Whatever the weather: future-proof budget rules
Executive Summary

The new chancellor, Rishi Sunak, takes charge at a critical moment that will largely define the government’s agenda for the next five years. The Prime Minister is keen to turn on the spending taps, bring austerity to an end and cement the new ‘blue wall’ of northern constituencies.

There is overwhelming pressure to boost spending on public services and begin to rebuild the public realm. But this must be done in a responsible way. This means accompanying greater spending with credible reform plans to ensure that taxpayers’ money is spent wisely. But it also means placing constraints on borrowing so that the public finances are sustainable, and the government doesn’t land future generations with an excessive bill for today’s largesse.

With spending promises already mounting, and economic growth stalled, it seems inevitable that borrowing is set to breach Philip Hammond’s outgoing ‘fiscal rules’ to have national debt falling and the budget deficit below 2 per cent of GDP this year. But on current plans even former Chancellor Sajid Javid’s looser proposed borrowing rules, outlined in the Conservative 2019 manifesto, look unlikely to be met. With the Treasury now on a shorter leash from a No 10 keen to spend, it looks likely that the Government will move to an even looser set of rules than the ones it was elected on just a few months ago. Consequently, there is a pressing need to articulate a new set of rules that will build confidence among both voters and the government’s creditors that the public finances are sustainable.

The core purpose of fiscal rules is to prevent excessive borrowing in normal times, while also allowing the government to use borrowing-funded spending to stabilise the economy in the event of a recession. If they are too hawkish on the deficit, such rules lack credibility, as chancellors will inevitably shelve them when the economy tanks rather than exacerbate the economic pain. But if they are too dovish on the deficit when the economy is ticking along as normal, they enable profligacy unjustified by macroeconomic conditions.

Navigating the path between these pitfalls is easier said than done. The recent past is littered with the wreckage of discarded frameworks, all of which ultimately failed due to unexpected economic developments. Rules that fail at times of uncertainty, when clarity on how the government will respond is most needed, undermine their entire purpose and don’t engender confidence among taxpayers and investors.

Sajid Javid’s proposals, to balance the current budget in three years’ time and keep debt interest payments below 6 per cent of GDP, would have been yet another framework too brittle to last: too lax in the short term but too rigid in the medium term. There is now an opportunity to rethink.

What should the new fiscal rules look like? A durable and effective set of rules should adhere to five principles:

- clarify the government’s intentions about the long-run level of debt;
- prevent it deviating from a path for borrowing consistent with that goal in ‘normal’ economic times;
- ensure that the public sector net worth grows over time;
- allow it scope to respond aggressively to stabilise a downturn; and
- allow more scope to borrow for investment at times when the affordability of debt is abnormally high, and less when it is unusually low.
We propose an all-weather fiscal framework to meet these principles, consisting of four elements:

- **A long-term target for government debt.** The Chancellor should articulate an intention to reach a specified level of debt-to-GDP in the long run. This would be translated into the implied *baseline deficit limit* by the Office for Budget Responsibility (OBR).

- **A real-time debt affordability test.** The baseline deficit limit would be adjusted to reflect the affordability of additional borrowing. The *adjusted deficit limit* would be higher when the long-term cost of borrowing over 10 years is lower than the sustainable growth rate of the economy, and lower when the opposite conditions prevail.

- **An escape clause.** This would enable fiscal policy to respond as necessary to stabilise the economy in a downturn.

- **A net worth goal.** To encourage a focus on investment, the government would be assessed against its progress towards increasing public sector net worth over five years so that the value of public assets rises more quickly than public debt.

What would such a framework imply today? If the government were to move closer to Germany’s debt levels with a target of 70 per cent debt-to-GDP ratio in the long term, compared to today’s 81 per cent, with trend growth of 1.5 per cent per year and inflation at 2 per cent, this would allow a baseline deficit limit of around 2.5 per cent of GDP.

However, the government can currently borrow very cheaply, and long-term interest rates of around 0.7 per cent suggest that the burden of new debt issued today will shrink as the economy grows. To reflect this the deficit limit would be adjusted upwards, to 3.3 per cent. This offers the government more headroom for borrowing than under the Javid proposals, which could allow a deficit of up to 3 per cent of GDP to finance investment. Were interest rates to rise above the trend rate of growth, to the 6 per cent seen in 1997-98, the burden of new borrowing would grow over time. Consequently, the deficit limit in our framework would be adjusted downwards, to 2 per cent.

This fiscal framework would offer the advantage of setting a long-term anchor for the national debt, giving voters and creditors confidence that the government’s plans for the public finances are sustainable. At the same time, it would allow borrowing to respond appropriately, both to economic shocks and periods when the affordability of debt is unusually high.

As well as combining long-term prudence with short-term flexibility, this framework also rewards good, and punishes bad, *microeconomic* policy: governments that can raise the sustainable rate of growth will have more scope for borrowing.

For too long, fiscal rules designed to govern the UK’s public finances have been re-written and broken, undermining their potential economic and civic benefits. This all-weather framework offers a remedy for those failures and valuable innovations to strengthen macroeconomic policy.
Introduction

A new Chancellor has moved into Number 11. The circumstances of Rishi Sunak’s ascent to the Treasury have raised critical questions about how he and the Prime Minister intend to manage the public finances. Number 10 recently refused to confirm that the public spending rules set out in the 2019 Conservative Party manifesto would be adopted. The answers lie in the fiscal framework that the new Chancellor chooses to adopt – a decision that will govern everything else he does and dictate the direction of travel for the government for the entire parliament. What should the Chancellor do?

The 2019 general election showed that there is now overwhelming political pressure to end austerity and begin to rebuild cash-starved public services. But this has to be done in a fiscally responsible way. This is the purpose of so-called ‘fiscal rules’.

