Institute for Public Policy Research

BUDGETING BETTER

HOW THE UK COULD START TO IMPROVE ITS FISCAL FRAMEWORK AND BOOST GROWTH

Carsten Jung
with foreword by
Lord Jim O'Neill

October 2024

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IPPR
4th floor,
8 Storey's Gate
London
SW1P 3AY

E: info@ippr.org
www.ippr.org
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ABOUT THE AUTHOR

Carsten Jung is a principal research fellow and head of macro and AI at IPPR.

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FOREWORD BY LORD JIM O'NEILL

Chronic underinvestment lies at the heart of the UK's recent and long term economic woes and underpins many of the challenges our nation currently faces. Investment in the UK has been at the bottom of the G7 for 24 out of the last 30 years. This has led to a doom loop of economic stagnation and decline, where inadequate capital allocation weakens both our productivity and exacerbates social and environmental issues.

The new Labour government has admirable ambition for a paradigm shift – including being the strongest growing G7 nation. It's frankly a bit hard to do that without a similar ambition for investment growth, including from the potenitally most patient investor of all, the government. Without this I struggle to see how the new government is to meet its target to make growth faster, never mind fairer and greener.

The private sector can be at the heart of this. But it cannot drive this monumental task alone. Nor will it regard a government as serious if at the same time it is cutting public investment spending. We therefore need a notable increase in public investment. Yet, the government has inherited spending plans that project significant real terms reductions – not increases – in public investment over the course of this parliament. A promised 'era of national renewal' cannot be achieved if these investment cuts are implemented.

Allowing public investment to fall would be tantamount to repeating past missteps, where investment reductions made under the guise of fiscal prudence have eroded the bedrock of our economy and undermined the UK's long term financial sustainability. Of course, the current fiscal framework , which the new government adopted, fosters this short-sighted approach, creating an inherent bias against investment.

IPPR has made thoughtful suggestions of how this can change. This report highlights how Labour can implement its fiscal rules in a way that embeds a more long termist approach. Focusing on a more comprehensive debt metric – such as public sector net worth – would provide greater room for borrowing to invest in line with a more transparent approach to fiscal rules. It would also bring fiscal rules more in line with how financial markets think about fiscal sustainability.

Indeed, financial markets would celebrate this. Bond investors understand that borrowing to invest – if part of a clear plan – increases future growth and improves the government's financial position. Incurring slightly higher debt to fund high quality investment will thus not permanently push up borrowing costs. And at the same time, our persistently low-valued equity market might celebrate steps that deliver an enhanced credible long term growth plan.

Having the OBR at the centre of this, gives immediate transparency and credibility, in so far as they can demonstrate those investment projects likely to have long term benefits, so called significant positive multipliers. Such evidence could then be shown in a couple of new budget line items where public sector investment spending is clearly shown as a share of GDP, indeed, consciously increased in the life of the parliament. Even if this resulted in a higher absolute debt to GDP ratio during the earliest years, the OBR's assessment could show that, over a 10 year time horizon, debt would be lower.

Fiscal rules have been chopped and changed eight times since their inception, including seven times by post-2010 governments. But this time can be different. I applaud IPPR's recommendations – they take us towards a more comprehensive framework that encourages productive investment and long-term thinking. The UK direly needs it.

Lord Jim O'Neill

Lord Jim O'Neill was chair of Goldman Sachs Asset Management Division, having previously being the firm's chief economist. He served as commercial secretary to the Treasury under David Cameron, and subsequently briefly, Theresa May. He currently chairs the Northern Powerhouse Partnership, and also chairs Northern Gritstone.

SUMMARY

The new Labour government's growth mission is to make the UK the fastest growing economy in the G7, achieving "good jobs and productivity growth in every part of the country, making everyone, not just a few better off". But UK growth is low, and UK investment is at the bottom of the G7. Planning reform and a clear industrial strategy will help boost private investment. But public investment will need to rise too.

Instead, the plans inherited from the previous government have public investment on a sharp downward path. The Labour party has stated its fiscal rules in its manifesto, including committing to only borrowing to invest and to have debt falling in year five of the forecast. But if the new government chose to target exactly the same measure of debt as the previous government, this would likely imply very little headroom to increase borrowing to invest, severely hampering its growth ambition.

In this paper, we highlight that the set up inherited from the previous government does not even work on its own terms of promoting fiscal sustainability. This is because public investment can have significant future returns and can thus be paid for by borrowing. A framework that delivers fiscal sustainability should account for this.

This is but one example of where our fiscal sustainability framework falls short. In this paper we highlight how it could be improved, through short term changes in the autumn budget and through longer term changes in the future. The UK has a proud history of pioneering fiscal institutions that have high credibility and are copied elsewhere in the world, such as the Office for Budget Responsibility (OBR). Starting a clear headed reform process now could make the UK fiscal framework one of the most growth friendly, but also one of the most rigorous, in the world.

We make the following points.

