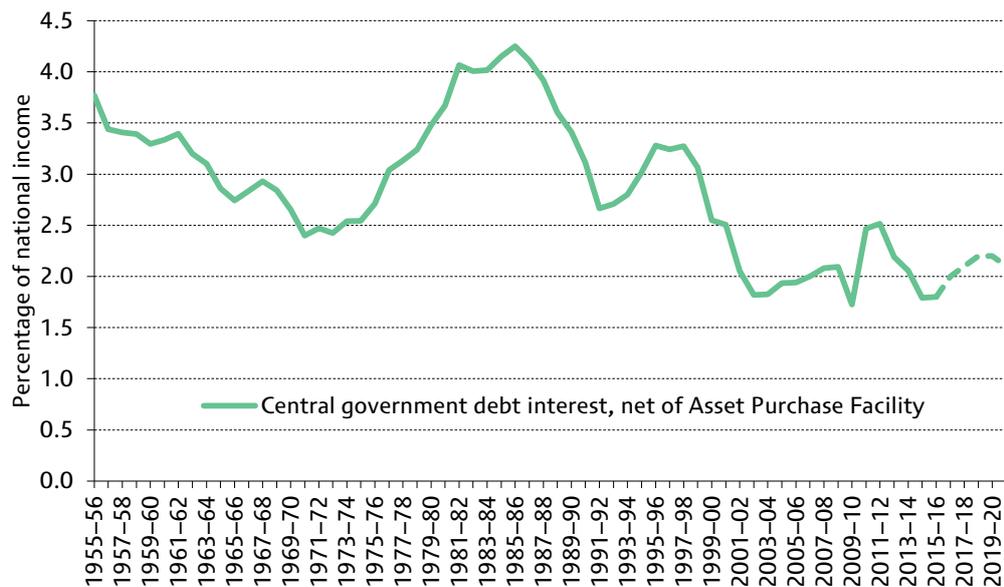
The costs of high debt

All else equal, there are two main costs of having a higher level of public sector debt. First, a higher stock of debt means that more government spending must be devoted to debt interest spending rather than spending that benefits current or future generations. How onerous this is depends on the rate of debt interest that the government must pay.

As shown in Figure 3.3, central government spending on debt interest payments has run at around 2% of national income throughout the period since 2001–02 and this is forecast to continue to be the case over the next few years, despite the high level of debt. This is a relatively low level of debt interest payments by historical standards and reflects the fact that the average interest rate being paid by the UK government has fallen over time.

The rate of debt interest payable changes over time and can be volatile. Therefore, a highly indebted country may face greater uncertainty than a less indebted country in its public finance forecasts because of potential movements in its debt interest payments. Rising interest rates and the unwinding of the Bank of England’s quantitative easing programme will increase both the cost of new borrowing and the rollover of existing government debt. To give a sense of scale of the impact of higher interest rates, a ready reckoner published by the OBR suggests that a 1 percentage point increase in gilt and short rates from April 2016 would increase debt interest spending in 2019–20 by about

Figure 3.3. UK central government debt interest payments



Source: Office for Budget Responsibility, ‘Public finances databank’, 15 January 2016, <http://budgetresponsibility.org.uk/data/>.

£8 billion.⁴ This is about 0.4% of national income or the same as is estimated to be raised by a 1.4p increase in the basic and higher rates of income tax.⁵

The second cost of a higher level of debt is that it may give governments less ‘fiscal headroom’ to adjust appropriately to shocks. If debt as a proportion of national income becomes too high, a government could lose credibility with investors and be unable to access finance. At that point, the government would be unable to respond to negative shocks with an expansionary fiscal policy, and it would be at risk of default (either through being unable to issue new borrowing to replace maturing debt or by being unable to meet debt interest payments out of tax revenues given other aspects of government spending). Even if the likelihood of this occurring is considered low, the costs would be huge.

The experience of the financial crisis and associated recession was that the UK government was able to respond by allowing public sector net debt to increase by 40% of national income (from about 40% of national income to about 80% of national income). We might worry that, if a shock of a similar magnitude struck again, the government might currently not have the option of increasing public sector net debt by as much again.

What is a desirable level of debt?

While it is relatively simple to describe the disadvantages of higher levels of debt, there is considerable uncertainty as to what constitutes a debt level that is *too high*. At what debt level would debt interest payments become too onerous or the government lose its ability to borrow any more? Unfortunately, the economic literature does not yet (though not for lack of interest or effort) provide an answer to this important question. Some models suggest that there is no need to reduce debt at all or perhaps only to do it very slowly (even if it starts at a high level), while other models suggest that – in the very long run – the government should aim to hold net assets rather than net debts.⁶

The lack of a good guide from theory means we – and indeed policymakers – can only focus on what has happened in practice. We have already shown that, at 80% of national income, the UK’s public sector net debt is very high by recent historical standards but is below average if we look much further back in time.

It is also possible to see how the UK’s debt compares with that of other similar types of countries. Table 3.1 shows data from the International Monetary Fund (IMF) for general government net debt (i.e. a narrower measure of debt than that presented above as it excludes any net debt held by the public sector outside of general government⁷) of the UK and 24 other advanced economies in 2015. The countries are listed from the largest to the smallest in terms of the size of their economy. Looking across all these countries, the UK’s current level of debt is the 7th highest out of the 25 countries. However, among the larger economies, which are arguably more comparable to the UK, the UK position does not look out of place: Germany and Canada do have considerably lower debt, but the US, Japan, France and Italy all have debt to national income ratios similar to, or higher than, that of the UK.

⁴ Fiscal supplementary table 2.28 of OBR’s November 2015 Economic and Fiscal Outlook.

⁵ See HMRC Collection, ‘Tax expenditures, reliefs and ready reckoners statistics’, <https://www.gov.uk/government/collections/tax-expenditures-and-ready-reckoners>.

⁶ See, for example, J. Portes and S. Wren-Lewis, ‘Issues in the design of fiscal policy rules’, University of Oxford, Department of Economics, Discussion Paper 704, May 2014, <http://www.economics.ox.ac.uk/materials/papers/13342/paper704.pdf>.

⁷ In the UK, general government comprises central government and local authorities.

Table 3.1. General government net debt across 25 advanced economies, 2015

	% GDP	Ranking (lowest to highest)
United States	79.9	8 th
Japan	126.0	2 nd
Germany	48.4	14 th
United Kingdom	80.3	7 th
France	89.4	5 th
Italy	113.5	4 th
Canada	37.8	15 th
Australia	17.5	20 th
South Korea	37.7	16 th
Spain	64.8	10 th
Netherlands	34.8	18 th
Switzerland	24.9	19 th
Sweden	-18.4	23 rd
Belgium	65.8	9 th
Norway	-261.7	25 th
Austria	48.7	13 th
Denmark	6.3	22 nd
Israel	63.7	11 th
Finland	-46.5	24 th
Ireland	82.4	6 th
Greece	194.1	1 st
Portugal	120.6	3 rd
New Zealand	8.8	21 st
Latvia	34.9	17 th
Iceland	50.8	12 th

Note: Countries ordered by 2014 GDP.

Source: International Monetary Fund, 'World Economic Outlook Database', October 2015, <https://www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx>.

Of course, many of these countries have, like the UK, experienced a sharp increase in government debt in recent years. So the current level of debt is, for many, in part caused by the shock of the global financial crisis. Out of 25 countries, only Norway, Switzerland and Sweden reduced debt as a percentage of national income between 2007 and 2015. The others all increased debt, in some cases considerably. So the UK's current debt level would look higher relative to the debt levels held in many economies prior to the crisis unfolding.

The problem for policymakers is that it is not possible to say with any precision either what is an optimal or what is a 'safe' level of debt when it comes to financing risk. What we do know is that the consequences of losing investor confidence and access to international markets are extremely severe. Given the uncertainty and the, even remote, possibility of dire consequences, it is perhaps not surprising that governments are looking to reduce current high levels of debt. There is little guidance, either theoretical or empirical, as to how fast they should be doing that. The costs of doing so in terms of lower public spending or higher taxes may be relatively clear. The benefits in terms of lower risk are uncertain and possibly not measurable at all.

