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Designing a New Fiscal Framework:

Understanding and Confronting Uncertainty

By Jagjit S. Chadha, Hande Küçük and Adrian Pabst (Eds)

National Institute of Economic and Social Research

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Fiscal Policy Choices: the role of informal rules and fiscal frameworks

The Rt. Hon. Liam Byrne MP

Pity the poor fiscal policy maker trying to steer the ship of state between the Symplegades of certainty and flexibility today. On the one hand, voters - and bond markets - like the comfort of a plan for balanced budgets. On the other hand, we live in the age of the shock wave. In my time in parliament, I've worked through military conflict, financial crash and global contagion. With a Brexit vote thrown in for good measure. All have wreaked havoc with the basic business of fiscal planning.

Of course, it didn't used to be like this. For most of the New Labour years we enjoyed fiscal rules that were robust, flexible to a degree but crucially, stable. The case for these rules was set out with admirable thoroughness by Ed Balls and Gus O'Donnell[49] but the political summary was simple: transparent, predictable fiscal rules helped open economies enjoy low inflation and interest rates especially when coupled with an independent central bank. And then the world's financial system crashed, and we were forced to think anew.

The old certainties now seem part of a sunlit past. Since 2010, the Coalition Government set out new fiscal rules in the June 2010 Budget, (formalised in the April 2011 Charter for Budget Responsibility), there have been a further four versions of the Charter, with a new fiscal framework - the sixth since 2010 - still to come, designed to meet rules set out in the 2019 Conservative manifesto. Shifting rocks indeed.

49 Ed Balls Gus O'Donnell (eds), Reforming Britain's Economic and Financial Policy: Towards Greater Economic Stability

Yet formal rules are only part of the picture. They do not reflect in full the way fiscal policy is made. So as we confront the next great fiscal consolidation, I hope it is useful to reflect on our experience of consolidation planning back in 2009.

Sailors used to navigate by the constellations and Chancellors are much the same. Amongst the myriad of indicators blinking in the dark, there are a few stars in particular that we used to steer by. On reflection I would say five 'stars' in particular were important: (1) the output gap, (2) the public spending envelope, which affected the plausibility of (3) our public service agreements, (4) the target for reducing the deficit and (5) the tax-spend mix in the consolidation plan.

In the months after the Great Financial Crisis, we faced uncertainty swirling around practically every element of this picture. In particular GDP projections were very difficult and so understanding what was required to close the output gap was not easy, especially as the labour market was not behaving as it had in the past. The advent of tax credits, for example, appeared to be supporting a much higher employment rate than we would have expected.

But, nor had we ever really encountered a shock like this in modern times and while we knew that the GDP components would bounce back, it was hard to forecast by just how much - and how fast. In particular, it was very difficult to forecast the restoration of the investment rate as we simply could not anticipate firm's ambitions to rebuild their own cash buffers and reduce their exposure to banks which in turn were aggressively trying to reduce the risk on their own balance sheets. The very method used to project GDP was fraught with problems. Hitherto, GDP forecasts were created by assessing how far the growth rate had drifted from the long-term trend rate of growth. Good demand management methods packing together a judicious mix of monetary policy and fiscal policy were then constructed to return the economy to trend. Such is the theory. But in 2008, there were clear signs that the trend rate of growth in the British economy had been damaged and so quite what trend rate we were seeking to return the economy too was not a straightforward calculation.

Second, the deficit was so big that the old balanced budget rules were, for the foreseeable future, broken beyond repair. New rules were needed, and so the Chancellor had to extemporise. Here, in this key judgement, politics and economics collide. On the one hand, there was a genuine concern that without a convincing timetable for reducing the deficit, the unprecedented quantum of gilts required to be sold would require a high coupon. Like inflation, interest rates are amongst the last components slot into the Treasury red book forecasts and small increases in this rate are one of the Chancellor's most important windfalls. In this instance, the Chancellor and the Prime Minister decided that the target to halve the deficit over four years was both economically realistic and politically viable, and so the basic numbers were fixed for what was the largest fiscal consolidation ever planned by a Labour government.

