BRIEFING

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SETTING THE FISCAL RULES

HOW THE NEXT GOVERNMENT SHOULD HANDLE INVESTMENT, DEBT AND THE DEFICIT

Institute for Public Policy Research

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IDEAS to
CHANGE POLICY

What are the major parties saying they would do?

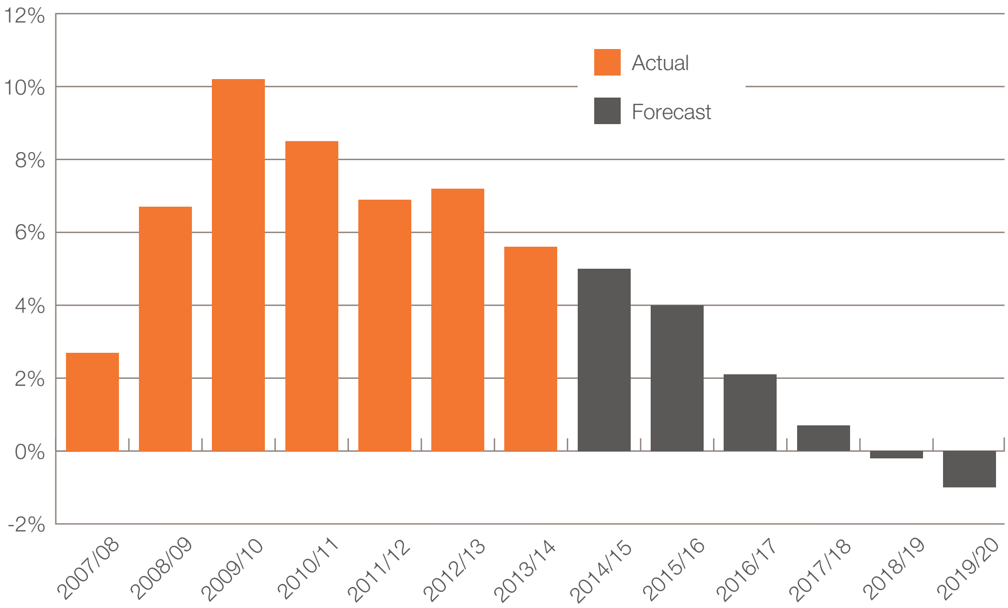
When it comes to deficit reduction over the next five years, the Coalition partners and Labour are offering the electorate variations on a similar theme. The Conservatives say they would eliminate the overall deficit and run a surplus on the public finances to reduce debt.[1] If they follow the plans set out in the 2014 Autumn Statement documents,[2] the first surplus would be achieved in 2018/19. Labour says it would get the current budget into surplus and the national debt falling as soon as possible in the next parliament, but that it would continue to borrow to fund investment spending.[3],[4] And the Liberal Democrats take a middle road, saying they would balance the budget, also by 2018/19, except for investment in 'productive economic infrastructure', while ensuring that debt is reduced to a sustainable level by the mid-2020s.[5]

Although only the Conservatives are promising to run an overall budget surplus, and thus to reduce the nominal value of public debt, the policies of all three parties would lead to a fall in debt as a percentage of GDP – and both Labour and the Liberal Democrats have said they would reduce debt on this basis.

Is now the right time to cut the deficit?

This might seem an odd question to ask at this juncture. Net borrowing has already been halved from 10.2 per cent of GDP in 2009/10 to a projected 5.0 per cent in 2014/15 and – as the promises of the three political parties show – there is a strong consensus for further cuts in the deficit in the next few years.

Figure 1
Public sector net borrowing, actual and forecast (% of GDP), 2007/08–2019/20



Source: ONS Public Sector Finances (ONS 2014a) and HM Treasury Autumn Statement (HMT 2014)

1 See Osborne 2014.
2 See https://www.gov.uk/government/topical-events/autumn-statement-2014
3 See Balls 2014.
4 Public sector net borrowing is equal to the deficit on the current budget (receipts less current spending) plus net investment spending. In 2013/14, the current budget deficit was £72.3 billion and net investment was £25.3 billion, thus net borrowing was £97.5 billion. These figures exclude public banks. See ONS 2014a.
5 See Alexander 2014.

