Over-ruled?

Assessing the options for changing the fiscal rules

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Although the Chancellor said she would stick with the previous Government's much-criticised rule of reducing public debt in the fifth year of the forecast, Rachel Reeves's conference speech has sparked a debate about whether the fiscal rules should be changed to allow the Government to borrow more. Three options have been mooted for changing the definition of debt: to include the Bank of England; to exclude the Government's National Wealth Fund and GB Energy; or to broaden the concept to include a wider range of assets, targeting either public-sector net worth (PSNW) or public-sector net financial liabilities (PSNFL).

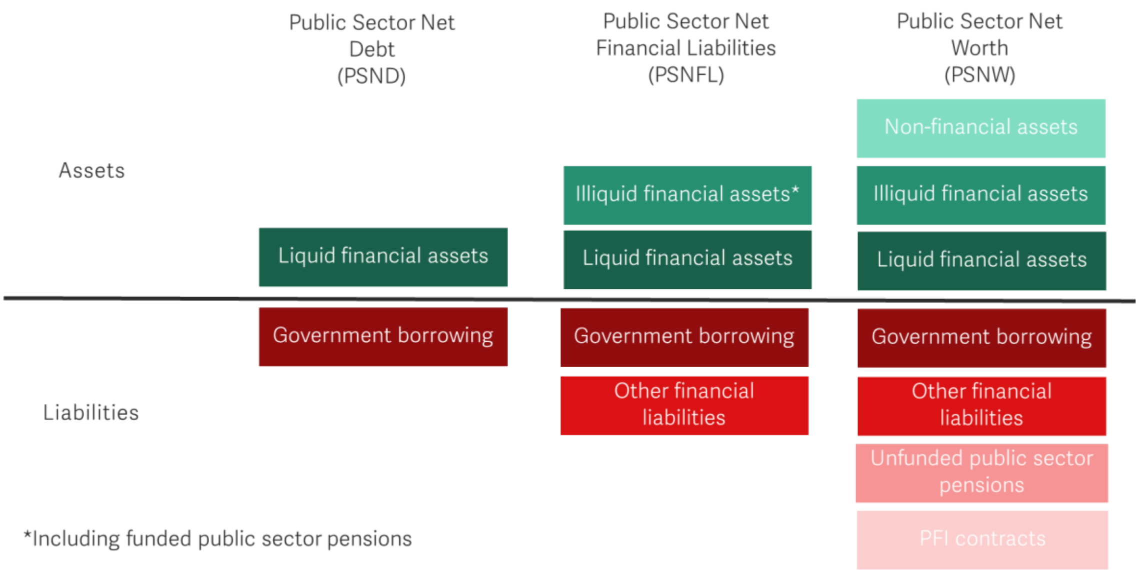
Much of the debate has focused on the idea that a change to the rules would mean room to borrow around £50 billion more in five years' time. But such a focus on how much borrowing any new rules might 'allow' misses the point that it's the decision about the fiscal policy that sets the rules, not the other way around. This means any change in the rules should be seen as the Government signalling that it wants to take a different approach to fiscal policy. A decision to move to a PSNW or PSNFL target, then, should be taken as the Government wanting to do more public investment than set out in its manifesto. Such an approach would address £26 billion in previous cuts to public investment and would resonate with the Government's 'mission' to address the UK's long-standing problem of weak growth. In that context, we have previously recommended that the UK Government should adopt a PSNW target and, of the options being discussed, this would be the one that incentivises governments to create public value for this and future generations by recognising that public investment will create assets. But adopting a PSNW target would need to be done carefully in order to address the practical issues associated with including assets in the fiscal targets and to make clear the Government remains commitment to sustainable public finances.

The Chancellor has sparked a debate about fiscal rules

At the Labour Party conference, the Chancellor hinted that the Government was considering changes to the fiscal rules that play a central role in tax and spending choices. This came as a surprise given Rachel Reeves had previously said she planned to keep the previous Government's (much-criticised) rule of getting public-sector debt, excluding the Bank of England, falling as a share of national income between the fourth and fifth year of the OBR's forecast. This rule has been the binding constraint on fiscal policy since it was introduced in the aftermath of the mini-budget.

