The Government's fiscal framework

November 2008

HM TREASURY

HM TREASURY

The Government's fiscal framework

November 2008

HM Treasury contacts

This document can be found in full on our website at:

hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861
E-mail: public.enquiries@hm-treasury.gov.uk

Printed on at least 75% recycled paper.
When you have finished with it please recycle it again.

ISBN 978-1-84532-520-6
PU647

Contents

Executive summary

The Government's fiscal framework

1.1 In 1997, the Government introduced a new fiscal framework as part of a comprehensive and inter-linked set of reforms to Britain's macroeconomic governance. These reforms aimed to deliver a more stable environment in which firms and households could plan and make decisions with confidence.

1.2 The fiscal framework was designed to complement the new monetary policy framework, which saw the Government setting an inflation target for which the Bank of England would have independent operational responsibility. Both frameworks sought to reconcile credible commitment to medium-term objectives with the need for short-term flexibility through the principle of constrained discretion. Within the fiscal framework, fiscal policy is constrained to deliver sound public finances, with the flexibility to respond to changing economic circumstances in the short term. The Government's commitment to significantly enhanced levels of transparency in fiscal policy supports this approach.

1.3 The Government's fiscal objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation should impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

1.4 The Government adopted two fiscal rules as a means to deliver these objectives, set over an economic cycle to give fiscal policy the flexibility to support monetary policy and smooth the normal fluctuations in the path of the economy:

- the golden rule: over the economic cycle, the Government would borrow only to invest and not to fund current spending; and
- the sustainable investment rule: public sector net debt as a proportion of GDP would be held over the economic cycle at a stable and prudent level. Other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.

1.5 The golden rule explicitly distinguished capital from current spending to protect investment. The sustainable investment rule, working with the golden rule, was designed to ensure sound public finances over the medium term. Maintaining low levels of public debt in ordinary circumstances would provide greater scope for fiscal policy to support monetary policy in the face of adverse economic shocks.

The performance of the framework over the last economic cycle

1.6 With evidence supporting the assessment that the economic cycle which started in 1997-98 ended in 2006-07, the Government is able to review the performance of the fiscal framework over a full economic cycle. Over the economic cycle from 1997-98 to 2006-07, the fiscal framework supported the Government's delivery of its fiscal policy objectives of sound public finances over the medium term and supporting monetary policy in the short term, and the fiscal rules were met:

- the average current surplus over the economic cycle was 0.1 per cent of GDP, meeting the golden rule that the Government borrows only to invest and helping ensure sound public finances and fairness between generations; and
- public sector net debt was reduced from 42.5 per cent of GDP in 1996-97 to 36.0 per cent in 2006-07, meeting the sustainable investment rule that net debt be held at a stable and prudent level over the economic cycle, and meeting the commitment that, other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.

1.7 The framework provided an effective constraint on policy discretion. Over the last economic cycle, the Government:

- significantly increased investment in public services; public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, rising from 0.6 per cent to 2 per cent of GDP in 2007-08, its highest level since 1979-80;
- reduced public sector net debt as a percentage of GDP to low levels by historical and international standards, thereby placing the public finances in a better position to support the economy and respond to economic shocks; and
- supported monetary policy in smoothing the economy's path over the cycle through the automatic stabilisers and discretionary changes in fiscal policy. Fiscal and monetary policy tightened together as the economy moved above trend in the late 1990s, and both loosened when it moved below trend in 2001.

1.8 The fiscal framework also delivered other benefits. Transparency in the operation of fiscal policy was significantly enhanced through, among other things, the publication of the End of Year Fiscal Report and Long-term Public Finance Report. Longer planning horizons for departmental spending, supported by greater macroeconomic and fiscal stability, helped to deliver value for money.

Responding to exceptional circumstances

1.9 As set out in the 2008 Pre-Budget Report, major economic shocks have hit every country in the world. These developments mean economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has entered an economic downturn, with persistent implications for the public finances.

1.10 The Government's objectives for fiscal policy in the face of these shocks remain unchanged. The Government's immediate priority is to continue to support the economy, while setting a path now for ensuring fiscal sustainability over the medium term.

1.11 In these circumstances, the role of the fiscal framework is to ensure fiscal policy has the flexibility to respond appropriately, while remaining committed to clear, transparent long-term goals. So, to achieve its objectives, and as provided for in the Code for Fiscal Stability, the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.

1.12 Consistent with the Code for Fiscal Stability, the Government is setting a temporary operating rule: **to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.**

1.13 The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

1.14 They set out how the Government intends to support the economy now, ensure medium-term sustainability, and maintain public investment. In advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver its objectives.

1.15 To build on the enhancements to transparency since the introduction of the fiscal framework, the Government will invite the National Audit Office to audit its approach to assessing the cyclically-adjusted position of the public finances, to adjust for the temporary effects of the economic cycle. The exceptional uncertainty at present underlines the importance of providing the public with key information on the fiscal position. The 2008 Pre-Budget Report sets out detail on the underlying assumptions that make up the fiscal forecast.

1.16 The independent Office for National Statistics will determine the impact on the fiscal aggregates of the interventions the Government has made to ensure the stability of the financial system. While the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on Public Sector Net Debt both including and excluding the impact of those interventions.

Outline of this document

1.17 Chapter 1 of this document outlines the rationale for the establishment of the fiscal framework from 1997, and how it was designed to operate. Chapter 2 assesses the framework's performance over the economic cycle 1997-98 to 2006-07. Chapter 3 outlines how the fiscal framework will respond in current exceptional circumstances.

1 The Government's fiscal framework

In 1997, the Government introduced a new fiscal framework as part of a comprehensive and inter-linked set of reforms to Britain's macroeconomic governance. These reforms aimed to deliver a more stable environment in which firms and households could plan and make decisions with confidence.

The fiscal framework was designed to complement the new monetary policy framework, which saw the Government setting an inflation target for which the Bank of England would have independent operational responsibility. Both frameworks sought to reconcile credible commitment to medium-term objectives with the need for short-term flexibility through the principle of constrained discretion. Within the fiscal framework, fiscal policy is constrained to deliver sound public finances, with the flexibility to respond to changing economic circumstances in the short term. The Government's commitment to significantly enhanced levels of transparency in fiscal policy supports this approach.

The Government's fiscal objectives are:

- over the medium term, to ensure sound public finances and that spending and taxation should impact fairly within and between generations; and
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy.

The Government adopted two fiscal rules as a means to deliver these objectives, set over an economic cycle to give fiscal policy the flexibility to support monetary policy and smooth the normal fluctuations in the path of the economy:

- the golden rule: over the economic cycle, the Government would borrow only to invest and not to fund current spending; and
- the sustainable investment rule: public sector net debt as a proportion of GDP would be held over the economic cycle at a stable and prudent level. Other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.

The golden rule explicitly distinguished capital from current spending to protect investment. The sustainable investment rule, working with the golden rule, was designed to ensure sound public finances over the medium term. Maintaining low levels of public debt in ordinary circumstances would provide greater scope for fiscal policy to support monetary policy in the face of adverse economic shocks.

Previous macroeconomic performance

1.1 In 1998, HM Treasury published Delivering Economic Stability: Lessons from Macroeconomic Policy Experience,[1] which outlined how, from the 1970s to the early 1990s, the UK economy was characterised by greater macroeconomic instability than most other G7 countries. Relatively poor performance included weaker and more volatile GDP growth, higher and more volatile inflation and higher short and long-term interest rates than in other G7 countries. Over this period, fiscal and monetary policy regimes changed frequently, reflecting a process of learning from problems generated by previous regimes and adapting to the changing institutional and external environments. A paper by HM Treasury on the experience of fiscal policy over the economic cycle from 1986 to 1997[2] outlined lessons which the fiscal framework sought to address:

- take a prudent approach by adjusting for the economic cycle and building in a margin for uncertainty. Estimating the impact of the economy's cyclical position on the public finances is complex, but if no attempt is made to do so, fiscal policy can be inappropriately tightened or loosened due to cyclical factors that may be only temporary, threatening the medium-term sustainability of the public finances. Also, forecasts for the fiscal balances are the difference between two large numbers – revenues and expenditure – which are difficult to forecast with accuracy; policy-making should recognise this uncertainty by using cautious assumptions;
- be open and transparent by setting stable fiscal rules and explaining fiscal policy decisions clearly. Unclear and changing policy objectives made it more difficult for policy makers to be accountable, and could lead to less coherent policy-making. Consistent objectives for the medium term and clarity over how they will be implemented in given circumstances help strengthen the credibility of fiscal policy, and can embed more firmly the expectations of households and businesses of the reaction of fiscal policy to new events, improving the outcome of policy interventions designed to improve stability; and
- fiscal policy should support monetary policy in promoting stability over the economic cycle. Inconsistency in the objectives or operation of monetary and fiscal policy can lead to poorly co-ordinated policy action and worse outcomes for policy. For example, in the early 1990s, in spite of the emergence of a negative output gap and the loosening of fiscal policy, reductions in interest rates from their 14 per cent level at the beginning of 1991 were delayed throughout 1991 and the first half of 1992, not least due to ERM membership. Flexibility for both monetary and fiscal policy to work together to smooth the path of the economy is an important part of any well-designed macroeconomic framework.

The place of fiscal policy within the macroeconomic framework

1.2 The macroeconomic framework introduced by the Government from 1997 was designed to learn from the experience of the UK's past performance. It sought to embed a more stable and effective institutional framework than had been in place in the past, thereby supporting the Government's goals of high and stable levels of growth and employment. Transparency, clear objectives and operating rules with the flexibility to apply appropriate discretion in achieving them, and a co-ordinated approach across different areas of policy, were key elements of the Government's approach.

[1] *Delivering Economic Stability: Lessons from Macroeconomic Policy Experience*, HM Treasury, 1998

[2] *Fiscal Policy: Lessons from the Last Economic Cycle*, HM Treasury, 1997

1.3 The fiscal framework is one pillar of this wider macroeconomic framework. It was designed to work alongside the public spending framework, the financial stability framework, and the monetary policy framework in delivering the Government's objectives for economic policy. These inter-locking frameworks are summarised below.

Monetary policy framework

1.4 In May 1997, the Government announced the establishment of a new monetary policy framework for the UK, with independent operational responsibility for meeting its monetary policy objectives transferred to the newly created Monetary Policy Committee (MPC) of the Bank of England.

1.5 The Government sets the objectives for both monetary and fiscal policy to ensure coordination between the two frameworks. Both arms of policy have the same fundamental objective of helping to achieve long-term growth and employment by delivering economic stability. Monetary policy does this by aiming to deliver price stability, while fiscal policy aims to deliver sound public finances.

1.6 Because the objectives of both arms of policy are clear, and their procedures transparent, both sets of policy makers are aware of what the other is trying to achieve and how the other may react to their policy decisions. The Bank of England's forecasts are conditional upon the latest stated plans for taxes and spending. If fiscal policy is set according to a clear framework, it becomes easier for the Bank to predict future fiscal policy decisions and set monetary policy accordingly.

1.7 The monetary policy framework is based on four key principles: clear and precise objectives; full operational independence for the Monetary Policy Committee (MPC) in setting interest rates to meet the Government's inflation target; openness, transparency and accountability; and credibility and flexibility.

Public spending framework

1.8 The public spending framework put in place in 1997 was designed to address past shortcomings in the allocation of public expenditure, including a lack of focus on the outcomes that spending programmes sought to achieve and a bias against capital spending stemming from cash budgeting. In addition, annual budgeting rounds had made it more difficult for departments to plan value for money spending, and also led to end-of-year surges in spending.

1.9 As a result, the public spending framework is underpinned by a number of principles. It encompasses a spending review process to give departments more certainty over a 3-year planning horizon to target resources to outcomes for which Departments are held accountable. The budgeting system distinguishes between capital and current spending, and accruals-based accounting has been introduced to the public sector to take account of the full economic cost of departmental activity. The framework seeks to clearly relate inputs it makes to outputs and outcomes it is seeking to achieve, and ensures issues are approached from the perspective of real-world agents involved rather than the current administrative structure, cutting across departmental boundaries where necessary.

Box 1.A: Role of fiscal and monetary policy in macroeconomic stabilisation

In the UK and in many other countries monetary policy has become the main demand management policy instrument with fiscal policy used in a supporting role. Monetary policy:

- can be more easily and frequently adjusted in either direction as required;
- has fewer effects on other policy objectives, such as ensuring fiscal sustainability; and
- can be effectively delegated to independent central banks, thereby reducing the perceived risk that demand management policy could be unduly influenced by political considerations.

Although monetary policy has become the primary demand management instrument, fiscal policy has continued to play an important role. Fiscal policy provides some "automatic" stabilisation that arises from the way that government spending and revenues respond to the fluctuations in economic activity. An important element in the design of the UK fiscal framework has been to ensure that these automatic stabilisers are allowed to operate.

Under the macroeconomic policy framework established by the UK Government in 1997:

- Monetary policy is the primary instrument of demand management, assigned to an operationally independent Monetary Policy Committee whose remit is to maintain price stability; and subject to that, to support the economic policy of the Government, including its objectives for growth and employment.
- Fiscal policy may support monetary policy, notably through the unconstrained operation of the automatic stabilisers. But the framework specifies that the use of fiscal policy for macroeconomic stabilisation purposes must be credibly and transparently consistent with the objective of ensuring sustainable public finances in the medium term.

Financial stability framework

1.10 The pivotal role of the banking system, and in particular the risk that bank failures pose for the wider economy, requires sector-specific regulation. In the UK, the framework to protect financial stability is enshrined in the 1997 Memorandum of Understanding (MoU) between HM Treasury, the Financial Services Authority (FSA) and the Bank of England (collectively known as 'the Authorities'). The division of responsibilities between the authorities is based on four principles: clear accountability; transparency; avoidance of duplication; and regular information exchange. The MoU was updated in 2006 and the Government has committed to review the arrangements once current financial instability has receded and new measures to ensure financial stability (for example, those contained within the Banking Bill) have been implemented.

1.11 International cooperation to ensure financial stability has become increasingly important as the degree of global financial integration has risen. Much of this cooperation takes place within the European Union or through engagement with non-legislative bodies such as the International Monetary Fund, the Financial Stability Forum (FSF) or global standard-setting bodies like the International Accounting Standards Board.

The Government's fiscal framework

1.12 The Government's macroeconomic framework drew from contemporary academic thinking on macroeconomic policy. Academic analysis has emphasised the importance of the credibility and time consistency of Government policy in shaping the response of firms and households.[3] A policy is time consistent if the policy that the Government commits to currently is one that it will wish to maintain in the future – its preferred policy will not change over time unless circumstances change. It is credible if firms and households believe that the Government will adhere to it. Unless these conditions are met, the private sector might not respond in the way that policy-makers intend.

1.13 The design of the fiscal framework, like the monetary policy framework, was based on the principles of constrained discretion as a means of ensuring Government policy-making is time consistent and credible. In the context of fiscal policy, this means Government setting clear constraints on its fiscal policy through the objective of sound public finances over the medium term, while allowing sufficient flexibility in the short-term to enable automatic stabilisers and discretionary fiscal policy to operate to stabilise the economy without compromising the commitment to that medium term objective. In particular, it allows:

- the automatic stabilisers to operate without markets responding adversely;
- the Government to employ discretionary fiscal policy in support of monetary policy if the economy is judged to be moving far away from trend, without compromising its commitment to sound public finances over the medium term; and
- the credibility of the fiscal policy framework to provide an anchor for expectations of fiscal outcomes. Together with a credible monetary policy framework, this would deliver lower long-term interest rates by lowering long-run expectations of the level and volatility of inflation, and hence risk premia.

1.14 Constrained discretion supports stability through credible commitment to sound public finances over the medium term, and in providing space for policy to smooth the economy's path in the short run. It is supported by principles central to the Government's fiscal and macroeconomic frameworks:[4]

- credibility, delivered by pre-commitment to a fiscal framework and clear objectives, operationalised through fiscal rules;
- flexibility, allowing fiscal policy to support monetary policy and smooth the economy's path; and
- transparency, which allows flexibility and reinforces accountability. This builds confidence and legitimacy and, by improving public scrutiny, reinforces the credibility of the Government's commitments.

Credibility

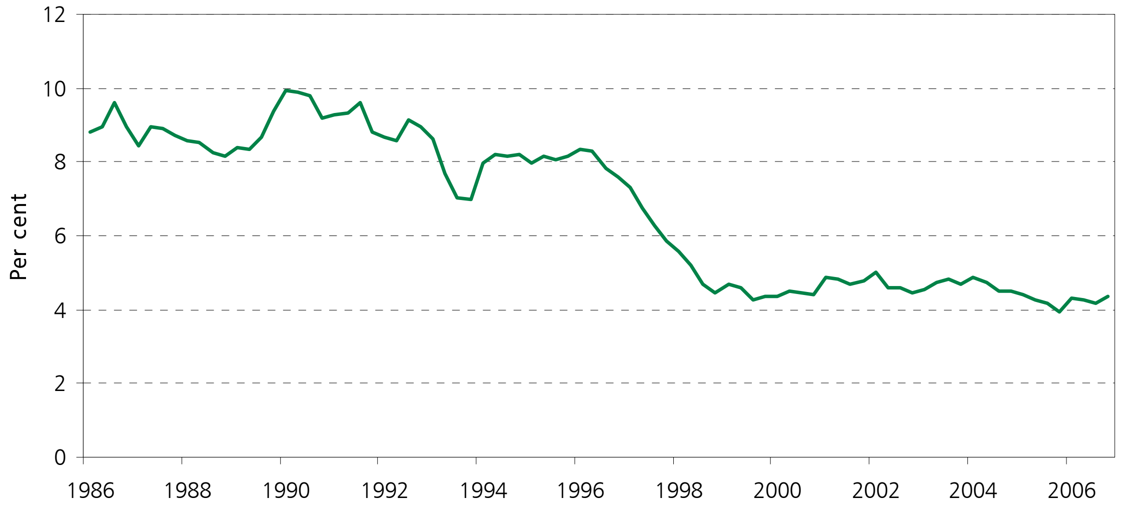
1.15 In an open economy, governments can have policy credibility and exercise constrained policy discretion only if they pursue, and are seen to be pursuing, fiscal policy objectives which are well understood, sustainable, and stable over time. The fiscal and macroeconomic frameworks are designed to support this.

