

TREASURY COMMITTEE

Eighth Report

**THE NEW FISCAL FRAMEWORK AND THE  
COMPREHENSIVE SPENDING REVIEW**

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**Memorandum submitted by Professor David Heald, Specialist Adviser to the Committee**

**THE NEW FISCAL FRAMEWORK**

INTRODUCTION

This memorandum examines the Treasury's new fiscal framework, as articulated in three recently published documents:

*The Code for Fiscal Stability* (Treasury, 1998a), henceforth the *Code*;

*Economic and Fiscal Strategy Report 1998* (Treasury, 1998b), henceforth *EFSR 1998*; and

*Fiscal Policy: Current and Capital Spending* (Treasury, 1998c), henceforth *Current and Capital*.

Because this memorandum is critical of aspects of the new fiscal framework, it will be helpful to summarise my own position on connected matters:

I doubt whether the existing functions of the UK state can be sustained within the public expenditure plans inherited by this Government;

there is at this juncture a powerful case for fiscal caution because of (a) the imperfectly understood dependence of the public finances upon the economic cycle, and (b) the potential impact of EMU upon the UK economy, whether or not the United Kingdom joins the single currency;

I welcome the way in which Government ministers and the Treasury have embraced the principle of transparency, but have yet to be convinced of the sincerity of such professions;

I have strongly supported the Treasury's development of Resource Accounting and Budgeting (RAB), though I have expressed concern about the lack of clarity as to how Resource Budgeting (RB) will operate;

I am sympathetic to the view that public capital expenditure has been neglected and have strongly supported capital charging as a mechanism for improving asset management; and

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I have supported the Treasury's resistance to various proposals to narrow its focus from public sector to general government, which are motivated by a desire to reposition certain borrowing outside the Maastricht-relevant boundary.

This memorandum deals in turn with the following issues; the role of transparency; the new fiscal framework; and the new system for public expenditure planning.

#### THE ROLE OF TRANSPARENCY

For claims of transparency to be more than empty rhetoric, two conditions must be satisfied:

relevant fiscal data must be regularly published in a form which allows the well-informed user to see the relationship between various aggregates; an obstacle to transparency is undoubtedly the inevitably technical nature of fiscal definitions, though lucid presentation can help enormously; and

the process through which such data are released must be conducive to public understanding, rather than serving to obfuscate; a particular worry at present is whether it is really possible for transparency to be achieved when there is such an obsession with "spinning" (manifested in the drip-feeding of material into the public domain).

After the *Pre-Budget Report* (Treasury, 1997b) was published, I complained about the discrepancy between claims and reality:

With regard to public expenditure, transparency appears at the top of the list of five "principles of fiscal policy management" set out in *A Code for Fiscal Stability*. If such aspirations are juxtaposed with current reality, there is a remarkable contrast; public expenditure numbers are becoming ever more opaque, resembling a hall of mirrors (Heald, 1998).

My specific complaint concerned many data which were missing, a state of affairs which had to be rectified by the *Financial Times* invoking the procedure on access to government information. I did recognise the complications introduced by the cancellation of the Public Expenditure Survey and the institution of the Comprehensive Spending Review. However, there seemed to be too much enthusiasm for heaping the blame for fiscal misjudgments upon the previous Government rather than engaging in measured analysis (Treasury, 1997a).

The new set of fiscal documents (Treasury, 1998b, c) has not assuaged my concerns. In *EFSR 1998*, there is too much "selling" and insufficient development of key stages in the argument; the term "strict fiscal rules" appears nine times and "tough" is used five times in connection with the new public expenditure control system. Moreover:

page 36 on Public-Private Partnerships reads more like sales blurb than serious analysis, seemingly unaware of the extent to which PFI finance is being embraced as "The Only Show in Town" while being presented as "The Best Deal in the World". (I confidently predict future humiliations for civil servants and public managers in front of the Committee of Public Accounts, and also the avoidance of responsibility by those ministers who contrived this situation);

the government guarantee for the Channel Tunnel Rail Link represents an important UK departure in terms of using guarantees; there has been much discussion of such mechanisms in the United States and a development of budget-scoring rules; and

the problem with codes of any kind is that compliance can be substantive or token; the Treasury's (1998c, p.13) entry concerning local government in its statement of compliance with the IMF Draft Code induces wry smiles.

If transparency is to be achieved, financial control systems have to be explicit, and to really operate on the stated basis.

#### THE NEW FISCAL FRAMEWORK

I would have preferred statutory effect to have been given to the *Code* as part of the legislation required for the implementation of RAB. As it is, the *Code* will derive its statutory basis from the 1998 Finance Bill.

Nowhere in *EFSR 1998* or in *Current and Capital* is there a careful exposition of the merits of the two fiscal rules (the golden rule and the sustainable investment rule). They are elevated to near-mystical status, seemingly rendering unnecessary a proper justification.

