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DEBATE PACK

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Balanced budget rule

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Contents

Summary

On 23 January 2019, there will be a debate on a balanced budget rule in Westminster Hall on Wednesday 23 January. The debate will be opened by Lee Rowley MP.

This Commons Library debate pack explains what budget rules are and how they are (and have been) used in the UK and elsewhere. It also provides an overview of the UK's public finances.

1. Background

Summary

Budget rules

Government rules for managing the public finances – often described as fiscal rules – are fairly common across the world. Broadly speaking, they aim to constrain policy and promote discipline in the public finances.

Fiscal rules can focus on different areas of the public finances such as debt, spending or revenues. Balanced budget rules focus on government borrowing/surpluses – the difference between government spending and revenues. There isn't one single type of balanced budget rule. For instance, some allow for different types of spending or adjust for the economic cycle.

The UK's fiscal rules are set out in the Charter for Budget Responsibility. The Government's overall objective for fiscal policy – its policy for managing the public finances – is to return the public finances to balance by the middle of the next decade. This would mean the Government spending no more than its income. The Government has targets to support it achieve this overall objective of reaching a budget balance, or eliminating borrowing. Chief amongst these is a form of balance budget rule (the fiscal mandate), a target for government borrowing, adjusted for the ups and downs of the economy, to be less than 2% of GDP in 2020/21.

In the past, the UK has operated different budget rules with different characteristics. The 2015 Conservative Government – while George Osborne was Chancellor – targeted reaching an overall budget surplus in 2019/20. The Coalition Government's target was forward looking, adjusted for the ups and downs of the economy and allowed borrowing for investment.

UK public finances

Government borrowing – the difference between public spending and income raised from taxes and other sources – is at a relatively normal level, having decreased from the peaks reached following the financial crisis. However, a recent decision by the ONS to change how student loans are accounted for is likely to increase borrowing fairly significantly.

While the situation for government borrowing looks positive, government debt – broadly speaking, the stock of past borrowing – remains high at 84% of GDP.

1.1 Budget rules (fiscal rules)

Government rules for managing the public finances – often described as fiscal rules – are fairly common across the world. Broadly speaking, countries adopt fiscal rules to constrain policy and promote discipline in the public finances. The International Monetary Fund (IMF) estimate that more than 90 countries are using fiscal rules.[1] Their main aims are to:

- commit policymakers to sustainability in the public finances;
- enhance transparity; and,
- signal to the financial markets the course of fiscal policy

1 IMF. Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability, April 2018, Executive Summary

Some countries have balanced budget rules, which focus on government borrowing/surpluses (the difference between government spending and revenues). Some fiscal rules focus on the stock of government debt, while some focus on government spending (or items of spending) and/or government revenues. Often, countries have a combination of different types of rules.

Box 1: Alternative ways of measuring the budget balance (borrowing/surplus)

Budget balance rules focus on different measurements of the budget balance. Below are some definitions for the most widely used measures.

The **overall budget balance**: the difference between total government spending and total government revenues from taxes and other sources. In the UK this is known as public sector net borrowing.

The **current budget balance**: the difference between government current spending – day-to-day spending on running public services, grants and administration – and government revenues from taxes and other sources. The current budget balance excludes investment spending. In the UK this is known as the public sector current budget deficit.

The **structural balance:** estimates the size of budget balance that would be expected if the economy was running at a sustainable level of employment and activity – it adjusts for the ups and downs of the economy. Structural elements are the underlying or persistent part of the budget balance, which are unrelated to the economic cycle. Further information on the structural balance is available in Box 2.3 of the Library briefing Autumn Budget 2018: Background briefing. In the UK this is often referred to as cyclically-adjusted net borrowing.

The **primary balance:** the overall budget balance excluding net interest payments.

Glossaries of public finances terms are available from the ONS and the IMF.

Balanced budget rules

The IMF estimate that in 2015 there were around 80 countries with some form of balanced budget rule. Balanced budget rules are not uniform; in fact there is quite a lot of variation: some rules target reaching an overall budget surplus; some target reaching a surplus after adjusting for the ups and downs of the economy; some allow borrowing for investment purposes; some look at keeping borrowing below a certain level relative to GDP; some have a forward-looking rolling target date; some have targets for different levels of government.