Targets or rules that place limits on government borrowing are a way to strengthen confidence among lenders that the public finances will remain sustainable. They also play an important role in strengthening the accountability of government to voters by making day-to-day tax and spending decisions consistent with the sustainability of the public finances. By themselves they are not sufficient to guarantee sensible fiscal decision-making – there is still a need for rigorous investment appraisal and ensuring that spending on public services offers genuine value-for-money – but they can give greater confidence that the public finances are heading in the right direction.

In recent years the UK has experimented with several different fiscal rules. Gordon Brown intended to balance the current budget over the economic cycle and keep debt below 40 per cent of GDP. George Osborne sought to reduce the cyclically adjusted budget deficit to zero on a rolling five-year horizon, while also planning to have debt falling as a share of GDP by 2015-16. Most recently Philip Hammond planned to have the structural deficit below 2 per cent of GDP by 2020-21 and have public sector net debt falling in 2019-20.

During his short tenure as Chancellor, Sajid Javid proposed to implement a new regime, offering somewhat greater scope for borrowing than Philip Hammond’s rigid rules. The new rules were articulated in the Conservative general election manifesto. But even these seemed likely either to be broken or to enforce tax rises in short order if the government wanted to deliver on its pre-election spending pledges. With Javid’s departure the Government now looks set to cast aside those proposals, and its fiscal plans are temporarily unanchored. In many ways this is no bad thing since Javid’s rules were likely too brittle to endure.

This is unsurprising: the past 20 years is littered with the wreckage of successive governments’ fiscal rules. Each framework was eventually breached due to adverse economic developments. This raises questions about the value of such rules. If their purpose is to build confidence that public debt is sustainable and that macroeconomic fluctuations will be minimised, rules that have to be rewritten in periods of unpredictability are failing in their central purpose. If they cannot endure unforeseen developments, there is little point in having them since they do little to build confidence among voters or market participants.
As the new chancellor prepares to set a new Charter for Budget Responsibility, it is a good opportunity to take a step back and rethink our approach to fiscal management. Yet more rules that are broken within a couple of years could represent the final ‘nail in the coffin’ for such frameworks, which could be damaging for political accountability as well as costly for the taxpayer. Any new framework must simultaneously balance the need for fiscal policy to respond strongly in a downturn, with constraints that prevent governments borrowing excessively at times when there is no macroeconomic justification for doing so. But it must also recognise the opportunity that low interest rates provide for making necessary long-term investments in the UK economy, while taking account of the longer-term challenges to the public finances stemming from the ageing of the population. Only by achieving all of these goals will a new framework be robust to likely macroeconomic developments and thereby succeed where past attempts have failed. This paper sets out a blueprint to achieve that goal.

How Can Fiscal Rules Help?

The merits of fiscal policy rules have been extensively discussed by economists. In broad terms, their purpose is to reassure market participants and citizens that the public finances are being appropriately managed to achieve stability in the macroeconomy and in the levels of taxes and public spending.

The benefits of well-designed rules are clear. By imposing restrictions on its own borrowing, a government might prevent itself from being tempted to follow imprudent fiscal policies or a ‘deficit bias’. If such restrictions are enshrined in law, or a country’s constitution, then they may even bind future governments’ hands. Even if there was little chance that the government would become fiscally lax, the act of setting a rule might give a signal to investors in sovereign bonds that the government is serious about ensuring its budget is sustainable. If they feel more confident about being repaid then they may demand lower yields, thus saving the taxpayer debt interest costs.

But the costs of making the rules too constraining are large. Rules that guard against deficit bias may be too inflexible to allow fiscal policy to play its critical role in smoothing economic shocks, with the result that unemployment rises further and persists for longer in a recession. Rules should not become a straitjacket that prevents sensible long-term policy making or the ability to respond to unforeseen events. Stringent deficit rules – such as ‘balanced budget’ rules – are unlikely to allow deficits to take the strain when the economy falters. For example, if deficits are not allowed to rise when unemployment mounts, this would force a government into cutting spending or raising taxes at just the wrong moment, thus deepening and lengthening the recession. Finding a way to eliminate deficit bias while still allowing sensible policy responsiveness at times of crisis is the central task of good fiscal rule design.¹
Good design is hard to achieve, but critically important to both the sustainability of the public finances and macroeconomic stability. If it’s so hard to get right, why have rules at all? As a corollary, it is very unlikely that the Bank of England would wish to rely solely on a simple monetary policy rule. Instead the Bank would typically rely on a wide range of economic, monetary and financial information without adopting a fixed formula when setting policy. For monetary policy the risk, or perceived risk, of unsustainable policies has been addressed by giving operational independence to the Bank of England in setting policy rates. The trust of financial market participants will stem from the decisions being taken by independent technocrats rather than politicians seeking to gain re-election.

It is neither possible nor desirable to hand the operation of inherently political fiscal policy to unelected technocrats. But there are steps that can be taken to delineate the elements of fiscal policy that are legitimately political from the aspects should be more objective. One critical example is the establishment of an independent fiscal council like the UK’s Office for Budget Responsibility (OBR). The creation of the OBR goes in the direction of giving greater technocratic oversight of the government budget. While the technocrats at the OBR do not set tax or spending plans, their rigorous and independent analysis provides an objective and expert assessment of the economic outlook against which government spending plans can be judged. But its role is even more important as it is charged with adjudicating on whether the government has met its self-imposed fiscal targets. Failing to do so, under such an institutional framework, raises the cost to the government of adopting unsustainable policies than would otherwise be the case. For instance, they may lose credibility with the electorate and/or the financial markets by implementing plans which seem risky on the basis of the OBR’s analysis.

