Fiscal rules OK?

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Introduction

After 16 consecutive years of economic growth, the UK is now facing the sharpest downturn in a generation. The crisis is also wreaking havoc with the public finances. Government debt is set to spiral to levels not seen since the 1970s.

This explosion in debt represents a failure for Labour's economic policies, above all its promise to bring order to fiscal policy through the application of strict rules. But the Conservatives are wrong to think that their proposed 'independent fiscal council' would be any more successful. The widely drawn analogy with monetary policy, where independence for the Bank of England has been a marked success, is misleading. The impact of 'bad' fiscal policy can be felt through higher interest rate charges, tighter monetary policy and potentially slower economic growth. But there is no straightforward definition of what constitutes 'good' fiscal policy. The risk is that such reforms would replicate the mistake that Labour made in 1998: to suppose that the right approach can be found by technocratic reasoning.

Fiscal policy is a political issue. The question of how to tax, spend and borrow cannot be deduced by technical calculation. There is no simple answer to whether 40, 50 or 60 per cent of GDP is an unsustainable level of debt.

Labour used the fiscal rules to divert voters' attention from the political choice that was being made for them: of higher long term debts in return for investment in public services. Creating an 'office for budget responsibility' will do the same thing – remove an essential debate from the democratic arena. Solving the UK's trillion-pound debt crisis will affect every area of public policy. Solutions should be worked out in public.

Voters and investors are the stakeholders that matter in fiscal policy. What they need is a clear debate in which all possible views are represented. Sticking narrowly to a set of rules or the pronouncements of appointed experts simply stifles this debate. They need to hear how the parties will deal with the debt, not how they will delegate the problem away.

1. What is good fiscal policy?

In contrast to monetary policy, there is no economic or political consensus about the goals of good fiscal policy. The debate therefore cannot be reduced to a technocratic discussion of best practice. However, this does not mean that it is impossible to distinguish between good and bad approaches: how the government balances its books has a major impact on the wider economy, as well as its own future financial position. Hence, it is possible in general terms to describe the character of good fiscal management. These include:[1]

1 European Commission, 'European economy: public finances in the EMU', 2006; M Heipertz, 'The Stability and Growth Pact – not the best but better than nothing', 2003.

It is impossible to design a fiscal rule that meets all possible requirements

- **Achieving low borrowing costs**
  High and unpredictable borrowing undermines confidence in the financial markets, which punish the government by charging a greater interest charge for lending.
- **Avoiding a 'deficit bias'**
  The benefits of short term fiscal profligacy usually accrue to the current government, leaving future administrations to repay the debt. This produces a bias in favour of deficits. It can also allow the concerns of the present to unfairly outweigh those of the future, undermining fairness between the generations.
- **Smoothing the economic cycle**
  Government tax and spending decisions can increase macro-economic volatility by boosting demand during upswings and cutting back during downturns. Even when macroeconomic stability is delegated to an independent central bank, excessive government deficits can compromise this independence by forcing it to raise rates to head off an inflation threat.
- **Stimulating government investment**
  Public investment has benefits that accrue over many years. Governments in financial difficulty find it easier to cut potentially beneficial investment plans than current spending: responsible fiscal policy should avoid such short sighted behaviour.

Fiscal rules

The purpose of fiscal rules is to bind a government into responsible behaviour that may not always be in its short term interests. They are meant to address the problem of 'time inconsistency': the way that the preferred choice of action for a government changes over time. So, in this case, a historic promise to keep borrowing low – which may have been rational in the past, given a need to keep down interest costs – may no longer appear worth keeping in the light of immediate priorities such as a looming election. Fiscal rules are designed to encourage governments to stick to their original tax and spending plans by increasing the political cost of breaking past commitments, or even making it a statutory requirement complete with penalties for non-compliance.

There are many examples of fiscal rules in operation worldwide, applying across every tier of government from local authorities to nation states. Such rules commonly target the annual or cyclically adjusted level of borrowing, the amount of outstanding debt or expenditure. The method of enforcement also varies, from, say, barring local councils from borrowing, to a looser requirement to bring overall debt levels down over an extended time period.[2]

Policymakers face a number of potential trade-offs when drawing up fiscal rules. One influential analysis concludes that eight properties mark out an effective rule: it should be well defined, transparent, simple, flexible, adequate, enforceable, consistent and efficient.[3] But it is impossible to design a fiscal rule that meets all possible requirements. A simple, transparent and enforceable rule such as 'governments that fail to achieve a budget surplus over the year will be dismissed' clearly lacks flexibility; however, if it were amended to permit some discretion for a crisis, it would no longer be well defined, simple or transparent.

