

THE UK GOVERNMENT'S APPROACH TO SETTING FISCAL POLICY

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2.1 Introduction

The UK government announced in June 1998 that, under the guidelines of its “Code for Fiscal Stability”, it would keep to two fiscal rules. These are designed to “help to achieve the central economic objective of high and stable levels of growth and employment” (HM Treasury, 1998). This short paper starts by describing the two fiscal rules and then looks at the latest set of HM Treasury forecasts, which suggest that these rules will indeed be met. We then go on to discuss the level of uncertainty that is implicit in any public finance forecasts and the importance of remembering that, if the rules are to continue to be met, a degree of caution should be maintained.

2.2 An Overview of Public Borrowing

Since coming to office in May 1997, the UK government has consistently stated that it will keep to two strict fiscal “rules”:

- The **golden rule**: over the economic cycle, the government will borrow only to invest and not to fund current spending. In the terminology defined below, the government will run a surplus on current budget.
- The **sustainable investment rule**: over the economic cycle, the ratio of net public sector debt to GDP will be set at a “stable and prudent” level, defined by the Chancellor as 40 per cent of GDP.

THE UK GOVERNMENT'S FISCAL OBJECTIVES

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Acknowledgements: The paper was funded by the ESRC Centre for the Microeconomic Analysis of Fiscal Policy at the Institute for Fiscal Studies (IFS). The authors would like to thank Andrew Dilnot for his help and advice during preparation of the paper. All remaining errors are the responsibility of the authors.

One of the UK government's arguments for adopting these rules is that the burden of public spending should fall fairly across generations. The UK government has taken this to mean that all public consumption benefiting the current generation should be paid for by that generation. By stating that the government does not borrow to fund current spending, the golden rule seeks to ensure that this is achieved. The sustainable investment rule supplements the golden rule, seeking to avoid the creation of an excessive burden of debt repayments on future generations. The sustainable investment rule aims to keep debt at a level that does not prove unsustainable or unfair to future generations.

There is nothing sacrosanct about these two rules, nor are they necessarily optimal. While it is true that meeting them would mean that the public finances were kept in good shape, a failure to do so would not automatically render the public finances unsustainable, and meeting them does not even necessarily imply generational fairness. The UK government has provided no justification for a net debt target of 40 per cent of GDP - it could just as easily have chosen 38 per cent or 42 per cent. The Maastricht Treaty, for instance, allows UK gross general government debt of no more than 60 per cent of GDP, which is consistent with net public debt being considerably higher than 40 per cent of GDP. Indeed, even if it is thought that there is an optimal level, there is no reason why this should remain constant over time.

Is a Balanced Budget Rule More Desirable than the Golden Rule?

Joining or being in a position to join the single currency formally requires UK fiscal policy to be set in accordance with the Growth and Stability Pact. This requires member countries to plan for a balanced budget. Planning in this way implies either higher taxes or lower public spending than just meeting the golden rule, since it prohibits the government from borrowing to invest.

The golden rule makes a distinction between current spending and capital spending on the basis that current spending is considered to benefit only the current generation while capital spending is considered to be an investment that will be of benefit in the future as well. A balanced budget rule would not recognise a difference between current spending and investment spending. As long as there is a genuine benefit to future taxpayers from an element of government spending, it seems reasonable that they should contribute towards its cost. An analogy is with individuals, who do often choose to fund purchases for the long term by borrowing – for example, by taking out a loan to buy a car or a mortgage to buy a property. Another example is companies, which often borrow to carry out investments.

One criticism of the golden rule has been that the distinction between capital and current spending is inadequate: it implicitly assumes that future generations only benefit from spending that falls under the National Accounts capital category. Ideally an assessment should be made over which types of public spending only benefit the current generation. For example, some education spending, which tends to be classified as current spending, may well be beneficial to future generations. Conversely,

government policy can impose costs on future generations that are not reflected in current spending; the most obvious example is future pension liabilities.¹ The golden rule risks inappropriately preventing such spending.