#### Golden rule

My concern is that these documents leap from the proposition that the public capital stock has been neglected (a proposition I accept) to the rule that borrowing should only take place to fund capital investment. There are two objections:

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the capital-current distinction refers to the classification of inputs, thereby treating school buildings as capital and teachers' pay as current. This input distinction may be only remotely related to the objectives of the educational system, which might be described as developing human capital and promoting personal development. If the best way to improve school performance is to pay teachers more, rather than let them work in better buildings, current expenditure should be increased. Privileging bricks and mortar, in the absence of proper policy analysis, is inappropriate. This argument can readily be extended to other public services. Accordingly the argument about which generations pay and which benefit is far more complicated than is acknowledged in the Treasury documents; and

given the importance of the quasi-public sector and the growing role of PFI-financed assets, the concept of public investment is becoming difficult to handle. *Current and Capital* (page 7) noted:

Public sector net investment is the measure used for the golden rule: it includes physical investment and grants in support of capital spending by the private sector. It is measured net of depreciation.

Even when RAB is fully implemented, there will be a lack of articulation between new capital investment and the balance sheet; much public sector capital investment (on the definition above) does not create an asset in the balance sheet of central government (which is likely to be the initial focus of Whole of Government Accounts). The more the government conceptualises the public sector as a purchaser and enabler, the greater this difficulty becomes; there may be few assets but many contractual obligations to purchase services over long timescales.

A number of statements do not, in my view, carry the weight which is placed upon them:

The golden rule was not met over the last economic cycle (1985–86 to 1996–97): current spending exceeded current receipts by over 1.5 per cent of GDP a year on average. Moreover, the golden rule has not been met over any cycle since the early 1970s (Treasury, 1998c, page 5).

Rather than encourage me to subscribe to the golden rule, this prompts the following observations:

there is an obvious distinction between the *ex-ante* cycle and the *ex-post* cycle, making the golden rule very difficult to operationalise;

during an economic cycle, fiscal policy ought to be governed by contemporary macroeconomic conditions, not by a mechanical rule which may be taken to mandate inappropriate fiscal tightening; and

a disturbing feature of the presentation of *EFSR 1998* is the way in which the principal tables (e.g., Tables 4.4–4.6) run from 1997–98 (estimate) to 2003–04 (projection), with no comparable data being provided for earlier years. Not least, such a run of figures would provoke scepticism about the fiscal stability implied by the projections.

Overall, there is too much reliance upon persuasive language, the kind which can be used by skilled officials to argue the point whichever way is desired. For example:

Decisions on spending will be based on the *prudent* and *sound* fiscal rules, rather than on an *arbitrary* target for expenditure as a proportion of GDP (Treasury, 1998a, page 26, emphasis added).

#### *Sustainable investment rule*

The sustainable investment rule requires the net public debt to GDP ratio be held at a stable and prudent level, interpreted to be 40 per cent. Nowhere is this figure justified. There are obviously good reasons for containing the level of public debt, particularly in light of the substantial unexpected increase during the last economic cycle; (Treasury 1998c, pages 9–10) noted that “the ratio of public sector net debt to GDP has risen by 18 percentage points from its trough in 1990–91”. Moreover, the United Kingdom is constrained by the gross debt rule contained in the Maastricht Excessive Deficits Protocol. Although I regard the formulation of debt objectives as outside my area of expertise, I would have preferred to see more exposition of the factors which led to this particular judgment.

#### NEW SYSTEM FOR PUBLIC EXPENDITURE PLANNING

It has been characteristic practice for the Treasury to revamp public expenditure definitions and control systems, concluding each time that this would bring a dramatic improvement over previously imperfect practice (Heald, 1995). On each occasion, it is asserted that this brings the United Kingdom more into line with international practice. Rarely is a convincing case made for change:

... there is a strong case for maintaining the present Control Total. This is not because it is entirely suitable but because the increasing instability of public finances makes it important to have a control aggregate whose behaviour can become reasonably well understood. Changes in the definition of a control aggregate both damage data continuity and hinder data interpretation (Heald, 1997, page 185).

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As usual, it will take a considerable amount of time to digest the implications of the new planning system, which will again be modified when RB is implemented.

The key features of the new system can be summarised as:

the Treasury will set for each department a three-year Departmental Expenditure Limit (DEL), initially for 1999–2000 to 2001–02, and then reset them in 2000 for 2001–02 to 2003–04 (RB will involve setting both resource budgets and total financing requirements for each department);

certain kinds of expenditure, to be known as Annually Managed Expenditure (AME), will be controlled on an annual basis; and

Total Managed Expenditure (TME) will consist of DELs plus AME, or—viewed alternatively—as the sum of (a) public sector current expenditure (the key aggregate for the golden rule), and (b) public sector net investment.