[3] For a summary of the evidence, see Chapter 2 of *Reforming Britain's Financial and Economic Policy*, Ed. Balls, E. and O'Donnell, G., 2002, Palgrave Press.

[4] See the Mais Lecture by The Rt Hon Alistair Darling, Chancellor of the Exchequer, at the Cass Business School (October 2008) and the Mais Lecture by The Rt Hon Gordon Brown, Chancellor of the Exchequer, at the Cass Business School (October 1999)

1.16 There are a variety of potential market measures of the credibility of macro-economic policy. For monetary policy, one important measure is the expected level of inflation, which reflects the private sector's confidence in the commitment of the monetary authority to low inflation. Another potential measure, which combines the market's view of both monetary and fiscal policy and the long-run prospects of the economy, is the long-term interest rate on government debt, which influences long-term interest rates in other sectors of the economy. Chart 1.A illustrates the reduction in UK long-term interest rates in the late 1990s, coinciding with the introduction of the Government's macro-economic framework. A significant proportion of the reduction in nominal yields is attributable to expectations of lower inflation associated with the introduction of the monetary policy regime.

Chart 1.A: UK long-term interest rates



Note: Nominal yield on 20-year gilts

Source: HM Treasury

1.17 To support credibility, the Government has based its macroeconomic framework on consistent, inter-locking medium-term objectives: for monetary policy, a primary objective to deliver price stability; and for fiscal policy, in the short term to support monetary policy to help smooth the path of the economy, and over the medium term to ensure sound public finances. These objectives complement each other and are sustainable over the long term.[5]

1.18 To ensure credible pre-commitment to fiscal policy objectives, the Code for Fiscal Stability requires the statement of fiscal rules which are designed to deliver those objectives in given circumstances, and which are an important element of Government accountability. This pre-commitment raises the reputational or other cost of diverting from the stated objective and course of policy. The credibility of this pre-commitment rests on both the Government's record in delivering its objectives and on the flexibility it builds in to reformulate appropriate fiscal rules as circumstances change.

1.19 The appropriate pre-commitment mechanism depends on the policy context. In the case of monetary policy, where a policy goal of price stability could be codified in an inflation target and delivered through a single policy lever, the Government chose to operationalise pre-commitment by setting an inflation target and delegating operational decisions to an independent central bank. However, it decided that similar institutional arrangements for fiscal policy could be more

[5] For a fuller discussion of how the macroeconomic framework facilitates coordination between monetary and fiscal policy, see O'Donnell and Bhundia (2002) '*UK policy coordination: the importance of institutional design*'

problematic. For example, they could require delegating responsibility for taxation and public expenditure decisions that impact on wider social and economic objectives. These reflect collective political and social choices requiring strong democratic accountability.

Flexibility

1.20 Attempting to achieve credibility in policy-making by adopting rules which leave no scope for discretion has been unsuccessful in the past, as such rules could not be robust to all possible shocks, and so could not be time consistent. Sticking to rules in the face of a large shock can be destabilising. If rigid rules are no longer seen to be delivering the Government's objectives, then market participants will begin to question the Government's commitment to maintaining the rules. This speculation can be destabilising, as was the case with the exchange rate target the UK adopted on entering the ERM in the early 1990s. Flexibility helps boost the credibility and legitimacy of the framework overall, so long as it is constrained. The Government's fiscal framework was designed to give it the flexibility to respond appropriately to shocks and other changes in circumstances.

Transparency

1.21 Transparency is an essential element in promoting understanding outside Government of policy makers' objectives, and is fundamental to democratic accountability. It also allows individuals and businesses to monitor whether policy decisions are consistent with stated objectives. The fiscal framework sought to achieve a high degree of transparency to match the monetary framework's transparency.

1.22 The greater the transparency surrounding Government objectives and the reasons for decisions, and the more information about policy outcomes is disseminated, the more likely it is that people and businesses will understand the Government's intentions. Moreover, greater transparency supports the flexibility of policy to react to short-term events and address medium-term problems. By making information available to the public and the markets about long-term objectives, the basis of policy, and the short-term state of the economy and public finances, the Government sought both to improve the effectiveness of policy and to reduce the credibility cost of deviations from stated objectives as a result of shocks.

The fiscal framework in practice

1.23 The Government introduced the fiscal framework in 1997, with the Code for Fiscal Stability underpinned by the 1998 Finance Act. The Code is reproduced in Annex A. It set out the key principles for fiscal management, new reporting requirements and a role for the National Audit Office to provide an independent audit of key assumptions underpinning the public finance projections.

1.24 The Code strengthens the openness, transparency and accountability of fiscal policy. It improves the quality of information made available to the public. It draws together and articulates the framework within which fiscal policy operates. Underpinned by legislation, it acts to demonstrate the Government's commitment, and aims to ensure that fiscal policy is time consistent.

1.25 Box 1.B sets out the operation of the Code through its different levels. It shows how the Government is committed to five principles of fiscal management, alongside the requirement for modern accounting methods, enhanced transparency, and the requirement to state objectives explicitly. In turn, the Government's fiscal objectives, operationalised through fiscal rules and underpinned by commitments in the Code, help fiscal policy play its role in delivering the Government's economic objectives of high and stable growth and employment through sound public finances and macroeconomic stability.

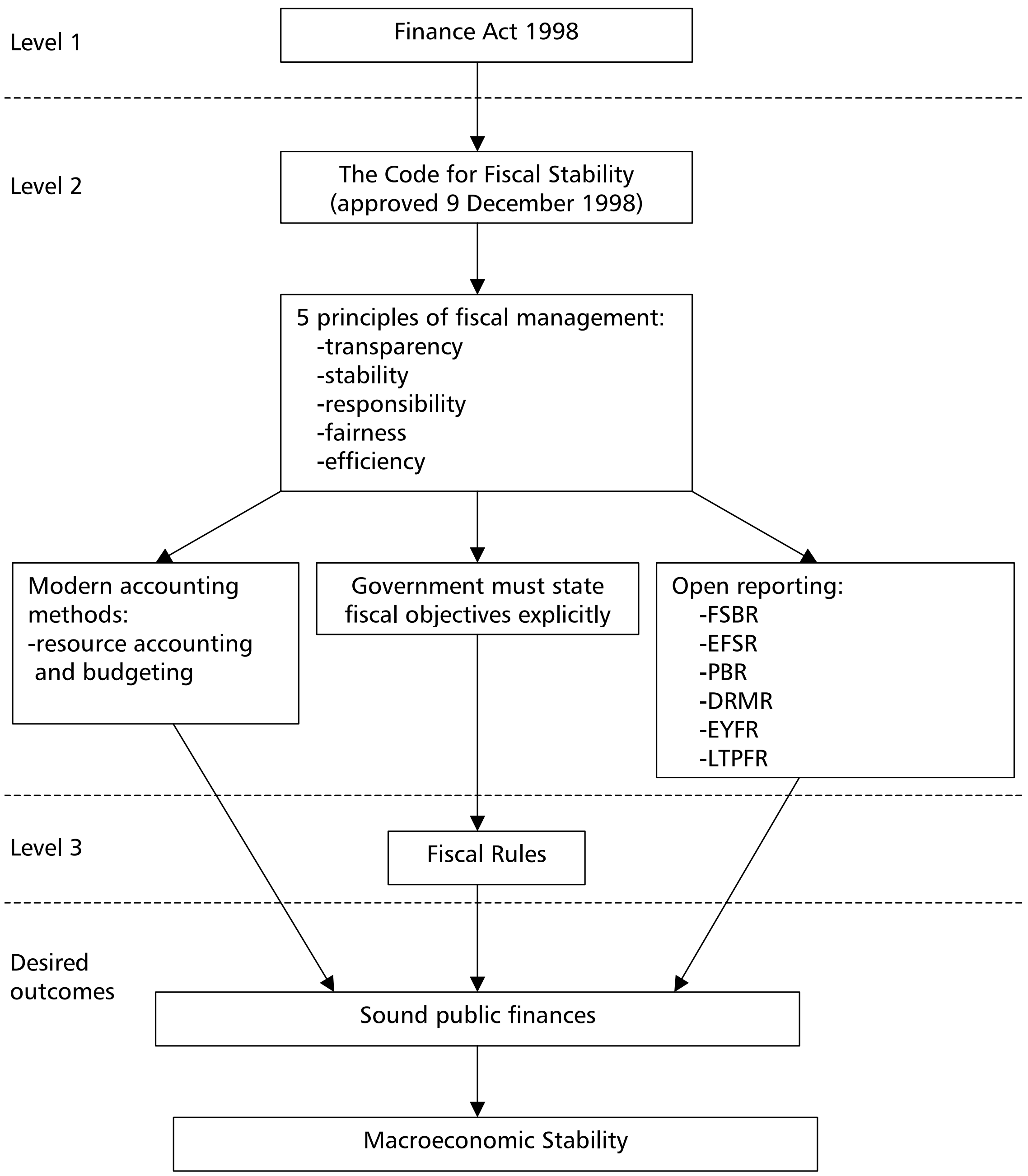
1.26 The following sections outline the role of fiscal policy objectives and operating rules under the Code for Fiscal Stability, and the terms under which the Government can change, or temporarily depart from, its stated objectives and operating rules. It explains the Code's five principles of fiscal management, the fiscal rules and the other features of the fiscal framework.

The role of fiscal policy objectives and operating rules under the Code for Fiscal Stability

1.27 The Code commits the Government to state clearly its fiscal policy objectives and operating rules. However, it leaves the choice of fiscal rules and objectives to the Government of the day. Legislating specific rules would have been unduly restrictive, and incompatible with the discretion required both for an elected Government to establish its own fiscal objectives and for the rules formulated to deliver those objectives to be adapted to unforeseen circumstances. The Code's approach is designed to ensure a more credible way of pre-committing Government to achieve medium-term fiscal objectives than would have been achieved by legislating permanent fiscal rules. To take account of all possible future economic circumstances, either such rules would have to be so loose as to not act as a constraint on policy in normal times, or they would not represent a credible policy commitment, as in some circumstances they would force the Government to act inconsistently with its objectives – for example, by requiring sharp fiscal tightening at a point which would destabilise the economy.

1.28 Instead, the Code provides the Government with the flexibility to respond appropriately to shocks or new circumstances through reformulating its objectives or rules.

Box 1.B: The fiscal framework in detail



Changes to objectives and operating rules under the Code for Fiscal Stability

1.29 As set out by the Code, the Government may change its fiscal policy objectives or operating rules provided that the new objectives or operating rules accord with the principles of fiscal management of transparency, stability, responsibility, fairness and efficiency, and that the reasons for departing from the previous rules or objectives are stated.

1.30 If the Government only intends to depart from its fiscal policy objectives or operating rules temporarily, it also needs to outline the fiscal policy objectives or operating rules it intends to apply in the meantime, and the approach and period of time it intends to take to return to the original rules.

The principles of fiscal management and objectives of fiscal policy

1.31 The fiscal framework is guided by five principles of fiscal management, as set out in the Code for Fiscal Stability. The Code requires Government to explain how its fiscal policy objectives and rules are compatible with these principles, which are:

- transparency in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts: this ensures that Parliament and the public can scrutinise the Government's fiscal plans, encouraging the Government to give more weight to the longer-term consequences of decisions, leading to a more sustainable fiscal policy;
- stability in the fiscal policy-making process and in the way fiscal policy impacts on the economy: this means that governments should, so far as possible, operate policy with a reasonable degree of predictability and in a way that supports stability and long-term growth in the economy;
- responsibility in the management of the public finances: this means that the Government should operate policy and manage public assets, liabilities and fiscal risks with a view to ensuring that the fiscal position is sustainable over the long term;
- fairness, including between generations: Government should take into account the financial effects on future generations when making fiscal and debt management decisions. It would be unfair to make future generations meet the cost of policies that primarily benefit the current generation. Conversely, the current generation should not be expected to pay unduly for policies that will mainly benefit future generations. Fairness within broad groups of the current generation is also important; and
- efficiency in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet: this means that the Government should not waste resources or cause resources to be wasted elsewhere in the economy.

1.32 The Government's fiscal policy objectives are:[6]

- over the medium term, to ensure sound public finances and that spending and taxation impact fairly within and between generations. In practice, this requires that:
  - the Government meets its key tax and spending priorities while avoiding an unsustainable rise in the burden of public debt; and
  - those generations who benefit from public spending also meet, as far as possible, the costs of the services they consume.
- over the short term, to support monetary policy and, in particular, to allow the automatic stabilisers to help smooth the path of the economy. In practice, this entails:
  - allowing the automatic stabilisers to play their role in smoothing the path of the economy in the face of variations in demand; and

[6] These objectives were first outlined in the November 1999 Pre-Budget Report, and are explained more fully in *Analysing UK Fiscal Policy*, HM Treasury, November 1999

- where prudent and sensible, providing further support to monetary policy through changes in the fiscal stance. This enables the Government to change the fiscal stance if the economy is projected to be some way from trend.

The fiscal rules

1.33 The role of the fiscal rules is to ensure the Government is credibly constrained to meet its fiscal objectives over the medium term. The Government set two fiscal rules that were designed as a means to deliver these objectives, and against which the performance of fiscal policy could be judged:

- the golden rule: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and
- the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.

1.34 The fiscal rules were designed to ensure that the public finances are managed prudently so that the Government can meet its spending commitments without jeopardising economic stability. But they needed to be flexible enough to react appropriately to economic developments, striking the right balance between a rigid mechanical approach and unfettered discretion. It is important that the rules should not constrain the ability of automatic stabilisers to support monetary policy (see Box 1.C) and, if necessary, to allow for discretionary adjustments to fiscal policy where required, to accommodate exceptional shocks not associated with the usual economic cycle.

1.35 The rules were chosen to apply to central and local government (together referred to as general government) and to public corporations combined. This was to ensure the fiscal aggregates encompassed the whole public sector, with the intention of providing an appropriate measure of the impact of decisions on the long-term economic costs to taxpayers.

Consistency with European commitments

1.36 As a member of the European Union, the UK is subject to the Stability and Growth Pact (SGP). Under the Maastricht Treaty, Member States agreed to regard their economic policies as a matter of common concern and to coordinate them within the European Council. Under the SGP, borrowing (defined in terms of the general government financial balance) should not exceed the reference value of 3 per cent of GDP, and gross general government debt should not exceed 60 per cent of GDP. The SGP aims to deliver sound public finances in support of European monetary stability. The Government's fiscal policy objective to maintain sound public finances is commensurate with the SGP.

Box 1.C: Automatic stabilisers

The automatic stabilisers are those elements of the tax and spending regime which fluctuate over the economic cycle in a manner which, without active policy decisions – i.e. "automatically" – act to dampen cyclical fluctuations.[7]

For example, during an upswing, tax receipts will rise as incomes increase, and this will act to mitigate the increase in disposable incomes and hence act to dampen the cycle. Similarly, in a downturn, unemployment benefit payments will rise, mitigating the decline in household incomes, and moderating the slowdown.

The strength of the automatic stabilisers is related to:

- the size of the government sector;
- the progressivity of the tax system;
- the degree to which the tax system taxes cyclically-sensitive items; and
- the level of benefits.

An advantage of the automatic stabilisers is that they avoid many of the difficulties inherent in operating fiscal policy for stabilisation purposes:

- there are no decision and implementation lags;
- they generally operate symmetrically over the cycle; and
- they can be reasonably clearly identified and hence separated from other aspects of fiscal policy.

The automatic stabilisers can only dampen the effects of a shock. They may therefore provide an insufficient degree of stabilisation, particularly for large shocks. In such circumstances a more active discretionary fiscal policy might be required.

The golden rule

1.37 The Government first committed itself to the golden rule in the July 1997 Budget. This stated that "over the economic cycle, the Government will only borrow to invest and not to fund current expenditure".[8]

1.38 This helped ensure sound public finances and that fiscal policy was fair between generations. Some forms of public expenditure generate benefits for long periods after the expenditure is incurred, whereas others produce benefits which are consumed within a year. It is not practical to match the timing of the streams of costs and benefits for each and every spending proposal. However, in aggregate, the Government took the view that current spending, which mainly provides benefits to existing taxpayers, should be paid for by the current generation of taxpayers. Similarly, because capital spending produces a stream of services over time, it is fair that this form of spending is financed initially through borrowing that is repaid over time.