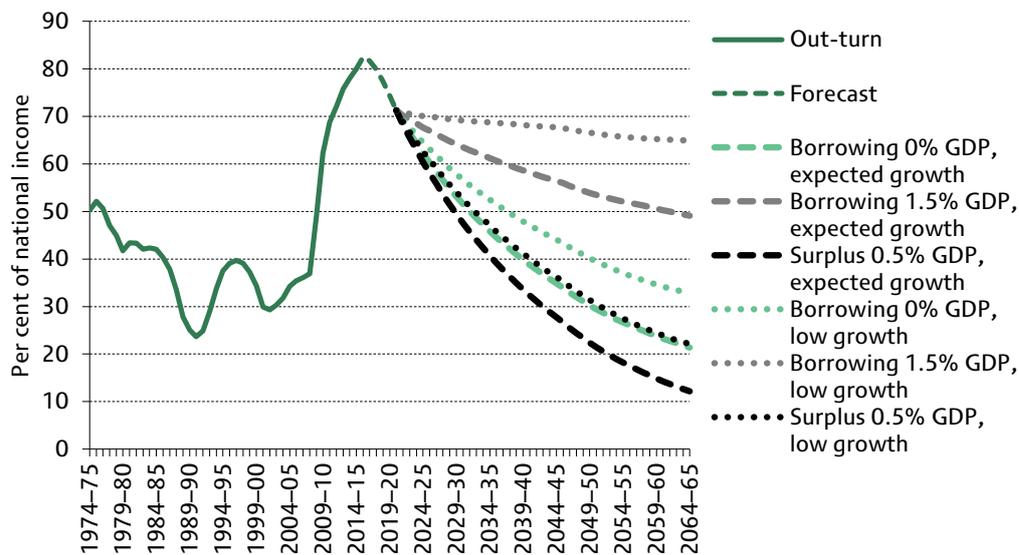
The implications of borrowing levels for debt

If having lower borrowing or achieving a surplus did not lead to weaker economic growth, debt would fall more quickly as a share of national income than if borrowing were higher. Figure 3.4 presents projections for public sector net debt under three different scenarios for annual borrowing and two different scenarios ('expected' and 'low') for growth. Assuming that the path of national income develops as the OBR expects – where the economy grows by 2½% a year – and assuming that this is unaffected by the level of government borrowing, running a balanced budget from 2021–22 onwards would return debt to below 40% of national income in 2040 (the dashed light green line). If instead the government pursued a less austere policy path – for example, choosing to borrow to invest (around 1½% of national income, say) – and growth was unchanged, debt would only be just below 60% of national income by this date (the dashed grey line), while a more austere 0.5% of national income surplus would reduce debt to below 35% of national income (the dashed black line).

As set out above, one rationale for striving to reduce debt is to allow greater headroom to accommodate the possibility of a less favourable economic environment. The alternative, 'low growth', scenarios have higher levels of debt persisting for longer. These assume that the economy grows at 1½% per year (as opposed to 2½% a year under the 'expected growth' scenario). This scenario, combined with a balanced budget, would lead to debt being projected to remain above 40% of national income until 2050. But under this low-growth scenario combined with deficits of 1.5% of national income, debt would still be above 65% of national income in 2050.

History suggests that, rather than experiencing decades of uninterrupted economic growth (as the lines in Figure 3.4 assume), the UK economy instead periodically experiences adverse shocks that lead to sudden increases in debt as a share of national

Figure 3.4. Projections of public sector net debt under different illustrative scenarios for borrowing and growth



Note: 'Expected growth' scenario based on OBR growth projection; 'low growth' scenario based on 1.5% real GDP growth a year. Addition to debt each year calculated as Public sector net borrowing (PSNB) + OBR forecast of non-PSNB changes to public sector net debt.

Source: OBR Fiscal Sustainability Report 2015, Economic and Fiscal Outlook November 2015, financial transactions series December 2015, Public Finances Databank (15 January 2016) and authors' calculations.

income. The recent financial crisis was a particularly dramatic – but perhaps rare – example of this. However, other shocks from the not too distant past have also added significantly to public sector net debt: for example, the recession of the early 1990s saw public sector net debt increase by roughly 15% of national income (it had fallen to 23.6% of national income in 1990–91 but increased to 39.1% of national income by 1995–96).

The Treasury has attempted to illustrate the potential impact of negative shocks of this sort by projecting public sector net debt in 2035, under different scenarios for the budget surplus/deficit, with and without a negative shock that adds 10% of national income to public sector net debt every eight years.⁸ Under its modelling, running deficits of 1.4% of national income, when combined with these shocks, would leave debt above 70% of national income in 2035.

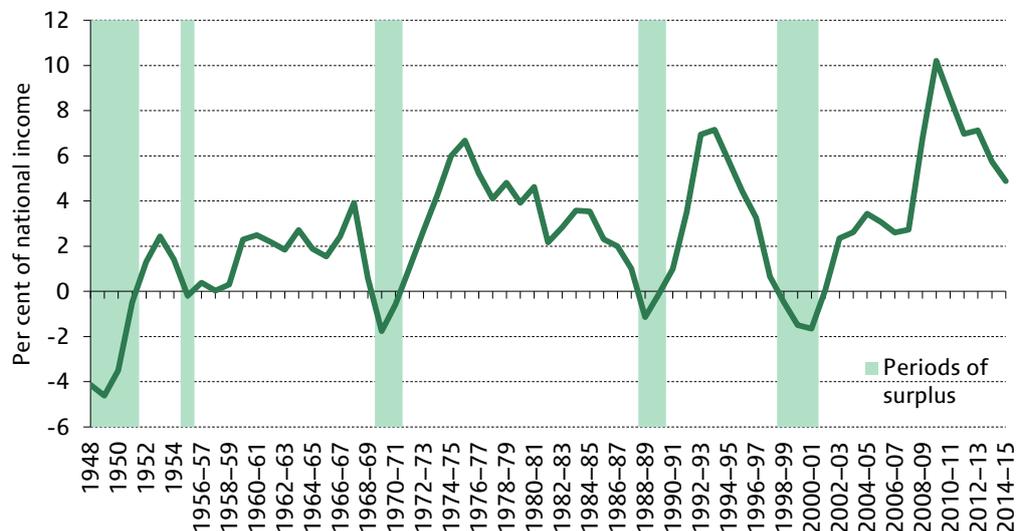
Should the UK aim to run budget surpluses?

The previous section has discussed why the government is concerned with reducing public sector net debt. In this section, we consider the desirability and suitability (or otherwise) of constraining a government to achieve a budget surplus in every year.

Context: historical UK practice

Aiming to achieve overall budget surpluses represents a departure from the rules of the previous coalition government and the Labour governments that preceded it, in that it requires total receipts to be greater than *total* spending rather than just *non-investment* (or ‘current’) spending.⁹ At a time when public sector investment spending is around 1½% of national income – around £30 billion per year – this constrains borrowing to be around £30 billion lower than a similar target applied to the current budget.

Figure 3.5. Public sector net borrowing



Source: OBR, ‘Public finances databank’, 15 January 2016, <http://budgetresponsibility.org.uk/data/>.

⁸ See chart 1.7 of HM Treasury, *Summer Budget 2015*, July 2015, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/443232/50325_Summer_Budget_15_Web_Accessible.pdf.

⁹ Operationally, Gordon Brown’s golden rule (which aimed to balance the current budget over the ups and downs of the economic cycle) and the coalition government’s fiscal mandate (which involved setting fiscal policy such that a cyclically-adjusted budget balance or surplus was forecast by the end of the forecast horizon) were different. But the underlying principle, that borrowing should be only due to investment spending or temporary weakness in the economy, was the same.

Achieving budget surpluses on a sustained basis would also represent a change from standard UK practice. As shown in Figure 3.5, budget surpluses are rare events. Ignoring the immediate post-war period, when large surpluses were run, since 1952 there have only been 8 out of 63 years in which the UK government has spent less than it has received in revenues, and it has never done so for more than three consecutive years.

Potential justifications for running a deficit

It is clear the UK has not often delivered a fiscal position where total tax and non-tax receipts are greater than total public spending. In previous Green Budgets, we have identified five broad reasons why running a deficit (or at least relatively looser fiscal policy) might be justified:

Investment spending: Governments should invest in a project if the expected net return (i.e. after taking into account the cost of financing) is positive. Investment spending often benefits future generations as much as, if not more than, the current generation. This is both because investment can generate economic growth and because it often takes a long time to receive all the benefits. Governments that are unable to borrow must finance all investment out of current receipts, whereas borrowing shares the cost across generations. If the benefit to the current generation does not outweigh the initial cost, highly beneficial investment projects may be refused when governments are unable to borrow.

The expected net return of an investment project depends on the cost of financing. When the cost of financing is low, it may be beneficial to pursue more investment projects. If, for example, long-term interest rates were very low (as they currently are), more projects would have a positive expected net return. In some cases, this could even be a net positive *financial* return, and it would seem particularly odd not to invest in such projects if the motivation is to improve the financial health of the nation (see Chapter 7 for a discussion of financing infrastructure spending). If governments are unable to borrow (because they are constrained to run surpluses), investment spending will not adjust to take advantage of a lower cost of debt (except in as far as debt interest payments fall as a result). Spending must instead be financed by current receipts and so governments may borrow less than is optimal. More generally, the optimal amount of borrowing depends on the price of that borrowing.¹⁰

These arguments imply that – if the cost of borrowing from the markets is lower than the cost of raising additional tax revenues – allowing more deficit spending should facilitate higher investment. That said, the actual correlation between the headline deficit (or surplus) and public sector net investment spending (both measured as a share of national income in the UK) over the last 60 years (1955–56 to 2014–15) is very low, at just +0.02, suggesting that periods with more borrowing have not particularly been periods with more investment spending.