International evidence

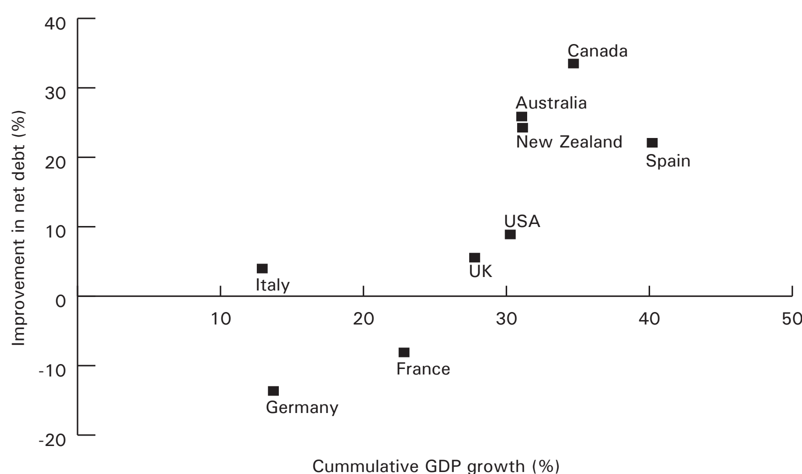
International organisations like the Organisation for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) have generally supported fiscal rules as a means of enforcing fiscal consolidation – that is, achieving a reduction in deficits and debt.[4]

It is difficult to find evidence that any particular fiscal institutions have helped budgetary consolidation. The decade from 1997 to 2007 saw developed countries generally reduce their outstanding government debt during a period of strong economic growth.

Chart 1 shows how those countries that achieved the fastest economic

2 European Commission, 'European economy: public finances in the EMU', 2006.
3 G Kopits and S Symansky, 'Fiscal policy rules', 1998.
4 IMF, 'United Kingdom: 2008 Article IV consultation', 2008; OECD, 'Economic outlook No. 72, fiscal sustainability: the contribution of fiscal rules', 2002.

Chart 1: Growth and consolidation performance, selected countries, 1997-2006



Source: OECD tables for gross financial liabilities, growth in GDP in 2000 domestic currency

growth rates also improved their debt ratios by the greatest amount. Cast in this light, the UK's performance appears unimpressive: the only three countries to see a lower improvement in public debt, Germany, Italy and France, had much weaker economic growth (and Germany's performance since 2006 has been very strong).

Australia, New Zealand and Canada stand out, having repaid 20 to 30 per cent of their debt, with only slightly more growth than the UK. These countries did not have strictly enforced fiscal rules. As with the UK, Spain's success in writing off debt is better explained by strong growth than through any choice of fiscal institution.

This chart, therefore, does not provide any evidence that fiscal institutions explain fiscal performance. Similarly, an OECD study found that although the introduction of fiscal rules usually accompanied improved performance, the direction of causality was not clear.[5] The introduction of such rules might make governments more responsible, but equally governments that are more responsible are more likely to make rules. Breugel, a European economics think tank, recently found that rules do not usually act to restrain governments, and are better understood as public statements of a government's commitment to fiscal discipline.[6] The report demonstrated that fiscal rules or institutions were on average set up three years after a fiscal consolidation started. Rules may be effective, but only as a means of securing electoral rewards when there is a pre-existing consensus for fiscal discipline.

The European Commission has also analysed whether numerical fiscal rules improve budgetary performance, noting how the number in operation increased continuously over the 20 years to 2006.[7] However, most of these related to local or regional levels of government, and hence were more likely to be enforced in law.

International fiscal rules

Australia: A Charter for Budget Honesty requires the government to 'spell out its objectives and targets', but is not enforced.

Canada: There are no legislated rules, but the government had a 'balanced budget or better' policy from 1998.

Germany: The Domestic Stability Pact contains a version of the UK's golden rule, requiring that the budget deficit does not exceed investment. It is not enforced.

New Zealand: A non-binding rule that debt and net worth be maintained at a 'prudent' level and operating surpluses be run over a 'reasonable' period of time. The government of the day sets its own numerical targets, without enforcement.

Spain: The 2004 Fiscal Stability Law requires that accounts at all levels of government show a surplus.

United States: From 1990 to 2002, the Budget Enforcement Act required that legislated changes to revenues or mandatory spending programmes be budget neutral over a five year time-frame.

European Union: The Stability and Growth Pact requires EU members to aim for a debt-to-GDP ratio of 60 per cent and keep annual deficits below 3 per cent of GDP, or face an 'excessive deficit procedure' with the potential for fines to be levied for the repeated breach of the rules. However, the 3 per cent target can be avoided in 'exceptional circumstances', the definition of which was substantially widened in 2004 after several countries breached it without real sanction. A number of countries, like Italy and Belgium, have never come close to meeting the 60 per cent debt ratio.

5 OECD, 'Economic outlook No. 81 special chapter: fiscal consolidation: lessons from past experiences', 2007.
6 X Debrun, 'Tying hands is not commitment: can fiscal rules and institutions really enhance fiscal discipline?', Breugel, January 2007.
7 European Commission, 'Public finances in the EMU', 2006.

The key to successful fiscal policy is not clever institutional design

Rules applying to central government were not enforced but relied on political agreement or the potential reputational cost. The Commission concluded that it is not clear whether the operation of rules led to the fiscal improvement at a national level.

The Commission report also discussed the effectiveness of independent fiscal councils, similar to the Conservative Party's proposed Office of Budget Responsibility. The Commission's survey found 15 institutions that were able to issue recommendations in the area of fiscal policy, such as the High Council of Finance in Belgium, and the Economic Council in Denmark. None of these councils had any real executive power, relying instead on influence and often a requirement to respond to their recommendations in parliament. The Commission argued that their effect was somewhat beneficial, improving the level of public debate and helping produce more realistic deficit forecasts. The report found that countries with independent fiscal institutions outperformed the others between 1995 and 2005. But this one period provides scant evidence as to what drives fiscal responsibility. Most of these councils were created a long time ago, and have existed during phases of both debt increase and reduction. It is difficult to prove that their presence had any significant effect on fiscal discipline.