Several issues need examining:

the most cyclically sensitive parts of public expenditure (cyclical social security has been outside the Control Total) are included in TME, raising questions about the operation of the automatic stabilisers;

the creation of the “Investing in Britain Fund” and the “Capital Modernisation Fund”, both of which seem to be expenditure lines rather than funds in a technical sense, appears to herald a centralisation of decision-making in the Treasury. The proposed compilation of Departmental Investment Strategies seems to be a move in the same direction. This runs seriously counter to the rationale of RB which emphasises budgetary delegation both from the Treasury to departments and from departments to their managerial units. A highly centralised apparatus might therefore be created when what is required is the discipline of capital charging and more managerial discretion about the restructuring of asset portfolios. In my view, there is a misrepresentation of what RAB seeks to achieve in terms of capital; RAB measures and values capital, but seeks to discourage an excessive compartmentalisation of capital and current expenditure;

although the modest relaxations of the control system for certain public corporations are welcome, there are disturbing signals that lessons have not been learned about the troubled relationship between central and local government:

Treating LASFE in this way is consistent with the relaxation of capping and the greater emphasis on local accountability. However, the Government will also retain strong reserve powers over local authorities. If other safeguards fail and spending financed by local taxes becomes excessive, it may also be necessary to cut back grants to local authorities when plans are reviewed in 2000 (Treasury, 1998b, page 27).

Moreover, the inclusion of local authority asset disposals of £2.75 billion per year of their existing assets (Treasury, 1998a, page 37) suggests a top-down approach which is neither desirable on constitutional grounds nor likely to be conducive to improved asset management; and

Several UK developments are putting strains on regulatory mechanisms, especially when the Treasury has powerful ministers to reinforce its traditional dominance. I anticipate considerable conflict over the accounting treatment of PFI assets (where the financial reporting treatment may influence public expenditure scoring and the national accounts) between the Treasury and the Accounting Standards Board (ASB). The Office for National Statistics does not enjoy as much autonomy as ASB; it is intriguing to note that the “scoring benefits” for student loans associated with RAB have been “brought forward”, at the same time as the cash system’s treatment of the sale of the student loan book continues to be exploited. Furthermore, the involvement of the National Audit Office in the setting of macroeconomic assumptions risks compromising the independence of the Comptroller and Auditor General. Quite apart from the question of whether the National Audit Office could reasonably be expected to have such expertise, this looks like a classic case of blame deflection.

## CONCLUSION

Although many of the Government’s professed objectives are admirable, there is much for the Committee to scrutinise before supporting the new fiscal framework:

the Treasury must demonstrate a genuine commitment to transparency, manifested in both *substance* (i.e., the relevant data are available) and *process* (i.e., the way in which data are released is designed to promote understanding);

key steps in the supporting argument for the two fiscal rules must be developed more carefully; and

there is a series of technical issues to be addressed as to how the new public expenditure planning system will operate, and what are likely to be the effects of its adoption.

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**Memorandum submitted by Dr Garry Young, National Institute of Economic and Social Research**

**THE ECONOMIC AND FISCAL STRATEGY REPORT 1998**

The government has made great progress in setting out a new framework for the conduct and analysis of fiscal policy. In its first Economic and Fiscal Strategy Report (EFSR) it stressed four key themes: fiscal prudence, investment and the best use of assets, stable and long-term plans as well as wider economic reforms to support the objectives of the Comprehensive Spending Review (CSR).

In my view, this new framework is a major improvement on what has gone before. Its attempts to clarify the distinction between current and capital spending and emphasise the role of its own balance sheet should lead to improvements in the conduct of fiscal policy in the UK. The previous emphasis on the public sector borrowing requirement (PSBR) was damaging. These reforms should reduce the extent to which long-term investment and planning are sacrificed whenever fiscal retrenchment is needed. The longer-term planning horizon is also beneficial in this respect.

However, there are a number of critical points to make about the setting of policy within the new framework. These are to do with the operation of fiscal rules in the long term and in the short term:

1. It is not obvious that the golden rule should be preferred to other possible settings of fiscal policy over the cycle. In other respects, the government's expenditure plans seem to be arbitrary.
2. It is not clear how the new expenditure control system will reconcile departmental freedom to decide on the split between current and capital spending and the achievement of the golden rule.
3. The potential role of fiscal policy in stabilising the economy is probably played down too much in the EFSR.

These points are expanded on below:

**FISCAL PRUDENCE AND THE GOLDEN RULE**

The government has proposed two strict fiscal targets to be applied over the economic cycle: the golden rule and the sustainable investment rule. These rules are intended to constrain the long-term development of the public sector balance sheet, ensuring that the government's fiscal position remains sustainable while protecting capital expenditure. It is useful to examine their implications for the future development of the public sector balance sheet.

First, adherence to the golden rule is broadly equivalent to zero government saving.<sup>1</sup> In the long run this rule will stabilise the net worth of the public sector (debt net of capital) at its current level since any net investment is financed by borrowing. But net worth will decline gradually to zero as a share of GDP because of economic

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<sup>1</sup> This is not strictly true because nominal interest payments on debt are treated as current spending. Since the inflation component of the interest payment actually represents a real repayment of the debt, the real value of the debt stock is reduced when the current balance is zero. This means that there is some saving when the current balance is zero.