Figure 8.1 Average Adjustments in Successful Fiscal Consolidations

Cut/Tax rise	%GDP
Government wages	-0.58%
Transfers	-0.54%
Public investment	-0.41%
Government consumption	-0.38%
Subsidies	-0.29%
Direct taxes	0.53%
Indirect taxes	0.17%

This deficit target, however, was fixed with a very clear eye on the public spending envelope and the scale and speed with which we thought it plausible to secure efficiencies. This is Treasury politics at its most raw, especially for a party that had made 'investment vs cuts' one of the key dividing lines in British politics. Our scope to reduce public spending was on the one hand constrained by what we thought was administratively plausible and what we thought wise, given the 120+ public service agreements defined between Treasury and Whitehall departments, which translated the poetry of manifestos and ministerial pronouncements into the prose of action plans to get things done. If we cut too far and too fast, ministers would quite rightly point out that manifesto commitments were in jeopardy. Furthermore, we were acutely alive to the Japanese experience of a double dip recession and so thought it unwise to unwind the fiscal stimulus too quickly, and second, as a centre-left party we wanted to close the deficit in a way that did increase inequality.

This then took us to the vexed question of the tax-spend mix. Simply put, once we had decided the speed with which we wanted to deliver a balanced budget - or in our case 'halve the deficit in four years', we had to agree what fraction of the consolidation should come from spending cuts, and what from tax rises. Here, we tried to learn from history. We looked at every fiscal consolidation around the world to assess the 'tax-spend' mix in successful consolidations. On average, we saw that 80% of successful consolidations were paid for with spending cuts. That was much too harsh for us. Our last budget therefore sought to reduce borrowing with a package composed of two-thirds spending cuts (71%) and around one third in tax rises (29%) (See Appendix Figure 8.2). Personally, I believe we got the tax-spend mix right. Mr Osborne subsequently sought to secure far more of the deficit pay-down through spending cuts (to over 90% in fact between 2012 and 2015) with terrible consequences for both growth and the welfare of poor communities.

Once the spending envelope is set, however, the Chief Secretary can set about her or his business negotiating new budgets across departments. I am sure that like unhappy families, budgets are each unhappy in their own way. But I suspect there are patterns which are similar. Reflecting on our experience I think there were five problems which really bedevilled us.

First, was the challenge of assuring markets that we were serious about spending reductions and deficit closure when, for all sorts of reasons, there was a reluctance to develop something akin to the Office of Budget Responsibility - an independent forecaster of GDP growth from which the Treasury estimates would then be drawn. I suspect our reluctance to embrace this had a political cost, and that we would have been permitted more political latitude in our spending plans if we have been prepared to embrace the transparency that the Conservatives later proposed, even if the quality of forecasts was not much improved.

Second, resisting cuts to the 'big numbers' in the budget, made delivery of all the other departmental settlements much harder. In particular, Alistair Darling and Gordon Brown were very reluctant to touch social security spending. I am sure that we made the right judgements in our restraint. But we never made a virtue of this and did not explain the way in which we were protecting social security payments.

Third, common to all spending reviews the challenge of information asymmetry create the most perverse outcomes. In particular it leads to a terrible gaming both between departments, and between departments and the Treasury. The Treasury has to land budget out-turns in line with the numbers promised to Parliament. It therefore relies on a number of tricks to ensure that it has the flexibility to deliver budgets, safe in the knowledge that it has less than a full picture of what departments are truly up to. For example, in a system of multi-year budgets, departments are typically promised the ability to 'carry over' underspends from earlier years into subsequent years; departments quite typically run significant surpluses because departments are generally very poor at spending the full allocation of their budgets. The last-minute Treasury whip-round before a budget is a tried and tested tactic for hoovering up unspent budgets and reallocating monies to something which is more virtuous than sitting in the department's theoretical bank account. These 'accumulated underspends' however can be cancelled pretty much at will. The budget which a department thinks it is carrying forward can suddenly evaporate. There would be less need for this kind of game playing if the Treasury had a much clearer line of sight, through to the precise monies which departments were actually spending. This requires wholesale reform of the way government accounting is managed.