The example of the USA reinforces scepticism about the efficacy of independent fiscal councils. The Congressional Budget Office, founded in 1974, is meant to provide neutral and objective reports on the economic outlook, spending and revenue levels for the next 10 years, and an estimate of the cost of future budget proposals. While this work is clearly valuable, it has had no impact in preventing wide swings in the US fiscal position, most recently with the federal budget moving from surplus to massive deficit after George W. Bush's 2003 tax cuts.

International experience, therefore, suggests that the key to successful fiscal policy is not clever institutional design. Instead, factors that change the political climate in favour of fiscal consolidation are more salient. In particular, the OECD found that fiscal consolidation efforts were more successful when the starting position was difficult (i.e. high levels of debt and interest rates) as this heightened public awareness of the problem. Similarly, the prospect of euro membership made fiscal consolidation much more politically palatable in a number of candidate countries.

2. The Code for Fiscal Stability – a break with the past?

The Labour government, which took office in 1997, was determined at the outset to rid itself of the party's reputation for fiscal mismanagement. It designed a new macroeconomic policy framework, with independence for the Bank of England as the centre-piece.[8] However, Gordon Brown also gave prominence to fiscal stability, repeatedly contrasting 'Labour prudence' with 'Conservative boom and bust' (See Chart 2).

The government introduced a number of reforms to help bolster its fiscal credibility. These reforms were built around a 'Code for Fiscal Stability' that passed into law in 1998.[9] Much of the code was uncontroversial, setting out general principles (transparency, stability, responsibility, fairness and efficiency) and objectives (including 'ensuring sound public finances' and 'supporting monetary policy, where possible'). It also formalised some procedures that had become customary, such as the use of multi-year spending plans, and established the Pre-Budget Report, which provides parliament with an opportunity to debate fiscal policy every autumn.

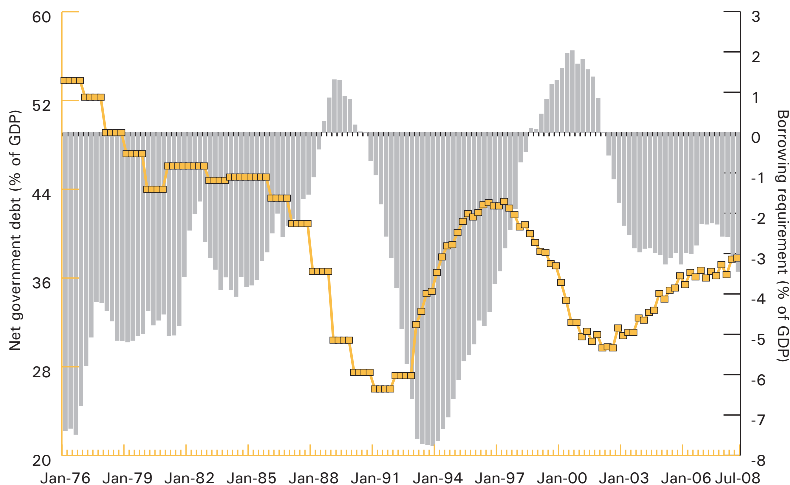
However, the code went beyond an assertion of uncontroversial principles in a crucial way: it established two new operating rules that promised to constrain government fiscal behaviour to a historically unprecedented degree:

- **The golden rule:** over the economic cycle, the government will borrow only to invest and not to fund current spending.

8 A Murray and G Wilkes, 'The new politics of inflation', CentreForum, 2008.

9 HM Treasury, 'Code for Fiscal Stability', 1997.

Chart 2: Government net debt and borrowing, 1976-2008



Source: Office for National Statistics

- **The sustainable investment rule**: public sector net debt as a proportion of GDP will be maintained over the economic cycle at a stable and prudent level. The government defined this level as 40 per cent of GDP.

For the next ten years these rules would occupy a central part in every budget and Pre-Budget Report. Unlike the principles and objectives, they seemed to provide a testable commitment to fiscally responsible behaviour.

The golden rule differed from a straightforward requirement for an annually balanced budget in two ways. First, it targeted the underlying or 'structural' deficit, to strip out the effect of the economic cycle. Economies usually oscillate around their trend level of growth. During above trend phases, tax receipts rise and some spending items like unemployment benefits fall, boosting the government's finances. In contrast, taxes fall and spending rises when the economy falls below trend. These effects are usually called the 'automatic stabilisers'. Allowing the Chancellor to carry surpluses over into deficit years reduces macroeconomic instability, in contrast to a strict balanced budget rule which would force a government to spend more or cut taxes during a boom and raise taxes or cut spending during a recession.

The golden rule thus ensured the government could permit borrowing to rise and fall flexibly across the economic cycle. But it lacks simplicity. The Treasury has to estimate the sustainable (or trend) growth level of the economy.[10] Movements above or below this level are not clearly signalled; ironically, the more stable the economy, the more difficult they are to discern. Even with hindsight, judging the beginning and end of an economic cycle is difficult. It is practically impossible in advance. But small adjustments to the dating of the cycle can have a major impact on the government's ability to meet the rule. This leaves open the suspicion that an adjustment might have been made for reasons of political expediency.

