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Issues in the Design of Fiscal Policy Rules

CFM-DP2014-12

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Theory suggests that government should as far as possible smooth taxes and its recurrent consumption spending, which means that government debt should act as a shock absorber, and any planned adjustments in debt should be gradual. This suggests that operational targets for governments should involve deficits rather than debt, because such rules will be more robust to shocks.

Beyond that, fiscal rules need to reflect the constraints on monetary policy. Fiscal rules for countries in a monetary union or fixed exchange rate regime need to include a strong countercyclical element. Fiscal rules should also contain a 'knock out' if interest rates hit the zero lower bound: in that case the fiscal and monetary authorities should cooperate to formulate a fiscal expansion package that allows interest rates to rise above this bound.

Rules should also reflect the extent to which governments are subject to "deficit bias. " Governments that had not shown a history of deficit bias could aim for rolling deficit target; in contrast, governments that were more prone to bias could target a cyclically adjusted deficit at the end of their expected period of office. In both cases fiscal councils would have an important role to play, in ensuring plans were implemented in the first case and allowing for departures from target when external shocks occurred in the second.

For the UK, experience over the last few decades suggests that, in contrast to many other countries, there has not been sustained deficit bias, but that governments are tempted to circumvent either the spirit or the letter of their own rules, and are too quick to cut public investment. This suggests an appropriate framework for the UK, once interest rates start to rise, would be to keep the five year rolling target, but with some modifications, and with a wider remit for the Office of Budget Responsibility.