[7] A full discussion of the role of the automatic stabilisers is contained in Chapter 5 of HM Treasury (2003) *'Fiscal stabilisation and EMU – a discussion paper'*. http://www.hm-treasury.gov.uk/fiscal_stabilisation_and_emu.htm.
[8] HM Treasury, *Financial Statement and Budget Report* (chapter 1), July 1997

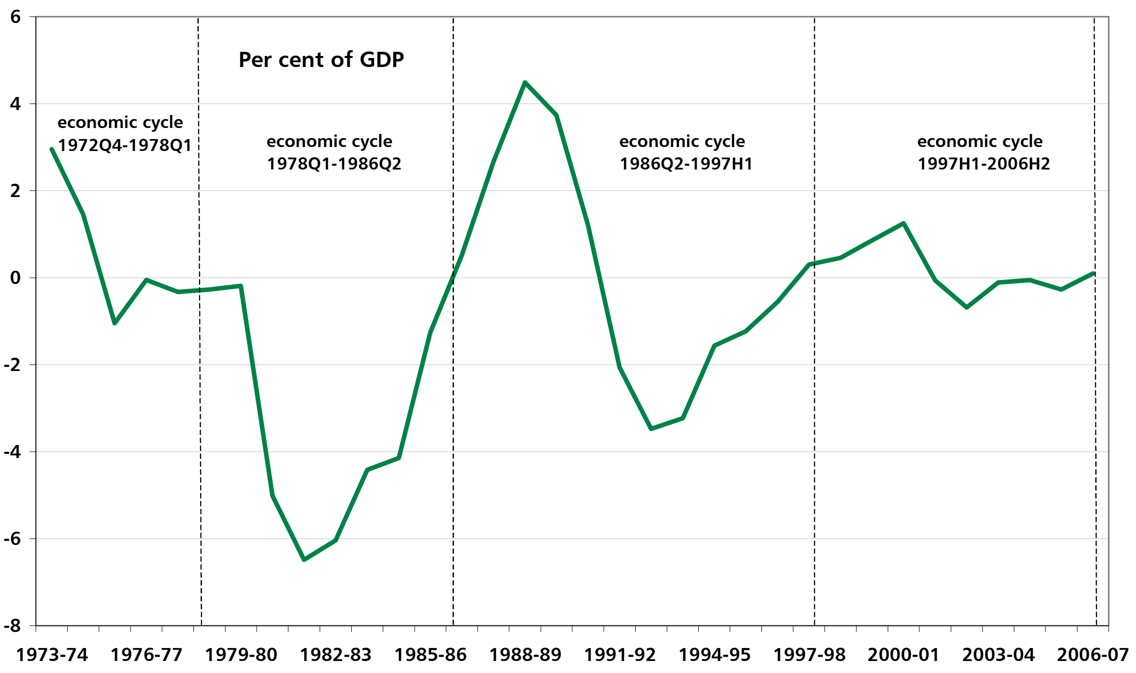
Avoiding bias against capital spending

1.39 To implement the objective that fiscal policy should impact fairly between generations, the golden rule drew a distinction between current spending (and revenue) and capital spending.[9] Previous spending regimes concentrated on targets usually expressed in terms of their impact on the public sector borrowing requirement, or PSBR (now called the public sector net cash requirement), and made no formal distinctions between capital and current spending. This created a bias against capital spending, which was easier to cut back to achieve a given reduction in cash expenditure. This failure to distinguish properly between current and capital spending previously contributed to under-investment in the public sector.

Definition over the economic cycle

1.40 The golden rule was defined over the economic cycle (see Box 1.D for an account of the economic cycle). This helped ensure that fiscal policy retained the capacity to respond to cyclical fluctuations. It is worth noting that the symmetry, or asymmetry, of economic cycles is also of importance in implementing the fiscal rules. It is likely to be more difficult, and less consistent with a fiscal objective based on fairness between generations, to achieve current balance over a cycle involving a relatively longer period of below-trend output. This issue is discussed further in Chapter 3.

Chart 1.B: The output gap in the UK over economic cycles from 1972-73 to 2006-07



Note: Output gaps on a financial year basis. Vertical lines represent start and end-cycle points as identified by HM Treasury.

Source: HM Treasury

[9] Current spending is defined as spending producing benefits that are consumed in the same year as that in which the spending occurs. In contrast the benefits of capital spending accrue over the life of the asset being purchased. Capital spending comprises gross fixed capital formation (purchases, less sales of non financial assets plus net stock building) and expenditure on capital grants. This definition of capital spending excludes some spending items that also have some of the characteristics of investment, such as spending on education, which will provide a return in future through increased productivity. In choosing a definition of capital spending, the Government has to balance the conceptual advantages of including investment in human capital with the advantages for transparency of using internationally recognised and independently verified aggregates such as those produced in the National Accounts.

Box 1.D: The economic cycle

Economic cycles[10] are often defined as economic fluctuations that take the form of deviations of the economy's actual output from its trend path. These deviations are often referred to as the 'output gap'. Chart 1.B illustrates the evolution of the output gap in the UK over 1972-3 to 2006-07.

When the economy is in an up-phase, actual output is above its trend level, implying a positive output gap; and when the economy is in a down-phase, actual output is below its trend level, implying a negative output gap.

Full cycles are usually characterised as successive periods of up-phase and down-phase, or slackness and tightness in resource utilisation, that together comprise a complete cycle. The cyclical evolution of the economy is influenced by changes in the nature of shocks, the structure of the economy, and in the behaviour of households and companies, which vary through time. So no two cycles are ever exactly alike.

The relevance of the economic cycle to fiscal policy centres around the cycle's short-term effects on the public finances through the operation of the automatic stabilisers, described in Box 1.C. Setting fiscal rules to take account of the economic cycle allows the automatic stabilisers to work without risking the long-term sustainability of the public finances.[11]

In practice, the dating of economic cycles involves a degree of judgement, not least because there is a range of views on exactly how cycles should best be defined and measured. Different methodological approaches can result in different conclusions, although there is often consensus among economic analysts about the broad shape and duration of specific cycles. The judgements reached from applying any one particular approach can also change over time if data are revised or if understanding of how the economy works prompts a re-interpretation of how data relate to the cyclical position of the economy.

HM Treasury uses a broad range of cyclical indicators to inform its judgements on the economic cycle. The advantage of this approach is that it brings more evidence to bear on the identification of economic cycles than alternative methods, such as more explicit production function approaches and statistical filters.[12] This helps to alleviate the problems involved in identifying a cycle using the more limited information applied by other approaches, especially those based purely on statistical filters. Economic-based approaches, including HM Treasury's, also have an advantage over statistical filters in terms of making it easier to allow explicitly for particular factors affecting trend in the latest cycle and beyond.

The sustainable investment rule

1.41 The Government first committed itself to a fiscal rule focused on public debt in the July 1997 Budget. This stated that "public debt as a proportion of national income will be held over the economic cycle at a stable and prudent level".[13]

1.42 The Government's specification of the level below which public sector net debt should be held over the economic cycle developed over time. In the 1998 Economic and Fiscal Strategy

[10] More details of the Treasury's approach to assessing the economic cycle are set out in *Evidence on the economic cycle*, published alongside the 2008 Pre-Budget Report

[11] The role of the economic cycle in influencing fiscal aggregates is discussed in *Public finances and the cycle* (chapter 2), Treasury Economic Working Paper Number 5, HM Treasury, November 2008

[12] Details of different approaches to assessing the economic cycle are set out in *Evidence on the UK economic cycle*, HM Treasury, July 2005.

[13] HM Treasury, *Financial Statement and Budget Report* (chapter 1), July 1997

Report (EFSR), the Government stated "other things equal, it is desirable that net public debt be reduced to below 40 per cent of GDP over the economic cycle".[14] At the 2001 Budget, the Government stated "other things equal, net debt will be maintained below 40 per cent of GDP over the economic cycle".[15] At the 2003 Budget, the Government stated that to "meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle".[16]

Theoretical and empirical considerations around specific debt levels

1.43 A number of academic studies have tried to identify the optimal public debt ratio – that is, a debt level that represents an optimal trade-off between the need to undertake public investment and the economic costs of associated with higher levels of public debt. Various approaches have been tried, such as inferring the optimal debt ratio from debt/equity ratios prevailing in the private sector or from tests of dynamic efficiency, or estimating the optimal public debt ratio using statistical techniques. The methods and assumptions underpinning each of these approaches have been contested, and the range of results presented by these studies point to the difficulty around the notion of an optimal debt level.[17] In turn, this suggests that the precise debt target chosen will be arbitrary to some extent.

1.44 As a result, neither economic theory nor empirical evidence provides a definitive guide for policy makers. This was reflected in comments made in the IMF's Manual on Fiscal Transparency in 1998: "judgements about excessive debt, and particularly excessive debt-to-GDP ratios, are hard to make... assessments of fiscal sustainability have to be made on a country-specific basis, relying on particular knowledge about the implications of, and market reactions to, the government's past and future fiscal policies".[18]

1.45 There is no single unique target level of debt, or debt-to-GDP ratio, that represents a prudent and sustainable level. In its latest assessment of long-term sustainability of the public finances, the European Union's Economic Policy Committee explained, "The issue of debt or fiscal sustainability is a multifaceted issue and there is no agreed definition on what a sustainable debt position is".[19]

Setting the sustainable investment rule limit in the last economic cycle

1.46 When deciding what level of debt to target for the sustainable investment rule in the Economic and Fiscal Strategy Report (EFSR) in 1998, the Government weighed up a number of factors pertaining at that time. These included the need for investment, the inter-generational impact of spending and revenues and prospects for the long-term growth of the economy, in order to balance "the need to undertake worthwhile public investment and fund this in a fair way, against the requirement that debt remains prudent and at levels that do not impose a burden on the economy, or future generations".[20]

1.47 The Government announced in the EFSR 1998, that, other things being equal, it would be desirable to maintain net debt below 40 per cent of GDP over the course of the cycle. This

[14] HM Treasury, *Economic and Fiscal Strategy Report* (chapter 3), June 1998

[15] HM Treasury, *Economic and Fiscal Strategy Report* (chapter 2), March 2001

[16] HM Treasury, *Economic and Fiscal Strategy Report* (chapter 2), April 2003

[17] For instance, H.H. Zee (1998) "*The Sustainability and Optimality of Government Debt*" (IMF Staff Papers 35(4), pp. 658-85) suggested that the optimal public debt level is less than 20 per cent of GDP, although the results are conditional on the parameters and assumptions made in the model. Alternatives to inferring the optimal debt ratio from tests of dynamic efficiency include estimating the optimal public debt ratio using statistical techniques. One such study (D.J. Smyth and Y. Hsing (1995) "*In Search of an Optimal Debt Ratio for Economic Growth*", Contemporary Economic Policy 13, pp. 51-9) suggested that economic growth was maximised when public debt levels are around 50 per cent of GDP, using US data. However, another US study (C.M. Asilis (1994) "*The US Public Debt – Implications for Growth*". IMF Working Paper No. WP/94/4) suggested that the costs of being away from the optimal level are quite small – public debt levels need to rise substantially before serious damage to the economy will occur.

[18] *Manual on Fiscal Transparency*, International Monetary Fund, 1998.

[19] *Long-term sustainability of public finances in the European Union*, Economic Policy Committee, 2006

[20] *Economic and Fiscal Strategy Report*, June 1998

recognised that "unexpected shocks due to other influences, such as developments in the world economy, will continue to impact on the British economy".

1.48 As set out in Reforming Britain's Economic and Financial Policy,[21] maintaining low levels of public debt in ordinary circumstances provides greater scope for fiscal policy to support monetary policy in the face of adverse economic shocks, allowing debt to rise without threatening long-term sustainability. By reducing debt, the Government provided space to cope with economic shocks, to ensure borrowing to support the economy would not result in an unsustainable burden of debt.

1.49 In the 2003 Budget, given the circumstances at that time, with net debt below 40 per cent of GDP as a result of surpluses in the up-phase of the cycle, but debt projected to rise as a result of fiscal policy supporting the economy during the down-phase, the Government stated that to meet the sustainable investment rule with confidence, net debt would be maintained below 40 per cent of GDP in each and every year of the then current economic cycle.

Measures of fiscal sustainability

1.50 Public sector net debt is based on internationally-agreed accounting rules and has the advantage of being easily understood and interpreted as a concept, helping to improve transparency. This makes it a good base for the sustainable investment rule. However, to enable a full assessment of sustainability, the Government is also interested in a range of other fiscal indicators. As explained in Box 1.E these include a range of backward looking measures of debt and asset positions as well as indicators based on projections.

1.51 One way of seeing fiscal sustainability is as a measure of solvency, in other words, the ability of governments to meet their current financial obligations.[22] But, as explained in the OECD Journal on Budgeting in 2005, the concept of sustainability has also been extended to cover a wider range of factors (including economic growth and inter-generational fairness) as well as longer time horizons and therefore future obligations. In the context of developed countries, "contemporary sustainability analysis focuses on fiscal conditions that may retard economic growth, cause tax burdens to rise, or transfer significant costs to future taxpayers".[23] The rationale for linking sustainability to economic growth is that growth is key to ensuring that in the long term the government remains in the position to meet its financial obligations. As long as fiscal policy is not set to shift current burdens unfairly to future generations, economic growth also ensures that both current and future generations benefit from higher standards of living.[24]

1.52 Future generations not only benefit from higher long-term economic growth but also from investment in public services made today. Debt therefore plays an important role in ensuring inter-generational fairness by spreading the costs of investment over the generations that benefit. It is, however, also important for inter-generational fairness to ensure that the burden on future generations is not excessive, because this would itself have detrimental impacts on long-term growth.

[21] *Reforming Britain's Economic and Financial Policy*, Ed. Balls, E. and O'Donnell, G., Palgrave (2002)

[22] An assessment of fiscal sustainability in major economies is set out in Neck and Sturm (eds) (2008) '*Sustainability of Public Debt*', CESifo Seminar Series, MIT Press.

[23] OECD Journal on Budgeting (Volume 5, Number 1), Organisation for Economic Co-Operation and Development (2005)

[24] HM Treasury's 2008 Long-term public finance report, published alongside Budget 2008, discusses the link between intergenerational fairness and fiscal sustainability in detail.

Box 1.E: Measures of fiscal sustainability

There is no single ideal measure of the fiscal stance and fiscal sustainability that can capture the interaction of all relevant factors. Instead, policy-makers and economists use a variety of measures to capture different aspects of the fiscal position and long-term fiscal sustainability.

Net debt versus gross debt:[25] Public debt figures can be defined in gross or net terms. Gross figures capture the total amount of the Government's financial liabilities whereas net figures subtract the value of liquid financial assets from this figure. Net debt has been given more prominence in the fiscal framework as it provides a fairer reflection of the Government's immediate solvency and a better indication of sustainability. The value of non-liquid financial assets is not netted off in the net debt measure.

Public sector versus general government debt: In line with its European commitments, the Government regularly publishes data and projections for general government gross debt. Unlike public sector debt measures, these do not take into account public corporations (PCs). Ultimately the liabilities accrued by PCs could fall on taxpayers and a comprehensive measure of fiscal sustainability should ordinarily take these liabilities into account.

Net financial assets: these take into account both liquid and non-liquid financial assets held by the public sector. Ordinarily, the value of these assets would be relatively small in comparison to public sector liabilities. In circumstances where the public sector holds large stakes in the financial sector, or, as with Northern Rock, the balance sheets of some financial corporations are included within the public sector, offsetting assets will be larger. Unlike net debt, net financial assets records both assets and liabilities at market values. Where financial markets are subject to exceptional uncertainty and volatility, it may therefore prove more difficult to use as a measure for assessing long-term sustainability.

Net worth: Public sector net worth measures the difference between the Government's total assets (including non-financial assets like roads) and liabilities at a balance sheet date. Changes in net worth provide an indication of the extent to which the net assets of the public sector are changing. However, many of these assets and liabilities are difficult to value accurately. The estimates of tangible assets, for example, are dependent on broad assumptions that may not always be appropriate.

Certain and contingent liabilities, and Whole of Government Accounts (WGA)[26]: the measures of debt discussed above include those liabilities that are certain to arise, but there are also uncertain (contingent) liabilities that may have to be met in the future. Measures that include contingent liabilities can therefore provide insights for sustainability analysis. The Government has published estimates of net liabilities, which include these additional liabilities, in successive Long-term public finance reports. However, these measures are subject to significant uncertainties, which limit the extent to which they can be used to determine fiscal policy in the short run. A full set of WGA will be published for the first time for 2009-10, based on International Financial Reporting Standards (IFRS).

[25] For a detailed description see *Government and Public Sector Debt Measures,* Office for National Statistics (http://www.statistics.gov.uk/about/methodology_by_theme/public_sector_accounts/downloads/debt_history.pdf)

[26] For a fuller explanation see *Financial Reporting Standard 12: Provisions, contingent liabilities and assets.* Accounting Standards Board.

Other features of the fiscal framework

Resource accounting and budgeting

1.53 The Code announced the introduction of Resource Accounting and Budgeting (RAB) for managing the public finances. The use of accruals-based accounting and budgeting recognises that the economic implications of capital expenditure are not the same as those of current expenditure, and also records expenditure as it is incurred rather than when cash is paid. The Code also requires the Government to ensure that accounts are prepared for the whole public sector.

Fiscal reporting

1.54 The Code for Fiscal Stability obliges HM Treasury to publish a Pre-Budget Report each year at least three months prior to a Budget (other than prior to the first Budget of a new Parliament) outlining, so far as reasonably practicable, any significant policy proposals under consideration for introduction in the Budget. It also requires the Government to publish an Economic and Fiscal Strategy Report (EFSR) each year, outlining its long-term economic and fiscal strategy, and to assess recent outcomes and the short-term forecasts contained in the Financial Statement and Budget Report (FSBR) against the longer-term strategy. Further, the Code requires the EFSR to present an analysis of the impact of the economic cycle on the key fiscal aggregates, including estimates of the cyclically-adjusted fiscal position. Illustrative projections of the outlook for the key fiscal aggregates are also required for a period of at least ten years.

Debt management

1.55 Following the transfer of Debt and Cash Management and oversight of the gilt market to HM Treasury in 1997, a detailed consultation on the future of UK Government debt and cash management operations took place, and in December 1997 Treasury Ministers announced that Government debt and cash management operations would be undertaken by an agency of HM Treasury, which would be called the Debt Management Office (DMO).

1.56 The Code requires the Government to minimise - over the long term - the costs of meeting the Governments financing needs. At the same time, policy is required to take account of risk and the need to avoid, so far as possible, conflict with monetary policy. It also requires the Government to report on its debt management obligations through the publication of a Debt and Reserves Management Report (DRMR) and through publication of the DMO's Annual Review each year.

Conclusion

1.57 The fiscal framework was designed to learn from the previous experience of domestic policy makers. In particular, it sought to build credibility around the Government's fiscal policy by establishing a framework which would improve the transparency of fiscal policy making. It sought to embed constrained discretion as a means of ensuring sound public finances over the medium term while retaining the discretion and flexibility to support monetary policy in smoothing the path of the economy both over the cycle and in the face of shocks. As such, it sought to avoid both the problems of unfettered discretion and those of excessively rigid rules.