The IMF's fiscal rules dataset provides information on the use and design of fiscal rules in 96 countries from 1985 to 2015. The IMF's related background paper provides details on the rules in operation in each country. The European Commission also has a fiscal rules database.

Below are examples of the approach taken on budget balances by a small selection of countries:

- EU Member States are constrained by the rules of the Stability and Growth Pact. This includes a requirement to keep borrowing below 3% of GDP;
- Structural borrowing (borrowing adjusted for the ups and downs of the economy) of the German federal government is capped at

0.35% of GDP in the country's constitution.[2] Germany also has targets for the Länders (states);

- A 'debt brake' operates in Switzerland. This has different components, but its cornerstone is that the budget must at least be balanced across the economic cycle. The rule works by linking spending and revenues and adjusting for the ups and downs of the economy.[3]
- New Zealand's Budget Responsibility Rules 2018 includes five fiscal rules, one of which is to "deliver a sustainable operating surplus across an economic cycle". The rules are consistent with principles set out in the Public Finance Act 2018, which set out that operating surpluses should be run when debt levels aren't 'prudent'. Once 'prudent' levels are achieved on average total operating balances should not exceed total operating revenues.[4]
- There is no budget balance rule for the US federal government. Many US states have laws that require a balanced budget, but what this means in practice differs across states.[5]

Effectiveness of fiscal rules

The IMF has found that the use of fiscal rules is associated with better performance in the public finances. However, this doesn't necessarily mean that the rules cause better outcomes. Rules might be adopted at a time when there has been a particular crisis that is then followed by a period of consolidation, which may well have happened regardless of a rule being in place. Also, countries using fiscal rules may have a preference for effective management of the public finances.[6]

The IMF argue that for fiscal rules to be effective they should have three main properties: simplicity, flexibility and enforceability.[7] They find that successful rules are linked to objectives for keeping the public finances sustainable, are easy to understand, and support fiscal policies that adapt to the economic cycle.

The OECD has published a table explaining the strengths and weaknesses of fiscal rules. The table below summarises the OECD's views for budget balance rules and structural balance rules (see Box 1).

2 Federal Ministry of Finance, Germany's Federal Debt Brake, 2015
3 Federal Finance Administration, Debt brake, May 2018
4 The Treasury (New Zealand), Fiscal Strategy. [accessed on 17 January 2018]
5 National Conference of State Legislatures, State balanced budget provisions, 2010
6 IMF. Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability, April 2018, Executive , page 15
7 ibid. page 7

OECD: Strengths and weaknesses of existing fiscal rules		
	Budget balance rules	Structural balance rules
Promotion of fiscal discipline	Numerical budget balance rules seem to have a positive impact (that is higher surpluses or lower deficits) on budgetary outcomes.	In principle, structural balance rules underpin fiscal discipline. As they set a target for the evolution of a core variable, which is purged of cyclical effects, they define the space for discretionary policy.
Impact on stabilisation polices	Strict budget balance rules fail to provide enough flexibility to pursue a counter-cyclical fiscal policy. They tend to induce pro-cyclicality that can be reinforced by weak coordination between different government levels	Structural or cyclically-adjusted balance rules provide some flexibility as they allow the automatic stabilisers to play in full. Indeed, they are less binding than budget balance rules as they account for the effects of the cycle.
Risks and side effects	They can induce governments under fiscal consolidation pressures to rely excessively on cuts to growth-enhancing, but politically less sensitive, expenditure such as public investment. To counter such adverse effects, it is often proposed to exclude investment and focus on the current balance	These rules are vulnerable to uncertainties about the measurement of the output gap, which renders real-time monitoring difficult. A structural deficit rule can be misleading if the output gap and potential growth estimates are too optimistic or too pessimistic.

source:
OECD. Prudent debt targets and fiscal frameworks, 2015, Table 4

The UK Government's fiscal rules

The Government's targets for the public finances are laid out in the Charter for Budget Responsibility (the Charter).[8] The Charter was first introduced by the 2010 Coalition Government – the targets contained in the Charter have been revised since its introduction. The Office for Budget Responsibility (OBR) – the UK's public finances watchdog – assess the Government's progress against the targets alongside its forecasts.

