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New chancellor, new rules

How Rachel Reeves can improve the framework for fiscal policy making

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Introduction

Fiscal policy – the big decisions on tax, spending, borrowing and debt – will be crucial to the success of the new government. The economic challenges facing the UK, and its chancellor and finance ministry, are well known. As is the fiscal discipline of Rachel Reeves, the first Labour chancellor in 14 years, who in opposition announced various measures that should, if implemented, improve how her Treasury designs policy.

These include a new 'fiscal lock' to ensure the Office for Budget Responsibility (OBR) always produces a new forecast to accompany big fiscal policy measures; the OBR would also be asked to comment more substantively on the longer term benefits of public investment. A new fiscal rule will require the government not to borrow for day-to-day spending and only for investment – the same distinction that Gordon Brown's 'golden rule' made[*] – while a new 'business tax roadmap' will provide greater clarity to the private sector about the government's direction of travel.[1]

Changes to the economic policy making framework are some of the most enduring changes that chancellors can make. Gordon Brown granting the Bank of England independence in 1997 has transformed monetary policy making in the UK, while George Osborne's creation of the OBR in 2010 has made UK fiscal policy making more transparent and the forecasts underpinning it far more reliable. The reforms that Reeves has already proposed, as she begins her chancellorship in 2024, could be similarly transformative.[2] Strengthening them, in the ways we put forward in this paper, would give them even more chance of this, and of embedding lasting improvements in a UK fiscal policy making culture that is crying out for change.

Recognising the problems with fiscal policy making that exist today is an important first step:

- Recent governments have **lacked clear priorities**. Without that, fiscal targets (which are only one part of what a government is aiming to achieve) have inappropriately dominated decision making: that is, meeting the letter of debt and borrowing rules has been prioritised over other outcomes that the government might care about.[3]
- **Spending reviews** have failed to systematically examine how public money is used or identify opportunities for improvement.[4]
- Successive chancellors have **'fine-tuned' tax and spending policy** to appear to be on course to meet forward-looking fiscal rules but with very little room for error. With forecasts being inherently uncertain, this has left chancellors frequently adjusting policy in response to forecast changes but in an asymmetric way, leaving debt ratcheting upwards.[5]

* And, indeed, several sets of more recent fiscal rules also had the same distinction between borrowing for day-to-day and investment spending, such as those in place from 2010–15 and 2019–22.

- Chancellors have also lacked a clear and lasting view of what **the tax system** should look like. Instead, frequent tinkering with policy has created an overly complex system and uncertainty about what it will look like in future and thus what incentives the private sector faces.[6]

- **Fiscal rules** that only bind five years ahead have allowed previous chancellors to give the illusion of fiscal discipline by requiring the OBR to base forecasts on implausible spending plans and to score revenue from taxes they are very unlikely to raise.[7] Past governments have failed to address the difficult question of how to prioritise public resources and have left the UK with a high and rising level of public debt.

One of the major reasons these problems persist is because of a perceived political benefit to behaving in this way. For example, tinkering with policy in multiple fiscal events a year gives the chancellor more high-profile moments in the Commons, through which they can command the news agenda (see, for example, Jeremy Hunt proudly announcing more than 100 'growth measures' in the 2023 autumn statement, eight months after the March budget).

And pencilling in spending cuts in the future that will never arrive (another feature of Hunt's chancellorship) allows the government to dodge difficult trade-offs in the present. But ultimately these all undermine a government's ability to achieve its objectives over the medium and longer term. As a result, recent chancellors have not succeeded in setting out and making progress on consistent agendas that could make a meaningful difference to how the economy and government operate.

As a new chancellor in a new government, facing deep-seated challenges and with broad and long-term ambitions reflected in the government's five missions, now is the right time for Rachel Reeves to make lasting changes to how fiscal policy is made. Doing this will give her and the new government the best chance of making a set of decisions that best support demonstrable progress on the government's priorities in three, five or ten years.

