BRIEFING PAPER

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Why Britain needs an Economic Responsibility Act

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Executive Summary

This briefing calls on the next government to pass an Economic Responsibility Act, which would place legally binding restraints on government's fiscal policies. Specifically, it would: (1) cap government spending at one-third of GDP; (2) cap the budget deficit at 3% of GDP; (3) cap the national debt at 40% of GDP; (4) require that off-balance-sheet obligations were fully calculated and openly stated; and (5) allow government to borrow only to invest in capital projects, not to fund current expenditure. This briefing also recommends that new rules be introduced to limit government's ability to raise taxes.

Introduction

It is commonly agreed that the British government has spent and borrowed far too much. But neither Labour nor Conservatives are willing to state the obvious – that tax rises or budget cuts are inevitable. Instead, they pretend to electors that they can expand public services without raising taxes.

The fact that politicians are able to overspend and over-borrow on such a scale, and their inability to prescribe the unpalatable cure of self-restraint, are deep problems in our democracy. Because of it, government spending and borrowing have both risen over the decades, while the value of money has steadily eroded.

The debt mountain

Last month's report from the Bank for International Settlements (BIS) – the world organisation of central banks – revealed that the United Kingdom government was borrowing deeply to finance its current spending (on civil-service salaries and pensions, for example) rather than on future investment (restructuring the banks, building roads and bridges, and suchlike).

The borrowing picture, BIS found, was 'deteriorating sharply'. In addition to all the borrowing that has been taken on to see us through the financial crisis, the future healthcare and pension commitments of our ageing population means that government is likely to continue borrowing far into the future. While the Treasury hopes that the deficit – the extra amount that the government borrows each year – will start to fall in a couple of years' time, it is not making any predictions that the government's total indebtedness, the national debt, will ever start to fall.

On present policies the national debt – the total amount that the government owes to people both in the UK and in other countries – will rise to more than five times GDP by 2040. That is, by 2040, the UK government will owe five times what the whole nation earns in a year. This is not just a very exposed position to be in – these days, it has become much harder for families to borrow five times their income because we have seen only too clearly the problems that come from such high levels of indebtedness. It is also a very costly policy. The BIS predicts that the interest payments on the government's borrowing, which now absorb about 6% of the nation's income, could rise to 27%. That is, more than a quarter of what we earn – and more than half the government's income – would be being spent, not on running public services but simply on paying interest.

The need for fiscal responsibility

Because of the damage done by chronic overspending, over-borrowing and inflation, Britain needs economic responsibility rules that prevent politicians from adopting policies that lead to these outcomes. We need to forestall

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the cycle of boom and bust that arises from governments coming in with extravagant spending promises, and then later having to raise taxes to pay for it, until the next election looms and the cycle of extravagance starts again.

When he became Chancellor in 1997, Gordon Brown adopted two rules that he claimed would do precisely this. His 'Golden' rule was that, taking account of the ups and downs of the economic cycle, government should borrow only to invest in things (like new schools and hospitals) that would benefit future generations. It should not borrow to spend on things (like higher unemployment pay) that only benefit people today.

Brown's second, 'Sustainable Investment' rule was that government should keep the amount it owed, the national debt, at a 'prudent' level – reckoned to be an amount equivalent to no more than two-fifths of the nation's income – 40% of GDP. In addition, he aimed to cap the amount that a government borrowed in any one year at no more than 3% of GDP – and he was instrumental in getting the EU as a whole to endorse this deficit target.

However, there have been four issues that have undermined these rules:

- First, it is rarely clear where an 'economic cycle' starts and ends (particularly while it is still going on), allowing Brown to put off the day of reckoning and continue borrowing.

- Second, Brown described almost all public spending as 'investment', allowing him to justify more borrowing.

- Third, the government has taken on large 'off the books' spending commitments (such as future pensions and the cost of running schools under long-term Private Finance Initiative contracts), which are not counted as 'debt' but which may be fifteen times greater in total.

- Fourth, the sudden financial crisis has been regarded, in other EU countries too, as a reason to tear up the borrowing and deficit rules rather than obey them.

In the UK system, no rule has constitutional power because a simple majority in Parliament is enough to overturn it. And indeed Parliament has eroded, if not abolished, important rules such as the right to trial by jury, the right not to be detained without trial, and the right of silence. However, it is relatively difficult for governments to breach principles that have wide public support if (unlike Brown's rules) they are clear and if the politicians themselves sign up to them.

