Reform Ideas No 1

Long-term fiscal sustainability

James Zuccollo

December 2012

REFORM

Summary

The problems facing George Osborne when he delivers his Autumn Statement are clear: he has committed to eliminating the structural deficit within five years and to have net public debt falling as a proportion of GDP between 2014-15 and 2015-16. But because of an economic recovery far slower than expected he appears unlikely to achieve these targets.

Yet even if the Chancellor of the Exchequer meets his fiscal targets, gross government debt would still be in the danger zone where growth is at risk. Recent estimates suggest that public debt levels over 85 to 90 per cent of GDP could reduce the annual growth rate by up to 1 percentage point. Under the Chancellor's plans gross debt is still expected to exceed 90 per cent of GDP by 2013.

There are many measures of fiscal sustainability and, as *Reform* argued in 2010, the criteria used by credit rating agencies should only be seen as a minimum standard.[1] One key measure is the sustainability of the level of debt (to avoid a "debt spiral"). This means that over the business cycle the Government must ensure that its average annual surplus is large enough to cover the interest payments on debt. Governments may run deficits to support the economy in periods of weakness, but over time they must, on average, have a surplus that at least covers the cost of servicing debt.

Measures of the sustainability of UK government debt show a long history of unsustainable borrowing: the surplus has been great enough to reduce public debt in only six of the past 34 years.[2] The UK is a persistent offender.

Fiscal rules can play an important role in helping the Government commit to a sustainable medium-term plan to deal with the debt problems it faces. Yet their previous use in the UK has not been a success. From 1998 to 2008 the UK had two rules: a golden rule to ensure budget balance, and a sustainable investment rule to constrain total debt. These rules did not prevent the increase in government debt in the UK between 2003 and 2008, even before the global financial crisis.

A better approach is required. International experiences with fiscal rules show a range of approaches can work, so long as they are appropriate to the situation. No one size fits all. However, key features that determine the success of fiscal rules include: comprehensive coverage of the Government's accounts to avoid gaming, the flexibility to deal with unexpected contingencies, and supporting institutions that hold the Government to account.

1 Bassett, D. et al. *Budget 2010: Taking the tough choices* (London, UK: *Reform*, 2010).

2 In 13 of the last 34 years debt as a share of GDP has fallen. High growth may lead to debt falling as a share of GDP in a particular year but this fall may still be below the sustainable level. In other words, the fall in debt may be less than should have been the case if the business cycle is taken into account. Debt may fall but by not enough.

Reform Ideas is an on-going series of short papers that illustrate new ways of thinking about policy problems and encourage debate on controversial and current issues. These papers are available free of charge from the Reform website at www.reform.co.uk

The way forward

This note illustrates the need for the Coalition to reduce public debt out of the danger zone and then to continue to put debt on a downward trajectory. To achieve this the current fiscal rules require revision.

In particular, the rule requiring debt to be falling as a percentage of GDP suffers from the same crucial flaw as the previous Government's golden rule: there is no clear rationale for it. International evidence shows that when fiscal rules lack a coherent rationale they become significantly weaker and far easier for governments to abandon. For the past decade in the UK the Government has been living by the idiom that "rules are made to be broken."

A new fiscal rule must commit the government to on-going, sustainable surpluses. Unlike previous fiscal rules (like the golden rule) these surpluses should be measured comprehensively, rather than excluding capital spending. Failure to do this will simply encourage gaming.

International examples also show the importance of strong and independent oversight of fiscal rules. The Office for Budget Responsibility should thus play an enhanced role in monitoring compliance. The rule should be theirs to enforce, not the Chancellor's to break.

The UK: a persistent offender

The Government has failed to maintain budget balance over the business cycle since the late 1990s, which has now led to accelerating debt levels. As Figure 1 shows, the UK has had a fairly consistent primary budget deficit for the past twenty years, slipping into surplus for only a few years at the height of the boom period around 2000, and briefly in the late 1980s before that.[3] Consequently, the public debt level has remained above 30 per cent of GDP for the entire period and has recently broken 80 per cent following the financial crisis of 2007-2008.