Three options seem to be on the table: broadening the definition of debt to include the Bank of England; excluding the National Wealth Fund and GB Energy, the Government's new vehicles for public investment from the definition of debt; or, more radically, broadening it to include a wider range of assets – targeting either public-sector net worth (PSNW), as we have previously argued for, or public-sector net financial liabilities (PSNFL). These options are shown in Figure 1.

Figure 1 **Possible fiscal targets differ in their coverage, creating incentives**
Coverage of different measures of the public sector balance sheet



Source: RF analysis.

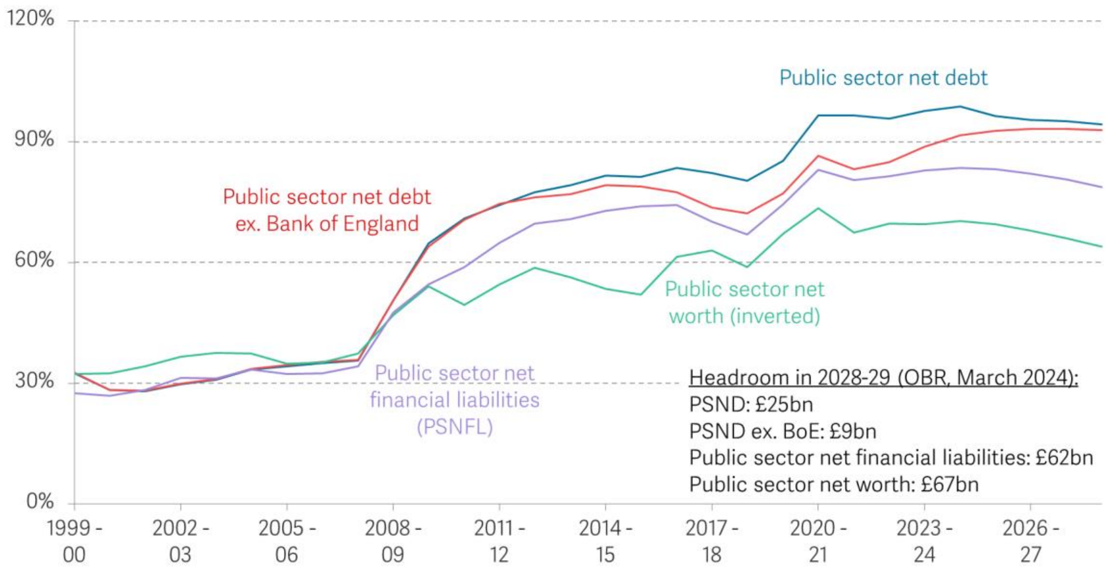
One reason this issue is getting so much attention is the possibility that any change could enable a loosening in the Government's purse strings. And, *at first glance,* a change could give the Chancellor a lot more scope to borrow. As shown in Figure 2, if the definition of debt was changed to PSNW or PSNFL, but *the target remained otherwise unchanged (i.e. it required an improvement in the new measure between the fourth and fifth year of the forecast)*, then, based on the Spring Budget forecasts, this would mean 'headroom' – the margin by which the fiscal rule is met – increasing from £9 billion to more than £60 billion. This is because these three broader measures are improving (i.e. net debt is falling) more quickly than PSND, mainly reflecting the fact that the constantly-increasing stock of student loans also represents a growing financial asset for the Government.[1] Less dramatically, tweaking the definition of the debt target to focus on total debt (rather than 'debt excluding the Bank of England') would (on the Spring 2024 forecasts) increase headroom by around £16 billion.

But the idea that changing the rules will 'allow' more borrowing misses the point of fiscal rules

Fiscal rules work by 'anchoring' expectations about the government's tax and spending strategy. Most obviously, they make clear to financial markets (i.e. those funding our national debt) how the government will act to prevent our public finances from heading onto an unsustainable path – and this is why any loss of this fiscal anchor can lead to a higher cost of borrowing (as was at least partly the case during the mini-budget episode).