Further information is available in the Library briefing The Office for Budget Responsibility and the Charter for Budget Responsibility.

Overall objective for the public finances

The Government's overall objective for fiscal policy – its policy for managing the public finances – is to return the 'public finances to balance at the earliest date in the next Parliament'. This would mean government spending being no greater than government revenues from taxes and other sources. The objective aims to provide sustainable public finances, ensure confidence in the economy, and support the effectiveness of monetary policy.

When the objective was introduced – in autumn 2016 – its wording suggested that the deficit would be eliminated by 2025 at the latest. The early election has made its interpretation questionable, but the 2017 Conservative Manifesto suggests the Government are still aiming for the 'middle of the next decade'.[5] The Treasury Committee recommended that the Government should clear up this ambiguity.[9]

8 HM Treasury, Charter for Budget Responsibility: autumn 2016 update, January 2017
9 Treasury Committee, *Autumn Budget 2017*, 17 January 2018, HC600 2017-19, para 55

The IFS has also recommended that the targets in the Charter should be assessed and updated.[10]

In its October 2018 forecast the OBR said that achieving budget balance by 2025/26 "looks challenging".[11]

Budget balance rule: the fiscal mandate

The Government has targets to support it achieve its overall fiscal objective of eliminating the deficit. Chief amongst these is the fiscal mandate, a target for controlling the level of borrowing. This focuses on an adjusted version of borrowing: the fiscal mandate is to reduce cyclically adjusted public sector net borrowing to below 2% of GDP by 2020/21.

The adjustment means the target focuses on structural borrowing, or the element that remains once borrowing related to the ups and downs of the economy are removed. This is what is meant by 'cyclically adjusted': removing the parts of borrowing related to the economic cycle. For more on structural borrowing see Box 2.3 of the Library briefing Autumn Budget 2018: Background briefing.

The supplementary debt target

The fiscal mandate is supplemented with a debt target. The supplementary target is for public sector net debt as a percentage of GDP – the debt-to-GDP ratio – to be falling in 2020/21.

The welfare cap

The Government has a further target for controlling spending on around 55% of welfare spending – the welfare cap. The target is for relevant welfare spending to be within the cap level. The main areas of welfare spending excluded from the cap are pensions and Jobseekers Allowance payments.

Negative shock to the UK economy: reviewing the targets

The Treasury can review the appropriateness of the fiscal targets if there has been a 'significant economic shock to the UK economy'. The Charter doesn't define what would be considered a shock, it is left for the Treasury to decide.

Any changes the Chancellor wishes to make to the fiscal targets must be approved by a vote in the House of Commons. The Chancellor will explain the reasons for the changes and present them in a revised Charter.

Previous targets: 2010-2016

The targets for the public finances have been revised on a number of occasions since the Charter for Budget Responsibility was first introduced by the Coalition Government in 2011. The Library briefing The Office for Budget Responsibility and Charter for Budget Responsibility has a summary of the changes made to the fiscal

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10 IFS. Green budget 2018, Box 3.1, 16 October 2018
11 OBR. Economic and fiscal outlook – October 2018 – para 1.51

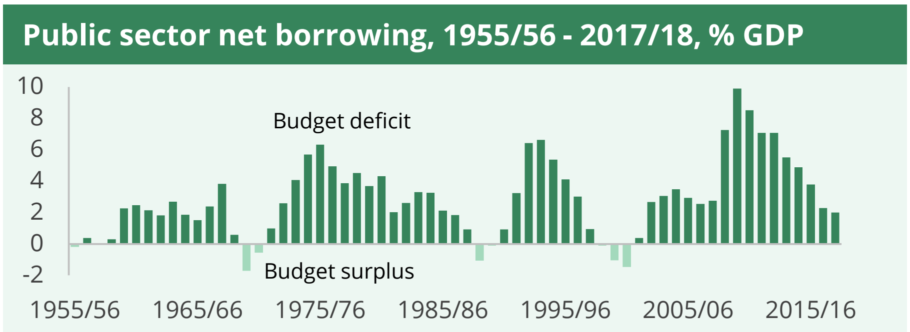
mandate, debt target and welfare cap. Changes to the budget balance target – known as the fiscal mandate – are discussed below.

