National Institute of Economic and Social Research

Nuffield Foundation

2019 UK GENERAL ELECTION BRIEFING:
THE FISCAL RULES

Jagjit S Chadha
National Institute of Economic and Social Research (NIESR)

OVERVIEW

The election campaign has focussed on the tax and spending plans of the main political parties, this brief outlines:

- The case for fiscal rules as part of the country's strategy of macroeconomic management.
- The need for comprehensive reform of the process of setting fiscal policy.
- This brief accompanies: "Where is the Money Coming from?"

KEY TAKEAWAYS

- Public (so-called National) debt allows the State to share the financing of its current expenditure plans with future, typically better off generations rather than simply applying taxes on the current generation.
- The control of public debt is necessary in order to prioritise current expenditure plans but also to maintain the capacity to deal with an uncertain economic future.
- Large expenditure shocks should generally be financed by gradual increases in taxes and immediate, but strictly temporary, increases in public debt.
- Previous episodes of high public indebtedness in the UK have been reduced, as a share of GDP, by targeting sequences of primary fiscal surpluses (government net borrowing excluding net interest payments) with nominal GDP growth then acting to ensure that the level of public debt is more affordable.
- Rather than arbitrary and unrealistic rules that will be subject to constant revision, it is preferable to accept a general objective for low and stable public debt and then publish forecasts of the current and future primary fiscal surpluses that may change given economic circumstances, just as with Bank Rate under an independent Bank of England.
- It is questionable whether the Chancellor of the Exchequer should be solely responsible for setting the path of the fiscal surplus and it may be preferable for a more normative Fiscal Council, possibly chaired by the Chancellor, accompanied by independent economic forecasts to set the path of the primary fiscal surplus as a function of expenditure and revenue-raising-plans.

Public Debt

- The government issues public (national) debt in order to fund any current and planned expenditure in excess of current tax receipts. The issuance of public debt involves borrowing at term from the private sector at home or abroad, as well as the public sector abroad.

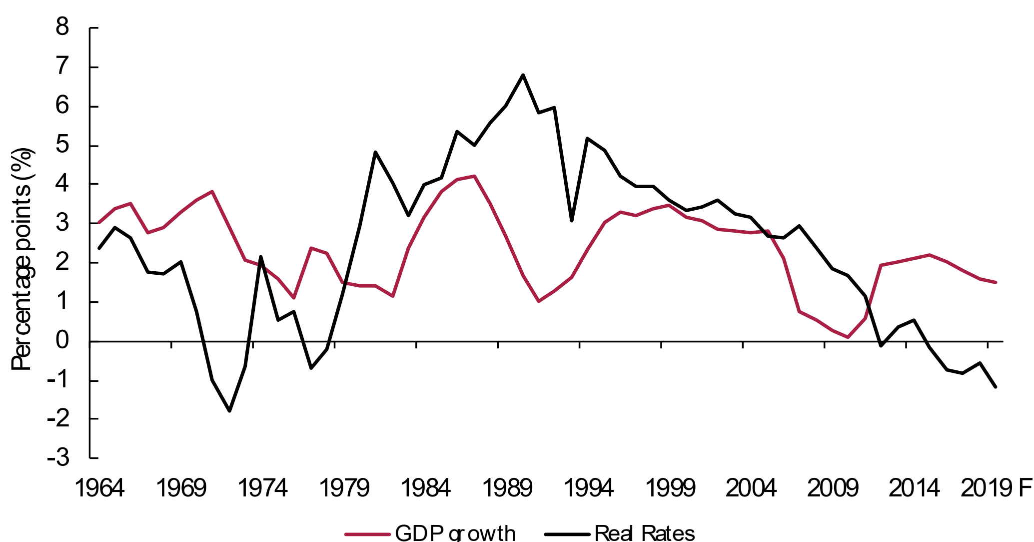
- The level of public debt needs to be managed in such a way as to allow the government to deal with any anticipated expenditure needs as they arise, such as those following the Great Financial Crisis in 2007-8, but also to leave the government with sufficient, what is called, **fiscal space** to deal with future shocks.