In large part, this is because the period between the mid 1950s and the mid 1970s had relatively high levels of public sector net investment and not particularly high levels of borrowing. Restricting the data to the most recent 41 years (1974–75 to 2014–15) reveals a much stronger positive correlation of +0.60. Moreover, over this period, the correlation between the size of the estimated structural deficit (or surplus) and the level of public sector net investment is even stronger (at +0.71), suggesting that, after

¹⁰ Putting such a principle into practice may be hard. The 2013 IFS Green Budget discussed one way in which a government might target the future flow of committed funds, rather than targeting borrowing or debt.

accounting for the estimated impact of ups and downs of the economic cycle, greater borrowing has indeed been associated with higher investment spending.

Overall, the picture painted by these historical correlations is mixed and, in any case, may not provide a good guide to what would happen in future. Higher borrowing need not necessarily deliver higher investment spending. There would be no guarantee that a government might not borrow instead to deliver more current spending and/or lower taxes.

Output stabilisation: When shocks hit the economy, there are temporary reductions in tax revenues and additional demands on spending. On these occasions, the government should have flexibility in its borrowing level to respond to these shocks and help stabilise the macroeconomy. During a recession, for example, it is likely that it would be appropriate for a government to allow borrowing to rise or any surplus to fall. Attempting to maintain borrowing at its previous level, through a combination of tax rises and spending cuts, would risk worsening the recession. This is especially true when the role of monetary policy is limited, which could occur either because interest rates are near zero or if exchange rates are fixed. The converse potentially also holds in temporary booms, when it may be appropriate for the government to allow borrowing to fall or any surplus to rise.

Adjusting gradually to shocks: When fiscal adjustments need to be made – for example, due to a revised outlook for growth or to accommodate the exploitation of a newly-discovered natural resource – it makes sense to adjust taxes and spending slowly rather than to make changes immediately. Rapid adjustments could have unwanted impacts on aggregate demand in the economy, which monetary policy would be unable to offset. Making changes too quickly would also likely mean less efficient changes being made than would be possible over a longer timescale.

Forecast errors: Even in the short run, forecasts for total public spending and total taxes are highly uncertain. On average, forecasts for the deficit one year after that forecast was made have been out by over 1% of national income.¹¹ In years when a forecast is overly optimistic and the balance turns out worse, governments should have the flexibility to run a deficit rather than have to make in-year adjustments which may well be suboptimal. Conversely, of course, a good out-turn should mean the government runs a larger surplus (or smaller deficit) than originally planned.

Tax rate smoothing: Economic theory suggests that smoothing tax rates over time is preferable to having variable tax rates, even if this means having varying levels of revenues over time. Reducing variation in tax rates over time might also help individuals making (in particular) savings and investment decisions. If it were apparent that the public finances would strengthen considerably in future – for example, because of a known downwards pressure on spending or a forthcoming revenue stream – it might be better to run looser fiscal policy now with the intention of running tighter fiscal policy when the strengthening is realised. In fact, there are good reasons to think that the UK's public finances will deteriorate in future. For example, the OBR's latest Fiscal Sustainability Report suggests that the pressures of an ageing population will push up spending on, particularly, health care and pensions, contributing to a deterioration in the public finances from a small surplus in 2019–20 to a deficit of 1.8% by 2033–34. If this

¹¹ The mean absolute error since 1978–79 is 1.07% of national income, based on the Budget forecast for the preceding financial year.

outlook proves correct, there would be an argument for the government to increase tax rates and run larger surpluses now in order to smooth out the funding of these future spending pressures.

These reasons imply that we would not want to constrain a government to running a budget surplus in each and every year. There are entirely appropriate reasons why the balance could vary from year to year. These arguments also suggest that there is nothing particularly special about a small surplus or balanced budget compared with, say, a small deficit. The long-run health of the public finances, and the flexibility for the government to adjust appropriately to various changes, opportunities and shocks, are more important than whether total revenues cover total spending in any particular year.

Are surpluses common elsewhere?

Table 3.2 examines how common it has been for 24 other advanced economies to deliver overall budget surpluses, using data from the IMF and ordering economies from largest to smallest in terms of GDP. Where possible, we take data from 1980 to 2015, but often

Table 3.2. Central government budget surpluses since 1980 in 25 advanced economies

	Years covered (1980 to 2015 unless otherwise stated)	Years in surplus %	Ranking (highest to lowest)
United States	2001 onwards	0%	23 rd
Japan		14%	13 th
Germany	1991 onwards	21%	12 th
United Kingdom		14%	14 th
France		0%	22 nd
Italy	1988 onwards	0%	21 st
Canada		31%	9 th
Australia	1988 onwards	48%	4 th
South Korea	1995 onwards (data for central government only)	100%	1 st
Spain		9%	18 th
Netherlands		14%	15 th
Switzerland	1983 onwards	38%	7 th
Sweden		46%	5 th
Belgium		11%	17 th
Norway		91%	2 nd
Austria	1988 onwards	0%	25 th
Denmark		34%	8 th
Israel	2000 onwards	0%	24 th
Finland		66%	3 rd
Ireland		29%	10 th
Greece		0%	19 th
Portugal	1986 onwards	0%	20 th
New Zealand	1985 onwards	40%	6 th
Latvia	1998 onwards	12%	16 th
Iceland		26%	11 th

Note: Countries ordered by 2014 GDP.

Source: International Monetary Fund, 'World Economic Outlook Database', October 2015, <https://www.imf.org/external/pubs/ft/weo/2015/02/weodata/index.aspx>.

consistent data do not extend that far back. We present for each country the percentage of years in which a budget surplus is observed. Across all 25 countries, an annual budget surplus has occurred 26% of the time, while (on these data) the UK achieved a surplus 14% of the time.

For some countries, such as Norway and Finland, running surpluses has been the norm. However, countries with GDP levels comparable to or larger than the UK are far less likely to run surpluses. Among the G7 set of countries (US, Japan, Germany, UK, France, Italy and Canada), a budget surplus has been seen 13% of the time. At no point in the available data has the US (back to 2001), France (back to 1980) or Italy (back to 1988) achieved an overall budget surplus.

Summary

At 80% of national income, the UK's public sector net debt is high by recent historical standards, although there have been long periods in the past when debt has been above this level. The UK's debt level is also high relative to those of most other advanced economies, although it is also noticeable that most of the other very large economies currently have debt levels similar to or higher than the UK's.

There are two reasons why high debt might be a concern. First, higher debt will mean a greater share of national income will have to be devoted to servicing that debt. Second, the higher the level of debt, the less fiscal headroom the UK may have to respond to any future negative shock.

So there are reasons why we might wish to reduce debt as a share of national income. But this does not necessarily require an overall budget surplus: as long as the stock of debt grows less quickly than the economy, the UK's fiscal position will become more sustainable. In that sense, there is nothing particularly special about running a headline surplus as opposed to a relatively small deficit. There is a trade-off between the (reasonably clear) costs of swift debt reduction and the, perhaps remote, possibility that slower debt reduction might one day lead to the huge costs associated with a loss of access to international capital markets following a further adverse fiscal shock.

If the UK did achieve and maintain a headline surplus, this would be a significant break from the past: the UK has not achieved more than three years of consecutive budget surpluses since 1951. Overall surpluses have also not been particularly common among many other advanced economies, especially the largest ones.

There are also good reasons why, in at least some periods, the government might want to borrow. It would seem odd for the optimal level of government investment and borrowing not to depend on the interest rate: in periods when the government can borrow cheaply, it would seem natural to choose to borrow more. And in the face of shocks to the public finances, it may well be better to adjust taxes and spending slowly and, where the deterioration is expected to be temporary, not to adjust them at all – even if that means temporarily running looser-than-normal fiscal policy and possibly spending more than is raised in revenues.

3.3 The new mandate for fiscal policy

With all fiscal rules, there is an inevitable trade-off between allowing flexibility to deal appropriately with the kinds of pressures discussed in the previous section and

maintaining simplicity, which helps ensure that the rule is easy to monitor and the government can be held to account. The current government's principal fiscal rule, which governs the level of borrowing and – to a large extent – debt, is the fiscal mandate. In this section, we describe the fiscal mandate and assess how well it trades off these objectives.

The Treasury describes the new mandate for fiscal policy as follows:¹²

- *In normal times, once a headline surplus has been achieved ...: a target for a surplus on public sector net borrowing in each subsequent year.*
- *For the period outside normal times from 2015–16 [until a headline surplus is achieved] ...: a target for a surplus on public sector net borrowing by the end of 2019–20.*

These targets apply unless and until the OBR assesses that GDP growth (on a rolling four-quarter-on-four-quarter basis): (i) has fallen below 1% in the most recent four-quarter period; (ii) is currently below 1%; or (iii) is forecast to fall below 1% during the forecast period. This is judged to indicate a significant negative shock to the UK economy.

If such a shock occurs before 2019–20, the Treasury will review the appropriateness of the target to have a surplus by the end of 2019–20. Any resulting change to the target, however, would need to be approved by a vote in parliament.