However, there are those who say further action should be postponed until the Bank of England has increased interest rates. They argue the UK economy is still in a 'liquidity trap', with nominal interest rates at zero (or as close to zero as it is possible for them to be in practice). This means that there is, therefore, no scope for conventional monetary policy, in the form of an interest rate cut, to offset the negative effects on the economy of cutting public spending or increasing taxes. Furthermore, the Bank of England seems reluctant to make further use of *un*conventional monetary policy – in the form of quantitative easing – perhaps because of the uncertainties about its distortionary effects. So, these critics argue, further cuts in the deficit should wait until the Bank of England has increased interest rates to the point where it could respond to a future negative shock to the economy by cutting them again.

Economists and financial markets are becoming increasingly worried about the global economy, and prospects for the eurozone in particular look grim in the short term. If external events hit demand in the UK and the next government continues to cut the deficit, there is a risk that growth will slip sharply, just as it did in 2011.

Underlying the debate about whether the deficit should be cut is disagreement about whether fiscal or monetary policy should be tightened first as the economy recovers. Those arguing against cutting the deficit now believe monetary policy should be tightened first because it is more the flexible tool: if the economy were to face difficulties in the next year or two, it would be easier to relax monetary policy again. The alternative view is that the deficit and debt in the UK are reaching dangerous levels and represent a long-term risk to the economy, and therefore that it is sensible to tighten fiscal policy first. For now, the latter view appears to have won the day: Labour, the Liberal Democrats and the Conservatives are all proposing continued deficit reduction.

How should deficit reduction be seen in the context of developments in the rest of the economy?

Analysis of developments in the rest of the economy – in particular, the net savings balances of households, companies and the rest of the world (imports/exports) – suggest this commitment to deficit reduction might be misplaced.

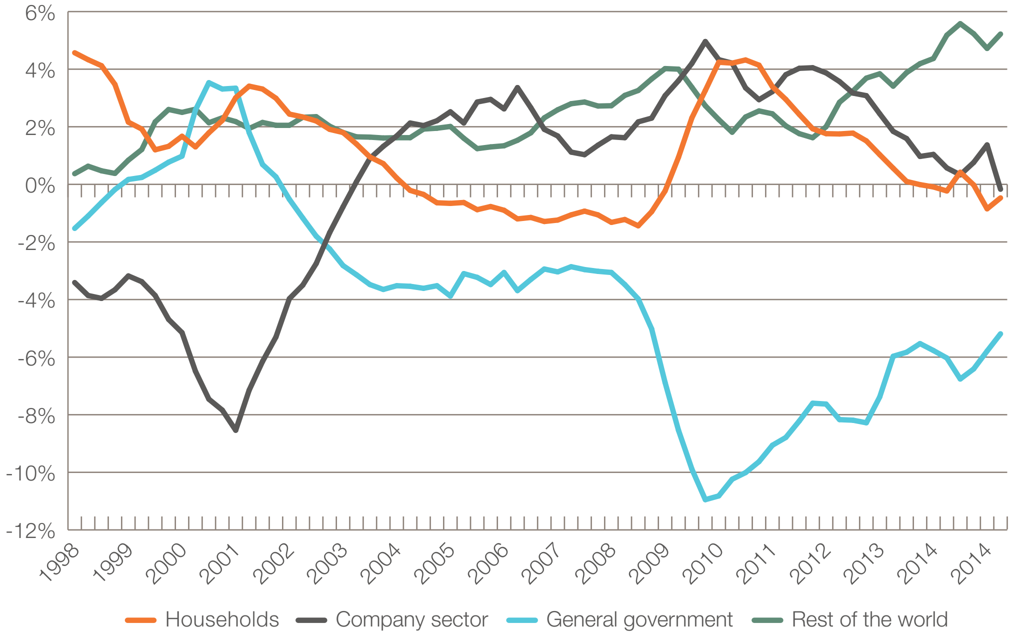
The Coalition government cut the budget deficit too quickly during its first two years in office. It hoped that stronger investment spending and exports would offset the effects of lower government spending and higher taxes, but this was not the case. The last two years have seen stronger growth because investment spending has increased and households have reduced their rate of saving, but also because the government has slowed the pace of deficit reduction. Exports, however, remain disappointing.

These shifts can be seen in developments in the sectoral balances – the gap between income and spending of the four sectors of the economy (see figure 2).[6] The government's deficit has reduced over the last five years, but only in the last three years has the company sector's surplus fallen, reflecting higher investment spending. Meanwhile, the rest-of-world sector's surplus has increased because export growth has disappointed.[7]

6 The balances of the four sectors must sum to zero since the total of income and spending in the economy are equal – if one sector is spending more than it earns, the opposite must be true for another sector.