- The UK framework needs to be better at delivering fiscal sustainability. It needs to meet a number of objectives, including covering the cost of the borrowing, the government's financial position and the growth impacts of today's fiscal decisions.
- The rules that the Labour government has inherited from the previous government do not yet achieve the right balance between the various fiscal sustainability objectives.
- There are a range of options Labour could consider at the budget to move closer to fiscal sustainability objectives, while staying true to its stated fiscal rules.
- Especially with regards to the debt rule, a broader measure is preferable – one that better accounts for the assets that government spending can create.
- On balance, we believe the government should thus broaden its definition of debt to include a greater number of assets as well as liabilities – such as targeting the measure of public sector net worth, which the Office for National Statistics (ONS) and OBR already regularly produce. In the past, the Resolution Foundation has endorsed this metric, as has a recent IMF paper, describing this target as being "more conducive to public investment and economic growth, while providing for sensible policy reactions [to changes in financial conditions]". We agree. We also highlight that the slightly less broad metric of public sector net financial liabilities is a second best option.

- When implementing its current budget rule, the government should use the 'cyclically-adjusted' metric. This retains the notion that it is only allowed to borrow to invest, but includes a buffer that reflects the state of the economy. This helps to avoid destabilising swings of economic policy making. Moreover, the government should follow common practice and clearly define an 'exit clause' that pauses this rule in the case of a clearly defined fiscal emergency, such as a pandemic.
- This should be complemented by improvements of the government's public investment framework, ensuring value for money and alignment of investments with missions. Alongside this, the government should seek to establish a public investment watchdog, potentially as part of the OBR, that monitors public investment quality and provides a high level of transparency about the types of projects that are funded. We will discuss reform options in forthcoming work.

Adopting a net worth target would provide an additional £57 billion headroom against the previous government's debt rule, as well as potential additional headroom to invest in high value assets. We argue that some of this should be retained as headroom against the target. The previous government left only £9 billion of headroom against its fiscal target – the second lowest in the OBR's history (OBR 2024a). Given the inherent uncertainty in economic forecasting, some of such buffer is needed to ensure that the government meets its target with high probability.

But even when retaining additional headroom, this measure would provide significant additional space to borrow to invest, get Britain building again and, in Rachel Reeves words, ensure there are "shovels in the ground [and] cranes in the sky, the sounds and sights of the future arriving".

Most importantly, we argue that these changes would start the journey towards a better and more comprehensive fiscal framework. For instance, a debt rule – even one that targets net worth – focussed on the difference between year four and five of the forecast is unnecessarily narrow. The current framework also lacks any emphasis on debt servicing costs. The framework should also be more long term and better reflect the likely future impact of different types of fiscal policy choices. Finally, it should also reflect the benefits of making the economy more resilient against future shocks (such as an energy crisis).

1.
TO ACHIEVE THE FASTEST GROWTH IN THE G7, THE UK NEEDS TO RAISE ITS LEVEL OF PRIVATE AND PUBLIC INVESTMENT

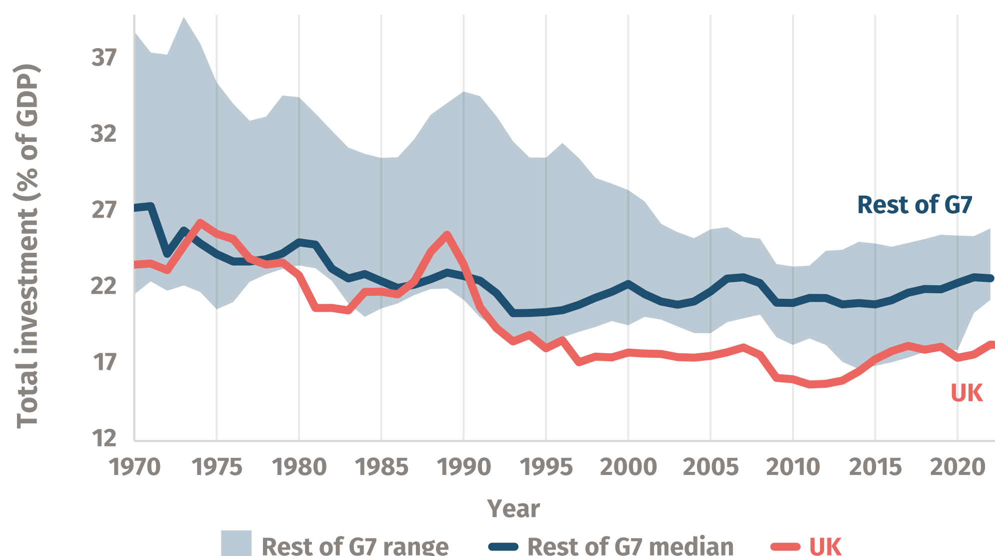
The new Labour government's growth mission is to make the UK the fastest growing economy in the G7, achieving "good jobs and productivity growth in every part of the country, making everyone, not just a few better off". But UK growth is low. The Bank of England forecasts it to be at only about 1 per cent in the next three years – about half the speed of the USA (Bank of England 2024).

A key factor in the UK's low growth rate is its low investment rate (Resolution Foundation 2023). The UK has had the lowest level of economy wide investment in the G7 for 24 of the last 30 years. Had the UK kept up with the G7 average over the past 32 years, it would have invested £1.9 trillion more in real terms (Dibb and Jung 2024) (figure 1.1). Worse, levels of investment in the UK are moving in the wrong direction. UK net public investment is set to fall to from 2.4 per cent of GDP in 2023/24 to 1.7 per cent at the end of the parliament. This puts the government's growth mission at risk.