Figure 2 **Changing the measure of debt in the debt target would mean more 'headroom'**

Public sector net debt, public sector net debt ex. Bank of England, public sector net financial liabilities and public sector net worth as a share of GDP: UK



Source: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

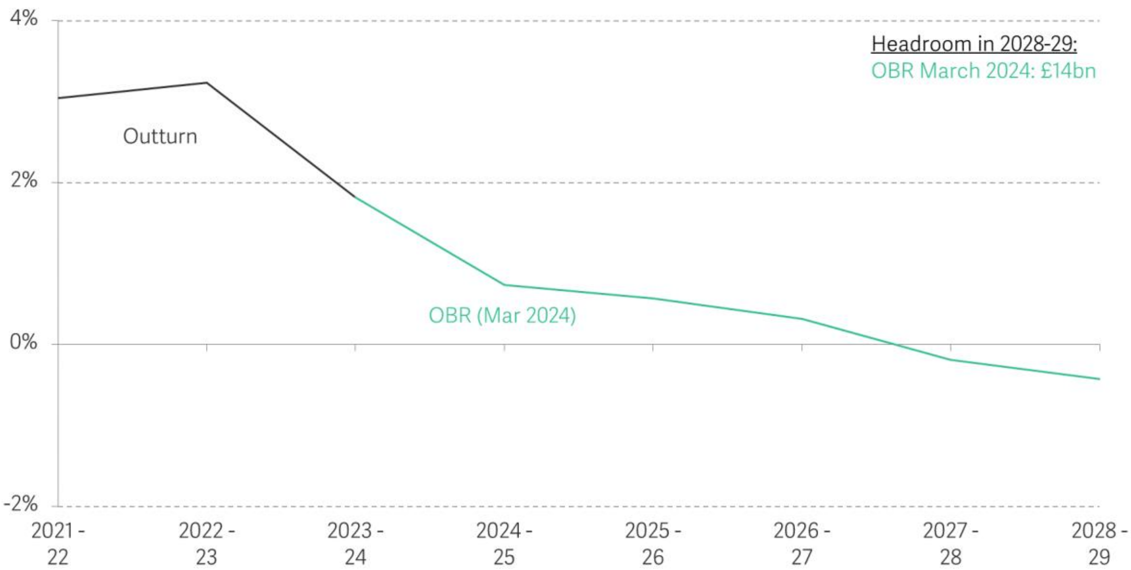
In an ideal world, governments wouldn't need fiscal rules: everyone (investors included) would trust them to borrow until the point when the risks being run with future debt-servicing costs began to exceed the benefits of the extra spending enabled. In reality, governments can't always tell when they've reached that point, and even if they could, they face political incentives to push too much of the problem of paying for things into the future. In this imperfect world, ministers can usefully set themselves fiscal rules of thumb to codify their approach towards striking the balance between risky and desirable borrowing, and publicly commit themselves to an earnest pursuit of that balance.

The key point here, then, is that it's the decision about the fiscal policy that sets the rules, not the other way around. So we should not see any change in the rules as being a backdoor way to allow greater borrowing; instead, a change in the rules should be seen as the new Government signalling that it wants to take a different approach to fiscal policy to its predecessors. And this in turn means that the debate about changing the rules, then, is really one about the type of fiscal policy we should be running – so what approach could justify the changes that are being discussed?

Change the definition of debt is a decision about borrow more to invest

As well as committing to get debt falling, the Government has (rightly) said it will balance day-to-day spending and tax receipts (in the jargon, this is a 'current balance' rule). Although it has not said over what horizon it will bring current spending into balance, Figure 3 shows that the current balance is forecast to fall over the five-year forecast, moving into surplus towards the end of the period. Whatever horizon is chosen, however, a current balance rule means there would be almost no scope to increase day-to-day spending without also increasing taxes (or to cut taxes without also cutting day-to-day spending), regardless of what definition of debt is also being targeted.

Figure 3 **The Government's current-balance rule means there is almost no scope to borrow more to fund higher day-to-day spending (or lower taxes)**
Public sector current budget deficit as a share of GDP: UK



Source: RF analysis of OBR, Economic and Fiscal Outlook, March 2024.