7 The overseas sector is in surplus if the rest of the world's income from the UK (UK imports) is greater than its spending in the UK (UK exports). A widening surplus therefore is a reflection of strong import growth or weak export growth, or both.

Figure 2
UK financial balances by sector (% of GDP), 1998–2014



Source: ONS Quarterly National Accounts, Q2 2014 (ONS 2014b)
Note: The chart shows four-quarter moving averages to smooth out volatility in the data.

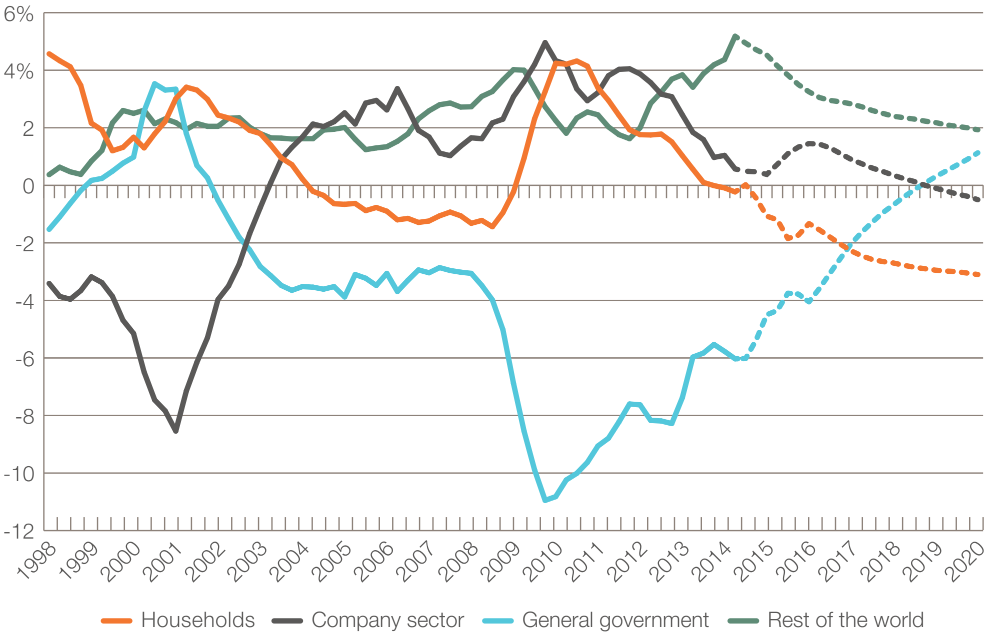
The Office for Budget Responsibility (OBR) forecasts that the government's deficit will be eliminated by 2018/19, in line with the chancellor's plans. It therefore has to forecast shifts in the other balances that are compatible with this view (see figure 3). In the projections it made at the time of the Autumn Statement, it reckons that just under half of the cut in the government's deficit will be offset by a reduction in the rest-of-world surplus – that is, it is still hoping for a revival in exports. And the same amount is accounted for by a shift into larger deficit by the household sector. By 2019, the OBR sees the household sector running down its savings or taking on additional debt at a pace twice as great as prior to the financial crisis.

Such a big adjustment by the rest-of-world and household sectors is necessary because the chancellor is planning to accelerate the pace of deficit reduction in the next three years. Cyclically adjusted net borrowing is forecast to increase from 4.1 per cent of GDP in 2013/14 to 4.2 per cent in 2014/15, but it is then set to be cut to 1.8 per cent of GDP in 2016/17 and -0.3 per cent (that is, a surplus) in 2018/19.

There is a strong possibility that neither the export sector nor the household sector will respond in the way the OBR assumes. Despite a big depreciation of sterling, export growth in the UK has been disappointing since the financial crisis, but particularly so in recent years. Exports in the first half of 2014 were actually worth less than they were in the first half of 2011. In this light, the OBR is being optimistic about UK export growth over the next few years.

It also appears to be optimistic about households' willingness to run down their savings or take on additional debt. The years before the financial crisis were seen as a period of loose lending conditions in the UK, which allowed households to take on too much debt and exacerbated the crisis when it came. It seems extraordinary that the OBR thinks lending conditions will be even more relaxed in coming years.