If such a negative shock occurs after 2019–20, the mandate to have a surplus each year would be suspended. The Treasury would have to set out a plan to return to surplus, with appropriate fiscal targets to accompany that new plan, and both the plan and the new targets would have to be approved by a vote in parliament.

Simplicity and transparency

The fiscal mandate is undoubtedly simple and transparent, particularly beyond 2019–20. The Chancellor must achieve (not merely forecast) an overall budget surplus. Public sector net borrowing is clearly defined and measured in a timely manner. The new fiscal mandate is much simpler than either the coalition government's old fiscal mandate or the golden rule operated by Gordon Brown in that it targets a measure that does not explicitly incorporate an adjustment for the ups and downs of the economic cycle. The old fiscal mandate targeted a cyclically-adjusted measure of current budget balance; this was therefore sensitive to what the OBR estimated the output gap to be, which was inherently subjective. Meanwhile, the golden rule was judged over the course of an economic cycle; judging the start and end dates of the cycle was difficult to do with any precision, necessarily subjective and consequently highly contentious.

With the new fiscal mandate, the public will find it easy to judge whether the Chancellor has met his target and, if not, hold him to account. Within a month of fiscal year 2019–20 ending (and, perhaps equally importantly, days before the planned date of the next UK general election), the Office for National Statistics will (at least if the current timetable is maintained) publish its first estimate of government borrowing for the previous year. This means that the Chancellor will quickly be held to account for his fiscal pledges. This simplicity and transparency does come at the cost of other weaknesses – discussed below – but the increased accountability that derives from simplicity has some value.

¹² HM Treasury, 'Charter for Budget Responsibility: Summer Budget 2015 update', July 2015, <https://www.gov.uk/government/publications/charter-for-budget-responsibility-summer-budget-2015-update>.

Reducing government indebtedness and smoothing tax rates?

A significant motivation behind the government's desire to run budget surpluses is a desire to reduce government indebtedness in order to buy additional fiscal headroom. However, one potential weakness of the fiscal mandate is that it applies to a specific measure of borrowing, which does not capture all the ways in which the current government might be increasing public sector liabilities. For example, if the current government makes a promise to pay money in the future but not today, this would reduce future fiscal headroom but would not be constrained by the fiscal mandate. An example of this type of behaviour could be increasing pension promises to public sector workers or making the indexation of certain benefits more generous (such as the 'triple lock' on the state pension), the cost of which cumulates over time.

This concern shows that it will be crucial for the OBR to continue to monitor the UK's long-run fiscal position and draw attention to any imbalances. Current practice could be enhanced through systematically publishing long-run costings for any policy measure where the long-run costing is thought to deviate significantly from the medium-term costing. This transparency would serve to make it harder for the government to implement reforms that weaken the long-run fiscal position and encourage it to put in place policies that will allow a gradual adjustment to known future increases in spending needs (such as from an ageing population) – that is, by smoothing tax rates over time, such that future spending pressures are partially pre-funded.

Allowing for output stabilisation?

The new fiscal mandate allows the government some flexibility to accommodate negative output shocks in that it will be suspended if growth drops (or is forecast to drop) below 1% a year. This is a different approach to adjusting for the economic cycle from the one taken under the old fiscal mandate or under Gordon Brown's golden rule. The old fiscal mandate instead targeted a measure of borrowing that explicitly adjusted for the ups and downs of the economic cycle, while the golden rule was judged over the course of an economic cycle.

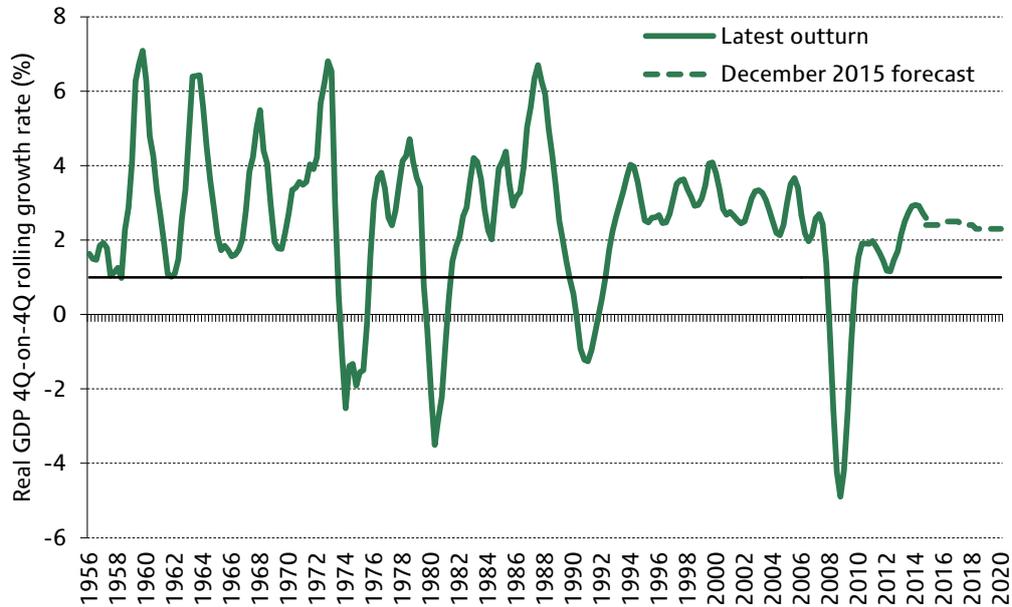
We do not know how often growth will drop below 1% in future. However, we can look at recent UK history to see how often the conditions defining a significant negative economic shock have occurred in the past. Because the mandate defines a significant negative shock as either actual growth dropping below 1% a year or growth being forecast to fall below this level, in this section we look both at the out-turns for growth historically and at the forecasts that were made contemporaneously.

Figure 3.6 plots GDP growth over the previous four quarters for each quarter between 1956Q4 and 2015Q3 based on the latest data. It also shows the OBR forecasts up to 2021Q1 from the 2015 Autumn Statement. These data show four broad periods when growth dipped below 1%: the mid 1970s, the early 1980s, the early 1990s and the late 2000s. In other words, in the last 50 years at least, there were no periods of growth below 1% other than periods of outright recession. The economy appears to grow strongly or to shrink. It does not appear to go through periods of growth between 0% and 1%.

However, GDP data are revised, often substantially, after initial estimates. To understand whether the rule (had it been in place) would actually have been suspended on the basis of earlier estimates of out-turn data, we must look at the estimates of GDP growth that were produced at the time; these data are only easily available from 1976. Figure 3.7 shows the same latest out-turn data as Figure 3.6 from 1976. The shaded areas indicate

all the periods in which the conditions for the rule to have been suspended on the basis of out-turn data (i.e. that one of the last four quarters had four-quarter-on-four-quarter growth below 1%) were met. Contemporaneous out-turn data have differed from the latest out-turn quite considerably at times: for example, concerning 2011 and 2012, we are much more optimistic now than we were at the time. However, the rule (had it been in place) would have been suspended for the same broad periods on the basis of initial

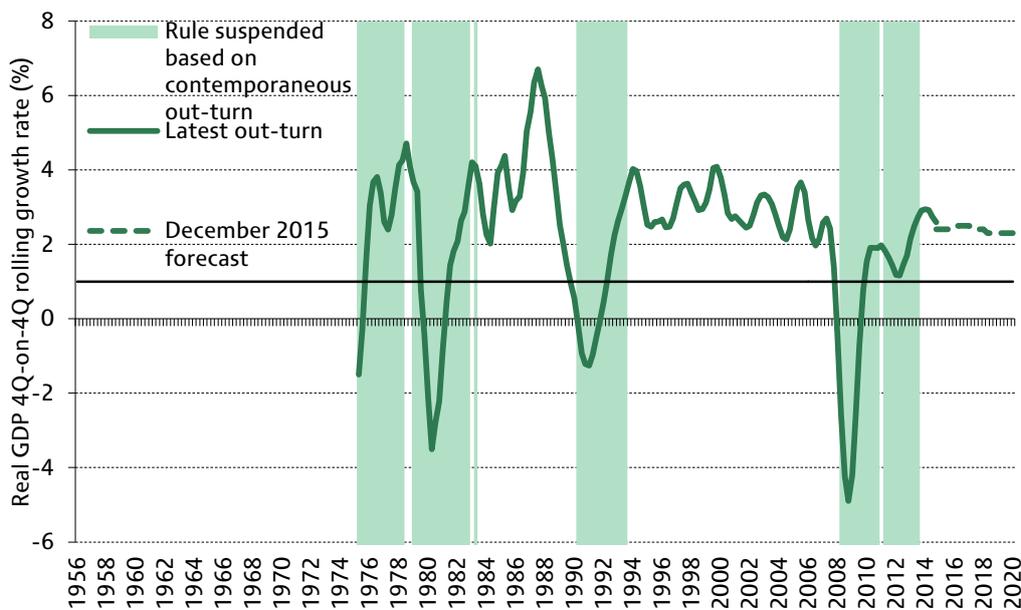
Figure 3.6. UK GDP growth since 1956



Note: GDP latest out-turn is the November 2015 release of ONS series ABMI, rolling four-quarter-on-four-quarter growth.