Moreover, the rule asks only for the *current* budget to be balanced. Capital spending items are excluded, and can be met through borrowing, as this better reflects the way that "investment today will benefit taxpayers in future years as well as now".[11] But, as Samuel Brittan points out, public investment is not the same as private investment: unlike the latter, it doesn't yield a reliable future stream of revenues that pay back the financing costs.[12] Some Conservative opponents of the golden rule called the current capital distinction a "deception", accusing the new government of employing the distinction in order to later use it to justify unbalanced budgets.[13]

In contrast to the golden rule, the sustainable investment rule was simple and transparent, with a clear limit on the total allowable level of debt. But this simplicity was achieved by sacrificing flexibility. A government with debt close to 40 per cent of GDP must either curtail borrowing or break the rule, regardless of the economic circumstances. Since markets and voters know that in sufficiently difficult circumstances the government will prefer to break the rule, its credibility is weakened. Moreover – as is the case with capital adequacy rules for banks – the rule gave the government the incentive to push spending off the balance sheet into schemes like the Public Finance Initiative.

The most significant aspect of the fiscal rules was their lack of enforceability. The Code granted explicit leeway for the government to depart from the rules, so long as it gave its reasons and provided a schedule for return.

10 www.hm-treasury.gov.uk/d/pbr06_trendgrowth_345.pdf

11 HM Treasury, 'Fiscal policy: current and capital spending', June 1998.

12 S Brittan, 'Budget deficits and noble lies', Financial Times, 2 September 2005.

13 Sir Michael Spicer in the House of Commons, 9 December 1998.

Did the rules change the government's behaviour?

Labour's fiscal rules may have contributed to an improved reputation for economic competence. But did they change Labour's fiscal behaviour?

Reducing borrowing costs

A key objective of fiscal policy is to convince the markets that the government will not act in a profligate manner. This ought to produce lower borrowing costs. The period from 1997 onwards saw long term bond rates falling considerably (see chart 3). Real gilt yields – that is, the yield minus inflation – also fell, from between 4 and 6 per cent in the early 1990s to 1 to 2 per cent a decade later.

These lower borrowing costs had a significant effect on the public finances. In 1997-8, central government gross debt interest was £29.8 billion.[14] In 2005-6 it was £25.8 billion, despite public sector net debt increasing by almost £100 billion in nominal terms.[15] But the biggest cause of this decline was the market's expectation of future low inflation, not the government's fiscal stance. A widespread reduction in price pressures saw most developed countries enjoy a large improvement in bond yields, regardless of the outstanding debt; Italy, for example, with a debt above 90 per cent of GDP, has borrowed at cheaper levels than the UK for much of the last eight years.[16] This suggests that confidence in the currency – Italy's membership of the euro – was, until recently at least, a more significant factor than fiscal performance.

Improving macroeconomic stability

The ten years to 2007 saw exceptional macroeconomic stability. Inflation remained within 1 percentage point of its target. From the middle of 1992 to 2008, the economy grew continuously, while the volatility of economic output fell.

The Treasury has argued that the fiscal rules helped support this improved economic performance. In 2007 its 'End of year fiscal report' described how the fiscal stance (meaning the discretionary decisions of the government, rather than just the automatic stabilisers) moved

14 HM Treasury, 'Pre-Budget Report', 1998.
15 HM Treasury, 'Pre-Budget Report', 2006.
16 Figures from European Central Bank.

Chart 3: Yields on British government debt, 1982-2008

Source: Bank of England

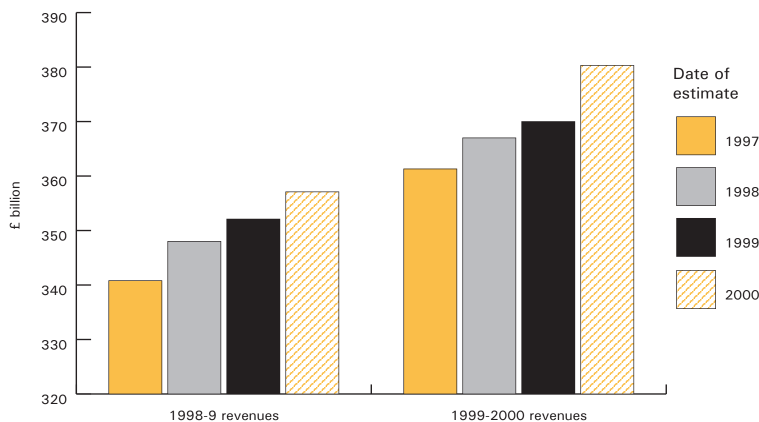
neatly against the direction of the general economy – tightening when the economy was above trend, and loosening when below.[17]

But Gordon Brown's discretionary decisions were clearly motivated by politics, not adherence to a rule. He had previously committed himself to match the tough spending plans of the Conservatives, and it was this commitment that ultimately ensured strong budget surpluses. The other key factor was the way that economic growth outstripped expectations without triggering inflation. As Chart 4 shows, public revenues consistently came in above the government's forecasts in the first four Pre-Budget Reports. The result was a vastly improving annual deficit that surprised most observers.[18] By the time the Code for Fiscal Stability had passed into law, Brown was able to foresee a large current budget surplus for 1999-2000.