- There are a number of key considerations when assessing whether the level of debt is problematic: its size relative to national income, the maturity of the debt and whether it is pays a fixed interest rate (conventional) or one linked to inflation (index-linked).

- A good debt management strategy would involve **retaining space to issue more debt if required**, having a **long term maturity structure** so that not too much debt has to be refinanced in any one year, and issuing **a mix of conventional and index-linked debt** so that the fiscal position neither encourages inflationary finance nor imposes too much of a burden on the Exchequer from an inflation shock. Those entities holding the debt will wish to receive interest payment in order to match their liabilities and so public debt can help offset private sector payment risk.

- There is no widely accepted definition of an appropriate level of national debt and if it was agreed it would change in response to fundamentals such as requirements for public infrastructure, state-funded education, demographic considerations, the state's revenue raising capability and the current and prospect costs of public debt finance.

Figure 1: GDP Growth and Real Rates.



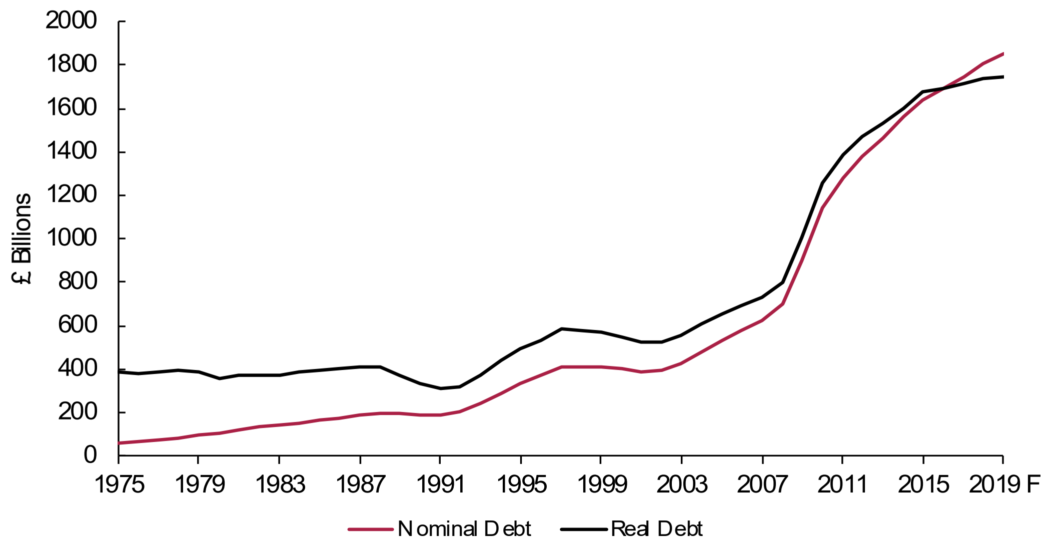
Source: NiGEM database and NIESR forecast

- In the long run, Figure 1, the real costs of public debt and the real growth of the economy tend to move together, which means it is not possible to run a permanent sequence of fiscal deficits without raising the ratio of public debt to output to unsustainable levels.

"Paying off National Debt"