Fourth, every Chief Secretary has to be prepared for a certain amount of special pleading which often risks throwing a spanner in the works. Typically, the special pleading is put forward by parts of the establishment which are extremely well connected and find it very easy to get themselves on the front page of *The Times* newspaper. I was very keen to cancel the Tate Modern extension for example, because I thought it was difficult to justify a spend of £140 million of our own art infrastructure in London at the time of more general spending reductions. One front page story later and I had the Prime Minister on the phone asking if I could apply my creativity to trying to solve the problem and letting the Tate Modern extension go ahead.

Fifth, however, is the risk of fighting the last war. This, to an extent, is inevitable when one is embarked on the difficult business of spending reductions. But we found a focus on solving the problems of the past distracted our attention from focusing on what was really going on amongst crucial parts of our political coalition. It was only in September 2009 that a team in the Treasury had uncovered the problem which we now call the 'squeezed middle' - the stagnation of living standards for significant numbers of people - but it was not until March 2010 that I was able to present these conclusions in a robust way to the cabinet with thoughts about how to fix the problem.

Conclusion

This is the most important lesson for the next consolidation because two different nettles have to be grasped.

First, the Government is lacking a proper framework for what it is actually trying to achieve, beyond 'getting Brexit done'. Many, myself included in work with the Centre for Progressive Policy, are looking at more sophisticated 'inclusive growth' indices that take us well beyond simple GDP targeting.[50] Kate Raworth[51] has important insights into frameworks for helping governments deliver both Sustainable Development Goals within harder 'budgets' for consumption of environmental resources. Governments need goals. It is very hard to set a public sector spending envelope properly without them. Right now, those goals are high level and vague.

Second, we need a radically different debate about tax which will play a much bigger part in the next consolidation. We need this for two reasons. On the one hand, we can now see very clearly that old-fashioned supply side strategies of slashing corporation tax rates do not bump up investment. By and large, they bump up share buy-backs.

More important however is the need for better taxes on 'carpet-baggers, capital and carbon', reducing tax avoidance, taxing either wealth,[52] or better still, the wealthy through capital gains and

50 https://www.inclusivegrowth.co.uk/inclusive-growth-time-measure-value/

51 https://www.kateraworth.com/doughnut/

52 The IFS inquiry is now underway, https://www.ifs.org.uk/events/1830

inheritance,[53] and creating some long-term certainty around carbon taxes.[54] Above all, we need a better debate about tax as Institute for Government[55] has argued and far more parliamentary oversight. We lack institutions like the US Congress and US Government (such as a Congressional Budget Office or the Office of Tax Analysis), and today the intelligence services have more parliamentary oversight than the tax authorities. Missing tax targets - by significant margins[56] - was a running problem for Mr Osborne, and frankly, for a country that fought a civil war about Parliamentary control of the tax system, these are reforms which are long overdue.

53 All the more important in the light of the Oxford Martin School's recent report which concludes; 'direct transmission of wealth across generations impacts directly on the extent of wealth inequality.' See https://www.oxfordmartin.ox.ac.uk/news/intergenerational-wealth-transfers-drive-inequality-in-britain/

54 See Ian Parry, A Carbon Tax for a Taxing Problem, https://www.imf.org/en/News/Podcasts/All-Podcasts/2020/01/20/parry-co2-tax

55 https://www.instituteforgovernment.org.uk/our-work/policy-making/better-tax-policy