This strong budgetary outcome meant that it was unnecessary for Gordon Brown to stick to Kenneth Clarke's tough spending plans. By doing so anyway, he went far beyond what the fiscal rules required. His objective was to cement a reputation for prudence. The economic growth that fortuitously dove-tailed with tight government spending came as a general surprise, as most observers – including the Treasury – expected a slowdown in 1998-9.[19] As one commentator argues, the strength of public finances was more the result of luck than policy: "Brown was fortunate in that the restraints on public expenditure did arise when private expenditure was booming."[20]

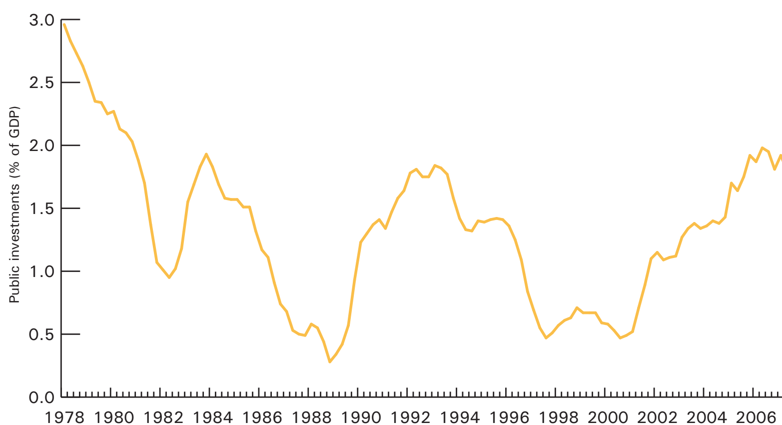
17 HM Treasury, 'End of year fiscal report', 2007.
18 The Economist, 'Boxed in', 4 March 1999.
19 The Economist, 'Budget games', 28 January 1999.
20 M Sawyer, 'Fiscal policy under new Labour', 2006.

Chart 4: Increasing estimates for public revenue, 1997-2000



Source: various Pre-Budget Reports, authors' calculations

Chart 5: Public investment, 1978-2006



Source: Office for National Statistics

The government gained a significant budget surplus from this period. Under the golden rule, this enabled it to afford several years of deficits. After the 2001 election, it made full use of this leeway. Expenditure increased from £341.5 billion in 1999-2000 to £522 billion in 2005-6. At the same time, the economy suffered a slowdown following the bursting of the 'dotcom' bubble. By replacing lost demand from the private sector, the government undoubtedly improved macroeconomic stability.

However, the government's decision to increase spending was again entirely political and neither based upon a clever assessment of the macroeconomic position nor strict adherence to its rules. The early years had seen continuing under-investment in the public sector. Mounting criticism of failing public services culminated in 2000 with Tony Blair pledging to raise health expenditure towards European levels, which implied tens of billions of extra spending on this alone.[21]

21 BBC News, 'Blair pledges health cash boost', 16 January 2000.

Ending the deficit bias

The Treasury uses various indicators to identify the beginning and end of the economic cycle, including surveys of the private sector, the labour market and inflation.[22] But this remains an inexact science. The Treasury changed the dates of 'the current cycle' three times during 2005 and 2006.[23] When the government shifted the beginning of the cycle back from 1999 to 1997, it was widely criticised: The Economist remarked that this let Brown use an extra £12 billion to £20 billion of surplus cash from earlier years to offset present day deficits, and therefore put off some hard spending decisions.[24]

Such uncertainty about the cycle clearly diminishes the effectiveness of the golden rule at curing the deficit bias. It allows the government to claim that current deficits are merely the mirror image of future surpluses. This badly undermines the purpose of fiscal rules: to bring discipline to present day decisions. Worse, the process of adjusting the cycle permitted the Treasury to include surpluses from six years previously in its calculations of acceptable future spending. It is highly unlikely that the Treasury would have done this if it meant including extra deficits. The golden rule let the government spend more when its assessments of both past and future were benign; but when the economic prospects suddenly deteriorated in 2008, the rule was simply abandoned. Hence, the actual operation of the golden rule did nothing to end the deficit bias.

Achieving high public investment

Labour ministers have repeatedly boasted of sustained high investment in public services. As the chart below shows, Labour has invested more, but only since 2001, and from a very low base (see Chart 5.)

The fiscal rules were designed to encourage higher public investment, but the government invested little until 2001-2 for political reasons. After 1998, with debt projected to fall well below 40 per cent of GDP, such austerity was not required by the fiscal rules. In their first term in office, the desire to establish a reputation for fiscal rectitude outweighed a clear need for increased public investment.

22 HM Treasury, 'Evidence from the economic cycle', 2008.

23 Institute for Fiscal Studies, 'Green budget', 2008.

24 The Economist, 'Revisionism', 21 July 2005.

From 2002 the government turned on the taps, in an attempt to improve public services. Afterwards, it found it difficult to keep public investment down, even as government deficits consistently exceeded projections from 2001 onwards. This resulted in national debt levels that were projected to veer perilously close to 40 per cent, even before the financial crisis.[25] It left no room for an economic slowdown or any other shock; fear of breaking the sustainable investment rule played only a very small part in recent Budget decisions.

During both famine and feast, the timing of investment was determined far more by political calculations than adherence to rules.

