Iain Begg November 11th, 2024

How Rachel Reeves should have changed the fiscal rules

*In her first Budget, Rachel Reeves changed the fiscal rules and redefined what counts as public debt. **Iain Begg** argues that these changes might not be as effective as the Chancellor hopes at helping her to control the public finances effectively. Instead, Reeves should have taken a leaf out of the EU's book and moved away from debt and balance rules in favour of an expenditure rule.*

Enjoying this post? Then sign up to our newsletter and receive a weekly roundup of all our articles.

In presenting her first budget, Rachel Reeves stressed the difficult choices she faced in reconciling the government's ambitions and keeping a tight rein on the public finances. She nevertheless introduced changes in the fiscal rules – the constraints successive governments have imposed to ensure fiscal sustainability – which somewhat eased matters.

The proposed new fiscal rules are set out in the draft version of a new Charter for Budget Responsibility, updating the one introduced by Jeremy Hunt in 2022, itself the latest in a succession of versions since being introduced by George Osborne early in the 2010-15 coalition government.

> *While not quite smoke and mirrors to mask a difficult position, the redefinition of public debt is unlikely to alter market perceptions of the sustainability of UK public debt.*

Reeves' other significant change was to opt for a different definition of public debt which takes more account of the assets created by public investment. In practice, this change should make it easier to stay within debt limits, at least as long as the very technical amendments pull in the right direction.

However, while not quite smoke and mirrors to mask a difficult position, the redefinition is unlikely to alter market perceptions of the sustainability of UK public debt. As a result, the burden of financing the debt will, at best, change only marginally. Despite that, as Paul Johnson of the Institute for Fiscal Studies observed: "none of this fiscal fiddling is of much help to Reeves when it comes to pressures on day-to-day spending".

Prior to the budget, commentators and former civil servants were lining up to condemn the fiscal rules she had inherited from the Conservatives. As concisely stated by former Cabinet Secretary, Gus O'Donnell: we "should ditch the last government's absurd debt rule".

This rule obliged the government to have the debt to GDP ratio falling in the fifth year ahead. It is a rolling target, with the deadline always five years ahead. Many critics have resorted to the word "fiction" to characterise the system, because it is easy for any Chancellor to be profligate in the early years and promise only to restore fiscal discipline later.

In future, current spending is to be balanced by revenue raising, hence the need for the sizeable tax increases.

Changing the fiscal rules

The two key changes are to distinguish between the approaches to current public spending (public services, welfare payments and so on) and public investment (for example on infrastructure), and to shorten the five-year period for meeting the rule to three.

In future, current spending is to be balanced by revenue raising, hence the need for the sizeable tax increases. This new framing means the restoration of what is called a balanced budget rule for the current component of the budget, rather than one focused on public debt. However, it will not be immediate, as the draft new version of the Charter for Budget Responsibility envisages reaching budget balance only by the 2029/30 fiscal year.

The three-year timetable will also apply a parallel rule that debt (on the redefined basis) should be falling by the same fiscal year. Thus, the primary emphasis is now on the current balance whereas it was previously on the debt to GDP ratio. Intriguingly, the current balance was the primary target in earlier versions of the Charter as documented in an Institute for Government explainer.

> *However, care will be needed as the new rule is implemented to ensure not just that public investment grows, but also that it is well-targeted.*

The "golden rule", borrowing to invest, is not so golden

The second change, reinstating a so-called "golden rule", will be to borrow only to invest. The reasoning is twofold. First, when governments face pressures on the public finances, experience shows that they always find it easier to cut public investment. The backlash against Reeves' decision to means-test the winter fuel allowance for pensioners is illustrative. It saves a relatively small amount of public money. Cutting HS2 to save vastly more was fairly easy.

The focus on investment, including rescinding cuts previously planned in public projects by the outgoing Tory government, has been broadly welcomed. However, care will be needed as the new rule is implemented to ensure not just that public investment grows, but also that it is well-targeted.

From crumbling public buildings to overstretched transport networks, the needs are obvious and extensive, and there are many areas needing public investment. But it is a means to an end, and the end Reeves seeks is to boost economic growth. Not all investment achieves this.

Other countries, such as Germany, which long had forms of golden rule, abandoned them because spending ministries tried to game the system by classifying as much as possible as investments. Rather than accounting distinctions between current and investment spending, one innovation Reeves should consider is to rate projects for their anticipated contribution to growth and to ask a body such as the OBR to assess the merits of the case.

Many European countries with far healthier public finances have moved away from debt and balance rules in favour of what is known as an expenditure rule.

Other options Reeves could consider

To forestall charges of being cavalier in its approach, a new government will tend to be cautious about diverging too much from an existing fiscal framework, but there are other changes which Reeves should consider. These could encompass not just the fiscal rules, but also other facets of the governance of fiscal policy, drawing on lessons from elsewhere. The Charter for Budget Responsibility is, in fact, about more than the fiscal rules even though they attract most interest.

Many European countries with far healthier public finances have moved away from debt and balance rules in favour of what is known as an expenditure rule. The main reason is that the government directly controls expenditure and, especially if it plans it over a number of years, can set a stable path for the economy. The Dutch, as an illustration, plan for a full parliamentary term.

By contrast, despite having the power to set taxes, governments can not be sure how much revenue will be raised because of the fluctuations in economic cycles. As a result, targeting the budget balance or the debt to GDP ratio is more prone to surprises.

Nevertheless, having a target for public debt (as in Sweden and Poland) could be another useful addition to the revised fiscal rules, rather than simply wanting it to fall in a distant future. In Sweden, the debt rule is about anchoring expectations rather than being a firm target, while in Poland it is a hard limit.

The core message for Rachel Reeves is that there will not be a better time to rethink the UK approach more radically.

Image credit: Fred Duval Shutterstock

About the author

Iain Begg

Iain Begg is a Professorial Research Fellow at the European Institute, London School of Economics and Political Science. His main research work is on the political economy of European integration and EU economic governance.

Posted In: Economy and Society | Government | LSE Comment