2 The performance of the fiscal framework over the last economic cycle

With evidence supporting the assessment that the economic cycle which started in 1997-98 ended in 2006-07, the Government is able to review the performance of the fiscal framework over a full economic cycle. Over the economic cycle from 1997-98 to 2006-07, the fiscal framework supported the Government's delivery of its fiscal policy objectives of sound public finances over the medium term and supporting monetary policy in the short term, and the fiscal rules were met:

- the average current surplus over the economic cycle was 0.1 per cent of GDP, meeting the golden rule that the Government borrows only to invest and helping ensure sound public finances and fairness between generations; and
- public sector net debt was reduced from 42.5 per cent of GDP in 1996-97 to 36.0 per cent in 2006-07, meeting the sustainable investment rule that net debt be held at a stable and prudent level over the economic cycle, and meeting the commitment that, other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle.

The framework provided an effective constraint on policy discretion. Over the last economic cycle, the Government:

- significantly increased investment in public services; public sector net investment is now over three times higher as a share of the economy than it was in 1997-98, rising from 0.6 per cent to 2 per cent of GDP in 2007-08, its highest level since 1979-80;
- reduced public sector net debt as a percentage of GDP to low levels by historical and international standards, thereby placing the public finances in a better position to support the economy and respond to economic shocks; and
- supported monetary policy in smoothing the economy's path over the cycle through the automatic stabilisers and discretionary changes in fiscal policy. Fiscal and monetary policy tightened together as the economy moved above trend in the late 1990s, and both loosened when it moved below trend in 2001.

The fiscal framework also delivered other benefits. Transparency in the operation of fiscal policy was significantly enhanced through, among other things, the publication of the End of Year Fiscal Report and Long-term Public Finance Report. Longer planning horizons for departmental spending, supported by greater macroeconomic and fiscal stability, helped to deliver value for money.

Assessing the performance of the fiscal framework

2.1 Chapter 1 described the approach taken by the Government in introducing the fiscal framework in 1997. As set out in more detail in Evidence on the economic cycle, published alongside the 2008 Pre-Budget Report,[1] evidence from the range of cyclical indicators monitored by HM Treasury, together with the latest National Accounts data, supports the assessment that the economic cycle that started in the first half of 1997 ended in the second half of 2006. The National Audit Office is publishing its audit of this judgement alongside the 2008 Pre-Budget Report.

2.2 This chapter sets out an assessment of the performance of the framework over the past cycle. In 2006 the International Monetary Fund noted that "the fiscal framework is at the forefront of international best practice".[2] With the fiscal rules set over the economic cycle, the end of the economic cycle presents a good opportunity to consider the impact of a decade's implementation of the framework in meeting the Government's objectives.

2.3 This chapter is structured as follows:

- the first section, *meeting the fiscal rules*, reports on performance against the rules;
- the second section, *meeting the objectives for fiscal policy*, discusses how meeting the rules contributed to the achievement of the Government's fiscal policy objectives; and
- the third section, *the Government's approach to fiscal policy in practice,* considers performance of the framework thematically, exploring how the framework: provided transparent rules which constrained policy; took account of the cycle and used assumptions designed to provide caution; enhanced efficiency in public spending; and facilitated responsible and sustainable management of the public finances.

Meeting the fiscal rules

2.4 Table 2.A shows that the Government met its fiscal rules over the economic cycle that ran from 1997-98 to 2006-07. The table shows the key fiscal aggregates over the cycle.

Table 2.A: Meeting the fiscal rules over the past cycle

	Per cent of GDP										
	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
Golden rule											
Surplus on current budget		-0.1	1.2	2.2	2.4	1.2	-1.0	-1.5	-1.6	-1.1	-0.3
Average surplus since 1997-98		-0.1	0.5	1.1	1.4	1.4	1.0	0.6	0.3	0.2	0.1
Cyclically-adjusted surplus on current budget		0.0	1.0	1.9	1.8	0.9	-0.7	-1.3	-1.5	-1.0	-0.3
Sustainable investment rule											
Public sector net debt	42.5	40.6	38.4	35.6	30.7	29.7	30.8	32.2	34.1	35.4	36.0
Core debt	41.2	39.3	37.5	35.1	31.0	30.2	31.0	32.2	34.0	35.2	35.9

Note: As debt is a stock measure, performance against the sustainable investment rule is measured against the end point of the previous cycle.

Source: HM Treasury

The golden rule

2.5 The golden rule stated that, over the economic cycle, the Government would borrow only to invest and not to fund current spending. The Government's performance against the golden rule

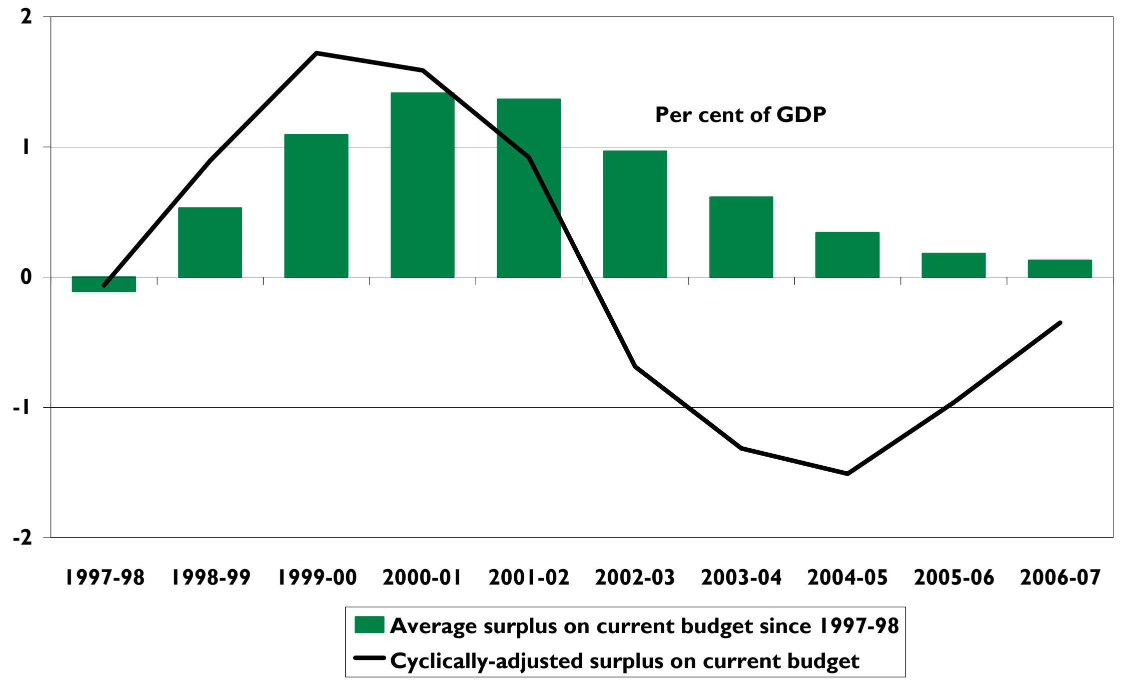
[1] *Evidence on the economic cycle*, HM Treasury, November 2008

[2] United Kingdom 2006 Article IV Consultation (March 2006), International Monetary Fund

was measured by the average annual surplus on the current budget as a percentage of GDP over the economic cycle. The current budget measures the difference between current receipts and current expenditure, including depreciation.

2.6 Over the economic cycle that started in 1997-98, there was an average current balance of 0.1 per cent of GDP.

Chart 2.A: Meeting the golden rule



Source: HM Treasury

The sustainable investment rule

2.7 The sustainable investment rule states that public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. The Government made the commitment that, other things being equal, net debt would be maintained below 40 per cent of GDP over the economic cycle. As set out in Chapter 1, in the 2003 Budget, the Government stated that to "meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle".[3] The sustainable investment rule was met over the last economic cycle. Net debt was reduced from 42.5 per cent of GDP at the end of 1996-97 to 36.0 per cent in 2006-07, and in every year since 1998-99 net debt was held below 40 per cent of GDP.

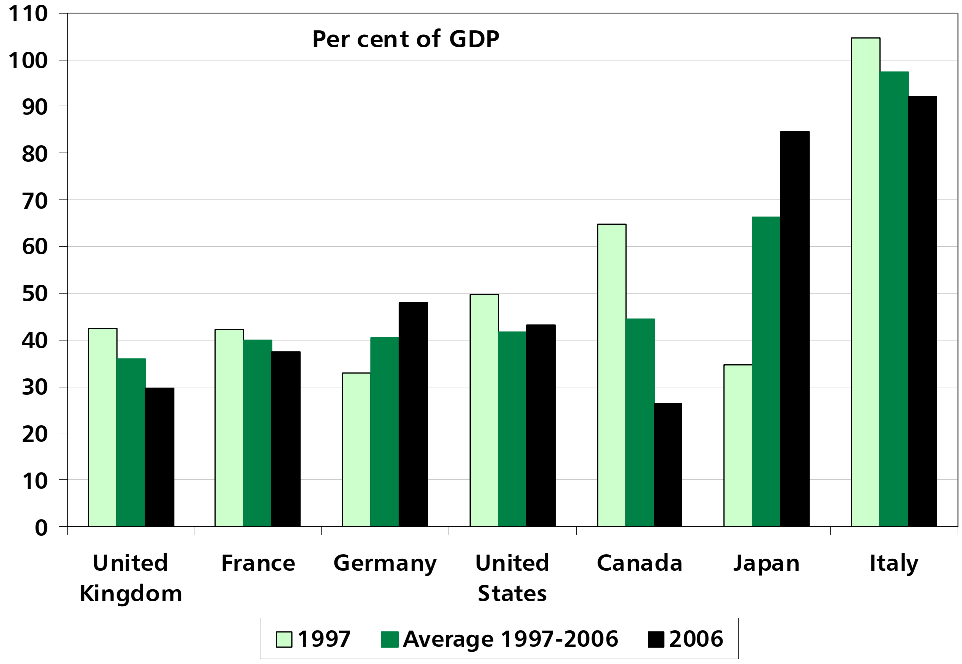
2.8 Chart 2.B shows how the UK's debt-to-GDP ratio over the cycle compared to that of the other G7 nations over the same period, using the OECD's general government net financial liabilities measure of debt to ensure more comparable figures.[4] On average over the period from 1997 to 2006, general government net financial liabilities in the UK were lower than in all G7

[3] HM Treasury, *Economic and Fiscal Strategy Report* (chapter 2), April 2003

[4] Note that the OECD definition of general government net financial liabilities differs from the UK Government's measure of public sector net debt (PSND) in a number of respects. In particular, the OECD measure excludes public corporations but uses a wider definition of general government assets and liabilities, values gilts according to their market value rather than their nominal value and uses different reference periods (debt is measured at the end of the calendar year as opposed to the end of the UK financial year, and GDP for the preceding year is used rather than GDP centred on the point at which the debt stock is measured).

economies, and in 2006, the last year of the last economic cycle, was lower than in all the G7 countries except Canada.

Chart 2.B: General government net financial liabilities in G7 countries



Note: The UK's levels of general government net financial liabilities reflect a classification change by the Office for National Statistics, to include the Housing Revenue Account asset. This classification change is reflected in the data from 2005 onwards.

Source: OECD Economic Outlook June 2008

Meeting the objectives for fiscal policy

2.9 In meeting its fiscal rules over the economic cycle, the Government was able to deliver the underlying objectives of the fiscal framework: supporting monetary policy in smoothing the economy's path over the short term and ensuring sound public finances and fairness between generations over the medium term. The constraints set by the framework also enabled Government to increase public investment while reducing debt.

Supporting monetary policy

2.10 As set out in chapter 1, the fiscal framework was designed to work in tandem with the monetary policy framework, with the rules set over the cycle to provide flexibility to allow the automatic stabilisers and fiscal stance to smooth the path of the economy.

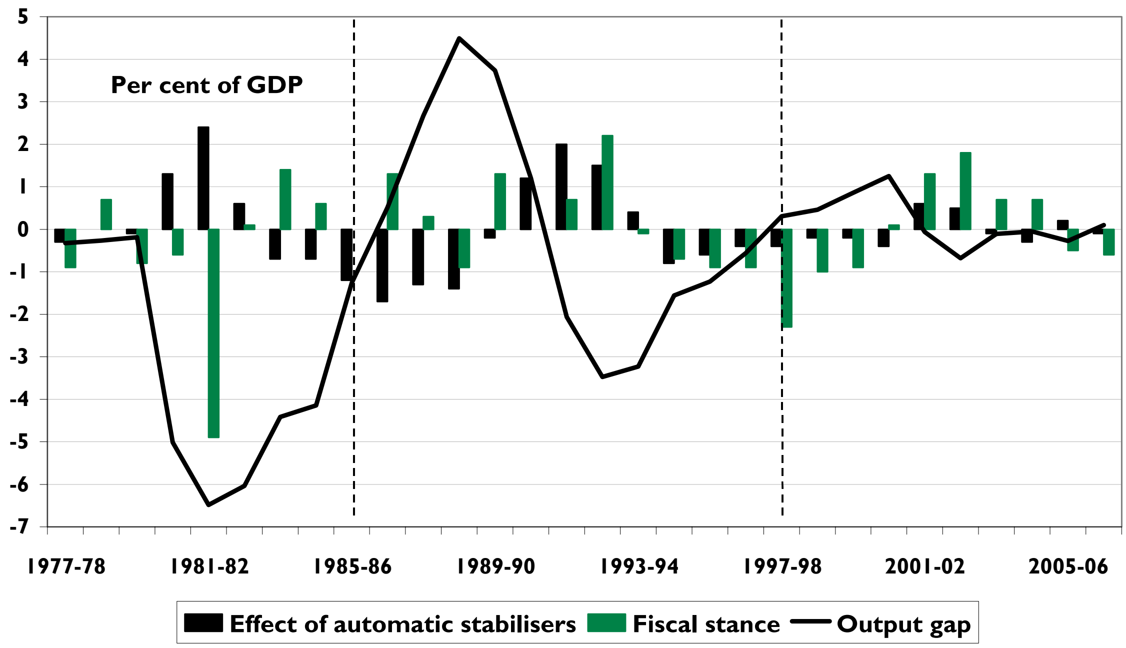
2.11 The overall impact of fiscal policy on the economy is made up of changes in:

- the fiscal stance: that part of the change in public sector net borrowing (PSNB) resulting from changes in cyclically-adjusted PSNB; and
- the automatic stabilisers: that part of the change in PSNB resulting from cyclical movements in the economy

2.12 The UK's economic performance over the last economic cycle was characterised by sustained growth, limited fluctuations in output, low inflation and low interest rates, supported by the introduction of the UK's macroeconomic frameworks. In 2008 the IMF noted: "For over a decade, the United Kingdom has sustained low inflation and rapid economic growth – an exceptional achievement…All this is the fruit of strong policies and policy frameworks, which provide a strong foundation to weather global shocks."[5]

2.13 Chart 2.C shows the contribution made by fiscal policy, through the evolution of the fiscal stance over the last three full economic cycles. Compared to previous cycles, the introduction of the fiscal framework has helped ensure that fiscal policy acted in support of economic stability. During the period from 1997-98 to 2002-03, when the economy operated above trend until 2001 and then below trend during the global slowdown from 2001 to 2003, fiscal policy played a significant role in smoothing the path of the economy, both through the operation of the automatic stabilisers and changes to the fiscal stance. Between 2003-04 and 2007-08, when the economy was generally operating close to trend, the degree of fiscal support moderated.

Chart 2.C: Fiscal policy supporting monetary policy



Note: The fiscal stance equals the annual change in the cyclically-adjusted PSNB. The effect of the automatic stabilisers equals the change in the cyclical component of PSNB, i.e. the difference between PSNB and the cyclically-adjusted PSNB.

Source: HM Treasury

Reducing debt

2.14 The constraints provided by the golden rule and sustainable investment rule meant that the delivery of a significant public investment programme did not come at the expense of a deterioration in net debt. Instead, as a result of the discipline provided by the sustainable investment rule, the UK's public debt is low by international as well as historical standards (see chart 2.B). A starting point of low public debt provides a sound foundation from which to respond to the global economic shocks that have hit the UK economy over the past year.

Supporting investment

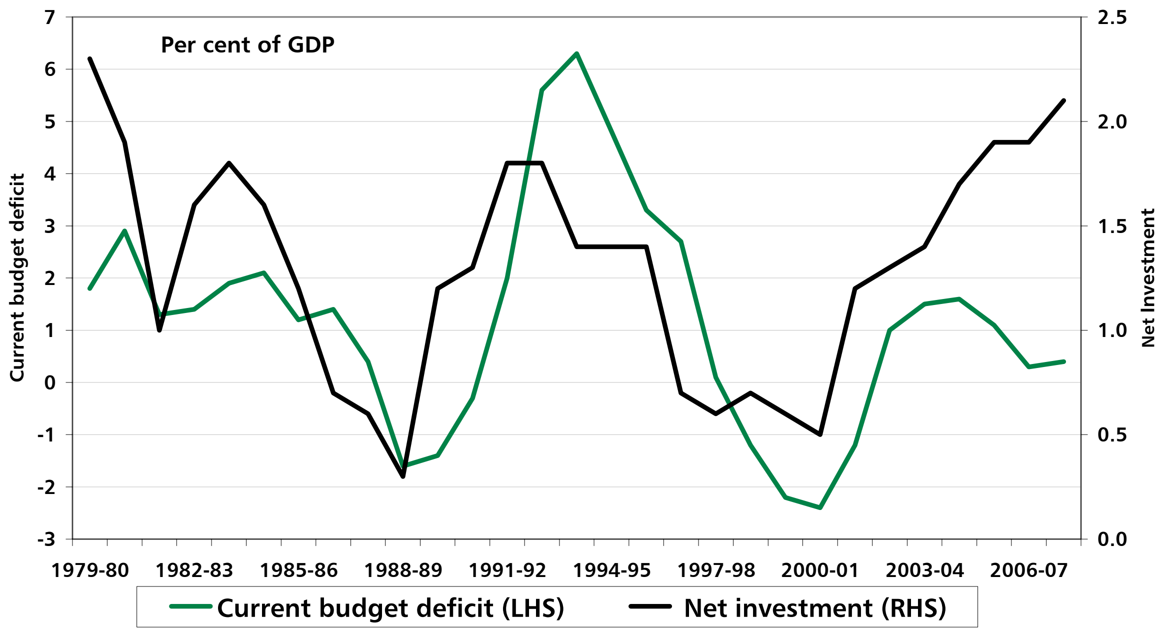
2.15 At the same time, over the last economic cycle, the Government was able to address a long-standing bias against capital spending in the public sector, and reverse a legacy of

[5] Source: IMF 2008 Article IV Consultation Concluding Statement of Mission

underinvestment in public services. The OECD commented that, "by separating current and capital spending, the fiscal rules have helped to tackle the United Kingdom's historical bias against capital spending and low investment in public infrastructure."[6]

2.16 Chart 2.D shows that public investment had been volatile over the two economic cycles prior to the past cycle, and had proved vulnerable in periods of fiscal consolidation. Historically, it has been extremely rare for public investment to grow during periods of fiscal consolidation, and prior to the introduction of the macroeconomic framework this had not happened for 40 years. The introduction of the fiscal framework helped break the relationship between borrowing for current spending and borrowing for investment and delivered a lasting and sustained increase in public investment. The fiscal rules ensured that, over the last economic cycle, borrowing was reduced at the same time as net investment was increased. Public sector net investment, at 2 per cent of GDP in 2007-08, is now over three times higher as a share of the economy than it was in 1997-98, and is at its highest level since 1979-80, delivering a public investment programme to increase the economy's long-run productive capacity and meet social objectives.