FIGURE 1.1

The UK has lower investment than other comparable countries

Gross fixed capital formation (total economy) for the UK and G7



Source: Dibb and Jung 2024

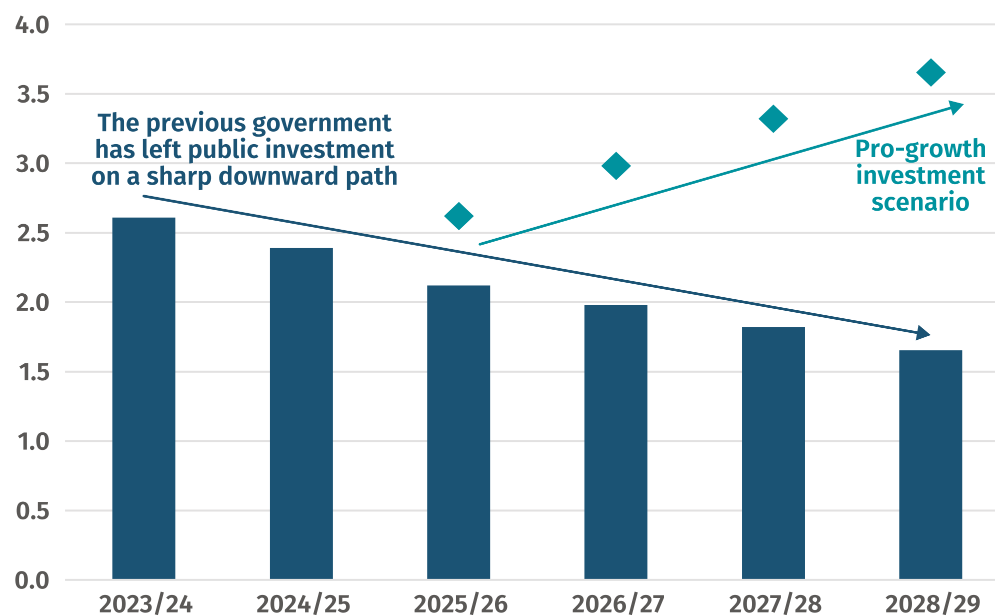
Much of this investment needs to be delivered by private sector businesses, boosted by industrial strategy and planning reform. However, investment by the public sector is crucial. Such investment can be in physical infrastructure such as roads and railways but also public buildings and crucial equipment, such as medical devices for hospitals. Higher levels of public investment increase efficiency in the private sector by improving the infrastructure that businesses rely on (Ramey 2020). The National Infrastructure Commission (2023) calls infrastructure investment the "backbone of our economy" as it provides essential services and connectivity. It also stresses that "better transport and digital networks can support economic growth across regions." The International Monetary Fund too has long highlighted the need for advanced economies to increase 'high quality' public investment, stressing that it can 'crowd in' private investment and make economies more resilient (IMF 2020).

But for the UK to merely maintain the level of investment of 2023/24, the government will need to deliver an additional 0.9 per cent of GDP in public investment by 2028/29 (£31 billion). And at least another additional 1 per cent of GDP will be needed to fill the UK's investment gap (IPPR EJC 2021). In figure 1.2 we depict a scenario that sees net public investment rising by 0.5 percentage points of GDP in the coming fiscal year, and then gradually increasing to two percentage points additional investment, by the end of parliament.

FIGURE 1.2

A significant turnaround in public investment is needed to boost growth

Public sector net investment, per cent of GDP, 2023



Source: OBR 2024a and IPPR analysis

2.
PUBLIC INVESTMENT CAN HAVE FUTURE RETURNS AND CAN BE PAID FOR BY BORROWING

Public investment in projects that enhance future economic growth is a fundamental principle of macroeconomic policy. Such investments improve a nation's productive capacity by upgrading infrastructure, advancing technology, and fostering human capital development.

Financing these growth-oriented investments through borrowing, rather than increasing taxes, can be advantageous from a pro-growth perspective. Borrowing allows the government to spread the cost of investments over the periods in which the benefits accrue, aligning payments with future gains and adhering to intergenerational equity.

This approach avoids the immediate dampening effect on consumption and private investment that higher taxes might cause. Largely funding an increase in public investment through higher taxes could thus run the risk of slowing the already anaemic economic recovery. The other option of spending cuts could put already struggling public services at risk. After a decade of austerity, futher cuts could be politically hard to achieve, undermine growth and would likely worsen social outcomes.

There is also an emerging evidence base that 'high quality' public investments can indeed generate high medium term economic returns, significantly boosting growth and in fact strengthening (rather than weakening) the government's fiscal position (box 1). In theory higher borrowing to invest could even go hand in hand with the previous government's debt rule. But, given uncertainties around timing and size of effects, and given its remit, the Office for Budget Responsibility (OBR) tends to be quite conservative in its forecasts of the positive effects of public investment. This means that the exact implementation of the debt rule can be important for the government's headroom to invest. We discuss the principles for guiding this decision in the next section.

BOX 1: THE RETURNS TO PUBLIC INVESTMENT

Public investment can have significant economic returns that can boost GDP growth and make the economy more resilient against shocks. For instance, advancing the UK's clean energy infrastructure will boost growth by leading to lower electricity and energy bills (OBR 2023). Another example is better transport infrastructure connecting people and places, which in turn facilitates more efficient housing and labour markets (NIC 2023). It will also make the UK economy more resilient by reducing its exposure to future global energy price shocks.