This paper, drawing on previous Institute for Government reports, highlights the four areas that offer the greatest opportunity for the new government to ensure that its fiscal policy best helps deliver its priorities and ends by setting out how these could be enacted in legislation.

Improve the fiscal rules

Fiscal rules should be consistent with government's wider objectives

Financial sustainability is an important objective. UK governments need to borrow from financial markets, whether to refinance past loans or to raise new funds to pay for day-to-day costs, major investments or to respond to crises. If the government cannot borrow at a reasonable cost because investors question the state's financial sustainability, it cannot hope to achieve any of its other objectives. The UK experience in the aftermath of Liz Truss and Kwasi Kwarteng's disastrous mini-budget in September 2022 laid bare the importance of fiscal competence – and the perception of fiscal competence – for the effective functioning of government.

Governments also have a tendency to exhibit 'deficit bias' – borrowing more than is sensible to offer tax cuts or spending increases because the benefits are felt quickly, that is inside an electoral cycle, while the costs are mostly borne in the future when the politicians are long gone. Fiscal rules are constraints imposed by governments on themselves to ensure their plans remain financially sustainable and that all parts of government confront the very real trade-offs between spending, tax and borrowing.

But the balance can swing too far in the other direction. Fiscal sustainability is just one objective of government: a means to ensure it can make progress in other ways. In the absence of other clearly articulated objectives, fiscal concerns can dominate, and tax and spending decisions can end up setting wider government strategy by default. In recent years, there has been an absence of a whole-of-government strategy, or any coherent set of government priorities. This vacuum has in practice been filled by the Treasury's spending review and budget processes, which were left to make trade-offs between departments' bids and, in doing so, set an implicit whole government strategy.

The new government should avoid making the same mistake and ensure that its fiscal strategy and rules are designed to deliver fiscal sustainability in service to its broader objectives, rather than in and of itself. Two things will help it do this.

- First, **No.10 should set out its priorities in a new 'programme for government'**. This should help avoid the temptation, to which earlier governments have succumbed, of observing the letter but not the spirit of their fiscal rules to avoid them undermining their wider policy objectives.
- Second, **the chancellor should ensure her fiscal rules promote fiscal sustainability while also being consistent with these wider priorities**. The Labour Party's manifesto committed to meeting a specific set of fiscal rules: "that day-to-day costs are met by revenues and debt must be falling as a share of the economy by the fifth year of the forecast".[8] These are reasonable rules, which broadly adhere to notions of fiscal sustainability and are rightly constraining given the current state of the public finances, but the manifesto wording leaves scope for refining the details.

There is no hard and fast definition of fiscal sustainability, and fiscal targets are rules of thumb that indicate broad compliance with that objective. If a rule is preventing a government from addressing a priority through policies that would not damage (a broader definition of) fiscal sustainability, the chancellor can and should make the case for amending it.

Features of good fiscal rules

As well as ensuring fiscal rules are consistent with the government's wider objectives, the chancellor should also ensure they are designed in a way that encourages good, consistent and prudent fiscal policy making over the longer term. Labour's manifesto was promising in this regard:

- The borrowing rule **distinguishes between day-to-day spending and investment**, providing an incentive for the government to prioritise investments that have longer term pay-offs.
- The borrowing and debt rules are **forward looking**, providing scope for fiscal policy to support the economy in the short term if it is hit by a negative shock.