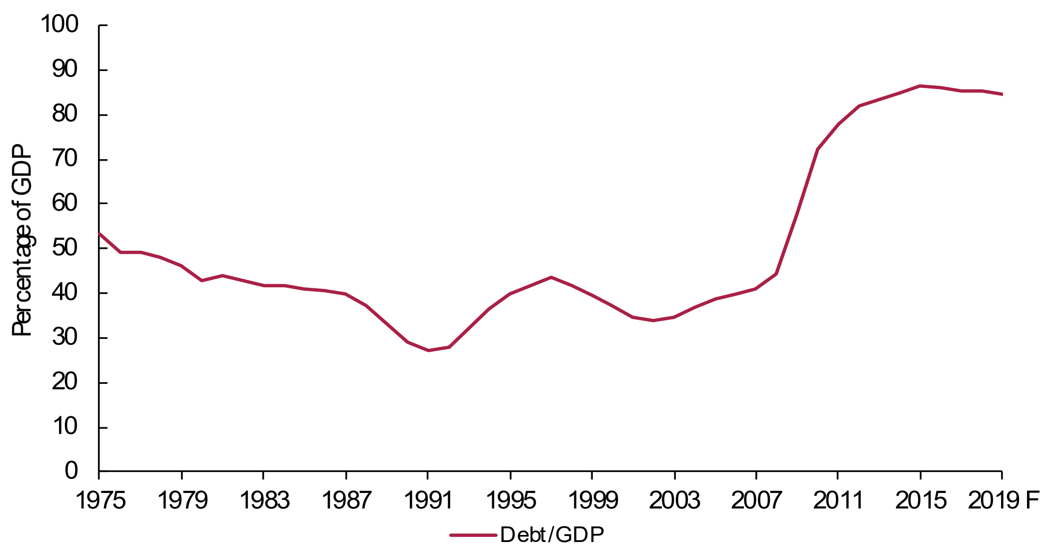
- Public or national debt tends to rise with income, both in nominal terms but also relative to the costs of a basket of goods (Figure 2), but not as a share of income in **normal times** (Figure 3).

Figure 2: Nominal Levels of Public Debt and Real Debt.



Source: NiGEM database and NIESR forecast

Figure 3: National Debt to GDP ratio.



Source: NiGEM database and NIESR forecast

- The national debt relative to income should therefore tend to rise in times of elevated public expenditure, e.g. in war-time, in a depression, and fall in times of sustained economic growth.

- Economists tend to think that tax smoothing is a good idea, which means that when public expenditures increase sharply, tax should not rise immediately, as they tend to distort economic behaviour, and this means that the ratio of debt to GDP will rise temporarily.

- The strategy for reducing the national debt burden, which in practice means reducing the debt to GDP ratio, has involved a two-step procedure. First targeting surpluses on the primary fiscal balance, which is the balance before adding back in the interest rate burden on existing national debt, that are at least as large as the interest rate burden so that the overall fiscal position is in broad balance.

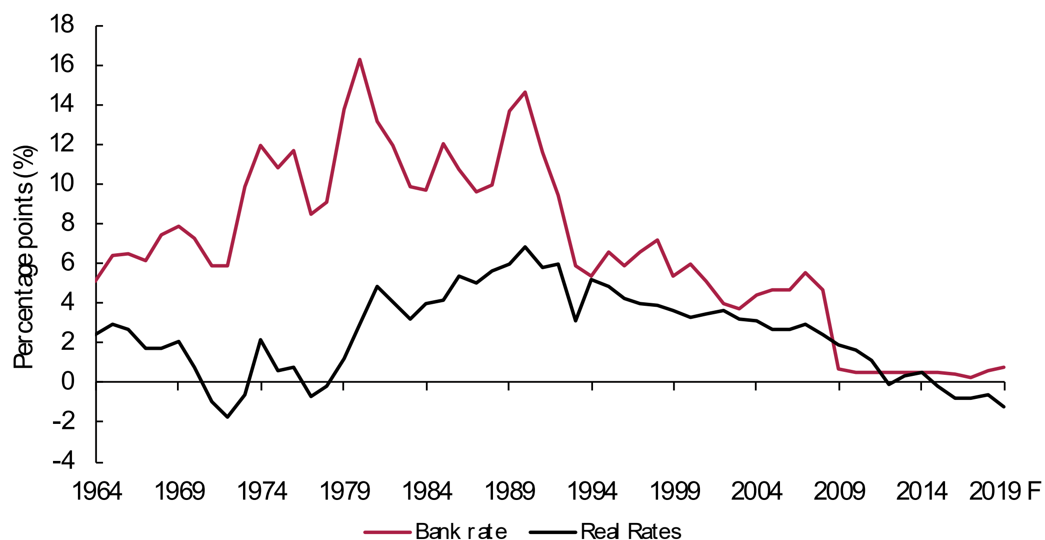
- Second, by adopting policies that limit increases in the magnitude of the national debt, the denominator, which is nominal GDP, can grow over time to reduce the debt burden. This strategy was adopted after each of the Napoleonic Wars, World War 1 and World War 2.