Combining fiscal rules set by political leaders with independent fiscal councils therefore offers a powerful combination for making better policy. But this combination is far from achieving its potential if one or other partner is not pulling its weight. Over the OBR’s first full decade, its outgoing chairman, Robert Chote, has succeeded in establishing the body as a permanent part of the constitution, with a reputation for analytical excellence, fierce independence and maximum transparency. On the other hand, Mr Chote’s tenure has seen three different sets of fiscal rules, all of which have been overtaken by events and ditched. For the macroeconomic policy framework to function effectively, the OBR needs to be complemented by a credible and durable set of fiscal rules.

The recent history of UK economic policymaking suggests that rules that have allowed insufficient flexibility for fiscal policy end up being shelved when economic developments go awry.

A Track-Record of Failure

The UK, like many other developed economies, has experimented with a variety of fiscal rules over recent decades with a somewhat mixed track record. There have been some successes from the era of fiscal rules since 1997: analysis by the Resolution Foundation (RF) suggests they may have reduced the earlier tendency for fiscal policy to stoke booms and exacerbate busts (‘pro-cyclical’ fiscal policy). However, fiscal frameworks have often been abandoned when they come under pressure from economic developments – precisely the moment when clarity over the direction for policy is most valuable.
Around two-thirds of the rules that have been adopted since 1997 have either been abandoned or broken, in the face of economic shocks. Across the various vintages of UK fiscal rules over the past 23 years, ten out of the 15 specific measures that were proposed have been missed. In recent years, a slower than expected recovery prevented the planned fall in debt as a share of GDP in 2016-17. Since then, sluggish economic growth, combined with various recent spending pledges, look likely to violate the outgoing ‘fiscal mandate’, to keep borrowing below 2 per cent of GDP. This, together with the Prime Minister’s apparent desire for more borrowing, has precipitated a fresh look at the framework. Past deviations from the various rules may often have been eminently sensible in the circumstances, as the alternative would have involved tightening policy in response to a weaker economy, exacerbating the economic misery. However, they also show that past rules have been too brittle and hence of limited value.

While it is not necessarily a sign of their failure, it is notable that the UK’s fiscal rules have not prevented a marked rise in government debt in recent years. As shown in the chart below the rules seem to have led to broadly stable government debt to GDP ratio in periods of economic recovery, but a very large rise during the financial crisis. There has also been a marked deterioration in the net worth of the UK public sector when taking into account a broader range of assets and liabilities. On this measure the UK performs poorly internationally. vi

Chart: Gross Public Debt

At the same time, the rise in debt around the financial crisis was both unavoidable and arguably insufficient, as the fiscal frameworks that were adopted were highly restrictive when the economy was still weak. During the acute phase of the crisis in 2008-09, allowing a sharp rise in debt was entirely sensible, as any attempt to try and prevent it would likely have deepened the economic pain substantially. However, during its early years, the 2010 Coalition Government sought to reduce the deficit rapidly, which is likely to have significantly slowed the pace of the recovery.
Well-designed fiscal rules should encourage governments to pay down debt in good times and also give them confidence to act decisively when storm clouds gather. If the fiscal framework is to lead to broad stability in the size of public debt in relation to the national economy, then rises in debt during downturns would normally need to be offset by declines during recoveries. But credible rules can also reassure the public and the markets that any rises in debt during downturns are a natural part of the economic cycle which can be addressed when conditions improve.

The experiment with fiscal rules to date has not always supported sensible long-term decision making. Rules that constrain the government budget deficit or debt stock may discourage public investment, or current spending on budget items which support longer term growth (such as education or research & development). The ‘Golden Rule’ from 1998-08 partly addressed this issue by focusing on the current budget deficit (therefore only borrowing for investment), but there was still a restriction to keep debt below 40 per cent of GDP, which encouraged various off-balance sheet innovations that did not fall under the definition of public sector net debt.

Against this inauspicious historical backdrop and the likely imminent failure to meet Hammond’s goals, the new Chancellor has to decide whether to adopt the proposals advanced by his predecessor or implement some other regime to govern the public finances. As Mr Sunak looks to recast the fiscal rules once again, he needs to do so in such a way that, unlike past efforts, avoids perverse incentives, ensures sustainability and is sufficiently flexible to weather the inevitable macroeconomic uncertainties ahead. How?

What Now?

The proposals outlined by Sajid Javid during the 2019 election campaign are the obvious starting point for considering what might come next. The framework consists of three parts. First, a balanced current budget in three years; second, investment spending of up to 3 per cent of GDP on average over the next five years; and third, debt interest payments limited to 6 per cent of tax revenues. These rules have some positive elements. The focus on the current budget (like the Golden Rule) should be less discouraging to investment than one constraining the overall budget balance. And the link with interest payments on government debt speaks to the affordability of debt by incorporating some market discipline.

However, the proposals also suffer from some significant flaws, which make them brittle and unlikely to survive the next bout of macroeconomic turbulence.

- **Unlikely to survive a downturn.** A three-year time horizon may not give enough flexibility to respond to economic shocks. In the absence of an escape clause, if a recession were to hit the economy in the next two years the rule would likely have to be cast aside or fiscal policy would deepen the pain. This is not a credible proposal, hence it devalues the fiscal rules in the eyes of both market participants and voters. There has been some speculation that the Chancellor might change the current budget balance target to a rolling five-year horizon. This would improve scope to respond to a downturn, but significantly increase the scope for borrowing over the course of the parliament.
• **Little short-term constraint from the interest rules.** The limit of debt interest payments to 6 per cent of tax revenues is also only likely to act as a weak constraint in the short-run. The UK government’s debt has an average time to maturity of around 15 years, which means that even if the cost of new debt were rising rapidly, for instance if markets took fright at government policies, this would only feed through to the overall debt interest over many years. Such a debt limit might therefore only begin to bite long after a profligate chancellor had left office. Debt interest payments are currently around 5 per cent of government revenue and so a rise to 6 per cent could be consistent with increasing the debt to GDP ratio from 81 per cent to almost 100 per cent which offers (perhaps excessive) scope for looser policy. However this rule could also prove too tight over the medium-term, leaving spending plans vulnerable to events beyond the government’s control, such as a rise in global interest rates, which RF has shown could quickly breach such a limit even on the watch of the most hair-shirted chancellor. This may require an abrupt correction in government spending plans as the interest bill approached the limit of 6 per cent.

