INSTITUTE FOR GOVERNMENT

Strengthening the UK's fiscal framework

Putting fiscal rules in their place

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About this report

Fiscal policy making in the UK has been far from perfect. Problems like short-termism, policy churn and gaming of the system are often blamed on fiscal rules. This report examines whether that is fair, or whether these issues are rooted more deeply in the underlying fiscal framework and makes recommendations for strengthening fiscal policy making.

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Contents

Summary

As chancellor, Gordon Brown introduced the UK's first formal fiscal rules in 1997 to "ensure an historic break from the short-termism and expediency that have characterised the recent fiscal policies of our country".[1] In doing so, he was following the lead of several other advanced economies, including Australia, Germany and Japan;[2] since then most others have followed. In the UK, governments have worked to some kind of fiscal rules almost continuously since their introduction and – since its creation in 2010 – the Office for Budget Responsibility has judged them on their adherence to those rules.

But increasingly, commentators from across the political spectrum are asking whether the UK would be better off without fiscal rules. They point out that the rules have been rewritten frequently, and so question whether they operate as truly effective constraints or promote genuine fiscal sustainability. And there are several systematic problems with how fiscal policy is made under a framework so centred on fiscal rules.

This report examines the current UK fiscal framework, and fiscal rules' role within it, and finds that the UK – like many other comparable countries – is best served by such a model. But that does not mean it is perfect, and we also find that the framework is not working and must be reformed. We offer our recommendations for how the system can be improved, based on Institute for Government analysis and interviews, supported by a private roundtable comprising experts and officials.

There are good reasons to have a strong fiscal framework that includes fiscal rules

The primary rationale for fiscal rules – that is, explicit constraints on borrowing, debt, spending or other public finance aggregates – is to protect against 'deficit bias': the habit of politicians to be tempted to spend more and tax less than is optimal, leaving a greater burden of debt for future generations to bear after they have left office. Fiscal rules, alongside a broader fiscal framework, can help to achieve this by increasing the political cost of pursuing policies that harm future generations.

Rules provide a signal, both to the public and markets, that the government is intent on sticking to particular fiscal limits. Evidence shows this can help to reduce the cost of borrowing from markets. This in turn means rules act as a commitment device for governments. They play a key role in the setting of medium-term tax and spending policy, encouraging prime ministers and chancellors to announce and deliver policy that is consistent with sustainable public finances. They also strengthen the chancellor's hand in internal government negotiations, where ministers are inclined to lobby for additional spending on their own priorities without factoring in the cost of raising the money from current and future taxpayers.

Other aspects of a fiscal framework, such as independent watchdogs like the Office for Budget Responsibility (OBR), are also important to ensure decisions are transparent and impose more discipline. And some countries' frameworks, like Canada's, function well without formal rules. However, rules help ensure the government sets clear fiscal objectives, which in turn helps watchdogs hold them to account with less risk that they will lose their reputation for independence.

Consistent poor policy practice shows the UK fiscal framework is not working as well as it could

In practice, fiscal policy has been far from perfect since fiscal rules were introduced, and several critics have argued that rules have in fact encouraged various adverse distortions to policy making. We identify six types of policy problems that have happened systematically over the past decades:

- **Inappropriate macroeconomic stance:** when interest rates are at or near zero and can no longer play their role in managing the demand-side of the economy, it follows that fiscal policy may need to step in to support it – but often cannot, if governments have used rules that focus on reducing borrowing or debt without appropriate exceptions, which ends up incentivising exactly the opposite.

- **Short-termism:** policies that pay off in the longer term (in particular, investment spending) are often the easiest to cut when governments are looking to reduce the deficit, but doing so has negative consequences in the long term, again exactly the opposite of most rules' intention.

- **Arbitrariness:** policies that cost relatively little in the context of the public finances are sometimes adjusted to meet a fiscal rule, but in a way that makes them much less effective, undermining the value-for-money case for the policy. Recently, a policy of more generous capital allowances for business investment was announced only temporarily, which meant it was expected to have no lasting benefit.

- **Gaming:** successive governments have made some policy decisions to help meet the letter of a fiscal rule without improving underlying fiscal sustainability – that is, missing the spirit of the rule. Sales of assets like the student loan book are prominent examples.

- **Fiscal fine-tuning:** chancellors have tended to make abrupt policy changes – for example, big swings in planned capital investment – based on changes to highly uncertain forecasts that change the government's 'headroom' against forward-looking fiscal rules. This creates uncertainty and excessive policy change.

- **Fiscal fiction:** a close cousin of 'gaming', this is when governments have tended to 'meet' forward-looking fiscal rules by pencilling in unrealistic policies that will not (or could not) be delivered – the most prominent examples being fuel duty increases that never materialise and the implausibly tight spending plans pencilled in for beyond the current spending review. This is disingenuous, worsens fiscal debate and threatens sustainability when those policies are inevitably changed.

As a result of some of these errors, fiscal rules have also been criticised for failing to promote fiscal sustainability. In the UK, more than any other OECD country, rules have been prone to churn: the UK is now on its ninth set of rules, and the eighth set since 2009. By contrast, New Zealand's budget balance rule has stood since 1994.[3] Forward-looking rules are also often only met through implausible assumptions about future policy (fiscal fiction, above). The current binding fiscal rule requires that debt be forecast to fall in five years' time – but in practice the government can be compliant with this without debt ever actually falling as a share of GDP, allowing governments to repeatedly announce short-term 'temporary' giveaways accompanied by plans to tighten policy later on that never materialise (as they have tended to do since 2010).

These problems are not all a result of fiscal rules

It is unfair to blame fiscal rules for all of these failings, as many reflect broader political incentives or genuine economic trade-offs, which fiscal rules force politicians to confront. Politicians' incentives naturally tend towards short-termism, for example, and some well-designed fiscal rules can even guard against this. And while policy decisions made to meet rules may appear arbitrary (and rules are, by necessity, somewhat arbitrary in where they choose to draw the line), this is not necessarily a policy error. Many seemingly reasonable decisions to spend more on policies could add up to an unsustainable total, and fiscal rules require politicians to confront the fiscal costs of these choices.

Other problems, like the incentive to take an inappropriate macroeconomic stance and gaming, are not necessarily inherent in any rules-based system but have shown themselves to be prevalent in the types of rules the UK has chosen in recent decades.

Reforms to the fiscal framework are needed to improve fiscal policy making

In our view, many of the problems outlined above would continue to exist, and could even be worsened, in the absence of fiscal rules. Without clear fiscal rules, the environment would in turn be far less clear, and the temptation to continuously cut taxes or raise spending would threaten fiscal sustainability over time. Fiscal policy would still be governed by some kind of objective – it is after all a means to an end, not an end in itself – but it would be less transparent, less well-specified and more subject to change than is currently the case.

That is not to say the problems outlined above are not real and in need of remedy: they are. Our fiscal framework is not working and is in need of reform.

The most significant change that needs to take place, which all our recommendations follow from or depend on, is that **the chancellor must set out a comprehensive fiscal strategy**. Debt and deficit targets are not ends in themselves: they are the means by which governments can make trade-offs between outcomes and across time. Chancellors, along with their ministerial colleagues, must work out the levels of taxation, expenditure and debt that are consistent with meeting government's overarching objectives. From this, a set of rules to constrain fiscal policy within those limits will follow.[*]

Developing and implementing this sort of fiscal strategy requires both a strong process at the centre of government for forming strategy and making these trade-offs, and a fiscal framework that implements it effectively. This report is concerned with the latter, while other Institute research has addressed[4] or will address[5] the former.

Recommendations in brief

The most significant change required to strengthen UK fiscal policy making is that the chancellor must set out a comprehensive fiscal strategy and a set of targets consistent with that to support the delivery of the strategy. To ensure that their intended outcomes are achieved, chancellors also need a strong fiscal framework. A chancellor eager to improve the UK's currently flawed framework should:

- **commit to holding only one fiscal event per year**
- **commit to a new regular cycle of spending reviews**, with budgets covering five years, reviewed every three years.

They should then ensure any future set of fiscal rules:

- **treats investment differently to current spending**
- **specifies targets as ranges rather than point targets**, to reduce the incentive to constantly tinker
- **is binding in the third, rather than fifth, year of the forecast.**

The chancellor should also expand the remit of the OBR, through updated legislation, to include the following changes:

* This report focuses on strengthening the fiscal framework. For more analysis and recommendations around how government can strengthen its strategic capacity see *Report of the Commission on the Centre of Government*, Institute for Government (forthcoming) and Wilkes G, Bartrum O and Clyne R, *Treasury 'orthodoxy'*, Institute for Government, 19 January 2024, www.instituteforgovernment.org.uk/publication/treasury-orthodoxy

- **At every fiscal event, the OBR should have greater flexibility** in its assessment of both the government's rules and its performance against them, with licence to consider progress against fiscal sustainability more broadly. Then, in each *Economic and Fiscal Outlook*, when assessing the government's performance on the fiscal rules, the OBR would spell out whether in its view announced policy was consistent not only with the letter of the rules but also with the government's broader fiscal strategy – that is, the spirit too. This would better enable it to call out practices such as gaming when deeming whether or not targets have been met.

- **Whenever rules are changed**, the OBR should assess whether they are consistent with the government's fiscal objectives – before they are voted on by parliament.

- **At the start of each new parliament, or again whenever rules are changed**, the OBR should produce a recommendation of how much headroom the chancellor should maintain against them, taking into account economic conditions and uncertainty.

- **Each set of rules should contain an 'escape clause'** making clear the economic circumstances under which they should – temporarily – be suspended, and the OBR should be given responsibility to assess when these conditions have been met.

Even in the absence of new legislation, there are still several changes the OBR could make to its analysis at each fiscal event, within its existing remit, including to:

- Place **more emphasis on uncertainty**, and the probability that rules will be missed or met, in the headlines of its fiscal analysis.

- Set out the **department-level implications of the government's pencilled-in spending plans** in more detail.

- Consider alternative presentation methods that **better capture the longer-term benefits of supply-side policies**, such as charts showing the expected effects of policies such as investment over a period of at least 10 years, even if the full forecast still only covers the next five.

Structure of the report

This report is arranged in three parts. First, we set out the case for a strong fiscal framework, and why fiscal rules – when well-designed – can play an important role within that framework. We then explore in detail the various problems with fiscal policy making we have identified, whether fiscal rules are to blame or what other problems have caused them. The report closes with recommendations for how to fix the UK fiscal framework.

A strong fiscal framework that includes fiscal rules can help improve policy

It is a natural inclination of governments to spend more and tax less – and thus borrow more – than is in the country's long-term interests. It is precisely this 'deficit bias' that motivated finance ministries across the world's developed economies, including the UK, to adopt formal fiscal rules and other improvements to fiscal policy making frameworks in the late 20th century.