The UK's OBR has made some recent progress on how such returns are reflected in its economy forecasts (OBR 2024b). One way it expresses its assessment of public investment is through the 'rate of return'. It estimates that the economy wide rate of return of on public assets is 8.7 per cent, whereas the fiscal return (ie the amount of it returned to the exchequer via the tax dividend from higher growth) is 1.9 per cent.

The OBR highlights a finding that the returns to public investment in core infrastructure (such as roads, railways, airports, and utilities, such as sewerage and water facilities) could be one-third larger than the average for public investments. Separate work by the OBR shows that poor population health is an important drag on the exchequer. It finds that: "improving the health of the population could reduce the rise in debt [by 2027] by a further 40 per cent of GDP" (OBR 2024c).

However, despite these potentially high returns, the OBR suggests that it might take longer than five years for a large share of these returns to occur and thus they could leave the debt level higher than if the investment had not taken place (OBR 2024c). Yet, over their lifetime they could still meet the cost benefit test.

In forthcoming IPPR work, we will highlight how the OBR's work could be further improved and stress there is significant further evidence on which types of investment could provide especially high returns, including from those that are part of an industrial strategy. We will also highlight that some types of investment can have high returns in the short-term, by crowding in private sector activity.

3.
THE UK FRAMEWORK NEEDS TO BE BETTER AT DELIVERING FISCAL SUSTAINABILITY

It is crucial that any increase in public investment – and indeed all major fiscal policy changes – should be governed and informed by a holistic fiscal sustainability framework. Growth without fiscal sustainability is risky at best and self defeating at worst.

Fiscal sustainability, in short, means that public finances should be run in a way that does risk destabilising the economy, now or in the future. Building on the IMF's definition, we define fiscal sustainability as the ability of a country to fund its spending commitments without significant disruption, either in the form of excessive borrowing costs or the need for abrupt adjustments to tax and spend measures. Equally, having to resort to unconstrained monetary financing or defaulting on debt are considered last resort measures to address fiscally unsustainable policies, undermining macro stability and growth.

A fiscal sustainability framework aims to answer at least four questions, shown in table 3.1, building on IMF (2017). At their heart they aim to ensure citizens and financial markets that the government can smoothly fund its operations, in the present and in the future.

TABLE 3.1

There are at least four questions that fiscal sustainability assessment should seek to cover

High level question	Specifying the question	Indicator	Labour's stated fiscal rules
A) How much will the government pay to service its debt?	What will the interest payments of government debt be?	Debt servicing metric, debt maturity	
B) Is the (future) financial position of the government manageable?	What are the (future) assets and liabilities of the government?	Deficit and debt metrics, including for instance public sector net worth	Debt rule, have debt falling in year five
C) Is borrowing used for future focussed spending?	Are spending items funded by borrowing that really should be paid for by taxes (eg wages of policy officers)?	Current budget	No borrowing for day to day spending
D) Is fiscal policy making the economy stronger and more resilient?	Does the government have a good growth plan, does its policy reduce economic risks?	Future facing policy analysis, eg via multipliers	

Source: Authors' analysis

If a government is highly transparent about its financial accounts and its plans, investors and citizens should be able to answer these questions for themselves. But many governments use fiscal rules as concise signalling devices for stating their intent – and publicly bind themselves to specific targets. While specific targets can be useful, there is a risk of missing the wood for trees: there is no one threshold number for any of these questions that gives a conclusive answer. Instead, they need to be interpreted jointly and in the context of external circumstances. Moreover, all these questions highlight that not just present values but future projections are hugely important. Forward looking scenarios can play an important role for reflecting this.

4. THE RULES THAT THE LABOUR GOVERNMENT HAS INHERITED FROM THE PREVIOUS GOVERNMENT DO NOT YET ACHIEVE THE RIGHT BALANCE BETWEEN THE VARIOUS FISCAL SUSTAINABILITY OBJECTIVES

Ultimately a fiscal (rules) framework should seek to signal answers to all of the four questions in table 3.1. In future work we will start from the above principles and explore what an improved fiscal framework could look like.

However, in the short term, the government has stated its fiscal rules in its manifesto (see box 2). This report therefore explicitly starts from these stated rules and suggests changes within the spirit of these rules to balance the need for greater investment and to achieve fiscal sustainability.

The fiscal rules set out by Labour in their manifesto have some strengths and some weaknesses.

As highlighted in table 3.1 (last column), the Labour government is explicitly targeting two questions. Its **current budget rule** states that it will only use borrowing for investment. On the one hand, this is a clear and reasonable rule highlighting the government will not borrow for day-to-day spending. This is a significant tightening of fiscal rules: this target has almost never been met over the last 50 years. This rule can prevent reckless decisions – such as those made by Jeremy Hunt – to cut current taxes in exchange for unspecified future spending cuts. On the other hand, the rule does not perfectly answer question C ("Is borrowing used for future focussed spending?") because not all investment necessarily brings future returns and, more importantly, there is some day-to-day spending that has significant future growth benefits (eg spending on public health programmes). Moreover, the rule runs risk of not sufficiently taking into account the fluctuations of the economy (and the different borrowing needs that this might cause).

The top line phrasing of the debt rule is equivalent to that of the previous government, stating that debt should fall in year five of the forecast. This has the advantage of being an easy to measure metric and is a core element of the government's balance sheet. However, the phrasing of the rule covers only a partial element of the government's balance sheet – crucially it excludes a wide range of assets and liabilities. Moreover, the focus on the difference between year four and year five is narrow, ignoring the overall evolution of the government's finances. There is an increasing chorus of voices stressing that the UK's falling

debt to GDP rule in particular is preventing politicians from making decisions that are good for growth.