Avoiding distortionary behaviour

Rules and targets can encourage perverse behaviour. The government's use of the Private Finance Initiative (PFI) to invest in public services was partly down to fiscal rules. There are some valid economic reasons for introducing private finance into the provision of public services: private sector incentives can improve efficiency. However, the fact that PFI investments do not appear on the balance sheet is also a major attraction for hard pressed governments. The Institute for Fiscal Studies estimated that in 2005 PFI deals totalled £48 billion, or 3.8 per cent of GDP – large enough to have broken the sustainable investment rule if these sums had been included in the national debt.[26]

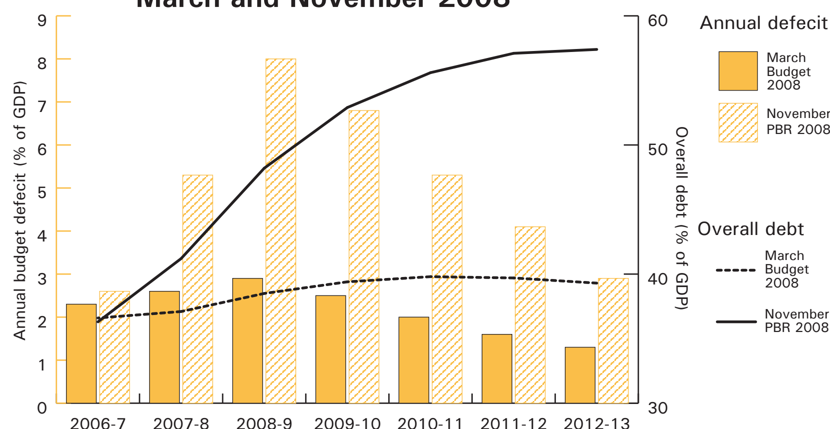
The abandonment of the rules

Between the March 2008 Budget and the Pre-Budget Report in November that year, the outlook for the public finances deteriorated dramatically as the country plunged into recession. Annual deficits are set to grow by many tens of billions more than previously projected. In little more than a year, the estimate for the national debt in 2012-13 grew by £300 billion to over £1 trillion. In a widely anticipated move, the government formally suspended the fiscal rules, and replaced them with a commitment to improve the cyclically adjusted current budget after the economy begins growing again (see Chart 6.)

25 The 2008 Budget forecast this ratio to be at 39.4, 39.8 and 39.7 per cent of GDP for the period 2009-10 to 2011-12.

26 Institute for Fiscal Studies, 'The government's fiscal rules', November 2006, www.ifs.org.uk/bns/bn16.pdf

Chart 6: Projections for borrowing and debt, March and November 2008



Source: Budget 2008, Pre-Budget Report 2008

In response to the downturn, the government unveiled a short term fiscal stimulus, delivered by temporarily cutting taxes and bringing forward some planned spending. This provided the immediate focus of political debate; however, only a small portion of the fiscal deterioration this year can be ascribed to new decisions. The major cause is the reassessment of Britain's economic prospects. After the escalation of the financial crisis in September 2008, a deep recession has begun, radically altering the fiscal projections. Government receipts projected for 2010-11 have fallen from £647 billion to £576 billion, while spending is largely unchanged.

The projections do not imply that the recession will be followed symmetrically by a period of above trend growth. Economic output will be permanently lost, and there will be a significant decline in government revenues. The inescapable conclusion is that the UK economy was probably operating above its potential for much of the past few years. Government revenues had been temporarily boosted by a booming housing market. The government ought to have built up greater surpluses to remain within the spirit, if not the letter, of the golden rule.

Despite the stream of targets and reports, the government made the same basic mistake as previous administrations: it erred on the side of optimism when estimating the growth potential of the economy to support desired spending increases. Now, whichever party holds power, the UK faces a prolonged period of austerity if public debt is to be brought back under control. As an early indication of this, the Pre-Budget Report revealed cuts in public spending of £37 billion

between 2011 and 2014, coupled with rises in income tax and National Insurance.

Brown's fiscal rules failed. They did not systematically affect the government's behaviour in fair times or foul. Politics determined the spending pattern of famine followed by feast that characterised Gordon Brown's Chancellorship. The flexibility of the rules mainly served to reduce the pressure on budget decisions when the government wanted to increase spending. While the suddenness of the recession has surprised most observers, ineffective fiscal policy meant that the government had dangerously little room for manoeuvre when the downturn arrived. The rules let it run years of deficits, relying on the blithe assumption that high growth in the future would balance the books. At the very least, this denied voters a clear choice: between debt-financed public investment or a return to fiscal conservatism.

3. Replacing the fiscal rules

Opposition voices have long called for a change to the UK's fiscal framework. Both Conservatives and Liberal Democrats see the fiscal rules as discredited. Vince Cable, the Liberal Democrat Treasury spokesman, said in July 2008: "Credibility has been degraded by the widespread assumption that the government routinely manipulates its self-assessment of performance to come up with the conclusions it wants."[27]

By opposing the government's attempts to stimulate the economy through deficit financed tax cuts and public spending, the Conservatives are determined to restore their reputation as the party of fiscal responsibility. A 2008 policy document insists: "Government must live within its means. Sound money matters, so the budget must be brought back to cyclical balance and then kept that way."[28]

Opposition proposals – delegate the problem

Both main opposition parties propose setting up independent institutions to monitor fiscal performance. For the Liberal Democrats, Vince Cable has argued that an independent body could verify fiscal projections and recommend sustainable policies: "It's completely lacking credibility for the Treasury to be marking its own exam papers and setting its own questions. What we need is an Ofsted for the economy."[29] Cable suggested that the National Audit Office (NAO) could assume this role; it is already mandated to audit the assumptions behind the Treasury's fiscal projections, but currently makes no comment on the overall stance of fiscal policy or adherence to the rules. For the Liberal Democrats, then, the problem with the last decade has not been the fiscal rules *per se* but a lack of rigour in monitoring the government's performance.