Figure 3
UK financial balances by sector (% of GDP), actual and forecast to 2019



Source: ONS Quarterly National Accounts, Q2 2014 (ONS 2014b) and OBR Economic and fiscal outlook – December 2014 (OBR 2014), economy supplementary tables

If the required adjustment in the other sectors of the economy seems implausible, then the deficit reduction planned by the chancellor in the next few years is too fast.

How should investment spending be treated?

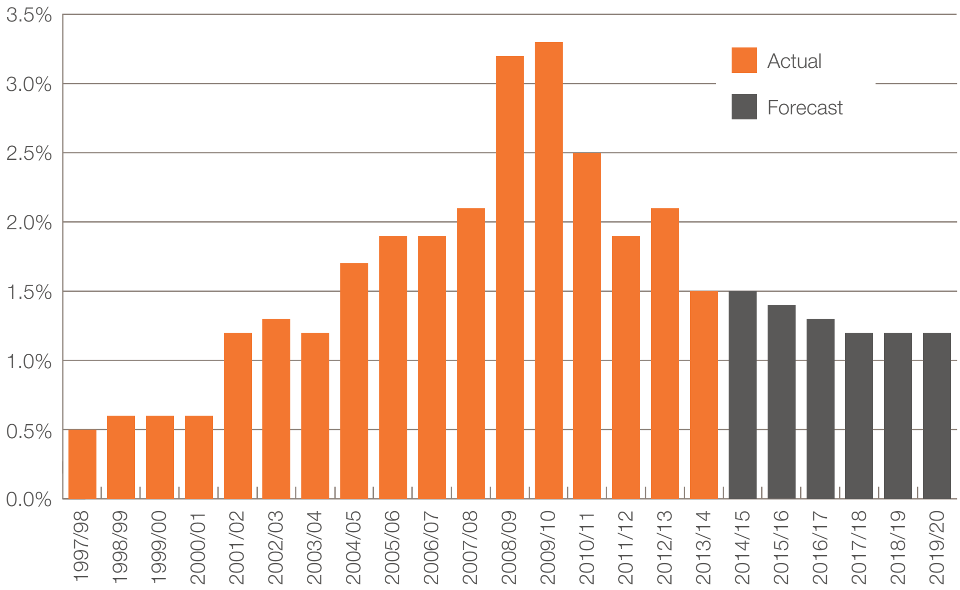
The main difference between the fiscal rules proposed by the Conservatives, Labour and the Liberal Democrats concerns borrowing to fund investment spending. Labour would continue to borrow to fund investment spending; the Liberal Democrats would borrow to fund investment spending on 'productive economic infrastructure', and the Conservatives would not borrow for any spending.

There is a certain logic to the Labour and Liberal Democrat positions. If some elements of government spending produce a sufficient return, in terms of higher economic output and higher tax revenues in the future, then it makes sense to borrow to fund them, as higher interest payments will be covered by the additional income. In proposing only to borrow for productive economic infrastructure (such as roads and railways), the Liberal Democrats are in effect saying the government should only incur extra interest costs if it can be reasonably sure that investment spending will produce the additional tax revenues needed to cover them. Labour is on shakier ground when it uses the same argument to justify borrowing to fund investment in other areas, such as the NHS, schools and defence, which do not appear to provide an associated source of future revenues. However, it could argue that capital spending on items with a long shelf-life, such as schools and hospitals, should have their costs shared by current and future taxpayers.

The assumption that some forms of investment spending produce economic returns while all other current spending does not is too simplistic. Politicians often talk of 'investing' more money in apprenticeships, because they recognise that a good apprenticeship can increase the productive potential of the person that completes it, enabling him or her to earn a higher income. Perhaps, therefore, the government should borrow to fund apprenticeships, because they result in higher incomes and thus higher tax revenues. If so, the same argument can be applied to other elements of vocational education and training, or indeed to all spending on education. When put to the test, it is extremely difficult to isolate those parts of government spending that produce a sufficiently high return in terms of tax revenues to match the interest costs of borrowing to fund them.

More fundamentally, this approach muddles two important fiscal choices: how much should the government spend on net investment and how fast should it bring down its debt? These should be separate decisions, but they are not under the Labour and Liberal Democrat approaches. There is no logical reason why the pace of debt reduction should depend on the level of investment spending. It should depend on the overall state of the economy. Similarly, if the government is to have a deficit target, it should be for net borrowing not the current balance.