The fiscal mandate: 2015-2016

At the start of the 2015-2017 Parliament the Conservative Government revised its budget target (the fiscal mandate) introducing a target for the budget to be in surplus by 2019/20. Once a surplus was reached, the fiscal mandate required a surplus in each subsequent year, so long as the economy was in 'normal times'.[12] The then Chancellor, George Osborne, said that a surplus was required to get "dangerously high levels of debt down".[13]

Achieving the fiscal mandate was thought by many to be challenging. Over the previous six decades, budget deficits have been the norm; surpluses have been rare. Since 1955/56 the UK's public sector budget has been in surplus in only eight years; the last surplus was recorded in 2000/01.

The OBR said that requiring a budget surplus by 2019/20 was "ambitious relative to the fiscal performance of past governments."[14]



Commenting on the budget surplus rule, the IFS said that:

- it represented a departure from previous rules, in that it didn't allow borrowing for investment purposes;
- running a surplus is not necessary to bring debt down as a share of GDP, but, all else equal, a bigger surplus would reduce debt as a share of national income more quickly. This might give the UK more flexibility in the face of another recession;
- there are reasons why running a deficit might be justified, including for: investment spending, output stabilisation, adjusting gradually to shocks, allowing for forecast errors, smoothing tax rates.[15]

The IFS looked at how often other advanced economies had run budget surpluses between 1980 and 2015. They found that some countries, such as Norway and Finland, regularly run surpluses. However, surpluses were less common in countries with economies similar in size to the UK:

> Among the G7 set of countries (US, Japan, Germany, UK, France, Italy and Canada), a budget surplus has been seen 13% of the

12 Section 3.4 of the Library briefing The Office for Budget Responsibility and Charter for Budget Responsibility discusses what is meant by 'normal times' and how it was measured.
13 Chancellor George Osborne's Summer Budget 2015 speech
14 OBR. Economic and fiscal outlook July 2015, 8 July 2015, para 5.18
15 IFS. Green Budget 2016, Chapter 3

> time. At no point in the available data has the US (back to 2001), France (back to 1980) or Italy (back to 1988) achieved an overall budget surplus.

Following the result of the EU referendum, the Government abandoned the 2019/20 budget surplus target, replacing it with the current target.[16] In his 2016 Autumn Statement the Chancellor, Philip Hammond, said:

> In view of the uncertainty facing the economy, and in the face of slower growth forecasts, we no longer seek to deliver a surplus in 2019-20.
>
> But the Prime Minister and I remain firmly committed to seeing the public finances return to balance as soon as practicable.
>
> While leaving enough flexibility to support the economy in the near-term.[17]

Budget balance targets (the fiscal mandate): 2010-2015

The 2010 Coalition Government's fiscal mandate was a forward looking rolling target for the cyclically-adjusted current budget to be balanced in the fifth year of the forecast period. This was later shortened to the third year of the forecast period.

Focusing on the cyclically-adjusted budget allowed for the ups and downs of the economy to be taken into account, while focusing on the current budget meant that the rule allowed borrowing for investment purposes.

According to the IFS, positive aspects of the Coalition Government's fiscal mandate were that: it allowed borrowing for investment and economic shocks; it gave policy time to adjust to shocks; it allowed for forecast errors for the government to keep tax rates smooth. They also highlighted that the rolling target meant there wasn't a need to aim to overachieve by a wide margin. The negatives of the rule for the IFS were that a government who promised to tighten in the future, but never did so, would not break it; it could still allow for redistribution to future generations; and some elements of it (such as the cyclical adjustment) are hard to measure and are never observed.[18]

Opposition parties

Opposition parties have proposed budget balance rules that focus on the current budget, rather than overall borrowing.[19] Focusing on the current budget would allow for borrowing for investment purposes.

