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Britannia waives the rules?

Lessons from UK and international experience with fiscal rules

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Summary

Fiscal rules, durable numerical constraints on fiscal policy decisions, are in place in around half of the countries in the world and have been employed by every government in the UK since 1997. The UK's current fiscal rules are set to expire in 2020-21, and all major political parties have committed to replacing them. This paper, the second in a trilogy on the subject, considers the lessons from international and UK experience with fiscal rules for the design of the UK's next generation of fiscal targets.[1]

Over the last three decades, most advanced economies and a growing number of emerging market and developing countries have adopted some form of fiscal rules, with the most common combination being targets for the stock of debt and flow of surpluses or deficits. These rules have become more sophisticated over time, both in their design (through adjustment for the economic cycle, inclusion of escape clauses, carve outs for investment, and codification in legislation) and institutional underpinnings (in the form of independent fiscal councils, binding multi-year budget frameworks, and analysis of near and long-term fiscal risks). While the mere adoption of a fiscal rule does not guarantee better fiscal performance, the latest cross-country analysis finds that *well-designed fiscal rules* are associated with lower government deficits, debts, and borrowing costs.

Thirty years of international experience with fiscal rules has highlighted a number of characteristics of successful rules. These include:

- having a firm basis in legislation which reflects a broad and durable political consensus about the objectives for fiscal policy;
- being comprehensive in coverage of public sector institutions and financial activities and measured according to recognised accounting concepts;
- being medium-term in orientation and calibrated to ensure that the public finances are robust to a range of plausible macroeconomic scenarios;
- incorporating features that enable fiscal policy to play an active role in stabilising the macroeconomy in both booms and busts such as cyclical adjustment, escape clauses, and self-correction mechanisms; and
- being supported by sound budget management arrangements which facilitate the preparation, execution, and monitoring of budgets in a manner consistent with the rules.

While the UK has been a pioneer in the introduction and development of fiscal rules over the past two decades, its track record in adhering to its stated fiscal objectives has

1 The first paper, *Seeking public value*, published in September 2019, made the case for including a target for the public sector balance sheet as part of the next set of fiscal rules. The third paper, to be published later this month, will include the Resolution Foundation's full set of proposals for the next generation of fiscal rules.

been mixed. Four different Chancellors have operated five different fiscal rules over this period, with life spans ranging from ten years to barely one. The UK's rules have always included objectives for public sector net debt and some variant of public sector net borrowing depending on the economic priorities of the Labour, Coalition, or Conservative governments of the day. The UK's fiscal rules have generally kept pace with global developments in fiscal frameworks including by being comprehensive in institutional coverage, generally medium-term in outlook, grounded in some form of legislation, usually adjusted for the economic cycle, and, since 2010, evaluated by the independent Office for Budget Responsibility.

However, in designing a new set of fiscal rules to replace those set to expire in 2020-21, there are a number of persistent shortcomings in the UK's fiscal framework that the Chancellor should look to address. These include the need to:

- look beyond the narrow range of instruments included in public sector net debt to adopt a stock rule which takes account of the wider balance sheet of assets and liabilities;
- avoid the perverse incentives that can come from rules that are either too backward-looking, forward-looking, or focused on hitting a particular figure in a specific year;
- take advantage of recent innovations in fiscal risk analysis to ensure that the rules can continue to be met under a range of macroeconomic scenarios;
- enable fiscal policy to play a more active role, alongside monetary policy, in insulating the macroeconomy from economic shocks without abandoning the entire framework; and
- engender a more durable political commitment to the rules through wider consultation about the rules themselves and firmer grounding in legislation.

Introduction

Fiscal rules are durable constraints on fiscal policy in the form of numerical targets or limits on one or more fiscal aggregates.[2] Like inflation targets in monetary policy, they are designed to solve the time-inconsistency problem inherent in fiscal policy: while it is in governments' long-run interest to keep borrowing low and debt sustainable, it is often in their immediate interest to tax less or spend more as a means of gaining political advantage over their opponents. By forcing governments to set clear medium-term objectives for fiscal policy, fiscal rules attempt to raise the political cost of deviating from those objectives and keep governments on the path of fiscal sustainability. To bolster the credibility of this commitment, rules are often enshrined in national constitutions, higher legislation, or international treaties. While governments have imposed self-denying ordinances on their own fiscal profligacy as far back as the 5th century BCE, modern fiscal rules have been around for a little over three decades.

Fiscal rules often cater to multiple macroeconomic objectives including restoring or preserving fiscal sustainability in the long-term, smoothing out cyclical fluctuations in the economy, and promoting policies which boost long-run growth such as infrastructure investment. Well-designed fiscal rules need to be flexible enough to allow policy makers to take decisions required to safeguard and enhance the welfare of their citizens while being firm enough to stop governments from pursuing persistently unsustainable policies.

The UK was one of the pioneers in the development of fiscal rules with the introduction in 1998 of the Golden Rule and Sustainable Investment Rule that guided the new Labour government's fiscal policy for the ensuing decade. Since then, the vast majority of advanced economies and a growing number of emerging market and developing countries have also adopted some form of fiscal rule. In the UK, no government or major opposition party has felt it could go without a fiscal rule as a summary expression of its fiscal philosophy and demonstration of its commitment to responsible stewardship of the public finances. Their track record in living up to those commitments has been more mixed.

The UK's current set of fiscal rules are set to expire in 2020-21 and are arguably already on track to be broken.[3] With all major political parties committed to replacing them with a new set of rules, this paper is intended to inform those considerations by reviewing the lessons from UK and international experience with fiscal rules. It is part of a series being prepared by the Resolution Foundation's (RF's) new Macroeconomic Policy Unit designed

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2 G Kopits & S Symansky, *Fiscal Policy Rules*, IMF Occasional Paper No. 162, July 1998
3 See D Tomlinson & T Bell, *Breaking the rules: Analysing the credibility of the Chancellor's commitment to keep to his fiscal rules*, Resolution Foundation, August 2019; and A Corlett, D Tomlinson, M Whittaker & T Bell, *Rounding up: Putting the 2019 Spending Round into context*, Resolution Foundation, September 2019.

to inform the public debate about reforms to the UK's macroeconomic policy framework.[4] Together with *Seeking public value: The case for balance sheet targeting in fiscal policy*,[5] it lays the conceptual and empirical groundwork for a forthcoming paper setting out RF's proposals for the next generation of fiscal rules of the UK.

The remainder of this paper:

- explores international trends in the adoption and implementation of fiscal rules over the last three decades;
- considers international experience with the fiscal rules over this period and what that has taught us about the key features of successful fiscal rules;
- reviews the UK's experience with fiscal rules since it first adopted them in the late 1990s; and
- draws a set of lessons for the UK's next set of fiscal rules.

International Trends in Fiscal Rules

Trends in the adoption of fiscal rules

All government's face an inherent conflict between their immediate budgetary incentives and their long-term fiscal objectives. However, this time-inconsistency problem is especially acute in democratic societies in which power is diffuse, government tenures are limited, and demands on the public purse come from both taxpayers demanding tax cuts and beneficiaries of government services demanding higher levels of public spending. The idea of placing a durable numerical constraint on fiscal policy is, indeed, as old as democracy itself, with the earliest record of a fiscal rule being that adopted by the Athenian Assembly at the commencement of the Peloponnesian War in the 5th century BCE to ensure it retained sufficient fiscal reserves to cope with a possible Spartan invasion.[6]

While a number of countries, including Germany and Japan, had fiscal rules embedded in their post-war constitutions, fiscal rules in their contemporary incarnation date back to the late 1990s. Over the last three decades, most advanced countries and a growing number of emerging market and developing countries have adopted some form of fiscal rule (Figure 1a). Today, fiscal rules are virtually universal in Europe,[7] widespread in North

4 J Smith, J Leslie, C Pacitti & F Rahman, *Recession ready?: Assessing the UK's macroeconomic framework*, Resolution Foundation, September 2019

5 R Hughes, *Seeking public value: The case for balance sheet targeting in fiscal policy,* Resolution Foundation, September 2019.

6 D Kagan, *The Peloponnesian War,* Penguin: New York, 2004.

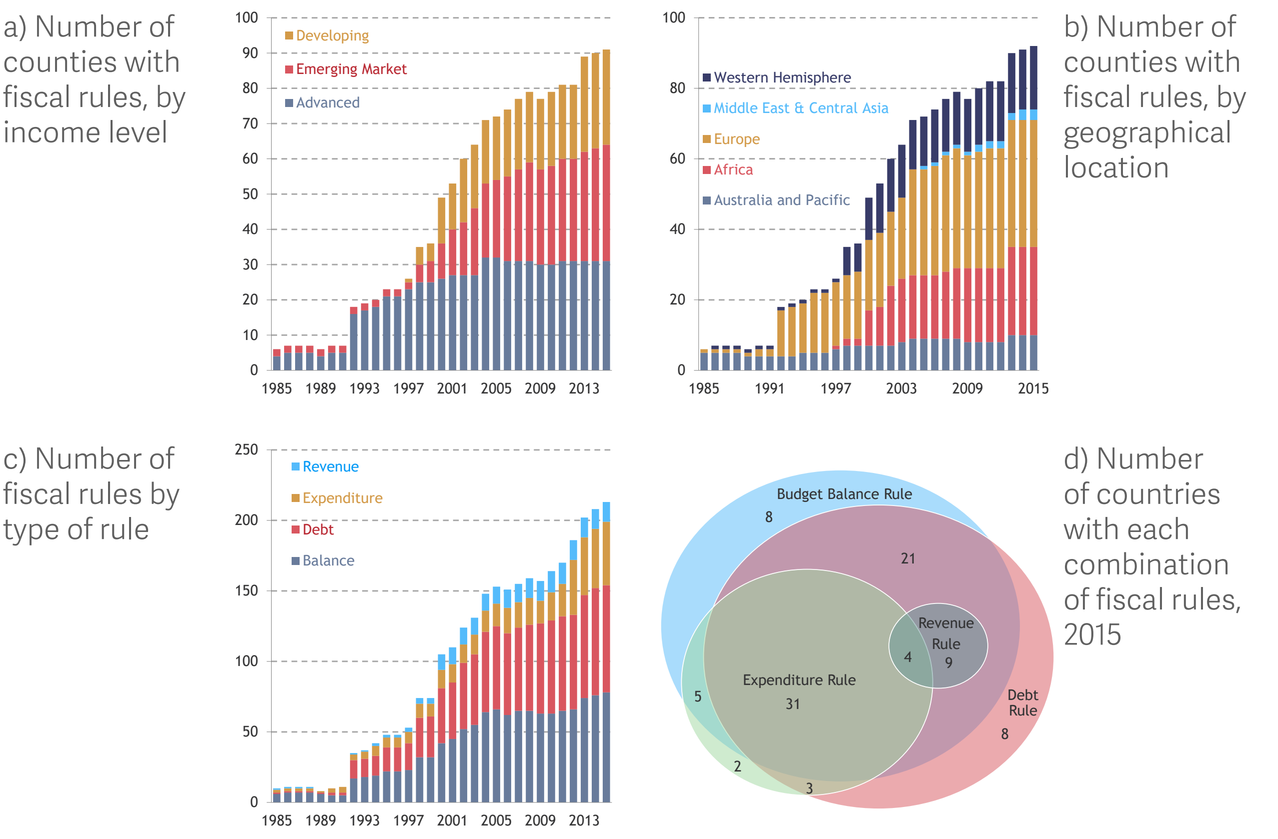
7 The widespread adoption of fiscal rules in Europe is due in part to the adoption of the Fiscal Compact in 2012 which requires all EU Member States to have in place national fiscal rules which are consistent with keeping their deficits and debts below, or returning them to, the 3% and 60% limits enshrined in the Stability and Growth Pact. Despite already complying with all elements of the Fiscal Compact, the UK was the one Member State to ask for and receive an opt-out.

and South America, increasingly common in Africa, but still relatively rare in Middle Eastern and Asian countries (Figure 1b). In 2015, fiscal policy in 92 of 189 countries was subject to one or more national or supranational rules.[8]

Types of fiscal rules

Among the fiscal rules currently in force, the most common combination has been a long-term “stock” rule for the level or trajectory of government debt and a medium-term “flow” rule for some variant of the balance between government revenue and expenditure. Taken together, these rules account for around 70 percent of fiscal rules currently in force around the world (Figure 1c). Expenditure rules have become increasingly popular in the last decade, but most often in combination with the first two rules which are used to calibrate the desired level of expenditure over the forecast horizon. Rules focused on the level of government revenue are relatively rare as are stock rules for net worth (the difference between assets and liabilities) (Figure 1d).