BOX 2: LABOUR'S STATED FISCAL RULES

The new Labour government's stated fiscal rules, outlined in its manifesto, are as follows.

- **Current budget/deficit rule**: "The current budget moves into balance, so that day-to-day costs are met by revenues". This in effect prevents government to borrow in order to pay for day to day government spending (eg the pay of public sector employees).
- **Debt rule**: "Debt must be falling as a share of the economy by the fifth year of the forecast". While being an important part of sustainability metrics, it is this debt rule that could constrain investment. It refers to any debt, including that taken up for investment.

Of the two, the current budget rule explicitly excludes investment spending so it is the debt rule that has a larger effect on the government's headroom for borrowing to invest.

TABLE 4.1

The UK framework could be improved in order to better deliver fiscal sustainability

High level question	Covered in Labour government's fiscal rules	Room for future improvement
A) How much will the government pay to service its debt?		Current rules do not reflect how much financing is needed or how much it costs. A bigger role for a debt servicing metric could be helpful.
B) What is the (future) overall financial position of the government?	Debt rule, have debt falling in year five	The target should be broader to cover the financial position better. Covering the change between year four and year five is too narrow.
C) Is borrowing used for future focusses spending?	No borrowing for day to day spending	The target should take more account of the state of the economy. Some current spending is future focussed, some investment spending is not future focussed.
D) Is fiscal policy making the economy stronger and more resilient?		Current rules do not reflect future spending commitments and receipts by the government – a crucial element of fiscal sustainability

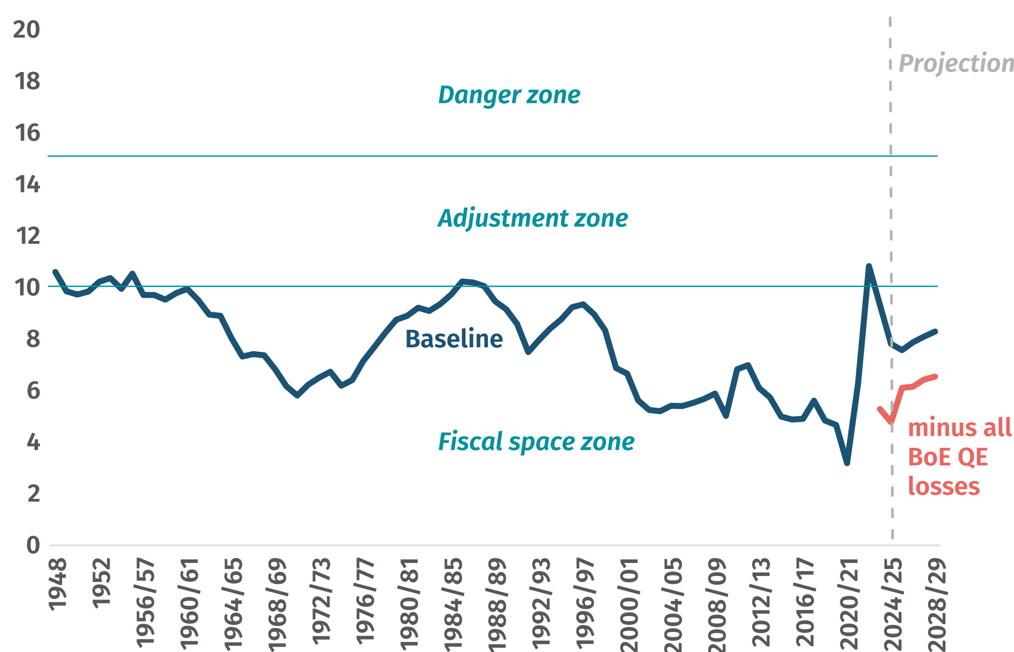
Source: Authors' analysis

Currently missing from Labour's framework are ways of capturing questions A and D. One way of reflecting the cost of servicing the debt is **the debt servicing ratio.** If presented as government interest payment over government receipts, it indicates the proportion of tax payer money that is spent merely on debt servicing. Crucially, the indicator also reflects the impact of macroeconomic conditions – if interest rates are high any given level of debt becomes harder to service. For this reason Furman and Summers (2020) have proposed a debt servicing metric as their

preferred fiscal sustainability indicator. Finally, it is also a useful metric for the public: it indicates how much of their tax payment is paid as interest to investors and is thus not used for productive or socially useful purposes. Looking at this metric shows the UK's position is elevated but manageable (figure 4.1), especially if one considers that a large amount of 'quasi-interest' spending takes place as a result of avoidable losses related to the Bank of England's quantitative easing operation.

FIGURE 4.1

The UK's debt servicing cost are elevated but below the 'adjustment zone' and could be reduced by addressing unintended Bank of England subsidy to commercial banks



Source: IPPR analysis of OBR 2024a

Note: For Bank of England losses we use the projected losses APF losses from the OBR. These consist of two elements: direct interest losses from the APF and losses from the bank selling gilts at lower value than it bought them. Unlike indemnified interest rate losses by the bank, indemnified QT losses are not included in net public sector interest payments metric (they show up only in public sector net borrowing). Thus the line showing debt servicing costs 'minus all Bank of England losses' should be seen as baseline interest rate costs minus BoE interest rates costs and assuming avoided QT losses were also used to reduce interest rate costs further. The adjustment zone is set at 10 per cent debt servicing to revenue. While by no means a hard threshold, "10 per cent or higher is considered to be towards the 'weaker' end of the Standard and Poor's six point scale" (Hughes et al 2019).