• **An arbitrary limit on investment.** The 3 per cent of GDP limit on investment provides room to increase government investment in the near term from its current 2.2 per cent level. However, there is no clear logic for an upper limit given the need for better infrastructure and public investment more generally. Here, RF’s suggestion of using a public sector ‘net worth’ rule, stipulating that the value of public assets should rise faster than public liabilities over a five-year period, seems superior.

The limitations of the Javid proposal point the way to a more effective and robust framework. In our view the optimal fiscal framework should adhere to five principles. It should:

• clarify the government’s intentions about the long-run level of debt;
• prevent it deviating from a path for borrowing consistent with that goal in ‘normal’ economic times;
• ensure that the public sector net worth grows over time;
• allow it scope to respond aggressively to stabilise a downturn; and
• allow more scope to borrow for investment at times when the affordability of debt is abnormally high, and less when it is unusually low.

The next section proposes how to meet these goals.

**An all-weather fiscal framework**

We propose a framework that builds on some of the insightful ideas that have been floated by various commentators in recent months, but seeks to make the regime both more versatile and better at preventing a deficit bias from creeping in. Our framework consists of four elements.
(1) A LONG-TERM GOVERNMENT DEBT OBJECTIVE.

As a first step, the government would specify a broad long-term objective for the debt-to-GDP ratio. In being explicit about their debt objective, the chancellor should set out the considerations that supported this decision. For example, if the chancellor believes it is reasonable to aim for a debt-to-GDP ratio of 90 per cent in the long run (compared to the 81 per cent level today), they would have to explain why the extra borrowing is justified. By contrast, if the chancellor wished to pursue a debt-reduction strategy, they should be explicit about what a more optimal level of debt is and why. For credibility, this debt objective should ideally remain fixed for some time, although a new government could reasonably adopt a different objective, provided it spelled out its reasoning.

The OBR would then convert long-term debt objective into an implied underlying structural deficit limit based on its forecast of the sustainable GDP growth rate (the growth of potential output) and inflation – the baseline deficit limit. This would be the highest deficit that would be consistent with the target debt-to-GDP ratio over the long-term. Naturally a Chancellor could opt for a lower deficit if they wished to speed the otherwise gradual adjustment towards their debt objective.

This approach would strengthen democratic accountability since the Chancellor would have to justify a simple level of debt to which he or she aspires, while allowing the technocrats to translate this into an implied maximum annual borrowing limit.

(2) A REAL-TIME AFFORDABILITY TEST.

The deficit limit implied by the first step would then be adjusted to reflect the affordability of additional borrowing, such that scope to borrow is expanded when borrowing is cheaper and reduced when it is more burdensome. This adjustment reflects the fact that, irrespective of the government’s longer-term objective for debt, there are times when it makes more sense to borrow than others. For instance, if borrowing costs are low then it could be cost-effective to take the opportunity to increase investment spending or improve key public services. By contrast if borrowing costs are high then we might expect the government to be more cautious about taking on more debt.

An adjusted deficit limit would be applied to the structural balance which would reflect the cost of financing new debt relative to the ability to repay through economic growth. The cost of financing could be reflected in the long-term real interest rate on ten-year government bonds minus ten year-ahead inflation expectations (or simply, the Bank of England’s inflation target). The ability to repay debt would be measured by the expected growth in real potential output over the next ten years (as forecast by the OBR). The result would be the adjusted deficit limit. An implication of this adjustment is that the debt-to-GDP ratio would tend to rise above the longer-term objective when borrowing costs are low and below it when it is expensive to borrow.
The intuition for this adjustment to the baseline deficit is that it links borrowing headroom explicitly to the affordability of new debt. If the real long-term interest rate is high relative to the ability to repay (as measured by the expected long-term growth) then the government should curb its borrowing, since the burden of new debt will grow over time. By contrast, if interest rates are low relative to the expected growth of the economy then it will be easier to repay new debt in future, so the adjusted deficit limit should be looser than the headline one, making more room for investment.

Second, it would put the brakes on deficit bias much more effectively than a debt interest rule. Unlike debt interest rules, such as the one proposed in the Conservative manifesto, this rule would bite much more quickly if interest rates increased, since it focuses on the marginal affordability of new debt rather than the cost of the existing stock of debt which only changes slowly. By linking the deficit limit to the prevailing, rather than average, government bond yield there is a greater chance that reckless spending – which led to a spike in bond yields – would be much more quickly reflected in this test than in one based on the average interest rate on government debt. At the same time the adjustment of spending plans to higher interest rates would be smoother under this proposal than under an arbitrary debt interest rule. Such a rule would require rapid consolidation if the limit looked set to be breached.

The final rationale for the real-time affordability test is that by taking account the ability to repay via potential output this rule rewards policies that raise the sustainable rate of economic growth (e.g. productive infrastructure investment, education and training, R&D etc) and penalises those that do the opposite (e.g. trade barriers).

(3) AN ESCAPE CLAUSE

An escape clause, to enable counter-cyclical fiscal policy, would suspend the deficit limit at times when output was 1 per cent of GDP below estimates of its potential. This would enable active counter-cyclical policy to operate at times when the economy was weak but, unlike a recent proposal by the RF, does not also require interest rates to be low. Such flexibility is important because the structural deficit may jump in the depth of recession through active countercyclical fiscal measures, and it would be counterproductive to hinder that stabilisation mechanism.