FIGURE 1: **Fiscal rules now cover about half the world**



NOTES: Includes both national and supranational fiscal rules. Venn diagram excludes Iran, which only has a revenue rule and the two net worth targets that are held by Australia and New Zealand.

SOURCE: IMF, *Fiscal Rules Database*, 2015.

8 IMF *Fiscal Rules Database*, 2015.

From first to second generation fiscal rules

Improvements in macroeconomic data and forecasting techniques together with the range of competing demands being placed on fiscal policymakers have fuelled a trend toward increasing sophistication in the design of fiscal rules. This so-called "second generation" of fiscal rules are expected to serve multiple objectives including preserving or restoring fiscal sustainability, enabling fiscal policy to stabilise the macroeconomy in the face of shocks, supporting long-term growth through investment in public infrastructure, and correcting for past deviations from fiscal plans.[9] This trend toward increasing sophistication can be seen in Figure 2 which charts the number of countries having adopted one or more of the following design features into their fiscal rules:

- a cyclical-adjustment factor designed to prevent the rule from impairing the operation of automatic fiscal stabilisers in smoothing out the path of the macroeconomy;
- an escape clause to allow the government to use discretionary fiscal policy in the event of an exceptional shock to the macroeconomy;
- a carve out for public investment on the grounds of its role in supporting long-term economic growth; and
- codification in primary or higher legislation, national constitutions, or supranational treaties.

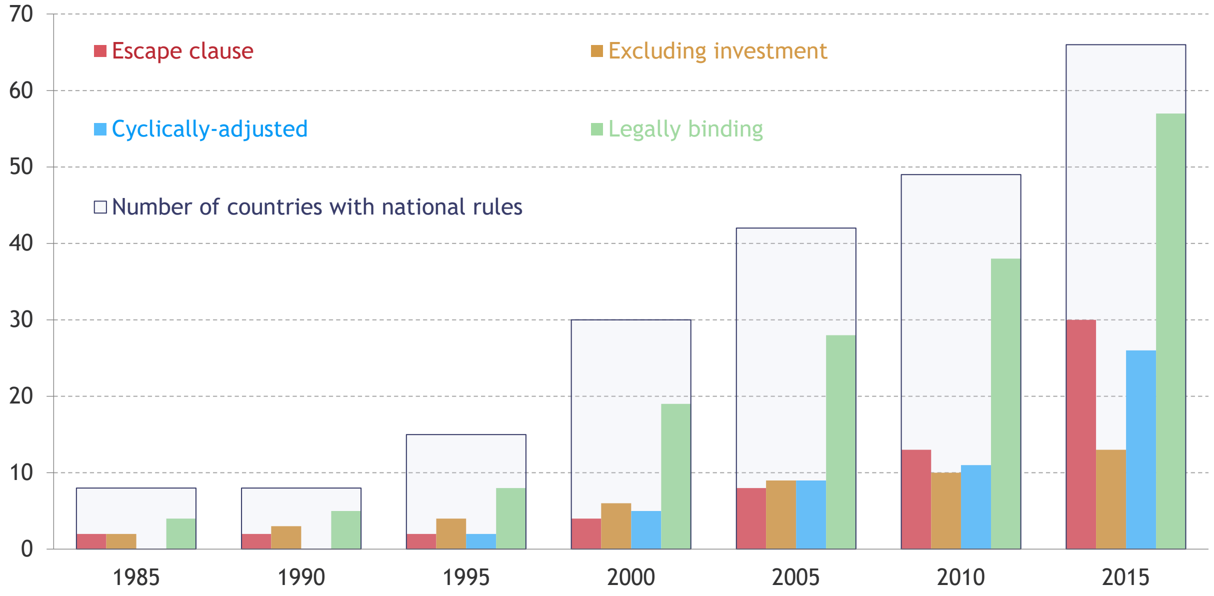
Trends in supporting institutions

As fiscal rules have grown in number and complexity, so has the need for the government's fiscal forecasts to be based on credible macroeconomic assumptions and for the government's performance against its rules to be assessed by an independent and authoritative body. This was needed, in part, to counteract the tendency for "gaming" on the part of governments looking to meet their fiscal rules through opportunistic behaviour such as overly optimistic macroeconomic or fiscal forecasts, changes in accounting treatment of particular institutions or transactions, manipulation of cyclical adjustment factors, or labelling of spending or revenue measures as "one-offs."

9 L Eyraud et al, *Second Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability*, IMF Staff Discussion Note, April 2018.

FIGURE 2: **Fiscal rules have become increasingly sophisticated in their design**

Number of advanced economies with fiscal rules adopted at a national level by year, split by characteristics of rules

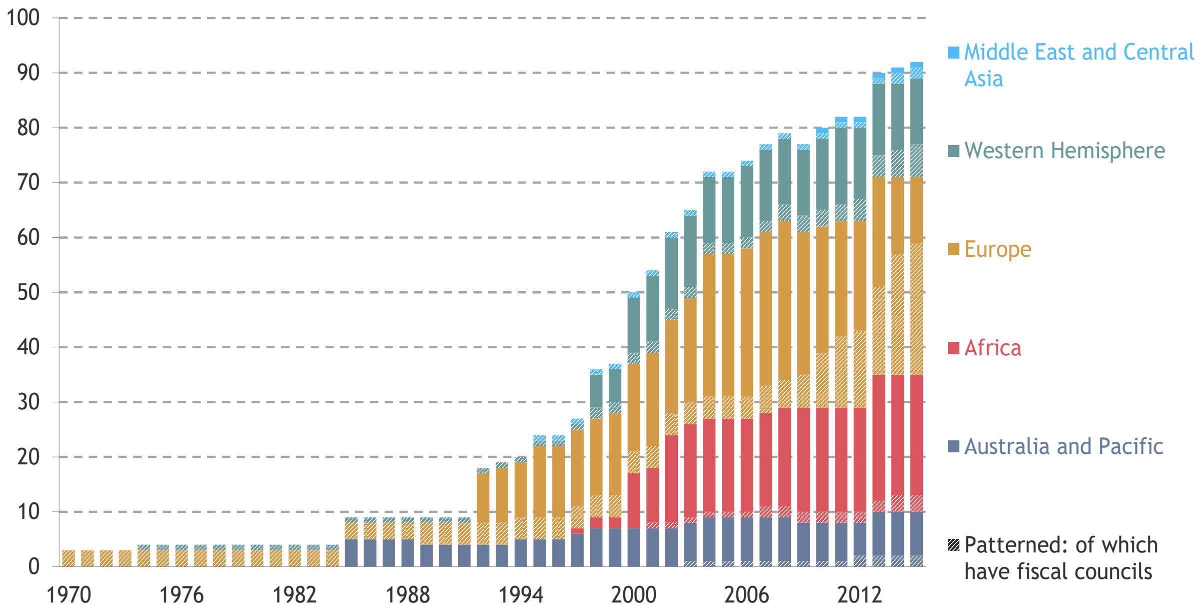


NOTES: Supranational-only rules are excluded and rules are shown from implementation date rather than announcement date.
SOURCE: RF analysis of IMF, *Fiscal Rules Database*, 2015.

The growth of fiscal rules has therefore been accompanied by the rise of independent fiscal institutions or fiscal councils (Figure 3).

FIGURE 3: **The rise of fiscal councils has accompanied the spread of rules**

Number of countries with fiscal rules, and of which have fiscal councils, by geographical location

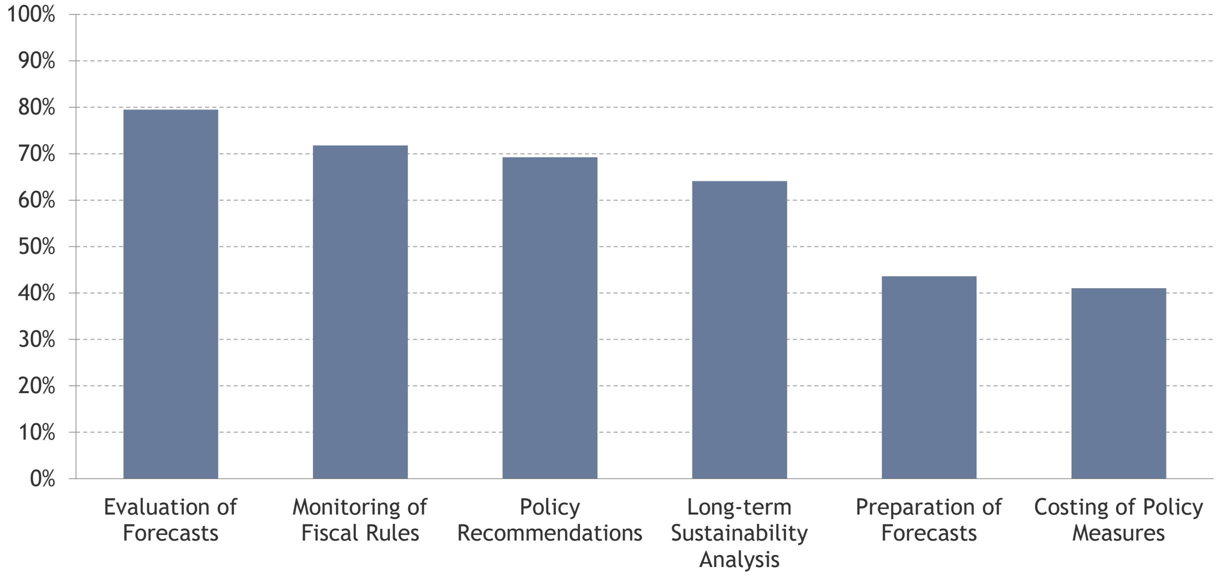


NOTES: Includes all rules including supranational, 'of which have councils' also includes countries that have fiscal councils but not fiscal rules.
SOURCE: RF analysis of IMF, *Fiscal Rules Dataset* and IMF, *Fiscal Council Dataset*.

Fiscal councils were relatively rare prior to 2000 with only 6 in existence before including the US Congressional Budget Office and Dutch Central Planning Bureau. However, the last 20 years has seen rapid growth in the number of independent fiscal institutions to 39 today, two thirds of which are in European countries. The mandates of these institutions vary considerably, but most play some role in assuring the credibility of macroeconomic and fiscal forecasts and monitoring the government's performance against its fiscal rules (Figure 4).

