

A framework for fiscal sustainability

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March 2015

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Reform

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Executive Summary

The fundamental purpose of fiscal rules is to ensure that the spending promises made by the government of the day are sustainable. On that count, the current framework has comprehensively failed: the Office for Budget Responsibility (OBR) estimates that unless NHS productivity more than doubles, immediately and permanently, debt will exceed 200 per cent of GDP over the coming decades.

The problem is that UK fiscal policy is characterised by a short planning horizon: forecasts for the Budget and Autumn Statement look forward five years. Spending Reviews typically look forward only three years. Yet the demographic challenges the country faces will unfold over decades and the reforms to pension and health provision necessary for fiscal sustainability need to begin early to allow citizens to plan for them. Substantial reforms to entitlements at short notice will jeopardise the wellbeing of many people who have based their retirement plans on current policy.

Enabling politicians to bring the long-term challenges into short-term focus requires reframing the problem. The current fiscal framework provides no incentive to consider costs and benefits beyond a five-year horizon. A better approach to fiscal management would:

- abandon short-run deficit rules that limit the planning horizon, and
- replace them with an explicit long-run debt target.

Long-run debt targets bring the implications of future promises into the realm of current political challenges. The Government might, for example, require that the ratio of debt to GDP fall to 20 per cent within 50 years. Similar rules have been successful overseas but only when monitored by a strong, independent institution. This is what the OBR has become over the past five years, although this new role would require some key changes to its mandate. It would need to:

- evaluate current Government policies for their consistency with the debt target and for their impact on economic wellbeing,
- conduct all forecasts based on unchanged policy, rather than relying on ‘Treasury assumptions’,
- combine its five-year Economic and Fiscal Outlook forecasts with its 50-year Fiscal Sustainability Report projections so that every official forecast looks out 50 years, and
- define a new headline measure of progress based on the ‘fiscal gap’ to the long-term target, to replace existing short-term measures such as the cyclically-adjusted current deficit.

1
The fiscal challenge

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Fiscal policy in the UK is characterised by a short planning horizon that both jeopardises fiscal sustainability and damages wellbeing. Fiscal forecasts for the Budget and Autumn Statement look forward five years. Spending Reviews typically look forward only three years. Yet the major fiscal challenges facing the nation cannot be solved in such short time scales. The demographic challenges the country faces will unfold over decades and the necessary reforms to pension and health provision need to begin early to allow citizens to plan for them.

Improving the UK’s fiscal planning requires re-framing decisions to bring long-term challenges into focus today. It must allow the Government to implement solutions that will reap real benefits beyond their current term in office. For example, reforming pension entitlements must happen now so that today’s youth can plan their retirement with confidence. Yet such reforms are unlikely to improve the fiscal situation for at least twenty years. A better fiscal framework must make that type of change worthwhile for today’s politicians.

Short planning horizons also encourage politicians to tackle current policy challenges too quickly. The obvious case in point is deficit reduction, where a more measured programme of fiscal consolidation could avoid the costs to incomes and employment that result from over-rapid fiscal adjustments. Trying to eliminate the deficit in one Parliament is too fast, but existing planning horizons do not support a longer-term solution.

Reform’s 2014 report, *The Debt Ratchet*, recommended that strict deficit rules be abandoned, replaced by a principles-based approach enforced by the Office for Budget Responsibility (OBR).¹ This report expands that recommendation by proposing specific fiscal principles and describing how these would require the role of the OBR to change.

1.1 Deficit reduction

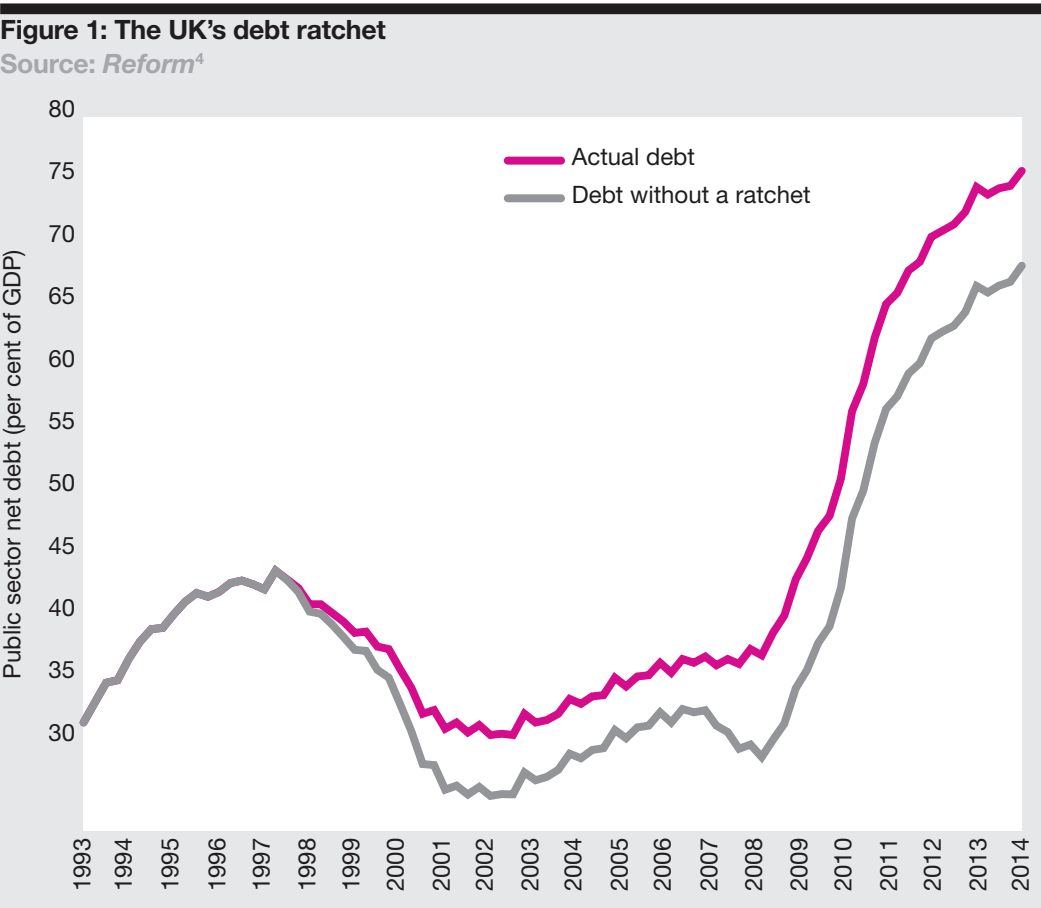
The Debt Ratchet analysed the recent history of UK debt and deficits. It found that the UK’s debt tends to grow in recessions but that growth is not reversed during booms. This effect is often referred to as ‘deficit bias’. For the past 20 years, this bias has resulted in deficits 70 per cent larger in recessions than the surpluses in booms.

For every percentage point that the economy shrunk below capacity in a recession, the deficit has grown by 1.1 per cent.² Yet, for every percentage point it expanded above its maximum capacity in a boom, the deficit shrunk by less than 0.7 per cent. The difference causes the national debt to grow over the business cycle.³

Figure 1 illustrates the difference between a balanced, countercyclical fiscal policy and the actual, ratcheted policy. It compares actual debt figures to the hypothetical level of debt if the UK were to save in booms to the same extent that it borrows in recessions. The result is that, by 2013, debt was 7.6 per cent of GDP greater than it would have been without the ratchet.

A separate but related issue of short termism in fiscal management is the definition of the deficit itself. The UK National Accounts, which are prepared in accordance with the European System of National and Regional Accounts, differ in a number of important ways from the financial reporting standards that apply to the rest of the economy. The main benefit to the Government is that a number of significant financial obligations are kept off-balance-sheet. These include £1,172 billion in public sector pension liabilities and £131 billion of provisions for nuclear decommissioning, clinical negligence, and other general liabilities.

1 Corrie, Fraser, and Zuccollo, *The Debt Ratchet*.
2 As measured by the output gap and the Government’s primary balance, respectively.
3 Corrie, Fraser, and Zuccollo, *The Debt Ratchet*.



For the last four years, the Government has prepared a parallel set of “Whole of Government Accounts”, compiled in accordance with generally accepted accounting standards. On this basis, the accounting deficit in 2012-13 (the latest year available) was £179 billion, considerably larger than the current deficit of £85 billion recorded in the National Accounts. As the Institute of Chartered Accountants in England and Wales notes:

“Financial analysis based on Whole of Government Accounts has the potential to change the public debate on the government’s finances from a narrow focus on balancing the public finance deficit in the National Accounts to a more comprehensive discussion around how the government plans to deal with its longer term financial challenges, using a similar financial language to that used by millions of people outside of government.”⁵

However, while the 2012-13 Whole of Government Accounts were judged by the Comptroller and Auditor General to present a “true and fair” picture of the Government’s financial position, there were a number of important qualifications to this opinion. Until these qualifications are resolved and until the Government is able to produce future accounts in a more timely fashion, the debate around deficit reduction must remain centred around the long established but less accurate National Accounts.

4 Ibid
5 Wheatcroft and Hodgkinson, “The Government’s Financial Accounts,” 5.

1.2 Fiscal sustainability

1.2.1 Long-term debt

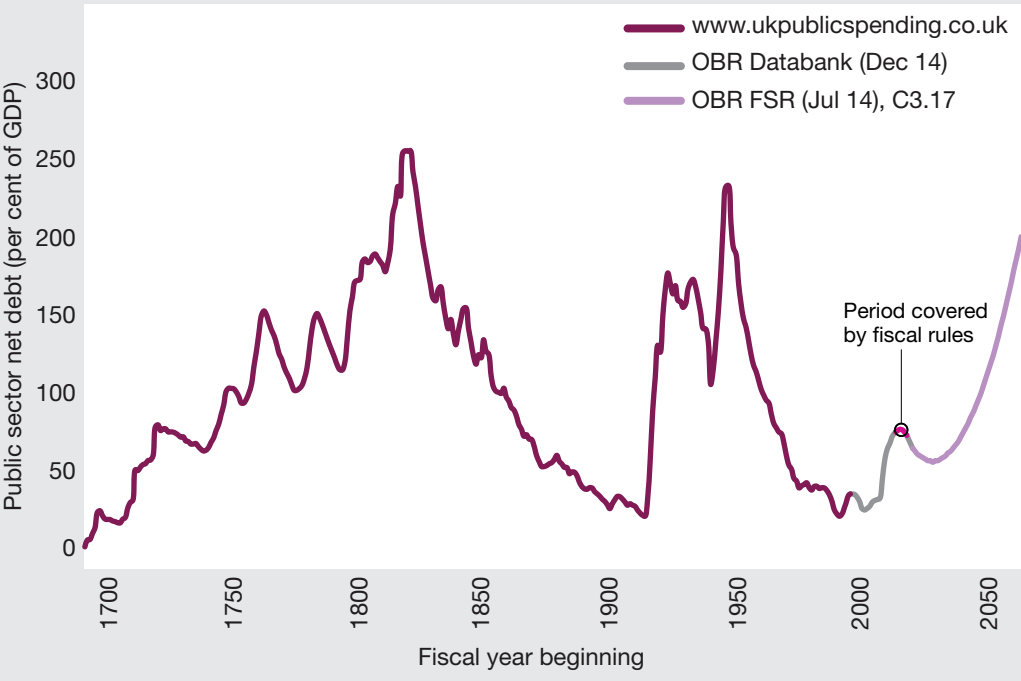
In each year since it was created in 2010, the OBR has judged the public finances to be unsustainable. For example, in 2011, it said:

“In the absence of offsetting tax increases or spending cuts [these pressures] would eventually put public sector net debt on an unsustainable upward trajectory. It is likely that such a path would lead to lower long-term economic growth and higher interest rates, exacerbating the fiscal problem.”⁶

In fact, the situation may be worse than the OBR suggests. Its ‘central scenario’ assumes an unprecedented rate of growth in healthcare productivity (discussed further below). A more conservative assumption in line with the long-run historical average⁷ would see levels of debt to rival those of the war years (Figure 2).