Figure 4
Public sector net investment, actual and forecast (% of GDP), 1997/98–2019/20



Source: ONS Public Sector Finances (ONS 2014a) and HM Treasury Autumn Statement (HMT 2014)

A better approach is to specify separate rules for the reduction of debt (or the deficit) and for investment spending, as the Conservatives have done. History shows that excluding capital spending from fiscal rules does not protect it from cuts – indeed, it is usually subject to bigger cuts than are made to current spending.[8] This is detrimental to the long-term growth prospects of the economy. Any set of fiscal rules should contain a commitment to maintaining a minimum level of investment spending relative to GDP, recognising that this means current spending has to be lower (or taxation higher). The average level over the last 30 years is 1.5 per cent of GDP, but this includes periods when spending was restrained in order to reduce the deficit. The UK needs more investment, particularly in energy and transport infrastructure, and the government has a key role to play. It should set a higher minimum ratio – perhaps 2 per cent of GDP – and should aim to reach this level by 2020/21.

8 The last Labour government's 'golden rule' was to balance the current spending and receipts over the economic cycle, while the Coalition's target is to eliminate the deficit on the cyclically adjusted current balance. Yet Labour planned and the Coalition implemented swingeing cuts in capital spending.

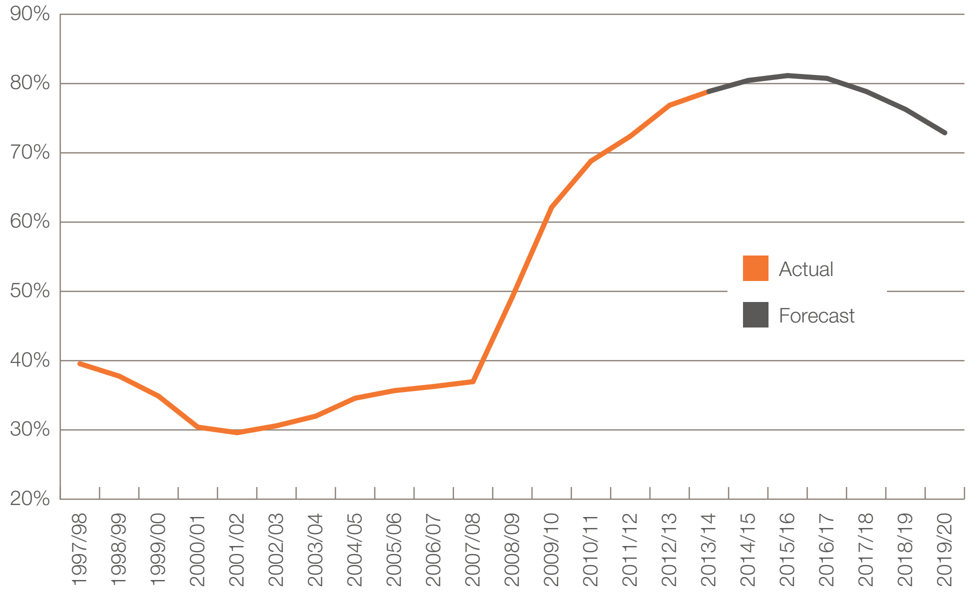
How quickly should debt be reduced?

The long-run fiscal objective of the UK government should be to reduce the ratio of government debt to GDP.[9] Academic research has not come up with a definitive answer to the question of what the optimal level of debt might be. But debt in the UK has doubled since the onset of the financial crisis and, as a result, it may be harder to respond to a future severe downturn in economic activity through an easing of fiscal policy. Debt needs to be reduced to create room for it to be increased again if needed. Furthermore, the latest projections from the OBR show debt interest payments increasing to 3.0 per cent of GDP in 2018/19 (OBR 2014). Although debt interest has been higher in the past, the more that is spent on servicing debt, the less there is available for spending on other items. The main fiscal rule therefore should be to put public debt on a downward trajectory, as a percentage of GDP, as soon as the economy is strong enough.

Just as there is no consensus about the optimal level of debt, so there is also disagreement about the appropriate pace of debt reduction. Theoretical arguments suggest the adjustment should be slow, because there are costs associated with sudden changes in taxes or public spending. But if the adjustment is too slow then the risk increases that debt will still be at a relatively high level next time fiscal policy needs to be relaxed to support growth. Ultimately, therefore, the chosen pace of debt reduction will be based on a pragmatic assessment of the risks of a severe economic downturn in the future and of likely developments in other sectors of the economy.