FIGURE 4: **Most fiscal councils play a role in monitoring compliance with rules**

Proportion of fiscal councils, by mandate



NOTES: Includes existing fiscal councils across the IMF membership as of end-December 2016.
SOURCE: RF analysis of IMF, *Fiscal Council Dataset*

Impact of fiscal rules

Over the past three decades, well-designed fiscal rules appear to have had a positive impact on fiscal performance in a number of respects. A 2018 IMF survey paper found that well-designed fiscal rules provide a focal point for fiscal policy and are associated with lower deficits than in countries with weak or no rules.[10] Countries with such fiscal rules benefit from lower government borrowing costs (especially if they stick to them), with the presence of a fiscal rule estimated to reduce sovereign bond spreads by 1-2 per cent and non-compliance with fiscal rules estimated to increase spreads by ½ to 1½ per cent.[11] Both of these relationships were stronger when there was an independent

10 See footnote 9.
11 A Afonso & J T Jalles, *Fiscal Rules and Government Financing Costs*, Fiscal Studies, Vol 40, No 1, March 2019; F D Kalan, A Popescu & J Reynaud, *Thou Shalt Not Breach: The Impact on Sovereign Spreads of Noncomplying with the EU Fiscal Rules*, IMF Working Paper No. 18/87, April 2018.

fiscal council charged with evaluating the government's performance against its rules. Moreover, while presence of fiscal rules in isolation tends to *increase* the optimism of fiscal forecasts, where an independent fiscal council is also in place, fiscal forecasts are actually *more* accurate.[12]

Lessons from international experience

While fiscal rules have been adopted, broken, and revised in many countries over the past thirty years, few countries have abandoned them altogether and returned to unfettered executive discretion in the making of fiscal policy. This suggests that well-designed fiscal rules continue to serve an important purpose in signalling the government's fiscal objectives and holding them to account for their delivery. Three decades of experimentation with fiscal rules around the world has highlighted ten characteristics of effective and durable rules.

1) Rules should reflect a broad and durable political consensus

Fiscal rules should reflect a broad and durable political consensus about the direction of fiscal policy across the government, the legislature, and the wider public. Fiscal rules adopted following periods of unusual economic and fiscal stress, such as the surplus rule adopted by the Swedish government following their economic and fiscal crisis in the 1990s, reflected a cross-party consensus about the importance of not repeating the economic and fiscal policy errors of this period. The need for fiscal rules to have not only economic merit but also political resonance argues for rules which are simple, clear, and easy to communicate in party manifestos, campaign speeches, and media reports. There is clearly a tension between this objective and the sophistication required to enable the rules to meet some of the other objectives set out below.

2) Rules should be enshrined in higher law

To ensure their enforceability and durability, rules should be enshrined in primary legislation, organic (higher) law, or the constitution. Codifying fiscal rules in higher forms of law helps to solidify the social consensus in favour of responsible fiscal policymaking, ensures the rules are binding on budget legislation itself, and raises the political cost of changing or deviating from those rules when government's come under political pressure to do so. Two of the more well-known fiscal rules, the German and Swiss debt break rules, are inscribed in the constitutions of both federations. This reflects, in part, the need for these rules to bind not only central government but also the financial decisions of sub-national governments in the Länder and Cantons which account for a significant proportion of revenue and expenditure in both countries.

12 R Beetsma et al, *Independent Fiscal Councils: Recent Trends and Performance*, IMF Working Paper No. 18/68, March 2018.

3) Rules should be comprehensive in coverage

Fiscal rules should be comprehensive both in terms of coverage of public sector institutions and the financial activities of government. Fiscal rules that cover only part of the public sector (by excluding extrabudgetary funds, local governments, or public corporations) or exclude some types of financial transactions (such a capital expenditure, public private partnership contracts, loans, or guarantees) create incentives to channel fiscal activity into these lacunae in the fiscal framework – with adverse consequences for value for money, transparency, and sustainability. The exclusion of public-private partnership (PPP) contracts from the definition of debt in the EU's Stability and Growth Pact led a number of EU Member States including Portugal and Greece to contract a significant proportion of infrastructure investments in the form of PPP liabilities which, when the private counterparties found themselves in financial difficulty during the Eurozone crisis, ended up being assumed by the government – contributing to the governments' loss of fiscal credibility.[13]

4) Rules should be based on recognised accounting concepts

Fiscal rules should be based on independently defined statistical or accounting concepts. Once a fiscal rule has been adopted, the decision about how it should be measured, and the production of the data used to evaluate the government's performance, should be in the hands of an independent statistics agency or accounting body. Otherwise, governments can be tempted to engage in "creative accounting" as a means of getting around the rule's strictures. The adoption of the Stability and Growth Pact rules in the EU was found to have significantly increased the use of creative accounting among Member States.[14] The persistent underreporting of deficits and debt contributed to collapse in the confidence in the financial sustainability of a number of Eurozone governments which triggered the Eurozone crisis in 2010. It also prompted the European Statistics Agency (Eurostat) to reinvigorate its efforts to harmonize national statistical and accounting practices across the EU through the development of European Public Sector Accounting Standards (EPSAS).[15]

5) Rules should be medium-term in orientation

Fiscal policy should facilitate forward planning by households and businesses and therefore avoid sudden, dramatic, or unexpected changes in tax or spending policies. For this reason, fiscal policy objectives should be set over the medium-term to allow fiscal policies to be adjusted gradually while still meeting the rules. Rules that impose strict annual limits on the budget balance tend to be broken eventually, as was the fate of the

13 IMF, *Fiscal Transparency, Accountability, and Risk*, IMF Policy Paper, 2012.
14 J von Hagen & G Wolff, *What Do Deficits Tell us About Debts? Empirical Evidence on Creative Accounting with Fiscal Rules in the EU*, Centre for Economic Policy Research Discussion Paper 4759, November 2004.
15 https://ec.europa.eu/eurostat/web/epsas

golden rule included in Japan's post-war Basic Law which required current spending to be below current revenue every year and has been broken in all but a handful of years since 1975.[16]

6) Rules should ensure sustainability under a range of scenarios

Fiscal rules should be calibrated to ensure that the public finances are robust to a range of plausible macroeconomic and other shocks. Countries which have proven most successful in meeting their fiscal rules over time have often explicitly incorporated risk analysis into the setting of successive fiscal targets. In the Netherlands, the setting of the 4-year expenditure ceilings for each new coalition government period is informed by a report by the Study Group on the Budget Margin which provides advice on, inter alia, the size of the contingency margins that should be retained between that ceiling and the government's deficit and debt targets to ensure the latter can be met on a range of potential macroeconomic scenarios.[17]

7) Rules should allow fiscal policy to stabilise the macroeconomy

Fiscal policy plays an important role in smoothing out the ups and downs of the economic cycle. In particular now that the scope for monetary policy to stabilise the macro-economy is constrained by low interest rates and already extensive asset holdings by central banks, fiscal policy needs to play a more overtly countercyclical role. Rules should therefore allow fiscal policy to stabilise the macroeconomy in the near-term without jeopardising the long-run fiscal position. The use of cyclically adjusted targets can enable the operation of automatic fiscal stabilisers while ensuring that the fiscal policy stance remains neutral over the long-term. As shown in Figure 2, 26 of 55 targets for the fiscal balance in force in 2015 made some allowance for the economic cycle.

8) Rules should have built-in escape clauses

Fiscal rules should include a well-defined escape clause to enable fiscal policy to provide discretionary support to the economy in the event of exceptional economic shocks. Cyclical adjustment of rules can help to ensure they do not impede the normal operation of the automatic stabilisers during typical economic downturns and upswings. However, in the event of exceptionally large macroeconomic shocks such as the 2008 crisis, the impact on the public finances is typically much greater than that allowed for by cyclical adjustment factors, which are usually estimated based on the average historic relationships between economic and fiscal outturns.[18] Moreover, in the event of such severe shocks, there is an important role for discretionary fiscal policy in limiting the potentially lasting economic harm to businesses and firms. This was the case in the

16 IMF *Fiscal Rules database*, 2015
17 http://rijksbegroting.nl/beleidsevaluaties/studiegroep-begrotingsruimte
18 IMF, *Analyzing and Managing Fiscal Risks: Best Practices*, IMF Policy Paper, 2016.

wake of the 2008 crisis when most advanced countries triggered the escape clauses in their fiscal rules, or abandoned them altogether, in order to provide a coordinated fiscal stimulus to their domestic economies and support their troubled financial sectors. From the perspective of the credibility and durability of the framework, it is preferable if the combination of rules and escape clause can be designed so as to provide for a return to the rule once the shock has abated.

9) Rules should include a self-correction mechanism

Fiscal rules should incorporate a self-correction mechanism to ensure there is not persistent deficit or surplus bias in the fiscal stance over time. Without a correction mechanism, persistent under-shooting or over-shooting of fiscal targets can result in fiscal policy being either looser or tighter than originally intended when the rules were set. Rules with a rolling time horizon (e.g. balancing the budget in five years' time) or based on future growth rates (e.g. keeping expenditure growth in line with trend GDP) are especially prone to what is termed "baseline drift" or the tendency for past errors to be built into future projections. To prevent this, the debt-brake rules adopted in Germany and Switzerland require any over or underachievement against the structural deficit targets prescribed for each level of government to be made up when setting fiscal policy for subsequent years.

10) Rules need to be supported by sound budget management

Fiscal rules cannot deliver responsible fiscal management on their own. They need to be supported by sound institutional arrangements for the management of the public finances. In particular, the successful conduct of rules-based fiscal policies requires (i) reliable and timely fiscal data to enable real-time monitoring of fiscal performance; (ii) credible multi-year budget planning to ensure that current policy settings are consistent with medium-term fiscal targets; (iii) a comprehensive and top-down approach to the preparation of the annual budget which gives primacy to aggregate fiscal discipline over bottom-up demands for tax cuts or spending increases; (iv) robust expenditure controls and tax administration systems which ensure that the annual budget is executed as approved; (v) institutional arrangements for coordinating fiscal decision-making across levels of government where their fiscal decisions are subject to the rules; and (vi) authoritative and independent fiscal institutions such as fiscal councils or national audit offices, which ensure that fiscal plans are based on realistic macroeconomic and fiscal assumptions and provide an objective evaluation of the government's performance against its fiscal rules. The EU's struggles in getting Member States to comply with the Stability and Growth Pact's deficit and debt limits in the years running-up to the Eurozone crisis highlighted to problems than can arise when trying to enforce fiscal rules on countries whose budgeting systems were not attuned to rules-based fiscal policymaking.