Figure 2: Three hundred years of UK public debt

Source: Office for Budget Responsibility, ukpublicspending.co.uk⁸



1.2.2 The challenges of an ageing population

The median age in the UK is projected to rise to 42.2 years by 2035, from 39.7 in 2010, with significant growth in the share of its population age 65 and above.⁹ In addition, the share of the population that is of working age is projected to fall over the same period (Table 1). As a result, the UK’s dependency ratio will rise significantly.

6 Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2011.
7 In its *Fiscal Sustainability Report*, July 2014, the Office for Budget Responsibility estimates that healthcare productivity “has risen by about 1.0 per cent per year on average between 1979 and 2010”.
8 Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2014. Riley and Chote, *Crisis and Consolidation in the Public Finances*, 7 and 59.
9 Nolan, Thorpe, and Trehwhitt, *Entitlement Reform*.

Table 1 Demographic changes in the UK

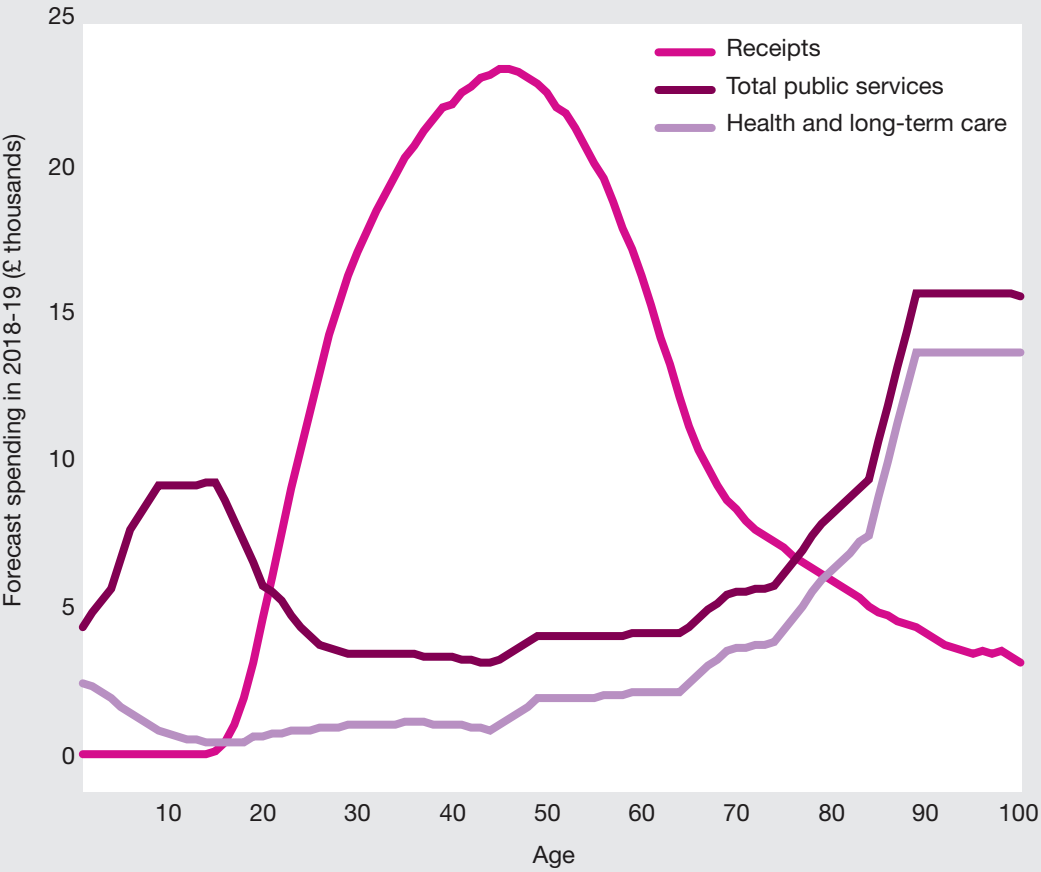
Source: *Reform*¹⁰

	65+, % of total	85+, % of total	Working age, % of total	Working age under 55, % of total	Old age dependency ratio	Inverse old age dependency ratio
2010	16.6	2.3	66.0	54.2	0.25	3.99
2015	18.0	2.5	64.3	52.9	0.28	3.57
2020	18.9	2.8	62.9	50.7	0.30	3.34
2030	21.7	3.9	61.1	49.3	0.36	2.81
2040	23.6	5.1	60.1	49.3	0.39	2.54
2050	24.2	6.4	59.4	47.6	0.41	2.45

The age profiles for tax and public service spending make clear why the demographic changes can be expected to threaten the public finances. Spending on public services for those aged over 75 outstrips revenue from that group and, over the age of 85, spending rises particularly steeply, primarily because of health and long-term care costs, with the remainder largely accounted for by the cost of providing state pensions (Figure 3). Net transfers to retired families have grown in real terms, from £5,422 in 1990 to £10,009 in 2010.¹¹

Figure 3: Age profile of tax and spending

Source: Office for Budget Responsibility¹²



10 Ibid.
11 Corrie and Nolan, *Seismic Shifts in the Welfare State*.
12 Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2014, fig. 3.6.

To improve fiscal sustainability the Government will need to address the rising cost of healthcare and state pensions in an aging population. At present, those liabilities are unfunded and projected to grow as a percentage of GDP. The Institute for Fiscal Studies (IFS) has estimated that government spending on pensioner benefits will increase by 8.7 per cent over the period 2010-11 to 2015-16 and by a further 2.3 per cent from 2015-16 to 2018-19.¹³

1.2.2.1 Healthcare costs

The NHS budget is one of the largest areas of Government spending, consuming 7.9 per cent of GDP, and 19.5 per cent of the 2014 Budget.¹⁴ Moreover, NHS spending poses the greatest risk to the long-term sustainability of the public finances.

The difficulty of controlling long-run health expenditure is the reason that the OBR considers it the primary risk to fiscal sustainability. In its analysis of fiscal sustainability, the OBR assumes that future productivity in the health sector will average 2.2 per cent growth each year, matching the rest of the economy. Under that assumption, healthcare expenditure will rise to 8.5 per cent of GDP by 2063-64. However, as noted above, actual productivity growth has been somewhat lower, at around 1.0 per cent per year.¹⁵ If that trend were to persist the OBR estimates that spending on the health system will rise to 14.4 per cent of GDP by 2063-64. Similarly, long-term care costs are expected by the OBR to rise by 92 per cent over the course of the projections. Given the borrowing that implies, national debt would exceed 200 per cent of GDP by 2063-64 (Figure 2).¹⁶

1.2.2.2 Pension costs

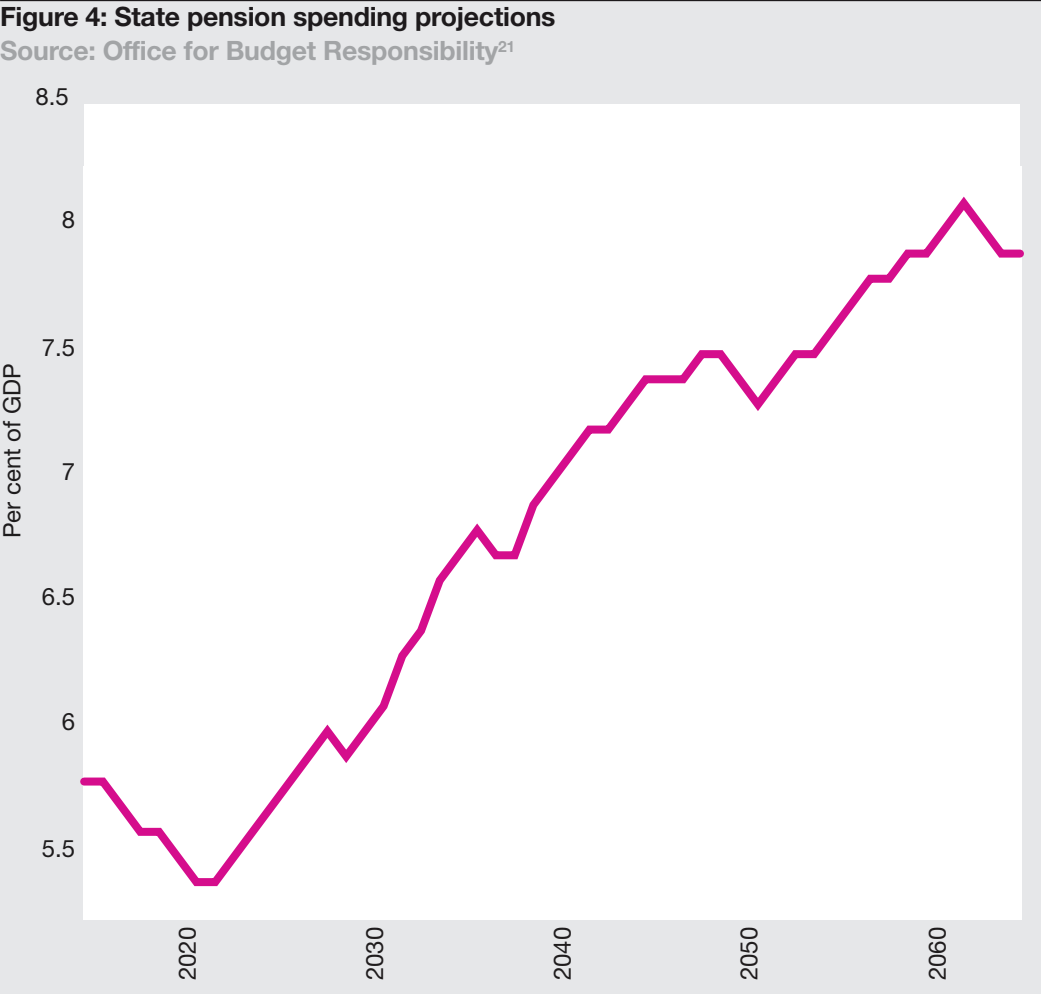
Government spending on pensioners has been protected in this Parliament, relative to other parts of the welfare budget, and pensioner poverty is now at its lowest level since the early 1980s.¹⁷ Upon coming to power, the Government accepted its predecessor’s decision to increase the retirement ages of men and women to 68 by 2048. The Government has also committed to increasing the State Pension Age in line with longevity. This decision has mitigated some of the future costs of an older population.