The danger with a balanced budget rule is that it would aggravate this situation by ruling out any spending being financed by future generations. This seems undesirable, since investment projects that were extremely beneficial to society as a whole but prohibitively expensive to finance from current taxpayers alone would not go ahead under a balanced budget rule.

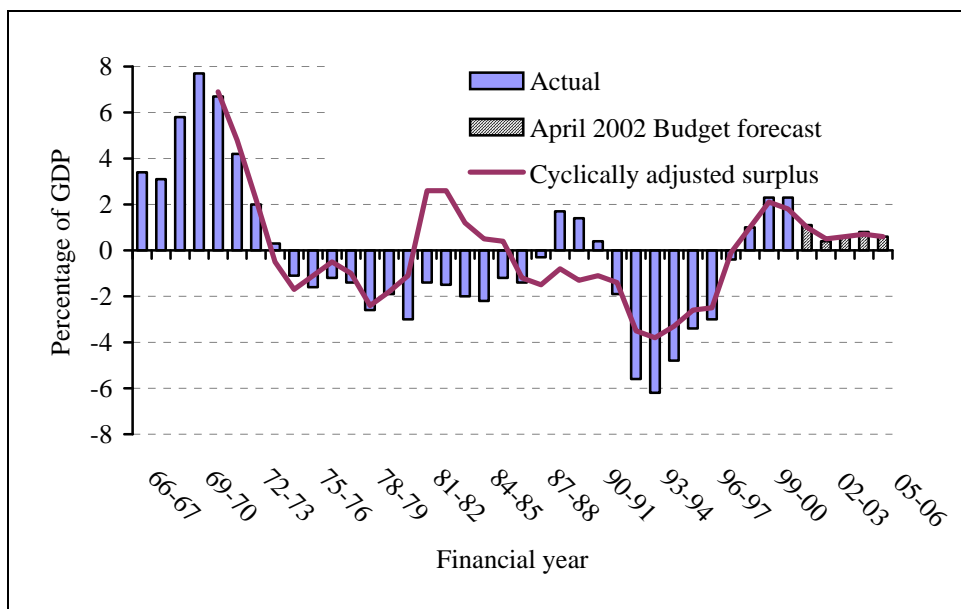
The fiscal rules chosen by the UK government are probably best regarded as sensible rules of thumb, but they are no more than that. This should always be borne in mind when assessing the sustainability of fiscal policy. Figure 2.1 shows the current budget surplus as a share of GDP since 1966-67 to the end of the present forecast period. Also shown, from 1970 onwards, is the cyclically adjusted current budget surplus. In the late 1960s and early 1970s, the golden rule was met. This was not because public sector net borrowing was particularly low, but because public investment at the time was high. For example, in 1967-68, despite a current budget surplus of 3.1 per cent of GDP, public sector net borrowing was some 4.0 per cent of GDP. During the 1980s, only two years – 1988-89 and 1989-90 – had a surplus on the current budget. In fact, the golden rule was met over this period, as shown by the cyclically adjusted series, since the economy under-performed for much of the decade. Over the first half of the 1990s, the golden rule was far from met, with the deficit on current budget averaging over 4 per cent of GDP between 1991-92 and 1996-97. This was partially due to high levels of public borrowing combined with falling levels of public investment.

Under the UK government's projections, the golden rule will be met going forward. The current budget has been in surplus since 1998-99 and is projected to remain so for the remainder of the forecast period. It is important to note, though, that (as will be seen below) there is a considerable amount of measurement error predicting the public finances. Whether the golden rule is actually met will depend on how accurate the projections are. Mistakes have been made in the past in assessing what level of output the economy can sustain.²

Figure 2.1: Compliance with the Golden Rule? UK Current Budget Surpluses and Deficits from 1966-67 to 2005-06, as a Percentage of GDP

¹ For a discussion of how to measure intergenerational equity and the golden rule, see, for example, Robinson (1998). Cardarelli, Sefton and Kotlikoff (2000) discuss the costs of an ageing population in a generational accounts framework. Banks, Disney and Smith (2000) discuss the sensitivity of generational accounts forecasts to the underlying assumptions.