The subsequent adoption of the Budget Frameworks Directive was designed to ensure that the above supporting institutions were in place in all Member States.[19]

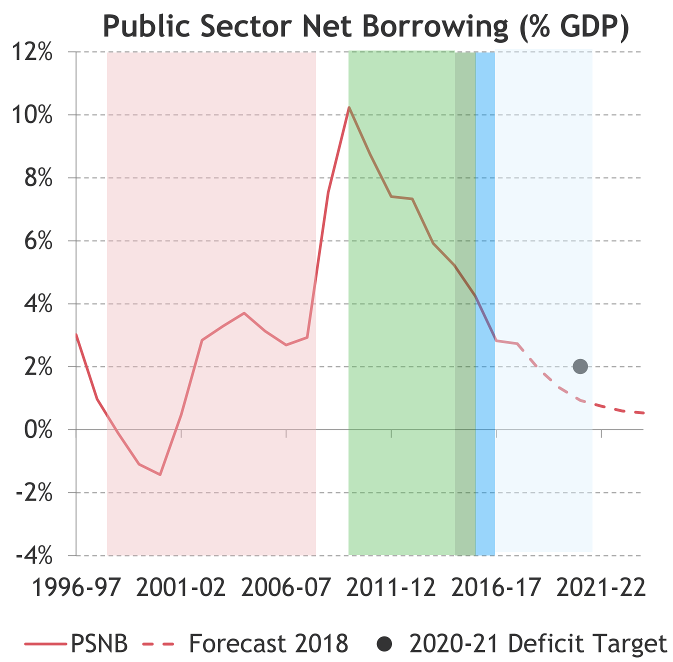
UK experience with fiscal rules

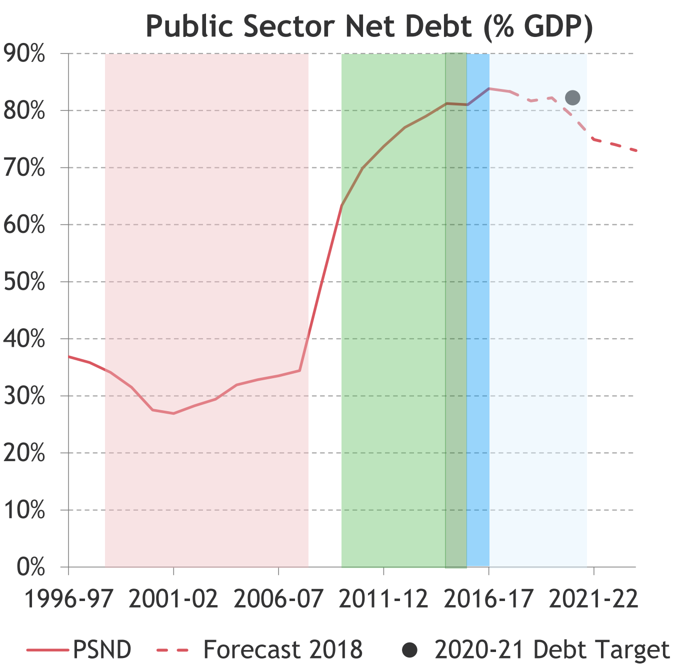
The UK was pioneer in the development of fiscal rules and was one of only 19 countries when it adopted its first set of fiscal rules in 1997. Since then every UK government, with the exception of a two-year hiatus in the wake of the 2008 financial crisis, has had some form of rules in force (Figure 5). This section reviews the UK's two decades of experience with fiscal rules and draws lessons for the next generation of rules that will guide fiscal policy into the 2020s.

FIGURE 5: **The UK has had 5 different fiscal rules over the past 20 years**

Fiscal Rules in Force

Period	Balance Rule	Debt Rule
1998-08	Current balance > 0 over the cycle	Debt < 40%
2010-14	Structural current balance > 0 by year 5	Debt falling from 2015-16
2014-15	Structural current balance > 0 by year 3	Debt falling from 2016-17
2015-16	Overall surplus in 2019 - 20	Debt falling every year
2016-21	Structural deficit < 2% by 2020-21	Debt falling by 2020-21





SOURCE: RF analysis of OBR, *Public finances databank*

19 https://ec.europa.eu/info/publications/fiscal-compact-taking-stock_en

UK Fiscal Policy in the Discretionary Era

Throughout the postwar period both Labour and Conservative Governments struggled to stick to their stated fiscal objectives. Borrowing averaged around 3 per cent of GDP between 1970-71 and 1997-98 with little relationship between the fiscal stance and cyclical position of the economy. For much of the post-war period, fiscal policy was largely the servant of other near-term economic objectives including demand management (in the 1960s), defending the value of sterling (during the 70s), or fighting inflation (in the 1980s and 90s).

While nothing that could be called a formal fiscal rule was in force during this period, the Conservative government did introduce multi-year restrictions on the growth rate of overall government expenditure first in real-terms (Planning Total in the late 1960s) and then in nominal terms (Control Total in the mid 1990s). While the latter proved more successful than the former in restraining the path of spending, excessive optimism about future growth and tax receipts (exacerbated by procyclical tax cuts) meant that governments often missed their objectives for the level of borrowing. Moreover, efforts to reduce the yawning deficits that emerged after Black Wednesday fell heavily on public investment which fell from 1.9 per cent of GDP in 1992-93 to 0.7 per cent in 1997-99, the eve of the general election that brought a new Labour government to power (Figure 6).[20]

Gordon Brown's Fiscal Rules (1998-2008)

Having been in opposition for 18 years, the introduction of fiscal rules was part of a wider attempt on the part of the newly elected Labour Government to convince markets and the electorate that they could be trusted with the management of the economy and public finances. They were also designed to allow fiscal policy the flexibility to support the economy over the economic cycle and to reverse the mid-1990s cuts in public investment.

Chancellor Gordon Brown's two fiscal rules, which were set out in Labour's 1997 election manifesto, were:

- a Golden Rule which required the government to balance the public sector current budget (revenue minus current expenditure) over the economic cycle. By excluding capital expenditure from the rule, this allowed the government to borrow to finance investment in any fixed or financial asset; and
- a Sustainable Investment Rule which required the government to reduce and keep public sector net debt below 40 per cent of GDP.

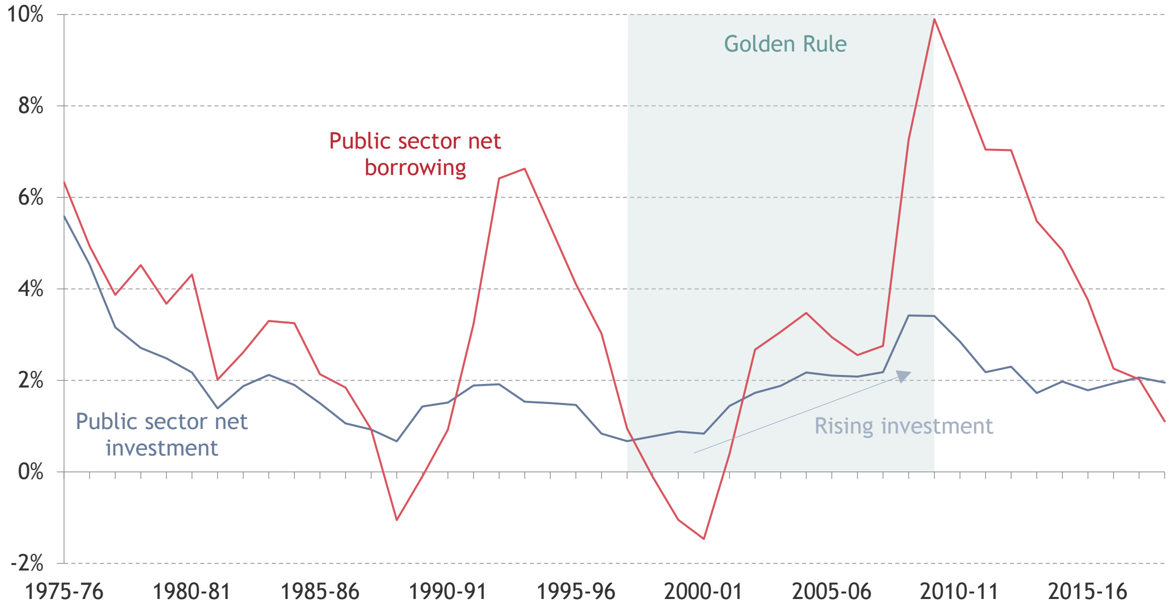
While the rules themselves were never enshrined in legislation, the requirement to state

20 T Ahnert, R Hughes & K Takahashi, "United Kingdom: Four Chancellors Facing Challenges" in Paolo Mauro ed., *Chipping Away at Public Debt: Sources of Failure and Keys to Success in Fiscal Adjustment*, IMF, January 2012.

and report on its fiscal objectives in each Budget was one of a number of obligations placed on the government by the Code for Fiscal Stability which was approved by Parliament as part of the 1998 Finance Act. In practice, these rules remained in place for a decade between 1998 and 2008, which compares reasonably favourably with the 7.9 year average duration for national fiscal rules worldwide.[21] The government ran current surpluses of 1-2 per cent of GDP for its first four years in power before a succession of expansionary Spending Reviews from 2002 onwards pushed the current budget into deficit. After a few years in which the public sector had to relearn how to spend capital, the level of public sector net investment rose steadily from a historic low of 0.7 per cent of GDP in 1997-98 to a 27-year high of 2.2 per cent of GDP by 2007-08 (Figure 6). The Sustainable Investment Rule was successful in keeping public sector net debt below 40 per cent of GDP which averaged 32 per cent of GDP over this period.

FIGURE 6: **Labour's Golden Rule helped rebuild public investment**

Public sector net borrowing and investment: proportion of GDP



SOURCE: OBR, *Public finances databank*

However, the UK's first decade of experience with fiscal rules was not an unmitigated success. The rules created a strong incentive for the Government to base its fiscal plans on overly optimistic macroeconomic and fiscal assumptions (especially for revenue growth) as a means of eking out more current expenditure within the strictures of the Golden Rule. This, together with the Government's opportunistic decision to change the start and end date of the economic cycle over which the Golden Rule was measured to bring in more surplus and exclude more deficit years, cost the Government and its rules a significant amount of credibility. Also, in retrospect, the relatively modest stress

21 IMF *Fiscal Rules Database*, 2015.

tests (known as the 'cautious case') used to calibrate the level of headroom needed to ensure the rules could be met with confidence meant they stood little chance of being adhered to when the UK was hit with a typical recession let alone a once-in-a-generation macroeconomic shock like the 2008 crisis.[22]

The Crisis Interregnum (2008-10)

The 2008 financial crisis and ensuing recession saw borrowing reach a post-war high of 9.9 per cent of GDP in 2009-10 and debt more than double as a share of GDP over the ensuing decade from 34 to 83 per cent of GDP. The Labour Chancellor Alistair Darling invoked the escape clause in the Code for Fiscal Stability and suspended the two fiscal rules in the November 2008 Pre-Budget Report (PBR).[23] In their place he adopted a temporary operating rule, as required under the Code, which committed the government to:

> "set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full."[24]

The temporary rule did not specify precisely how to measure when the economy had "emerged from the downturn" or how to judge when "the global shocks have worked their way through the economy in full." However, the cyclically adjusted current balance did improve in every year from a deficit of 4.4 per cent of GDP in 2009-10 to 2.3 per cent in 2014-15 (albeit shy of the 1.1 percent forecast in PBR 2008).[25] Debt proved more difficult to bring under control. The November 2008 PBR forecast debt to continue rising from 36.3 per cent of GDP in 2007-08 and stabilise at around 57 per cent in 2012-13. In the end, PSND continued rising for another five years and peaked at 83.8 per cent of GDP in 2016-17.

To provide stronger political and legal force behind the government's commitment to bring borrowing and debt back under control, Chancellor Darling introduced in his final PBR in 2009 a Fiscal Responsibility Act which passed into law in February 2010. The Act placed on the government a three-fold obligation for:

- public sector net borrowing to be more than halved as a share of GDP between 2009-10 (where it was estimated at the time to be 12.6 per cent) and 2013-14 (where

22 The "cautious case" assumed that the trend rate of real GDP growth was 1 per cent lower than reflected in the government's central fiscal forecast which at the time was assumed to be between 2½ - 2¾ per cent.
23 The Code allows the government to depart from its stated fiscal rules temporarily so long as it specifies (i) the reasons for departing from the previous objectives and operating rules; (ii) the approach and period of time that the government intends to take to return to the previous objectives and operating rules; and (iii) the objectives and operating rules that shall apply over this period.
24 Pre Budget Report 2008
25 OBR Public Finances Databank and PBR 2008

it was forecast to reach 5.5 percent of GDP);

- public sector net borrowing to be reduced as a share of GDP in each and every year from 2009-10 to 2015-16; and
- public sector net debt to be falling as a share of GDP in 2015-16.