Chart 2.D: Supporting investment



Source: HM Treasury

The Government's approach to fiscal policy in practice

2.17 The fiscal framework supported the Government in meeting its objectives for fiscal policy, through the operation of the fiscal rules. The remainder of this chapter considers the performance of the framework as a whole, and the impact it has had on the Government's approach to fiscal policy. In particular it reviews how the framework:

1 delivered policy objectives;

2 took account of the cycle;

3 enhanced efficiency in public spending; and

[6] OECD Economic Survey 2007: United Kingdom

4 facilitated responsible and sustainable management of the public finances.

2.18 In designing a policy framework, judgements must be made, balancing precision with a framework that can be operationalised effectively. Commentators have made the point that even if a fiscal rule is not optimal in a perfect world, it may well be the best economic response in a situation where unconstrained policy produces uncertainty and outcomes that are even less desirable.[7] Reflecting this, over the past decade's implementation, alongside endorsements of the role of the framework in guiding policy, external commentators have also made a number of proposals for the framework. This section also looks at these proposals and explains the choices the Government made in designing the framework.

Framework delivered policy objectives

2.19 By setting clear objectives and rules to operationalise them, and by increasing transparency, the Government sought to ensure that fiscal policy was better placed to support its economic goals of high and stable growth and employment. This makes it easier for the Government to be clearly accountable for its policy decisions, and for markets to judge the Government's intended fiscal policy response to a changing outlook for the economy and the public finances.

2.20 The potential benefits of complex and sophisticated fiscal rules that might take account of a wide range of unexpected circumstances need to be balanced against the need for rules to be widely understood so that they can deliver an effective constraint on discretion. This potential trade-off has been recognised by external commentators. For instance, the Institute for Fiscal Studies stated in its 2008 Green Budget that "designing fiscal rules require a trade off between precision on the one hand and simplicity and transparency on the other. The golden rule and sustainable investment rule are not optimal as currently applied and could be improved. But they still have significant value as rules of thumb". [8]

[7] See, for example, Keech, W.R. *"A Theoretical Analysis of the Case for a Balanced Budget Amendment"*, Policy Sciences 18, pp. 157-183, 1985

[8] *The IFS Green Budget*, Institute for Fiscal Studies, January 2008

Box 2.A: Recent independent comment on the UK fiscal framework

IFS[9]	The Institute for Fiscal Studies (IFS) has noted that the fiscal framework was successful in reducing net debt and the cyclically-adjusted deficit over the last economic cycle. However, the IFS has also expressed the view that the 'over-the-cycle' approach of the current framework should instead be modified to include a forward-looking golden rule with a symmetrical target for either the total or the cyclically-adjusted current balance, whilst maintaining the sustainable investment rule as a rule of thumb. To complement this, it has suggested various ways in which HM Treasury could enhance transparency. These include publishing fan charts of forecasts and a more in-depth explanation of assumptions used. It also suggests that an independent body or bodies be given access to privileged information that HM Treasury uses to form its forecasts.
NIESR[10]	The National Institute of Economic and Social Research (NIESR) has also suggested that the current fiscal framework could be improved by adopting a 'forward-looking' approach, given the difficulties surrounding the dating of an economic cycle. It has expressed a preference for a framework in which policy is set according to long-term needs - specifically that current policy seeks to keep expected future tax rates constant. NIESR has suggested that there is scope for more 'independent assessment' within the fiscal framework.
IMF[11]	The IMF has acknowledged that the macroeconomic framework conceived in 1997 helped to deliver a decade of low inflation and rapid economic growth – 'an exceptional achievement'. In the past, the IMF has advocated a move away from the 'over-the-cycle' approach, whilst maintaining the sustainable investment rule at 40 per cent of GDP, with the Government outlining its plans to return to 40 per cent if a breach were to occur. The IMF also proposed the establishment of expenditure rules to constrain spending growth and to include stability in the external balance as a fiscal policy objective. It also argued for a broadening of the reach of the auditing process.
OECD[12]	The OECD has commented that the fiscal rules have put the public finances on a sounder footing than in previous economic cycles and have succeeded in improving transparency and breaking a historical bias against capital spending. It has suggested that the end of the economic cycle should be taken as an opportunity to reform the fiscal framework. It has suggested that a target level for the current budget in the medium-term might be an appropriate approach, coupled with comprehensive auditing of revenue projections. It also argues for tighter spending controls, particularly on unexpected revenue windfalls, and a greater consideration of off-balance-sheet liabilities within the framework.

[9] *The IFS Green Budget*, Institute for Fiscal Studies, January 2008

[10] "*The Policy Framework*" By Martin Weale (Director, NIESR), in The National Institute Economic Review No.206, October 2008

[11] See 2008, 2006 and 2005 IMF Article IV Consultation Concluding Statements of the Mission to the United Kingdom

[12] OECD Economic Survey 2007: United Kingdom, and OECD Economic Outlook No. 72: "*Fiscal Sustainability: the contribution of the fiscal rules*", 2002

Significantly enhanced transparency

2.21 The Government's approach to transparency, through the Code for Fiscal Stability and subsequent developments, was designed to improve the range and quality of information available on fiscal prospects. This approach ensures that the Government's objectives and rules are easily understood and that information is made available so that the Government is accountable for its fiscal policy decisions. It includes:

- publishing full five-year forecasts for the public finances – including cyclically-adjusted fiscal aggregates and performance against the fiscal rules;
- setting out the economic and other assumptions underpinning the public finance projections twice a year in the Budget and Pre-Budget Report;
- publishing the Government's estimates of the output gap and cyclically-adjusted fiscal aggregates so that progress against the fiscal rules can be assessed across the economic cycle;
- ensuring that key assumptions are subject to audit by the NAO; and
- publishing full and complete information on the fiscal outturns and forecasting performance in the End of Year Fiscal Report and a thorough analysis of the long-term fiscal projections covering the next decades in the Long-Term Public Finance Report.

2.22 The range and depth of information made available since 1997 goes beyond what was available previously, allowing the public, Parliament and expert commentators to form a view on the performance of fiscal policy.

2.23 The International Monetary Fund's Code of Good Practices on Fiscal Transparency provides a benchmark for worldwide comparison. In an assessment carried out soon after the publication of the Code for Fiscal Stability, the IMF noted that the UK had "achieved a very high level of fiscal transparency" (see Box 2.B).[13]

[13] IMF Experimental Report on Transparency Practices, 1999

Box 2.B: The IMF Code of Good Practices on Fiscal Transparency (2007 update)

The IMF has developed a Code of Good Practices on Fiscal Transparency which covers four key areas of transparency:

- clarity of roles and responsibilities (distinguishing between the Government, the rest of the public sector and the rest of the economy; disclosure of policy and management roles in the public sector; a clear and open framework for fiscal management);
- open budget preparation, execution, monitoring and reporting;
- public availability of information, providing comprehensive information on past, current and projected fiscal activity and on major fiscal risks. Fiscal information should be published in a timely way and presented in a way that promotes analysis and accountability; and
- assurances of integrity, through data quality standards, internal oversight and external audit, statistical independence and independent scrutiny.

The IMF's Code was designed to increase the level of transparency in fiscal policy making worldwide, based on the view that fiscal transparency promotes better-informed public debate about the design and results of fiscal policy, makes governments more accountable for the implementation of fiscal policy, and strengthens credibility and public understanding of economic policies and choices. These are crucial elements in securing economic stability and high-quality growth in an increasingly globalised economic environment.

Originally published in 1998, the Code was updated in 2007, alongside a revised Manual on Fiscal Transparency (2007) which includes references to the UK Code for Fiscal Stability, medium-term spending review process and other aspects of the fiscal framework in highlighting examples of international good practice.

2.24 The Government's approach to enhancing transparency in fiscal policy making was supported by the steps taken to enhance transparency and accountability in other related aspects of policy making. For example:

- statistics: the Government has sought to increase public confidence in statistics, including statistics on the public finances. The measures taken since 1997, including most recently the establishment of the independent UK Statistics Authority, have aimed to reinforce confidence and integrity in official statistics including those used in fiscal policy making;
- debt management: the Code for Fiscal Stability requires the Government to operate debt management policy to achieve a specific primary objective, and through an annual debt management report set out clearly the overall size, maturity structure and type of gilt issuance and a gilt auction calendar. By enhancing transparency and predictability of debt management, this framework has enabled the Debt Management Office (DMO) to conduct its debt management operations in an efficient, cost effective manner by minimising the cost of borrowing over the longer term subject to risk and consistency with monetary policy. This has resulted in financing being raised smoothly over the last cycle despite variable and sometimes difficult market conditions. The DMO has been able to respond to a wide range of annual financing quanta whilst maintaining the efficient functioning of the primary

and secondary markets. The framework also has proved sufficiently adaptable to allow innovations that are to the benefit of both the Exchequer and the gilt market.

Institutional approaches to accountability

2.25 There are a variety of approaches to ensuring accountability and credibility in fiscal policy making.[14] A number of countries, like the UK, Australia and New Zealand, have sought to improve credibility through enhanced transparency. The OECD for example has recognised this route, stating that "a way to alleviate the trade-off between credibility and flexibility is by improving transparency".[15] Some have chosen more institutional approaches, including setting up an independent fiscal institution that provides economic forecasts and fiscal analysis (Box 2.C). Proponents have argued that such institutional arrangements could provide greater assurance around the credibility of forecasting, and contribute to greater accuracy in forecasting as well as increased scrutiny.

2.26 There is no single blueprint for enhancing accountability, as reflected in the diversity of institutional arrangements across countries. It is hard to draw definitive conclusions about the impact of independent fiscal institutions on fiscal outcomes given this diversity of arrangements and the difficulty in stripping out the role of the institution from other factors such as the specification of new rules. HM Treasury's forecasting record for the public finances compares well with that of other countries and international organisations.[16] Moreover, introducing divided lines of responsibility for the forecast and policy-making functions of fiscal policy could make it more difficult to properly ensure Government is accountable in delivering its objectives, as policy makers would be acting on forecasts for which they were not responsible.

2.27 The UK's existing institutional arrangements incorporate a range of checks and balances, from the scrutiny function of Parliament, to NAO audits and comment from non-governmental organisations and the media, all of which contribute to holding the Government to account. The IMF has commented on the strength of the UK's institutional arrangements in the context of the NAO's audit role, stating: "This reliance on independent audit puts the United Kingdom, along with some other countries, on the frontier of institutional development."[17] The level of public scrutiny and of commentary on the Government's fiscal policy in recent years suggests these are providing challenge to the Government and contributing to an active and informed public debate.

2.28 Accountability comes from clarity of objectives, openness about performance, and a track record that demonstrates that the Government has respected its long-term fiscal objectives whilst responding effectively to changes in the economy. The Government's adoption of the Code for Fiscal Stability and the actions it has taken under it have shown its commitment to credible management of the public finances. It will continue to be open about its objectives for fiscal policy and the results of policy decisions, so that it can be accountable for delivering these objectives.

[14] See *"The role for fiscal agencies"* in Eds., Kumar, M.S. and Ter-Minassian, T. *"Promoting Fiscal Discipline"*, International Monetary Fund, 2007

[15] OECD Economic Survey 2007: United Kingdom

[16] See the *End of year fiscal report*.

[17] IMF 2005 Article IV Consultation Concluding Statement of the Mission

Box 2.C: International approaches to accountability

Australia

The Charter of Budget Honesty Act 1998 outlines principles of responsible and transparent fiscal management, reporting requirements and accountability. It requires that governments release annual fiscal strategy statements (usually with every budget) that specify the government's long-term fiscal objectives, explain the broad strategic priorities on which the budget is or will be based, and specify the key fiscal measures against which fiscal policy will be set and assessed. The Charter also sets out fiscal reporting requirements, which include: an economic and fiscal outlook report at each budget, at mid-year, and prior to elections; a final budget outcome report released at the end of each financial year; and, an intergenerational report every five years.

France

Fiscal targets for the budget and stability program are set, consistent with the requirements of the Stability and Growth Pact. There is a commitment to produce regular fiscal reports that include information on government financial assets. Accounts include a statement of off-balance sheet items and contingent liabilities. In 2001, measures were announced to improve fiscal transparency, including provision of a technical annex to the budget that described methods used to forecast revenues, changes in the presentation of expenditure between one year and the next, and the financial relationship between different parts of government. More recently, the government has committed to introduce multi-annual budgets.

The Netherlands

The Netherlands has a fiscal framework that sets out stable expenditure rules and mandates the use of multi-year expenditure ceilings to guide policy. Macroeconomic forecasts are supplied by an independent government agency, the Netherlands Bureau of Economic Policy Analysis; these include two medium-term scenarios, one cautious and one optimistic. Decisions on expenditure ceilings and fiscal targets are, however, taken by democratically elected representatives. Program budgeting was introduced in 2001 to provide parliament with a more transparent budget document: line ministry budgets are structured around strategic objectives and policy areas and then connected to performance targets.

Constraining policy in practice

2.29 The fiscal rules were designed to provide a constraint on policy discretion, so ensuring that the public finances would be managed effectively, and allowing the Government to meet its spending commitments without jeopardising economic stability or intergenerational fairness.

2.30 Fiscal rules support HM Treasury in its role in managing the public finances, enabling competing departmental and Government priorities to be traded off appropriately within a firm and affordable envelope that defines available resources.

2.31 By specifying transparent and understandable rules, based on independently produced statistics, the evidence demonstrates that the fiscal framework in place since 1997 has been successful in constraining discretion:

- the Government used spectrum receipts to pay down debt in 2000-01, reinforcing other policy decisions to ensure that debt was reduced in the early years of the economic cycle so that the economy was well placed to deal with shocks, such as the bursting of the dot com bubble and the 2005 housing market slowdown;

- the specification of the fiscal rules, based on current balance and debt, broke the historic link between fiscal consolidation and reductions in investment to correct the legacy of public sector under-investment in the UK; and
- in the later years of the economic cycle, as the economy moved up towards trend, the Government undertook moderate discretionary fiscal tightening focused particularly on the later years of the projection period, supporting the sustainability of the public finances without putting at risk economic stability.

2.32 The role of the rules in constraining government policy has been recognised by external commentators. The IMF Article IV report in 2006 concluded: "The fiscal rules – the sustainable investment rule and the golden rule – have helped to constrain discretion and protect investment."[18]

Framework took account of the economic cycle

2.33 By being set over the economic cycle, the fiscal rules allow the automatic stabilisers and the fiscal stance to operate without endangering the long-term sustainability of the public finances. Taking account of the economic cycle is key to ensuring that fiscal policy can act to support stability in the economy and this chapter has already set out how the fiscal rules supported the Government in meeting this objective.

Understanding the economic impact of fiscal policy

2.34 The economic cycle has important short-term effects on the public finances. These impacts need to be taken into account when assessing the cyclically-adjusted position of the public finances. The Code for Fiscal Stability introduced the requirement that the Government publish estimates of the fiscal position adjusted for the effects of the economic cycle. Since the 1998 Pre-Budget Report, the Government has published cyclically-adjusted figures for the current budget balance and public sector net borrowing as part of the public finance forecasts in each Budget and Pre-Budget Report. This helps to promote transparency in the operation of fiscal policy and enhance the quality of policy decisions.

2.35 Chapter 2 of the Treasury working paper, *Public finances and the cycle*, published alongside this PBR,[19] is HM Treasury's latest assessment of the effect of the cycle on the public finances. It updates the cyclical adjustment ready-reckoners with the latest data and methodological improvements and concludes that they should remain unchanged. Drawing on the approaches used by organisations such as the OECD and ECB, the paper also provides an assessment of the robustness of HM Treasury's top-down approach to cyclically adjusting fiscal aggregates. These alternative methods produce very similar results to HM Treasury's estimates.

2.36 The setting of both fiscal rules over the economic cycle means that the Government's assessment of the start and end point of the cycle has an impact on the measurement of the rules. In practice, as set out in Evidence on the economic cycle,[20] the dating of economic cycles involves a degree of judgement. This judgement becomes more difficult in a cycle where output growth remains relatively stable. Over the course of the economic cycle from 1997-98 to 2006-07, HM Treasury made provisional judgements on the start and end points of the economic cycle, which were subject to revision as new data emerged. There is a strong in principle rationale to take account of the cycle. The fiscal rules did so by being measured over the course of the economic cycle; nonetheless, some commentators have proposed that it might be better

[18] IMF 2006 Article IV Consultation Concluding Statement of the Mission
[19] *Public finances and the cycle*, Treasury Economic Working Paper Number 5, HM Treasury, November 2008
[20] *Evidence on the economic cycle*, HM Treasury, November 2008

to target the cyclically-adjusted current balance because of uncertainties in dating the start and end-points.