² For a discussion of the errors in Treasury forecasts in the late 1980s, see HM Treasury (1997).



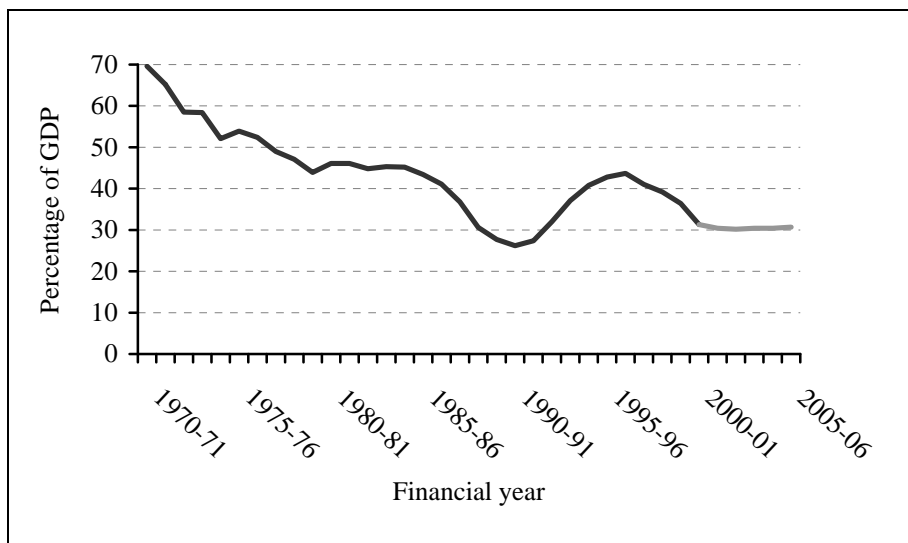
Note: Measures exclude the windfall tax and associated spending.

Source: HM Treasury (2002a).

Net public sector debt is shown in Figure 2.2. During the Conservatives' period of office, the net public debt ratio averaged 39.0 per cent of GDP, which is in line with the second of the current UK government's fiscal rules. This was achieved during a period of historically low growth in public spending, enabled in part by public sector net capital investment falling, in real terms, from STG£14.1 billion in 1978-79 to STG£5.8 billion in 1996-97 (2000-01 prices). As a share of national income public sector net investment fell from 2.4 per cent in 1978-79 to 0.7 per cent in 1996-97.³ In the process, the UK government's balance sheet deteriorated markedly. The net wealth of the public sector fell from 73.6 per cent of GDP in 1989-90 to under 15.6 per cent of GDP in 1996-97. According to the UK government's projections, the sustainable investment rule should continue to be met into the future. Moreover, this is planned to coincide with a time of increasing, rather than decreasing, investment.

Figure 2.2: Meeting the Sustainable Investment Rule? Net Public Sector Debt, from 1970-71 to 2005-06, as a Percentage of GDP

³ Source: Table C24 in HM Treasury (2002b). The largest part of the fall in gross public investment over this period was by public sector corporations, with investment by local authorities also falling – see Chart 2.3, p. 6 of HM Treasury (2000). For a description of which spending programmes were most affected by the cuts to public sector investment see Clark, Elsby, and Love (2001).



Source: HM Treasury (2002a).