Source: ONS series ABMI.

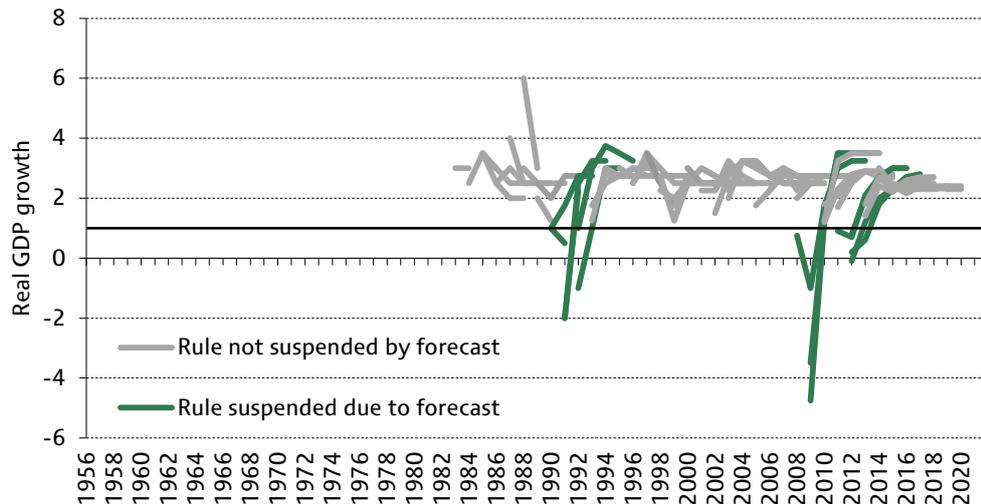
Figure 3.7. Occurrences of ‘significant negative shocks’



Note: GDP latest out-turn is the November 2015 release of ONS series ABMI. The rule is suspended if rolling four-quarter-on-four-quarter growth is judged to have been below 1% in one of the most recent four quarters.

Source: ONS series ABMI; Bank of England GDP database.

Figure 3.8. Historical forecasts for real GDP growth



Source: OBR, 'Historical official forecasts database', <http://budgetresponsibility.org.uk/data/>.

estimates of GDP growth (the mid 1970s, the early 1980s, the early 1990s and the late 2000s) as our most recent out-turn data would suggest.

The mandate could also be suspended if growth is forecast to be below 1%. Figure 3.8 shows successive historical official forecasts for economic growth, taken from Budgets, Autumn Statements and Pre-Budget Reports since the Autumn Statement of 1983. The grey lines show forecasts that would not have led to the mandate being suspended (had it been in place), while the green lines show forecasts that would have resulted in suspension of the mandate.

Our analysis of Figures 3.7 and 3.8 reveals two key facts. First, the same broad two periods between 1984 and 2021 would be identified as negative output shocks using the contemporaneous out-turn data (Figure 3.7) as using the contemporaneous forecasts (Figure 3.8) – that is, the early 1990s and the recent recession starting in 2008. Second, in both cases, the suspension would have been prompted first by the forecast data, rather than by out-turn data. Figure 3.8 shows that the November 2008 Pre-Budget Report first forecast that annual growth would drop below 1% in 2008, whereas this did not show up in the out-turn data until 2008Q4 (as shown in Figure 3.7). In the early 1990s, the forecasts would have triggered suspension of the rule in November 1990, whereas the downturn was not reflected in out-turn data until March of the following year.

This analysis of past forecasts and out-turns for GDP growth suggests that the mandate – had it been in place – would have been suspended on perhaps four occasions over the last 40 years. With the benefit of hindsight, these are probably the only four periods that we would now identify as negative output shocks in the UK: the mid 1970s, the early 1980s, the early 1990s and the late 2000s. This suggests that the fiscal mandate would have allowed sufficient flexibility to accommodate the output shocks that we have seen in the UK over the last 40 years. We noted earlier that the UK has achieved a surplus in 8 out of 63 years since 1952. This would improve to 8 out of (at most) 46 years if we ignore the years in which the rule would have been suspended.¹³

¹³ We only have data on contemporaneous out-turns from 1976 and forecasts from 1983. To calculate whether the rule would have been suspended before 1976, we use the most recent out-turn data.

The 1% threshold is, of course, somewhat arbitrary. It is certainly not optimal that, with growth only just above this level, the government would be constrained to running a surplus while, with growth just below 1%, it could potentially borrow an unlimited amount. One way to assess the importance of the threshold in practice is to ask whether, historically, the suspension of the rule would have been different if a slightly different threshold were used. We have looked at past data to see whether slightly different thresholds (0.7% and 1.3%) would have led to big changes in whether or not the rule would have been suspended. The answer is that, over the period since the mid 1970s, they would not have done. The only exception is the late 1990s, when a threshold of 1.3% would have meant the November 1998 Pre-Budget Report forecast of growth in the range 1–1½% (as the dot-com bubble burst) could have led to the rule being suspended. (With hindsight, loosening fiscal policy significantly at that point might not have been justified, since the UK, unlike the US, avoided a recession.) This may suggest that, in practice, the arbitrary nature of the 1.0% threshold may not be hugely important in practice. However, as Figure 3.6 shows, growth often hovered around 1–2% in the 1950s. And, of course, we do not know that the pattern of growth rates in the future will mimic that of the recent past: it is possible that growth will be more likely to be just below or just above 1% than it has been historically.

The analysis above does, though, suggest that forecasts can matter because they may well be the first trigger for suspending the rules. One potential adverse implication of this, coupled with the sharp threshold at 1% growth, is that it increases the politicisation of the forecasting decisions of the OBR. For example, if it forecast GDP growth of 0.9% then the government would be allowed to borrow, while if it forecast GDP growth of 1.0% then the government would not be able to borrow without breaking its rule. This may seem like a purely theoretical conundrum, but a forecast around this level of growth is not unprecedented. In March 1990, growth was forecast to be 1% exactly in that year, before increasing thereafter. If the rule had been in place, therefore, it could not have been suspended, though a slightly lower forecast would have allowed the government free rein. The OBR will be aware of this implication, and even if it legitimately forecasts GDP growth of 0.9%, this could lead to questions about its independence.

This politicisation would be more acute if growth were often expected to be close to the 1% threshold. It is difficult to know, going forwards, whether UK economic growth is likely to be forecast to fluctuate around 1% or whether (as appears to have been the case for over 85% of the years since 1700¹⁴) it will most often be thought to be clearly above or clearly below the threshold.

Adjusting gradually to shocks?

The discussion above suggests that the ability to suspend the fiscal mandate when economic growth drops below 1% is likely to allow the government to accommodate most negative output shocks. The fact that, once suspended, the government then has flexibility about how and when the mandate is reinstated also suggests that the rule allows flexibility to adjust gradually if the negative output shocks turn out to be structural, rather than purely cyclical.

¹⁴ Data from the Bank of England suggest that annual real GDP growth in the UK was either above 1.5% or below 0% for 272 out of the 314 years between 1701 and 2014 (inclusive). Source: Bank of England, 'Three centuries of macroeconomic data', <http://www.bankofengland.co.uk/research/pages/onebank/threecenturies.aspx>.

The financial crisis of 2008 is a clear recent example of a large shock to the UK economy, which pushed economic growth below 1%, that is judged to have caused structural damage and which the previous and current governments have chosen to take many years to adjust to. On current forecasts, it will take until 2016–17 for borrowing to fall back to the level it was at as a share of national income in 2007–08 and a further three years to reach the Chancellor’s desired ‘new normal’ of running an overall budget surplus. The fiscal mandate requires that the government complete this adjustment by 2019–20. Provided a future structural shock were accompanied by sufficiently low growth in the short term (i.e. below 1%), the fiscal mandate would provide flexibility to adjust gradually to that shock too, since the rule would be suspended and the government could set out a new plan for returning to surplus. How much scope a future government would have to adjust to such a structural shock would depend in part on how much fiscal headroom had been bought by that time and what investors’ appetite was for buying more UK government debt.

Accommodating forecasting errors?

Table 3.3 provides an indication of the errors surrounding the current central forecast for the UK’s public sector net borrowing, on the assumption that the current forecast is as accurate as past forecasts made by the Treasury and the OBR. This suggests that forecast errors even just one year out can be sizeable. For example, in 13 out of the 37 years since 1978–79 for which data are available, the deficit ultimately exceeded the forecast made just before the start of the financial year by at least 0.5% of national income (or £10 billion in today’s terms). In other words, if the past is any guide to the future and the Chancellor continues up to March 2019 to plan for a surplus of 0.5% of national income in 2019–20, there is a 35.1% chance that this surplus would not materialise.

However, this figure somewhat overstates the chance that the mandate would be breached since the historical data include years when the deficit was higher than expected but this was also associated with growth falling below 1%. If we exclude these years from the analysis, then there were 8 years out of 30 in which the deficit ultimately exceeded the forecast made just before the start of the financial year by at least 0.5% of national income (or 26.7% of the time).