Forward looking rules, setting fiscal policy to meet medium-term objectives

2.37 The Government has set fiscal policy on a forward-looking basis to ensure that its fiscal rules can be met in outturn. This helps to ensure that the rules provide a clear test of the impact of future policy, constraining policy so that the rules will be met in future and so that the Government's objectives for sound public finances will be achieved. Some commentators have proposed that the rules should be forward-looking at all times, taking no account of outturn and targeting either the current balance or the cyclically-adjusted current balance a number of years into the future with the target rolling forward each year. If the fiscal target were framed in terms of the cyclically-adjusted balance, this would continue to allow the automatic stabilisers to operate over the course of the cycle. However, such a rule may hold the Government less clearly to account, as there is no outturn measure of success against which actual performance can be judged.

Caution and the forecasting record

2.38 In addition to allowing for the influence of the economic cycle, the fiscal framework has also sought to inject caution into public finances forecasts. The Government uses a number of assumptions audited by the National Audit Office (NAO) designed to provide caution, to underpin the public finance projections. In principle, the degree of caution in the assumptions underpinning the public finance projections increases over the projection period. The Government bases its public finance projections on a trend growth assumption that is a ¼ percentage point lower than its neutral view, to accommodate potential errors arising from misjudgements about the trend rate of growth of the economy in the medium term.

2.39 The End of Year Fiscal Report, first published in 2002, assesses short-term forecast performance in terms of accuracy and caution. Accuracy is measured using the absolute average difference: the smaller the average absolute difference, the more accurate the forecast. Caution is measured using the average of the differences of forecast from outturn. A net borrowing forecast is cautious if the outturn for borrowing is lower than had been forecast – this is indicated by a positive forecast difference, which is calculated as forecast minus outturn. Table 2.B is reproduced from the 2008 End of Year Fiscal Report, published alongside the Pre-Budget Report.[21]

Table 2.B: Summary statistics for net borrowing forecast differences

	Per cent of GDP			
	Whole sample	Before 1997-1998	Since 1997-1998	Number of observations in whole sample
One-year ahead PSNB forecasts				
Average absolute difference	1.1	1.2	0.8	38
Average difference	0.0	-0.1	0.2	
Two-year ahead PSNB forecasts				
Average absolute difference	1.4	1.5	1.2	27
Average difference	0.0	0.0	-0.1	

Note: The one-year ahead forecasts sample is from 1970-71 onwards, and the two-year ahead forecasts sample is from 1980-81 onwards. This reflects the length of the available time series.

[21] *End of year fiscal report*, HM Treasury, November 2008

2.40 The key findings of the assessment of the Government's fiscal forecasting record since the introduction of the new macroeconomic framework, as set out in this year's EYFR, are as follows:

- outturn net borrowing has on average been marginally lower than the year-ahead forecast since the introduction of the new macroeconomic framework in 1997. This is shown by the positive average forecast difference of 0.2 per cent of GDP since 1997-98, which compares favourably with an average of -0.1 per cent before 1997-98. The profile of the forecast differences since 1997 is such that PSNB has tended to be higher than forecast when the output gap is negative, and lower than forecast when the output gap is positive;
- the two-year ahead net borrowing forecast differences in the period since 1997-98 have been similar on average to those in the preceding period. However, borrowing has been marginally higher than the two-year ahead forecasts on average in this period, with a -0.1 per cent of GDP forecast difference, compared to a 0.0 per cent average forecast difference prior to 1997-98;
- the overall accuracy of one-year ahead PSNB forecasts under the new framework is similar to that of the period before 1997-98, with an average absolute forecast error of 0.8 per cent of GDP since 1997, compared to 1.2 per cent of GDP in the earlier period. The accuracy of the two-year ahead PSNB forecasts under the new framework has also been of similar accuracy to that of the period before 1997-98. In each Budget since 2003, both the one-year and two-year ahead forecasts have been more accurate than the respective long-run averages; and
- the UK's forecasting performance compares well with that of other countries and international organisations: on average since 1997, UK net borrowing forecasts have been equal to the average of the EU 15 Member States in terms of caution (as measured by average forecast difference), and better than average in terms of accuracy (as measured by average absolute forecast difference).

Managing risks

2.41 Some commentators have suggested that uncertainty surrounding fiscal outcomes could be illustrated by presenting a range of possible forecast values for the fiscal aggregates. This approach would use past errors in fiscal forecasts to present a probability distribution (a "fan chart") around the central forecast for a given fiscal aggregate, in a similar fashion to the Bank of England's presentation of its projections for inflation and growth in the Inflation Report. This could in theory help provide transparency around the uncertainty inherent in economic forecasting, and potentially aid risk management. However, since fan charts are based on past forecast errors, they could be potentially misleading if future risks differ substantially from past ones. This drawback is particularly pertinent when the economy is hit by the kind of significant economic shock experienced in recent months.

2.42 It is also unclear how much caution fan charts would inject in practice. Presenting fiscal targets as probability distributions might actually weaken the impetus to meet those targets, particularly if tough fiscal choices were needed. It would be difficult to incorporate policy responses into fan charts, so potentially giving a misleading picture of the probability of meeting a given fiscal target. In monetary policy, the issue is less marked, since the Bank of England can incorporate market interest rate expectations into its forecasts.

2.43 Caution in fiscal policy-making promotes consolidation in periods of economic growth, so allowing countries to deal with any adverse shocks that might arise from a position of fiscal strength. Some commentators have argued that this could be achieved through the creation of reserve funds that could be drawn on in the event of a shock to the public finances. This approach is one that has been adopted by several countries, including Australia, New Zealand, Sweden and Norway. However, it is conceivable that such funds might encourage pro-cyclical spending if the framework for use of these funds is not sufficiently tightly defined.

2.44 An alternative approach would be to build in explicit margins or "headroom" into meeting fiscal rules or targets.[22] The Government's approach as set out above, has instead been to adopt a number of assumptions audited by National Audit Office (NAO) to underpin the public finance projections, in particular trend growth, and to supplement this through an emphasis on enhanced transparency and a fiscal policy that paid down debt.

Framework enhanced efficiency in public spending

2.45 The Code for Fiscal Stability embedded the principle of efficiency in the Government's fiscal framework, according to which "the Government shall seek to ensure that it uses resources in ways that give value for money, that public assets are put to the best possible use and that surplus assets are disposed of. The Government shall also have regard to economic efficiency and compliance costs when forming taxation policy".

2.46 The Government sought to implement this principle in a number of ways:

- reforms of the budgeting system to distinguish capital from current spending;
- the introduction of a new public expenditure control framework; and
- schemes to improve asset management.

Reforms of the budgeting system

2.47 Separate capital and current budgets were introduced to protect capital investment, consistent with the golden rule. Previously, the focus of Government spending allocation and control had been primarily on total spending. Capital spending is now explicitly ring-fenced and protected in spending allocation: departments have the flexibility to move funds from current spending to capital expenditure, but not the other way.

2.48 Over the last economic cycle, this has helped ensure a better balance between capital and resource spending when departments' budgets have been under pressure. Across the UK this has enabled increased investment in key Government priorities between 1998-99 and 2007-08:

- total capital investment in education rose from £1.7 billion to £7.2 billion, an annual average real growth rate of 14 per cent;
- total capital investment in housing and community amenities has risen from £2.6 billion to £9 billion, an annual average real growth rate of 12 per cent;
- total capital investment in transport has risen from £2.9 billion to £11.4 billion, an annual average real growth of 13 per cent; and
- total capital investment in health has risen from £1 billion to £4.6 billion, an annual average real growth rate of 16 per cent.

The public expenditure framework

2.49 The public expenditure framework is firmly embedded in the fiscal framework. For given tax rates, the fiscal rules constrain the overall spending envelope available and the breakdown between current and capital spending. Moreover, the credibility of the fiscal framework

[22] IMF Article IV Consultation Concluding Statement of the Mission, May 2008

reinforces the credibility of medium-term spending allocation and thus promotes better use of resources at departmental level.

2.50 Starting with the 1998 Spending Review, the Government introduced a new public expenditure control system which split Government spending between Departmental Expenditure Limits (DEL) spending and Annually Managed Expenditure (AME). AME consists of large, volatile, and demand-led items such as social security benefits and debt interest that are budgeted for on an annual basis. Government departments were allocated DEL funding over three-year horizons. This was designed to provide greater stability and certainty in departmental spending. Through greater certainty and longer spending and planning horizons, departments were better able to allocate resources, supported by a policy approach focused on driving efficiencies.

2.51 Government departments also committed themselves to specific, quantified and measurable performance targets against which progress could be judged. Central to these targets were measurable outcomes for public policy goals articulated through PSAs (Public Service Agreements) and DSOs (Departmental Strategic Objectives).

2.52 The extension of End Year Flexibility (EYF) across the public sector sought to avoid wasteful expenditure of funds where departments found themselves with significant unspent resources at year end, by providing a mechanism for unspent funds to be carried forward to future years.

Schemes to improve asset management

2.53 The improvement of asset management across the public sector has been driven forward over the past ten years. Resource Accounting and Budgeting has made available much better information on the costs of holding assets. Government departments were required to produce Departmental Investment Strategies in the 2000, 2002 and 2004 Spending Reviews and Asset Management Strategies (with a much greater focus on the stock of assets underpinning public service delivery), alongside meeting targets for disposal.

2.54 Full Resource Accounting and Budgeting was adopted in the public sector between 2001 and 2003. This led to the provision of better information in accounts and incentives to manage resources. The National Audit Office in particular welcomed this move, with Sir John Bourn, Comptroller and Auditor General at the time, saying that these reforms would be "the most important reform of central government accounting and budgeting since Gladstone's reforms of the mid-19th century".[23] More recently, the NAO has said '"This [the implementation of RAB] has allowed departments to better understand how they are using their financial resources, for example by offering more detailed information to manage their assets and liabilities. Departments have used this information to help identify under-utilised assets and to dispose of those no longer required".[24] By moving away from purely cash-based accounting methods, the introduction of resource accounting and budgeting allowed Government to take a clearer view of the real costs of providing individual services by taking account of the full economic costs of holding assets.

Framework facilitated responsible and sustainable management of the public finances

2.55 There is a range of measures of fiscal sustainability that can inform fiscal policymaking. No single aggregate gives a complete picture of the sustainability of the public finances. As a result, the Government has chosen to publish a wide range of information, covering a number of

[23] *Resource Accounting and Budgeting in Government*, NAO, January 1995

[24] *Managing financial resources to deliver better public services: report by the Comptroller and Auditor General*, February 2008

different measures, to help support transparency. Nonetheless, as set out in Chapter 1, the Government chose to focus on Public Sector Net Debt as its measure for the sustainable investment rule.

2.56 Some commentators have argued that the sustainable investment rule should be broadened to include other items such as the total estimate of unfunded public service pension liabilities or payments relating to Private Finance Initiative (PFI) projects not recorded on the Government's balance sheet. They argue that these are future commitments that will have to be met from the public purse, in a similar way to debt repayment.

2.57 The Government's approach has been to adopt a transparent and independently verifiable measure of debt for the purposes of measuring the sustainable investment rule, and to assess long-term sustainability comprehensively – looking at future revenues as well as future costs. The measure of debt used for the sustainable investment rule is based on independently produced national accounts. Future commitments like the estimated costs of public service pensions are considered alongside other similar commitments, like the costs of paying the basic state pension in future, or the funding of future health services, in the Long-term Public Finances Report.

2.58 There are substantive differences between future commitments like service concessions or public service pensions and debts like government bonds, which mean the former are not currently included in national accounts measures of debt. In the case of those PFI projects which are currently recorded as service concessions rather than finance leases, on the basis of independently audited accounts, the government is not regarded as the economic owner of those assets and liabilities for the purposes of national accounts. The Government is instead contracting to pay for a stream of services in the future, as it does in a range of other situations. These current costs are funded from departmental DELs and so included in the fiscal projections.

2.59 The estimate of unfunded public service pension liabilities depends on uncertain assumptions about a number of factors. These include assumptions about the future, such as the longevity of current and future pensioners and the discount factor used to express future cash flows in today's prices. Moreover, for the purpose of assessing sustainability, a meaningful interpretation of the estimate can only be made by projecting the cash payments which will be needed in future years to honour the liability and assessing them in the context of future revenues. The latest Government projections, published in the 2008 Long Term Public Finance Report, show that public service pensions remain a relatively small fraction of GDP.

2.60 Since 2002, the Government has published a Long-Term Public Finance Report (LTPFR) in each financial year to consider in more detail issues around sustainability. In particular the LTPFR provides a comprehensive analysis of long-term demographic developments and their likely impact on the public finances, in line with the Code for Fiscal Stability's commitment to managing the public finances in the long-term interests of the UK. The IMF's Manual on Fiscal Transparency (2007) noted that the UK was "among the few countries that have taken a considered approach to long-term issues".[25] The introduction of an annual LTPFR significantly enhanced transparency about the sustainability of the Government's fiscal position. The Government exceeds the requirements of the Code for Fiscal Stability to publish illustrative fiscal projections covering a period of at least 10 years, by publishing projections for the next decades.

2.61 More recently the Government expanded its analysis of long term trends in the publication of Long-term opportunity and challenges for the UK: analysis for the 2007 Comprehensive

[25] *Manual on Fiscal Transparency*, International Monetary Fund, 2007

Spending Review,[26] which considered among things pressures on natural resources and the global climate based on The Stern Review of the Economics of Climate Change.[27]

Conclusion

2.62 This chapter has assessed the performance of the UK fiscal framework over the last economic cycle. Its key conclusions are:

- the fiscal rules – the means by which the Government's fiscal objectives were operationalised – were met over the cycle, with an average current surplus of 0.1 per cent of GDP and net debt falling from 42.5 per cent of GDP in 1996-7 to 36.0 per cent in 2006-07;
- the Government reduced public sector net debt as a percentage of GDP to low levels by historical and international standards, placing the public finances in a better position to support the economy and respond to economic shocks;
- at the same time, the framework also enabled the Government to increase investment in public services significantly; in 2007-08, public sector net investment was over three times higher as a share of the economy than in 1997-98;
- the framework's rules were transparently applied, thereby increasing debate about the framework and allowing the Government to be more accountable on fiscal policy;
- by taking into account the cycle, fiscal policy was able to support the operation of monetary policy, without destabilising the economy through policy action;
- efficient management of the public finances was enhanced by the implementation of the new public spending framework;
- policy acted to support medium-term sustainability in the public finances, and transparency around the long-term pressures on the public finances from demographic change was considerably enhanced.

2.63 The following chapter sets out how the Government is responding to the exceptional circumstances the UK economy currently faces.

[26] *Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review,* HM Treasury, 2006
[27] *The Stern Review of the Economics of Climate Change,* HM Treasury, 2006

3 Responding to exceptional circumstances

As set out in the 2008 Pre-Budget Report, major economic shocks have hit every country in the world, including the UK. These developments mean economic prospects are subject to exceptional uncertainty. But it is clear that the UK, like many advanced economies, has entered an economic downturn, with lasting implications for the public finances.

The Government's objectives for fiscal policy in the face of these shocks remain unchanged. The Government's immediate priority is to continue to support the economy, while setting a path now for ensuring fiscal sustainability in the medium term.

In these circumstances, the role of the fiscal framework is to ensure fiscal policy has the flexibility to respond appropriately, while remaining committed to clear, transparent long-term goals. So, to achieve its objectives, and as provided for in the Code for Fiscal Stability, **the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.**

Consistent with the Code for Fiscal Stability, the Government is setting a temporary operating rule: **to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.**

The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

They set out how the Government intends to support the economy now, ensure medium-term sustainability, and maintain public investment. In advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver its objectives.

The independent Office for National Statistics will determine the impact on the fiscal aggregates of the interventions the Government has made to ensure the stability of the financial system. **While the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on Public Sector Net Debt both including and excluding the impact of those interventions.**

Implications of current economic shocks for the fiscal framework

3.1 Over the past year, major economic shocks have hit every country in the world. While commodity prices have recently eased, the credit shock has intensified into the worst global financial crisis for generations, a crisis that is being addressed by a global policy response of unprecedented scale and scope. These developments mean economic prospects are subject to exceptional uncertainty, but it is clear that the UK, like many advanced economies, has entered an economic downturn. Asset markets and the financial sector have been severely affected, with persistent implications for the public finances.

3.2 The economic and fiscal climate is exceptionally challenging, but because of the macroeconomic framework introduced in 1997, the UK is facing these shocks from a solid foundation. The Government remains committed to the macroeconomic framework and the objectives enshrined within it. The Government's immediate priority is to continue to support the economy, while setting a path now for ensuring fiscal sustainability in the medium term. Chapter 2 of the 2008 Pre-Budget Report provides an analysis of changes in the fiscal position as a result of these economic shocks and the Government's fiscal policy response.

3.3 This chapter sets out how the fiscal framework enables the Government to continue to deliver its objectives for fiscal policy in these challenging circumstances.

Ensuring fiscal policy responds appropriately to economic shocks

3.4 When the economy faces significant shocks, the role of the fiscal framework is to ensure fiscal policy has the flexibility to respond appropriately to those shocks, while remaining committed to clear, transparent long-term goals. This pre-commitment to sound medium and long-term policies allows Government the discretion to provide short-term support to the economy within a framework that commands credibility with the markets and the public.

3.5 The framework allows the Government the flexibility to change fiscal policy, its fiscal objectives and rules in response to evolving circumstances. It also allows for the possibility of exceptional shocks that can have significant impacts on the public finances by providing the flexibility to temporarily depart from the fiscal rules that guide policy-making if that should prove necessary.

3.6 As set out in Chapter 1, the UK's fiscal framework builds in appropriate flexibility in three ways:

- firstly, the design of the fiscal rules over the last economic cycle, measured on average over the course of the cycle, gave fiscal policy the flexibility to allow the fiscal aggregates to vary between years to support monetary policy in smoothing the path of the economy, changing the fiscal stance as necessary in response to normal cyclical fluctuations;
- second, under the Code for Fiscal Stability, the Government restates and explains its fiscal policy objectives and the rules by which it intends to operate fiscal policy in each Budget, and may change them provided that new rules accord with the principles set out in the Code. The Government must in that case set out the reasons for doing so. This allows the Government to adapt its fiscal rules as appropriate to new circumstances, while ensuring continued transparency in the setting of those rules; and
- third, the Code also provides for temporary departure from the Government's fiscal rules in exceptional circumstances, provided that the Government clearly states the reasons for departure, the approach and time period for returning to the previous rules, and the temporary operating rules that will apply in the meantime.