This means that any change in the definition of debt in the fiscal rule is likely to be driven by a desire on the part of the Government to borrow more to invest, so the question of which debt rule to adopt depends in part on how much extra debt-funded investment the Government is considering. For example, the modest increase in investment set out in Labour's election manifesto – of around £5 billion by the end of the forecast period – could be accommodated under a standard PSND target, and especially if the measure of debt were tweaked to include the Bank of England. This approach would also provide continuity with the previous Government, and would be clearly consistent with the plans set out in opposition, and the minor broadening of the target debt measure would be sensible given the distortions created by the Bank of England's pandemic-related lending have now dissipated. But it would also almost certainly leave only a thin margin against the debt-falling rule, leaving future policy decisions exposed to changes in the OBR's economic forecasts.

But a more substantive change in the definition of debt would be a strong signal that the Government wants to do more public investment than set out in its manifesto. Such an approach would address £26 billion in cuts to public investment and resonate with the Government's mission to address the UK's long-standing problem of weak growth where the Chancellor has said that "investment is the solution." And as we have previously argued, there's certainly no low-investment route to faster sustained growth.

We have previously recommended that the UK government should adopt a PSNW target and, of the options being discussed, the key advantage of such a rule is that it is the only one which incentivises governments to create public value for this and future generations, because it recognises that public investment will create valuable assets. As mentioned above, a PSNFL target would also almost certainly allow more room for investment now. But, because this measure does not include the assets created by investment, it does not provide incentives to continue that investment in the future. And a drawback with excluding specific types of debt (such as the *National Wealth Fund* and *GB Energy*) from the measure being targeted is that it gives future Chancellors an incentive to expand the use of that type of debt purely to get around the rules, much as some of the rush for public finance initiative (PFI) contracts in the 1990s and 2000s was motivated by the desire to keep liabilities off of the government balance sheet. So, although excluding the *National Wealth Fund* and *GB Energy* from the measure of debt or adopting a PSNFL rule would almost certainly lead to more much-needed public investment, those rules would not necessarily incentivise good policy making in future.

On the other hand, a PSNW target would need to be carefully considered and designed. There are practical issues created by targeting such a broad measure – including the extent to which data on net worth may be revised in future as asset values change. Also, such a target would, on its own at least, provide little or no constraint on the level of debt-funded investment, because any increase in investment would likely lead to roughly offsetting increases in assets and liabilities (a current-balance rule, though, would prevent debt-funded increases in day-to-day spending, or in tax cuts). There is, therefore, a risk that a PSNW target would be seen as a weakening of the fiscal framework, and that might lead to the Government paying more to borrow so as to compensate investors for the greater risk associated with investing in our debt. At the very least, particularly given there is a clear case for building fiscal policy space for future downturns, if the Treasury wanted to adopt a PSNW target then it would be wise to complement this approach with a rule for investment spending (as we have previously called for), that reinforces the Government's commitment to sustainable public finances.

The choice of fiscal rules will be a key decision for the new Government

The Autumn Budget will set the policy tone for the Parliament ahead, and the choice of fiscal rules is clearly a key part of the overall strategy for the coming years. But the interest should not be solely in which rule 'allows' the largest expansion in borrowing. Instead, any changed rule needs to be seen as telling us something about the fiscal priorities of the new Government. Sticking with a debt target might be perceived as a 'safe' approach, providing continuity with previous rules, and consistency with Labour's election manifesto. Within this approach, tweaking the definition of debt would – fortuitously – allow a modest increase in investment. But the status quo could equally be viewed as risky given its implications for public investment. If the Government wants to deliver a sustained increase in public investment, it will almost certainly need to go further. In this context, targeting PSNW would support such an approach by recognising that investment creates long-term assets, as well leading to a rise in debt. But such a move would need to be handled carefully given practical measurement issues and the need to make clear the Government remains committed to sustainable public finances.

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[1] PSNW is a negative number reflecting the UK's net liability position. So, to aid comparability with debt and PSNFL it is shown inverted in Figure 2. In the chart, a fall in PSNW indicates a smaller net liability position, or an improvement in PSNW.