Also missing from Labour's current framework is a way of addressing question D – the question of whether today's fiscal policy (including borrowing) is used to make the economy stronger or more resilient. There are some promising ways of doing this, which should be explored. The IMF has, in 2016, revised the way it assesses fiscal space as part of its 'surveillance' of countries' macro stability, (see IMF 2018 for a summary). **Crucially the IMF introduced 'dynamic analysis of expansionary fiscal policy'. This acknowledges that there are good and bad ways of using fiscal space.** In the IMF case it distinguishes between a "high multiplier" package, where the state borrows to invest in infrastructure. This has "high short-run multiplier" and a "notable long-term multiplier". The Fund juxtaposes this with a scenario that includes a 'reduction in corporate income tax' which it implies is a downside scenario, with lower multipliers.

In fact, financial markets and sophisticated macroeconomic institutions like the IMF already conduct a much broader and more future oriented assessment of fiscal sustainability than many fiscal rules suggest (see box 3).

All this shows that a better fiscal sustainability framework is possible. In future work, we will argue how further reform could help the UK achieve this.

BOX 3: FINANCIAL MARKETS SEE BORROWING TO INVEST IN A POSITIVE LIGHT

The IMF– the world's macroeconomic watchdog – sees the UK's risk for 'sovereign stress'[1] as low (see appendix 1). In fact recommended in its annual assessments in 2023 and 2024 that the UK should 'increase public investment for the green transition'.

Financial markets agree with the IMF's judgement that the UK's risk of sovereign stress is low and that somewhat higher borrowing to invest can be justified. Quotes from a recent FT (2024) article underline this view.

"The UK would be well served by a reassessment of the fiscal rules by a group of credible experts tasked with integrating them in a more sophisticated manner with the government's growth mission."

Mohamed El-Arian, former CEO of PIMCO (the world's largest bond investing asset manager)

"If Labour borrows to invest, markets will not worry about it."

Ales Koutny, head of international rates at Vanguard (the world's second largest asset manager)

"If the UK were to borrow a little bit more, would it get out of hand? No." "Markets have been quite agnostic about high deficits."

Simon Ward, an adviser at Janus Henderson (one of the largest asset mangers globally)

"There is scope to modify the framework to allow more borrowing," as long as updated rules were policed by the OBR. Labour could "probably" add "£20 billion or £30 billion" to the gilt remit without pushing up borrowing costs.

Tomasz Wieladek, chief European economist at T Rowe Price (also one of the top global asset managers)

1 The IMF defines fiscal stress as periods when a government experiences extreme funding difficulties or when there is a high probability of a sharp increase in sovereign borrowing costs.

5. THERE ARE A RANGE OF OPTIONS LABOUR COULD CONSIDER AT THE BUDGET TO MOVE CLOSER TO THE FISCAL SUSTAINABILITY OBJECTIVES, WHILE STAYING TRUE TO ITS STATED FISCAL RULES

Given the government will likely focus on implementing its two stated fiscal rules, in this section we highlight how this could be done in a way that moves towards a better fiscal framework, as highlighted in table 4.1.

A key question facing the government is the need to specify the exact measure of debt its rule will be targeting. An important distinction is how narrow or wide the range of assets and liabilities that are included in the debt measure should be. Table 5.1 below shows the menu of options. It starts from A with the most narrow metric which excludes the Bank of England and policy banks (such as the British Business Bank) to E 'public sector net worth' which includes a much wider range of assets and liabilities. Metric C ('public sector net debt') was used until 2019, while B ('net debt excluding the Bank of England') was the most recent metric used by the previous government.

An OBR (2021) working paper describes the difference between net debt and net worth as follows: "As a relatively narrow measure of the public sector balance sheet, [net debt] provides an incomplete picture of the overall health of the public finances. In particular, it excludes the £820 billion (37 per cent of GDP) in less liquid financial assets held by the public sector such as its growing portfolio of £89 billion (4.0 per cent of GDP) in student loans and £417 billion (19 per cent of GDP) in equities, largely held by pension funds".

TABLE 5.1

The five debt metrics the government could use for implementing its debt rule, ranking from less to more comprehensive

More comprehensive →

	Liquid financial assets (cash, foreign currency reserves) and liabilities (debt liabilities)	Policy banks' balance sheets	Bank of England balance sheet	Illiquid financial assets and liabilities (eg equity stakes, pension scheme liabilities)	Non-financial assets (eg value of infrastructure) and liabilities (eg loan guarantees)	Future tax receipts and spending obligations
A) Public sector net debt (excluding BoE and policy banks)	✓					
B) Current measure: Public sector net debt (excluding BoE)	✓	✓				
C) Previous measure: Public sector net debt (including BoE and policy banks)	✓	✓	✓			
D) Public sector net financial liabilities	✓	✓	✓	✓		
E) Public sector net worth	✓	✓	✓	✓	✓	
F) Intertemporal public sector balance sheet	✓	✓	✓	✓	✓	✓

Source: Author's analysis

With regards to question B from table 3.1 and 4.1 ("What is the (future) financial position of the government?") a more comprehensive metric is desirable. This would mean including more, rather than fewer, factors affecting the government's financial position. Including more 'illiquid assets' (ie those that cannot readily be sold on financial markets, such as public equity stakes) and liabilities (such as pension liabilities) gives a better picture of the government's financial position. They indicate not just the level of debt liabilities, but also what these are used for. This is akin to investors in a company not merely looking at a company's indebtedness, but also what the assets and growth strategy of the company are that it has borrowed to invest for.