A well understood counter-cyclical fiscal response framework could enhance the capacity for discretionary fiscal policy to respond to downturns but would need some oversight to ensure that it is not misused. Oversight is necessary to ensure that a fiscal framework is only used for macroeconomic management, and not political manipulation of the electoral cycle, and that it does not call into question the sustainability of the public finances.
(4) A NET WORTH GOAL

Consistent with a proposal from the RF, the government would also be assessed against its progress towards increasing public sector net worth over five years. Conceptually a net worth objective is appealing as it is more closely related to sustainability than the net debt concept that is typically used. Moreover, it does not create perverse incentives to incur liabilities that are not included in the narrower debt definition. However, the problem with such an approach has been the lack of stable and timely data on all the assets and liabilities needed to estimate net worth. In recent years there has been considerable progress in this area, both from the ONS in terms of statistics and the OBR in assessing likely future developments in the various components of net worth. Nevertheless, there is still a need to obtain more timely estimates and test the stability of these estimates in real time to ensure that they are a practical guide for policy-makers.

A net worth target could become fully operational once it can be shown that reliable and stable real-time measures of net worth are available with sufficient timeliness. The net worth constraint would complement the need for the government to spell out its rationale for the debt objective by limiting the degree to which short-termist governments could cut investment in favour of current spending.

How Would the Framework operate?

The critical elements of the framework are the orientation for debt in the long term and the real-time affordability test. So how would these rules work in practice to determine constraints on the government’s ability to borrow?

The first step would involve the government specifying a long-term debt orientation. For example, a new chancellor might decide to target debt reduction and aim for a 70 per cent debt-to-GDP (compared with a current level of 81 per cent). The OBR would then calculate the baseline deficit limit consistent with this aspiration in ‘normal times’, based on its view of potential growth and inflation. With potential growth currently thought by the OBR to be around 1.5 per cent and inflation at 2 per cent, a debt objective of 70 per cent of GDP would be consistent with a baseline deficit limit of 2.5 per cent of GDP in ‘normal times’. For the purposes of this rule, normal times would be defined as when the real long-term interest rate and the expected growth in potential output are aligned (which has been true on average since 1997) and the economy is not operating significantly below capacity.
The second step would be to derive the adjusted structural deficit limit. This would be calculated using the initial orientation defined in step one (i.e. 2.5 per cent) adjusted for the expected increase or decrease in the cost of changes in debt relative to output over the next ten years. This would be defined using two components:

1. **Real Financing Cost** (RFC) is defined as the interest rate on ten-year government bonds minus the Bank of England inflation target, compounded over ten years.
2. **Future Potential Output** (FPO) is defined as the level of real potential output expected in ten years’ time (derived from the OBR’s forecast) relative to current real potential output.

At times when interest rates (RFC) are higher than the sustainable rate of economic growth (FPO), the burden of debt is set to grow, so borrowing should be reined in. When the opposite is true borrowing can be higher, reverting to the long-term limit when economic conditions normalise.

As an illustration, the chart below shows how these variables would have evolved over the past 45 years if we assume perfect foresight for inflation and potential output over this period. There are broadly three distinct phases to consider. With the decline in inflation in the 1980s and 1990s between 1980 and 1997, the RFC of new debt was well in excess of the growth in the potential of the economy, hence new borrowing represented a growing burden, and under our rule the structural deficit limit should have been adjusted downwards to reflect this. In the second phase, since the start of the current macroeconomic framework – characterised by the operational independence of the Bank of England in 1997 – RFC and FPO have been approximately equal on average, implying no need to adjust the baseline deficit consistent with the objective for debt. Most recently, RFC has been below FPO since around 2011, such that borrowing now becomes more affordable over time, hence the deficit limit should reflect that reality.

**Chart: Real Financing Costs and Future Potential Output**
The baseline structural deficit limit would be adjusted according to the prognosis for its affordability. As an illustrative example consider how this rule would work with differing long-term financing costs. For the purposes of the calculation we set the long-term debt target at 70 per cent. With inflation at 2 per cent and potential output growth over the next ten years at 1.5 per cent, this produces a baseline structural deficit limit of 2.5 per cent of GDP. The projected growth of potential output gives FPO as 1.16. What happens to the adjusted deficit limit as interest rates change in these circumstances? The examples below show that when interest rates are high - e.g. 6 per cent - then the adjusted deficit limit would be reduced to 2 per cent. But when interest rates are low – e.g. 0.7 per cent - then a looser adjusted deficit limit of 3.3 per cent could be permitted.

- **Case 1:** Long term interest rates of 6 per cent (e.g. in 1997/98) which gives an RFC of 1.48:
  
  \[ \text{Adjusted structural deficit limit} = 2.5\% \times \frac{1.16}{1.48} = 2.0\% \]

- **Case 2:** Long term interest rates of 3.5 per cent (e.g. in 2009), giving an RFC of 1.16:
  
  \[ \text{Adjusted structural deficit limit} = 2.5\% \times \frac{1.16}{1.16} = 2.5\% \]

- **Case 3:** Long term interest rates of 0.7 per cent (e.g. in early 2020), giving an RFC of 0.88:
  
  \[ \text{Adjusted structural deficit limit} = 2.5\% \times \frac{1.16}{0.88} = 3.3\% \]

As is evident from the examples above, the rules allow greater headroom for borrowing – and particularly for investment given the net worth goal – at times when new debt is more affordable. As a result, the fiscal framework can not only respond to cyclical downturns thanks to the escape clause, but also to secular slowdowns, such as the current one, characterised by persistently low interest rates when the economy still appears to be operating at potential.