Figure 5

Public sector net debt, actual and forecast (% of GDP), 1997/98–2019/20



Source: ONS Public Sector Finances (ONS 2014a) and HM Treasury Autumn Statement (HMT 2014)

The 2014 Autumn Statement projections see the debt ratio peaking at 81.1 per cent in 2015/16 before falling to 72.8 per cent in 2019/20. If the fiscal stance in 2019/20 is maintained in subsequent years, the debt ratio would fall back to its pre-crisis

9 Ideally the debt target should be for general government debt, which excludes public sector bodies like the Green Investment Bank, rather than public debt, which is a broader category. This would be in line with the international norm. However, shifting definitions might create some suspicion that the government was deliberately opting for an easier target (though this need not be the case). In the rest of this note, we assume the target is for public debt, in line with the government's chosen definition.

level (below 40 per cent) around 2030. As argued above, however, the pace of deficit reduction underlying this scenario requires very implausible developments in other parts of the economy.

There is no 'ideal' or 'correct' pace of debt reduction, but one possibility that would allow for the slower adjustment in other sectors of the economy would be to target a reduction in the debt ratio to 70 per cent by 2025/26, with the intention of reducing it to 55 per cent over the following decade. The rationale for setting a 10-year rather than a five-year target would be to avoid the risk, during a period of economic weakness, of having either to abandon the target or to tighten policy in order to achieve it (thereby avoiding the trap George Osborne fell into with his original debt target[10]). The target should be rolled forward at the beginning of each parliament and – barring a downturn in economic activity so severe that it required a higher level of public debt to counter it – lowering debt would remain the principal aim of fiscal policy for at least 20 years.

Should the government target debt or the deficit?

The main fiscal rule should be to reduce public debt over a 10-year time horizon, but this might not be strong enough to oblige governments to be sufficiently disciplined in the short term. There should, therefore, also be an intermediate target to be achieved over a five-year period. This target should be for the deficit rather than debt, because if the economy is hit by a negative shock then getting back on course against a short-term debt target could necessitate damaging short-term tax increases or spending cuts. This response is less likely to be required against a deficit target.

If we agree, then, that it should focus on the deficit rather than debt, **should this shorter-term target be set in terms of the actual or the cyclically adjusted11 deficit**? Both the last Labour government and the Coalition have favoured cyclical adjustment. Labour's 'golden rule' required current spending and receipts to be in balance over the course of the cycle, and the Coalition aims to eliminate the cyclically adjusted current deficit over a five-year period. The reason for targeting a cyclically adjusted measure is to allow the 'automatic stabilisers' to work,[12] and to avoid the situation where policy has to be tightened in a downturn to compensate for an undershooting of tax revenues and overshooting of spending relative to target levels.

However, cyclical adjustment is far from a perfect science. It requires an estimate of the level of GDP that is consistent with inflation being stable at the government's target rate of 2 per cent. This is not observable and current estimates of it, from respectable economic forecasters, vary by several percentage points.[13]

Should the target be for a fixed date (the last year of the current parliament for example), or set on a rolling basis (always for a date that is, say, five years ahead)? The Coalition's target for the cyclically adjusted current balance is on a five-year rolling basis. Initially, it set out plans to achieve balance by 2014/15, but by the time of the 2014 Autumn Statement the target date for balance had shifted forward to 2017/18. This lays it open to the obvious criticism that it never actually has to achieve the target, only to plan to do so. However, a rolling target does allow the government some flexibility to adjust the pace at which the deficit is reduced if the economy is hit by a shock, which in effect is what the Coalition did.

10 In 2010 the Coalition's plan was for the debt ratio to peak in 2013/14 (although its target was for debt to be falling by 2015/16). It is now set to start falling in 2016/17.

11 The cyclically adjusted deficit is the deficit that would remain if economic output was equal to productive potential, that is, if the level of real GDP was consistent with inflation stable and in line with the government's target rate of 2 per cent.

12 That is, allowing tax revenues and spending on benefits for the unemployed to fluctuate with the economic cycle without taking offsetting measures.

13 In its latest economic and fiscal outlook, the OBR outlined estimates made by external forecasters of the gap between actual and potential GDP in 2013 that ranged from 0.0 to 4.5 per cent.

The danger with a fixed-date target is that the government's scope for flexibility diminishes as the target date nears. If the economy is hit by a shock in the year before the target date, the government is faced with the choice of tightening policy in a downturn or missing the target. This could be a problem for the Conservatives if they win the election and stick with their target to eliminate the deficit by 2018/19 (and for the Liberal Democrats too). But, in the current climate, there are also dangers in being too vague. Labour has been criticised for the vagueness of its promise to balance the current budget 'as soon as possible'.