MEASURES OF UK PUBLIC BORROWING

In order to facilitate monitoring of the UK government's two fiscal rules, there is a distinction between current and capital spending in the public accounts. In order to assess the state of the public finances, the UK government looks at three main fiscal aggregates:⁴

- The **surplus on current budget** – defined as the difference between total tax receipts (including social security contributions) and current public spending (including all social security payments and depreciation) – is the measure used to judge whether the golden rule is being achieved.
- **Public sector net borrowing (PSNB)** – the Treasury's preferred measure of government borrowing – is the finance needed to meet current and capital spending over and above that raised by taxes.
- The **net public debt ratio** is total public sector debt, net of liquid assets, as a percentage of GDP. This is used to see whether the sustainable investment rule is being met.

Since the government's fiscal rules are judged over the economic cycle, the government can run current budget deficits and still keep to its rules, as long as it genuinely believes that the economy was below the level of output that it can sustainably produce. This is because lower levels of economic output reduce tax revenues – in particular, from corporation tax and income tax, since profits, employment and wages will be lower. In addition, public spending on social security benefits such as income support and the jobseeker's allowance is higher when economic output is lower.⁵ Hence, the government also uses measures of the current budget

⁴ A more detailed description of these, and other measures of public borrowing, can be found in HM Treasury (1999a).

⁵ It is estimated that every additional 100,000 unemployed would cost an extra Stg£580 million in public spending in 2000-01 and Stg£610 million in 2001-02. Source: Department of Social Security (2000).

surplus and PSNB that are cyclically adjusted in order to see if the level of borrowing in any one year is consistent with meeting its fiscal rules.

The old measure of borrowing – the public sector borrowing requirement (PSBR) – is now known as the public sector net cash requirement (PSNCR). This is similar to the PSNB but is based on the cash payments rather than accrued income. Privatisation receipts, other financial transactions and accruals adjustments are added to the PSNB to get to the PSNCR. Thus, for example, the sale of the third-generation mobile phone spectrum licences reduced the PSNCR in 2000-01 by a full STG £22.5 billion (2.3 per cent of national income), but its effect on the PSNB is spread across the 20 years for which the licences have been awarded. The government no longer focuses on the actual cash needs of the public sector (PSNCR), although they still have a role to play as they measure the addition to net public debt each year. The central government component of the PSNCR determines the necessary amount of gilt sales.

The general government component of the PSNB (i.e. excluding public corporations' net borrowing) is the aggregate used in judging compliance with the Maastricht criteria. General government gross debt is forecast to remain below 40 per cent of national income, while the General government net borrowing is forecast to rise from 1.0 per cent of national income in 2002-03 to 1.4 per cent in 2005-06. These are below the 60 per cent of GDP for net debt and 3.0 per cent for net borrowing that are set out in the Excessive Deficits Procedure.

2.3 How Large are Errors in the Projections?

Figures 2.1 and 2.2 above show that the government is on course to meet both the golden rule and the sustainable investment rule. But there have been many occasions in the past when it has proved unwise to place too much weight on forecasts of future levels of public borrowing without considering the large margins of error that these contain. There are two main ways in which the public finances could follow a different course from the Treasury's forecasts.

INCORRECT ASSESSMENT OF SUSTAINABLE OUTPUT IN THE ECONOMY

Judging whether the golden rule is being met is not possible without an assessment of the level of output the economy can sustain both now and in the future. In particular, if the government overestimates what the economy can sustain, it will underestimate the likely future level of public borrowing. To assess what the economy can sustain, forecasters make a judgement on the level of the current output gap (i.e. the difference between what the economy is currently producing and what its current sustainable capacity is) and the trend rate of growth of the economy (i.e. the rate at which the economy's sustainable capacity will grow). Errors can be made in both these judgements.

Overestimating the Output Gap

The output gap is the difference between what the economy is currently producing and the level of output that it could sustainably produce. The government needs to judge whether the current levels of borrowing are consistent with meeting the fiscal rules, which are assessed over the economic cycle. This means that a current budget deficit in any one year is still potentially consistent with meeting the golden rule, as long as the economy was operating below its sustainable level (i.e. there was a negative output gap). Hence, the size of the output gap is used to cyclically adjust measures of borrowing in order to remove the effect of the economic cycle on government receipts and spending.⁶ Incorrectly estimating the size of the output gap will lead to policy-makers believing that the current level of cyclically adjusted borrowing is better (or worse) than it actually is.