But there are two further changes that the chancellor could make to increase the extent to which the fiscal rules help incentivise good fiscal policy making:

- **Specify ranges rather than point targets.** Much recent fiscal policy making has been beset by constant 'fine-tuning', with tax and spending policies being tweaked at least twice a year in response to changes in the (inherently uncertain) economic and fiscal forecasts. This creates uncertainty for the private sector and public services and undermines government's strategic approach. To reduce the temptation for the government to do this, the Treasury should specify fiscal rules as ranges rather than point targets; for example, requiring that debt be on course to fall by between 0% and -1% of GDP in a future year, rather than just saying it should fall as a share of GDP in that year.[*]
- Specify a **binding target for the third, as well as the fifth, year of the forecast**. Labour has said that it will get debt falling as a share of GDP in five years' time. But having a target so far out raises the risk of it being 'gamed' or met only through pencilling in fictitious policy assumptions, as the last government did. Given the current level of borrowing and the existing trajectory of public debt, it is unlikely to be feasible or desirable for the government to try to get debt falling within three years – but the chancellor could set an interim target (such as debt only rising by a given amount or borrowing falling to a certain level) that would apply in three years to provide a stronger commitment to fiscal sustainability.

* A Resolution Foundation report, for example, calls for an "aim to achieve a cyclically adjusted public sector current balance of +1 per cent of GDP and no less than -1 per cent of GDP" over a fixed period. Hughes R, Leslie J, Pacitti C and Smith J, *Totally (net) worth it*, Resolution Foundation, 29 October 2019, www.resolutionfoundation.org/app/uploads/2019/10/Totally-net-worth-it.pdf

Make tax policy more strategic

Debates, and denials, about tax were a prominent feature of the general election campaign. Labour committed to a few tax measures in its manifesto and ruled several others out. Now in government, to help deliver on existing commitments and potential new ones the chancellor is likely to want to make changes to the tax system.

The chancellor must avoid slipping into the reactive, incremental and inconsistent pattern of tax changes that her predecessors have. Frequent changes to the tax system, sometimes counteracting or reversing previous policies, create uncertainty for businesses and families. They can also use up 'fiscal space', political capital and policy making capacity, meaning that many previous chancellors' periods in office have been defined by small, incoherent tweaks to the tax system rather than genuine reform in pursuit of objectives like enhancing growth or creating a fairer tax system.

Reeves has already committed to reforms that should support a more strategic approach to tax policy making. In particular she has committed to hold only one 'major' fiscal event per year and promised to introduce a 'business tax roadmap' to provide more certainty about the path of corporation tax and other levies affecting the private sector.[9] These are both welcome developments, but the chancellor should go further to ensure that she can deliver what is intended from these changes: more stability and certainty.

- The chancellor should **commit to holding only one fiscal event a year**, not just one 'major' event per year. Past attempts by chancellors to show restraint at a second fiscal event (a pre-budget report or spring or autumn statement) have failed as small policy announcements steadily became larger. And many of the internal benefits of a single fiscal event – like freeing up the time of civil servants to work on more strategic policy for the rest of the year – will be undermined if the internal policy development process still has two deadlines per year.

  Unless a crisis requires it, the chancellor should commit to not announcing any fiscal policy alongside the second OBR forecast each year. To reduce the political incentive to react to an updated forecast, there is a case for amending the OBR's charter so that it is only required to produce a minimum of one forecast each fiscal year.

- The chancellor should **go further than a business tax roadmap, and introduce a tax strategy**, incorporating personal as well as business taxes. Many of the benefits of a business tax roadmap – like providing certainty, and ensuring different changes pull in a consistent direction – also apply to personal taxes (such as income tax, VAT, National Insurance, capital and property taxes).

  A tax strategy would also allow the chancellor to lay the groundwork for some of the reforms she might want to make to how people and businesses are taxed. This does not mean tying the government's hands by announcing every tax measure for five years in advance, but it should provide a clear set of principles and direction of travel, so businesses and families can be confident of how the system might change, even if they do not know the precise details.