From April 2016, the new Single Tier pension will be introduced, replacing the previous system of a Basic State Pension and additional pension. This is expected to make some savings to future costs, but only from 2040. More importantly, the Government has committed to indexing the State Pension to whichever is highest of CPI inflation, average earnings, or 2.5 per cent. As the OBR points out in the 2014 Welfare Trends report:

“Between 2007-08 and 2012-13, a period that spans the late 2000s recession and slow recovery that followed, spending increased by 2.5 per cent of GDP ... The largest contribution was from the uprating of state pensions as inflation outstripped growth in earnings and GDP.”¹⁸

In the long term, spending on state pensions¹⁹ is projected to rise from 5.5 per cent of GDP in 2018-19 to 7.9 per cent of GDP in 2063-64.²⁰

13 The IFS Green Budget.
14 Office for Budget Responsibility, Office for Budget Responsibility. Ibid.
15 In Public Service Productivity Estimates: Healthcare, 2012, the Office for National Statistics estimates that the average growth rate for public service healthcare productivity was 0.8 per cent per year between 1995 and 2012.
16 Office for Budget Responsibility, Fiscal Sustainability Report, July 2014, para. 3.101.
17 Cribb, Hood, and Joyce, Living Standards: Recent Trends and Future Challenges.
18 Office for Budget Responsibility, Welfare Trends Report, 6.
19 Including the State Pension, Pension Credit, Winter Fuel Allowance, Free Television Licences and the Christmas Bonus
20 Office for Budget Responsibility, Fiscal Sustainability Report, July 2014.



1.3 Economic wellbeing

Sustainability is the core goal of fiscal policy but it also affects growth, earnings, and employment:

- In the short run, fiscal policy can support jobs and incomes through a recession when monetary policy is ineffective, as many argue is the case when interest rates approach zero.
- In the long run, investment in physical and human capital through infrastructure and education are crucial for prosperity.

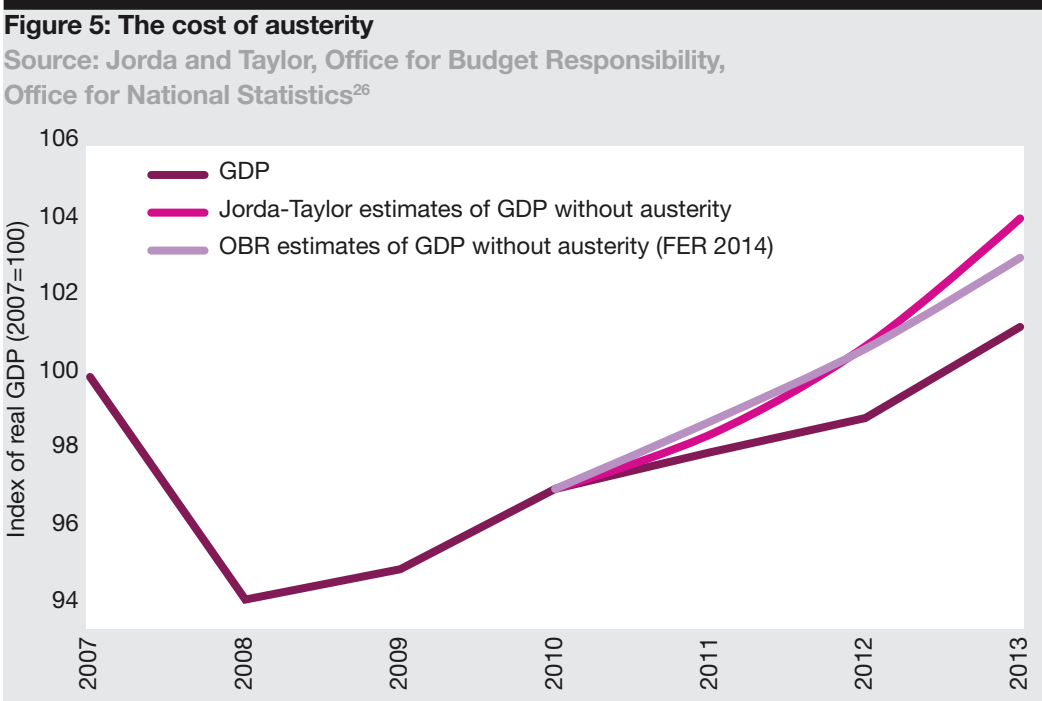
1.3.1 Fiscal policy at the zero-lower bound

Ordinarily, it would be the role of expansionary monetary policy to offset any effect of contractionary fiscal policy. However, the 2007 financial crisis saw many central banks, including the Bank of England, lower their policy rates to the effective floor, and pursue a programme of quantitative easing. In these circumstances, monetary policy is unlikely to be able to fully offset the effect of fiscal consolidation.

That means that reductions in Government expenditure have a more direct impact on economic growth. These unusual circumstances have led many macroeconomists to call for fiscal policy to be used more actively to support growth in incomes and employment through the recession, at least until monetary policy is once again effective.²²

21 Ibid., fig. 3.7.
22 For example, Jordà and Taylor, The Time for Austerity.

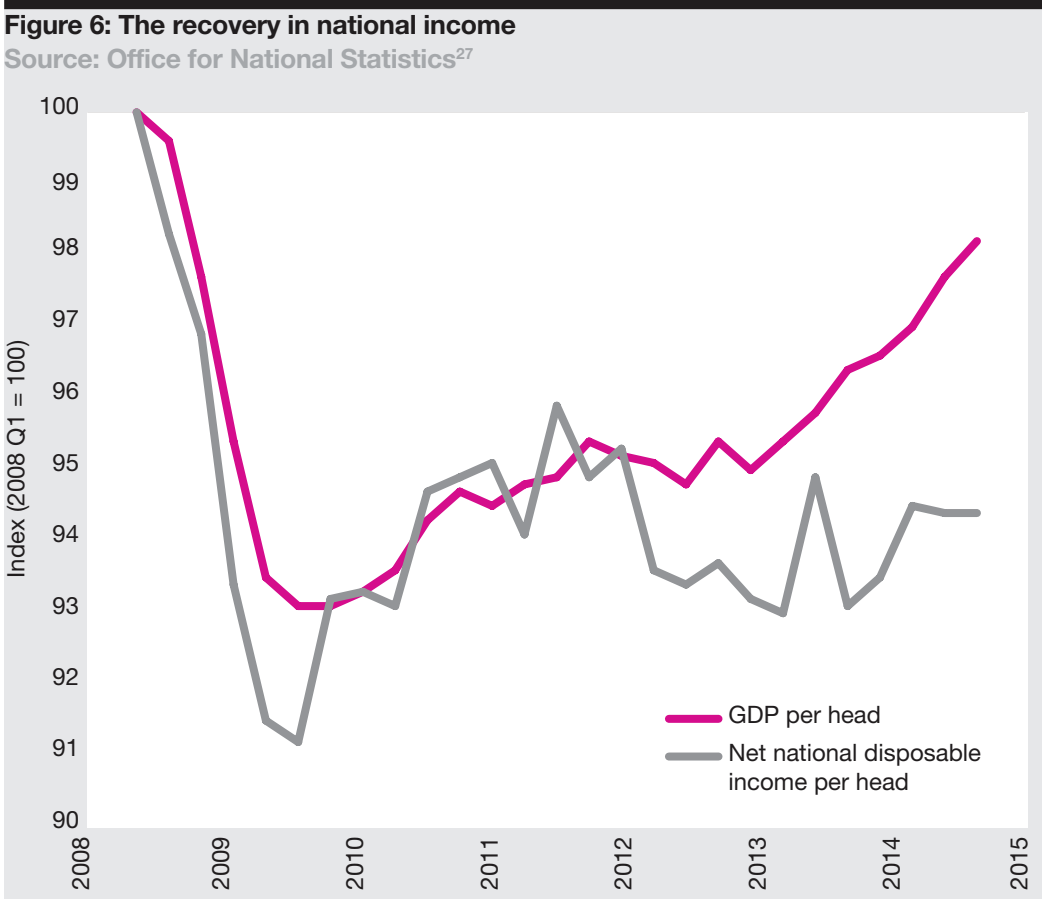
By contrast, all three major political parties went into the last General Election with similar plans to close the deficit from 2010 through fiscal contraction.²³ The best current estimates suggest that GDP in 2013 was 2-3 per cent lower than it would have been had fiscal consolidation not been pursued over the intervening three years (Figure 5).²⁴ That is up to £1,300 of income per person by 2013.²⁵



Rigorous analyses of the effect on other measures of economic wellbeing have not yet been conducted but a survey of the key measures suggests that their growth has been even more muted than that of GDP.

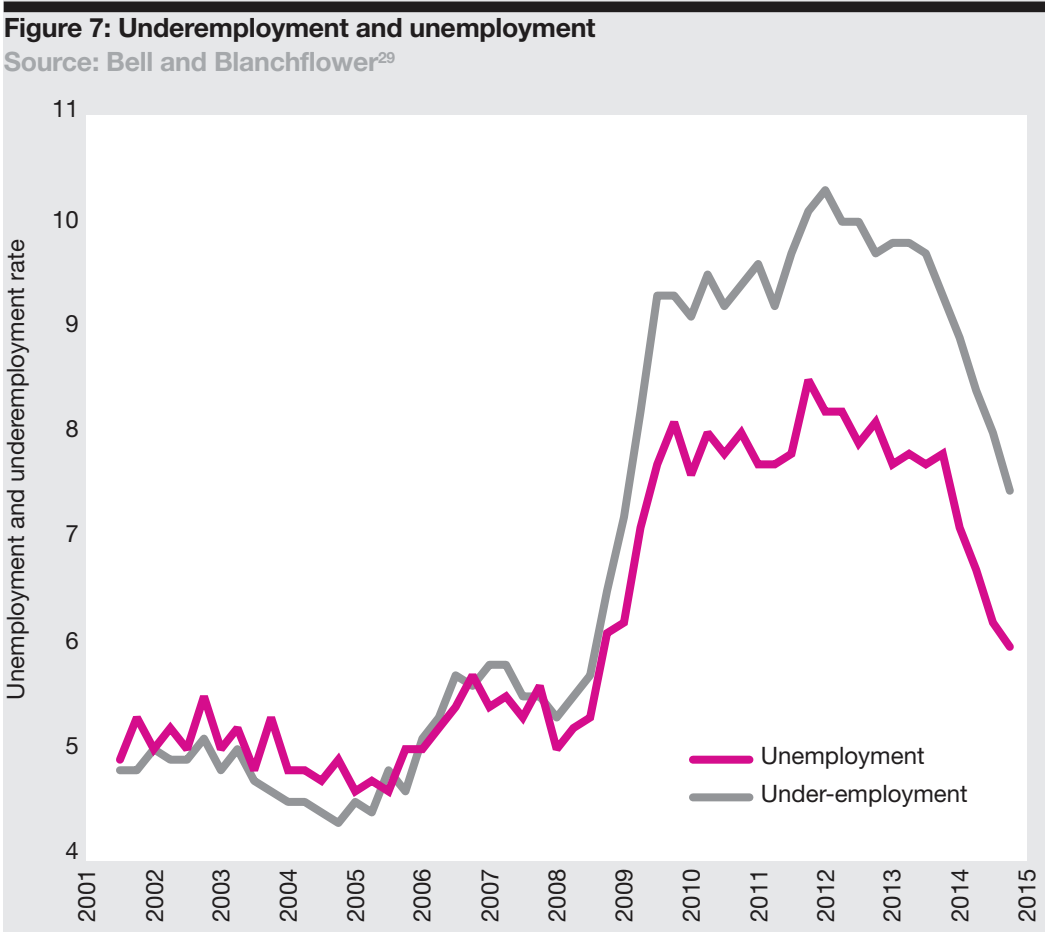
Figure 6 shows that the disposable income of households has not grown along with GDP. The divergence is due to population growth and the quantity of UK output that is owned by foreigners.