The responsibility rules required

A set of economic responsibility principles for the UK might include the following rules:

Cap government spending at one-third of GDP. This would prevent the government spending more than one pound out of every three earned by the nation's population. However, rather than setting the budget on the basis of anticipated current GDP – the current practice – the budget cap should be calculated as one-third of *past* GDP outcome.

Thus, a falling GDP, as in 2009, would require matching cuts in the next year's government budget. The public sector would have to take the strain along with the private sector. Averaging GDP over the previous five years, rather than just taking a single year, would avoid wide swings in budget limits, whilst still ensuring that governments cannot fudge things by redefining the 'economic cycle'.

This of course runs counter to some economists' belief that when the economy dips, government spending should be increased to 'stimulate' it. In fact, public spending is never as efficient, well-targeted and productive as private spending and investment, so when times are tight, we should aim to scale back public spending. If rising unemployment unleashes a rise in spending on social benefits, government spending must be reined in elsewhere.

However, the longer-term effect of a budget cap would be to reduce the boom and bust cycles in the economy. Like families and private businesses, governments would know that profligate policies today would have to be paid for by painful cutbacks tomorrow. This would provide an incentive to resist overspending and over-borrowing.

Cap the deficit at 3% of GDP. This would mean that in any year, the government could borrow no more than 3% of what the country earned. Since a budget deficit *adds* to the existing total of government debt, this rule keeps future additions to borrowing under control. Again, using the average of GDP over the last five years would allow us to avoid sudden budget swings while still keeping the basis of calculation honest.

Cap the national debt at 40% of GDP. Without strict limits on the total that governments can borrow, debt quickly gets out of control. Politicians enjoy the benefits of spending today, while passing the bill on to future generations. In 1997, the national debt was £350 billion. Now it has more than doubled, to £770 billion. The Treasury expects it to double again to £1,406 billion in five years' time.

At the same time, the costs associated with an ageing population, such as state pensions and generous public-service pensions, will place an even higher burden on the public purse. The Bank of International Settlements forecasts that in 30 years' time, on present spending trends, Britain's national debt will have grown to a level five times larger than its national income.

A limit on the total level of the government's indebtedness is therefore a prudent measure. Economists and international rating agencies believe that a debt level of 40% of GDP is sustainable.

Off balance sheet obligations must be stated, and limited. The bulk of the government's future commitments, however, are not stated on the books. These include the cost of future state pensions, a cost of perhaps £1-£1.5 trillion for future pension payments to government employees, the potential liabilities of Network Rail and of the banks, future payments to private companies agreed under the Private Finance Initiative, and much more.

At present, nobody really knows how large these future obligations are. In *The Alternative Manifesto*, I calculated them at six times the published figure for government debt. However, in 2004 the IFO calculated that they could be as large as 13.7 times the published debt figure.

Some people argue that obligations like future pension payments are not important, because the government is a 'going concern' and it does not need to find all the money right now: it can assume that it will continue to collect taxes in future years, from which these future obligations can be paid. However, unless the scale of future obligations is calculated, the government has no way of knowing whether they will actually be affordable in future years. Moreover, the assumption that there will be nothing to worry about encourages politicians to take on further obligations, adding to the future problem.

The government requires commercial companies to calculate their future commitments precisely so that adequate funding arrangements can be put in place to deal with them. Plainly, it is just as important that governments are put under the same obligation they impose on others – particularly in view of the fact that at present, political decisions are often made for short-term reasons without much thought to their future costs.

Borrowing only to invest. This rule, promoted by Gordon Brown, is sound in principle, though it has been abused in practice. The idea is that it is quite legitimate for governments, like households or businesses, to borrow in order to finance long-term commitments that bring future benefit. Thus, a family might borrow to buy a house, which will provide them with shelter over many years to come; a business might borrow to buy an asset or another business that will produce profits in future years; and a government might borrow to build schools, hospitals and roads that provide a stream of future social benefits.

But it does not make sense to borrow to finance current consumption – to borrow to pay the gas bill, or to pay workers' wages, or to take on more civil servants. If these things cannot be met out of current income, the borrowing will just grow higher and higher, with no end in sight.

