
A CODE FOR FISCAL STABILITY

Introduction

A key role for Government is to provide a stable economic environment in which people and businesses can plan for the future, and growth and employment can prosper. Openness and predictability about policy is an indispensable ingredient in this. This is one of the reasons why the Chancellor proposed, in his statement to the Interim Committee in September, that the IMF, in conjunction with the World Bank and the OECD, draw up a Code of Good Practice for openness and transparency in fiscal and monetary policy.

The framework inherited by the Government placed insufficient emphasis on these vital characteristics. Accordingly, one of the Government's first steps was to announce a new framework for monetary policy - one that now ranks amongst the most open and transparent in the world. The Bank of England Bill, which is now being taken through Parliament, will give operational independence to the Bank in setting interest rates so as to achieve the Government's target of low inflation.

Similarly, in the July Budget, the Government began to put in place a new framework for fiscal policy - the overall approach to spending and taxation - based around two strict fiscal rules:

- over the economic cycle, the Government will only borrow to invest - public consumption (including the consumption of capital) will be paid for by taxation; and
- over the economic cycle, the Government will ensure the level of public debt as a proportion of national income is held at a stable and prudent level.

These changes to the framework for monetary and fiscal policy represent significant advances. However, the Government recognises that it is now time to develop the fiscal policy framework further and to build on the openness, transparency and accountability that already characterises the monetary policy framework.

This paper discusses an important proposal in this direction. The Government intends to implement a Code for Fiscal Stability to strengthen, and demonstrate further, its commitment to a commonsense and honest approach to managing the public finances in the best long-term interests of Britain. The paper outlines the rationale for the Code and suggests some options concerning the form that it might take.

The advantages of the Code

The need for policy credibility and transparency, and the advantages, are well recognised, particularly in the context of monetary policy. This is why the Government chose to give the Bank of England operational independence in setting interest rates. Now there can be no doubt that monetary policy is firmly focused on achieving long-term goals, clearly and publicly defined by the Government, and free from political interference. The fall in long-term interest rates following the announcement provides tangible evidence of the benefits of putting in place institutional arrangements that demonstrate the Government's commitment to sensible long-term policy.

Credibility and transparency are, however, just as important when it comes to setting fiscal policy. The task now is to develop the framework for fiscal policy further so that it can benefit from the same disciplined approach. It is in this context that the Government sees a role for the Code for Fiscal Stability.

The proposed Code will draw together and make clear the framework in which fiscal policy will operate. It will act to demonstrate the Government's commitment to this framework, putting its reputation firmly and squarely on the line. It will ensure that governments follow the commonsense principles set out in the Pre-Budget Report, providing a valuable discipline on fiscal policy, and helping to rebuild trust in economic policy more generally. This approach is not unprecedented. Both New Zealand and Australia have taken this step.

The success of the Code will largely depend on its content. Indeed, many of the proposals outlined below would have merit even if a Code was not put in place. However, the advantage of the Code is that it will provide a clear focus for fiscal policy.

Legislation and the Code

The design of the Code must encourage governments to implement fiscal policy in a way that promotes Britain's long-term interests, and it must represent a credible commitment in the eyes of the public. The fact that the Government puts its reputation at stake by publishing the Code, and publicly committing itself to it, may go a long way in this direction.

But an argument can be made for going further and enshrining the Code in legislation. This would make it more difficult for governments to ignore the provisions of the Code or drop it altogether. This is the approach that has been chosen in both New Zealand and Australia.

The Government accepts this argument. It believes that legislation will enhance the credibility-building process, allowing the gains to be realised sooner than otherwise.

The content of the Code

A Code for Fiscal Stability should address two key issues. It should:

- describe what constitutes a disciplined and honest approach to managing the public finances; and
- set out a process that ensures that Parliament and the wider public can monitor the Government's progress in applying this approach.

A careful balance needs to be struck. The Code needs to be restrictive so as to rule out the possibility of profligate fiscal behaviour and so that governments can be held accountable for their policy decisions. At the same time, however, it needs to be flexible enough to cope with changing circumstances. The challenge, therefore, is to design a Code that strengthens the fiscal policy framework without also inadvertently ruling out sensible development.

The Government's Pre-Budget Report set out five principles of a commonsense approach to fiscal policy. Therefore, a natural approach might be for the Code to:

- reaffirm, and elaborate on, these principles of fiscal policy management;

and commit the Government to:

- more transparent fiscal reporting, so as to enable greater scrutiny of fiscal policy against those principles; and
- improved standards of accounting, so as to enhance the quality of the information available.

The Principles of Fiscal Policy Management

The principles of fiscal policy management set out in the Pre-Budget Report and which the Code would require the Government to have regard to are:

- (i) **transparency** in the setting of fiscal policy objectives, the implementation of policy, and in the presentation of the public accounts;
- (ii) **stability** in the policymaking process and in the way fiscal policy impacts on the economy;
- (iii) **responsibility** in the management of the public finances;
- (iv) **fairness**, not least between generations; and
- (v) **efficiency** in the design and implementation of fiscal policy, and in managing both sides of the public sector balance sheet.

More Transparent Fiscal Reporting

Transparency requires that governments should specify the range of economic and fiscal information that they should publish if Parliament, and people generally, are to be able to monitor and appraise their performance. Accordingly, the Government proposes to enhance the structure of fiscal reporting.

The aim is to produce reports that provide a comprehensive description and assessment of the state of the public finances and a clear statement of the Government's strategy for the future, in a way that is more focused than hitherto. Not only will this help to improve the quality of decision-making within Government - it will also sharpen the level of external scrutiny of the Government's fiscal policy, both by the Treasury Select Committee and the wider public. This will contribute to improved economic, social and fiscal outcomes.