The fiscal mandate requires that, from 2019–20 onwards, the government must *achieve* a budget surplus (provided growth remains at or above 1%). This is in sharp contrast to the previous fiscal mandate, which required that a surplus (on the cyclically-adjusted

Table 3.3. Average errors in forecasting public sector net borrowing

Time period	Average absolute error (% of national income)	% of occasions deficit underestimated by more than 0.5% of national income
One year ahead	1.07	35.1
Two years ahead	2.28	65.5
Three years ahead	2.93	68.0
Four years ahead	3.31	81.3
One year ahead when growth > 1%	0.79	26.7

Note: Based on Budget forecasts only, starting from the fiscal year 1978–79.

Source: OBR, ‘Historical official forecasts database’ and ‘Public finances databank’,

<http://budgetresponsibility.org.uk/data/>.

current budget) be forecast at the end of the rolling five-year forecast horizon but not that a surplus ever actually be achieved. The requirement to achieve a budget surplus makes the Chancellor's new fiscal mandate much more constraining than the old mandate in relation to the types of forecasting errors shown in Table 3.3. This inflexibility could result in two important differences in behaviour compared with the old rule:

- The Chancellor may want to build additional caution into his plans to help ensure that they are robust to forecasting errors (which, as Table 3.3 shows, can be significant). In other words, he may wish to run fiscal policy that was – in expectation – significantly tighter than simply running a small budget surplus, particularly if the costs of failing to adhere to the mandate were perceived to be large.
- The Chancellor may be required to take sudden action in-year if forecasts are downgraded. If, after 2019–20, forecasts were to prove inaccurate and tax revenues came in less strongly and/or spending grew more strongly than anticipated, the Chancellor may have to take very quick action – immediately cutting spending or raising taxes – to help ensure the rule would not be breached (action which may only need to be temporary). It is unlikely that any such quick adjustments would represent optimal fiscal policy. In particular, some types of changes will be much easier to implement in-year than others. For example, the last government and the current government have both shown that it is possible to cut central government departments' budgets in-year, whereas changes to many taxes are much harder to make immediately and the recent reversal of planned reforms to tax credits demonstrates the difficulty of imposing nominal cuts to the level of existing claimants' benefits. Alternatively, of course, faced with these unpalatable options, the Chancellor could simply breach the rule (as he chose to do with the welfare cap in November; see Section 3.4) and run a deficit in that year.

Optimal investment decisions

The fiscal mandate requires that (during 'normal' times) current revenues should cover all spending done in the current year, including investment spending. As a result, the government's decisions about whether or not to carry out an investment project will be governed by an assessment of the benefits of the project against the cost of raising the necessary money through levying additional taxes. In contrast, under the old fiscal mandate and the Labour government's golden rule, the government was able to borrow to pay for investment spending and so (in principle, at least) the cost-benefit analysis of investment projects depended on the cost of raising additional funds from the gilt markets. In other words, under the old fiscal mandate, if the government's borrowing costs fell, more investment projects would become profitable; in contrast, the cost-benefit analysis would be unchanged under the new fiscal mandate. This suggests that the new fiscal mandate may prevent the government from investing in some projects where the benefit to future generations outweighs the debt interest costs that would be incurred because the cost of raising revenue from taxes in the short term is too high. Certainly it seems odd for the price of additional borrowing (the interest rate) not, at least in some circumstances, to affect how much we choose to do.

In practice, the existence of a fiscal mandate that allowed the government to borrow to invest did not prevent the previous coalition government from cutting investment spending significantly during the last parliament. In part this was because, even though the fiscal mandate did not constrain borrowing for investment, the supplementary debt rule did impose a limit on how much could be borrowed overall. In other words, allowing

a government to borrow for investment is not a sufficient condition to ensure that all investment projects of sufficiently high value are carried out, but it is a necessary condition for public investment plans to be responsive to the government's borrowing costs.

Summary

The fiscal mandate provides flexibility to accommodate some of the occasions on which a government might be well advised to borrow (or at least to run looser-than-normal fiscal policy). In particular, the fact that the rule will be suspended if growth drops below 1% should provide the flexibility to accommodate most negative output shocks, if in future they take a similar form to what they have over the last 300 years. The suspension of the rule in those same circumstances also provides scope to adjust gradually to large shocks. The simplicity of the rule also means that it is transparent and so it will be relatively easy for the public to hold the Chancellor to account for his promises.

However, the fiscal mandate also suffers from some severe limitations. First, the requirement to achieve (and not merely forecast) a budget surplus means that either the Chancellor will need to run fiscal policy that is in expectation significantly tighter than simply running a budget surplus or he may be forced into making sharp adjustments to policy in-year if forecasting errors go against him. It is unlikely that any such quick adjustments would represent optimal fiscal policy. Second, on the face of it, the sharp threshold at 1% growth is suboptimal, particularly given the risk that it might make the OBR's growth forecasts highly politicised. In practice, historical data suggest that economic growth in the UK rarely hovers around 1%. If the future resembles the past, then the fact that there is a sharp threshold at that point may not be so important, but it is impossible to know for sure how GDP growth will evolve in future. Third, the requirement that the government run a surplus prevents the government from responding to lower interest rates with more investment spending, even though the optimal level of borrowing will almost certainly depend, at least in part, on the interest rate.

3.4 The supplementary targets

In addition to the mandate for fiscal policy, the Charter for Budget Responsibility includes two supplementary targets:

- *For the period until 2019–20*: a target for public sector net debt as a percentage of GDP to be falling each year.
- A cap on welfare spending, at a level set by the Treasury in the most recently published Budget report, for each year of the rolling five-year forecast period.

The debt rule

The current target, that debt should be falling as a share of national income each year between 2015–16 and 2019–20, replaced the previous rule that debt should be falling at a fixed date in 2016–17. Like the new fiscal mandate, if growth drops below 1%, the Treasury will review its appropriateness, with any resulting change to the target requiring the approval of parliament.

The measure of debt the UK government focuses on – public sector net debt – is the total debt of central government, local authorities and organisations deemed to be under public sector control, net of any short-term financial assets (i.e. it does not net off the value of any physical assets or of any long-term financial assets held by the public sector). The government is currently forecast to be complying with this supplementary rule: the Autumn Statement forecast was for public sector net debt to fall by 0.6% of national income in 2015–16, by 0.8% of national income in 2016–17, by 1.8% of national income in 2017–18, by 2.6% of national income in 2018–19 and by 3.0% of national income in each of 2019–20 and 2020–21.

Is a supplementary debt rule required?

On the face of it, the fiscal mandate described above – which requires that the government run surpluses in ‘normal times’ from 2019–20 – also heavily constrains public sector indebtedness. However, there are potentially three reasons why a government might want to have a debt rule to constrain public indebtedness in addition to this mandate:

- The fiscal mandate allows the government to run deficits in any of the years prior to 2019–20, meaning that public debt could (theoretically) accumulate substantially over this period.
- The measure of borrowing targeted by the fiscal mandate excludes loans and repayments made and received by the government and other financial transactions (such as buying and selling financial assets), while these may affect public debt in the short or long run. This means that simply measuring headline borrowing does not provide a full picture of how the government’s balance sheet is evolving.
- The fiscal mandate does not capture (and therefore does not constrain) promises made by governments to increase future (but not current) spending. Similarly, it does not constrain a government from making a commitment to reduce future, but not current, taxes.

The key question, therefore, is whether the supplementary debt rule addresses any of these concerns.

Assessing the supplementary debt rule

The supplementary debt rule partly addresses the first point mentioned above – that is, providing a constraint on the accumulation of public sector net debt between now and 2019–20. However, this is the least important of the three arguments for a debt rule set out above. If the government is implementing a credible plan for achieving a budget surplus by 2019–20, it seems unlikely that such a plan would be consistent with spiralling debt levels. If the government were concerned about excessively loose fiscal policy over the next few years, it could simply impose limits on the deficits in 2016–17, 2017–18 and 2018–19.