23 Chote et al., *Filling the Hole*.
24 Jordà and Taylor, *The Time for Austerity*. Ibid.
25 Cumulative cost so far. The annual cost for 2013 is £730 per person.
26 Jordà and Taylor, *The Time for Austerity*; Office for Budget Responsibility, *Forecast Evaluation Report*, fig. 2.9.



Unemployment has recovered sharply in the past 18 months. The Bell-Blanchflower index indicates that many people still have not been able to work as many hours as they would like to but, generally, the employment data is showing a far more positive picture of the recovery than income data (Figure 7). That is particularly good news because the evidence shows that employment is far more important to people's wellbeing than incomes.²⁸

27 Office for National Statistics, *Economic Well-Being*, Q3 2014.
28 Layard et al., "What Predicts a Successful Life?"



1.3.2 The long-run effects of fiscal policy on economic wellbeing

The long-run effects on economic wellbeing are likely to be felt through capital investment, which is best done during recessions. In its latest World Economic Outlook the International Monetary Fund (IMF) concluded that:

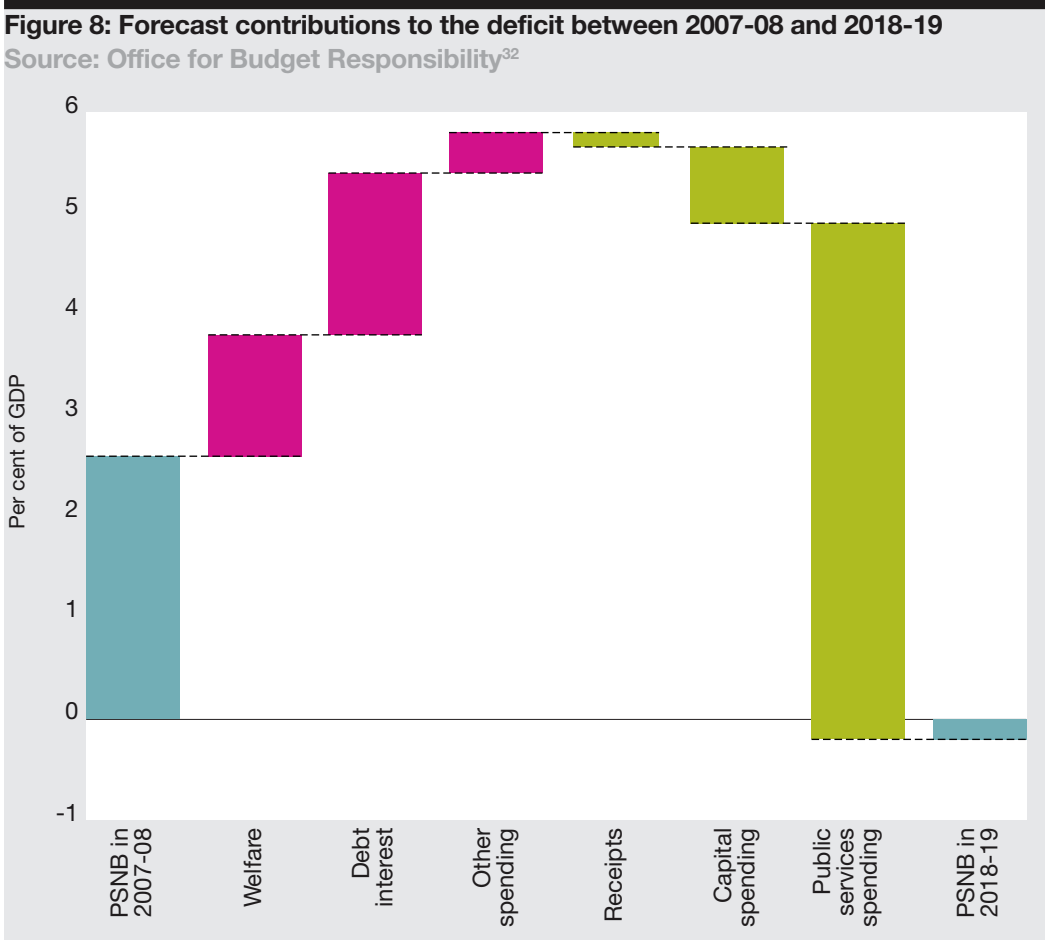
During periods of low growth, a public investment spending shock [of 1 per cent of GDP] increases the level of output by about 1.5 per cent in the same year and by 3 per cent in the medium term, but during periods of high growth the long-term effect is not statistically significantly different from zero. Public investment shocks also bring about a reduction in the public-debt-to-GDP ratio during periods of low growth because of the much bigger boost in output.³⁰

The IFS Green Budget 2013 estimated that the fiscal cost of public investment would be low:

[An] additional £10 billion of capital spending in both 2013–14 and 2014–15 would increase the level of GDP by almost 1% by the end of 2014 ... and, with stronger growth yielding higher tax receipts, the impact on the deficit would have been relatively small.³¹

Figure 8 summarises the key fiscal measures implemented by the Government as it sought to reduce the deficit. They show that the Government made significant cuts to investment over the course of the recession and plans further cuts over the coming decade.

²⁹ Bell and Blanchflower, "The Bell-Blanchflower Underemployment Index."
³⁰ International Monetary Fund, *World Economic Outlook: Legacies, Clouds, Uncertainties*, 82.
³¹ *The IFS Green Budget*, 30.



On balance, the evidence suggests that fiscal policy after the 2008-09 recession has had a detrimental effect on growth and wellbeing. Much of this is due to the unusual macroeconomic circumstances, with the Bank of England arguing that there was little more it could do to offset the Government's actions. However, such circumstances may become more common in future if long-term interest rates continue to fall, as they have for the past fifty years. Theories of "secular stagnation" are beginning to gain currency among economists and suggest that the developed world may be headed for an extended period of low rates, which could reduce the effectiveness of monetary policy for smoothing business cycles.³³ That possibility reinforces the need to improve the fiscal framework's flexibility to deal with episodes of deep recession.

³² Riley and Chote, *Crisis and Consolidation in the Public Finances*, 7 and 59.
³³ Summers, "U.S. Economic Prospects."

2

The evolution of fiscal frameworks

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The problem of deficit bias has been well documented internationally: across the OECD, the average debt burden rose from 40 per cent of GDP to 75 per cent between the 1970s and 1990s. That led many countries to look for solutions to the deficit bias.³⁴ Three have proven particularly popular:

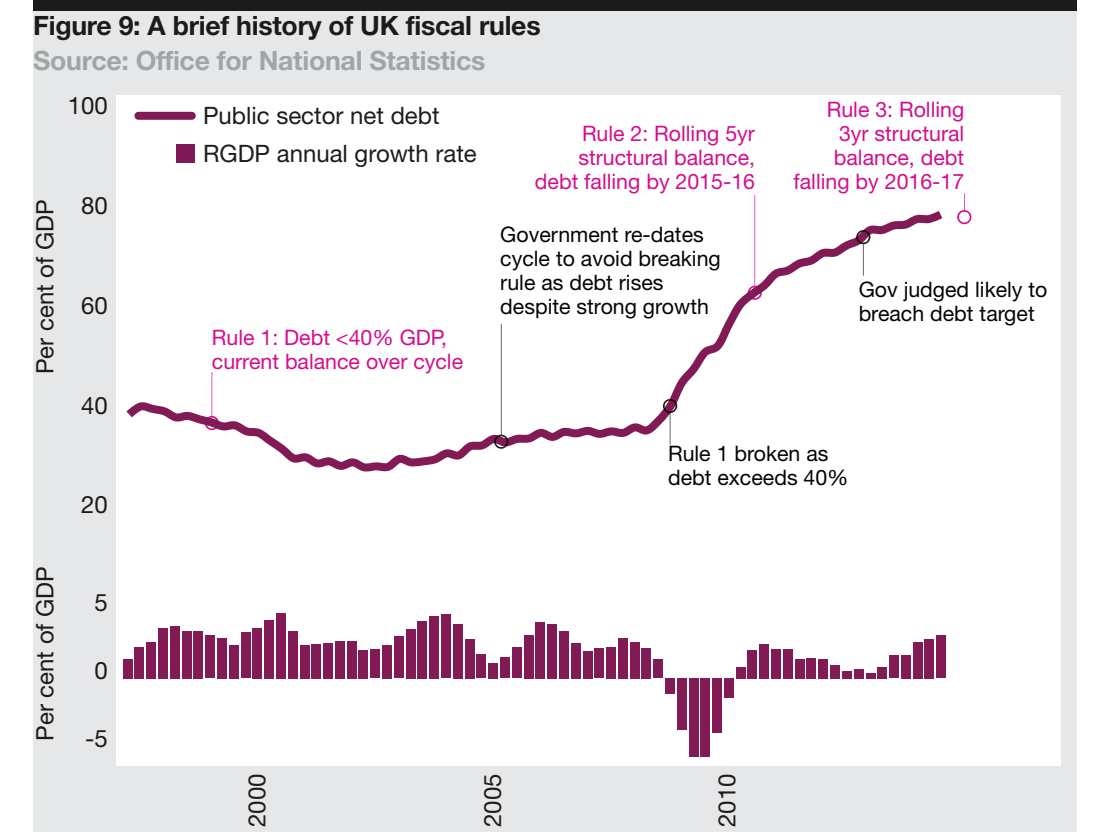
- Increased transparency to encourage public scrutiny and accountability
- Fiscal rules to constrain the actions of the Government
- Independent fiscal councils to enforce the rules and scrutinise the Government's actions.

2.1 Transparency, rules, and institutions

Rules experienced a boom in popularity through the 1990s as developed nations scrambled to deal with deficit bias. Between 1990 and 2013 the number of countries with fiscal rules increased from 9 to 87.³⁵ They were reasonably successful in reducing the debt burden of many nations and reviews by the IMF have pointed to three factors that contributed to an effective rule:³⁶

- The simplicity to be publically credible and enforceable
- The flexibility to respond to economic shocks
- Effective mechanisms for monitoring compliance.

Despite the initial success of fiscal rules, constructing a durable rule has proved challenging. The UK has discarded two sets of rules since the financial crisis began (Figure 9) and the latest iteration is likely to be short-lived.



³⁴ Calmfors and Wren-Lewis, What Should Fiscal Councils Do?

³⁵ Schaechter et al., Fiscal Rules in Response to the Crisis—Toward the “Next-Generation” Rules.

³⁶ Kumar et al., Fiscal Rules—Anchoring Expectations for Sustainable Public Finances.

The difficulty is that there are competing pressures on a fiscal rule and it must be designed for the specific circumstances of a country. When those circumstances change, the appropriate form of the rule changes. For example, a country with a strong deficit bias will need a stricter rule than a country with a history of prudence.³⁷ However, a stricter rule has less capacity to respond to changing economic circumstances and could prove extremely costly in a financial crisis. When the financial crisis struck in 2008, many countries, including the UK, encountered problems such as these with their fiscal frameworks and were forced to alter or suspend their fiscal rules.

The impossibility of designing a perfect fiscal rule led to the rise of independent fiscal councils, such as the OBR. The number of fiscal councils more than doubled between 2008 and 2013 as countries sought to restructure their fiscal frameworks.³⁸ The council can provide effective, independent monitoring of compliance with a rule. It can also create transparency, which allows for effective public scrutiny and builds trust in the fiscal framework.