- The rapid increase in national debt following the Great Financial Crisis can broadly-speaking be dealt with in the same way with a gradual return to a sequence of primary surpluses. Though after the most recent crisis, we are still waiting for the return of a sequence of primary fiscal surpluses.

Monetary and Fiscal Co-ordination

- Monetary policy plays a large role in public debt accumulation. There are two main channels. First changes in Bank Rate influence aggregate demand in the economy, which affects the revenues collected by the state. Secondly, Bank Rate heavily influences the costs of funding public debt as its current level and expected path determines much of the cost of debt issuance (Figure 4).

Figure 4: Bank rate and Real rates.

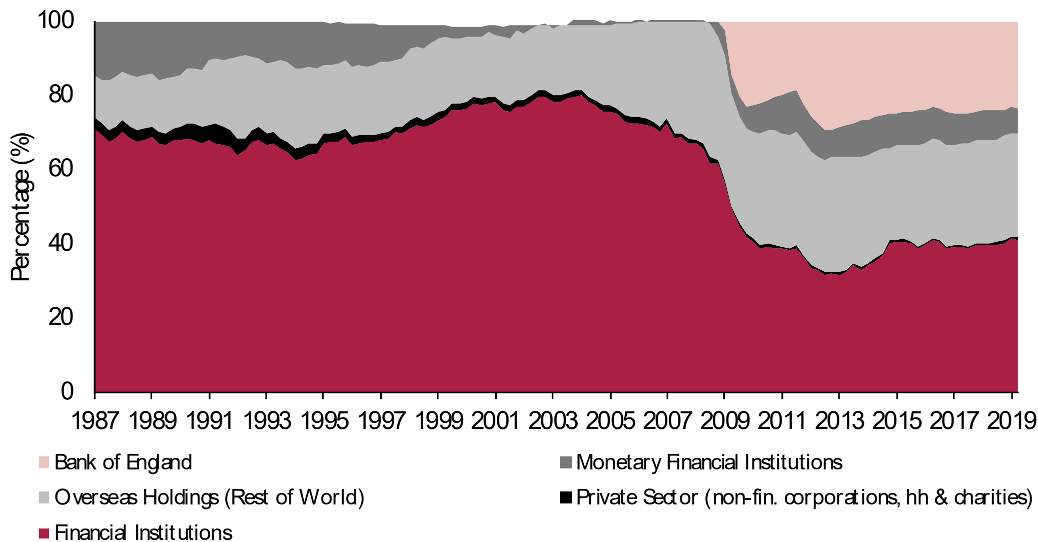


Source: NiGEM database and NIESR forecast

- Since 2009, the Bank of England has been buying public debt from the non-financial private sector and now holds come 25% of the outstanding debt stock (Figure 5). These operations, known as Quantitative Easing (QE), have reduced the stock of debt that would otherwise be held by the private sector and consequently stabilised its price at a level higher than would otherwise

have obtained. The net effect is that longer term interest rates are some 1-1.5% lower than they would otherwise have been.

Figure 5: Public debt holdings



Source: ONS.

- The profits from this trade, which are remitted to the Treasury, have temporarily ameliorated the fiscal balances. This is because the purchase of bonds yielding typically 2% or more is financed by borrowing at Bank Rate, which has typically been 0.5%.