The differences between monetary and fiscal policy greatly outweigh the similarities

The Conservatives, on the other hand, have rejected employing a set of rules. Instead, they propose setting up a new institution, the Office for Budget Responsibility (OBR), with a mandate to target "the budget balance and the sustainability of the public finances". The OBR would not have executive authority; instead its power would stem from "its independence, credibility and ability to create strong political pressure".[30]

This interest in independent fiscal bodies is understandable. The Treasury faces a clear conflict of interest in acting as judge and jury on its performance. There is also a superficial parallel with the success of the independent Bank of England. If handing over monetary policy to a committee of impartial technocrats has proven successful, why not do the same with fiscal policy?

But there are two important objections to the idea of delegating responsibility for fiscal policy. The first is that the differences between monetary and fiscal policy greatly outweigh the similarities, making it unlikely a fiscal council could achieve the success that accompanied the Bank of England's independence. The second is that such a body could only be

27 V Cable, Speech to the IFS, 7 July 2008.
28 Conservative Party, 'Reconstruction: plan for a strong economy', 2008.
29 V Cable, Independent, 19 July 2008.
30 The Conservative Party, 'Reconstruction: plan for a strong economy', 2008.

successful by seriously undermining the vigorous, pluralistic debate that should determine fiscal policy.

The trouble with delegation

Handing over responsibility for fiscal policy to an unelected council of 'experts' presents a number of serious problems:

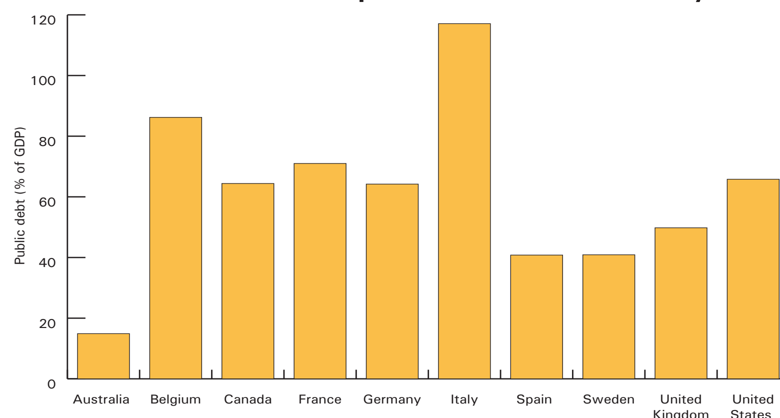
There is no consensus about the goals of fiscal policy

All the mainstream political parties now view price stability as a valuable and achievable objective for monetary policy. But there is no consensus about fiscal policy – neither is it likely that there ever will be. Levels of tax, spending and borrowing depend on the economic situation, political goals, and any number of other factors. Identical circumstances can produce vast differences of opinion. Ray Barrell of the National Institute of Economic and Social Research (NIESR) points out: "Some economists... suggest that we should be running a government surplus of 6 per cent of GDP to pay for future ageing related commitments. Other economists are happy with the idea that borrowing to invest is a good idea."[31]

The Conservatives say that the OBR would force the government onto a path of fiscal sustainability. However, sustainability is a highly contested term: its meaning can range from a Victorian style aversion to any annual budget deficit to the managed high debt levels found in some developed economies (see Chart 7).

Neither is it possible to determine, for each item of government spending, which benefits will accrue to each generation, so as to spread the debt costs accordingly. The very concept of intergenerational fairness is inherently difficult. For example, the Second World War bequeathed an enormous national debt on the future – over 200 per cent of GDP – which took decades to pay down. But most would accept that the benefits of peace were incalculably greater than the costs of the war. Moreover some current spending has long term effects: for example, spending on teachers' salaries could raise educational achievement and increase the future economic potential of the country. On the other hand, some spending incurs large but unquantifiable future costs, such as the damage to the

Chart 7: Recent levels of public debt internationally



Source: OECD. Note they use a slightly different definition of public debt than the UK.

environment caused by industrial activity. It is unrealistic to expect a clear consensus on how to balance these items.

Forecasting government borrowing is notoriously difficult

The Bank of England can predict growth and inflation over two or three years with some degree of accuracy. A single instrument, the short run risk free interest rate, is usually enough to control inflation. As CentreForum has argued elsewhere, the Bank has generally been successful in keeping it within a tight range.[32]

Forecasting government borrowing is a different matter. The relevant timeframe is much longer – government finances can take many years to turn around. But forecasting, even over a two year period, is more difficult: in eight of the last 20 years the two year forecast has been wrong by over 2 per cent of GDP.[33] It is not certain that an independent body such as the NAO would have made better forecasts than the Treasury; after all, they formally approved the Treasury's key assumptions. It is difficult to see how any set of delegated experts could lay out a 'correct' fiscal path, as the Monetary Policy Committee does for the Bank of England.

The current government cannot bind future governments

By ceding control over interest rates to the Bank of England, the Labour government made a decision that its successors are unlikely to reverse: to remove monetary policy from the realm of politics.

31 R Barrell, 'Comments on the Conservative plan for fiscal responsibility', NIESR, 29 September 2008.

32 A Murray and G Wilkes, 'The new politics of inflation', 2008.

33 HM Treasury, 'End of year fiscal report', 2008 www.hm-treasury.gov.uk/d/pbr08_endofyear_403.pdf

The same cannot be done for fiscal policy. As the Conservatives recognise, even if an OBR was established, executive control over tax and spending should remain with politicians. The choice of whether to follow the OBR's advice or not would still be political. Politicians are ultimately answerable to voters; should the short term political calculus encourage them to suspend fiscal rectitude, they will probably choose that course – just as the Labour government did with the fiscal rules. An incoming administration might even abolish the OBR. Therefore it would be unlikely to influence long term expectations.