Figure 1 Fiscal performance in the UK
Source: IMF World Economic Outlook, October 2012

3 The primary deficit is the government's budget deficit before interest repayments are made. The greater the public debt, the larger the primary surplus required to adequately service it.

A need for restraint

There is cross-party support for long-term action to bring down the Government's debt levels. The Conservative MP for Ipswich, Ben Gummer MP, recently introduced a Bill that would create a fiscal rule for the Government, and Kwasi Kwarteng MP claims that "[for] too long governments have treated their responsibilities too lightly, spending recklessly and amassing high debt. Fiscal prudence is the very least we should expect from a Chancellor."[4] This has been supported by Stella Creasy MP, who said "[we] cannot ignore public debt, and its impact on people … we owe it to the people we represent to think about the next 20 years, and the challenges that will come."[5]

Even among economists who favour fiscal stimulus in the short term there is broad agreement that debt levels need to come down in the medium term. For example, Jonathan Portes, the Director of the National Institute for Economic and Social Research, argues for fiscal stimulus in the present recession but still believes that action is required to ensure long-term fiscal credibility: "The focus needs to be… on ensuring that we have a sensible framework that will ensure long-run fiscal sustainability."[6]

Why public debt is a problem

The rising public debt is causing concern because high debt levels have adverse effects on economic growth:[7]

> They seem to encourage pro-cyclicality of fiscal policy, which can exaggerate the economic cycle and prolong recessions.

> They can decrease growth. Debt levels exceeding 90 per cent of GDP could decrease growth rates by up to 1 per cent.[8]

> They restrict the government's ability to respond to crises with fiscal policy.

For these reasons, it is prudent for governments to keep debt levels anchored below about 90 per cent of GDP. In the UK this level is now being approached, which indicates a pressing need to ensure that future debt levels return below that threshold. Controlling debt requires the deficit to be maintained at a sustainable level.

What is a sustainable level of borrowing?

In the long run, public debt cannot rise faster than the nominal growth rate of the economy.[9] If it were to do so then the level of taxation would have to rise, or the services provided fall, in order for the government's revenues to keep pace with interest payments. That means that the government's primary surplus must be large enough to cover the interest repayments on debt.[10] That rule does not need to hold in every year, but it must be satisfied, on average, in the long run.

If the primary surplus falls below the required level then the government has to borrow more to

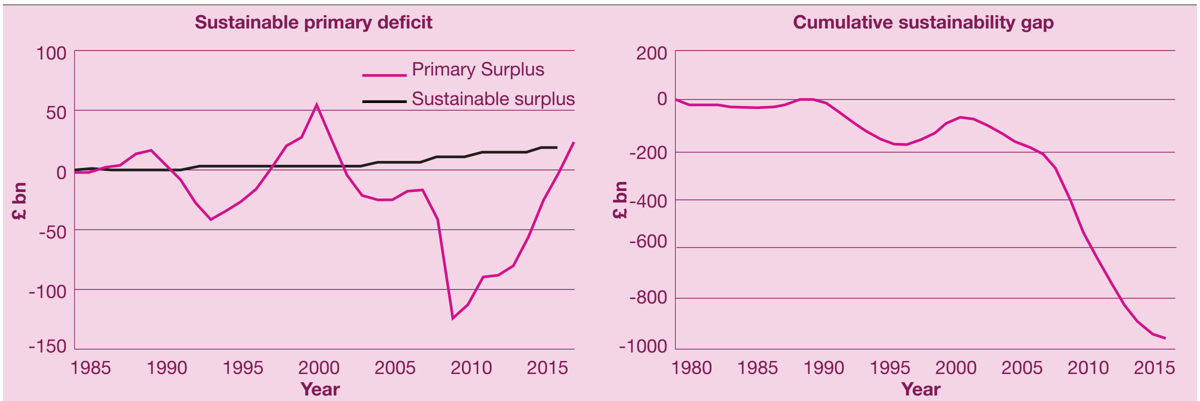
4 Gummer (MP for Ipswich). *Public Debt Management Bill: Second Reading*. London, UK: Hansard, 2012; 'IEA: Cut Chancellor's Pay If He Fails to Balance Budget – Telegraph', *The Telegraph*, May 31, 2012, http://www.telegraph.co.uk/news/uknews/9300459/IEA-Cut-Chancellors-pay-if-he-fails-to-balance-Budget.html.
5 'Labour Should Focus on Value for Money, Says Rising Star of Party | Politics | Guardian.co.uk', *The Guardian*, August 14, 2012, http://www.guardian.co.uk/politics/2012/aug/14/labour-focus-value-for-money.
6 'Jonathan Portes: Debt, Deficits and the Fiscal Framework', *HuffPost Politics: United Kingdom,* September 12, 2012, http://www.huffingtonpost.co.uk/jonathan-portes/debt-deficits-and-the-fiscal-framework_b_1876949.html.
7 D. Sutherland, P. Hoeller, and R. Merola, 'Fiscal Consolidation: Part 1. How Much Is Needed and How to Reduce Debt to a Prudent Level?' (2012): 13, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1985994.
8 Carmen M. Reinhart and Kenneth S. Rogoff, *Growth in a Time of Debt* Working Paper (National Bureau of Economic Research, January 2010), http://www.nber.org/papers/w15639 Their prescription has been the subject of much debate among economists but it seems prudent to err on the side of caution when the evidence is uncertain.
9 Assuming that the nation chooses not to default on its debt.
10 The primary balance is the fiscal balance, excluding the costs of debt servicing.