Overestimating the Trend Rate of Growth

The trend rate of growth is the rate at which the economy can sustainably grow. Since the fiscal rules are judged over the economic cycle, an overestimate of the trend rate of growth has more serious consequences than an overestimate of growth in a particular part of the cycle. The golden rule is perfectly consistent with deficits on the current budget as long as the economy is correctly judged to be operating below its potential level of output. Any revision to trend output will change the assessment of how comfortably the golden rule is being met, since it will affect the amount of economic growth that is possible in future years.

If trend output is overestimated, then future economic growth will also be overestimated, and hence borrowing will turn out worse than forecast. The current government believes that the trend rate of growth is 2¾ per cent or possibly higher. Since the cost of overestimating the trend rate of growth is that taxes would have to rise or spending commitments be cut back during a period of lower economic growth, the government is using a lower estimate of 2½ per cent in its public finance forecasts.⁷ Prior to the April 2002 Budget the trend growth had been considered to be 2½ per cent since the late 1990s, with the government working with 2¼ per cent to ensure caution in their public finance forecasts. The move to a higher estimate of the trend rate of growth was made on the basis of the UK Treasury's belief that 2½ per cent is an underestimate of the rate of growth the economy could sustain.

ERRORS IN FORECASTING LEVELS OF UK GOVERNMENT SPENDING AND RECEIPTS

Forecasts for public borrowing are still subject to large margins of errors, even if growth in the economy is correctly forecast. The reason for this is that, even if forecasts of both government receipts and government spending are almost accurate, there can still be large errors in forecasts for

⁶ For more details, see HM Treasury (1999b).

⁷ See HM Treasury (2002b).

borrowing.⁸ For example, the April 2002 Budget forecast for government revenues in 2002-03 is STG£407 billion (38.7 per cent of national income), while the forecast for current expenditure (including depreciation) is STG£404 billion (38.4 per cent of national income). This gives a forecast current budget surplus of STG£4 billion (0.4 per cent of national income, numbers do not sum due to rounding). Should government revenues turn out to be just 1 per cent lower and government spending turn out to be 1 per cent higher, rather than a current budget surplus of STG£4 billion there will be a deficit of STG£4 billion.

The presence of errors in forecasting levels of government receipts and expenditure is shown by looking at the accuracy of previous forecasts. Table 2.1 shows the average error in Treasury forecasts of PSNB. The average absolute error for borrowing in the following year is 1.2 per cent of GDP, which in 2001-02 is equivalent to STG£12 billion. Moreover, Table 2.1 also shows that errors made in the underlying economic assumptions do not fully explain forecast errors in public borrowing. Even if growth is accurately forecast, the error is still equal to 1 per cent of GDP on average, equivalent to nearly STG£11 billion. Looking further ahead, the errors are much larger. It would not be unusual for the borrowing forecasts for 2004-05 to be in the region of STG£30 billion (3.0 per cent of national income) out. Of course, this could mean that the golden rule will be met very comfortably. It is also possible that the outturn is worse than expected, which could potentially require tax increases or spending cuts in future Budgets.

Table 2.1: Average Errors in Forecasting UK Public Sector Net Borrowing (PSNB), as a Percentage of GDP and in STG£billion

Time Period	Average Error (% GDP)	Average Error (STG£bn)	Average Error, Correct GDP (% GDP)	Average Error, Correct GDP (STG£bn)
One year ahead	1.2	12.6	1.0	10.5
Two years ahead	2.0	21.0	1.4	14.7
Three years ahead	3.0	31.5	2.0	21.0
Four years ahead	4.1	43.1	2.4	25.2

Notes: Figures in STG£ billion are calculated assuming HM Treasury GDP forecast for 2002-03 of STG£1,051 billion. Average error corresponds to the average absolute error over the period 1985-86 to 1997-98.

