

The UK is well ahead of the US and the EU in its use of fiscal rules

Much of the speculation leading up to the Chancellor's Autumn Statement, as well as the debate which followed it, has centered around George Osborne's fiscal rules. In this post [Simon Wren-Lewis](#) examines the government's surviving fiscal rule and some of the difficulties which surround it.



In one area macroeconomic policy in the UK is well ahead of the US or the Eurozone: the use of fiscal rules. The US seems to prefer cliffs to rules – yes, I know that is a cheap jibe, but you know what I mean. In the Eurozone fiscal rules now come in [packs](#), the individual parts of which are of variable quality and may not be consistent with each other. By contrast, the surviving UK fiscal rule (or ‘mandate’) makes some limited sense, as did Gordon Brown's [predecessors](#). It says the government should achieve structural (cyclically adjusted) balance, excluding investment spending, within five years – where that five year period rolls forward.

What is good about this rule? Its main advantage is that, by having a rolling target, nothing is adjusted too quickly. One thing that stands out from the [literature](#) is that, as long as you are able to sell debt, fiscal adjustments should be slow, and the government's deficit should act as a shock absorber. The analogy with consumption smoothing is pretty close. Now it is true that a rolling target could allow a government to keep delaying adjustment, but that is hardly a problem right now.

Two additional features of the UK rule are the use of the cyclically adjusted deficit and the exclusion of investment. Although cyclical adjustment gets [talked about](#) a lot, for this particular rule it would in normal times be largely irrelevant, because we would expect to have a zero output gap in five years time anyway. Right now it is not irrelevant, but I will have more to say about the current conjuncture below. Whether it is right to exclude spending on investment is a difficult question, which I will leave for another post.

Where the rule is more problematic is the focus on the deficit, and the idea that ‘balance’ for the current deficit is a meaningful target. Ultimately we are concerned about government debt. We want to stop debt rising relative to GDP, and then we want to get it down. The speed at which that is done will imply a path for deficits, but these deficits will almost certainly be varying over time, and there is no magic in zero (i.e. balance). The rule that an economist would naturally think of (and which is commonly [used](#) in academic work) is to adjust instruments in proportion to the difference between actual debt and its target level. However, a zero deficit over the medium run will imply a reduction in debt (as the OBR shows), so at least its moving us in the right direction.

While for the macroeconomist as scientist there is plenty of scope for exploring these issues, I think they miss the two major problems that the macroeconomist as engineer has to deal with. The first is whether we are designing rules for a (roughly) benevolent government, or for a government that departs from benevolence in particular ways. Second, good rules will inevitably involve making guesses about the future, and many people find it difficult to get their head around this.

As an example, we only need to look at the reaction to the Autumn Statement in the UK. Whether the measures taken by the Chancellor are sufficient to meet his rule depends on where you think the economy will be in five years time. Given the current uncertainty about the output gap, the Chancellor could be being too optimistic or embarking on unnecessary austerity. For instance see [Ian Mulheirn](#) on the implications of alternative assumptions. Commentators, particularly those political commentators for whom the long run is after the next election, but also in my experience some macroeconomists, yearn for rules or targets that are not conditional in this way. Why cannot we have something straightforward like an inflation target? I mention all this not because I think these concerns are legitimate (I have [argued](#) against unconditional inflation targets), but because if fiscal rules are to command public confidence,

they may need to take this into account. Perhaps concerns like these explain why most rules focus on deficits rather than debt.

However, there is one point that has to be made if we are discussing fiscal rules in relation to current events, and that is that all the discussion above presumes that monetary policy is unconstrained, and in particular that interest rates are not at the Zero Lower Bound (ZLB). This is a very familiar point, that Paul Krugman has made again and again: at the ZLB things are very different. Monetary policy has lost much of its power, and it has certainly lost its claim to predictability and superiority. We need fiscal policy to help in eliminating excess supply. In this situation, if we need a fiscal rule at all it is more likely to look like a Taylor rule than a rule involving a debt or deficit target. However, when there is no danger of hitting the ZLB, there is no need for fiscal policy to be concerned about the output gap or inflation at all – if we are talking about an economy with a floating exchange rate. The [conventional assignment](#) can apply.

Some fiscal rules attempt to address this point by having terms in both debt stabilisation and output gap stabilisation. Now while this might make [sense](#) under fixed exchange rates, it is a pointless compromise under flexible rates. If the effectiveness of monetary policy is quite different at the ZLB, then optimal fiscal policy is also bound to be very different at the ZLB. So the main problem with the UK government's fiscal mandate has nothing to do with cyclical adjustment or any of the other things discussed above. It is just inappropriate for the situation we are now in.

This article was first published on Simon Wren-Lewis's [Mainly Macro blog](#).

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our [comments policy](#) before posting.

About the author

Simon Wren-Lewis is a professor at Oxford University and a Fellow of Merton College. He began his career as an economist in H.M.Treasury. In 1981 he moved to the National Institute of Economic and Social Research, where as a Senior Research Fellow he constructed the first versions of the world model NIGEM. From 1988-1990, as Head of Macroeconomic Research, he supervised development of this and the Institute's domestic model. In 1990 he became a professor at Strathclyde University, and built the UK econometric model COMPACT. From 1995 to 2006 he was a professor at Exeter University. He has published papers on macroeconomics in a wide range of academic journals including the *Economic Journal*, *European Economic Review*, and *American Economic Review*. His current research focuses on the analysis of monetary and fiscal policy in small calibrated macromodels, and on equilibrium exchange rates.

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