service its existing debt: debt begets more debt when the rule is broken. In the long run that is unsustainable. This note refers to the level at which the government has a primary surplus large enough to prevent such a debt spiral as the 'sustainable surplus'.

A history of unsustainable borrowing

Figure 2 shows actual and forecast primary surpluses alongside the surplus that would be required to maintain a stable debt level: the sustainable surplus. As debt rose the primary surplus also needed to rise to cover the increased costs of servicing the debt. However, as the chart shows, the government's fiscal balance only ventured above the sustainable level for six of the past 34 years to 2012.[11] The primary balance only needs to exceed the sustainable surplus on average, not in every year. However, while the cumulative gap was not so great through the 1990s, it has clearly departed from average balance since 2002. As a consequence, gross debt levels have risen steadily over that period.

Figure 2 Sustainability of UK debt
Source: IMF World Economic Outlook, October 2012; *Reform* calculations



The chart also includes the latest Office for Budget Responsibility forecasts through to 2016-17, which indicate a rapid decline in annual borrowing and a return to stability by 2017. The plausibility of those forecasts is being questioned by independent economists, many of whom expect the Office for Budget Responsibility to revise down its forecasts in the near future.[12] The figures show that the UK has not had a sustainable level of debt for some years, most notably through the boom period of the mid-2000s, when it would ideally have accumulated large surpluses. The advent of the financial crisis has amplified these problems and, as a result, debt has ballooned.

The UK's previous attempt at a fiscal rule

The Government has previously used a fiscal rule to guide its fiscal management. However, the previous discussion shows that the rule did not lead to sustainable deficits.

The UK last formalised fiscal rules in the Finance Act 1998. That rule had two parts:

1. The golden rule prevented net government borrowing over the economic cycle, except to fund investment.

11 The sustainable primary balance is calculated as $PS^* = (r-g)D$, where r is the long-run, average, nominal interest rate on government debt, g is the long-run, average, nominal growth rate of the economy, and D is the level of public debt at the beginning of the year. We use the OBR's assumptions of 5 per cent and 4.9 per cent for the interest rate and nominal growth rate, respectively.
12 Ian Mulheirn et al., *Fiscal Fallout: The Challenge Ahead for Public Spending and Public Services* (London, UK: Social Market Foundation, November 12, 2012), http://www.smf.co.uk/research/economic-policy/fiscal-fallout-the-challenge-ahead-for-public-spending-and-publi/.