There are three main reasons why governments exhibit deficit bias.[1]

1. The **electoral cycle** – which lasts a maximum of five years in the UK – incentivises the incumbent government to care more about short-term outcomes than longer term ones. Spending more and taxing less in the short term will often be electorally advantageous, since voters quickly see the benefits of these policies, while the costs – higher levels of public debt, requiring a greater share of future revenues to be devoted to meeting debt interest costs rather than other public priorities – take much longer to become apparent. Governments also have little incentive to be prudent and therefore allow their successors (who may be their political opponents) more fiscal capacity to spend.

2. There is a **'common pool problem'** among the different spending ministries within government.[*,2] Departments are focused on delivering their own objectives, and securing the up-front funds with which to do so, with far less attention paid to the costs – which will ultimately be borne by taxpayers. Every spending department faces this same incentive.

3. Governments tend to be (wilfully or inadvertently) **over-optimistic** about the growth prospects for the country and thus for future tax revenues. Basing spending plans on unrealistic expectations for future tax revenues can lead to an unintended accumulation of borrowing when tax revenues fall short, but spending has already been committed to.

Borrowing too much has costs in the longer term. For a given interest rate, a larger stock of debt means higher debt interest costs and thus more money from future taxes needing to be spent on this. Building up large volumes of debt can also make investors concerned about the government's ability to repay, if not outright 'spooking the market' as seen in the fallout from the disastrous September 2022 'mini-budget' then

* The classic example is fisheries, which, without some mechanism in place to prevent exploitation, will see stocks run down as fishermen compete with one another to catch the current fish but, in the words of one, have no long-term "incentive to conserve the fishery, because any fish I leave is just going to be picked by the next guy".

at least prompting lenders to demand a higher interest rate. High levels of government borrowing are also likely to drive up inflation, which will induce the Bank of England to raise the base rate in an effort to return inflation to target, the anticipation of which will typically feed through to higher government borrowing costs.

That being said, we do not argue here that there is some magic level of borrowing or debt that should be targeted at all points in time. There are legitimate reasons why a government may wish to borrow to fund certain types of spending. A recent report from the London School of Economics, for example, calls for "targeted and temporary borrowing to invest in sustainable technologies and infrastructure".[3] Fiscal rules and frameworks need not be a barrier to pursuing this kind of policy: rather they can be designed to support it while ensuring that borrowing and debt do not go beyond what is intended due to deficit biases.

Fiscal rules can help to counter deficit bias

As explicit limits for fiscal aggregates like spending, borrowing and debt, fiscal rules are a central (though not the only) plank of fiscal frameworks designed to counter deficit bias in many advanced economies. They can do this by acting as a signal and a commitment device.

Rules provide a signal to markets and the public

A primary rationale for the adoption of fiscal rules has been the signal it can send to financial markets. An excessive accumulation of government debt can raise future debt interest costs not only because there is more debt to service but also because investors may be more concerned about the government's ability to repay it and so charge a higher interest rate – what is known as a 'risk premium'.[*] One benefit of fiscal rules, therefore, can be to reassure investors that the government is committed to fiscal discipline and will repay their creditors in full, thus reducing the risk premium a country faces.[**] Investors in UK government debt may also be concerned that excessively expansionary fiscal policy (that is, borrowing large amounts of money even when the economy is operating at or above its sustainable level of output) would cause the independent Bank of England to raise interest rates to counter resultant upward pressure on inflation; that too would push them towards demanding higher interest rates.

International experience provides some evidence to support this. Analysis by the International Monetary Fund shows that countries in continental Europe that breach the European Union's fiscal rules and are subject to the excessive deficit procedure face relatively higher interest rates.[4] As we note below, fiscal rules are not the only focus of financial market participants, and other aspects of a framework could compensate for an absence of rules, but the presence of rules has historically reassured markets at least to some extent.

* For a country like the UK, which issues debt in its own currency and has not defaulted for centuries, the concern of investors is less about a future default and more about other actions that could reduce the value of the money that is ultimately returned to them – such as, the possibility of high inflation or currency devaluation.

** As summarised by Diaz Kalan, Popescu and Reynard (2018), there is a large literature that shows that the adoption of rules has led to a decline in interest rates relative to counterparts and a greater responsiveness of spreads to fiscal variables. Diaz Kalan, Popescu and Reynard (2018), 'Cost of not complying with fiscal rules: A European perspective', Second generation fiscal rules – background papers, IMF.

The clearest response in recent times of UK government borrowing costs to fiscal plans came in September and October 2022. UK government borrowing costs began to rise through the summer of 2022 as it became increasingly clear that Liz Truss, who was committed to large tax cuts, was likely to win the Conservative leadership contest. When she did, there was an even sharper rise in the cost of long-dated government bonds, which was closely related to the announcement of wide-ranging tax cuts by the chancellor, Kwasi Kwarteng (and subsequent comments by him and Truss), which undermined confidence that they were committed to fiscal discipline. They also sidelined, and were even aggressive towards, key economic policy institutions such as the OBR and Bank of England.[*,5] The apparent abandonment of fiscal rules as an anchor for long-term policy probably contributed to the crisis, although interviewees agreed the broader rejection of independent institutions (including a commitment to transparency around fiscal plans) was more important.

Fiscal rules also act as a signal to the public. The Labour Party in the 1990s had committed in opposition to adhering to a set of fiscal rules as a way of reassuring voters that it could be trusted as guardian of the public finances. This commitment aimed to address lingering concerns after the previous Labour governments of Harold Wilson and James Callaghan in the 1970s had presided over high levels of government borrowing – much like Rachel Reeves has done to date in the run-up to the 2024 election.

In every election since 1997, the fiscal rules and borrowing plans of the main UK political parties have attracted considerable attention, with the Conservatives, Labour and the Liberal Democrats all typically seeking to demonstrate that their manifesto promises are 'fully costed'. Even though in practice many of the fiscal rules have been suspended, abandoned and rewritten, the main political parties still appear to believe that they provide an important signal to the public and that there would be a political cost to abandoning them. Rival parties frequently try, for example, to discredit their opponents prior to elections by saying their plans 'do not add up'.[6]

Rules act as a commitment device for the government

As rules act as a useful signal for governments, once that signal has been sent, they impose some discipline on government fiscal policy. Fiscal rules are a key tool in the budget and spending review processes and, alongside the government's tax plans, help to set the overall level of government spending (its 'envelope'). The fiscal rules frame the fiscal policy options faced by the chancellor and prime minister, and generally the chancellor will ensure plans are consistent with the government being on course to meet its fiscal rules.

Chancellors do retain the option to break their fiscal rules, or to replace them with a more permissive set. As we highlight below, chancellors have not been shy of doing this in recent years. However, they have generally only done so when there has been a compelling narrative to justify the decision (for example, due to economic shocks like the global financial crisis and pandemic) and then typically replaced rather than

* Although UK government borrowing had also increased sharply during the pandemic and earlier financial crisis, Truss's fiscal plans were a choice rather than being forced on the government by external events.

abandon rules. Ideally, breaking rules or changing them to be more accommodative should come with political costs. The requirement to meet the fiscal rules – or explain publicly why they are on course to be missed – imposes a sharper discipline on chancellors than would be the case without them.

As well as constraining the chancellor's decisions, fiscal rules also provide a useful tool for the chancellor and Treasury officials in negotiations with spending departments – helping to overcome the 'common pool problem' described above. This mechanism underlines the importance of rules being based on a wider fiscal strategy.

Current and former Treasury officials, advisers and ministers emphasised to us in interviews for this report the importance of the fiscal rules in helping act as a 'line in the sand' in spending negotiations with other departments and their secretaries of state. In other words, they help the Treasury to force other parts of government to face necessary trade-offs and to prioritise among competing spending programmes. In practice, this occurs mostly through the setting of the envelope for public spending, which is a more credible 'non-negotiable' when it is set with reference to publicly stated fiscal rules.[*]

International evidence suggests that fiscal rules have tended to be effective at preventing countries from running large budget deficits, although they also make it somewhat less likely that governments run large surpluses as they permit higher borrowing than might be optimal while good economic conditions prevail.[7] There is also some evidence that stronger, well-designed fiscal rules do lead to lower levels of borrowing.[8]

Rules need to have certain properties to play this role well

The mere presence of a fiscal rule does not guarantee that deficit bias will be curbed. And fiscal rules can also pose other risks: the rules will inevitably be somewhat arbitrary and potentially reductive – with 'lines in the sand' being drawn off the back of a few fiscal variables when what constitutes good fiscal policy is very complex. We touch on some of the problems caused by this below. However, designing rules well can help to promote fiscal sustainability without promoting bad fiscal policy choices.

When designing fiscal rules to try to ensure fiscal sustainability, governments will seek the right balance between three competing design principles:[9]

- **Simplicity:** the rules should be comprehensible, easy to explain; it should be clear whether or not the government is meeting them. Simplicity also aids the extent to which these rules can be used by the Treasury to manage spending and budgets.

* UK fiscal rules have always related to the current budget deficit, borrowing or debt and so the 'spending envelope' is derived from these rules coupled with government tax plans. However, some other countries (such as the Netherlands) have explicit expenditure ceilings. A future UK government could choose this approach instead.

- **Flexibility:** the government should have enough space within the rules to respond appropriately to shocks.

- **Enforceability:** the rules should be designed in a way such that there is a sufficiently strong incentive to comply. Given that sanctions are hard to implement in the UK context because of a very strong executive,* it makes more sense to think of this as **credibility** in our context: are the rules and wider framework resilient to gaming by the government?

Flexibility is desirable but can reduce enforceability

Some degree of flexibility is essential to prevent dramatic and inappropriate short-term policy adjustments being made to meet the rules. Governments need space to respond appropriately to shocks – or, if there has recently been a major shock, they need time to adjust gradually back to a more normal policy stance. The OBR's average error in forecasting public borrowing one year ahead is £12 billion (0.5% of GDP):[10] that is a relatively small number in the context of annual public spending and revenues (which each total around £1 trillion a year), but it is a very large amount to suddenly take out of already allocated public spending budgets or to try to raise from a limited tax base. For these reasons, it is sensible for rules to be medium-term rolling targets, giving governments short-term flexibility while still requiring that fiscal policy be consistent with medium-term fiscal sustainability.**

In response to some shocks, the flexibility afforded by forward-looking rules may not be sufficient. Large shocks like the 2008 financial crisis caused permanent damage to the economy and required a prolonged period to return the fiscal position to something that was consistent with long-term fiscal sustainability. This prompted the first changes to the original 1997 rules, where the requirement to run a surplus on the current budget was replaced with a "temporary fiscal operating rule" to reduce the current budget deficit every year "until global shocks will have worked their way through the economy in full" in the 2009 budget.[11] To ensure the government can act appropriately in these circumstances, it is desirable that rules have 'escape clauses' that, when triggered, mean the rules are temporarily disapplied. This is preferable to changing or abandoning the rules as it maintains some consistency between the rules and underlying framework.