A more comprehensive debt rule encourages the government to make *better* investments. **A new IMF (2024) working paper puts this succinctly: "by focusing on net worth [the fiscal rule] creates an incentive for productive investments.** A project with greater costs than benefits leads to a reduction in net worth, thus would not make the cut under the net worth rule. Only those projects whose benefits exceed the costs would be permitted under the net worth anchor."[2] With the previous

2 This however depends on the exact valuation method employed. The current method of using 'replacement costs' for non financial assets could be improved upon, as we discuss in the next section.

government's debt rule, many projects that have strongly positive benefit cost ratios might not go ahead because fiscal rules do not reflect the benefits.

A more comprehensive rule would also have the advantage of covering more government transactions that affect sustainability of modern government policy. For instance, government taking equity stakes in companies (eg via the national wealth fund), providing student loans, providing guarantees to businesses (as in the pandemic), are all assets that are not reflected in simple net debt metrics. This shows that a broader metric does not necessarily have the effect of allowing for more borrowing – instead it allows for a more complete picture, positive or negative, depending on the policies. A Resolution Foundation report states that broader metrics thus provide a "more honest picture" of fiscal policy.

That said, even a broad based indicator, such as public sector net worth, has limitations. As Zaranko (2023) argues: "it does not and cannot comprehensively capture the assets and liabilities of the government: **it ignores the state's single greatest asset (its ability to tax future generations) and its greatest liabilities (the implicit promise to provide healthcare, pensions, education and security to future generations".** This points to a more comprehensive approach that also accounts for future revenues and future spending. The IMF (2021) has attempted to calculate this as a metric: "intertemporal public sector balance sheet", which is the most comprehensive metric in table 5.1.

6.
ON BALANCE, WE THINK THE GOVERNMENT SHOULD TARGET PUBLIC SECTOR NET WORTH OR PUBLIC SECTOR NET LIABILITIES WITH THE DEBT RULE

Considering the above, we argue that the government should commit to public sector net worth increasing in year five. This adjustment would create additional headroom against the target in the order of £57 billion as well as potential additional room to borrow to invest if it is used to invest in high value assets. It would support the principle of bringing more items into the fiscal rules target, being a more accurate indicator of the government's fiscal position. It would include the value of non-financial assets such as infrastructure and introduce a crucial forward-looking aspect into the government's fiscal framework. For this reason, it has been floated by several mainstream macro institutions, such as the IMF (2024), and by the Resolution Foundation (Hughes et al 2019).

Targeting net worth would build on the increased use of this measure in fiscal rules frameworks. The UK currently already has a supplementary target of improving the public sector balance sheet (including net worth). While the UK would be the first country to make this *central* to its fiscal rules, Australia and New Zealand also have given a role to public sector net worth in their fiscal rules.[3] A new IMF (2024) paper highlights that "a public sector net worth anchor is more conducive to public investment and economic growth, while providing for sensible policy reactions to changes in long-term interest rates".

As we highlight in table 6.1, using a net worth target would not be without challenges. For one, valuing illiquid non-financial financial assets (such as the value of infrastructure assets) is not easy (not least because of the uncertainty around returns to infrastructure investment highlighted in box 1). And the current valuation approach uses the cost of building the asset, as an imperfect proxy for their financial value. But as a recent Resolution Foundation report highlights "a decade of work on the part of HM Treasury and Office for National Statistics (ONS) to improve the comprehensiveness, reliability, and timeliness of public sector balance sheet data has also made targeting PSNW a practical proposition for the first time" (Hughes et al 2019). Still, as Zaranko (2023) highlights, there remains measurement uncertainty. But the way to deal with uncertainty is for the OBR to forecast it with uncertainty bands. It already provides probability estimates for meeting fiscal targets – and it could build on this approach by forecasting different pathways for net worth, and clearly state its assumptions. It would make the fiscal

3 Australia's fiscal strategy was aimed at improving net financial worth over the medium term and New Zealand's has a long-term objective of "using net worth to maintain a productive, sustainable and inclusive economy".

framework more comprehensive and it would also make the discussion around it grounded in scrutinising the types of investments the government makes. It would also force a discussion of what risks a government is taking by either targeting an upper bound or lower bound of projections.

This should be complemented by improvements of the government's public investment framework, ensuring value for money and alignment of investments with missions. Alongside this, the government should seek to establish a public investment watchdog, potentially as part of the OBR, that monitors public investment quality and provides a high level of transparency about the types of projects that are funded. We will discuss reform options in forthcoming work.