A credible, independent fiscal council allows the fiscal rule to be more flexible because the council can monitor for compliance and expose gaming of the rule. A flexible rule is more likely to cope with economic shocks and can be appropriate to a broader set of circumstances. An extreme example is the framework used by New Zealand.

The New Zealand Public Finance Act sets out 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. With the exception of these principles of responsible fiscal management, the Act is not prescriptive about what the fiscal objectives and fiscal intentions should be. Rather, it requires the government of the day to state its objectives and intentions, whether they have changed, and how they accord with responsible fiscal management.³⁹

New Zealand lacks a fiscal council but, in a recent review of New Zealand’s fiscal framework, Teresa Ter-Minassian, the former Director of Fiscal Affairs at the IMF, praised

“...the operational independence of the Treasury in the preparation of the forecasts and other documents of its responsibility, its well-established non-partisan reputation, its increased openness to outside inputs, and its strong record of relatively (compared to other national forecasters) accurate and unbiased macroeconomic and fiscal forecasts.”

New Zealand’s framework demonstrates the effectiveness of combining a strong fiscal institution with a broad, flexible fiscal mandate.

Importantly, Ter-Minassian also cautioned that

“[A deficit rule] might weaken the Government’s ‘ownership’ of the debt target, and its preparedness to save revenue windfalls... It might create incentives for governments to comply with the rule through policies that would weaken other parts of the balance sheet.”⁴⁰

This raises an important question about the appropriate goal of fiscal policy. Most fiscal rules are specified in terms of the deficit to provide governments with an achievable, short-run target. For example, the UK has set a core target of eliminating the cyclically-adjusted current deficit within a three-year period. Deficit rules provide an operational target for the government but they are a proxy for the ultimate goal of fiscal sustainability, which relates to the level of debt.⁴¹

The advantage of an operational target is that it provides guidance for short-run government policy. The disadvantages are twofold. First, it limits the horizon of fiscal

37 Portes and Wren-Lewis, *Issues in the Design of Fiscal Policy Rules*.
38 Debrun et al., *The Functions and Impact of Fiscal Councils*.
39 Mears et al., “Fiscal Institutions in New Zealand and the Question of a Spending Cap.”
40 Ter-Minassian, *External Review of the Treasury’s Fiscal Policy Advice*.
41 Portes and Wren-Lewis, *Issues in the Design of Fiscal Policy Rules*.

policy, which reduces the incentive for governments to tackle long-run liabilities, such as those created by the aging population. Secondly, as Ter-Minassian points out, a specific, operational rule allows compliance that worsens fiscal sustainability by creating a future liability. For example, a government could reduce investment in public health today to improve the deficit, but at the cost of creating future, acute health costs that will eventually worsen the balance sheet.

These problems suggest that a deficit rule is a second-best solution that should be used only when short-term policy guidance is crucial. That is likely to occur when there is no strong, independent institution to effectively monitor and enforce a genuine fiscal sustainability rule.

2.2 Evolving goals

The early fiscal rules were designed to overcome the deficit bias that existed in many nations. However, the financial crisis has exposed problems with this singular focus. A deficit rule typically requires balance over a 2-5 year period, which implicitly assumes that any economic shock will have dissipated within that timeframe. The length of the recession in many European nations has upended that assumption and forced nations to choose between breaking their fiscal rule and pursuing an overly rapid fiscal contraction. As discussed previously, when monetary policy has reached the limits of its effectiveness, the cost of that contraction is likely to be felt in incomes, employment, and growth.

The next generation of fiscal rules will need to account for the possibility that these exceptional circumstances could become more common. Many sophisticated deficit rules, such as the Swiss and Swedish examples, have clauses that allow the rules to be suspended in exceptional circumstances. That is a workable solution; a better alternative would leverage the benefits of a strong fiscal council to implement a sustainability rule flexible enough to remain in force throughout a recession.

2.3 The UK’s current framework

2.3.1 A combined deficit and debt rule

The UK’s present fiscal rule has two parts:

- 1. It requires the Government to forecast a cyclically-adjusted, current account surplus within three years.
- 2. Public sector net debt is required to fall as a percentage of GDP in 2016-17.

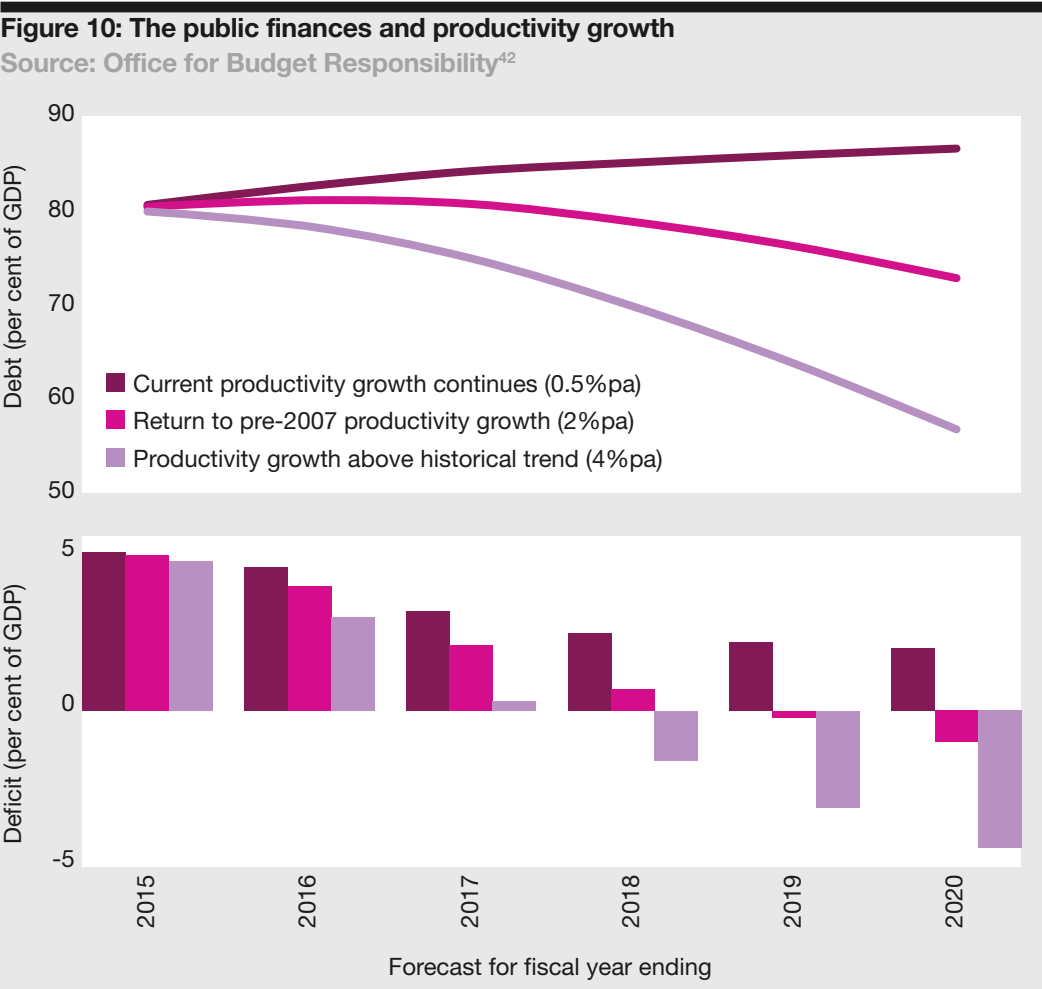
The rolling deficit target is common to many fiscal rules but has all the drawbacks described above. It has not been entirely effective in eliminating the deficit bias and has not aided the Government in tackling long-term fiscal sustainability. Furthermore, it has encouraged rapid fiscal contraction through the recession, which has reduced income growth.

Mindful of the UK’s deficit bias, HM Treasury included a debt component with a fixed date to anchor the rule and prevent the Government from forecasting surpluses that are never achieved. The aim is laudable but the execution has created an exceptionally fragile rule.

Rules that require a debt target to be met by a particular date are insufficiently flexible to cope with changing economic conditions. Each of the Chancellor’s rules has anchored falling debt to a particular fiscal year and, when growth forecasts have proven over-optimistic, those rules have been broken.

The Office for Budget Responsibility’s December 2014 forecast demonstrates the fragility of the present rule. Figure 10 shows three debt and deficit paths for three possible rates of productivity growth. If the current stagnation of productivity continues, as it has done

since 2007, then the Government is forecast to break its debt rule. To satisfy the rule, the Government will need productivity growth to increase fourfold, as in the central forecast. To meet it a year early the Government needs productivity to rise eightfold.



2.3.2 An independent fiscal institution

The most important and successful fiscal innovation of this Parliament has been the establishment of the OBR. Its transparency has lent additional credibility to the Government's macroeconomic policy and it has already forced the Chancellor to adjust his plans on a number of occasions. In doing so, it may have curbed the deficit bias that led to a debt ratchet in the early part of this century.

The current remit of the OBR is:

1. To undertake five-year forecasts of the economy and the public finances at least twice a year.
2. To act objectively, transparently and impartially.
3. To examine the impact of decisions made by the government on the sustainability of public finances. However, the OBR should not comment on the merits of individual policies, or examine alternative policy scenarios.⁴³

In practice, the OBR assesses each Budget and Autumn Statement for compliance with the Government's fiscal rule in its Economic and Fiscal Outlook forecast publications. These documents form the Government's official macroeconomic forecast and extend five years into the future.

⁴² Office for Budget Responsibility, *Office for Budget Responsibility*, fig. 5.7.
⁴³ HM Treasury, "Letter from the Chancellor to Robert Chote Regarding the Terms of Reference."

To determine the path of Government taxation and spending for the five year horizon the OBR uses settled plans from the Spending Review where possible, and Treasury assumptions for all other years. The Spending Review documents detail the departments' spending envelopes and the major programmes on which they will spend the money. These documents typically extend three years into the future, although there have been deviations from that pattern in recent years.⁴⁴

The OBR's second role is to assess the fiscal sustainability of the current policy settings. It does that once each year in a Fiscal Sustainability Report released in July. These projections extend forward fifty years, using the most recent five-year forecast as a starting point. For the years between the end of the Spending Review and the five-year horizon it uses Treasury assumptions about the level of Government expenditure. For the next 45 years to the end of the sustainability horizon it assumes 'unchanged' policy and projects spending on that basis.

These long-term projections form the basis of the OBR's assessment of fiscal sustainability; however, they are not directly related to the Government's fiscal rule and have failed to gain the same political currency as the five-year forecasts.

The OBR's inability to comment on policy has also hindered it from explicitly detailing the trade-off between growth and deficit reduction through the recession. Its little-read Forecast Evaluation Reports contain the necessary figures, but they are not highlighted for the lay reader. The OBR's Chairman, Robert Chote, went so far as to publicly chastise the Prime Minister for claiming that OBR analysis showed no such trade-off, which demonstrates the importance of the matter.

⁴⁴ The first four Spending Reviews (in 1998, 2000, 2002, and 2004) covered overlapping three-year periods. There was then a pause until 2007 to coincide with Gordon Brown's premiership. The next Spending Review did not take place until the Coalition took office in 2010 and covered a four-year period, followed by a one-year "Spending Round" in 2013.