These two elements of flexibility are desirable, but they make rules less credible if the government inappropriately took advantage of this flexibility. For example, if fiscal rules only require that borrowing or debt conform to some target several years hence, governments could be tempted to announce regular short-term temporary giveaways, while pencilling in tax rises or spending cuts later on, and so never actually reach the deficit or debt target. We have previously described the spending plans currently pencilled in for after the end of the 2021 spending review period (from March 2025),

* Enforceability makes more sense in other countries where the executive can be sanctioned and constrained by other parts of government on fiscal policy issues. An example, discussed below, would be the way in which Germany's constitutional court is able to rule on the legality of the government's fiscal stance.

** Gordon Brown's golden rule for borrowing applied over the course of an economic cycle. This became problematic towards the end of the economic cycle when the government had very little time remaining to offset any overshoot in borrowing. In practice, Brown resorted to adjusting the dating of the cycle to make the rules easier to meet, rather than making major short-term adjustments to tax and spending plans.

to which Labour has also committed, as implausible and symptomatic of this sort of gaming.[12] This demonstrates the way in which the desirable properties of rules can be in conflict. Sets of fiscal rules attempt to balance these competing design principles to provide the government with suitably constrained discretion.

Simple rules are easier to monitor and enforce but may not ensure sustainability

This is most easily understood through the example of UK rules restricting debt. Ever since 1997, one of the UK's fiscal rules has related to a measure of public sector net debt (PSND). For example, Brown's sustainable investment rule required that PSND should remain below 40% of GDP, while the current fiscal rules require that PSND excluding the Bank of England (PSND ex) should fall as a share of GDP between the fourth and fifth years of the forecast horizon. In its November 2023 report, the OBR expected PSND ex to rise from 86.1% of GDP in 2022/23 to 93.2% of GDP in 2027/28, before falling slightly to 92.8% of GDP in 2028/29.[13]

PSND is a national accounts measure of public sector indebtedness, produced by the Office for National Statistics (ONS) and forecast by the OBR twice a year in line with the ONS's method. This makes it easy to monitor and gives limited scope for the government to adjust the definition to suit its own purpose.

However, the downside of PSND is that it is not a comprehensive measure of the government's assets and liabilities. In particular, PSND excludes long-term, illiquid assets (such as structures or long-term loans that will be paid back). This means that measured PSND can be reduced by selling long-term assets and converting them into cash, even though doing so may do nothing to improve fiscal sustainability (or could even worsen it if the asset was sold for less than it is worth). As a result, pursuing a simple measure risks a government targeting the letter of the rule in a way that may not achieve the ultimate aim of fiscal sustainability. We highlight several examples below including the sale of student loan debt, which helped to meet fiscal rules but was not positive for sustainability.

Fiscal rules can also be designed to guard against other consequences of short-termism

The design principles above are necessary to ensure fiscal rules help to promote fiscal sustainability and avoid deficit bias. But fiscal rules have also been used to try to help correct other consequences of short-termism beyond this.

One key feature of Brown's first set of fiscal rules was that it created a distinction between spending for investment and spending to meet day-to-day costs. One of Labour's criticisms of the previous Conservative government was that it had slashed capital spending during the 1990s because it was easier to do this than cut day-to-day spending, which the public would notice more quickly. But cutting capital spending stored up problems for the future.

Brown's 'golden rule', therefore, required that day-to-day spending be covered by tax revenues but allowed government to borrow for investment (as long as this was consistent with the 40% debt ceiling). This design was intended to ensure that Brown – and his successors – would no longer be able simply to cut capital spending as a politically easy way to reduce borrowing in the near term.

Of the eight other sets of fiscal rules that have been in place since the golden rule was abandoned in 2008, after the financial crisis, four have retained a distinction between capital and day-to-day spending (by targeting the current budget balance), while the other four (including the current set of fiscal rules) did not.

Other elements of the fiscal framework are also needed to facilitate good policy

Fiscal rules have tended to sit at the heart of the UK fiscal framework, and those of many other advanced economies. But rules on their own do not guarantee a strong fiscal framework that promotes good policy and fiscal sustainability.

Fiscal rules are not – on their own – a sufficient signal of credibility to markets

Financial market participants we spoke to for this project said that they take a nuanced view of fiscal sustainability. They are not fixated simply on the existence of rules and a simplistic assessment of whether the letter of them has been met but instead pay attention to whether there is a credible set of fiscal plans that support the achievement of fiscal sustainability.* Having a set of fiscal rules can contribute to this appearance of credibility but is not sufficient on its own. One interviewee noted that the frequency with which the rules have been rewritten in the UK in the past decade means market participants are now less familiar with the precise details of the current rules but nonetheless take a view on whether the government's wider approach to fiscal policy suggests a commitment to fiscal discipline.

Financial market experts we spoke to for this report were somewhat divided over whether it would be possible for the UK now to operate without fiscal rules without affecting perceptions of its fiscal credibility, having had them in place for a quarter of a century and now having a high debt level. All those that we spoke to suggested that investors would be concerned if a government abandoned rules if it seemed they were not going to be met. Some we spoke to, however, suggested that a new government may be able to avoid spooking financial markets if they came to power and – from the start – announced they would not have fiscal rules but put in place other measures that provided reassurance that they were committed to fiscal sustainability. In particular, it was felt that it would be important to have a clear commitment to adhering to tax and spending plans that would keep public borrowing and debt under control and to structures to create transparency and enable scrutiny of the fiscal plans.

* For example, in December 2023, Fitch cited the policy changes made in the November 2023 autumn statement as a reason for keeping the UK's credit rating on a negative outlook, citing the "uncertain prospects for fiscal consolidation". It went on to say: "Fitch considers that projected real expenditure cuts underpinning the fiscal consolidation strategy will be difficult to implement. The reformed fiscal rules provide significant flexibility to authorities to use projected fiscal space (against a rolling fiscal target) and come short of rebuilding the fiscal space utilised by successive shocks." www.fitchratings.com/research/sovereigns/fitch-affirms-united-kingdom-at-aa-outlook-negative-01-12-2023

Combining rules with independent fiscal watchdogs like the OBR is crucial to improving policy making

One of the most important elements of a fiscal framework is an independent watchdog that can provide an objective assessment of government plans and increase the reward for governments pursuing sustainable fiscal policy.[14,15] By assessing the rules independently and transparently, the OBR can ensure that governments can be held accountable even when rules are more complex. The OBR can also highlight where government actions might be consistent with the letter – but not the spirit – of the fiscal rules. Importantly, the OBR's broader commentary can assess how the government is ensuring compliance with its rule, highlighting practices that might appear inconsistent with sustainability, affecting the political narrative around fiscal policy and providing some check against egregious attempts to game rules.

George Osborne's motivation for establishing the OBR was, in his words, to "remove [from politicians] the temptation to fiddle the figures".[16] This was achieved by tasking the OBR with producing an entirely independent set of economic and fiscal forecasts, which are also the government's official forecast.[*,17] This imposes an additional check on the government, because it cannot massage the forecasts to remain compliant with their fiscal rules. Over the 13 years of the OBR's existence, there have been several instances of forecast downgrades that have been untimely for the government and forced fiscal action to remain compliant with rules. These would have been unlikely to have happened in the same way in the absence of the OBR and this remit if the Treasury determined the forecast.[18] Gordon Brown, for example, was accused of redefining the 'economic cycle' (a judgment that would now be in the hands of the OBR) in order to meet his 'golden rule'. At the time, one of this report's authors (then at the Institute for Fiscal Studies) argued that this action "may have undermined the credibility of the fiscal framework".[19]

Independent fiscal watchdogs may appear to make fiscal rules less necessary, and in cases like Canada, mentioned above, a watchdog is seen to strengthen a framework that has no explicit rules. However, the presence of rules can help to make the watchdog's role easier. What constitutes fiscal sustainability is inevitably a contested question, and ultimately the right path for overall fiscal policy is a political choice. Without an explicit statement of the government's fiscal objectives set out in a fiscal rule, a watchdog would need to develop its own framework, which would make it subject to claims of bias. Rules, or at least a clear statement of objectives from the government, help the watchdog to be firm in its analysis without appearing to breach political impartiality.

Broader policy making structures also matter

Rules and independent institutions are two key aspects of a fiscal framework. But other structures that affect how fiscal policy is made in government, which we also define as part of the fiscal framework, matter too. These include the process by which tax and spending policies are agreed within government and announced externally, such as budgets and spending reviews.

* Fiscal councils in other countries often produce forecasts, but the government will also produce its own.

When working well, fiscal rules help to crystallise the fiscal trade-offs facing the government to help make sensible choices over tax and spending. However, how well fiscal rules trigger these decisions depends on whether broader decision making tools – like spending reviews – are well aligned to the time period covered by fiscal rules. As we outline below, too often in the UK these decisions are not aligned. Fiscal events happen too frequently, making decisions less strategic. And spending reviews happen at irregular intervals and not always aligned to tax decisions. Delivering good fiscal policy relies on these internal processes working well, as well as external checks like rules and institutions.

It should also be emphasised that fiscal rules should be an output of a much broader and more comprehensive fiscal strategy. A certain level of debt (or target profile for debt over a limited time frame) is not an end in itself. The public finances should be managed in a way that helps government to achieve its overarching objectives, whatever those may be.

The government's broader fiscal objectives are likely to include preserving fiscal space to respond to future shocks, managing the proportion of public spending spent on servicing debt, and so on. These will need to be traded off against other potentially conflicting objectives such as investing in core infrastructure, such as that needed to enable the net zero transition. Government must first set out its fiscal strategy, saying how it wishes to trade these objectives off against one another, with implications for the levels of taxation, expenditure and borrowing that are required. This should then give rise to a set of rules that are consistent with this strategy such that deficit bias does not allow borrowing and debt to rise above what is intended. The fiscal rules could simply specify limits for debt and borrowing or current budget balance (as has typically been the case with previous UK fiscal rules) or they could also specify targets for particular types of spending (as some other countries do).

Fiscal policy has been beset by persistent problems

The experience of fiscal policy in the UK since the advent of fiscal rules has been chequered. Rules have certainly not been a panacea leading to flawless fiscal policy making, and they have been blamed by a variety of commentators for worsening the quality of fiscal policy decisions, or at least being the root cause of some questionable ones.

We have identified six problems with how fiscal policy has been made in recent years. Each of these has been blamed on fiscal rules by commentators: some fairly, others less so. But all are genuine problems that need to be addressed through improvements to the fiscal framework.

Inappropriate macroeconomic stance: a lack of focus on the macroeconomic role of fiscal policy

Some have argued that fiscal rules have led governments to take an inappropriate overall fiscal stance.[1] In particular, for much of the period from 2008 to 2021 the economy was operating below capacity and interest rates were near zero. In those circumstances, there was a strong economic case that – with monetary policy having in effect exhausted its firepower – fiscal policy should have stepped in more decisively to support demand.[2]

Fiscal rules generally focus on the need to keep fiscal aggregates within certain limits, and often do not account for the role fiscal policy plays in managing the demand-side of the economy. In standard macroeconomic frameworks, this is considered appropriate because monetary policy is thought to be the more effective *primary* tool for demand management.[3] But this ceases to be the case when interest rates are at or near the 'zero lower bound', as they were for over a decade following the financial crisis.