Labour's fiscal credibility rule says that a Labour government would eliminate the deficit on current spending at the end of a rolling five-year period. This is supplemented with a target that debt will be lower at the end of every Parliament, as a % of trend GDP, than at the start. The IFS

16 There is more on the background to this in section 3 of the Library briefing Autumn Statement 2016: Background briefing.
17 Autumn Statement 2016: Philip Hammond's speech
18 IFS. Presentation at fiscal rules roundtable, 21 May 2014. Also see IFS. Green Budget 2013, Chapter 4.
19 Labour Party Manifesto 2017; Liberal Democrat Manifesto 2017; SNP, *What do the SNP propose as an alternative to austerity?*

said that the forward-looking target for the current budget has 'much commend it'.[20]

The previous Labour government

For much of Labour's time in office it operated two fiscal rules:

- the **golden rule** which required borrowing only to pay for investment. This was judged on average over the economic cycle, rather than every year;
- the **sustainable investment rule** which required the Government to keep the public sector's debt (net of its short-term financial assets) at a 'stable and prudent' level. The Treasury defined this as less than 40% of national income (GDP) at the end of each financial year of the economic cycle

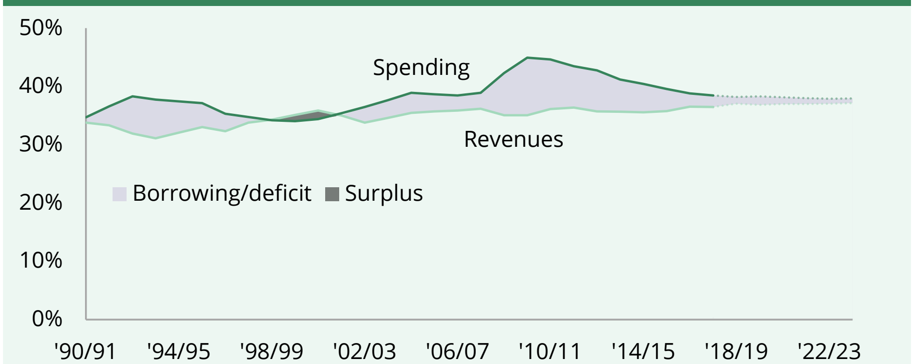
When the 2007-2008 financial crisis came, these rules were suspended and a new framework was introduced.[21] The rules were replaced in the Fiscal Responsibility Act 2010. Further information is available in the Library briefing [Fiscal Responsibility Bill (2009-10)](#).

1.2 The UK's public finances

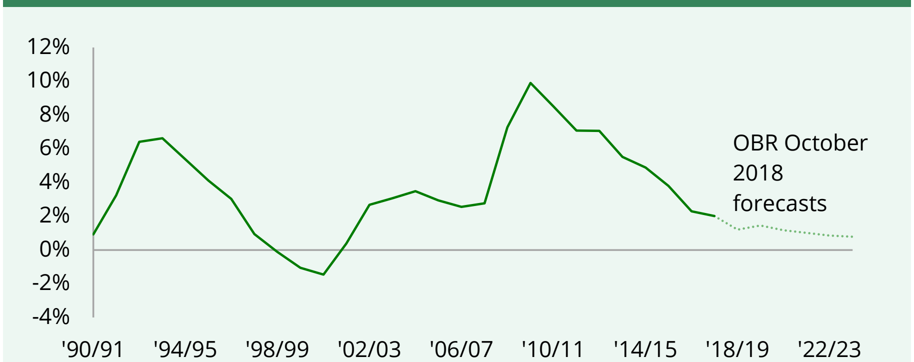
Government borrowing (or deficit)

When the Government spends more than the revenue it raises from taxes and other sources it has to borrow. In 2017/18, the Government borrowed £41 billion to fund its spending. The borrowing is sometimes referred to as the Government's deficit.

UK government's spending and revenues, % of GDP



Government borrowing, % of GDP



[20] IFS. [General election analysis 2017: the outlook for the public finances](#), 2017
[21] HM Treasury. Pre-budget report 2008, [page 15](#)

Government borrowing has come down significantly since it peaked at 10% of GDP in 2009/10. Borrowing in 2017/18 is equivalent to 2% of GDP, which is below the average for the past 70 years and the lowest level since 2001/02.

The Office for Budget Responsibility (OBR) – the UK's public finances watchdog – forecast that government borrowing will fall to 0.8% of GDP in 2023/24.