3.7 So the UK fiscal framework enables the Government to respond to shocks on the scale of those which have hit the global and UK economy over the last year, while at the same time ensuring transparency in the way fiscal policy is being formulated and requiring pre-commitment to clear objectives and sound policies over the medium and long term. This flexibility and transparency is necessary to ensure fiscal policy is set to meet the Government's objectives, and that the Government is credibly accountable for the way it has responded and its progress in achieving its stated objectives.

Departing from the fiscal rules until global economic shocks have worked through

3.8 As set out in Chapter 2, the fiscal rules set for the last economic cycle were met, delivering the Government's fiscal objectives, with debt reduced from 42.5 per cent of GDP in 1996-97 to 36.0 per cent over the course of the economic cycle. However, applying the rules in these circumstances would not be consistent with achieving the Government's objectives for fiscal policy at a time when it needs to act with monetary policy to support the economy. Three key aspects of the current situation mean that seeking to meet the fiscal rules in the face of these shocks would not be appropriate:

- Given the distinctive nature of the current global crisis, particularly the impact it has had on the normal monetary transmission mechanism, **fiscal policy will need to play a much more significant role in the year ahead** in helping to support demand within the economy;
- **the current economic cycle is projected to be unusual, with the up-phase interrupted by major economic shocks**. This implies that aiming to balance the current budget on average over the cycle would require a sharply pro-cyclical fiscal policy. In these exceptional circumstances it would be damaging to the welfare of both current and future generations to seek to balance the current budget on average over the current economic cycle; and
- the **large and persistent impact of these shocks on the public finances means policy must adjust over a period** to avoid short-term pro-cyclical tightening. The right approach is to allow public debt to rise to absorb the shock and allow fiscal policy to support the economy, until adjustment has been completed and debt is set on a declining path as a proportion of GDP.

3.9 Given these factors it would be inappropriate to rigidly apply the existing rules at this point – even though they remain appropriate for when the global shocks have worked through the economy in full.

3.10 As a result, as provided for in the Code for Fiscal Stability, **the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full.**

Setting a temporary operating rule

3.11 Consistent with the Code for Fiscal Stability, the Government is setting a temporary operating rule: **to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full.**

3.12 The fiscal projections set out in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. They imply, as the economy emerges from the downturn, an adjustment in the cyclically-adjusted current balance of over 0.5 per cent of GDP a year from 2010-11.

3.13 In setting its fiscal policy stance in this Pre-Budget Report, the Government has to balance its medium-term objective to deliver sound public finances with its short-term objective to ensure fiscal policy supports monetary policy in smoothing the path of the economy. In particular, the Government needs to take account of expectations for the economy in response to global shocks and ensure that policy action to address the impact of those shocks on the public finances does not have pro-cyclical effects or a significant negative impact on future economic growth. International evidence suggests steady and sustained fiscal consolidations are more successful in delivering debt sustainability.[1]

3.14 The fiscal projections in this Pre-Budget Report are consistent with returning to cyclically-adjusted current balance and debt falling as a share of the economy by 2015-16 when the global shocks will have worked through the economy in full. This approach will continue to support the Government's fiscal objectives in current circumstances. In summary:

- to ensure fiscal policy supports monetary policy and helps to smooth the path of the economy, the operating rule is designed to accommodate an increase in borrowing to support the economy in the short term and is measured on a cyclically-adjusted basis, to allow the automatic stabilisers to operate in full at all times and avoid a sharp, pro-cyclical fiscal tightening;
- over the medium term, to ensure sound public finances and that taxation and spending impact fairly within and between generations, the operating rule will ensure policies are set so that in the medium-term borrowing is low and debt is stable and falling as a proportion of GDP. It ensures the Government remains on course to deliver sound public finances in the medium-term, through a sustained improvement in the cyclically-adjusted current balance; and
- setting policies to balance the cyclically-adjusted current budget will continue to protect capital spending and support inter-generational fairness, maintaining investment now to support the long-term productivity and competitiveness of the economy.

3.15 The fiscal projections in this Pre-Budget Report show how the Government intends to achieve those objectives in the medium term. **In advance of the public finances reaching cyclically-adjusted current balance, the Government will set out how it will apply the fiscal framework in future to continue to deliver those objectives.**

3.16 The following sections set out in more detail how the decisions the Government has taken in the Pre-Budget Report support these objectives while the economy and public finances are affected by global economic shocks.

Fairness between generations

3.17 As set out in Chapter 1, the golden rule was set to work alongside the sustainable investment rule to:

- protect intergenerational fairness. It ensures that current generations pay for the public services that they consume, rather than funding consumption through borrowing that will have to be repaid by future generations;
- address the bias against capital spending, ensuring investment is protected. The rule draws a distinction between current and capital spending, recognising that

[1] OECD Economic Outlook No. 81 Special Chapter: *Fiscal consolidation: lessons from past experiences*, May 2007

both have important roles to play in the provision of public services and that decisions on all spending must be considered on a value for money basis; and

- allow the automatic stabilisers to operate and fiscal policy to support monetary policy.

3.18 The current surplus over the economic cycle – net borrowing excluding for investment items – remains a simple measure of intergenerational fairness. However in these exceptional circumstances it would be damaging to the welfare of both current and future generations to seek to balance the current budget on average over the current economic cycle. As set out above, this would require sharp, pro-cyclical tightening of fiscal policy which would be likely to exacerbate the downturn at a point where impairment to the monetary transmission mechanism means fiscal policy needs to play a more active role. It would also impose large and unevenly distributed costs on current generations through lost output.

3.19 The Government's temporary operating rule, which is intended to improve the cyclically-adjusted current budget as a percentage of GDP each year until the global shocks have worked their way through the economy in full, will ensure that the public finances are in a position to deliver inter-generational fairness over the medium term, while allowing policy to support the economy in the short-term.

Maintaining debt at a stable and prudent level

3.20 As set out in Chapter 1, the Government set the sustainable investment rule so that, other things being equal, public sector net debt would be maintained below 40 per cent of GDP over the last economic cycle. This judgement was made on the basis of a series of factors pertaining at the time, including the need for investment in public infrastructure and the desirability of ensuring debt was low and stable in normal times to allow fiscal policy to respond and support monetary policy in smoothing the path of the economy in the face of major shocks, without debt rising to an unsustainable level.

3.21 However, in the face of large economic shocks and exceptional levels of uncertainty around economic prospects, it would not be appropriate to continue constraining public debt to a fixed target in this way.

3.22 Holding debt to a stable and prudent level in normal times allows space for debt to rise to absorb shocks when they come. One corollary of allowing the automatic stabilisers to operate to smooth the path of the economy in the face of large shocks is that public debt becomes more volatile. Seeking to constrain it would imply very sharp pro-cyclical tightening, which would tend to damage the long-run potential of the economy. Because public debt is financed out of future resources produced by the economy, that damage in itself would make any given level of public debt less sustainable. Instead policy should be set to ensure that levels of public debt are declining as a proportion of GDP once economic shocks have worked through, to begin to prepare for future economic shocks.

3.23 The Government's temporary operating rule is intended to ensure the debt to GDP ratio begins to fall again once the global shocks have worked their way through the economy in full to prepare for future shocks and other long-term challenges.

Ensuring progress toward the Government's objectives

3.24 There is considerable uncertainty over the path of the economy and public finances in the short term, and over the persistence of the impact of the economic shocks. Setting a rule focussed on steady improvement in the public finances over the medium term allows the Government flexibility to cope with that uncertainty, while constraining fiscal policy to deliver sound public finances.

3.25 The rule is designed to ensure consistent progress in improving the public finances while still allowing flexibility to deal with uncertainty in the interim, and ensuring support for the Government's fiscal objectives. It has two key features to deliver this:

- the rule is measured on a cyclically-adjusted basis, reflecting the Government's judgement on the fiscal position excluding the temporary effects of short-term cyclical fluctuations. This allows the Government to continue to make progress toward fiscal consolidation, while allowing the automatic stabilisers full freedom to operate should the actual path of the economy deviate from expectations. This process of cyclical adjustment, discussed in Box 3.A, requires the Government to estimate the element of the fiscal position it believes to be permanent. To ensure transparency about the process for doing so, the Government is publishing alongside the Pre-Budget Report a technical paper on the process of cyclical adjustment and it will invite the NAO to audit this approach to cyclical adjustment;[2] and
- it protects investment by focussing on improving the current budget. An adjustment rule which applied instead to all borrowing including for investment would reintroduce the bias against capital spending.

3.26 Setting this temporary operating rule allows the Government to make a judgement on the rate of fiscal adjustment of the public finances which it can undertake without significant negative impacts on prospects for economic activity, while at the same time ensuring steady progress. In making this judgement at the Pre-Budget Report the Government has taken account of a range of factors including its plans for improving value for money in public service provision, the need to maintain investment now to support the long-term productivity and competitiveness of the economy, and the likely impact of tightening on the economy.

Further improvement in the transparency of the fiscal framework

3.27 Building on the improvements in transparency put in place with the introduction of the fiscal framework and in subsequent changes, the Government is continuing to improve the transparency of fiscal policy-making. Providing the public with key information on the fiscal position and formulating policy as transparently as possible is particularly important at a time when there is considerable uncertainty surrounding the outlook for the economy and public finances. The 2008 Pre-Budget Report provides detail on the underlying assumptions that make up the fiscal forecast.

3.28 To further improve transparency, the Government is publishing alongside the 2008 Pre-Budget Report an update on the methodology that underpins cyclical adjustment.[3] It will also invite the National Audit Office to review HM Treasury's approach to cyclical adjustment.

3.29 The Government also remains committed to ensuring transparency in the impact on the fiscal aggregates of measures to support financial stability. The next section sets out the Government's approach to doing so.

[2] *Public finances and the cycle*, Treasury Economic Working Paper Number 5, HM Treasury, November 2008

[3] *Public finances and the cycle*, Treasury Economic Working Paper Number 5, HM Treasury, November 2008

Box 3.A: Public finances and the cycle

As set out in chapter 2, one of the key achievements of the fiscal framework has been to build in a greater understanding of the cyclically-adjusted position of the economy and the public finances.

The public finances tend to fluctuate with the economic cycle, partly as a result of the automatic stabilisers. These are the features of the tax and benefit system that automatically dampen the impact of shocks on output. For example, other things equal, when the economy is below its trend level, unemployment tends to be higher, leading to temporarily higher social security spending and lower income tax receipts.

This means that, in a downturn, Government borrowing will naturally tend to rise to support the economy, and fall when output moves above trend. This automatic effect, while less visible than, for example, a change in interest rates, will tend to moderate economic downturns. When assessing fiscal prospects, it is essential to adjust for the effects of the economic cycle on the public finances.

HM Treasury's methodology for calculating cyclically-adjusted fiscal aggregates is set out in the Treasury economic working paper, Public finances and the cycle, published alongside the Pre-Budget Report. The working paper also updates HM Treasury's existing cyclical-adjustment 'ready reckoners' with the latest data and concludes that they should remain unchanged.

HM Treasury's ready reckoners for calculating cyclically-adjusted estimates of key fiscal indicators are:

- Cyclically-adjusted net borrowing = net borrowing + 0.50 * output gap in the current fiscal year + 0.20 * output gap in the previous fiscal year
- Cyclically-adjusted current budget = current budget - 0.50 * output gap in the current fiscal year - 0.20 * output gap in the previous fiscal year

Overall a 1 per cent increase in output relative to trend after two years is estimated to reduce the ratio of public sector net borrowing to GDP by just under ¾ percentage point, while increasing the ratio of surplus on the current budget to GDP by just under ¾ percentage point.

Measuring the impact of policy action in the financial sector on fiscal sustainability

3.30 With continuing exceptional instability in the global financial markets, the Government has taken decisive action to implement a comprehensive set of measures making commercial investments in UK banks and building societies to stabilise their position and support the long-term strength of the economy, and to deal with particular individual institutions that have experienced problems. The aim of these interventions has been to ensure the stability of the financial system; protect ordinary depositors' and consumers' money; and safeguard the interests of taxpayers.

3.31 As was the case with the measures transferring Northern Rock into temporary public ownership, there is potential for these further interventions to have a significant impact on ONS measures of Public Sector Net Debt and on other fiscal aggregates. The Government is therefore setting out how it would approach any potential impacts from the standpoint of fiscal policy.

Box 3.B: Measures to support financial stability

The impact on the public finances of these various interventions will be exceptional and mostly temporary. Some interventions involve central Government borrowing on the capital markets to invest in financial institutions. Other interventions, like the measures taken to bring Northern Rock into temporary public ownership, affect the fiscal aggregates through the reclassification of entities into the public sector. The main interventions to date have been:

- measures to bring Northern Rock into temporary public ownership, bringing the company's balance sheet and operations within the public sector finances;
- measures to bring elements of the business of Bradford & Bingley into public ownership;
- measures to protect depositors in Bradford & Bingley, Landsbanki, Heritable, and Kaupthing Singer and Friedlander, including payments made by the Financial Services Compensation Scheme financed by central Government borrowing on the capital markets;
- recapitalisation of several major UK banks, involving central Government borrowing on the capital markets to finance investments in the companies concerned in return for equity, including preference shares;
- making available to eligible institutions a Government guarantee of short and medium-term debt issuance to assist in refinancing maturing, wholesale funding obligations. In return the taxpayer will receive premia commensurate with the level of risk the taxpayer is taking on; and
- measures to ensure the banking system has access to sufficient liquidity, including under the Special Liquidity Scheme, a system of collateralised loans in exchange for financial assets valued at more than the value of loans made.

The independent Office for National Statistics will determine the impact on the fiscal aggregates of these interventions in consultation with Eurostat (the Statistical Office of the European Union) and statistical offices in other member states to ensure consistent interpretation of international statistical guidance.

3.32 Any extra liabilities classified to the public sector through these interventions, including through central government borrowing on the capital markets to finance investments or payments to depositors, will be:

- mostly temporary, in that it is the Government's intention to hold investments or controls for no longer than is necessary to ensure the stability of the institution concerned and value for money for the taxpayers; and
- exceptional, in that any liabilities will be backed by financial assets offering returns to the taxpayer commensurate with the risks being taken on.

3.33 The long-term impact on the public finances, and any burden on future generations, would therefore be determined not by the gross value of any liabilities assumed by the public sector but by any eventual economic profit or loss incurred on the intervention. The Government's intervention helped support inter-generational fairness by supporting financial stability and hence macroeconomic stability. Any eventual profits would reduce the public sector's indebtedness, providing resources that can be used to pay down debt elsewhere. Any eventual losses would leave the public sector with financial liabilities without the financial assets to fund their repayment, increasing debt.

3.34 In line with this analysis, the Government will, in assessing the fiscal position:

- **exclude the impact of any gross liabilities** incurred on these interventions from measures of the sustainability of the public finances used to inform policy;
- **include any economic profit or loss** which will affect the burden of debt borne by taxpayers over the long term in measures used to inform policy at the point at which that profit or loss crystallises; and
- **ensure transparency in the level of risk borne by the public sector balance sheet by accounting for and reporting on the fiscal position both including and excluding the impact of financial sector interventions** where appropriate and where publication will not reveal confidential data on individual transactions and institutions.

3.35 As a result, **while the public sector fiscal aggregates continue to be affected by interventions in the financial sector the Government will report on Public Sector Net Debt both including and excluding the impact of those interventions**. Any economic profit or loss on interventions will be included in both measures when that profit or loss crystallises for central government. This approach is based on the approach the Government announced at Budget 2008 when the ONS announced its intention to classify Northern Rock as a public corporation. Annex B of the 2008 Pre-Budget Report sets out details on the composition of the fiscal aggregates published at this Pre-Budget Report.

A The Code for Fiscal Stability and supporting legislation

This annex reproduces the Code for Fiscal Stability, as approved by Parliament on 9 December 1998, and the relevant sections of the 1998 Finance Act.

The Code for Fiscal Stability

Purpose of the Code

1. The purpose of the Code is to improve the conduct of fiscal policy by specifying the principles that shall guide the formulation and implementation of fiscal policy and by strengthening the reporting requirements incumbent on the Government.

2. In this Code, except where the contrary is stated, fiscal policy includes debt management policy.

Principles of Fiscal Management

3. The Government shall conduct its fiscal policy in accordance with the following principles:

   a. transparency in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts;

   b. stability in the fiscal policy making process and in the way fiscal policy impacts on the economy;

   c. responsibility in the management of the public finances;

   d. fairness, including between generations; and

   e. efficiency in the design and implementation of fiscal policy and in managing both sides of the public sector balance sheet.

4. The principle of transparency means that the Government shall publish sufficient information to allow the public to scrutinise the conduct of fiscal policy and the state of the public finances, and shall not withhold information except where publication of that information would:

   a. Substantially harm:

      i. the national security, defence or international relations of the United Kingdom;

      ii. the investigation, prosecution, or prevention of crime, or the conduct of civil proceedings;

   iii. the right to privacy;

   iv. the right of other parties to undertake confidential communications with the Government;

   v. the ability of the Government to undertake commercial activities; or

b. harm the integrity of the decision-making and policy advice processes in Government.

5. The principle of **stability** means that, so far as reasonably practicable, the Government shall operate fiscal policy in a way that is predictable and consistent with the central economic objective of high and stable levels of growth and employment.

6. The principle of **responsibility** means that the Government shall operate fiscal policy in a prudent way, and manage public assets, liabilities and fiscal risks with a view to ensuring that the fiscal position is sustainable over the long term.

7. The principle of **fairness** means that, so far as reasonably practicable, the Government shall seek to operate fiscal policy in a way that takes into account the financial effects on future generations, as well as its distributional impact on the current population.

8. The principle of **efficiency** means that the Government shall seek to ensure that it uses resources in ways that give value for money, that public assets are put to the best possible use and that surplus assets are disposed of. The Government shall also have regard to economic efficiency and compliance costs when forming taxation policy.