This is a legitimate critique of some fiscal rules but is again not an inevitable result of rules themselves. Rules can include an 'escape clause', which means they can be temporarily suspended when macroeconomic conditions worsen and fiscal policy needs to step in to play a demand management role. In fact, in the early 2010s the UK's rules were disapplied for several years and so did have this flexibility. And the current set of fiscal rules only need to be met in the fifth year of the forecast, which also provides sufficient flexibility for large temporary fiscal support to manage demand.

Short-termism: underspending on areas that pay off beyond the forecast horizon

Other criticisms of (some) fiscal rules centre on their incentivising short-termism, in the way they impel governments approach tax and spending.[4] In particular, rules place limits on fiscal aggregates in the short or medium term – at most the next five years – meaning they can be met by taking decisions whose short-term benefits mask their potential to actively harm the economy and the government's fiscal sustainability in the longer term. This might include, for example, cuts to capital spending or other spending that might yield long-term benefits beyond the five-year forecast to get the deficit down or debt falling as a share of GDP.

While critics are right to identify short-termism as a problem, fiscal rules alone are not the reason politicians underinvest in capital or other preventative spending that might pay off in the long term. This is a long-standing behaviour that was apparent before fiscal rules. Indeed, it was the low level of public investment by the Conservative government in the early and mid-1990s that led Gordon Brown to introduce a distinction between capital spending and day-to-day spending in the framing of the UK's first set of fiscal rules in 1997. Some rules help to counteract this behaviour – for example, by targeting aggregates that exclude capital spending – while others (including the current set) do not.

Arbitrariness: policies can be designed to fit the rules at the expense of other valid considerations

Fiscal rules have also been blamed for driving seemingly arbitrary smaller policy decisions. A notable recent example of these incentives playing out in practice was the decision at the March 2023 budget to introduce more generous deductions from corporation tax for business investment (known as 'full expensing'), but only as a temporary three-year policy, rather than a permanent change. This meant that the policy did not cost any money in the fifth year of the forecast, which was the crucial point at which the government's debt rule was binding.

But, by making the policy temporary, it was likely to have a very different effect than if it were permanent. A temporary change in expensing rules would have been likely to bring forward investment but not to change companies' *overall* level of planned spending, whereas a permanent policy change would be expected to permanently boost the economy-wide capital stock – recognising this, the policy was eventually made permanent in the November 2023 autumn statement. The chancellor originally announced the policy as a way to address "lower business investment" to tackle low productivity, but the policy as first announced would only have done this temporarily and as such would have been unlikely to have a lasting effect on productivity.[5] This is just one example where policies appear to have been modified to meet the fiscal rules, but with possible adverse consequences for the effectiveness of the policy or the meeting of broader government objectives.

This apparently arbitrary decision making is problematic, but the line does need to be drawn somewhere. While exceeding the government's stated fiscal stance by a few billion pounds would not make a big difference to fiscal sustainability, there are countless other policies where a similar argument could be made. This was the justification, outlined earlier, for having fiscal rules in the first place. The rules themselves did not force the government to water down the policy: the government could both have committed to its fiscal rules and decided it wanted to adopt the expensing policy permanently by changing some other policy on tax or spending that it deemed less valuable or less worthwhile than this one. The decision the government made – making the policy temporary – seemed arbitrary. But the decision implicitly underlying that was that this policy was less worthwhile than all other spending or tax reliefs or prospective tax rises that could have freed up the required amount of money.

This policy error principally reflects incremental policy making. The government failed to take a more strategic approach, reviewing other existing policies that might have been worse value for money, and instead focused only on how new policies could be watered down to remain within fiscal constraints.

Gaming: making changes that appear to improve the targeted fiscal measures without strengthening underlying sustainability

Some fiscal rules – in particular, those concerning debt – are prone to being gamed by policy makers. The measure of debt generally used for the UK's fiscal rules (public sector net debt, PSND[*]) excludes some of the assets – including long-term financial assets – held by the public sector. For example, PSND does not include the value of shares the government might hold in private companies (such as the banks that were rescued during the financial crisis), or other income-bearing assets like the student loan book. This means that governments have been able to 'reduce debt' simply by selling off these assets – since once the assets are sold the cash generated *is* then captured in the measure of debt, as cash is counted as a short-term financial asset.

Economically, an asset sale strengthens the public finances only when the asset is sold for more than it is worth. An asset sold for a fair value neither strengthens nor weakens the public finances, while selling an asset for less than it is worth actively weakens them. However, due to the above classifications of what is and is not captured in debt calculations, even selling an asset for less than it is worth reduces measured net debt. A prominent example of this was the sale of the student loan book for less than it was worth in 2017.[6] George Osborne, the chancellor at the time, had also relied on sales of shares in Royal Bank of Scotland and Lloyds Bank to meet an earlier debt-related fiscal rule.[7]

The use of private finance initiatives to fund new public investment during the New Labour era (PFIs, for example in schools and hospitals) represented another sort of gaming. The way these contracts were drawn up meant that the initial building cost was not added to recorded public debt even though it was ultimately a more expensive way to finance the projects.[8]

* To be more precise, the government's current fiscal rule refers to PSND excluding the Bank of England.

All rules will come with some risk of gaming if a government is so inclined, but some are much more vulnerable to this than others. Public sector net debt measures are particularly vulnerable: net debt is improved by asset sales, and affected by other changes in the cash position of the government's finances that may not reflect the true economic position. Rules that require a stock measure like debt to fall between two years in the future are particularly prone to being met through gaming rather than genuine actions to improve fiscal sustainability. In general, 'flow' measures like public sector net borrowing are less prone (but not immune) to gaming.

Fiscal 'fine-tuning': abrupt policy changes are made in response to highly uncertain forecasts

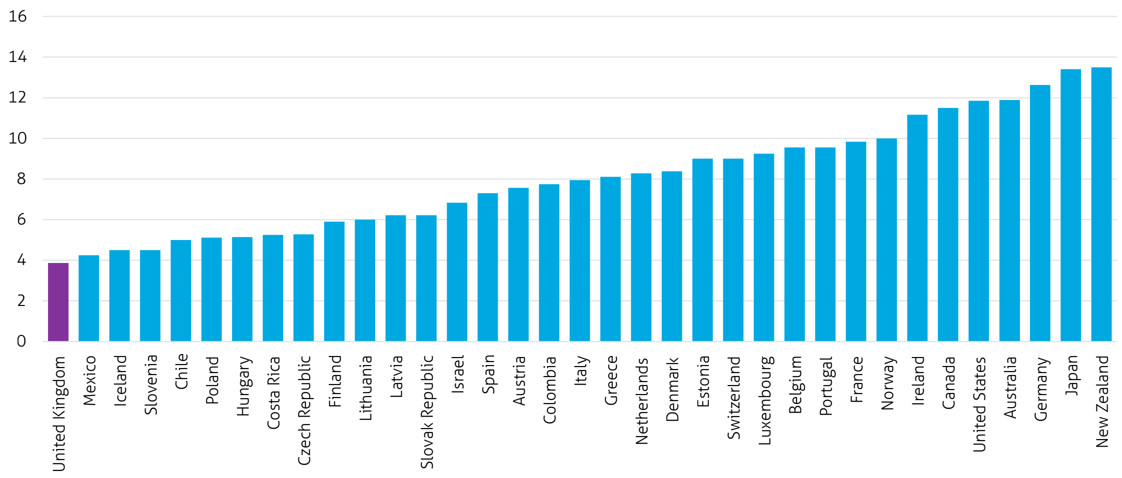
As we highlighted above, there are good reasons to have forward-looking rules. However, the forecasts on which such rules inevitably rely concern the future path of tax revenues and spending, which in turn depend on how the economy performs and several other highly uncertain assumptions. The OBR has a better forecasting record than the in-house Treasury forecasts that preceded it.[9] But even so, outturns will often inevitably differ from forecasters' central view by large margins. Relatively small changes in the outlook for spending or tax can have a large effect on forecast borrowing, or changes in debt, as those figures are the difference between two very large numbers. As a result, governments that try to calibrate their plans very precisely to achieving their fiscal targets (or retain a given amount of headroom against those fiscal targets) will often end up responding to every forecasting change with new offsetting spending or tax announcements – in the current era, twice a year – even though the forecasts might then move back in the opposite direction months later. We call this '**fiscal fine-tuning**'.

This sort of behaviour is especially problematic because the way governments have responded has not tended to be symmetric. The Institute for Fiscal Studies (IFS) has shown that chancellors have tended to give away most of the 'good news' when forecasts have been revised upwards but to consolidate only partially when forecasts are revised down.[10] This leads to borrowing systematically overshooting original plans and to debt ratcheting up more than initially intended.

Governments have tended to retain relatively low headroom against fiscal rules, treating them more as a target than an upper limit for borrowing or debt. This is a risk of having fiscal rules that the IMF has identified: while the presence of rules is associated with lower borrowing in challenging times, it can also be associated with smaller surpluses in good times (called the 'magnet effect').[11] In other words, fiscal rules do not encourage governments to run tighter fiscal policy when growth is high and in fact may even encourage governments to loosen policy at those times.

When the fiscal outlook has deteriorated, low headroom has meant governments have been forced to announce policy changes to avoid breaching their fiscal rule or, more drastically, to abandon the rule entirely – as has happened repeatedly in the UK since 2010. While, like other countries, the UK enshrines its rules in legislation, the strong executive in the UK system means that it has, in practice, been easier for UK governments to abandon and replace rules. The UK has changed its rules much more frequently than many other countries and has the shortest average duration of its fiscal rules internationally.

Figure 1 **Average lifespan of fiscal rules in different countries (years)**



Source: Institute for Government analysis of International Monetary Fund, Fiscal Rules Dataset 1985–2021. Analysis was performed on all OECD member countries for which data is available.

Since 2010, UK governments have exhibited the pattern of spending good fiscal news to keep headroom mostly unchanged, and only sometimes making policy tighter when the situation deteriorates, in other instances abandoning fiscal rules. As the fiscal outlook has deteriorated much more than it has improved, borrowing and debt have ratcheted upwards compared to what might have happened if policy was adjusted less frequently in response to forecast changes.* This poses a risk to fiscal sustainability.

Fine-tuning contributes to, and is a symptom of, the UK's incremental rather than strategic approach to fiscal policy. It is exacerbated by holding multiple fiscal events per year, which creates more opportunities – and incentives – for the chancellor to fine tune policy in response to a new forecast.** This also squeezes the amount of time the government has during the year to step back and think about its fiscal strategy: it steers them towards preparing for the next fiscal event, and what incremental changes it will make then, rather than the bigger picture.