Sources: Table B13 of HM Treasury (1998); HM Treasury (2002a).

2.4 Conclusions

Since coming into office in 1997, the government has committed itself to meeting the golden rule and the sustainable investment rule. Given current levels of planned investment, meeting these rules implies historically low levels of borrowing. Under current forecasts, the government is set to meet its rules, even under cautious assumptions. The government's projections, which are already based on lower-than-expected trend growth, predict that these fiscal rules will still be met if trend output is 1 percentage point lower than currently believed. An important reason for including a level of caution in the government's projections is that past experience shows that there are large margins of error when predicting both the state of the economy and the public finances. If actual borrowing differs from the government forecasts by a similar extent to which they

⁸ For a discussion of forecasting techniques, see, for example, Robson (1998).

have in the past, then, if favourable, this would allow substantial tax cuts or spending increases, or, if unfavourable, it would lead to the fiscal rules not being met unless taxes are increased or spending cut.

APPENDIX A: HISTORICAL SERIES OF UK GOVERNMENT BORROWING

Table A.1: Public Sector Net Borrowing and Current Budget Surplus, in STG£ billion and as a Percentage of GDP, 1966-67 to 2005-06

Year	Public Sector Net Borrowing		Current Budget Surplus	
	STG£bn	% of GDP	STG£bn	% of GDP
1966-67	1.0	2.5	1.3	3.4
1967-68	1.6	4.0	1.3	3.1
1968-69	0.3	0.6	2.6	5.8
1969-70	-0.9	-1.8	3.7	7.7
1970-71	-0.3	-0.6	3.6	6.7
1971-72	0.6	1.1	2.5	4.2
1972-73	1.9	2.8	1.3	2.0
1973-74	3.7	4.9	0.2	0.3
1974-75	5.9	6.6	-0.9	-1.1
1975-76	7.8	7.0	-1.8	-1.6
1976-77	7.2	5.5	-1.6	-1.2
1977-78	6.5	4.3	-2.1	-1.4
1978-79	8.7	5.0	-4.5	-2.6
1979-80	8.5	4.1	-4.0	-1.9
1980-81	11.5	4.9	-7.2	-3.0

1981-82	6.0	2.3	-3.6	-1.4
1982-83	8.5	3.0	-4.3	-1.5
1983-84	11.7	3.8	-6.2	-2.0
1984-85	12.2	3.7	-7.2	-2.2
1985-86	8.7	2.4	-4.2	-1.2
1986-87	8.0	2.1	-5.2	-1.4
1987-88	4.2	1.0	-1.3	-0.3
1988-89	-6.4	-1.3	8.1	1.7
1989-90	-1.2	-0.2	7.4	1.4
1990-91	5.7	1.0	2.5	0.4
1991-92	22.4	3.8	-11.4	-1.9
1992-93	46.6	7.6	-34.2	-5.6
1993-94	51.0	7.8	-40.6	-6.2
1994-95	43.2	6.3	-32.8	-4.8
1995-96	34.9	4.8	-24.7	-3.4
1996-97	28.4	3.7	-23.1	-3.0
1997-98	8.4	1.0	-3.6	-0.4
1998-99	-3.4	-0.4	9.0	1.0
1999-2000	-17.0	-1.9	21.5	2.3
2000-01	-17.2	-1.8	22.1	2.3
2001-02	0.1	0.0	11	1.1
<i>HM Treasury forecasts</i>				
2002-03	10	1.0	4	0.4
2003-04	13	1.2	7	0.6
2004-05	13	1.1	9	0.8
2005-06	17	1.4	7	0.6

Note: Measures exclude the windfall tax and associated spending.

Source: HM Treasury (2002b).

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