56 See Appendix 2

Appendix

Figure 8.2 Tax Spend Mix in Budget Consolidation Plans

	forecast (% GDP)			
	Budget year	**5 years later**	**% point change**	**Contribution of receipts/ spending to change in borrowing**
March-2010 (last Labour budget)				
Receipts	36.1%	38.3%	2.2%	29%
Spending	47.9%	42.4%	-5.6%	71%
Public sector net borrowing	11.8%	4.1%	-7.8%	
June-2010				
Receipts	37.2%	38.7%	1.6%	18%
Spending	47.3%	39.8%	-7.4%	82%
Public sector net borrowing	10.1%	1.1%	-9.1%	
March-2011				
Receipts	37.2%	38.4%	1.1%	13%
Spending	47.1%	39.9%	-7.3%	86%
Public sector net borrowing	9.9%	1.5%	-8.4%	
March-2012				
Receipts	37.5%	37.9%	0.4%	5%
Spending	45.8%	39.0%	-6.8%	95%
Public sector net borrowing	8.3%	1.1%	-7.2%	

forecast (% GDP)

	Budget year	5 years later	% point change	Contribution of receipts/ spending to change in borrowing
March-2013				
Receipts	38.0%	38.3%	0.3%	9%
Spending	43.6%	40.5%	-3.0%	90%
Public sector net borrowing	5.6%	2.2%	-3.4%	
March-2014				
Receipts	37.7%	38.1%	0.4%	7%
Spending	43.5%	38.0%	-5.5%	94%
Public sector net borrowing	5.8%	-0.1%	-5.9%	
March-2015				
Receipts	35.8%	36.3%	0.5%	9%
Spending	40.7%	35.9%	-4.8%	91%
Public sector net borrowing	5.0%	-0.3%	-5.3%	
July-2015				
Receipts	35.9%	36.8%	0.9%	21%
Spending	39.6%	36.3%	-3.3%	79%
Public sector net borrowing	3.7%	-0.5%	-4.2%	

forecast (% GDP)

	Budget year	**5 years later**	**% point change**	**Contribution of receipts/ spending to change in borrowing**
March-2016 (last Osborne budget)				
Receipts	36.3%	37.4%	1.0%	23%
Spending	40.2%	36.9%	-3.3%	77%
Public sector net borrowing	3.8%	-0.5%	-4.3%	
March-2017				
Receipts	36.7%	37.2%	0.4%	23%
Spending	39.3%	37.9%	-1.5%	77%
Public sector net borrowing	2.6%	0.7%	-1.9%	

Notes: Receipts are formally described as 'public sector current receipts'
Spending is formally described as 'total managed expenditure'

Source: Office for Budget Responsibility. Historical official forecasts database.

Figure 8.3 Forecasts of Tax Receipts and Actual Out-turns Varied Widely

OBR forecasts of current receipts (ex APF) and outturns

£ billion						
		2010-11	2011-12	2012-13	2013-14	2014-15
June-2010	Forecast	547.7	584.2	621.9	661.9	
	Outturn	561	581	590	610	
	Difference	13	-3	-32	-52	
AS 2010	Forecast	550	586	620	659	
	Outturn	561	581	590	610	
	Difference	11	-5	-31	-49	
Budget 2011	Forecast	549	589	620	660	
	Outturn	561	581	590	610	
	Difference	12	-8	-30	-51	
AS 2011	Forecast		576	594	624	
	Outturn		581	590	610	
	Difference		6	-5	-14	
Budget 2012	Forecast		570	592	623	
	Outturn		581	590	610	
	Difference		11	-2	-13	
AS 2012	Forecast			594	621	
	Outturn			590	610	
	Difference			-4	-11	

OBR forecasts of current receipts (ex APF) and outturns

£ billion						
		2010-11	2011-12	2012-13	2013-14	2014-15
Budget 2013				587	612	
				590	610	
				3	-3	
AS 2013					607	
					610	
					3	
Budget 2014					608	
					610	
					2	
AS 2014						646
						646
						1
Budget 2015						647
						646
						-1