* The IFS estimates that public sector net debt on the eve of the pandemic was between 3% and 11% of GDP higher than it would have been had governments over the preceding decade responded symmetrically to forecast upgrades and downgrades, Emmerson C, Stockton I and Zaranko B, 'Chancellors' responses to economic news', *Green Budget 2023*, Institute for Fiscal Studies, September 2023, https://ifs.org.uk/publications/chancellors-responses-economic-news

** For example, in his November 2023 autumn statement (allegedly not a full fiscal event), Chancellor Jeremy Hunt proudly announced "110 growth measures", Hunt J 'Autumn Statement 2023 speech', GOV.UK, 22 November 2023, www.gov.uk/government/speeches/autumn-statement-2023-speech

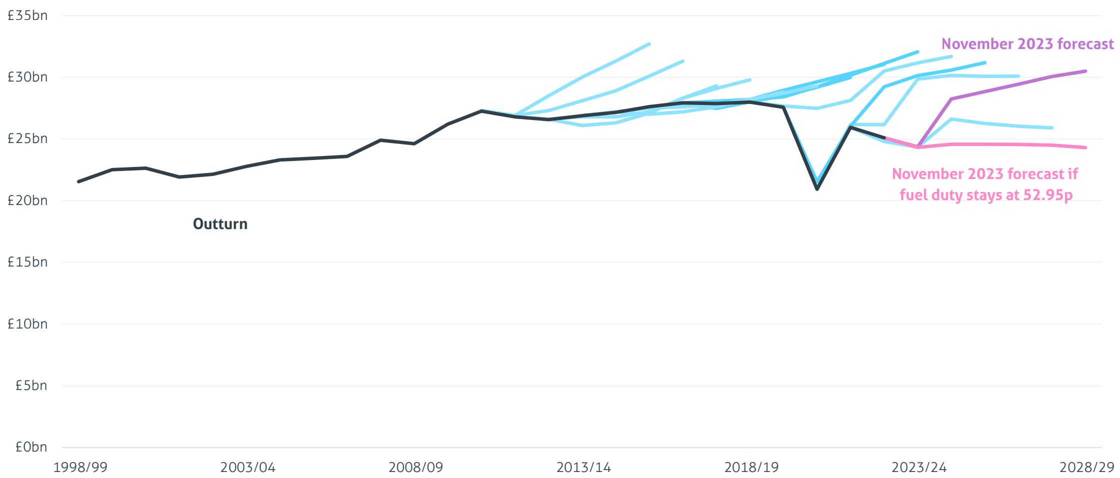
Fiscal fiction: governments have systematically pencilled in unrealistic future policies

Depending on the exact timescale covered, forward-looking rules have also allowed governments to avoid consequential fiscal decisions in the face of unflattering forecasts by instead 'committing' to future policies that are unlikely ever to be delivered. This is most easily done with departmental spending. Beyond spending reviews (which ordinarily set firm spending plans for departments for three or four years), the figure for total departmental spending the OBR uses in its forecasts is simply whatever the government says it will be. But in the absence of specific budget allocations for each department, this assumption is not especially meaningful. This creates a **fiscal fiction**: the government is forecast to meet its targets only on the basis of unrealistic policies that will never be implemented in reality.

In recent years, governments have pencilled in tight spending plans beyond spending reviews, helping them to appear to be on course to meet fiscal rules. However, at later spending reviews – when the chancellor needed to make difficult decisions about how to allocate the money – those spending plans were then topped up.[12]

A similar incentive also exists on tax. The OBR includes in its forecast assumptions about how the rates and thresholds for individual taxes will change in future, based on stated government policy. Fuel duty is an especially egregious example. Since 2010, the assumption in the forecast (as based on what successive governments have claimed will happen) is that fuel duty will increase in line with inflation in each future year[13] – however, in reality in every single year since it has been frozen or even cut in cash terms, undermining two decades of forecasts and allowing governments to boost revenues in future years, creating the useful illusion that they are on course to meet the fiscal rules. Figure 2 shows how the fuel duty collected by government has repeatedly fallen well short of OBR forecasts because of this behaviour.

Figure 2 **Fuel duty revenue at successive spring forecasts, 2011–2023**



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2023, Chart 4.6.

This causes two related, major problems with how fiscal policy is made. When a 'pencilled in' policy needs to be delivered, and proves to be undeliverable, the government increases spending or reduces taxes in the short term (for example, by topping up spending plans or announcing a further one-year freeze to fuel duty). Systematically, therefore, the government tends to deliver policy giveaways in the short term, while announcing unrealistic never-to-be-delivered tax rises or spending cuts in the longer term. This is another risk of forward-looking rules in the UK's current policy framework and is a risk to fiscal sustainability: even if a government is 'on course' to have debt fall, that need never be achieved in reality.

Figure 3 shows how pronounced this pattern has been. Over the 13 years from November 2010 to November 2023, there have been 27 forecasts published by the OBR. On only four occasions did the government announce measures to cut spending or raise taxes overall in the first year of the forecast; on the other 23 occasions, policy was loosened for the first year, with the average change across all 27 occasions being a 0.31% of GDP loosening, equivalent to £8.4bn in today's terms. Looking at the second year of the forecast, policy was tightened on only five occasions, compared to 21 loosenings, the average change being a 0.17% of GDP loosening, or £4.6bn in today's terms. In contrast, governments tightened policy in the fourth year on 15 occasions (with an average change of a 0.06% of GDP tightening, or £1.5bn), and in the fifth year on 14 occasions (with an average change of a 0.18% of GDP tightening, or £5.0bn).*

Figure 3 **Effects of policy on borrowing in different years of OBR forecasts, November 2010 to November 2023**

Source: Institute for Government analysis of Office for Budget Responsibility, Forecast revisions database, March 2023. Note: A number greater than zero represents an increase in the deficit as a result of policy; a number less than zero represents a decrease. Year 1 is counted as the first full financial year after the forecast date.

The ability to pencil in unrealistic policy also means the government avoids grappling with major fiscal trade-offs. As demands on public services grow, the government will need to spend and tax more, or offer less. Pencilling in tight spending implicitly means it has chosen to offer less in terms of the quality and scope of services, but without needing to provide any detail of what that might look like in practice. As the Institute

* Source for calculations in this paragraph: Institute for Government analysis of Office for Budget Responsibility, Forecast revisions database, March 2023.

for Government's *Performance Tracker* analysis shows, most major public services are performing worse than they were before the pandemic and are struggling to maintain the scope and quality of their services (with, for example, large backlogs of cases in the criminal courts and hospitals) and it is implausible that the budgets allocated beyond the next election will be sufficient to meet the government's apparent aspirations.[14] Maintaining the fiction that these spending plans will be delivered without acknowledging what reduction in service will be accepted to make this possible worsens the quality of fiscal debate and enables and encourages incremental policy making.

Our fiscal framework is not working

Our analysis shows that the status quo is not sustainable. Our current fiscal framework is incentivising bad policy decisions while not doing much to promote fiscal sustainability. All of the problems outlined above have happened at a time when UK governments have had fiscal rules at the heart of their fiscal framework. But this does not mean that the rules themselves caused all the problems. The incentives from electoral politics – for example, the tendency towards short-termism and pencilling in unrealistic policies, which push problems into the future – are as much to blame for some of these problems as Treasury rules. Other poor behaviours, like the tendency to adjust policy in response to highly uncertain forecasts and making seemingly arbitrary decisions, do appear to be encouraged more directly by the presence of rules but are also worsened by weaknesses in the broader fiscal framework.

The past decade or so has been a challenging period for fiscal policy. Since the financial crisis, the economy has performed much worse than official forecasts anticipated. Initially, the OBR – along with most other forecasters – expected the economy to return to its pre-crisis growth rate of a little over 2% per year within a few years. However, this has failed to materialise – in part because of a series of further shocks from uncertainty created by the UK's Brexit vote, the pandemic and recent energy price rises – and as a result the outlook for the economy and the public finances has been serially, and substantially, downgraded.

This has meant revenues being lower than expected and borrowing and debt higher than planned. Governments have had to respond to this. Fiscal rules are the mechanism through which they have been confronted by difficult trade-offs between tax, spending and borrowing – but the rules did not create these trade-offs. Nonetheless, the fiscal framework operating throughout that period – the rules and the rest – has been found wanting. Our recommendations set out how to go about fixing it.

How to strengthen the UK's fiscal framework

Fiscal sustainability is an important objective for government. To ensure the wellbeing of current and future generations of UK residents it is vital that governments do not bequeath unsustainable fiscal plans to their successors. In this the state of the public sector balance sheet and the growth prospects of the economy that are being passed on are as important as the deficit itself.

But there are many incentives and pressures in the real world that mean governments can struggle to do this. Many of the problems laid at the door of fiscal rules arise from the fact that the amount of revenue being generated by the tax system is fundamentally insufficient to pay sustainably for all the public spending that voters have become accustomed to and appear to want – even though tax revenues are at a historically high level relative to GDP. This is a result of the well-documented upward pressures on health and welfare spending. These have existed for some time but are currently being compounded by calls on government to spend more on public investment.

Accommodating increased spending on health in the past has been partially enabled by falling spending on debt interest and defence: the trend for both has now reversed.[1] A strong fiscal framework and well-designed fiscal rules can help to overcome the incentives politicians face to duck these difficult questions and this can improve the quality of fiscal policy making.

Some countries – like Canada – operate without explicit fiscal rules, instead following more loosely defined fiscal sustainability objectives. In principle this may seem an attractive way of avoiding some of the problems described above that have been associated with fiscal rules. But in practice these broader objectives end up being used in a very similar way to fiscal rules.

The Canadian government adopts what it calls a 'fiscal anchor', defined at its 2023 budget as an objective to reduce federal debt as a share of the economy over the medium term (five years). In its reports,[2] the Canadian Parliamentary Budget Officer (PBO) appraises the likelihood that the government will meet this objective. This looks very much like a fiscal rule and shows that, even in the absence of formal rules, governments will anyway need to set out what their objectives are for fiscal policy and will face political costs if these are not met.

In the words of one academic expert on fiscal frameworks:

> **"If you think fiscal rules are a waste of time, tell me how you would conduct fiscal policy. Your answer is an implicit fiscal rule. Fiscal rules are a useful way of talking about good and bad fiscal policy in this very imperfect world."**[3]

While, in principle, a government operating without fiscal rules could take a more sophisticated and nuanced approach to fiscal policy, given political incentives we conclude that simply abolishing fiscal rules would not lead to a marked improvement in fiscal policy.

What we do strongly believe is that **governments should have an overarching fiscal strategy that is much greater than a set of rules**. In thinking about how to conduct fiscal policy, ministers should be considering its role in macroeconomic management, responding to crises, driving investment, supporting long-term economic growth and so on. Developing such a strategy, and ensuring its consistency with government's other priorities, should then lead to a set of principles around how much a government is willing to tax, spend and borrow, and for what purposes. Fiscal rules – targets for fiscal aggregates over the medium term – should then drop out of this overarching strategy and ensure that deficit bias does not allow debt to rise beyond what the government intends via the mechanisms we describe above.

Rather than being considered solely the fault of fiscal rules, many of the problems with fiscal policy making should instead be attributed to successive governments' strategies of trying to cope with a deteriorating fiscal position in an incremental way, by freezing a tax threshold here and chipping away at a capital project there, rather than taking bigger, strategic (but probably unpopular) decisions proportional to the scale of the problem. Certainly, from the outside, it appears that fiscal rules have become government's fiscal strategy, rather than being tools with which to implement it.