Box 2: Accounting for student loans: a significant change to come

In December 2018, the ONS announced that it is changing the way it accounts for student loans, which will effect government borrowing. The accounting change, which aims to ensure that the treatment of the loans better reflects how they work in practice, could increase the Government's deficit by around £12 billion in 2018/19 and relatively similar amounts in other years. The change has no impact on government debt data.

The ONS's decision isn't reflected in the data presented above – it looks like the change will not be fully incorporated into the ONS's figures until autumn 2019. The OBR might incorporate the changes in their next set of forecasts, which are expected in spring 2019.

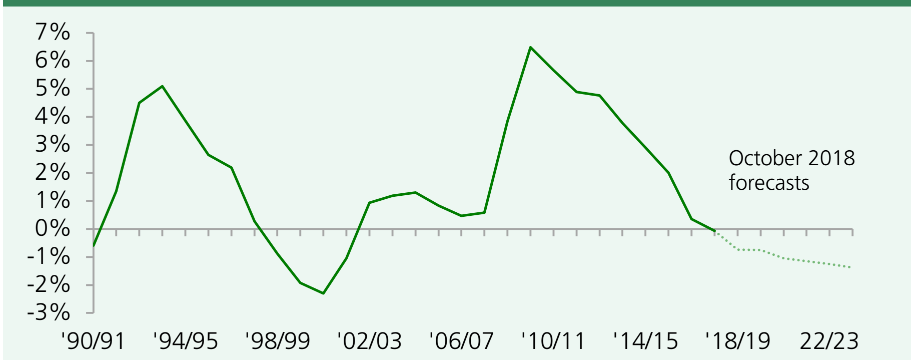
Further information about the change is available in the Library Insight Student loans: ONS changes accounting rules.

Government current borrowing

The current budget deficit is the difference between government current spending[22] – day-to-day spending on running public services, grants and administration – and government income from taxes and other sources. Unlike public sector net borrowing, the current budget deficit doesn't include investment spending and therefore is said to measure the degree to which taxpayers meet the cost of paying for the services provided to them.

The current budget was in surplus in 2017/18 by £1.3 billion, equivalent to 0.1% of GDP. This means that the Government's current spending was smaller than the taxes and other revenues it received. The current budget has fallen significantly since its peak of £100 billion in 2009/10 and the surplus reached is the first since 2001/02.

Public sector current budget deficit, % GDP



The OBR's forecast suggests that the current budget surplus will grow annually over the forecast period, reaching £34 billion, or 1.4% of GDP, by 2022/23.

22 current spending includes depreciation

Government debt

The Government's debt is, broadly speaking, the stock of its past borrowing to cover annual deficits.

Public sector net debt, % GDP

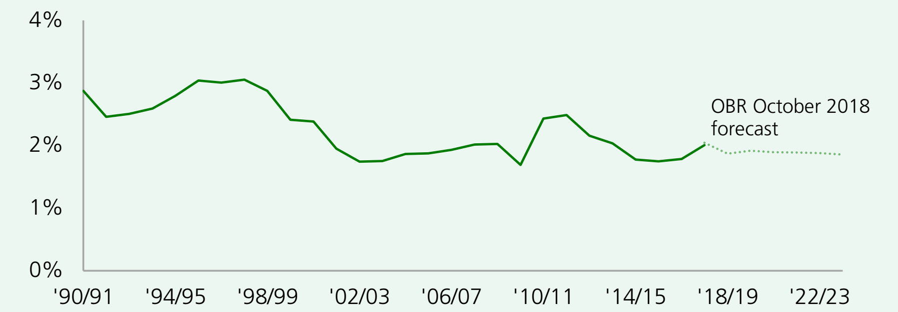
The large government deficits recorded in the years since the financial crisis have seen government debt grow significantly. Prior to the financial crisis government debt was around 35% of GDP; it is now close to 84% of GDP.

The OBR forecasts that debt will fall to 74% of GDP by 2023/24. Putting the period since the financial crisis aside, debt of 80% of national income was last recorded in the late 1960s, when it was still recovering from reaching over 200% of GDP during World War II.

Debt interest payments

Despite recent significant increases in debt, the government's debt interest payments have remained relatively low. One reason for this is that low interest rates have meant that the government can issue new borrowing at low cost. This impacts on both new borrowing and also the refinancing of old borrowing. Some interest payments are linked to inflation, so low inflation up until late 2016 also helped to keep debt interest payments down.