However, the terms 'investment' and 'spending' seem to have been used interchangeably by Gordon Brown and his government colleagues, meaning that this is exactly what has happened. Indeed, the word 'investment' has been used in order to justify greater borrowing, even though the government has really borrowed to spend. The largest increase in departmental budgets has been in services like health and education, where it has gone into paying for an increase in staffing levels, with higher wages and more generous pensions; yet the services produced by the NHS are overwhelmingly enjoyed today, rather than producing a stream of benefits far into the future. Other departments such as Defence, which arguably does provide for our future security, have not enjoyed similar expansion.

If the 'borrow only to invest' rule is to make any sense, therefore, there must be a rigorous definition of what counts as investment and what counts as spending. This is not always an easy distinction to make, but it will certainly be abused if it is left up to the politicians themselves. Economists have decades of experience in separating investment from spending, and the best policy would seem to be to place the decision with the professional economists at the Office of National Statistics, which maintains at least some measure of independence. Their view on what counts as investment would then set the cap on what the government could borrow.

Limits on tax rises. Governments cannot be considered prudent if they rein back on their borrowing but keep pushing up taxes in order to pay for more and more extravagant spending. High taxes make the UK less attractive as a place in which to live, to invest, and to do business. There is strong evidence that in a mature economy like the UK's, high taxes choke off economic growth. This is particularly true today, when so much of our productive capital is highly mobile – particularly financial capital and our human capital, our talent.

Consequently, there must be limits on tax rises too. One possibility would be to have public **referenda** before any rise in taxation can be put into effect. At the local government level, it would be possible to have **budget referenda**, by which local electors would have to approve the council's budget before it is adopted (a system which works in various state and local governments around the world). A third option is to have a **fiscal policy committee**, analogous to the monetary policy committee of the Bank of England, which sets interest rates: the fiscal committee would set the level of taxation which would be safe in terms of economic growth and future investment, and would also ensure that taxes were not used to aid or harm particular groups for purely political reasons.

Prospects for economic responsibility

With governments running such large annual budgets, with such high taxes and in particular such high annual borrowing and such a mountain of existing debt, it may take time for these financial targets to be realised. That is no reason to reject them as unworkable. If we accept that keeping the government's books broadly in balance is a wise principle, we should work towards it. The budget, deficit and borrowing rules should be a target for the next five years, the total debt rule a target for the next fifteen. With strong economic growth, they could even be reached earlier. On the other hand, there is no reason why the proposed rules on off-balance-sheet obligations or tax rises should not be brought in immediately.

Nor should we be put off by the argument that the government needs to spend and borrow in order to keep the recovery on track and to invest for the future. Private spending and investment is always better targeted than public; if we are serious about boosting economic recovery, we should be freeing resources for the private sector, not maintaining high taxes, and continuing to borrow, in order to spend more in the public sector. Indeed, it is in the places where public spending has surged fastest and highest – increases in civil-service numbers, pay and pensions – that the public budget should be scaled back quickest and most.

High taxes are a burden on entrepreneurial businesses and therefore on economic recovery. High borrowing means that money that could be generating new businesses is instead being used to pay off the interest on past debts.

Nor should we be deterred by the argument that governments should rightly spend when economic times are difficult. That might win adherents if they then saved when times were good: but plainly, they do not. The whole direction of government spending is in one direction – to increase – and that is why we need restraints upon it.

Of course there may be some increased public spending during a downturn – on increased welfare and unemployment benefits, for example. And lower tax revenues during a downturn will likewise put pressure on the public budget and lead to some temporary borrowing. Families and businesses too borrow to see themselves through hard times. But they should borrow only in ways that will get them through the crisis and earning again – not to maintain a lifestyle that cannot be maintained. The same is true of governments.

In any event, one of the most potent reasons why we have booms and busts is precisely that there are few, if any, restraints on government spending and borrowing. Elections call forth extravagant and costly promises; governments and central banks love to create booms; and the bills are put off to later. Eventually, though, the bill for extravagance has to be paid, and the economy lurches into downturn again. Adopting a set of economic responsibility rules such as we have proposed – and sticking with them, even when things do get tough or when the electorate's demands get even higher – would actually help smooth out the boom and bust cycles and allow both governments and businesses to plan better for the future. Only from that sort of solid foundation can we ever expect to build Britain's future economic growth.