It is the broader fiscal framework – the architecture around how decisions are made – that has enabled this to happen, alongside a strategic weakness in the centre of government (on which our report on Treasury 'orthodoxy', and forthcoming report of the Commission on the Centre of Government, have much more to say). Given that our main contention is that the problems documented above are due to broader issues with the fiscal policy making framework rather than the existence of a particular set of rules, that is where our recommendations are centred.

The framework should encourage slower and more strategic decision making

One of the major errors we identified with fiscal policy making was 'fiscal fine-tuning' – regular changes to policy in response to uncertain forecasts, and an accompanying unwillingness to meet fiscal rules by too wide a margin. We also identified that gaming of rules by taking advantage of quirks in accounting rules often undermines wider fiscal objectives and reflects the incremental, rather than strategic, approach that has too often characterised fiscal policy in recent years.

A single fiscal event would allow the chancellor, Treasury and rest of Whitehall to think more strategically

The UK government makes major fiscal policy announcements twice a year. On the face of it, whether to have one or two major fiscal events may seem trivial. However, more fiscal events clearly results in more ad hoc changes than there otherwise would be, because for chancellors an opportunity to stand up in the Commons and make announcements is hard to resist. But this poses a risk for fiscal sustainability because it encourages those chancellors to respond asymmetrically to forecast improvements and deteriorations. The IFS estimates that holding only fiscal event per year would be expected to reduce the deficit by £4bn per year on average in today's terms if stuck to for a period of five years.[4] Perhaps even more importantly, it crowds out strategic thinking, consuming more of Treasury officials' time on short-term questions over how to tweak policy at fiscal events rather than overall fiscal strategy.

This view is shared by many within the Treasury itself. John Kingman, the Treasury's former second permanent secretary, said in a 2016 speech that:

> "I do think one must concede that there have been some gimmicks over the years, including some that have been expensive and wasteful. It is also true that the nature of the Budget and Autumn Statement/Pre-Budget Report processes creates pressure for these."[5]

It should be noted that Treasury officials, in the words of a former official we interviewed, "hate gimmicks". Yet its processes create incentives to produce them. One example is tweaks to the tax system. The Treasury tends to have a preference for a simple tax system, yet the UK's has become increasingly complex over the years.

The chancellor should re-commit to a single fiscal event per year in normal times, as his predecessor Philip Hammond did, and his opposite number on the Labour benches Rachel Reeves has said she would do. This would still provide flexibility for a chancellor to announce emergency measures when required, as happened during the pandemic and 2022 energy crisis, but the default would be just a single budget each year.

Several chancellors have begun their tenure with just such a commitment, including Gordon Brown and George Osborne. Over time, however, pre-budget reports, or spring and autumn statements that were intended to merely 'update the house' on progress and announce policy consultations morphed into full fiscal events. To help make the commitment credible, **the chancellor should set out firmly that, in normal circumstances, no policy at all will be announced at the 'second fiscal event'**, and there will be no scorecard of policies (that is, no list of policies with their costings produced by the Treasury). This would make it easier to identify when the commitment has been broken than if the chancellor allowed 'small' policy announcements at those events, which would make their slow creep into full-blown fiscal events inevitable.

If another chancellor commits, but fails to maintain, a single fiscal event per year, further reforms might be necessary. It is useful to have an updated economic forecast from the OBR twice a year. But the publication of a new forecast makes it tempting for the chancellor to announce policies too. **The Charter for Budget Responsibility could be changed to require the OBR to produce a minimum of one forecast per fiscal year, rather than two.** The Treasury would still be able to monitor and model itself how wider economic changes are affecting the fiscal position: the department has previously insisted that it retains a strong macroeconomic modelling capacity[6] and the model used to produce OBR forecasts is jointly owned by the Treasury's economists.[7]

External researchers, including the Institute for Government, do benefit from having regularly updated official government forecasts, but receiving them less frequently might be a price worth paying for better fiscal policy (and regular forecasts from other sources such as the Bank of England and external research institutes should suffice).

Rules should be designed to encourage tighter fiscal policy in good times

One of the negative consequences of fiscal fine-tuning is that governments almost always use up any improvement in fiscal headroom from an improved fiscal forecast, but do not tighten policy by as much in response to bad news.[8] Debt will also ratchet up over time if governments legitimately make use of escape clauses and forward-looking horizons to respond to shocks like the financial crisis or coronavirus pandemic (described in more detail in the next section).

To compensate for these effects, the fiscal framework needs to ensure that governments 'offset' this in good times.[9] The UK's current set of fiscal rules does not do this. Governments would need to stop running fiscal policy so close to the wire at every fiscal event and have enough headroom against their fiscal rules so that a buffer is built that can be used to respond to unanticipated shocks.

To achieve this, fiscal rules should be designed in a way that explicitly incorporates the expected effects of future shocks and responses to past shocks. One possible approach to this would be to change how rules are written to account for the likely impact of future shocks: that is, setting more binding constraints in normal times.[*] The Netherlands takes a different approach, which we favour, appointing a 'Study Group on Fiscal Space' at the start of each parliament that, on the basis of its analysis of potential fiscal risks, advises the government on how much headroom they should maintain against their fiscal rules to be confident that they will not need to be broken.

The Dutch approach should be applied in the UK. **The chancellor should change the OBR's charter such that, whenever new fiscal rules have been approved by parliament and at the start of each new parliament, the OBR produces a recommendation of how much headroom the chancellor should maintain against them.** Analysis of this type is, of course, already produced by Treasury officials privately advising the chancellor, but having it in the public domain would make it much easier, politically, for the chancellor to resist pressure to run fiscal policy so close to the wire.

* The Tony Blair Institute, for example, proposes that governments should set themselves a long term debt objective several decades into the future. The OBR should then calculate a short-term deficit target consistent with achieving that long-term objective, taking account of factors such as expected economic growth and borrowing costs. If this projection also built in expectations of future shocks, it would mean that the short-term deficit target is consistent with building up fiscal buffers for future shocks. Browne J and Mulheirn I, 'Fiscal Rules, OK? Managing the Public Finances After Covid-19', Tony Blair Institute for Global Change, 2021, www.institute.global/insights/economic-prosperity/fiscal-rules-ok-managing-public-finances-after-covid-19

The OBR and Treasury should place more emphasis on uncertainty in how they set targets and monitor performance against them

A related issue that seemingly contributes to the 'fine-tuning' problem is that targets are expressed as 'point estimates' – there is a very precise level of debt or borrowing that defines where governments meet or breach their fiscal rules. This can mean that, at any fiscal event where there is a forecast change (as is always the case), there is an incentive for chancellors to fine-tune tax and spending to meet the objective – or, rather, to meet it with a certain amount of 'headroom'.

The issue is not that government is adjusting policy to meet fiscal rules: if this was not happening the rules would clearly be ineffective. Rather, the problem is that policy is adjusted too frequently to meet rules with an undue level of precision. Adjusting policy once every six months to meet a very specific fiscal rule, when, in many cases, the size of the policy adjustment is no larger than a reasonable margin of error on the fiscal forecast, is one of the reasons that fiscal policy choices can seem arbitrary. There are two possible ways in which this problem of excessively frequent policy tinkering in response to uncertain forecasts could be addressed.

The OBR and Treasury should place more emphasis on the *probability* that chancellors will meet or miss their fiscal rules, rather than a 'tick or cross' model. The OBR has undertaken considerable work to improve its analysis and communication of uncertainty in its economic and fiscal forecasts.[*,10] But its reports still focus on the point estimates: the fan charts it produces did not appear until page 135 of the March 2023 *Economic and Fiscal Outlook.* **The charter should be adapted to allow the OBR to make a more subjective assessment of performance against fiscal rules and the likelihood of them being met: its current form necessitates the pass/fail nature of the OBR's judgment.** This would allow the OBR to place more emphasis on uncertainty.[**] There is evidence that presenting quantitative information about the range of uncertainty around point estimates does help to improve users' understanding of the uncertainty.[11]

To support this move away from pass/fail assessments of government performance against fiscal rules, which often imply an illusory[***] level of precision, **the Treasury should specify rules as target ranges rather than point estimates**. A Resolution Foundation report,[12] for example, calls for an "aim to achieve a cyclically adjusted public sector current balance of +1 per cent of GDP and no less than -1 per cent of GDP" over a fixed period.

* The OBR's reports make use of various methods such as fan charts (based on simulations drawing on historical experience), sensitivity analysis (looking at how variations in key variables such as growth and interest rates affect the forecast) and alternative scenarios (based on different types of economic and fiscal shocks). Since 2021, it has also been able to carry out stochastic simulations of the sort necessary to conduct debt sustainability analysis as recommended by the IMF.

** An instructive example of a different approach that takes emphasis on uncertainty more seriously is exemplified by Canada's Parliamentary Budget Officer (PBO). In their pre-budget reports their 'headline' measures of performance against fiscal rules are provided as probabilities rather than focusing on the estimate from a central forecast.

*** We describe this as an illusory level of precision because of the level of uncertainty inherent in predicting whether governments will meet their fiscal rules or not. This is because economic forecasts are uncertain. Data revisions also lead to substantial movements in the measured ratios of debt and deficits to GDP.

We acknowledge that these changes are unlikely to be transformative: even when there is a range, politicians and commentators will be tempted to fix on a single point (either the centre or upper end of the range) for ease of communication. However, having uncertainty feature more prominently in fiscal debate should help to temper some of the tendency towards fine-tuning and obsessing over a single number. To communicate the uncertainty in a more relatable way, the **OBR should continue making use of scenarios representing different narratives for outcomes that differ from the central forecast** in addition to greater use of probabilities. Using scenarios can help to explain more clearly (than with fan charts alone) what circumstances may cause outturns away from the central forecast.

The OBR should have more freedom and flexibility in assessing fiscal rules and performance against them

As we describe above, governments at risk of not meeting their rules often engage in 'gaming' to meet them. Some rules are easier to game than others and rules covering changes in debt between two years have proved especially easy to game in the past. However, none are immune. Governments that are determined to meet the rules through an accounting trick rather than a policy change genuinely consistent with their fiscal objectives will, at least on a small scale, be able to do so.

The OBR's role with respect to fiscal rules, as set out in the Charter for Budget Responsibility, is to assess the government's compliance with those rules. However, this leaves little room for the OBR to comment on the quality of the rules themselves and whether those rules, and the ways they are being met, is consistent with fiscal sustainability. When fiscal fiction and gaming are so central to a government meeting the letter of a fiscal rule, there is nothing in the OBR's explicit remit to identify that it is doing so without meeting the rule's spirit.[13]

As the OBR has become more established, it has grown in confidence and its commentary within its *Economic and Fiscal Outlooks* has more explicitly identified ways in which the government is meeting its rules. For example, the March 2016 publication included an extended list of the various measures – including accounting tricks – that ensured the government appeared on track to meet its rules.[14] And more recently, the OBR has indicated whether the government would still be compliant with its rule if fuel duty were frozen rather than increasing in line with inflation and laid out the consequences of pencilled-in spending plans beyond the next spending review for unprotected spending areas.[15] Through its long-term assessments of fiscal sustainability,[*] it is also able to highlight the myriad fiscal pressures facing the government in future that they are not currently addressing.