A second-best solution that would be a more incremental change would be to move towards public sector net financial liabilities. This metric would not include assets like buildings or infrastructure, but it would include illiquid financial assets such as equity holdings by public sector banks. It would also increase fiscal space substantively, similar to the net worth option. We judge this option to be somewhat easier to implement as it includes fewer hard-to-value assets, but it would come at the cost of being less comprehensive and less reflective of the future benefits of public investment. This rule would create about **£52 billion additional headroom against the debt target.**

TABLE 6.1

Public sector net financial liabilities or net worth are our preferred options, though the latter will somewhat more difficult to implement

	Moving towards better fiscal framework	Technical difficulty of implementing now
A) Public sector net debt (*excl* BoE and *excl* public policy sector banks)	Undesirable	Straightforward
B) Status quo		
B) Public sector net debt (*including* BoE)	Desirable	Straightforward
C) Public sector net financial liabilities	Desirable	Straightforward
D) Public sector net worth	Best option	Some challenges

Source: Author's analysis

7.
WITH ITS CURRENT BUDGET RULE, THE GOVERNMENT SHOULD REFLECT THE STATE OF THE ECONOMY

The current budget rule generally will not constrain borrowing to invest. It ensures that the government does not borrow to pay for day-to-day activities (such as paying salaries of the police). But it is nonetheless crucial that it is well designed, to ensure macroeconomic stability. A rule that targets only the headline number of the current budget rule does not reflect the state of the economy. This would, for instance, prevent Keynesian stimulus spending in a recession.

Instead of moving to a current balance target, **the government should adopt a 'structural' current balance target, which cyclically adjusts the current budget metric for the output gap. In other words, it reflects to what extent the economy is performing below or above its underlying potential.** If the economy is performing below its potential, it allows for some somewhat more borrowing to support the economy, and vice versa.

This has various advantages. Structural targets are widely used, partly because they allow for automatic stabilisers (natural increases in spending depending on the state of the economy) to play out. For example, if the economy is in recession, more unemployment benefits (ie current spending) will automatically be paid out. If the economy is booming, the exchequer will collect more tax receipts. These automatic stabilisers help to smooth over fluctuations in the economy by providing a boost to incomes and stimulus to the economy during recessions and vice versa. Fiscal rules should allow automatic stabilisers to do their work rather than force reductions in spending at a time of recession when this might hamper economic recovery.

More broadly, this approach allows for more flexibility in case of external shocks to the economy, and supports the use of government spending to counteract the effects of recessions. That said, structural balance metrics are not always geared to capture the size of shocks and the exact spending needs in a crisis situation. It is thus sensible for the government to follow the common practice of specifying an 'exit clause' that pauses this rule in the case for extreme shocks, such as a pandemic.

The downside is that this indicator is slightly harder to communicate and, in the current context, it does not immediately have a significant impact on fiscal space, given the OBR projects the economy to edge closer to potential in the coming years.

Overall, we think the macroeconomic benefits outweigh the disadvantage of making it slightly harder to communicate.

8.
CONCLUSION

The UK is stuck in a low growth trap, which to a large degree has been caused by a three decade period of ultra low investment. Living standards have barely improved since the financial crisis. The new Labour government has been elected on a platform to change this. It has pledged to raise growth and achieve "good jobs and productivity growth in every part of the country, making everyone, not just a few better off". But the government has inherited a set of fiscal rules that neither promote growth nor succeed on their own terms in delivering fiscal sustainability. The government should address this.

The UK has a proud history of pioneering fiscal institutions that have high credibility and are copied elsewhere in the world, such as the Office for Budget Responsibility. Starting a clear headed reform process now could make the UK fiscal framework one of the most growth friendly, but also one of the most rigorous, in the world.

Adopting a net worth targeted would provide an additional £57 billion headroom against the previous government's debt rule, as well as potential additional headroom to invest in high value assets. We argue that some of this should be retained as headroom against the target. The previous government left only £9 billion of headroom against its fiscal target – the second lowest in the OBR's history (OBR 2024a). Given the inherent uncertainty in economic forecasting, some of such buffer is needed to ensure that the government meets its target with high probability.

But even when retaining additional headroom, this measure would provide significant additional space to borrow to invest, get Britain building again and, in Rachel Reeves' words ensure there are "shovels in the ground [and] cranes in the sky, the sounds and sights of the future arriving".

Most importantly, we argue that these changes would start the journey towards a better and more comprehensive fiscal framework. For instance, a debt rule – even one that targets net worth – focussed on the difference between year four and five of the forecast is unnecessarily narrow. The current framework also lacks any emphasis on debt servicing costs. The framework should also be more long term and better reflect the likely future impact of different types of fiscal policy choices. Finally, it should also reflect the benefits of making the economy more resilient against future shocks (such as an energy crisis).

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APPENDIX
IMF ASSESSMENT OF FISCAL STRESS LIKELIHOOD OF G7 COUNTRIES

TABLE A1

IMF's 2024 assessment of risk of sovereign stress risk

	Risk	Factors cited
Japan	Moderate	Japan's domestic investor base, home bias, and long maturity debt in local currency.
USA	Low	Strength of institutions, the depth of the investor pool, and the role of the US dollar in the international system.
UK	Low	Exceptionally long debt maturity, lack of foreign currency debt, large market absorption capacity, large international investor base, sterling's status as global reserve currency
Germany	Low	Overall low vulnerability.
Italy	Moderate	High debt, ECB's toolkit mitigating disorderly dynamics, long debt maturity, retail appetite for bon
Canada	Low	Risks in the near and medium terms are mitigated by the government's sizeable holdings of financial assets and the strength of institutions.
France	Low	Likely future adjustment due to EU fiscal rules. large institutional investor base, home bias, and ECB stabilising role.

Source: IMF 2024b, 2024c, 2024d, 2024e, 2024f, 2024g, 2024h

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