The supplementary debt rule also partly addresses the second concern, in that by targeting debt rather than borrowing it assesses a broader picture of how the government’s balance sheet is evolving – which, as discussed in Section 3.2, is what the government is ultimately concerned with. However, its usefulness in this regard is hampered by the definition of debt on which the government focuses. Public sector net debt is measured net of short-term financial assets only, and so financial transactions can appear to have misleading impacts on the public finances. For example, selling assets appears to strengthen the public finances by reducing public sector net debt, when in fact

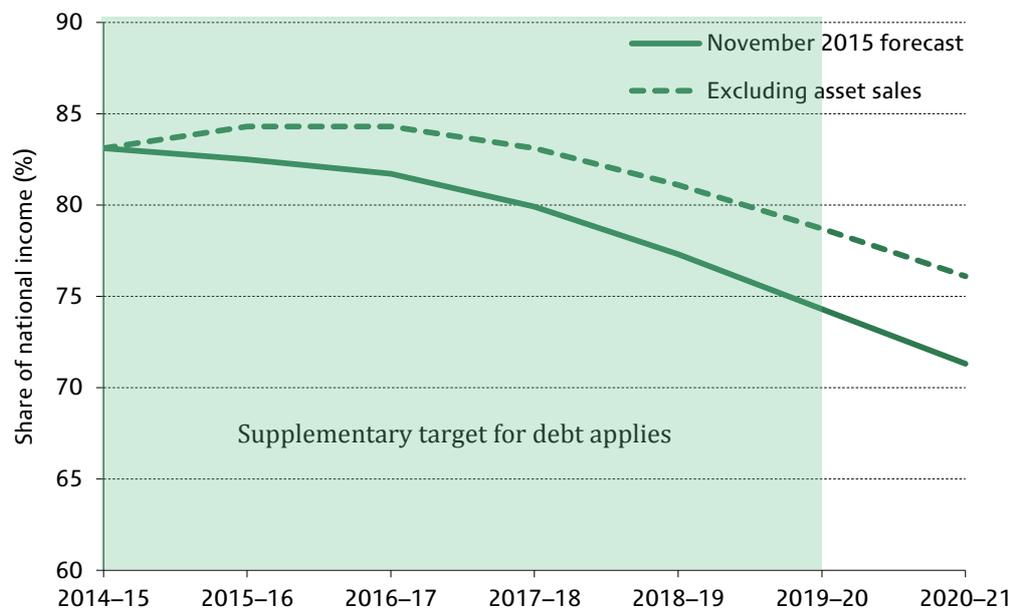
selling a state-owned asset for what it is worth has no impact on the true public finance position. Similarly, increased spending on student loans appears to significantly weaken the public finances by increasing public sector net debt, but in large part that is because the asset owned by the government in exchange (the promise of future repayments by graduates) is not netted off.

The focus of the supplementary debt rule on the relatively narrow measure of public sector net debt also makes the rule vulnerable to manipulation. The government can easily affect the profile of debt by selling government assets in particular years. Figure 3.9 shows the forecast for the path of debt over the parliament both with and without asset sales. The government is currently on course to have debt falling each year, but absent asset sales the government would be on course to breach the debt rule in 2015–16 and 2016–17. It is possible that these asset sales are desirable and would have been undertaken by the government even if no rule were in place, but the fact that asset sales can be used to meet the supplementary debt target means that in reality the rule may do little to constrain the fiscal prudence of the government. Furthermore, hasty asset sales in order to meet the debt rule might be achieved at a lower-than-possible price, which would actually serve to weaken the underlying public finances.

Finally, the supplementary debt target does little to address the concern that the government is not constrained from introducing policy changes with unattractive long-run implications for the public finances. To help address this concern, a debt rule would need to target a much broader definition of debt, which included contingent liabilities accrued by the government. Such ‘Whole of Government Accounts’ measures of the public sector finances are discussed in Chapter 4.

Overall, therefore, there seems to be little benefit to having the supplementary debt target in addition to the fiscal mandate. Focusing on whether a broad measure of debt is falling as a percentage of national income between some specific dates in the near term

Figure 3.9. Impact of asset sales on the path of public sector net debt



Note: The ‘Excluding asset sales’ series excludes only the direct effect of asset sales on the level of public sector net debt and does not assume any knock-on effects from changing net debt interest spending. Source: Chart 5.2 of Office for Budget Responsibility, *Economic and Fiscal Outlook November 2015*.

gives little indication of the long-run sustainability of the public finances. Because the target can be met through asset sales, without any underlying change in the strength of the public finances, the rule is unlikely to constrain government policy or enforce austere fiscal policies over the next four years. This is not especially problematic – the task of navigating the public finances towards a budget surplus in 2019–20 in reality constrains policy over the next four years as well. However, this means that at best the debt rule is somewhat superfluous, while at worst it may lead to hasty and suboptimal asset sales to ensure the target is met.

The welfare cap

The cap on welfare spending places a limit in each year of the forecast horizon on spending on ‘welfare in scope’. This essentially covers spending on all social security benefits and tax credits that are set by central government apart from the state pension and the most cyclical benefits.

In each Autumn Statement, the OBR assesses whether the government is meeting its cap. The government may exceed the cap by up to 2% if this is due to forecasting changes rather than policy changes, but the cap is deemed to be breached if either (i) spending rises above the cap by more than 2% as a result of forecasting changes or (ii) the government makes policy decisions that would increase welfare spending above the cap.

If the cap is deemed by the OBR to have been breached, the government must hold a debate on a votable motion in the House of Commons, normally within 28 sitting days, giving an assessment of the reasons for the breach and following one of three possible courses of action:

- Propose policy measures to reduce welfare spending below the cap.
- Seek the approval of parliament for the cap to be lifted.
- Explain to parliament why the breach is justified.

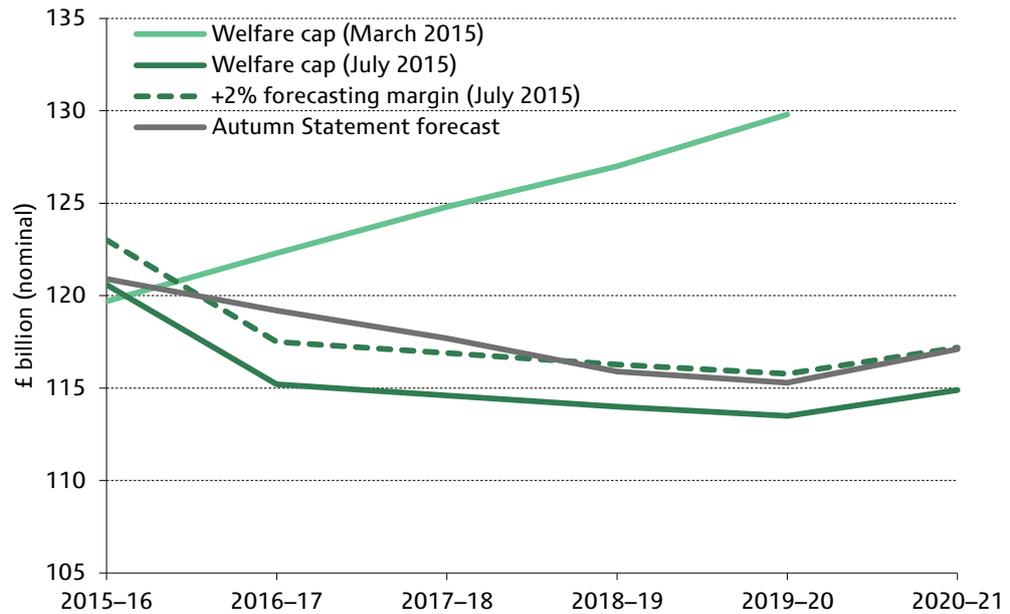
The last of these means that the welfare cap could, in practice, be a weak constraint and essentially allows the government to take no action at all if it deems that the breach is ‘justified’.

The rationale behind the cap on welfare spending is the perception that governments find it difficult to curb unexpected and unplanned increases in benefit spending since this requires unpopular decisions about how to make the benefit system less generous. By introducing a cap, governments will be forced to make active decisions about a desirable level of welfare spending, rather than allowing it passively to drift upwards.

The level of the cap was originally set by the coalition government in March 2014, and it remained unchanged in the March 2015 Budget. However, in the July 2015 Budget, when the new Conservative government announced a number of policy changes intended to reduce benefit spending, the Chancellor chose to lower the level of the welfare cap to match the new, lower forecast for spending on welfare in scope. This change is shown by the movement from the pale green line to the solid dark green line in Figure 3.10.

In November 2015, the OBR issued its second judgement on the government’s compliance with the cap. This proved to be the first test of how constraining the cap really is and how the government would respond.

Figure 3.10. Welfare cap



Source: Office for Budget Responsibility, Economic and Fiscal Outlooks, March 2015, July 2015 and November 2015.

As a result of reversing planned cuts to tax credits (which had been announced in the July 2015 Budget and were due to be implemented from 2016-17), the new OBR forecast (shown by the grey line in Figure 3.10) suggested that the welfare cap would be breached in 2016-17, 2017-18 and 2018-19.¹⁵ In response, the Chancellor decided to take the third course of action mentioned above – to explain to parliament why the breach was justified. He did not attempt to take action to reduce spending elsewhere, nor did he seek permission to increase the cap.

The Chancellor did not choose to attend Parliament himself to explain the breach; the motion was instead proposed by Shailesh Vara, a junior minister from the Department for Work and Pensions (DWP). This was a direct contradiction of what George Osborne said in March 2014, when introducing the welfare cap:¹⁶

The charter makes clear what will happen if the welfare cap is breached. The Chancellor must come to Parliament, account for the failure of public expenditure control, and set out the action that will be taken to address the breach.