The Government did manage to reduce PSNB as a share of GDP every year from 2009-10 to 5.5 percent in 2013-14, although a downward revision to the outturn level of PSNB in 2009-10 to 9.9 percent meant this was slightly less than half. As discussed above, the aim of getting debt to fall as a share of GDP remained elusive for a further two years.

The crisis interregnum highlighted the challenges of trying to commit to a set of numerical fiscal objectives in the face of extreme economic and fiscal uncertainty. The 2008 crisis tested the escape clause in the Code to the breaking point, and the government ended up never returning to the previous rules. Instead it set new fiscal targets every year for the next three years, all of which were variants of "keep reducing the deficit and get debt falling eventually". However, the Darling years did initiate the UK's first experiment with putting its fiscal rules in legislation in the form of the Fiscal Responsibility Act which laid the foundation for the more comprehensive Budget Responsibility Act and Charter for Budget Responsibility introduced by the Coalition Government after the May 2010 general election.

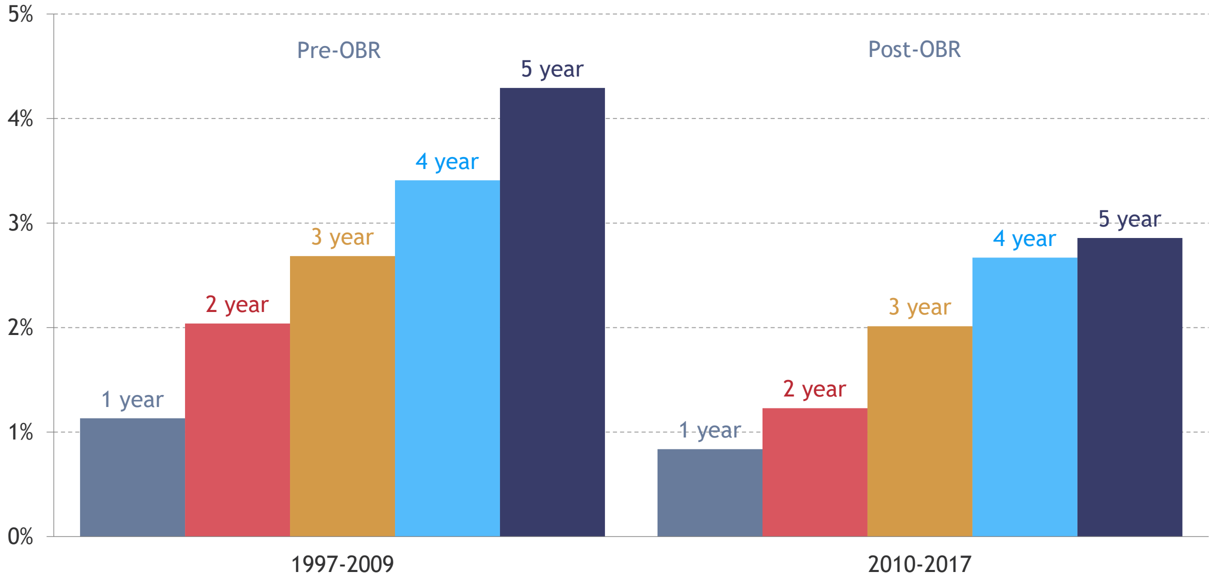
The Coalition's Fiscal Rules (2010-15)

The election of the Conservative-Liberal Democrat Coalition in May 2010 saw the advent of a new and somewhat more durable set of fiscal rules. The Coalition government's rules required the government to reach a structural current balance over a rolling 5-year forecast horizon and get debt falling as a share of GDP by 2015-16. The first rule allowed for full operation of the automatic stabilisers and, unlike Labour's Golden Rule, did not rely on judgements about the start or end date of the economic cycle. However, it did require a calculation of the output gap (the difference between potential and actual GDP) in order to measure the cyclical component of borrowing, which, in turn, required a judgement about the long-run potential growth rate of the UK economy - in the wake of one of the most disruptive economic episodes in its post-war history.

The rules were accompanied by a set of legal and institutional reforms designed to address some of the weaknesses in Labour's 1998-2008 fiscal regime. Stronger political commitment to the new rules was sought by the passage of the Budget Responsibility Act of 2010 which required the rules to be debated and approved by Parliament in the form of a secondary instrument, the Charter for Budget Responsibility. The credibility of the rules was further bolstered by the establishment of the independent Office for Budget Responsibility (OBR). By the standard of other fiscal councils, the OBR was given a broad mandate which included the production of the government's official macroeconomic and fiscal forecast, costing of government policy measures, assessment of the government's performance against its fiscal rules, and analysis of issues relevant to the sustainability of the public finances. This removed the Treasury's ability to either inflate the macroeconomic and fiscal forecast or make opportunistic judgments about the cyclical position of the economy to give it more resources within its fiscal rules. Despite the challenges of forecasting trend growth and the pace of the post-crisis economic recovery, the OBR proved better than the Treasury at forecasting the medium-term trajectory of both GDP and borrowing (Figure 7).

FIGURE 7: **The OBR has improved the credibility of the fiscal forecast**

Absolute forecast errors for public sector net borrowing each year after the forecast: proportion of GDP



NOTES: Errors are calculated as the absolute deviation between the forecast value (for one to five years ahead) and the outturn. Errors are adjusted to be net of the estimates impact of reclassifications between the forecast period and the current headline historic data.

SOURCE: RF calculations of OBR, *Historical official forecasts database*

The new fiscal rules and supporting reforms proved relatively successful in bringing down the deficit, albeit with some slippage allowed by the rolling nature of the target. To prevent the successive loosening of fiscal policy as the public finances improved, the deadline for reaching a structural current balance was brought forward to three years ahead in 2014, while the target year for getting debt falling with pushed back a year to 2016-17. Expenditure bore the brunt of the consolidation effort with total public spending falling from 45 to 40 per cent of GDP between 2010-11 and 2015-16. The exclusion of capital expenditure from the deficit did little to protect public sector net investment which fell from 2.8 per cent of GDP in 2010-11 to 1.8 per cent in 2015-16 (Figure 6). Receipts fell slightly from 36.2 per cent of GDP in 2010-11 to 35.8 in 2015-16, partly as a result of tax cuts introduced by the Coalition. The cyclically-adjusted current deficit fell from 4.1 per cent in 2010-11 to 1.6 per cent in 2015-16, but only reached a small surplus of 0.1 per cent in 2017-18 – two years after the deadline set in 2010. The government also missed its target to get debt falling by two years with public sector net debt peaking at 85.1 per cent of GDP in 2016-17.

George Osborne's Surplus Target (2015-16)

With the structural current budget deficit more than halved and conscious that the rolling nature of the 2010 and 2014 targets meant that it was possible to never actually reach its stated objective, the new elected Conservative majority government set a new target in July 2015 of delivering overall balance (including capital expenditure) by 2019-20 and keeping debt falling in each year after 2015-16. The aim of these rules was to rebuild the resilience of the UK's public finances to future economic shocks. The rule also included a more explicitly defined escape clause which allowed the rule to be suspended in the event of a significant adverse economic shock defined as real GDP growth of less than 1 per cent on a rolling 4 quarter-on-4-quarter basis.[26]

The post-election Summer Budget in July 2015 forecast the two rules being met by only the slimmest of margins with a surplus of 0.4 percent of GDP in 2019-20 and debt falling by just 0.5 per cent in 2015-16. This was the smallest amount of headroom any Chancellor had set aside against his fiscal rules at the time of setting them (see Figure 11). Within a year, both rules were on course to be broken. In the March 2016 Budget, the Government made a number of one-off changes to tax and spending designed to bring the post-measures public finances back into surplus by 2019-20 and keep debt falling as a per cent of GDP in 2016-17. These included changing the timing of corporation tax payments to move more of them into 2019-20 and 2020-21 and pencilling in additional cuts to Departmental Expenditure Limits in 2019-20 and 2020-21, six months after the conclusion of the 2015 Spending Review. Despite these measures, the post-EU Referendum slowdown in GDP and receipts growth saw the point at which surplus was to be achieved and debt begin falling retreat even further into the future.

Philip Hammond's 2% Target (2016-Present)

The victory for Leave in the June 2016 EU Referendum and subsequent departure of Prime Minister David Cameron and his Chancellor George Osborne rung the death knell for the 2015 fiscal rules. While real GDP growth was never forecast to fall below the 1 per cent threshold required to trigger the escape clause, the new Chancellor Philip Hammond suspended his predecessor's fiscal rules and announced a set of looser fiscal objectives in his 2016 Autumn Statement. These included:

26 Charter for Budget Responsibility 2015.

- an overall objective of balancing the budget by 2025-26, six years later than envisaged by his predecessor;
- a fiscal mandate to reduce cyclically adjusted borrowing below 2 per cent of GDP by 2020-21; and
- a supplementary target to get debt falling by 2020-21.

In addition to returning to a cyclically-adjusted measure, the Chancellor set aside significantly more *structural* headroom (£26.6 billion or around 1.3 per cent of GDP) against the 2 per cent mandate in 2020-21 to allow fiscal policy to respond to any shocks to the economy or public finances around the time of the UK's exit from the EU.

The new rules were supported by a further innovation in fiscal management encouraged by international institutions like the IMF and OECD – the publication by the OBR of a biennial Fiscal Risks Report (FRR) designed to assess the potential medium and long-term threats to the UK's fiscal sustainability. The FRR, first published in July 2017 with a Government response a year later, included a fiscal stress test, modelled on those done by the Bank of England to assess the fragility of the banking sector, which looked at the fiscal impact of a plausible combination of macroeconomic shocks and related fiscal risks.[27]

Both the 2 per cent of GDP cyclically-adjusted borrowing and the debt falling targets were met two years early in 2018-19 based on outturn data at the time. Hammond left office in July 2019 with £26.6 billion (1.2 per cent of GDP) of headroom against his 2 per cent of GDP structural deficit target largely intact. The longer-term objective of returning the public finances to overall balance continued to elude the Treasury over its five-year forecast horizon which showed borrowing falling gradually to 0.5 percent of GDP by 2023-24.

However, the latest estimates from RF and other institutions suggest that the £26.6 billion headroom against the 2 percent target bequeathed by Chancellor Hammond to his successor has been more than consumed by a combination of disappointing fiscal outturns since March 2019, changes by the ONS to the accounting treatment of student loans, and additional spending announced by the new Chancellor Sajid Javid in his Spending Round for 2020-21.[28] Chancellor Javid has announced his intention to replace the current rules with a new fiscal framework to be announced alongside the 2019 Budget.

27 https://obr.uk/frr/fiscal-risk-report-july-2017/
28 A Corlett, D Tomlinson, M Whittaker & T Bell, *Rounding up: Putting the 2019 Spending Round into context*, Resolution Foundation, September 2019; C Emmerson, C Farquharson & P Johnson, *Green Budget 2019*, Institute for Fiscal Studies, October 2019; and A Hantzsche & G Young, *Why the Chancellor will not meet the fiscal mandate*, National Institute for Economic and Social Research blog, August 2019.

Lessons for the next set of fiscal rules

By comparison with many other countries, the UK has made relatively effective use of fiscal rules to meet its public finance objectives. Labour's fiscal rules were in place for a decade and enabled the Government to rebuild public investment while keeping government debt well below the European average. Like most other fiscal regimes at the time, Labour's fiscal rules were a casualty of the 2008 crisis and subsequent change of government. The new Coalition Government also made effective use of a succession of rules to plan and deliver a sustained reduction in borrowing and stabilise the debt-to-GDP ratio since 2010. The legal mechanism of the Charter of Budget Responsibility increased the degree of collective political commitment to these rules, which was especially critical in a Coalition government where no one party had a majority in Parliament. The establishment of the OBR corrected the optimism bias in official macroeconomic and fiscal forecasts and prevented the government from "marking its own homework" when it came to judging its performance against its fiscal rules.