2. The sustainable investment rule required that government debt never exceed 40 per cent of GDP.

At the time they were considered a model of excellent fiscal management.[13] They were enshrined in statute, monitored by HM Treasury, and overseen by the National Audit Office. Following the 2008 financial crisis, the Government was no longer able to achieve those targets and formally abandoned them.

DuPont and Kwarteng suggest that the rules failed partly because they left the Government too much scope to circumvent their spirit.[14] For example, defining the rule in relation to operating expenditure, rather than total expenditure, allowed the Government to borrow for investment purposes and maintain debt very close to the 40 per cent limit.

What can be done?

As early as 2000, Balassone and Franco were critical of the golden rule's enforcement mechanisms.[15] They argued that the vagueness of the concept of 'public investment' could lead to spending being categorised as 'investment' and a continued lack of fiscal discipline. That "… would leave unaltered both the margins for stabilisation policy and the safeguard of a structural budget consistent with a sustainable debt level."[16] Essentially, the restriction of the golden rule to the operating balance did not ensure counter-cyclical fiscal policy, nor did it ensure a safe overhead before the debt limit was hit. In addition, the rules granted explicit leeway for the Government to depart from the rules, so long as it gave reasons and provided a schedule for return.

As Wyplosz discusses, fiscal rules with explicit debt targets—such as the sustainable investment rule—are prone to being broken because they lack a solid basis: there is no reason for a particular limit of 40 per cent, so the target is easy to justify breaking when the need arises, as during the crisis.[17] The rules incorporated no mechanism to ensure that the Government allowed for a margin for flexibility to respond to contingencies. That meant the Government's finances were ill-prepared to respond to the costs of the 2008 crisis.

There are two lessons from this experience: First, fiscal rules must not allow for creative accounting that keeps some government expenses out of scope, as was the case with investment under the golden rule. Secondly, arbitrary debt targets, such as the sustainable investment rule, provide a false sense of security and should be avoided. Optimal macroeconomic policy will often involve using debt as a short-term buffer to accommodate unexpected shocks.[18] A more flexible rule allows that to occur while still maintaining credibility. The difficulty, then, is in designing a rule flexible enough to be credible, strict enough to be binding, and simple enough to be easily monitored.

Overseas governments have taken a variety of approaches to fiscal rules and their supporting institutions. It is tempting to think that these examples could be examined and the most successful implementation borrowed wholesale. That would be a mistake: as Calmfors and Wren-Lewis detail, the specifics of each country's rule owe much to the different problems they are designed to remedy.

13 *Fiscal Rules – Anchoring Expectations for Sustainable Public Finances* (Washington, DC: International Monetary Fund, Fiscal Affairs Department, 2009).
14 Jonathan Dupont and Kwasi Kwarteng, Binding the Hands of Government – a Credible Fiscal Rule for the UK, IEA Current Controversies Paper (London, UK: Institute of Economic Affairs, May 2012), http://www.iea.org.uk/sites/default/files/publications/files/Bindingpercent20theper cent20handsper cent20ofper cent20government-1.pdf.
15 F. Balassone and D. Franco, 'Public Investment, the Stability Pact and the "golden Rule"', *Fiscal Studies* 21, no. 2 (2000): 207–229.
16 Ibid., 224.
17 C. Wyplosz, 'Fiscal Policy: Institutions Versus Rules', *National Institute Economic Review* 191, no. 1 (2005): 64–78.
18 Lars Calmfors and Simon Wren-Lewis, *What Should Fiscal Councils Do?* Economics Series Working Paper (University of Oxford, Department of Economics, 2011), 5, http://ideas.repec.org/p/oxf/wpaper/537.html.

For example, if the government's deficit is thought to be caused by over-optimistic forecasts, as Dupont and Kwarteng assert is the case in the UK, then an appropriate response might be to simply set up an independent forecasting unit to oversee government budgeting. Indeed, that is what the Government did with the Office of Budget Responsibility that it created in 2010. However, if the problem is that the government is overspending in election periods then a fiscal rule with an independent supervisor explicitly judging adherence—to ensure loss of government credibility if the rule is breached—may be more appropriate.