Fiscal and Debt Management Objectives and Operation of Fiscal Policy

9. Subject to paragraph 12, the Government shall state and explain its fiscal policy objectives and the rules by which it intends to operate fiscal policy over the life of the Parliament. These objectives and operating rules shall accord with the principles stated in paragraph 3, and shall be restated in each Budget.

10. The Government may change its fiscal policy objectives and operating rules, provided that:

    a. any new fiscal policy objectives and operating rules also accord with the principles stated in paragraph 3; and

    b. the reasons for departing from the previous objectives and operating rules are stated.

11. The Government may depart from its fiscal objectives and operating rules temporarily, provided that it specifies:

    a. the reasons for departing from the previous fiscal policy objectives and operating rules;

    b. the approach and period of time that the Government intends to take to return to the previous fiscal policy objectives and operating rules; and

    c. the fiscal policy objectives and operating rules that shall apply over this period.

12. The primary objective of debt management policy shall be to minimise, over the long term, the costs of meeting the Government's financing needs whilst:

    a. taking account of risk; and

    b. seeking, so far as possible, to avoid conflict with monetary policy.

Accounting Practice

13. The Government shall ensure that accounts are to be produced for the whole public sector. Where reasonably practicable, these accounts also shall be produced on a consolidated basis.

14. The Government shall, as soon as reasonably practicable, adopt a Resource Accounting and Budgeting approach for planning and accounting for the costs of resources consumed by Government, based on Generally Accepted Accounting Practice in the United Kingdom, adapted as necessary for the public sector.

The Pre-Budget Report

15. If, as is usual, there is only one Budget in a financial year, the Treasury shall publish a Pre-Budget Report (PBR) at least three months prior to it, unless this is the first Budget of the Parliament, in which case a PBR shall not be required. In addition, if there is more than one Budget in any financial year, only one PBR shall be required.

16. The PBR shall be consultative in nature, and shall include, so far as reasonably practicable, proposals for any significant changes in fiscal policy under consideration for introduction in the Budget. However, the PBR shall not be taken as an indication of all tax policy areas where the Government may choose to act. In particular, consultation may not be possible in areas which:

    a. carry the risk of significant forestalling activity by existing or prospective taxpayers; or

    b. could lead to significant temporary distortions in taxpayer and market behaviour, including disruption in financial markets.

17. The PBR shall also include, either in the main document, or in a subsidiary document:

    a. an Economic and Fiscal Projection (as defined in paragraphs 20-25); and

    b. an analysis of the impact of the economic cycle on the key fiscal aggregates, including estimates of the cyclically-adjusted position, so as to shed light on progress against the fiscal objectives stated under paragraphs 9-11.

The Financial Statement and Budget Report

18. The Treasury shall publish a Financial Statement and Budget Report (FSBR) at the time of the Budget. The FSBR shall provide, at a minimum:

    a. an Economic and Fiscal Projection (as defined in paragraphs 20-25);

b. an explanation of significant fiscal policy measures introduced in the Budget; and

c. an explanation, where necessary, of how these policy measures restore the path of the public finances to a position consistent with:

   i. the fiscal policy objectives and operating rules specified in paragraphs 9-11; and

   ii. the Government's European commitments, in particular the terms of the Stability and Growth Pact.

The Economic and Fiscal Strategy Report

19. The Treasury shall publish an Economic and Fiscal Strategy Report (EFSR), usually at the time of the Budget. But if there is more than one Budget in any financial year, only one EFSR shall be required. Within the context of the specified principles of fiscal management, the EFSR shall:

   a. set out the Government's long-term economic and fiscal strategy, including any long-term objectives for the key fiscal aggregates;

   b. assess both recent outcomes and the short-term economic and fiscal outlook contained in the Financial Statement and Budget Report against this longer-term strategy;

   c. assess whether the short-term outlook and long-term strategy is consistent with the Government's European commitments, in particular, the terms of the Stability and Growth Pact;

   d. present illustrative projections of the outlook for the key fiscal aggregates for a period not less than 10 years into the future, based on a range of plausible assumptions, so as to shed light on the inter- generational impact and sustainability of fiscal policy; and

   e. present an analysis of the impact of the economic cycle on the key fiscal aggregates, including estimates of the cyclically-adjusted position.

Economic and Fiscal Projections

20. Where a report published under this Code contains an Economic and Fiscal Projection, that report shall contain, as a minimum:

   a. the key assumptions, forecasts and conventions underpinning the projection;

   b. projections of:

      i. GDP and its components;

      ii. retail prices (including any measure of prices that is the formal inflation target of the Government); and

      iii. the current account position of the balance of payments.

c. upon the implementation of Resource Accounting and Budgeting, an operating statement, reflecting the Government's projected current revenue and current expenses for each financial year;

d. a statement of cash flows, reflecting projected cash flows for each financial year;

e. a statement outlining proceeds received from the sale of public assets;

f. any other such statements as are necessary to reflect fairly the projected financial performance of the Government; and

g. an analysis of the risks surrounding the economic and fiscal outlook, including Government decisions and other circumstances that have still to be quantified with certainty, other material contingent liabilities and an indication of past forecast errors for aggregates noted in paragraph 20(b) and for Public Sector Net Borrowing.

21. The financial statements issued under paragraph 20 shall include projections of key fiscal aggregates, including: current spending and current revenue, the Surplus on Current Budget, Public Sector Net Borrowing, the Public Sector Net Cash Requirement, the General Government Financial Deficit, General Government Gross Debt, Public Sector Net Debt and a measure of net wealth. Where possible, the statements shall provide a breakdown of expenditure and revenue by sector and economic and/or functional category.

22. The financial statements shall also include any other such indicator as is required to judge achievement against the Government's fiscal policy objectives and rules and against the Government's European commitments, in particular the Stability and Growth Pact.

23. Every economic and fiscal projection contained in a report published under this Code shall be based, so far as reasonably practicable, on all Government decisions and all other circumstances that may have a material impact on the fiscal outlook:

a. where the fiscal impact of these decisions and circumstances can be quantified with reasonable accuracy by the day the projections are finalised, the impact should be included in the published projections.

b. where the fiscal impact of these decisions and circumstances cannot be quantified with reasonable accuracy by the day the projections are finalised, these impacts should be noted as specific fiscal risks.

24. The projection horizon is to be a period of not less than two full financial years following the date of publication. For each of the statements, comparative figures for the key fiscal aggregates covering the previous two financial years are to be published.

25. The Treasury shall also provide an explanation of all significant accounting policies, including any changes from previous practice.

Role of the National Audit Office

26. The Treasury shall invite the National Audit Office (NAO) to audit any changes to the key assumptions and conventions underlying the Fiscal Projections. The Comptroller and Auditor

General shall ensure that any advice is communicated to the Treasury and laid before Parliament.

Conduct of Debt Management and the Debt and Reserves Management Report

27. The Government shall report annually on the structure of its borrowing and the cost of the government debt, giving sufficient information to allow the public to scrutinise the conduct of its debt management policy. The overall debt portfolio used to finance past fiscal deficits will be presented in the Debt Management Report, to be issued within each financial year. The Government's agents for implementing debt management policy, the Debt Management Office and National Savings, shall publish more detailed information in their own annual reports and accounts.

28. The Government shall set remits for its agents in the annual Debt and Reserves Management Report. This report will include:

    a. a forecast of the net funding through National Savings;

    b. the overall size of the gilts issuance programme for the coming financial year;

    c. the planned debt maturity structure and the proportions of index-linked and conventional gilts; and

    d. the gilt auction calendar.

29. The remits shall be subject to revision or confirmation as the Government publishes more subsequent fiscal projections.

Referral to Select Committee

30. The Treasury shall refer to the House of Commons Treasury Select Committee every report published as a requirement of the Code.

Disclosure of Other Information

31. The Treasury shall publish, from time to time, other information that it determines would better enable the public to scrutinise fiscal policy and the state of the public finances.

Publication and Inspection of Reports

32. The Treasury shall, in respect of every report published as a requirement of the Code, arrange for the publication of a notice indicating:

    a. where copies of the report are available for inspection free of charge; and

    b. where copies of the report are available for purchase.

33. The Treasury shall make available copies of each report for inspection or purchase for at least 6 months following publication. Copies of all reports shall also be made available on the Treasury's internet website.

1998 Finance Act – Sections pertaining to the Code for Fiscal Stability

Part VI – Miscellaneous and Supplemental

Fiscal Stability

155. Code for Fiscal Stability

(1) It shall be the duty of the Treasury to prepare and lay before Parliament a code for the application of the key principles to the formulation and implementation of—

(a) fiscal policy, and

(b) policy for the management of the National Debt.

(2) The key principles are transparency, stability, responsibility, fairness and efficiency.

(3) The code prepared under this section must set out, in particular—

(a) the Treasury's understanding of what each of the key principles involves in relation to fiscal policy and policy for the management of the National Debt;

(b) the provision appearing to the Treasury to be necessary for the purposes of so much of section 156 below as refers to the code; and

(c) the methods and principles of accounting to be applied in the preparation of accounts, forecasts and other documents used for the purposes of the formulation and implementation of the policies mentioned in subsection (1) above.

(4) Where any code has been laid before Parliament under subsection (1) above, the Treasury may from time to time modify that code; but, if they do so, they shall lay the modified code before Parliament.

(5) A code (including a modified code) that has been laid before Parliament under this section shall not come into force until it has been approved by a resolution of the House of Commons.

(6) It shall be the duty of the Treasury to publish, in such manner as they think fit, any code which has been laid before Parliament and approved by the House of Commons under this section.

(7) The first code to be laid before Parliament under this section shall be so laid before 31st December 1998.

156. Annual Budget documents

(1) It shall be the duty of the Treasury, for each financial year, to prepare and lay before Parliament the following documents, that is to say—

(a) a Financial Statement and Budget Report;

(b) an Economic and Fiscal Strategy Report; and

(c) a Debt and Reserves Management Report.

(2) The preparation and laying before Parliament of the Financial Statement and Budget Report for any financial year shall be preceded, in such cases and by such period as may be set out

in the code for fiscal stability, by the preparation by the Treasury of a document to be known as the Pre-Budget Report.

(3) The Treasury shall lay before Parliament any Pre-Budget Report prepared by them under subsection (2) above.

(4) The contents of the documents which the Treasury are required to prepare and lay before Parliament under this section, and the occasions on which those documents are to be so laid, must conform to any provision about those matters made by the code for fiscal stability.

(5) It shall be the duty of the Comptroller and Auditor General to examine and report to the House of Commons on such of the conventions and assumptions underlying the preparation by the Treasury of the documents prepared by them under this section as, in accordance with the code for fiscal stability, are submitted to him by the Treasury for his examination.

(6) A report by the Comptroller and Auditor General under subsection (5) above must be made at the same time as, or as soon as reasonably practicable after, the laying before Parliament of the documents to which it is referable.

(7) It shall be the duty of the Treasury to secure the publication in the manner required by the code for fiscal stability of any document which they have laid before Parliament under this section.

(8) In this section "the code for fiscal stability" means the code for the time being in force under section 155 above.

(9) The first financial year for which the documents mentioned in subsection (1) above are required to be prepared and laid before Parliament is the year beginning with 1st April 1999.

157. Supplementary powers of the Comptroller and Auditor General

(1) The Comptroller and Auditor General—

(a) shall have a right of access, at all reasonable times, to all such relevant Government documents as he may reasonably require for the purpose of carrying out any examination under section 156(5) above; and

(b) shall be entitled to require from any person holding or accountable for any relevant Government documents any assistance, information or explanation which he reasonably thinks necessary for that purpose.

(2) In this section "relevant Government documents" means documents in the custody or under the control of the Government department primarily responsible for the adoption or formulation of the convention or assumption in question

B Bibliography

Accounting Standards Board Financial Reporting Standard 12: Provisions, contingent liabilities and assets, Accounting Standards Board

Asilis, C.M. (1994) "The US Public Debt-Implications for Growth", IMF working paper No. WP/94/4

Balls, E. and O'Donnell, G. (2002) "Reforming Britain's Economic and Financial Policy", Palgrave

Comptroller and Auditor General (2008) "Managing financial resources to deliver better public services", National Audit Office

Debrun, X. and Manmohan S.K. (2007) "The Discipline-Enhancing Role of Fiscal Institutions: Theory and Empirical Evidence", IMF Working Paper, International Monetary Fund

European Policy Committee (2006) "The Long-term sustainability of public finances in the European Union", European Commission

HM Treasury (1998) "Delivery Economic Stability: Lessons from Macroeconomic Policy Experience", The Stationery Office, London

HM Treasury (1997) "Fiscal Policy: Lessons from the Last Economic Cycle", The Stationery Office, London

HM Treasury (1997) "Financial Statement and Budget Report", The Stationery Office, London

HM Treasury (1997) "Financial Statement and Budget Report", The Stationery Office, London

HM Treasury (1998) "Economic and Fiscal Strategy Report", The Stationery Office, London

HM Treasury (1999) "Analysing UK Fiscal Policy", The Stationary Office, London

HM Treasury (1999) "Pre-Budget Report", The Stationary Office, London

HM Treasury (2001) "Economic and Fiscal Strategy Report", The Stationery Office, London

HM Treasury (2003) "Economic and Fiscal Strategy Report", The Stationery Office, London

HM Treasury (2003) "Fiscal stabilisation and EMU – a discussion paper", The Stationery Office, London

HM Treasury (2005) "Evidence on the UK economic cycle", The Stationery Office, London

HM Treasury (2006) "The Stern Review of the Economics of Climate Change", The Stationery Office, London

HM Treasury (2006) "Long-term opportunities and challenges for the UK: analysis for the 2007 Comprehensive Spending Review", The Stationery Office, London

HM Treasury (2008) "Evidence on the economic cycle", The Stationery Office, London

HM Treasury (2008) "Public finances and the cycle", Working Economic Working Paper Number 5, The Stationary Office, London

HM Treasury (2008) "End of Year Fiscal Report", The Stationery Office, London

HM Treasury (2008) “Long-term public finance report”, The Stationery Office, London

IFS (2008) “The IFS Green Budget”, Institute for Fiscal Studies

IMF (1998) “Manual on Fiscal Transparency”, International Monetary Fund

IMF (1999) “Experimental Report on Transparency Practices”, International Monetary Fund

IMF (2005) Article IV Consultation Concluding Statement of Mission, International Monetary Fund

IMF (2006) United Kingdom Article IV Consultation, International Monetary Fund

IMF (2006) Article IV Consultation Concluding Statement of Mission, International Monetary Fund

IMF (2007), Eds., Kumar, M.S. and Ter-Minassian, T. “Promoting Fiscal Discipline”, International Monetary Fund

IMF (2008) *World Economic Outlook*, International Monetary Fund

IMF (2008) Article IV Consultation Concluding Statement of Mission, International Monetary Fund

NAO (1995) “Resource Accounting and Budgeting in Government”, National Audit Office

Keech, W.R. (1985) “A Theoretical Analysis of the Case for a Balanced Budget Amendment," Policy Sciences

Neck and Sturm (eds) (2008) “Sustainability of Public Debt”, CESifo Seminar Series, MIT Press

O’Donnell and Bhundia (2002) “UK policy coordination: the importance of institutional design”, Fiscal Studies

OECD (2002) “Fiscal Sustainability: the contribution of the fiscal rules”, *OECD Economic Outlook 72*, Organisation for Economic Co-operation and Development

OECD (2005) Economic Survey: United Kingdom, Organisation for Economic Co-operation and Development

OECD (2005) “Journal on Budgeting (Volume 5, Number 1)”, Organisation for Economic Co-Operation and Development

OECD (2007) Economic Outlook No. 81 Special Chapter: Fiscal consolidation: lessons from past experiences, Organisation for Economic Co-operation and Development

OECD (2007) Economic Survey: United Kingdom, Organisation for Economic Co-operation and Development

ONS “Government and Public Sector Debt Measures”, Office for National Statistics

Smyth, D.J. and Hsing, Y. (1995) “In Search of an Optimal Debt Ratio for Economic Growth”, Contemporary Economic Policy 13

Svensson (2003) “Monetary Policy and Real Stabilization”, National Bureau of Economic Research Working paper, No. 9486

Weale, M (2008) “The Policy Framework”, The National Institute Economic Review, No. 206

Woods (2004) “The Role of Public Debt in the UK Fiscal Rules”, Banca d’Italia workshop

Zee, H.H (1998) “The Sustainability and Optimality of Government Debt”, IMF Staff Papers 35(4)

C List of charts, tables, boxes and abbreviations

List of charts

List of tables

List of boxes

List of abbreviations

AME Annually Managed Expenditure
DEL Departmental Expenditure Limits
DMO Debt Management Office
DRMR Debt and Reserves Management Report
DSO Departmental Strategic Objectives
ECB European Central Bank
EFSR Economic and Fiscal Strategy Report
ERM Exchange Rate Mechanism
EU European Union

EYF	End Year Flexibility
EYFR	End of Year Fiscal Report
FSA	Financial Services Authority
FSBR	Financial Statement and Budget Report
FSF	Financial Stability Forum
G7	A group of seven major industrial nations (comprising: Canada, France, Germany, Italy, Japan, UK and the US)
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IMF	International Monetary Fund
IFRS	International Financial Reporting Standards
IFS	Institute for Fiscal Studies
LTPFR	Long-Term Public Finance Report
MoU	Memorandum of Understanding
MPC	Monetary Policy Committee
NAO	National Audit Office
NIESR	National Institute of Economic and Social Research
OECD	Organisation for Economic Co-operation and Development
ONS	Office for National Statistics
PAC	Committee of Public Accounts
PBR	Pre-Budget Report
PC	Public Corporation
PFI	Private Finance Initiative
PSA	Public Service Agreement
PSBR	Public Sector Borrowing Requirement
PSNB	Public Sector Net Borrowing
PSND	Public Sector Net Debt
RAB	Resource Accounting and Budgeting
SGP	Stability and Growth Pact
TME	Total Managed Expenditure
TSC	Treasury Select Committee
WGA	Whole of Government Accounts

ISBN 978-1-84532-520-6