The solution lies in thinking about these two issues together. If a fixed-date target is adopted, then it should be for the cyclically adjusted deficit, in order to avoid the risk that the automatic stabilisers have to be overridden if the economy is growing weakly in the year before the target date. But if a rolling five-year target is adopted, then the actual deficit can be targeted and there is no need for the uncertainties associated with cyclical adjustment.

Given the scale of these uncertainties, there is a slightly stronger case for targeting actual public sector net borrowing, as a percentage of GDP, on a rolling five-year basis. The initial aim should be to reduce borrowing in even steps during the five years of the next parliament and then to hold it at its 2020/21 level for the next five years, so that the debt target is hit. The target for 2020/21 should therefore be 1.0 per cent of GDP, compared to a current OBR projection for 2014/15 of 5.0 per cent.

Should the pace of deficit reduction be sensitive to the economic cycle?

If this approach is adopted, it would be wise to build greater sensitivity to the economic cycle into fiscal policy. That is to say, the timing and extent of deficit reduction should be explicitly linked to growth in the economy. When monetary policy is unable to support the economy further, it is not sensible to start pulling the levels of fiscal policy without some awareness of the economic cycle. The Coalition's big mistake in its first two years was to plough ahead with its deficit reduction plans even when it became clear that the economic recovery was in danger of stalling due to weakness in the eurozone and high energy prices.

This means more than just letting the automatic stabilisers work. It means relaxing the planned pace of deficit reduction when the economic outlook is weak and stepping it up when growth is expected to be relatively strong.[14] Thus, over the last four years, it would have been better to have pursued less deficit reduction in 2010/11 and 2011/12 and relatively more in 2012/13 and 2013/14.

The problem with this approach, of course, is that it is always easier to see with hindsight when deficit reduction should have been speeded up and slowed down than it is to judge the correct speed in the moment. An overly optimistic (or pessimistic) forecast for the economy over the next year or so could result in the deficit being cut too much (or too little) given the economic circumstances. But attempting to judge the strength of the economy and tailoring fiscal policy accordingly is surely better than simply ignoring the way the economic tide is moving.

What role should the Office for Budget Responsibility play?

The Office for Budget Responsibility (OBR) has quickly become an important part of the fiscal landscape. It should remain the chief arbiter of the government's chances of achieving its fiscal targets and also the body responsible for assessing the medium-term sustainability of fiscal policy. The OBR should, therefore, say whether the government is on course to meet its debt target.

14 An approach IPPR first advocated three and a half years ago – see Dolphin and Lent 2011.

In addition, if the government is going to vary the pace of fiscal adjustment depending on the short-term outlook for the economy in the way we suggest (cutting debt more when growth is strong and less when it is weak), then the OBR should also have the role of validating or challenging the government's judgment in this respect. That is, the OBR should be the arbiter of whether the government is pursuing appropriate fiscal discipline. This would constrain the government and make it more likely to stay on course to achieve its longer-term debt reduction target and less likely to relax its fiscal discipline for political reasons.