Government debt interest, % GDP



note: includes the impact of the Bank of England holding government debt

The fact that the Bank of England holds some government debt is a further significant reason keeping debt interest payments low relative to the size of the debt. The Bank purchased the debt as part of its quantitative easing programme, where the Bank bought government bonds from private investors such as pension funds and insurance companies to get money into the economy. While the debt is held by the Bank debt interest payments are made from one public sector body to another (the Treasury to the Bank) and as such cancel out. The result, broadly speaking, is that the net interest payment made by the government for this interest is £0.2 If the debt held by the Bank were held by an organisation outside of the public sector, such as a pension fund, the government's debt interest payments would have been £14 billion higher in 2017/18 at £55 billion.

Further information

The Library briefing Government borrowing, debt and debt interest: statistics includes further data on government borrowing, debt and debt interest.

The Library briefing The public finances: a historical overview includes data on government debt and government borrowing/surpluses back to the 1700s.

2. Press Articles

[Philip Hammond downgrades objective of eliminating UK deficit: Chancellor says focus will shift to boosting economic growth]

Chris Giles

Financial Times, 5 November 2018

[Liz Truss: let voters sue government when we overspend]

Henry Zeffman

The Times, 14 August 2018

[A super day for fiscal policy, but not much 'super' to look forward to]

Paul Johnson

The Times, 23 July 2018

[UK will need to impose tax rises of £30bn to balance budget – IFS: Chancellor will fail to cut deficit by 2025 without extra taxes, Institute of Fiscal Studies says]

Philip Inman

The Guardian, 14 March 2018

[The debt numbers do not justify Hammond's 'Tiggerish' outlook: Good times are not here again, despite political pressure to loosen the pursestrings]

Paul Johnson

Financial Times, 13 March 2018

[There's good borrowing and bad borrowing, chancellor]

The Times, 11 March 2018

[Kwasi Kwarteng calls on government to balance books]

Philip Aldrick

The Times, 9 March 2018

[A balanced budget has been put on the back burner]

Paul Johnson

The Times, 19 May 2017

[George Osborne, the really unfortunate chancellor: Like some of his predecessors, Osborne has to cope with a trade deficit and budget deficit at the same time]

Larry Elliott

The Guardian, 22 May 2016

[Fiscal policy: Balancing budgets]

The Economist, 15 October 2015

[Only eight times in the past 60 years has Britain's budget been in surplus: In the space of less than a month, Labour's shadow chancellor John McDonnell seems to have gone full circle on the fiscal rule]

Allister Heath

Daily Telegraph, 13 October 2015

[George Osborne's coup: converting Labour to fiscal conservatism: The chancellor's most remarkable achievement has been to change assumptions about public spending]

Matthew d'Ancona

Guardian, 21 June 2015

[Osborne is mistaken to apply Victorian values to fiscal policy: Public borrowing is not always an evil. It is quite appropriate to borrow to invest]

Martin Wolff

Financial Times, 11 June 2015

[Osborne confirms Budget surplus law]

BBC, 10 June 2015

[It is unrealistic to hope politicians will balance the books every year: As we've seen over the past five years, budget deficits have a horrible tendency to overshoot even in better times]

Allister Heath

Daily Telegraph, 14 January 2015

3. Parliamentary material

3.1 Debates

Charter for Budget Responsibility

HC Deb 24 Jan 2017 c 234-58

Charter for Budget Responsibility

HC Deb 13 Jan 2015 c 738-793

4. Further reading

4.1 Library briefings

The Office for Budget Responsibility and Charter for Budget Responsibility

January 2019

Government borrowing, debt and debt interest: statistics

December 2018

The public finances: a historical overview

March 2018

4.2 Other materials

Fiscal Rules: Make them Easy to Love and Hard to Cheat

IMF, April 2018

Spring Statement 2018: An assessment

IFS, March 2018

Two parliaments of pain: the UK public finances 2010 to 2017

IFS, May 2017

Fiscal Rules at a Glance

IMF, March 2017

Prudent Debt Targets and Fiscal Framework

OECD, July 2015

How much is too much borrowing?

IFS, June 2015

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