3

A new framework for fiscal sustainability

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Achieving fiscal sustainability requires bringing the demographic challenges of the next fifty years into focus today. To improve the fiscal framework, any reform must have the flexibility to support incomes and employment in recessions through fiscal expansion. As *The Debt Ratchet* details, fiscal rules can always be overturned, so cannot truly bind future administrations. A better approach is to frame the rule and supporting indicators in a way that enables the Government to focus on the long term.

3.1 A long-term fiscal rule

3.1.1 Target the debt not the deficit

Since its establishment in 2010, the OBR has successfully built credibility and brought transparency and independence to its monitoring role. It is now secure in its role and in principle that allows fiscal rules to be less prescriptive and closer to optimality. Taking a long-term view of the public finances requires abandoning the short-run deficit targets of recent fiscal rules. Instead, the Government should set itself a long-run debt target and a fixed timeframe for achieving it. Subsequent administrations would of course be free to alter both the target and the timeframe. This is the approach taken in New Zealand and it has proven remarkably successful through the financial crisis.

A long-run debt target would put fiscal sustainability at the core of the government's fiscal rule, rather than aiming for interim targets as is done at present. The target level of debt is likely to be between 20 and 60 per cent of GDP, while the timeframe for achieving it will probably be in the order of 30 to 60 years. That timeframe would require the government to eliminate 5-10 per cent of the remaining excess debt each year.

Using a debt rule naturally lends itself to long run planning: it allows the Government to see the benefit of long-term plans in headline fiscal numbers. A long-term rule also enables the Government to take sustainability seriously. The OBR's Fiscal Sustainability Report is of secondary importance since it does not inform the fiscal rule. Removing the fig leaf of a short-run deficit rule helps to frame the fiscal debate around the demographic challenges that loom in the UK's future.

3.1.2 Flexibility to deal with recessionary surprises

A debt target is simpler, more credible, and more flexible than a deficit target. It is straightforward to explain and relates directly to a matter of obvious importance. It is achieved over decades rather than years, which makes it far more robust to changing economic circumstances. Nearly all shocks to the economy will have dissipated over a timescale of forty years, which means that economic surprises will have little effect on a government's ability to achieve a debt target. That contributes to the durability of the rule.

The corollary is that, in contrast with a three-year deficit rule, the debt rule provides little guidance on fiscal policy during a Parliamentary term. Many possible deficit paths are consistent with long-run fiscal sustainability; the debt rule does not distinguish between them. However, short-term fiscal policy should be guided not by the deficit but by economic wellbeing considerations: primarily incomes, earnings, and employment. Not all possible fiscal paths will lift wellbeing, subject to the debt rule's sustainability constraint. In combination, wellbeing and sustainability provide guidance for the Government across both the short- and long-term.

3.2 Reshaping the OBR

3.2.1 A new mandate

Turning a debt rule into an operational target requires a new approach to the OBR’s assessment of fiscal policy. In future, the OBR would be required to assess the consistency of the Government’s spending plans with its debt rule. That assessment would need to incorporate the forecast elements of the Economic and Fiscal Outlook, along with the long-term projections of the Fiscal Sustainability Report. At present, those two forecasts are contained in separate publications that assess the Government’s plans against its fiscal rule, and the fiscal sustainability of the Government’s policies. With those two tasks combined by the debt rule there would be no need to have separate publications and they could be merged.

Publishing a single, long-run projection would re-frame the policy discussion and eliminate the artificial, five-year fiscal horizon, which is presently reinforced by the span of the OBR’s forecasts. It would also change the basis of the forecast: the five-year forecast rests on the Government’s total spending assumption, whereas the fifty-year projection assumes unchanged policy. If the five-year point is no longer significant, then requiring the Government to make arbitrary assumptions about spending beyond the duration of the current Spending Review becomes unnecessary.

The Spending Review, in concert with the Budget and Autumn Statement, defines the period for which spending plans exist and, beyond that, the OBR can reasonably assess sustainability on unchanged policy. Projections would not be forecasts of the next fifty years of debt but, rather, would make the implications of the current policy settings explicit. The debt rule would be assessed not based on possible, future policies but current policies. That prevents governments from promising plenty today without accounting for the cost tomorrow.

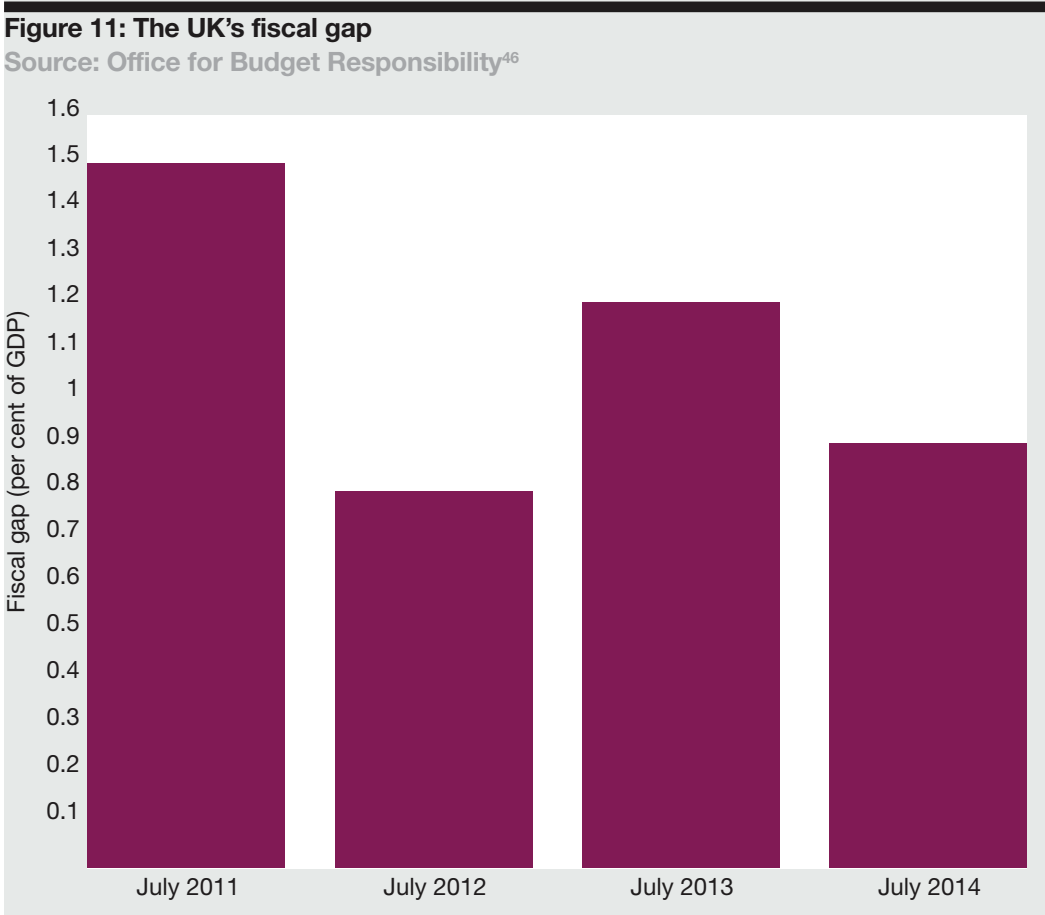
3.2.2 Sustainability measures

A key difficulty for a debt rule is that it provides no obvious, short-run measure of progress towards the target. Moreover, the reforms required to achieve sustainability may not be feasible in the course of one Parliament, which could render the obvious target of sustainability unachievable for a single administration.

Overcoming these problems requires a single, headline measure that summarises the Government’s progress towards the target, against which it can be measured. The OBR has already developed a key measure of fiscal sustainability. In its Fiscal Sustainability Report, the OBR calculates the ‘fiscal gap’, which it defines as the “immediate and permanent change in the primary balance needed to achieve a certain, pre-determined debt-to-GDP ratio in a specific year.”⁴⁵

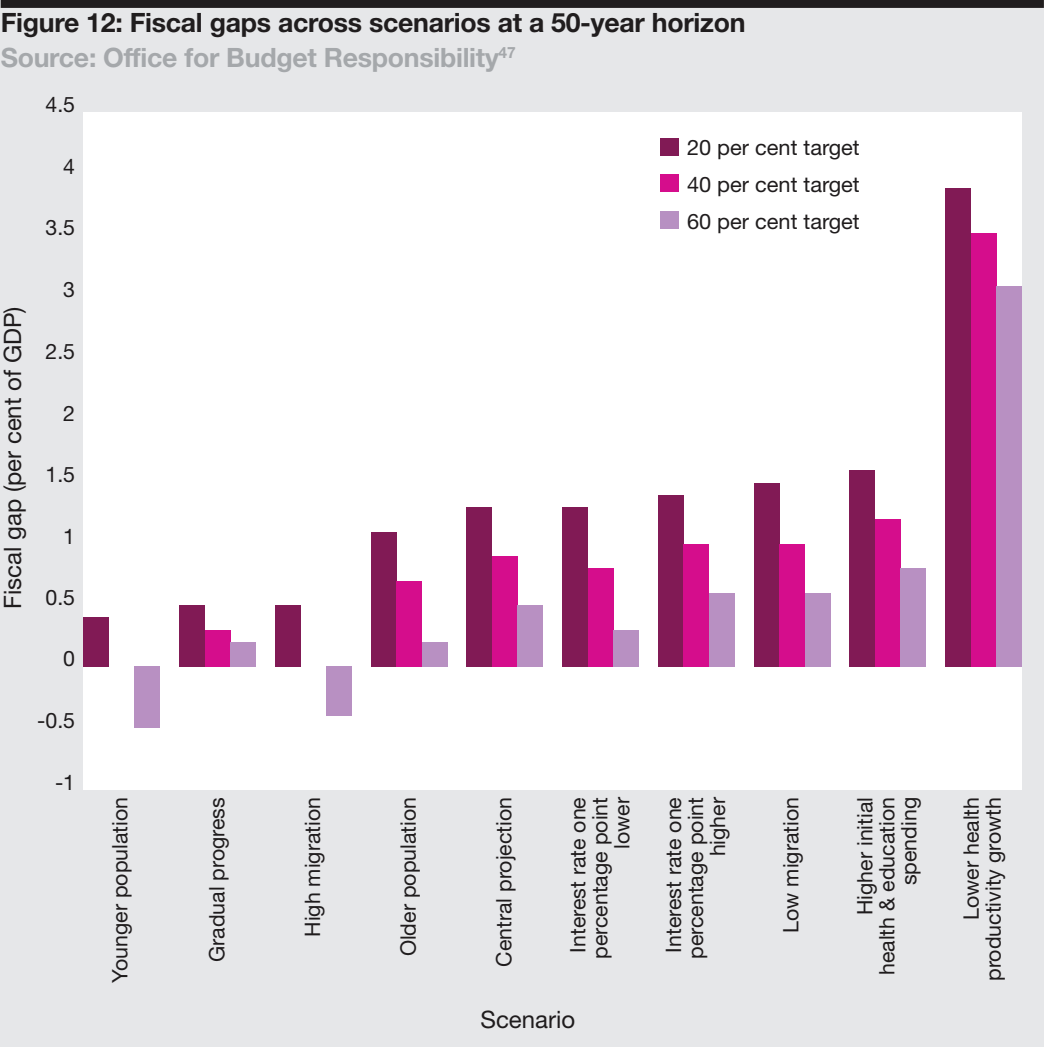
Figure 11 illustrates the OBR’s estimate of the gap to achieving a debt-to-GDP ratio of 40 per cent over the next 50 years. It shows the gap from the end of the Government’s current plans. For example, the 2014 figure indicates that a once-and-for-all policy tightening of 0.9 per cent of GDP in 2019-20, on top of the cuts through to 2018-19 that the Government has already announced, would be required to achieve 40 per cent debt ratio in 2063-64.