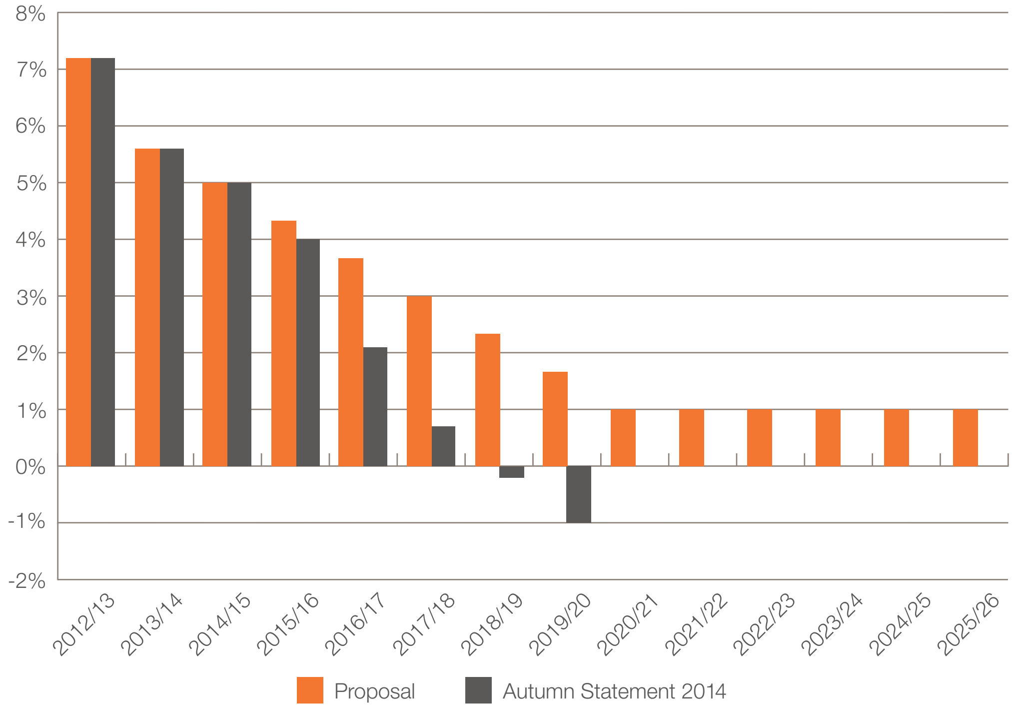
What then should be the fiscal targets for the next parliament?

Assuming the economic and fiscal outlook does not change materially between now and May 2015, and in particular that there is a reasonable prospect of interest rates increasing during the next parliament, the next government should adopt the following fiscal targets:

- The ratio of public debt to GDP will be reduced to 70 per cent of GDP by 2025/26.
- Net investment spending should be increased – perhaps to 2 per cent of GDP by 2020/21 – and subsequently not fall below this level.
- Public sector net borrowing, as a percentage of GDP, will be reduced to 1.0 per cent in 2020/21. This will be achieved by cutting it in even steps over the five-year period.
- If the economy is forecast to grow rapidly or slowly, the pace of adjustment in any year could be increased or decreased.
- The OBR would, as now, judge whether the government's plans were consistent with it achieving its fiscal rules. If the government judged that the growth outlook merited a short-term change in the pace of deficit reduction, the OBR would also be required to say whether or not it was acting appropriately.

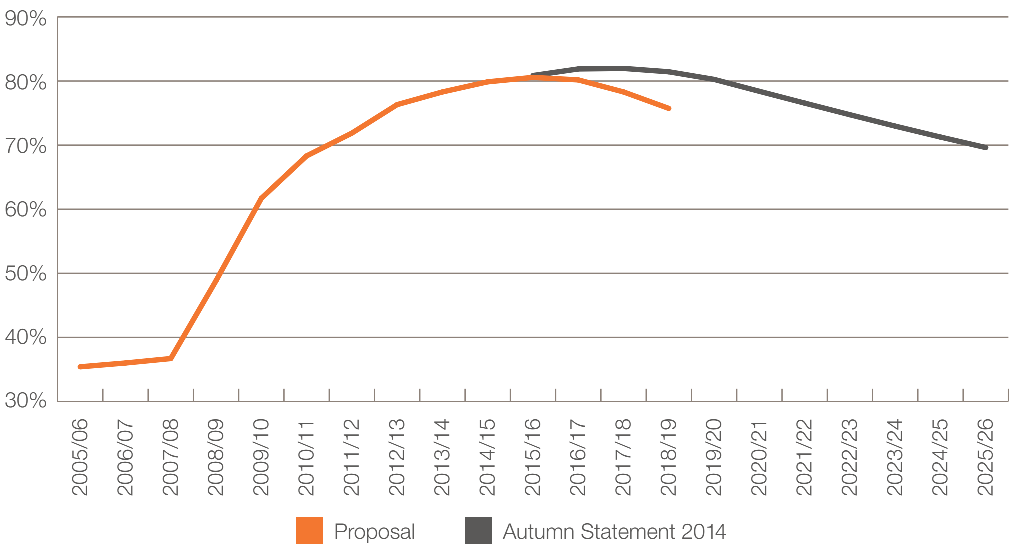
The following charts show the implications of these rules for net borrowing and debt and compare them with the trajectories set out in 2014 Autumn Statement.

Figure 6
Public sector net borrowing scenarios (% of GDP), 2012/13–2025/26



Author's calculations, based on OBR 2014

Figure 7
Public sector net debt scenarios (% of GDP), 2005/06–2025/26



Author's calculations, based on OBR 2014

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