The main lessons from the overseas examples are that the right rule, implemented in the right way, can make a difference for debt and deficits. Furthermore, there are a wide range of rules that can work, so long as they are appropriate to the country's situation. The challenge for the Government is finding the right one to deal with the problems they face today.

Table 1 Fiscal rules across nations
Source: Barker, F., and R. Philip. 'Comparative Approaches to Fiscal Rules'. In *The Business Cycle, Housing, and the Role of Policy*. Wellington, New Zealand: New Zealand Treasury, and the Reserve Bank of New Zealand, 2007.

Country	Fiscal Rules	Outcomes
Switzerland	> "Debt Brake", requiring a yearly balanced structural budget, ensures that spending growth never eclipses cyclically adjusted tax revenues. This prevents structural budget deficits and allow free reign for the operation of automatic stabilisers on the revenue side. > "Error correction" – deviations from structural balances are collected into a notional compensation account. This balance is taken into account to determine next year's targets, thereby ensuring forecasting mistakes have no long-term effects on Swiss debt levels.	> Government spending growth has fallen from 4.3 per cent a year in 2003 to 2.6 per cent a year of GDP now. > Gross debt has fallen from around 72 per cent in 2006 to around 54 per cent in 2009 since it was fully implemented in 2006.
Chile and Russia	> Natural resource exports are an important part of economy, so mechanisms are needed to manage large and on-going revenue fluctuations from change in the terms of trade. > Fiscal rules here are based on adjustments to the fiscal balance. At the start of the year Chile calculates annual budget expenditure by adjusting revenue for the output gap and divergences of the copper price from its long-term average. > So, the essence is: they predict revenues at the beginning of each year, and set expenditure based upon those estimates. In both cases, cyclical revenue is invested in a fund to be drawn on when exports are below average. If the changes in revenue are permanent, however, this can be spent immediately, e.g.: if there are permanent rises in price of copper/oil. > Russia emphasises the importance of fiscal policy in stabilising output, whilst Chile is not so concerned with stabilising output.	> Chile's budget turned around from a deficit of -1.2 per cent of GDP in 2002 to a surplus of 8.8 per cent in 2008. It briefly fell to a deficit of -4.5 per cent in 2010, but has now returned to a surplus of 1.4 per cent. > Russia's budget turned from a budget deficit of -6.3 per cent of GDP in 1998 to a budget surplus of 9.9 per cent in 2006. It fell down to a deficit of -7.9 per cent in 2010, and is now back up to a surplus of 0.8 per cent.

New Zealand	> Target a particular operating balance and back this approach with a debt limit. This operating balance applies over the economic cycle, supporting sustainability by ensuring temporary operating deficits are offset by temporary operating surpluses, whilst the debt target ensures the budget meets sustainability objectives. (Similar to the UK, then). > A non-binding rule that debt and net worth be maintained at a 'prudent' level and operating surpluses be run over a 'reasonable' period of time. The government of the day sets its own numerical targets. > Allows the operation of automatic stabilisers, and is transparent about fiscal policy objectives.	> From 1999 to 2007 budget surplus grew from 0.1 per cent of GDP to 5.7 per cent of GDP. It has since fallen to a deficit of -8.4 per cent of GDP.
Sweden and Netherlands	> Structural or average overall budget balance targets, in order to set multi-annual expenditure ceilings. > In the Netherlands, the government sets expenditure targets over a 4 year period to achieve structural surplus over business cycle. > In Sweden tri-annual expenditure ceilings are set to maintain an annual budget surplus of 2 per cent. These ceilings are not revised with revised revenue forecasts, so these flow through to debt. > These practices are used because of the difficulties of estimating the structural surplus.	> The Swedish budget surplus shifts a lot year on year, but is generally a surplus of between 1 and 3 per cent of GDP, only in deficit thrice between 1999 and 2012. > The Dutch budget is less successful. Though between 1994 and 2000 it reduced government debt by 32 per cent, since 1998 they have largely been in deficit, with only few marginal surpluses, and very heavy deficits since 2009.