While important progress has been made in improving the design of fiscal rules and in putting in place supporting institutions, the fact that the UK has had five different sets of fiscal rules over the past 20 years (and three in the last six years) testifies to the challenges that the governments of all parties have faced in nailing their fiscal colours to the mast. As these parties consider what rules should guide government fiscal policy into the 2020s, they should look to correct a number of persistent deficiencies that have characterised successive fiscal frameworks in the UK. This final section identifies ten lessons from the UK's two decades of experience for the next generation of fiscal rules.

1) What gets excluded gets exploited

Limitations in the scope of fiscal aggregates targeted under the rules created incentives to conduct significant fiscal activity outside the scope of the rules. This was the case with capital expenditure during the Labour Government which was outside the scope of the Golden Rule and became subject to sometimes wildly optimistic forecasts about how quickly it could be ramped up after years of underinvestment.[29] This was also the case with PFI in the Labour years, whose long-term obligations did not count as a liability within the definition of public sector net debt used to calculate the Sustainable Investment Rule. The focus on public sector net debt as the principal stock measure within the fiscal frameworks of all three governments also failed to account for the impact of the acquisition, creation, and disposal of significant financial assets (e.g. student loans), non-financial assets (e.g. social housing) and non-debt liabilities (e.g., public service pensions) on the public sector balance sheet. The recent RF paper

29 R Crawford, P Johnson & B Zaranko, *The planning and control of UK public expenditure, 1993–2015*, Institute for Fiscal Studies, July 2018.

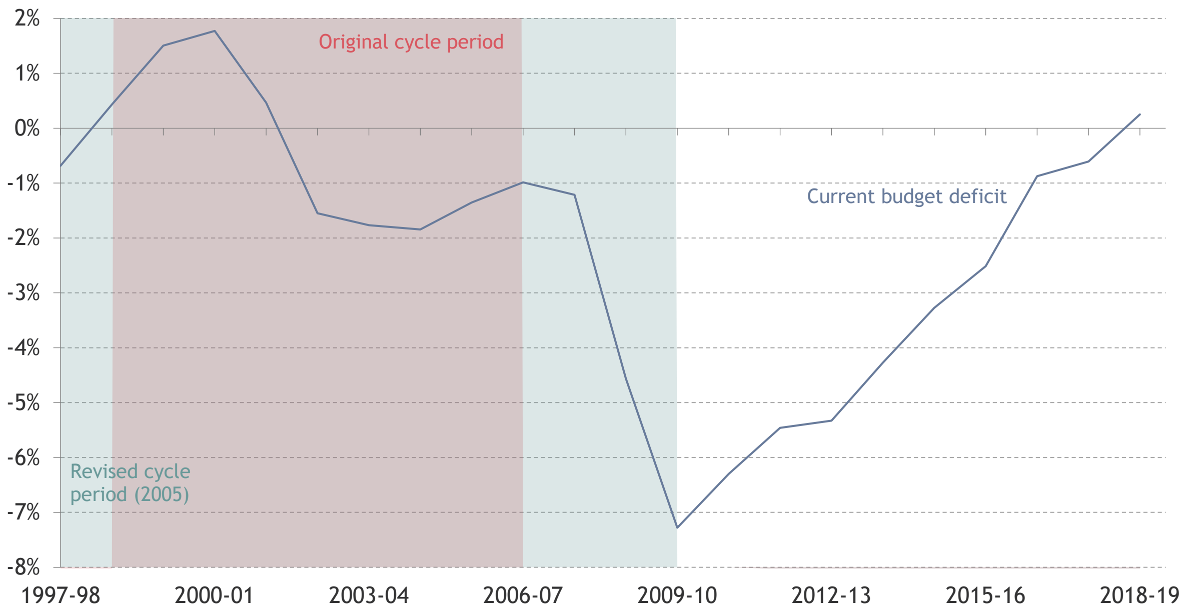
Seeking public value: The case for balance sheet targeting in fiscal policy discusses the benefits of targeting a more comprehensive balance sheet measure within the fiscal framework.[30]

2) Point targets pervert behaviour as deadlines loom

The tendency for both Labour and Conservative Governments to set fiscal rules which require them to land on specific numbers in particular years frequently give rise to disruptive, inefficient, and opaque budgeting practices. In the case of Brown's Golden Rule, the requirement to balance the current budget on average over the economic cycle prompted the Treasury to change the start and end dates of the cycle to bring in more surplus and exclude more deficit years (Figure 8). In the case of Osborne's headline surplus rule, attempts to deliver a small surplus in 2019-20 prompted the Treasury to make purely cosmetic changes to the timing of quarterly corporation tax payments and impose an unallocated top-slice on departmental budgets in that year (which ultimately proved impossible to deliver). The government's attempts to get debt falling in a particular year (by means other than reducing the deficit) led to repeated revisions to the size and time scale of various financial and non-financial asset sales, with potential consequences for the value of the sale.

FIGURE 8: **Labour's Golden Rule prompted changes to the timing of the cycle**

Current budget deficit and Labour's estimated economic cycle period: proportion of GDP



SOURCE: OBR, *Public finances databank*

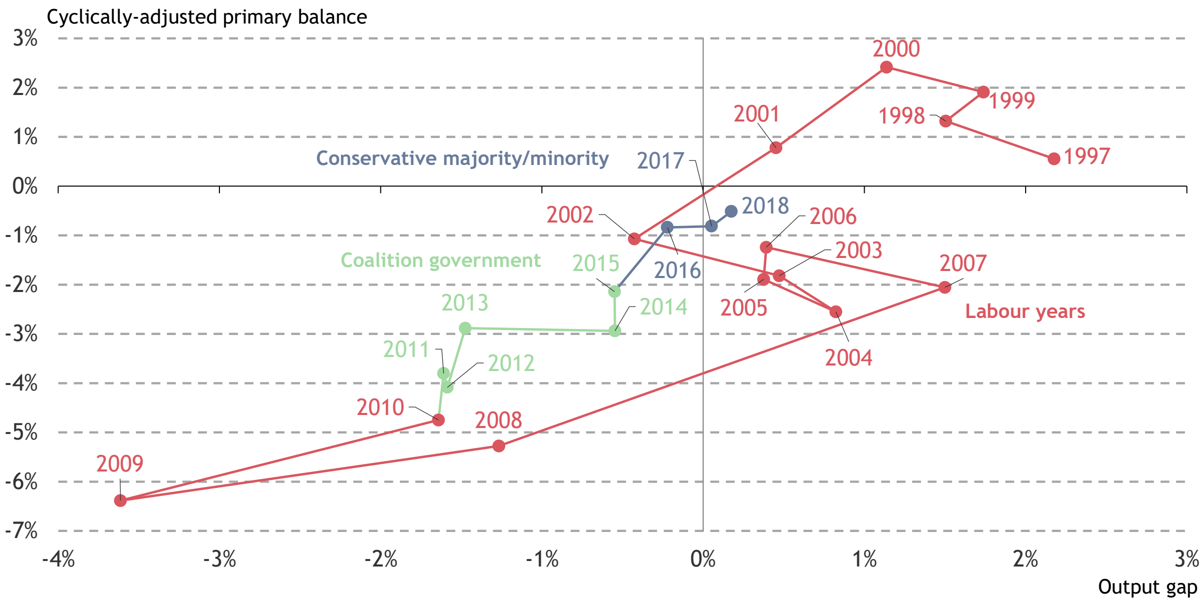
30 See footnote 5.

3) Rules can be too backward or too forward-looking

Labour's Golden Rule was too backward-looking while the Coalition's 5-year rolling target was too forward-looking as a guide for the appropriate fiscal stance. Fiscal rules need to take account of not only the current state of the economy and public finances but also the legacy of past fiscal policy errors and future evolution of the public finances. However, by taking the GDP-weighted average of all of the current surpluses/deficits over the economic cycle, Labour's Golden Rule actually allowed the government to run an increasingly pro-cyclical fiscal policy from 2002 onwards as it "cashed in" the current surplus it built up in the late 1990s and early 2000s, as shown in Figure 9. By contrast, the Coalition's rolling 5-year structural current balance rule in force from 2010-14 allowed for the deadline for meeting target to retreat into the distance with each successive forecast, regardless of the current cyclical position of the economy (Figure 10).

FIGURE 9: **Labour's Golden Rule allowed to become pro-cyclical post 2002**

Output gap and cyclically-adjusted primary balance: proportion of GDP, 1997 to 2018

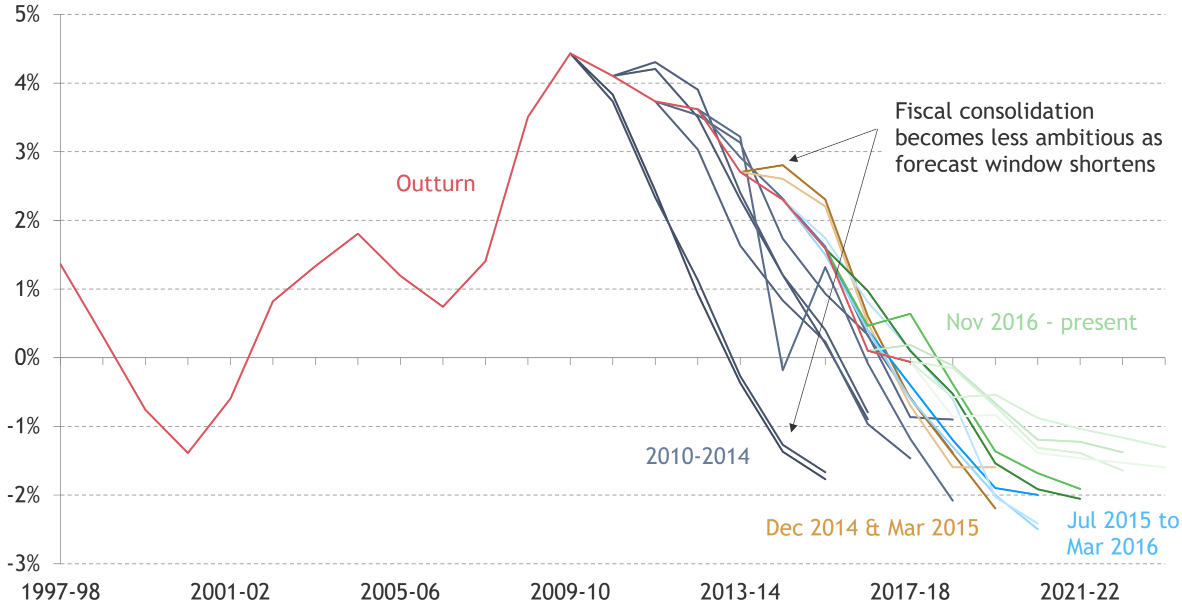


NOTES: Years refer to the first part of the government financial year (i.e. 1997 is the 1997-98 financial year).