Financial Statement and Budget Report

The Financial Statement and Budget Report (FSBR) is the main vehicle for describing the Government's short-term economic and fiscal forecasts and the detailed policy announcements contained in the Budget. However, at present, governments are under limited obligation as to what it should contain.

In the past, the FSBR has provided an explanation of new policy measures and a description of the economic and fiscal outlook. The Code could enhance the value of the FSBR by requiring governments formally to provide:

- the key assumptions and conventions underpinning the forecast and projections;
- a description of the economic outlook, including forecasts for not only GDP, inflation, and the current account balance, but also for a wider range of variables;
- an analysis of the risks surrounding the economic outlook, with implications for the key variables mentioned above;
- a description of the fiscal outlook, including forecasts for the major categories of spending and taxation, the current balance, the PSBR, the GGFD, public sector debt and net wealth;
- an analysis of the impact of the economic cycle on the key fiscal aggregates, including estimates of the cyclically-adjusted fiscal position;
- an analysis of the risks surrounding the fiscal outlook with implications for the key fiscal variables;
- a backward look at any discrepancies between outcomes and previous Budget forecasts, including as far as possible, an explanation of these discrepancies.

Economic and Fiscal Strategy Report

It is important that governments make clear, in public, how their specific objectives relate to their declared principles. In this regard, there may be merit in requiring government to publish an Economic and Fiscal Strategy Report, complementary to the FSBR, but more analytical and high-level in its focus.

Within the context of the stated principles of fiscal policy, the report could require governments to:

- explain their long-term economic and fiscal strategy, including their long-term objectives for the key fiscal variables;
- reconcile the short-term fiscal outlook contained in the Financial Statement and Budget Report with this longer-term strategy, and if inconsistencies arise, explain the transition path needed to return to the long-term strategy;
- assess whether the long-term strategy is consistent with the Government's European commitments, in particular, the terms of the Stability and Growth Pact; and
- present illustrative projections of the outlook for the key fiscal variables for an extended period into the future, thus illustrating the sustainability and intergenerational impact of fiscal policy under a range of scenarios.

Pre-Budget Report It is essential that governments draw upon the skills and experience of people across the economy in order to formulate a fiscal policy that best serves Britain's interest. That is why the Government has taken the step of publishing, for the first time, a Pre-Budget Report. The Code could formalise this by requiring governments to publish a consultative paper each year, several months before the Budget, providing an update of the fiscal position and progress in meeting the fiscal rules, and laying out proposals for any significant changes to policy, and inviting comments from the public.

Other information A range of additional fiscal policy analysis and information is produced within Government. The Code could commit governments to taking steps which would help the Treasury Select Committee and the public to scrutinise on a regular basis the conduct of fiscal policy and the state of the public finances. This could include, for example, a post-budget progress assessment, examining how recent outturns compare with the plans set out in the Budget, material on spending and taxation trends over the course of the financial year, and an examination of the economic outlook.

Opening up the economic and fiscal forecasts

Before the July Budget, the Government invited the National Audit Office (NAO) to audit key assumptions and conventions underpinning the economic and fiscal forecasts. The aim was to ensure that the forecasts were consistent with the principles of transparency and responsibility. To build on this approach, the NAO was invited to audit four additional assumptions used in the Pre-Budget Report forecast. The NAO will have a continuing involvement in auditing the public finances in future Budgets. The nature of this involvement could be spelt out in the Code.

Improving Accounting Standards

If high quality policy decisions are to be made, the quality of information that is available is at least as important as the amount of information. The Government is committed to enhancing the integrity of official statistics, including economic data, by ensuring that they are of assured quality and are produced and presented in a way which is free from political interference. But, more specifically related to fiscal policy, the Government believes that it is important it pursues best practice accounting standards in the preparation of the public accounts. The Code could recognise this requirement.

Resource accounting and budgeting

The move to resource accounting and budgeting is an integral part of the Government's new fiscal framework. Based on accrual accounting, this approach captures the full costs of resources consumed in the production of outputs during the reporting period, and will provide better information for purchase and ownership decision-making than cash information alone provides. The Code could stress the Government's commitment to this approach and to the philosophy on which it is based.

Whole of government accounts

A prudent approach to managing the public finances demands that governments monitor all public bodies which represent either actual or contingent liabilities to the taxpayer. The Code could commit governments to producing consolidated accounts for the public sector, subject to the study of feasibility that is being undertaken jointly between the Treasury and the NAO.

Measures of the public sector balance sheet and net worth

The public sector balance sheet, and the measures of net worth that are derived from the balance sheet, can be important indicators of the sustainability and equity of fiscal policy over time. They complement the current balance and debt statistics used in judging the fiscal rules. The Government will publish soon a discussion paper outlining the potential benefits of balance sheet data and the challenges involved in developing this approach further. The Code could commit governments to developing further these measures over time.

Conclusion

The Government is committed to developing an economic policy framework that will help Britain to achieve its long-term economic and social goals. This paper has outlined the Government's intention to implement a Code for Fiscal Stability to take the framework forward in a way that will generate public confidence that the Government is determined to stand by this commitment.

The Government welcomes comments on this discussion paper. After taking into account views, the Government intends to draw up the Code based on statute. The Government will use the next Finance Bill to the maximum extent possible to give effect to this. If there are desirable aspects of the Code which, for technical reasons, cannot be given the force of law by the Finance Act, the Government will consider other legislative solutions.

Comments can be sent by post to:

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