How would the rules guide the evolution of public debt under present economic conditions? As shown above, in Case three, a long-term target of 70 per cent debt-to-GDP would allow an adjusted deficit limit of 3.3 per cent under current (cheap) financing costs and estimated potential growth. While debt interest remains lower than potential output growth, this will cause debt to drift higher than its current level of 81 per cent. Were interest rates to gradually rise back to the rate of potential output growth in five years’ time, the adjusted deficit limit would fall back to 2.5 per cent, putting the debt back on track to 70 per cent. As shown in the chart, if the deficit was fixed at the maximum value implied by the limit, the projected return of debt to the underlying target of 70 per cent would be delayed compared to a baseline fixed deficit of 2.5 per cent, but the direction of travel would be similar. By contrast, despite offering more flexibility to spend in the short-run, the adjusted deficit limit would be consistent with a lower long-run debt stock under the current rules proposed in the Conservative manifesto (if the maximum flexibility for investment were to be used in perpetuity).
Would the framework survive economic storms?

This approach to adjusting the structural deficit limit can be applied to the data from the past 39 years to judge how the proposed rules would have fared in the past. For the purposes of this backward-looking illustration, the baseline deficit limit is fixed at 2.5 per cent of GDP for the whole period. The baseline deficit limit was then adjusted for changes in the cost of finance and potential growth and the results of this calculation are shown in the chart below.\textsuperscript{44} On this basis, the rule was passed around two-thirds of the time over the past 39 years (around half of the time this was solely due to the escape clause).
The chart above shows that there have been times in the past when borrowing was above the limit implied by this adjustment, but that in recent years it has been somewhat tighter than it needed to be. During the mid-2000s the structural deficit was above the limit. In the latter case this was after several years when policy was much tighter than required by the rule. More recently the limit has risen well above the structural deficit, mainly because there have been further falls in cost of finance below the expected growth in potential output.

During the financial crisis the rule would not have constrained fiscal policy in playing an active role in stabilising the economy. It would also have enabled a later start to deficit reduction than the relatively rapid tightening undertaken by the Coalition Government. The escape clause would have been in operation between 2008 and 2013, allowing both fiscal stabilisers and discretionary policy to minimise the loss in output and delaying the need for austerity. With economic conditions improving by 2014, the rule would then have required the government to implement a clear plan for deficit reduction back to the underlying limit within a reasonable timeframe.
Would It Provide Sufficient Incentive to Invest?

Even though this rule targets the overall deficit, it still enables governments to make sensible long-term investments to boost the potential of the economy. As shown in the chart above, currently it appears that the deficit could be around 1.5 percentage points higher than the current stance without breaching the limit, suggesting significant scope to increase investment, even with a long-term objective of reducing debt to 70 per cent of GDP. For instance, if the government aimed to balance its current spending then it could use the headroom implied by this rule to raise investment spending from 2.2 per cent to 3.3 per cent of GDP. This is significantly more than would be allowed under the current government’s rules.

If a government wanted to allow further increases in borrowing for investment, it would have to be explicit about this by setting a higher long-term objective for government debt which would then be reflected in the deficit limit. For instance, if the government was prepared to accept that the debt-to-GDP ratio would stay roughly at its current level of 81 per cent over the longer-term, it could accept a higher deficit of up to 3.8 per cent giving room for another 0.5 per cent of GDP in investment spending. Furthermore, if the government made the case that important national priorities spoke in favour of more substantial investment - even if that pushed the debt to GDP ratio to 100 per cent of GDP over the longer term - then the deficit could rise to as much as 4.7 per cent adding nearly 1.5 per cent of GDP to investment spending. These would be political choices that would be made explicit by this fiscal framework.

Investment would be encouraged by the goal of raising net worth while the framework would also enable spending to be directed towards a broader notion of investment than has been the case with previous approaches. Most other fiscal rules have targeted the current budget deficit and have therefore privileged public investment (see Table). While there are solid accounting arguments for this, as investment is likely to yield an asset which can be set-off against the additional debt liabilities, it may not be optimal from an economic perspective. First, investment is not automatically superior to current spending as it still must be in worthwhile projects that offer good value for money (i.e. avoiding while elephants). Second, some current spending can represent a form of investment for the economy as a whole. The most obvious example would be an increase in spending on education and training which would increase the human capital of the labour force. This would raise the capacity of the economy and the tax base, albeit without providing an asset for the government accounts. Similar considerations could also apply for appropriate spending on research and development, improving health outcomes or environmental improvements.

The framework encourages investment and other productive spending by taking affordability and long-run growth into account. If the OBR judged that the additional government spending would raise the underlying growth rate of the economy, then these rules would reflect that through the FPO variable in the adjustment calculation. This may also help reassure the markets that the government’s plans are broadly sustainable and help keep the cost of finance (RFC) under control. By contrast, if the OBR took the view that a government’s plans were not supporting long-term growth then they would not see this benefit and the cost of finance might rise if the markets began to doubt the wisdom of the additional spending.
The potential magnitude of these effects can be illustrated with a scenario in which there was a rise in bond yields or change in potential output expectations. For instance, a rise in bond yields of five percentage points would reduce the adjusted deficit limit from 3.3 per cent to 1.9 per cent. By contrast a rise in potential output growth expectations of one percentage point per annum would directly raise the adjusted deficit from 3.3 to 3.6 per cent. xxi

Therefore, a government that undertook credible investments in the productive potential of the economy could be rewarded with a looser budget constraint or scope to target a lower debt. This could come through faster potential growth which made the burden of repayment lower and increased the level of the deficit that would be consistent with the desired level of debt to GDP. There could also be reduced financing costs if the bond market had greater confidence in the economy’s capacity to generate tax revenues to repay debt.

By contrast a profligate government that increased only unproductive spending, made poor quality investments, or otherwise undermined the smooth functioning of the economy might be punished with a tighter limit. Weaker expected potential growth would directly lower the deficit limit and doubts about the direction of government policy may lead investors to demand higher sovereign yields.