However, the OBR's remit is still constraining. As we have highlighted, the current fiscal rules are imperfect, but the OBR is not in a strong enough position to point this out. And identifying 'gaming' or other questionable means of meeting rules in commentary is not as powerful as the OBR having a formal statement on whether the government's

* Since 2011 the OBR has produced *Fiscal Sustainability Reports*, setting out long-term (50-year) projections for key fiscal metrics. In 2016 it also began to produce reports on key fiscal risks. Since 2022 these have been combined into an annual *Fiscal Risks and Sustainability* report.

approach to the public finances is, in the OBR's judgment, sustainable. While this concept is inherently subjective, there are relatively objective means by which the OBR could assess it with reference to key indicators factoring in the plausibility of stated government policy.

Rather than proposing a new set of rules, our favoured solution is to **give the OBR greater flexibility in its assessment of both the government's rules, and its performance against them, by modifying the language in the charter**. This does not require that the OBR develop its own definition of fiscal sustainability, but instead it should highlight where the government's policies may not meet its own definition.

Whenever rules are changed or adapted the OBR should assess whether they are consistent with the government's broader fiscal objectives before they are voted on by parliament. For example, the current debt rule is clearly intended to force government to make the choices necessary to reduce public debt. This ambition is so significant for the current government that it is one of the five pledges Rishi Sunak set out upon becoming prime minister. However, the rule currently in use is particularly susceptible to gaming: all that is required for the current debt rule to be met is that debt is forecast to fall relative to GDP between the fourth and fifth years of the forecast. The rule is rolling such that it only ever needs to be met in forecasts not in reality: there will not come a point where government actually has to get debt falling.

Finally, because the measure of debt used is not a fully comprehensive measure of the government's net asset position, it can be gamed – for example, by exchanging assets that do not count against net debt for cash that does reduce measured net debt. When such a rule is proposed, and before it is voted on by parliament, the OBR should point out how the government may be able to take advantage of the proposed rule such that parliament is better able to scrutinise and debate their effectiveness.

In assessing the government's performance against its fiscal rules in its *Economic and Fiscal Outlooks*, the OBR should be able to use its judgment to provide a more holistic view of the government's performance against its objectives. The OBR is already able to – and does – point out when governments meet their rules through gaming rather than through policy that genuinely supports fiscal objectives. But it is still obliged to use the 'pass/fail' approach to formally assessing performance, described in more detail below. Our suggestion is that the OBR should be able to take into account practices such as gaming when assessing whether the government has met its fiscal rules. In other words, it should assess whether government policy is consistent with the spirit, as well as the letter, of fiscal rules. This would mean that the specific wording in the charter needs to move away from a formal assessment of whether the rules are met based on a probabilistic assessment of stated government policy.

As well as assessing whether rules have been met through gaming, the OBR should also set out a broader assessment of whether policy changes by the government are consistent with the broader strategy it has set out, as described above. To help do this it should provide a fuller commentary of how forecast changes and government decisions have affected a broader suite of metrics related to fiscal sustainability. The Charter for Budget Responsibility already sets out five additional measures that the government will have regard to, including the cost of debt servicing and public sector net worth (see below), on top of its fiscal rules, which the OBR could refer to support a more holistic view of the government's adherence to fiscal sustainability.

The framework should encourage a focus on the long term

Gordon Brown said he was introducing fiscal rules to "ensure an historic break from the short-termism and expediency that have characterised the recent fiscal policies of our country". Yet arguably short-termism has continued to characterise fiscal policy, especially in recent years. Ensuring fiscal rules provide the right incentives is part of the solution, but broader changes to how fiscal policy is made and judged are needed too.

Fiscal rules should treat investment spending differently

One of the most obvious ways in which short-termism manifests itself in fiscal policy is the temptation to cut capital spending to reduce the deficit. This was a pattern in the 1990s, when public investment reached record lows, and again in the early 2010s. It is also a feature of the government's current plans, with capital spending set to be frozen in cash terms for four years from 2025/26. These cuts do not cause immediate, visible problems in infrastructure or front-line services but do cause problems in the longer term.

Given politicians' tendency to focus on the short term, **a well-designed set of fiscal rules should treat investment differently**. Many iterations of UK fiscal rules have done this, targeting the current deficit (the difference between revenues and day-to-day spending). But the most recent set of rules has lost this distinction, with a deficit target making it possible to meet the rule by cutting investment.

This does not mean that investment spending should be unlimited, as this could still pose risks for fiscal sustainability. Current budget balance rules would therefore need to be supplemented by others, like a constraint on overall debt or debt servicing costs. However, setting capital apart in the design of rules is an important implicit statement by the chancellor that they are aware of the tendency towards short-termism and will not bow to it.

However, other changes are needed to further incentivise politicians to focus on the long term, especially when it comes to investment.

A greater appreciation of public sector net worth would improve decision making

Proposals for fiscal rules based on a measure of public sector net worth (PSNW) have gained popularity in recent years. This measure aims to provide a complete measure of what the government owns and its liabilities – the most significant way it differs from public sector net debt (PSND) is that it includes the estimated value of non-financial assets such as roads and buildings.

Proponents argue that adopting a rule relating to PSNW would help to address both short-termism and gaming. Andy Haldane, former chief economist of the Bank of England, has argued that "misguided fiscal rules" are to blame for the UK failing to take advantage of record low interest rates for investment that persisted for the years following the financial crisis.[16]

There is a reasonable case that fiscal measures that take account of, and incentivise investment in, non-financial assets would lead to better policy choices. Fiscal sustainability depends not only on the size of a government's fiscal buffer, but also how resilient it is to future shocks. Greater resilience to natural disasters, for example, reduces the expected future borrowing associated with such disasters. An investment in flood defences, for example, would increase borrowing and debt (as usual) but would make a positive contribution to PSNW.

While attractive for these reasons, a rule targeting PSNW would come with problems. The best account of these comes from the IFS's *Green Budget 2023*,[17] which outlines how rules relating to PSNW:

1. are not necessarily informative about the government's ability to access capital markets or service its debt. That is because many of the non-financial assets within PSNW cannot be sold in order to service the government's debt: conventional measures of the debt and deficit in relation to GDP (and therefore receipts) are more helpful here.

2. are subject to difficulties in measuring and forecasting PSNW: it is highly sensitive to economic conditions, definitions and modelling choices. A methodology change by the ONS could, without a rule change, demand a large fiscal adjustment from the government.

3. are highly susceptible to gaming as well, because of the measurement issues described above.

For these reasons, we believe that targeting a specific level of PSNW is probably unwise. However, it may be possible to make a different judgment in the future if the ONS continues its work on developing these statistics, with co-operation and sufficient funding from the Treasury. **If a government wanted to go further than just saying it would 'consider' PSNW (as in the current charter), it could target *the impact of government policy on PSNW***, for example: that the effect of policy must be to increase it. In any case, where possible, **the OBR should prominently assess the impact of policy on PSNW** in its *Economic and Fiscal Outlooks*.

This would have the intended effect on fiscal policy of a broader PSNW target, while mitigating some of the problems described above. In particular, governments would be incentivised to make (financial and non-financial) investments with good net returns and would gain less from selling off assets in order to improve the measure of PSND. It would also sidestep the issues highlighted by the IFS around how changes *unrelated to policy* can lead to volatility and level shifts in the measure of PSNW.

The structural effects of policies should be more clearly analysed and communicated

The five-year forecast horizon that all OBR forecasts cover (as required by the government) can also contribute to short-termism. Looking only five years ahead can obscure the full impact of supply-side policies, particularly those that are designed to have effects that materialise over a longer time horizon. Investment in infrastructure, for example, is likely to improve the underlying strength of the economy, but these effects will often take more than five years to materialise. Similarly, policies designed to boost the skills of young people will only pay off economically once those individuals enter the labour market, which may be beyond the five-year forecast horizon.

The OBR's medium-term forecasts attract far more political and public attention than the longer term forecasts that it periodically publishes, and recent fiscal rules have mostly focused on targets within the next five years. So these five-year forecasts can create a bias towards policies that yield short-term impacts within that window, even if their long-term effects are less beneficial than some other types of policies.

The OBR should consider alternative presentation methods that better capture the longer term benefits of supply-side policies. The most comprehensive version of this would be to produce a full economic and fiscal forecast for (say) 10 years ahead, rather than the current five-year forecast. This would make clearer the longer term economic impacts of policies. However, we think there are downsides to this approach that make it less valuable than alternative approaches discussed below. It would require significant resources to produce. More significantly, it would require some potentially questionable assumptions to be made about some aspects of the forecast – most importantly the assumptions about public service spending in years six to ten.

We, therefore, favour some alternative **approaches that would focus resources on setting out the longer term economic and fiscal impacts of the most relevant policies**, rather than devoting substantial resource to producing fully comprehensive but potentially spuriously accurate longer term forecasts every six months. One option would be **to include, alongside the five-year forecasts and five-year policy scorecard, calculations of the impact of policies at 10- and 20-year horizons**, assuming the policy is sustained.[*] This would provide a more accurate picture of the potential long-term costs and benefits of policies.

The OBR already conducts analysis of this type for key policies,[18] but could do so more systematically and even more prominently within the biannual *Economic and Fiscal Outlook*, released alongside the budget or spending review, rather than in its separate publication on long-term fiscal sustainability (the *Fiscal Risks and Sustainability* report). This will enable chancellors to point to the analysis – and observers to hold the chancellor to account using this information – on the day that the policy is announced, rather than several months later.

* An excellent example of how this could be done can be found in analysis by the US Congressional Budget Office of the macroeconomic effects of physical infrastructure spending. See *Effects of Physical Infrastructure Spending on the Economy and the Budget Under Two Illustrative Scenarios*, Congressional Budget Office, 2021, www.cbo.gov/system/files/2021-08/57327-Infrastructure.pdf

Addressing 'fiscal fiction' in spending plans

One of the most urgent issues to be addressed is the way governments can avoid confronting fiscal reality by pencilling in implausible spending plans. One of the main purposes of fiscal rules is to ensure governments confront the difficult trade-offs needed to achieve their own fiscal objectives. But when the rules bind at a point in the future where government has not set out detailed spending plans, it can dodge difficult choices by pencilling in spending plans that would be impossible to meet given what it has (or rather, has not) said about its willingness to scale back the scope or quality of what the state provides.

Spending reviews should cover a longer period and be frequently reviewed

The problems associated with unrealistic pencilled-in spending plans are most severe when there are several years between the end of the current spending review and the year when the fiscal rule applies. Currently, there are four years of hypothetical plans before the fiscal rules bind in 2028/29, which allows several successive years of unrealistic spending increases to cumulate to a very large effect by the final year.