SOURCE: OBR, *Public finances databank*

FIGURE 10: **The Coalition's rolling target allowed successive loosening of policy**

Outturns and successive forecasts of cyclically-adjusted current balance: proportion of GDP



NOTES: Forecasts are adjusted to reflect subsequent reclassifications in the underlying series.
SOURCE: OBR, *Historical official forecasts database*

4) Fiscal policy has been run too close to the wire

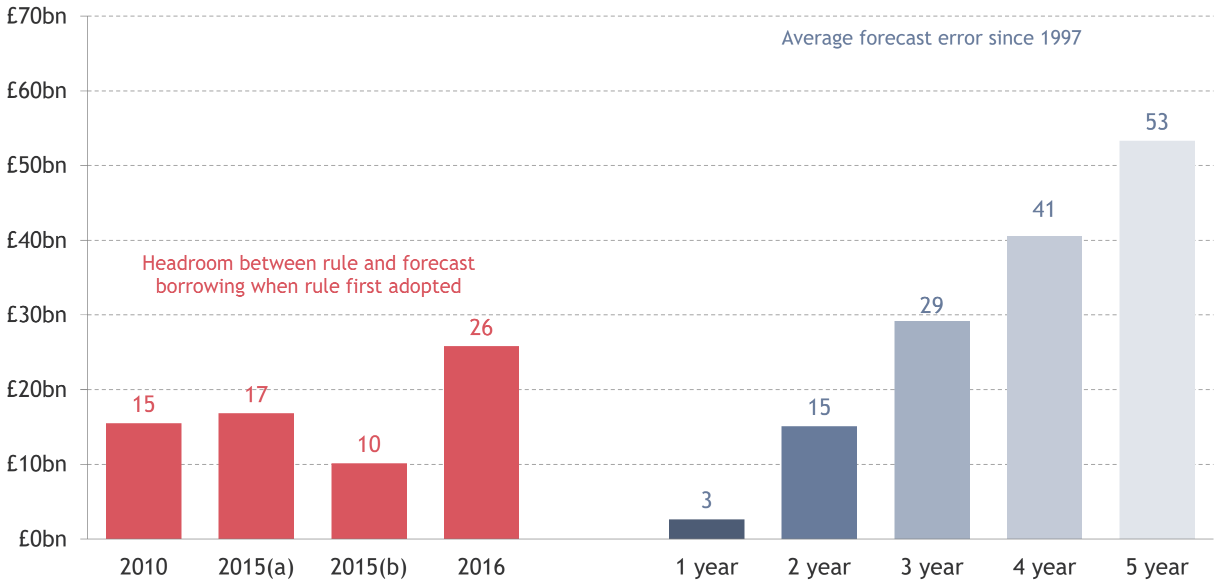
Governments have typically run the public finances "close to the wire" and failed to build sufficient headroom into their forecasts to ensure they meet their fiscal rules with a high degree of confidence. When first setting their fiscal rules, Labour, Coalition and Conservative Chancellors typically gave themselves less than 1 per cent of GDP in headroom against their targets despite the fact that the average five-year forecast error for borrowing has been around 3 per cent of GDP since 1997-98 (Figure 11). Given the optimism bias inherent in fiscal forecasting, it is therefore not surprising that all three of the UK's time-bound fiscal rules in 1998, 2010, and 2016 have been, or are likely to be, missed in the target year.

Despite recent advances in fiscal risk analysis, including the OBR's presentation of probabilistic "fan charts" for borrowing in their Economic and Fiscal Outlook since 2010 and publication of a comprehensive Fiscal Risks Report in 2017, no Chancellor has made effective use of different forms of fiscal risks analysis to calibrate their fiscal stance so as to meet their rules with confidence. Indeed, within two months of taking office, Chancellor Sajid Javid had already spent most of the fiscal headroom bequeathed to him by his processor Philip Hammond - despite there still being 18 months left to the target date.[31]

31 See footnote 3.

FIGURE 11: **Chancellors never build in enough headroom against their rules**

Headroom of fiscal rules at introduction compared to average forecast errors



NOTES: Headroom is defined as the difference between the fiscal rule limit and forecast borrowing at the point the rule is introduced. Forecast errors are calculated as the deviation between the forecast value (for one to five years ahead) and the outturn. Errors are adjusted to be net of the estimates impact of reclassifications between the forecast period and the current headline historic data.

SOURCE: RF analysis of OBR, *Fiscal Risks Report* (July 2019) and *Historical official forecasts database*

5) Fiscal policy needs to be more active in responding to shocks

One reason to build greater headroom against the next set of fiscal rules is to give the government more scope to use discretionary fiscal policy to respond to potential shocks. The cyclical adjustment component present in four of the UK's five fiscal rules is likely to under-state the *structural* fiscal space governments will require to support the economy in response to future economic shocks. This is true for a number of reasons:

First, the automatic stabilisers have been weakened by post-2010 reforms to the tax and benefit system which means that discretionary changes in tax and benefits are more likely to be required to protect the most vulnerable during downturns.[32]

Second, future economic shocks may combine shocks to both supply and demand, especially if they are brought on by a 'No Deal Brexit' or intensification of global trade wars. By only capturing the aggregate demand element of the shock, traditional cyclical adjustment does not allow fiscal policy to play an active role in

32 J Smith, J Leslie, C Pacitti & F Rahman (2019).

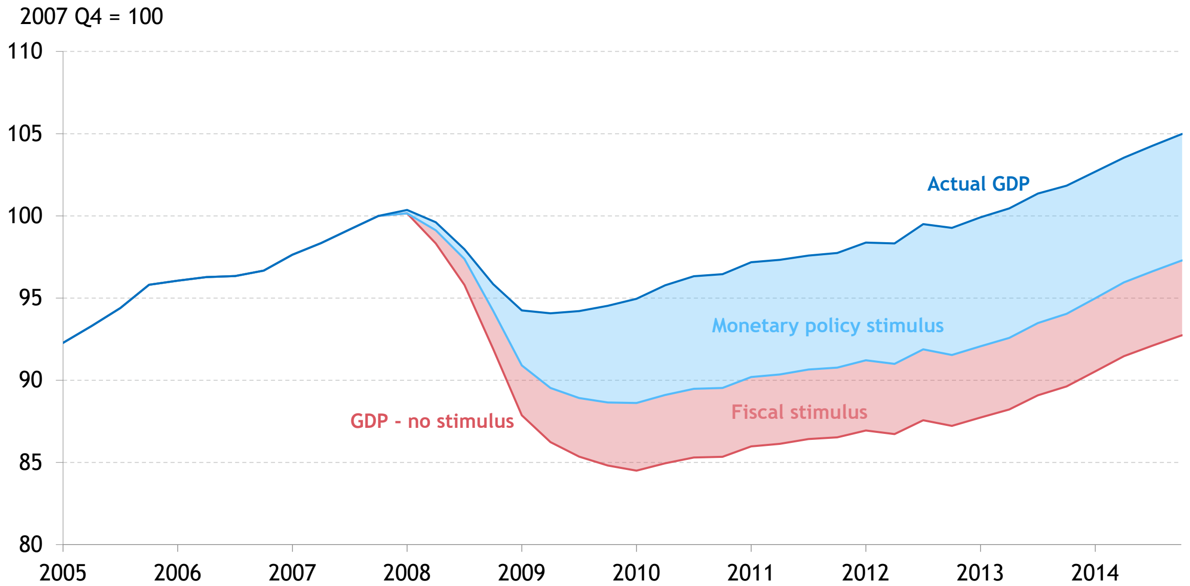
mitigating the temporary elements of any supply shock or facilitate adjustment to new external trading arrangements.[33]

Third, during previous economic downturns monetary policy has been the principal instrument for supporting aggregate demand (Figure 12). However, with interest rates close to the zero lower bound and the Bank of England already holding around a quarter of government debt, there is limited scope for monetary policy to loosen further in the next recession. In this environment, fiscal policy will need to play a more active role beyond merely allowing the full operation of the automatic stabilisers.

The UK's next fiscal framework therefore needs to not only recognise the significant risks to the fiscal outlook but actively provision for a more active fiscal response in the event that those risks materialise.

FIGURE 12: **Monetary policy led in supporting the economy post 2008**

Impact of monetary and fiscal policy during the Financial Crisis: index of real GDP (2007 Q4=100)



NOTES: Stimulatory impact of monetary and fiscal policies estimated to 2013. For monetary policy, these are taken from Bunn, Pugh and Yeates, March 2018; for fiscal policy these are calculated based on a simple mapping from the change in the cyclically adjusted primary balance (implying a 'fiscal multiplier' of 1). Excludes any long-run impact from the unwinding of policy stimulus.

SOURCES: RF analysis of ONS; OBR; P Bunn, A Pugh & C Yeates, *The distributional impact of monetary policy easing in the UK between 2008 and 2014*, Bank of England Working Papers no. 720, Bank of England, March 2018

33 R Hughes, J Leslie, C Pacitti & J Smith (2019), *Dealing with no deal: Understanding the policy response to leaving the EU without a formal agreement*, Resolution Foundation.

6) Escape clauses need to provide for greater survivability

In the case of exceptional macroeconomic shocks which cannot be accommodated within the headroom retained against the fiscal rule, fiscal frameworks need to include escape clauses which allow for temporary suspension of the rule under well-defined circumstances. While successive fiscal frameworks have incorporated escape clauses, the rules themselves have seldom survived the onset of an economic shock. Labour's Code for Fiscal Stability and the Coalition and Conservative Government's Charters for Budget Responsibility have both included escape clauses which allowed the rule to be temporarily suspended in the event of an economic shock. The 2015 Charter went so far as to specify the magnitude of shock required to justify the triggering of the clause – GDP growth of less than 1 per cent in any four-quarter period.

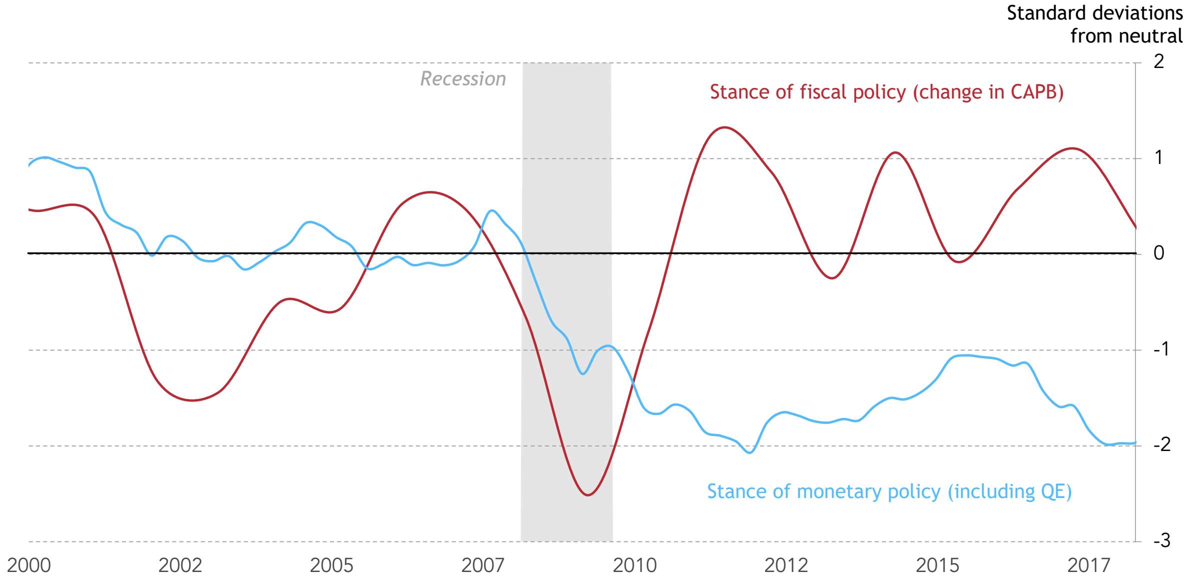
However, in all cases in which escape clauses have been invoked, the rules themselves were abandoned and replaced with new targets for borrowing and debt. This was partly due to the fact that rules tend to be designed either for "normal times" (as in the period 1998-2008) or periods of fiscal adjustment (as in the period 2010-15) but never both. As the next set of fiscal rules will need to guide fiscal policy through a period of economic uncertainty, they are going to need to cater for a range of possible macroeconomic scenarios and incorporate a more workable combination of targets and escape clauses. Otherwise, they are also likely to have a limited shelf-life.