In short, the design of these fiscal rules ties borrowing headroom to the quality of microeconomic policy, as well as market conditions.

Conclusion

For too long fiscal rules to govern the UK’s public finances have been re-written and broken, undermining their purpose and their potential economic and civic benefits. This has tended to happen because their authors have assumed that good times would continue to roll, even though it is when bad times prevail than the need for a stable fiscal framework is at its greatest.

This paper has proposed an all-weather framework that would give voters and market participants confidence about the long-term orientation of policy while allowing the necessary flexibility to respond more optimally to both cyclical and secular slowdowns. It also rewards good microeconomic policy and punishes bad, rather than treating the macroeconomic role of fiscal policy as distinct from it. For these reasons the framework would be a valuable innovation in macroeconomic policy.
### TABLE: KEY FEATURES OF SELECTED FISCAL RULES

<table>
<thead>
<tr>
<th></th>
<th>Coalition 2010-15</th>
<th>Sajid Javid’s proposal</th>
<th>Resolution Foundation</th>
<th>TBI proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deficit</strong></td>
<td>Balance structural current budget over five years</td>
<td>Balance current budget over three years</td>
<td>Structural current deficit between -1/+1 per cent of GDP</td>
<td>Limit for the structural deficit consistent with debt objective, adjusted for affordability [e.g. 3.3 per cent]</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>Falling as a percentage of GDP by 2015-16</td>
<td></td>
<td></td>
<td>Target decided by government [e.g. 70 per cent of GDP]</td>
</tr>
<tr>
<td><strong>Net Worth</strong></td>
<td></td>
<td></td>
<td>Improve as a percentage of GDP over five years</td>
<td>Improve as a percentage of GDP over five years*</td>
</tr>
<tr>
<td><strong>Interest limit</strong></td>
<td></td>
<td>6 per cent of current revenues</td>
<td>Greater than 10 per cent of current revenues</td>
<td>Cost of financing affects amount that can be borrowed</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>Accompanied by creation of OBR</td>
<td>Investment limited to 3 per cent of GDP</td>
<td></td>
<td>Long term growth affects amount that can be borrowed</td>
</tr>
<tr>
<td><strong>Escape Clause</strong></td>
<td></td>
<td>Escape clause when the output gap greater than 1 per cent of GDP and Bank of England policy rates are below 1.5 per cent</td>
<td></td>
<td>Escape clause when the output gap greater than 1 per cent of GDP</td>
</tr>
<tr>
<td><strong>Strengths</strong></td>
<td>Gave long-term orientation to restoring public finances and did not a priori restrict investment</td>
<td>Enables some more investment and recognises cost of finance</td>
<td>Enables more investment and recognises cost of finance, net worth test and possible need for macro-stabilisation role</td>
<td>As RF, but provides stronger safeguards against deficit bias and allows a greater macro-stabilisation role. Also clarifies debt target for stronger public accountability and facilitates broader forms of investment such as spending on education &amp; training.</td>
</tr>
<tr>
<td><strong>Weaknesses</strong></td>
<td>Didn’t take account of economic weakness from 2010-13 and targets missed.</td>
<td>Unlikely to survive a recession or a modest rise in borrowing costs</td>
<td>Cost of finance test not binding initially, restricts macro-stabilisation to periods where interest rates are very low</td>
<td>Some additional complexity and requires forecasts for potential output (already available)</td>
</tr>
</tbody>
</table>

* Subject to the availability of timely and stable data for net worth
From populist leadership to public protest, our current political landscape is marked by extremism, with ‘us’ and ‘them’ attitudes pervading debate on a global basis. Alongside this, we’re living in an unprecedented era of technological progression; one that offers renewed prosperity and connection, but which also presents challenges that threaten further division.

Our work is necessarily bold, but it’s practical too, shaping the debate, and offering a programme that is both radical and realistic: fully cognisant of the modern world and its present direction, and of the size of steps necessary to achieve the change we want to see.

GENERAL ENQUIRIES
info@institute.global

MEDIA ENQUIRIES
mediabids@institute.global

FOLLOW US
facebook.com/instituteglobal
twitter.com/instituteGC
instagram.com/institutegc

All rights reserved. Citation, reproduction and or translation of this publication, in whole or in part, for educational or other non-commercial purposes is authorised provided the source is fully acknowledged. Tony Blair Institute, trading as Tony Blair Institute for Global Change, is a company limited by guarantee registered in England and Wales (registered company number: 10505963) whose registered office is 50 Broadway, London, SW1H 0BL.
benefit of higher long limit to rise temporarily to 4.6 per cent of GDP consistent with an unchanged longer relationship between the underlying objectives for the deficit and the debt stock. If inflation remained unchanged, a 1 per cent the underlying debt target of 70 per cent of GDP would have been consistent with a 2.5 per cent deficit over this period.

However, the growth rate of nominal GDP has averaged around 3.5 per cent since 2004, suggesting that the run target for the debt stock of 55 per cent of GDP. Faster growth in nominal GDP would imply that a larger deficit could be tolerated for a given debt stock target. The assumption of perfect foresight for inflation is likely to be broadly appropriate since 1997 once inflation expectations became broadly anchored around the Bank of England’s target. To the extent that the period of disinflation from the late-1970s to the mid-1990s was not fully anticipated, then the ex-ante real interest rates would not have been perceived to have been as high as implied by the chart. However, the chart does reflect the ex post cost of financing government debt.

This calculation illustrates the direct impact of changes in the cost of finance and potential output growth on the adjustment to the baseline deficit. It abstracts from the impact of changes in the growth of nominal GDP on the relationship between the deficit and debt targets. By keeping the baseline deficit limit fixed at 2.5 per cent - which is consistent with a 70 per cent debt stock at the current growth of nominal GDP – any lasting changes in the growth of nominal GDP will be reflected in an adjustment to the implied target for the debt stock. So, when inflation and GDP growth were higher in the 1980s, a 2.5 per cent deficit would have been consistent with a lower debt to GDP ratio than 70 per cent. However, the growth rate of nominal GDP has averaged around 3.5 per cent since 2004, suggesting that the underling debt target of 70 per cent of GDP would have been consistent with a 2.5 per cent deficit over this period.