45 Office for Budget Responsibility, Fiscal Sustainability Report, July 2014, para. 5.11.



The fiscal gap is an exceptionally useful measure because it aids a better understanding of the obstacles to sustainability. To assess the key obstacles, the OBR develops scenarios that estimate the fiscal gap under a range of different assumptions. Figure 12 charts the fiscal gap for key scenarios against the OBR’s central projection. It shows that the gap is highly sensitive to the level of health productivity, moderately sensitive to the rate of immigration, and fairly insensitive to the interest rate. The clear implication is that controlling health costs is by far the greatest challenge to sustainability.

46 Office for Budget Responsibility, Fiscal Sustainability Report, July 2011, 112; Office for Budget Responsibility, Fiscal Sustainability Report, July 2012, 118; Office for Budget Responsibility, Fiscal Sustainability Report, July 2013, 126; Office for Budget Responsibility, Fiscal Sustainability Report, July 2014, 134.



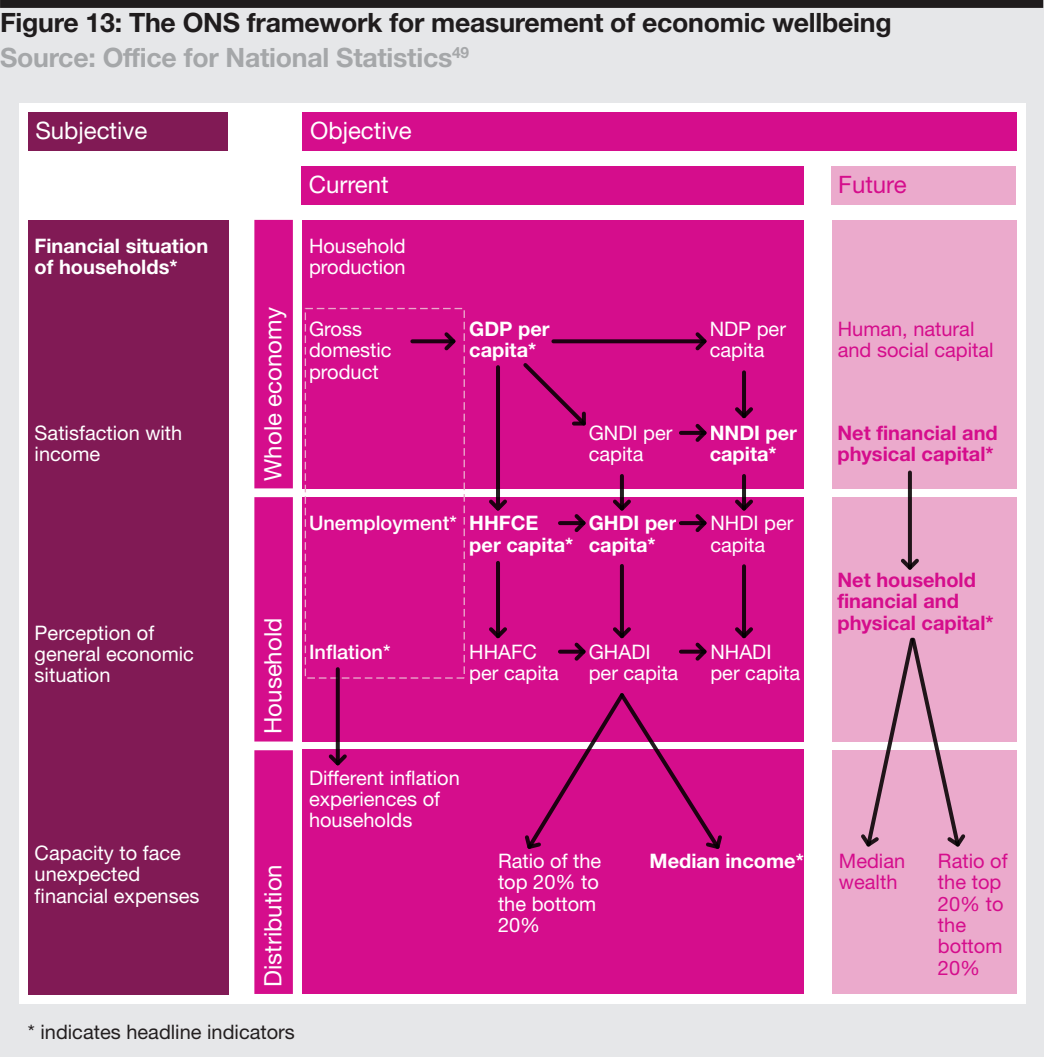
3.2.3 Short-run progress measures

In addition to an effective measure of sustainability, the Government requires short-run measures of economic wellbeing within that envelope. The ONS has distilled the principles of the Commission on the Measurement of Economic Performance and Social Progress, chaired by the Nobel Prize winning economists, Amartya Sen and Joseph Stiglitz,^[cite]⁴⁸ in order to construct a series of measures for economic wellbeing in the UK. They summarise the core principles for measuring economic wellbeing as follows.

1. Consider income rather than production or consumption.
2. Emphasise the household perspective.
3. Consider wealth in conjunction with income and consumption.
4. Give prominence to the distribution of income, consumption, and wealth.
5. Broaden income measures to non-market activities.
6. Account for inflation and population growth.

Using these principles, the ONS has constructed national accounting measures that represent the lived experience of households in the UK. These indicators allow fiscal policy to go beyond GDP growth in considering the impact of decisions on the wellbeing of households in the UK.

⁴⁷ Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2014, fig. 5.1.
⁴⁸ Stiglitz, Sen, and Fitoussi, *Report by the Commission on the Measurement of Economic Performance and Social Progress*.



The OBR's forecasts should report against the ONS' headline measures of economic wellbeing, rather than focussing on debt, the deficit, and GDP growth. In their reporting it would be important for the OBR to evaluate not just the forecast path but also the impact of policy changes on these measures. An informed policy debate rests on an understanding of the impact of individual policies on things that matter and the OBR's canonical forecast and costings provide an effective basis for that conversation.

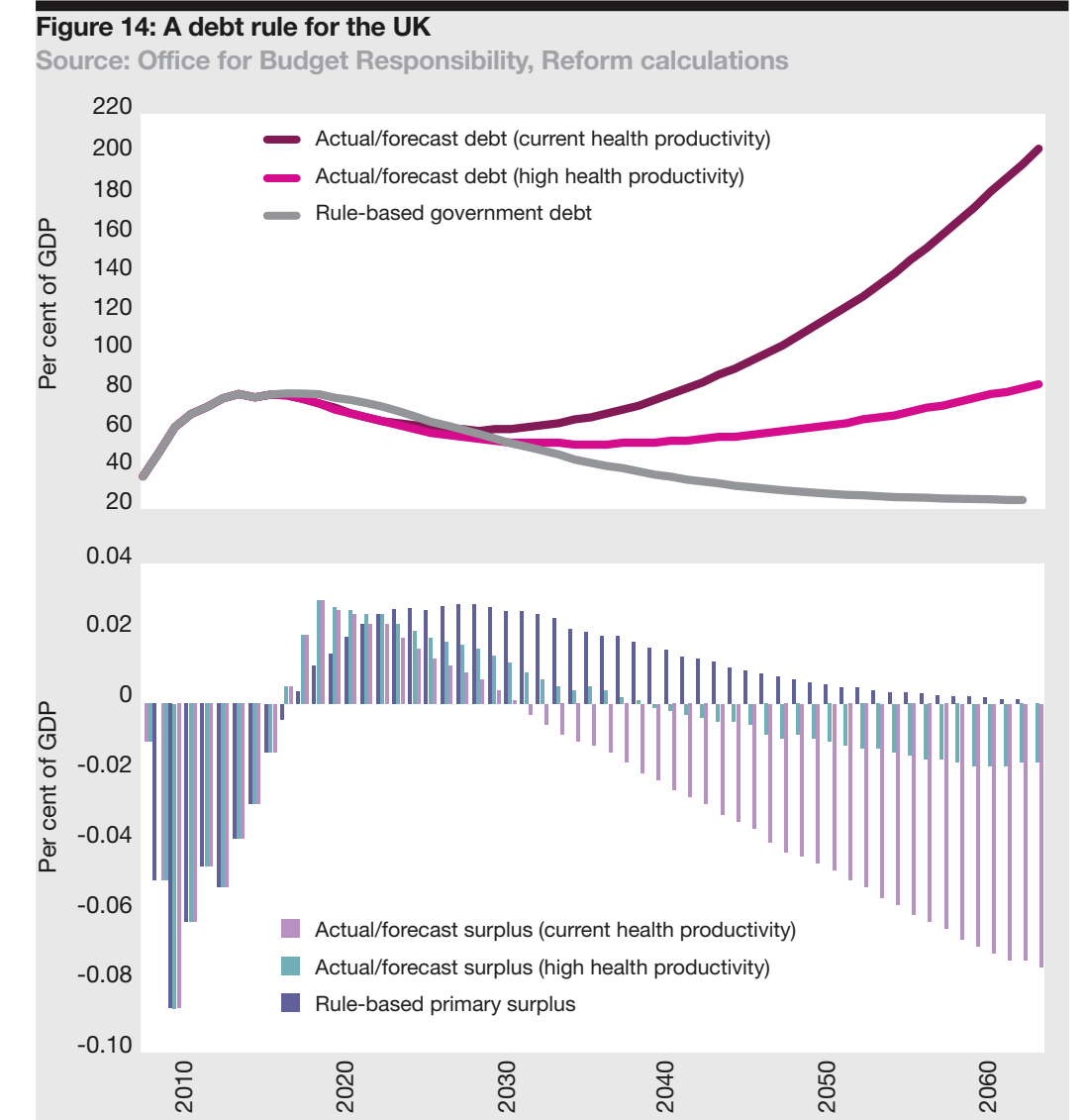
⁴⁹ Office for National Statistics, *Economic Well-Being - Framework and Indicators*.

4

Practical implications of a debt rule

To demonstrate the practical implications of this new approach, suppose the Government set a long-term target for national debt of 40 per cent of GDP. It might choose to close the gap over fifty years, which would require eliminating about 6 per cent of excess debt each year. Most notably, the gap at 6 per cent each year means that most of the debt will be cleared early on to reduce the fiscal risk, after which it will be paid off increasingly slowly to minimise the tax burden.

Figure 14 illustrates what that rule might mean for the UK's current fiscal situation.⁵⁰ It compares possible paths of debt and the deficit over the next fifty years to the OBR's latest projections. Two comparators are included: the OBR's central projection, which assumes that health productivity increases dramatically to 2.2 per cent per annum; and the OBR's projection that assumes health productivity remains at the historical rate.