7) Fiscal and monetary policy need to be more actively coordinated

Not only will fiscal policy need to be more active in supporting the economy in the event of a downturn, it will need to do so in much closer coordination with monetary policy. Any macroeconomic coherence between the government's fiscal and monetary policy targets over the last two decades has happened largely by accident rather than design. And there have been cases where the two were operating at cross purposes. This was less of a problem in the face of temporary, modest demand shocks in which the UK's fiscal and monetary policy regimes have generally allowed both to support aggregate demand. It has been more of a challenge in the face of lasting shocks that affect both supply and demand, as occurred in 2008. In this environment, the government's fiscal rules demanded a significant and rapid fiscal tightening within 18 months of the shock to bring borrowing back to its target level within 5 years. The Bank of England therefore had to make full use of the flexibility within its Monetary Policy Remit to keep monetary policy loose for an extended period and engage in successive rounds of quantitative easing and asset purchases to counterbalance the drag on output by conventional fiscal policy (Figure 13).

FIGURE 13: **Fiscal and monetary policy have not always been coordinated**

Measures of the 'stance' of monetary and fiscal policy: standard deviations from neutral



NOTES: Stance of monetary policy is given by the deviation of the short-term real interest rate from long-term equilibrium (as estimated by Holston, Laubach and Williams, 2017) plus an adjustment for QE. Stance of fiscal policy is given by the change in the cyclically adjusted primary balance (expressed as a proportion of GDP).[34]

SOURCE: RF analysis of OBR; Bank of England; Holston, Laubach & Williams, 2017.

It can be debated whether, over the last ten years, fiscal policy should have remained looser for longer to support demand and allow monetary policy to rebuild policy space. What is clear is that there will be a much greater need for active fiscal-monetary coordination in the next recession. This is true partly because both sides have more limited scope for action, which puts a premium on maximizing their joint impact on economic activity. It is also true because, as the Bank of England purchases a growing share of outstanding government debt, government borrowing and central bank asset purchases will need to be more explicitly coordinated to prevent gilt market illiquidity or disfunction. Greater fiscal-monetary coordination is also likely to be necessary given the direct impact that monetary policy can have on the fiscal aggregates being targeted under the government's fiscal rules. This was evident in the latest round of unconventional monetary policy through the Bank of England's Term Funding Scheme which created a temporary "hump" in the debt/GDP ratio between 2016-17 and 2021-22 and which ended up played a key role in helping the government to meet its debt-falling objective in 2020-21.

34 K Holston, T Laubach & J C Williams, "Measuring the Natural Rate of Interest: International Trends and Determinants", *Journal of International Economics* 108, pages 39-75, 2017.

8) Debt is a hard aggregate to target

Related to the above, all UK fiscal rules over the last decade have included a target for the level or trajectory of public sector net debt. However, these debt targets have proven hard to meet during periods of economic volatility. The last Labour Government managed to keep debt below the Sustainable Investment Rule limit of 40 per cent of GDP in large part due to a relatively high and stable rate of GDP and revenue growth. However, the onset of recession in 2008 saw debt rise as a share of GDP for almost a decade, breaching three successive rules for the level or trajectory of debt in the process. Relative to other fiscal aggregates, the difficultly in controlling the trajectory of debt is due to three main factors. First, being a stock rather than a flow, the level of debt is difficult to affect from one year to the next. Second, the debt/GDP ratio is sensitive to changes in both the numerator and denominator, both of which are large and typically move in opposite directions. Third, debt represents only one side of the public sector balance sheet and therefore does not benefit from offsetting changes in illiquid assets acquired through, for example, financial transactions, statistical reclassifications, or nationalisations.

9) Collective political commitment to rules has been lacking

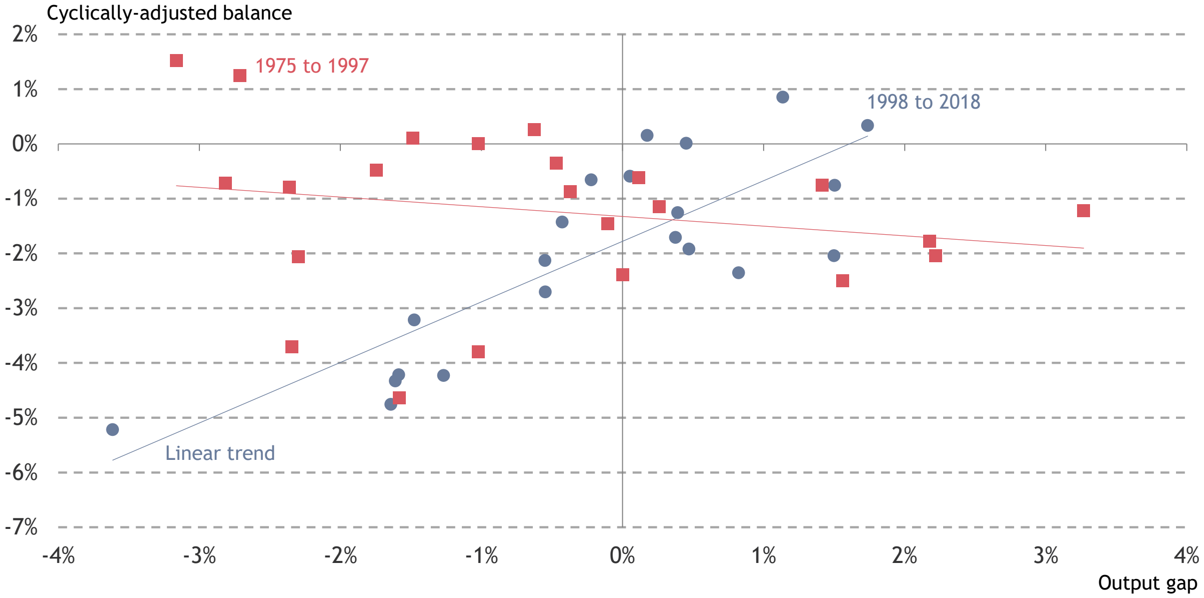
From their inception, fiscal rules in the UK have been closely associated with the government and Chancellor of the day – Gordon Brown's Golden Rule, George Osborne's surplus target, Philip Hammond's 2% deficit target. Beginning with Alistair Darling's 2009 Fiscal Responsibility Act, there have been more recent efforts to build wider political commitment around the overall objectives for fiscal policy. Nonetheless, Chancellors have typically relied upon the support of a disciplined majority of MPs from the governing parties to pass successive Charters of Budget Responsibility. The result has been fiscal rules which, so far, have never outlived the careers of the Chancellors who authored them. This approach stands in contrast to rules in place in countries like Germany and Switzerland where greater effort was put into building cross-partly support for their fiscal rules and enshrining these rules in their national constitutions. Were periods of effective minority or coalition governments to become the norm in UK politics, then Chancellors will need to find ways of building greater cross-party consensus for their proposed fiscal objectives.

10) Fiscal rules are necessary

Both the long period prior to the introduction of fiscal rules and the short period since the Johnson government has come to power have highlighted the risk of going without a clear guide for fiscal decision-making. In the two decades before the advent of fiscal rules in 1998, UK fiscal policy was slightly tighter (with an average structural deficit of 1.2 per cent of GDP) but also marginally pro-cyclical as shown by the relationship between the output gap and structural balance between 1975 and 1997 (Figure 14). Since the introduction of fiscal rules in 1998, fiscal policy has been slightly looser (with an average structural deficit of 2.0 percent) but has demonstrated a significantly more countercyclical pattern. More recently, the multitude of major spending announcements made by the Johnson government since taking office in July has highlighted the risks associated with suspending one set of fiscal rules without putting in place another. In his 2019 Spending Round announcement last month, Chancellor Sajid Javid announced an almost doubling in the real growth rate of spending on public services (Departmental Expenditure Limits) to 4.1 per cent – the highest growth rate in this spending since Labour's most generous Spending Review in 2002.[35] However, unlike at the time of the 2002 SR, no indication of the implications of this additional spending for the trajectory of the public finances beyond 2020-21 has been provided. Despite all the criticism levied at fiscal rules over the past twenty years, the only thing worse may be no rules at all.

FIGURE 14: **Fiscal policy has been more countercyclical in the fiscal rule era**

Cyclically-adjusted balance versus output gap: proportion of GDP



SOURCE: OBR, *Public finances databank*

35 A Corlett, D Tomlinson, M Whittaker & T Bell, *Rounding up: Putting the 2019 Spending Round into context*, Resolution Foundation, September 2019.

Conclusion

The UK was a pioneer in the development of fiscal rules when it introduced them in the late 1990s, and every government since has used fiscal rules to give expression to its fiscal philosophy and shape to its fiscal strategy. From the start, the UK's fiscal framework boasted a number of inherent advantages including:

- coverage of the entire public sector including all of central government, local authorities, and public corporations;
- use of independently defined and internationally recognised statistical aggregates as targets;
- clearly defined target values which combined objectives for both stock and flow measures of the fiscal performance;
- a medium-term orientation which facilitated longer-term planning of tax and spending policies;
- adjustment for the economic cycle, first by defining the rule over the cycle and later by defining the rule in cyclically-adjusted terms; and
- a supportive institutional environment for rules-based fiscal policy making including high quality fiscal data, a comprehensive and top-down multi-year budgeting process, strict controls over central government spending and borrowing by wider public sector entities, and regular long-term analysis of fiscal sustainability.

Over the years, the UK has also adapted and developed its fiscal rules and wider institutional framework to reflect the lessons of its own experience and those of other countries. This is evident in efforts over the last twenty years to:

- improve the credibility and transparency of official macroeconomic and fiscal forecasts by outsourcing them, together with responsibility for assessing performance against the rules, to the independent Office for Budget Responsibility in 2010;
- garner greater political and parliamentary commitment to the rules by enshrining them first in the Fiscal Responsibility Act in 2009 and later in successive Charters for Budget Responsibility starting in 2010;
- incorporate clearly defined escape clauses into the rules which allow them to be suspended during periods of exceptional macroeconomic instability; and

- improve the surveillance and management of fiscal risks which threaten the achievement of the government's fiscal targets through the publication of the biennial Fiscal Risks Report starting in 2017.

However, there are a number of persistent weaknesses in the UK's fiscal framework and changes in the wider economic and political environment for fiscal policymaking which need to be taken into account in designing the next set of fiscal rules. These include the need to:

- move beyond the narrow focus on public sector net debt to encompass a wider range of assets and liabilities which matter for the long-term sustainability of the public finances;
- avoid the perverse incentives that can come from being either too backward-looking, forward-looking, or focused on hitting a particular figure in a specific year;
- make use of recent innovations in fiscal risk analysis when calibrating the fiscal stance to ensure sufficient headroom is retained against the rule to cope with a plausible range of macroeconomic shocks;
- design the rules themselves and any escape clauses to allow fiscal policy to play a more active role in responding to macroeconomic shocks without abandoning the entire framework; and
- engender a wider and more durable political commitment to the rules through greater consultation about the rules themselves and firmer grounding in legislation.

The Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged.

We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

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