By adding one percentage point to nominal income growth an additional impact of a rise in potential growth could be to change the relationship between the underlying objectives for the deficit and the debt stock. If inflation remained unchanged, a 1 per cent in the growth rate of potential output would raise nominal GDP growth from 3.5 per cent to 4.5 per cent per annum. This could allow the deficit limit to rise temporarily to 4.6 per cent of GDP consistent with an unchanged longer-term debt objective of 70 per cent of GDP. Alternatively, the government could maintain the baseline deficit of 2.5 per cent and adjusted deficit limit of 3.6 per cent and reap the benefit of higher long-term growth in the form of a lower long-run target for the debt stock of 55 per cent of GDP.

References

1 Jonathan Portes & Simon Wren-Lewis (2014), Issues in the design of fiscal policy rules, NIESR.
2 For instance, there is the well-known Taylor rule which links policy interest rates to the deviation of inflation from its target and the output gap (deviation of actual output from potential). Rules of this type have been used to represent monetary policy in macroeconomic models or as a benchmark against which to examine actual policy rates.
3 The UK is certainly not the only country to have struggled with the implementation of fiscal rules. For a discussion on fiscal rules in Europe see Wyplosz, C., et al (2019) Fiscal Rules in Europe, IFO Dice Report, Summer Vol. 17.
6 See figure 2 in R Hughes, Seeking public value: The case for balance sheet targeting in fiscal policy, Resolution Foundation, September 2019.
7 See Mulheirn & Browne (2019) op cit
8 Analysis by the RF suggests that the 6 per cent rule could easily be breached in the event of a range of shocks which is why they recommend a 10 per cent ceiling
9 According to simple arithmetic, in the long run the government debt to GDP ratio will converge to a value that equals the deficit to GDP ratio divided by the growth in nominal income. For instance a country that recorded a permanent deficit of 3 per cent of GDP with nominal income growing at 5 per cent per annum will ultimately achieve a debt to GDP ratio of 60 per cent of GDP (0.03/0.05) irrespective of whether its debt started at 40, 60 or 80 per cent of GDP.
10 The choice of a ten-year horizon for bond yields and potential growth is a simplification for illustrative purposes. In practice the calculation could be refined to reflect the average horizon of new debt issued by the government and relate this to the projected potential growth over the same period. Furthermore, it may also make sense for the OBR to make a projection for the evolution of RFC and FPO, e.g. for the next three years, so that it can project the future evolution of the adjusted deficit limit to help the government plan its finances.
11 Recent work by the Resolution Foundation (RF) proposes developing such a framework so that policy could act at speed (or at least more quickly than in the past) when a downturn comes. This could specify the circumstances in which fiscal policy would be used, how large the stimulus would be, and which taxes and spending measures would be adjusted in the event of a downturn. Importantly, a clear pre-announced framework could be fully understood and internalised by economic agents. The idea is that if people see a credible framework for fiscal intervention, they could be less nervous when the downturn hits and this moderation in adverse expectations could contribute to a shallower recession.
12 See the discussion on the net worth concept and statistical progress in R Hughes et al (2019), Totally (net) worth it: The new generation of UK fiscal rules, Resolution Foundation, October
13 In its March 2019 Economic and Fiscal Outlook, the OBR projected potential growth of 1.5 per cent in 2019 rising to 1.6 per cent by 2023
14 As already highlighted, the relationship between the debt and deficit targets is conditional on the growth rate of nominal GDP. Faster growth in nominal GDP would imply that a larger deficit could be tolerated for a given debt stock target.
15 The assumption of perfect foresight for inflation is likely to be broadly appropriate since 1997 once inflation expectations became broadly anchored around the Bank of England’s target. To the extent that the period of disinflation from the late-1970s to the mid-1990s was not fully anticipated, then the ex-ante real interest rates would not have been perceived to have been as high as implied by the chart. However, the chart does reflect the ex post cost of financing government debt.
16 RFC = (1+0.06-0.02)^10 = 1.48
17 This calculation illustrates the direct impact of changes in the cost of finance and potential output growth on the adjustment to the baseline deficit. It abstracts from the impact of changes in the growth of nominal GDP on the relationship between the deficit and debt targets. By keeping the baseline deficit limit fixed at 2.5 per cent - which is consistent with a 70 per cent debt stock at the current growth of nominal GDP – any lasting changes in the growth of nominal GDP will be reflected in an adjustment to the implied target for the debt stock. So, when inflation and GDP growth were higher in the 1980s, a 2.5 per cent deficit would have been consistent with a lower debt to GDP ratio than 70 per cent. However, the growth rate of nominal GDP has averaged around 3.5 per cent since 2004, suggesting that the underling debt target of 70 per cent of GDP would have been consistent with a 2.5 per cent deficit over this period.
18 By adding one percentage point to nominal income growth an additional impact of a rise in potential growth could be to change the relationship between the underlying objectives for the deficit and the debt stock. If inflation remained unchanged, a 1 per cent in the growth rate of potential output would raise nominal GDP growth from 3.5 per cent to 4.5 per cent per annum. This could allow the deficit limit to rise temporarily to 4.6 per cent of GDP consistent with an unchanged longer-term debt objective of 70 per cent of GDP. Alternatively, the government could maintain the baseline deficit of 2.5 per cent and adjusted deficit limit of 3.6 per cent and reap the benefit of higher long-term growth in the form of a lower long-run target for the debt stock of 55 per cent of GDP.

22