The more powerful the OBR became, the more its legitimacy would be challenged

On the other hand, a situation where the OBR gained such credibility that ignoring its advice became politically damaging, would create an even greater set of problems. OBR members would perform one of the most important economic functions in the UK. The views of its chairman would have extraordinary significance. A difference of opinion as to whether a debt level of 50 or 60 per cent of GDP was 'sustainable' would have an enormous impact on public investment and other future spending decisions. The Chairman's decisions about the UK's long term growth potential or its future demographic shape would have a huge impact on the political debate – but would take place far from the normal parliamentary process.

Unelected officials would secure a position of great responsibility within an area that is intrinsically political. Voters, meanwhile, would lose influence over key decisions, for example, opting for increased borrowing in return for higher public investment.

The OBR would quickly be called into question

Even if the OBR demonstrated real technical competence, it would still have to make controversial decisions, such as on the future path of health spending. But if it did so and sided with the government, political opposition would suspect behind-the-scenes ministerial pressure. Given how closely such an Office would have to work with the Treasury, it would be impossible to rule out a version of 'regulatory capture', in which the supposedly impartial watchdog ends up adopting most of the attitudes of the government it is meant to be watching. In this case, the OBR would be seen as merely a vehicle for providing cover for political decisions.

Accountability for fiscal policy would be weakened

The creation of an OBR would blur responsibility for fiscal decisions. It would see the Chancellor first mandating the OBR with a long term goal for public finances, the OBR responding to this with its own forecasts and recommendations, and then the Chancellor choosing whether to ignore them. If mistakes were made, what or who should be blamed – the original mandate, the members of the OBR, or the Chancellor's response to its advice? This is no way to make fiscal responsibility more transparent.

Independent scrutiny of government policy would be undermined

Currently, a plethora of different bodies comment upon the UK's fiscal position, from consultancies like Capital Economics, through domestic think tanks such as the Institute for Fiscal Studies to international organisations like the IMF and OECD. At present, any of these potentially possess the "independence, credibility and ability to create strong political pressure for responsible fiscal policy", to quote the Conservatives. In combination with the media and the markets, they create ongoing pressure on the government to weigh future debts in their decisions.

There is a risk that an effective OBR would have such a loud voice in the fiscal debate that independent third parties would be drowned out. 'Fiscal responsibility' would henceforth mean agreeing with the OBR. Just as Labour ministers have responded to criticism with 'we have stuck to the fiscal rules', Conservative ministers would argue that 'the OBR tells us this is right'.

The role of voters and markets

Ultimately, governments need to consider the response of two groups when making borrowing decisions: the voters, who bear the present and future tax burden, and the markets, who lend the money and share the consequences of unsustainable behaviour. Fiscal policy fails when they are ignored.

Within a few years investors will hold £1 trillion of UK government debt. The smallest indication that

the government's repayment plans are unrealistic will immediately lead to an increase in borrowing costs. International bond markets are also a force for greater transparency in the government's accounts – professional investors do not lend out billions without knowing how they will be repaid. Pressure from the market is unrelenting. Unsustainable plans are swiftly punished.

But financial markets indicate only the likelihood of debt being repaid in valuable currency. They are silent about how this burden is distributed or how the proceeds are spent. A government could always guarantee payment by ignoring the welfare of its citizens. This is where pressure from the voters comes in.

Institutional innovations – whether the government's fiscal rules or the Conservatives' Office for Budget Responsibility – soften democratic pressure from the electorate. Such inventions are a distraction, and therefore deny voters a clear political choice. Both provide a black box into which the debate about important tax and borrowing decisions is locked away from regular public scrutiny.

Tellingly, the recent suspension of the fiscal rules has ushered in a much more vigorous debate about fiscal policy. Instead of bland assurances that the rules will be met, Labour ministers have had to justify the first prospective rise in income tax since the 1980s. The merits of higher or lower VAT rates have been vigorously debated, as, in time, will the parties' proposals for cutting public spending.

Fiscal policy will be a pivotal issue at the next election. In such an environment it would be patronising to think that the interests of voters would not count. They have always counted: a reputation for financial incompetence helped keep the Labour Party out of office from 1979 to 1997, just as it has the Conservative Party for over 12 years.

A rejection of fiscal institutions does not mean going back to the 'bad old days of boom and bust'. Some innovations of the last two decades should be maintained – the Pre-Budget Report

The recent suspension of the fiscal rules has ushered in a much more vigorous debate about fiscal policy

being a good example. But it is worth remembering that the period leading up to 1997 contained noteworthy episodes of fiscal consolidation without any rules or fiscal councils. In the mid 1990s, the then Chancellor Kenneth Clarke arrested the increase in government debt with a variety of tax rises and spending cuts, despite the unpopularity of the measures. Labour did not invent the idea that Chancellors must be clear about their plans for borrowing.

The most powerful message any incoming Chancellor could make about fiscal responsibility would be to eschew gimmicky innovations. It is time to move the discussion from the structures to the substance of fiscal policy. That discussion should be at the centre of the political debate, not delegated away to a super-quango.

About the authors:

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