The timing of spending reviews should also be amended. Some of the reasons for doing this relate to the need for greater certainty and predictability over spending plans for government departments, local authorities and other public bodies.* However, changes to the timing of spending reviews would also help to address the problems created by fiscal fiction identified in this paper.

Spending reviews since the turn of the century have ordinarily set spending plans for three or four years, although in recent years (2019 and 2020) there have been one-year spending rounds. The timing and duration of a review is decided by the Treasury. With the exception of the 2013 spending round (which was presented in May 2013 and extended plans to 2015/16), since 2007 spending reviews have happened during the summer and autumn of the final year covered by the previous spending review. This has meant that there have been several occasions when departments have not known their spending allocations until a few months before the start of a fiscal year – a difficult basis on which to make sensible decisions for the medium term. This contrasts with the approach taken during the New Labour years, when a spending review was held every two years between 1998 and 2004 covering three years.

Our view is that **a new norm of setting spending plans for more than three years, and reviewing those plans every three years, should be established**. Setting multi-year budgets on a predictable, regular basis would increase the level of certainty that departments have over their budgets and enable them to spend more efficiently. A regular rhythm, rather than a timeline dictated by the Treasury, would also help other departments to prepare their submissions for spending reviews with a longer lead time. Fundamentally for the health of the fiscal framework, though, the crucial effect will be to ensure that government always has a minimum of two years of firm spending plans set out.

* We will explore these issues more fully in a forthcoming paper setting out more detailed proposals on how to improve future spending reviews.

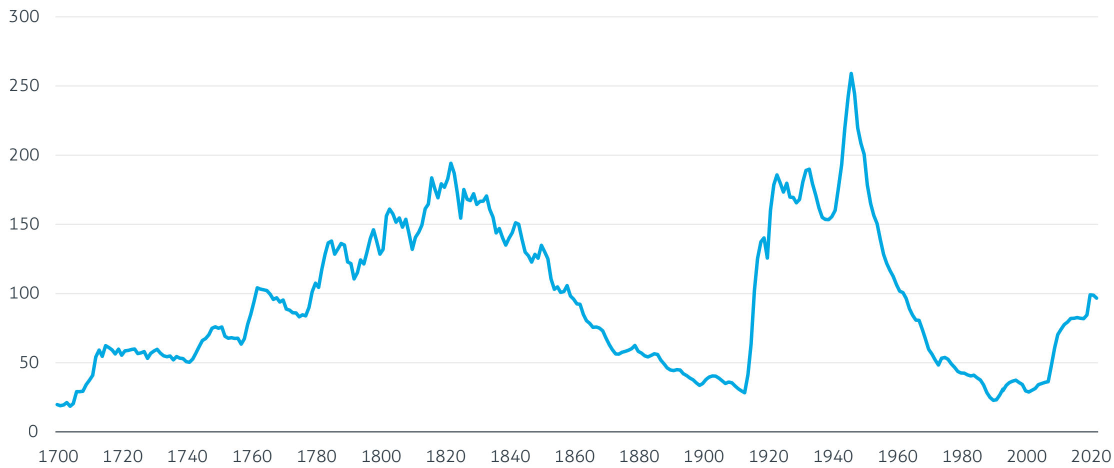
This regular cycle of spending reviews should be established as a norm, possibly through new legislation. This would not preclude government from the current practice of making adjustments to these plans at intervening budgets and, in the event of crises, emergency fiscal events. However, establishing a norm whereby spending for all departments is reviewed on a regular would provide a mechanism whereby governments must confront the necessary trade-offs between choices over borrowing, tax and spend. A government with a sound majority determined to take a different course would be able to ignore this, but it should at least present an additional hurdle that might make it more likely the government would stick to the original timetable in normal times.

Achieving flexibility through three-year horizons and knockout clauses

Alongside this new cycle of spending reviews, government should **shorten the horizon of its fiscal rules**. The justification for having forward-looking rules is that they provide flexibility: governments will need scope for higher borrowing to respond to major shocks such as wars, pandemics and financial crises. History shows that these are the events that drive up public sector debt (Figure 4). Sometimes governments may also need to be able to use fiscal policy to stabilise the economy outside of major crises, particularly when monetary policy is constrained.

The current rules – like the borrowing rules in place between 2010 and 2015, and since 2019 – do provide this flexibility by only requiring that the borrowing and debt targets are met in five years' time. Typically, economic fluctuations that push monetary policy to its limits would not be expected to last that long.

Figure 4 **Public sector net debt (excluding public sector banks) as a percentage of GDP, 1700-2022**



Source: Institute for Government analysis of Bank of England, A millennium of macroeconomic data v 3.1, 2017 (for 1700 to 1993) and Office for National Statistics, Public sector finances time series, H56X (for 1993–2022).

However, the five-year horizon provides an unnecessary degree of flexibility for dealing with most shocks and too much scope for fiscal fiction. A three-year horizon strikes the right balance here: allowing government to respond to relatively minor shocks (with an impact of three years or less) while staying within the rules and, when combined with our recommendations for more regular overlapping spending reviews, reducing the potential for gaming through pencilling in implausible spending plans.

To enable the government to respond appropriately to more substantial shocks (lasting longer than three years), there should also be some form of 'escape clause' – setting conditions under which the rules can be suspended. Some sets of rules, both proposed and implemented, have included such 'escape clauses' – provisions that the rules would be suspended when growth is sufficiently low.

The escape clause should **specify the conditions under which the rules can reasonably be suspended and require the chancellor to set out the timeline and necessary steps to return to the rules**. To minimise gaming but also recognising the difficulty in specifying ahead of time all of the conditions under which it would be reasonable to activate the clause, **the OBR should be asked to assess whether the conditions for activating the escape clause have been met**. For example, the government followed a set of rules in 2015 that stated they would no longer apply if the OBR assessed that the UK economy had experienced a "significant negative shock".[*19] Given that we recommend that rules should bind at a three-year horizon, this could be tightened to say "negative shock that is expected to have significant effects on the economy for a period of more than three years".

The OBR should set out the implications of the government's stated future policies, especially spending plans

The above two changes should ensure that governments have to make the necessary trade-offs between choices over tax, spending and the fiscal position. This would allow fiscal rules to serve their intended function.

However, there will still be scope for governments to escape difficult choices including by disapplying the new legislation on spending reviews or activating the escape clause against the advice of the OBR. And if the government does not adopt the changes above, fiscal fiction will continue to limit the quality of fiscal discourse and policy making. In these instances, the OBR could play a stronger role in monitoring these actions and setting out their implications.

In recent *Economic and Fiscal Outlooks*, the OBR has already started to do more to highlight what the government's stated spending plans imply for public services to help make clear that they are implausible. In its November 2023 publication, it showed that taking these plans alongside the government's commitments for spending on areas like the NHS, aid and defence implied a 2.3% per year real-terms

*

cut to unprotected day-to-day spending beyond 2024/25.[20] In a departure from usual practice, it also assumed that the underspend against the government's stated totals would be zero (previously, underspends have been assumed to be between 0.5% and 1% of total day-to-day departmental spending).*

The OBR should go further. **The OBR should set out the department-level implications of the government's top line spending assumption**, incorporating concrete commitments already made and allowing the government to provide any additional assumptions about departments' likely allocations. For any department without an explicit commitment or additional assumption, the OBR could assume it receives the average increase of whatever remains in the spending envelope. In practice, the analysis underlying this work is very similar to analysis already presented by the OBR on projected cuts to 'unprotected' spending, but setting out the implications for each department individually, and giving the Treasury the opportunity to change the spending assumption for different departments if it wanted, would make more explicit the choices that are currently implicit in the Treasury's headline spending numbers.

If the OBR wanted to go further still, it could lay out what level of spending would be consistent with public services maintaining their current level of scope and quality, allowing it to say explicitly whether current spending plans are likely to be consistent with service improvement or decline. It already has models to capture likely changes in demand for (and cost of) services in the longer term, and could apply similar models to cover shorter time horizons. The main downside of this approach is the risk that such analysis would appear to present a 'correct' level of government spending, when in practice it is a legitimate political choice to change the scope and quality of services, and risks politicising the OBR further.

An intermediate solution that we favour is set out in a guest comment from Andy King, who was until recently a member of the OBR's Budget Responsibility Committee. He suggests that **the OBR should set out a breakdown of the government's pencilled-in spending plans in terms of what it means for the public sector workforce, pay, and then non-pay budgets**. The OBR, unless government wanted to set out where the axe would fall, would then set out implications of spending totals according to these relatively politically neutral assumptions.

Any of these approaches could take the OBR into territory that is politically uncomfortable. In situations where the government is clearly dodging difficult choices by making fanciful spending assumptions, **the Treasury Select Committee (which contains representatives from all the main political parties) should ask the OBR to produce analysis of the type described above**, including specifying the assumptions on which it should be based.

* This assumption was intended to reflect the OBR's scepticism that the provisional totals would in fact be underspent at all, given that plans tend to be topped up at spending reviews. However, in response to the OBR assuming a zero underspend, the Treasury reduced its headline spending assumption to leave the total level of spending (after underspend) unchanged. Source: paragraph 4.50 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2023, https://obr.uk/docs/dlm_uploads/E03004355_November-Economic-and-Fiscal-Outlook_Web-Accessible.pdf

Conclusion

Magical thinking, and a denial about the state of the state and insufficient strategies to fix it, has become widespread among political classes[1] but is most clear, or at least quantifiable, in fiscal policy. The original purpose of our fiscal framework – to embed a clear and comprehensive fiscal strategy and to force difficult trade-offs – has been lost.

Going into the upcoming election, neither main political party has a clear fiscal strategy. They are both committed to fantastical spending plans. The Conservatives are offering short-term tax cuts (largely offset by larger tax rises announced just a few years ago, though some of which are yet to be take effect), further reducing the space available for what seems like inevitable spending rises (absent any significant reduction in the functions of the state) at the next spending review. Committing to also replicate recent tax cuts partly contributed to Labour's abandonment of the one fiscal policy – investing £28bn a year in the green economy – that distinguished it from the current government.

Politicians should not let themselves be governed by a poorly designed fiscal rule – particularly one as flawed as the one currently tying government's hands. It is their responsibility to develop a coherent strategy – consistent with what they want to deliver in government – and this should give rise to their rules. But even the existence of meaningful rules seems to have lost its significance: meeting their letter but not their spirit through trickery and games has become routine.

We need a change of approach. Most importantly, we need a government willing to make the difficult choices necessary to confront the fiscal challenges that they face. This report provides a guide to how this or future governments can reform the fiscal framework in a way that supports and enables them to do so.

While some have advocated for the abolition of fiscal rules, we conclude that they are an important and inevitable part of any robust fiscal framework. But they should be a tool for supporting broader, coherent fiscal objectives, and other aspects of the fiscal framework can and must be bolstered to help governments avoid the temptation for short-termism, gaming, fiscal fine-tuning and engaging in fiscal fictions.

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Conclusion

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