Curiously, the requirement that the Chancellor must account for the breach of the rule was never, despite Mr Osborne's claims, a part of the fiscal charter. For a DWP minister to propose the motion was entirely in accord with the wording of the charter. This does

¹⁵ The reversal of the planned tax credit cuts was precipitated by a successful House of Lords motion in October 2015, which required the government to 'delay consideration of the regulations until a report has been produced addressing the Institute for Fiscal Studies' analysis of the regulations and their impact' and 'until consultation and a report to Parliament on the provision of full transitional protection for a minimum of three years for all low-income families and individuals currently receiving tax credits before 5 April 2016 has been completed' (<http://www.parliament.uk/business/news/2015/october/lords-tax-credits-si/>; this actually refers to 'transactional protection', but from the context it seems clear that 'transitional protection' is intended).

¹⁶ Hansard, 26 March 2014, volume 578, column 380, <http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm140326/debtext/140326-0002.htm>.

leave the question of why the Chancellor stated something to the contrary to parliament in 2014.

Has the cap lost credibility already?

The welfare cap was breached on just its second outing in November, and welfare spending is now forecast to be above the level permitted by the cap until 2019–20. The ease with which this happened and the government’s ability simply to ‘justify’ this without taking remedial action call into question the power of the welfare cap really to constrain spending in this area.

Another detail of the November 2015 assessment of the welfare cap further harmed the credibility of the cap. While it was deemed to be breached for the next three years, the OBR judged the welfare cap met for 2019–20 and 2020–21. However, this was only achieved because the government reclassified an element of housing benefit spending such that it was incorporated into central government grants to local authorities rather than being a separate payment.¹⁷ The charter specifies that the government cannot reclassify which welfare spending is in the scope of the cap; welfare spending can only be affected by policy change. However, because the mere fact of reallocating this spending from central to local government may put downward pressure on this element of spending, this transfer has been treated as a policy change and the entire cost of the grants has been taken out of scope.¹⁸ It is highly doubtful that this stream of spending will be reduced to zero as a result of the policy change, so at the very least the government’s performance relative to the cap is flattered by the reclassification of this spending item. This somewhat opaque method of meeting the cap does little to enhance what was left of its credibility.

Verdict on the welfare cap

If your aim is to constrain (working-age) welfare spending, on the face of it the welfare cap looks like a reasonable fiscal rule. The 2% buffer for forecasting errors provides sensible flexibility where the deficit rule does not, avoiding suboptimal in-year changes. At the same time, in theory at least, ‘welfare in scope’ should be a fixed and well-defined target that is difficult to manipulate, which is a clear improvement on the supplementary debt target.

In reality, however, it has proved relatively easy to abandon the cap. Furthermore, the definition of ‘welfare in scope’ has proved somewhat more fluid than intended, enabling the government to meet the cap in the last two years of this parliament only due to a reclassification of an element of spending. The welfare cap has not, at least up to this point, acted as a credible constraint on welfare spending. Whether or not this condemns the cap to irrelevance and failure in the longer term remains to be seen.

3.5 Conclusion

In July 2015, the government introduced a new fiscal mandate that requires it to achieve a budget surplus by 2019–20, and to maintain a surplus thereafter so long as economic growth does not fall below 1%. The government’s motivation for introducing such a target is the desire to reduce public sector debt as a share of national income more

¹⁷ The spending item in question is funding for temporary accommodation.

¹⁸ The Treasury argues that the reallocation to local authorities will tend to put downward pressure on spending in this area because overall local government grants are being cut considerably – see Chapter 6.

quickly than would be the case with higher levels of government borrowing. The latest forecasts suggest that the government is currently aiming for a small budget surplus (0.5% of national income) in 2019–20.

Public sector net debt in the UK is high by recent historical standards. Debt as a share of national income is forecast to be 82.5% by the end of 2015–16 – the highest level it has been since the 1960s (when debt was high but falling in the wake of the First and Second World Wars). The government's desire to reduce debt is therefore understandable. Doing so would reduce the amount of public spending that needs to be devoted to debt interest payments and it might leave the public finances better placed to respond to future adverse economic shocks through increased borrowing and rising debt (if that were deemed appropriate by the government, as it was with the response to the recent financial crisis).

It is worth pointing out, though, that there is nothing particularly significant about a surplus from the point of view of debt reduction. As long as the economy were growing, a small deficit would also lead to debt falling as a share of national income over time, just not as quickly as would be the case with a budget balance (and even less quickly than would be the case with a larger surplus).

There can also be good economic reasons for government borrowing. For example, investment projects that benefit future generations might not be undertaken if they have to be funded through taxes on current generations but they might be judged profitable if the funding could instead be raised more cheaply through borrowing. Borrowing to finance such investment would allow the costs to be passed on to the future generations who benefit, and so might enable these projects to be undertaken.

More generally, it is important that the government has some flexibility in its borrowing level. This allows the government to smooth tax rates over time, to engage in output stabilisation, to adjust gradually to economic shocks, and to respond flexibly to forecast errors. This could be achieved whilst always running a surplus, but this would require a surplus large enough in ordinary times that the surplus could be allowed to fall when shocks or forecast errors occur without resulting in borrowing. If the government only runs a small surplus in ordinary times, there would be less scope for such reactions if the government were wedded to achieving a surplus.

The government's new fiscal mandate does allow some flexibility. The requirement for surpluses will be suspended if economic growth falls, or is forecast to fall, below 1%. This means the government will be able to borrow to respond to most large economic shocks and stabilise output.

However, shocks to the public finances can occur without economic growth falling below 1%. If the government ordinarily only runs a small surplus (such as the 0.5% of national income surplus currently forecast for 2019–20), its ability to respond flexibly in these circumstances will be limited. For example, since 1978, there have been 30 years when forecasts for borrowing have been made at the beginning of the fiscal year and when economic growth turned out to be above 1% in that year. In 8 out of these 30 years (i.e. 26.7%), the out-turn for borrowing (the surplus) in the year ended up being at least 0.5% of national income higher (lower) than had been forecast at the start of the year. In other words, if the past is any guide to the future, this suggests that, even if the government sets out a plan in March 2019 to run a surplus of 0.5% of national income in 2019–20 (as the latest plans suggest), there might be around a one-in-four chance that the planned

surplus would not materialise due to forecasting errors, potentially leading to suboptimal in-year policy changes in response.

Once we have reached 'normal' times, the new fiscal mandate therefore suffers from two main drawbacks: it affords the government only limited flexibility to respond to shocks, and it does not allow the government to pass on the costs of investment projects directly to future generations (even if those future generations would benefit from them).

However, in exchange for these problems, as well as mapping out a path to lower debt, the mandate is simple, clear and transparent. This should enhance the credibility of the rule for constraining government behaviour. It will be easy for the OBR, and independent observers outside of government, to assess whether the government has complied with the letter of the rule. Within a month of fiscal year 2019–20 ending (and, perhaps equally importantly, days before the planned date of the next UK general election), the Office for National Statistics will (at least if the current timetable is maintained) publish its first estimate of government borrowing for the previous year.

Unfortunately, simplicity and transparency are not sufficient to ensure a fiscal rule has a credible impact on government behaviour. The supplementary fiscal targets are also relatively clear but their ability to constrain the government has already been called into question. The welfare cap was breached in the November 2015 Autumn Statement, less than two years after its introduction, with little apparent political consequence and no constructive action from the government to mitigate the breach. The supplementary target for debt as a share of national income to be falling every year is currently forecast to be met, but only as a result of the government's planned asset sales in 2015–16. Selling an asset for what it is worth does not make the public finances any stronger. The fact that asset sales affect debt (and, therefore, whether or not the government is compliant with its debt target) is the consequence of the government focusing on a particular measure of public sector net debt which excludes non-liquid assets.

The fiscal mandate could fall foul of the same type of gaming: the government could meet the letter of the rule without adhering to its spirit. There are two obvious methods for gaming the fiscal mandate. First, the evolution of debt over time depends not just on public sector net borrowing but also on financial transactions undertaken by the government, yet only the former is targeted by the fiscal mandate. Policies that replace government spending with government loans would reduce borrowing but – unless all of those loans were expected to be repaid and the interest rate charged covered the government's cost of borrowing – the positive impact on debt in the long run would be smaller than the reduction in borrowing would imply. The last and the current governments have already made use of policies of this sort: in particular, they have traded direct government support for higher education for private payment of fees covered by loans made from the government to students. Second, the government could meet the fiscal mandate over the current forecast horizon by introducing policies that improve the public finances in the short term but either do so temporarily (for example, by simply bringing forward future revenue) or perhaps even worsen the public finances in the long run. A recent example of the former type of policy is the accelerated payment schemes introduced for some corporates in the December 2014 Autumn Statement. These schemes require companies to pay the tax they owe earlier than they previously had to – this obviously had the effect of boosting tax revenues in the short term but largely at the expense of lower revenues expected in later years.

This all suggests that there is a continued role for the OBR, and other independent commentators, to assess the government's compliance with both the letter and the spirit

of its fiscal rules. Chapters 5 and 6 outline the main risks to the public finances over this parliament on the revenue and spending sides. There is a high degree of uncertainty going forwards, which means it is likely that the fiscal rules will bite at some point and force the government to change its plans. At that point, we will discover whether the rules really are credible and binding on the government or if, like the welfare cap, the other rules prove relatively easy to ignore.