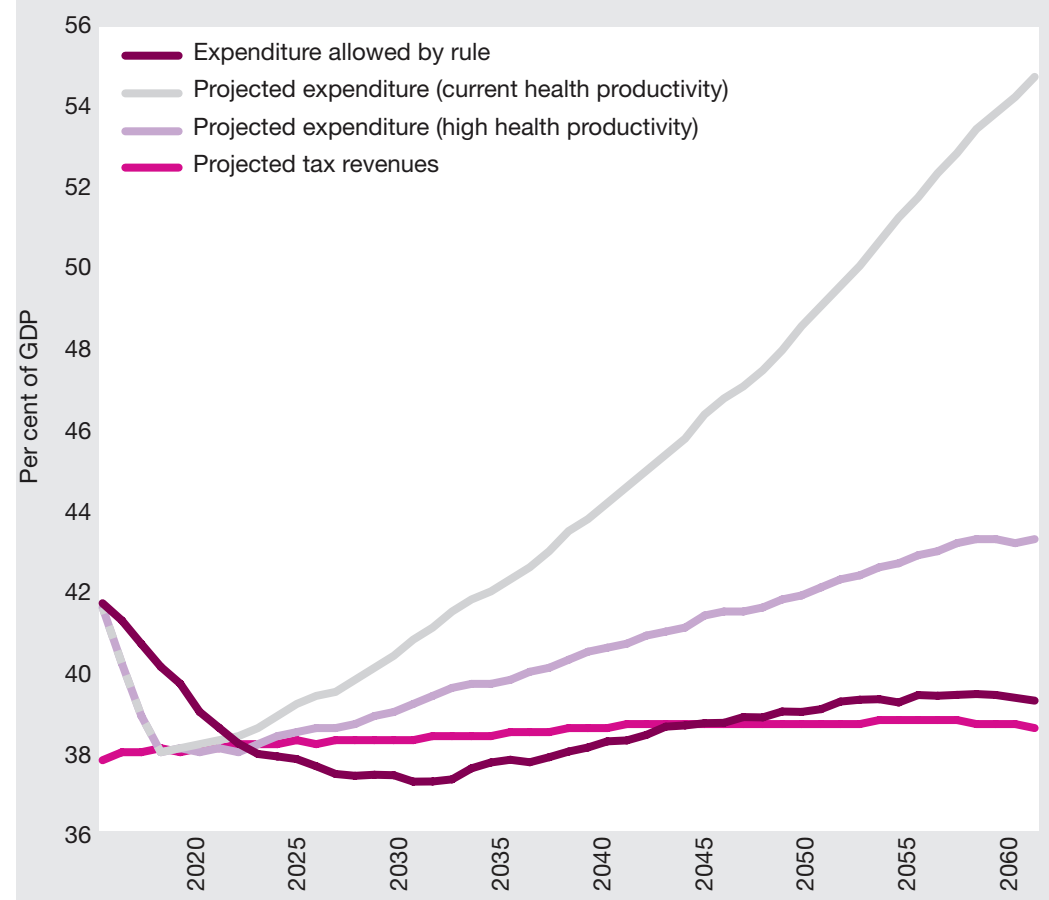
The path calculated for the debt rule includes a gradual taper from the current fiscal position to debt reduction. The taper ensures that a rapid fiscal adjustment does not again cause the Bank of England to run out of headroom to move interest rates and offset the effect of deficit reduction.

⁵⁰ The data used in this section does not include policy announcements made in the December 2014 Autumn Statement. Including those announcements introduces a discontinuity with the projections in the OBR's latest Fiscal Sustainability Report of July 2014. However, none of the announcements in the Autumn Statement are likely to have a significant impact on long-run fiscal sustainability.

Figure 14 demonstrates that the rapid contraction implied by the Coalition Government's current plans for the next Parliament are not required to achieve debt reduction. Nevertheless, there is no avoiding the need for significant surpluses at some point to pay down the debt. The key requirement is that those surpluses are maintained, on average, for the coming decades.

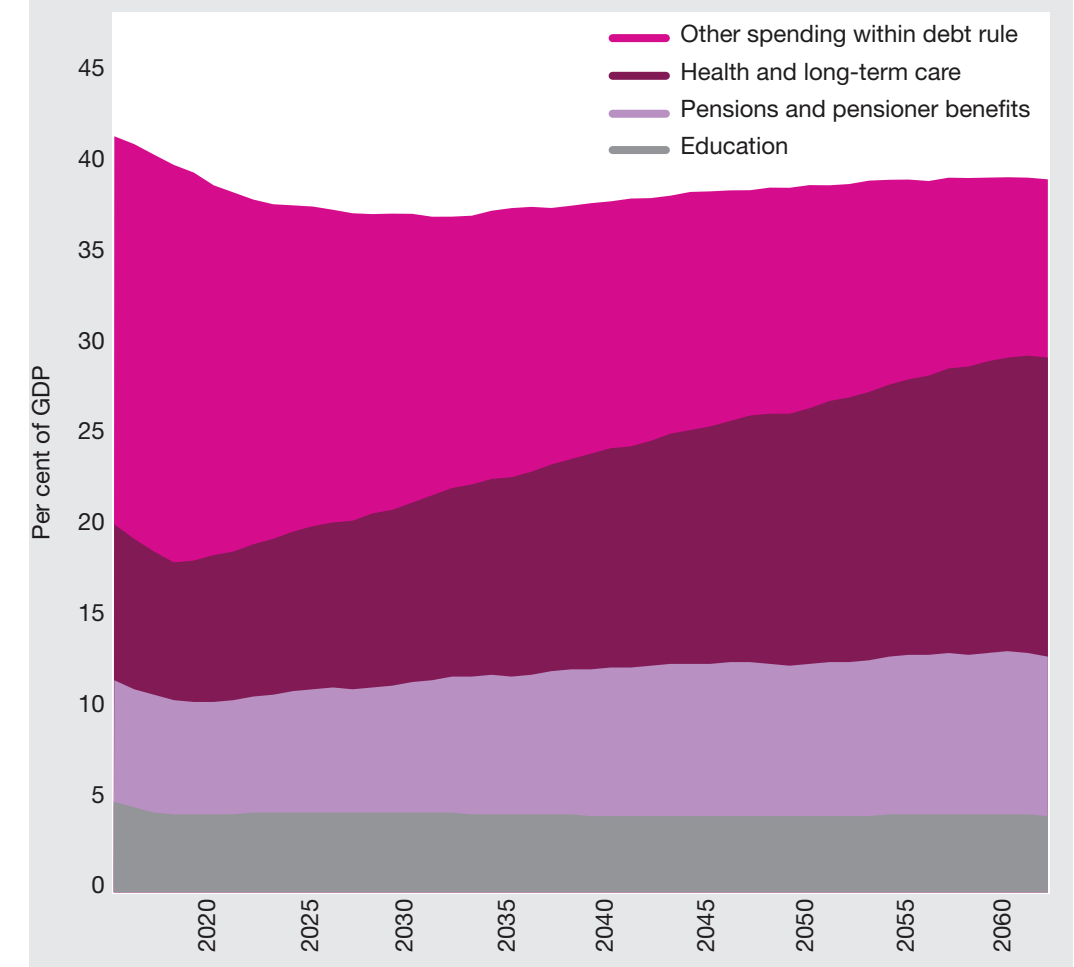
Assuming future tax revenues are as projected by the OBR, Figure 15 charts the size of the state implied by each of these three deficit paths. It shows that, without tax increases, total Government expenditure will need to drop below 37.3 per cent of GDP to pay down the debt. That is a level seen only eleven times since 1948.

Figure 15: Implied paths of Government expenditure
Source: Office for Budget Responsibility, Reform calculations



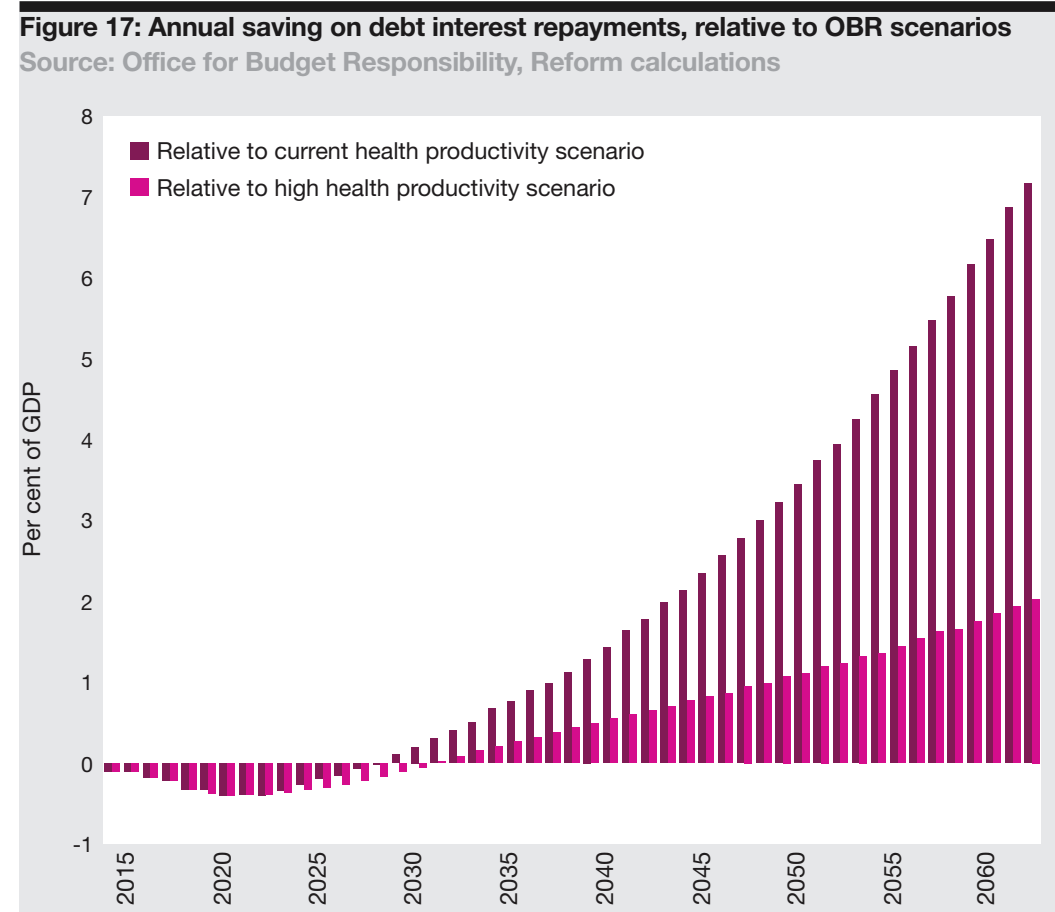
The expenditure path implied by current policy settings at current rates of health productivity are clearly implausible. That demonstrates the urgent need for a conversation about dealing with the sustainability of health expenditure. Figure 16 charts the implications for unprotected areas of spending if the debt rule was adhered to and health productivity did not rise dramatically.

Figure 16: Implied expenditure on protected areas
Source: Office for Budget Responsibility, Reform calculations



Under this model, healthcare and pensions absorb an increasing share of public expenditure, rising from about 14 per cent of GDP at the end of this Parliament to over 25 per cent of GDP by 2063. That would force unprotected expenditure to contract by about 54 per cent, from 21 per cent of GDP today, to under 10 per cent of GDP in 2063.

The cut in expenditure on services is even greater because much of that unprotected expenditure is committed to paying interest on the Government's rising debt. The OBR projects the cost of interest payments to absorb over 7 per cent more of GDP in 2063-64 than would be the case under our debt rule (Figure 17).



Adopting a debt rule along the lines proposed in this report highlights the need for urgent reform of our key public services. It reframes the fiscal challenge away from short-term deficit reduction and in favour of long-term fiscal sustainability.

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