- The overall fiscal deficit, which includes interest rate payments on debt and flows from these central bank operations, is directly affected by Bank Rate and so we propose making the **primary fiscal balance** the explicit instrument of fiscal policy.

- As shown in a variety of papers the primary balance has, what economists call a state-contingent role in supporting the economy, particularly when monetary policy is constrained at the zero lower bound. This means that the appropriate future path of primary fiscal surpluses will change with the view of the economy and they must be set in manner that is not subject to the political cycle and so implies a strong role for an independent Fiscal Council for judging the appropriate stance of fiscal policy.

Fiscal Rules

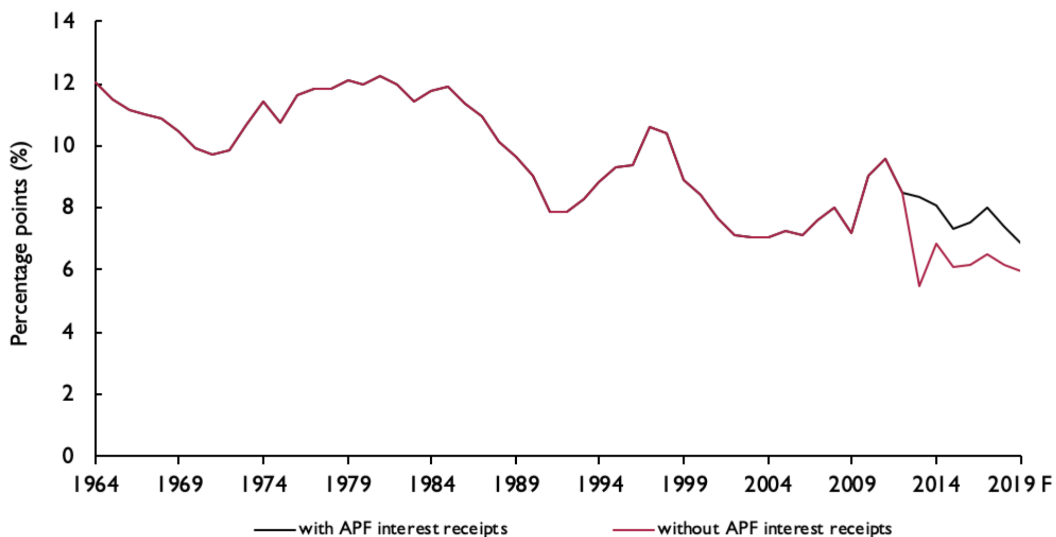
- Currently the Office for Budget Responsibility (OBR) more or less only assesses whether the Chancellor's self-imposed plans are likely to be hit. There is not mandate for assessing the optimality of those plans, individual departmental expenditures or of various tax reforms.

- The regular changes in the fiscal rules suggest there is a fundamental problem in being able to write down a "timeless" objective for fiscal policy, which can be simply numerated. An appropriate conceptual basis would be to **target low and stable levels of public debt in the long run**. The instrument would then be a state-contingent **path of the primary fiscal surplus.**

- To promote transparency and credibility, we would have a fixed annual timetable for the Budget in the Spring and a spending assessment in the Autumn, at which the fiscal path for the current year and the next five fiscal years would be set.

- The rules proposed by the Conservative and Labour Parties are subject to the criticisms that **they are arbitrary and difficult to monitor**. **They simply will not last**. Each party has adopted rules for debt interest rates payments as a fraction of public revenue and I show the series since 1964 with a line at the end for the series including remittances to HMT from the Bank of England under QE. It shows how even this target is distorted by central bank policy.

Figure 6: Interest Payment to Revenues ratio.



Source: NiGEM database and NIESR forecast

- The path of primary fiscal surpluses can be set by HMT in the form of a Fiscal Policy Council of experts and Whitehall advisers. The Chancellor would choose to chair such a Council.

References

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