- The chancellor should **ensure the tax strategy or roadmap provides direction and is not just a series of platitudes**. There was a stark contrast between the 2010 corporate tax roadmap, which was clear and widely lauded, and the 2016 business tax roadmap, which did not provide certainty or direction and merely stated a set of policies that had already been announced.[*] Reeves should follow the former model.
- To provide further clarity for taxpayers about the direction of travel on tax and to ensure that tax changes deliver the intended results, the government should **commit always to consult on significant tax policy changes**. It is particularly important that it consults more regularly and widely in the early stages of policy development when alternative options are being considered.[10] The Treasury and HMRC should also take a more active approach to consultation to ensure they get input from a full range of perspectives.[11]

Approaching tax policy in this way would provide more certainty and create more space for the chancellor to make meaningful improvements to a tax system in dire need of it. When used well, strategies can lay the groundwork for reform. Slowing down policy making should also help to improve how evidence can feed into the process and how policies are developed. It would also create more space to review the various reliefs and tax expenditures in the system in more detail, and in conjunction with spending that aims to achieve similar outcomes, which we discuss in the next section.

If the new chancellor wanted to go further to embed a more strategic approach to tax policy making and create more space politically for substantive reforms, she could consider creating a **new independent Office for Tax Reform**. She has identified the potential for independent bodies to support good fiscal policy making in other areas – such as the OBR and possible new Office for Value for Money (OVM). There is a strong case for having a new independent body for tax too, especially since the Office for Tax Simplification (OTS) was abolished in Kwasi Kwarteng's short time in No.11.

An Office for Tax Reform could play a slightly different role from the OTS, delivering periodic independent reviews of specific areas of the tax system – such as the emerging gap on fuel duties as drivers switch to electric vehicles – to help to increase public knowledge, improve public debate and create space for change.[12]

* Rutter J, Dodwell B, Johnson P and others, *Better Budgets: Making tax policy better*, Institute for Government, 2017, p. 19, www.instituteforgovernment.org.uk/publication/report/better-budgets-making-tax-policy-better

Use a multiyear spending review to tackle deep-seated problems

The Labour manifesto set out major ambitions, from boosting economic growth to enhancing public services and making the transition to net zero. It also reiterated the party's intention to orient government around its five 'missions'. The UK government spends over a trillion pounds a year, meaning there is huge scope to make a difference and to align public spending with new ministers' priorities.

There are a lot of problems that the new government wants to fix. But because economic growth – and thus growth in tax revenues – is likely to remain subdued, at least in the near term, achieving better outcomes will require reprioritising how existing money is spent, not just allocating more.

The spending review provides the most consequential opportunity to achieve this sort of strategic reprioritisation of spending. However, recent reviews have failed to do this because they have focused excessively on enforcing strict spending totals, rather than assessing how well money is allocated to achieve government's objectives, and have adhered to and entrenched departmental silos rather than budgeting for cross-cutting priorities.

While the new chancellor will need to set out spending plans for the 2025/26 financial year within a few months, and may want to announce some other longer term spending settlements (for example, to fund explicit manifesto commitments), she should **allow around a year to carry out a multi-year review to develop full plans for spending in later years of this parliament**.[13]

To ensure the spending review can effectively prioritise spending to achieve the government's objectives, it is crucial that the new government starts by setting out its priorities for government, in a programme for government as described above. It is also important for the next and all future multi-year spending reviews to provide departments, local and devolved authorities, public bodies and those working with government with greater certainty over future spending plans. To this end, the new government should commit to a new timetable for future spending reviews, **setting budgets for five years, reviewed every three**.

Taking extra time over the next multi-year spending review will allow Reeves to set up and run a new, more robust process that would:

- **budget for Labour's missions** by insisting on joint, interdepartmental spending plans for each mission and replacing bilateral negotiations with multilateral 'star chamber' negotiations with the centre
- **include social security spending, tax and regulation alongside departmental spending** when considering the suite of policies needed to deliver missions

- **commission targeted reviews on key policy areas** to build the evidence base, in particular related to the government's key strategic priorities, or missions, and areas that are thought to currently be delivering poor outcomes and poor value for money
- **produce and publish independently scrutinised multi-year expenditure baselines** for each department to show how spending would need to change, given expected demand and cost pressures, to continue with current policy. These should form the basis for decisions in the spending review, and would build trust in the process and ensure that ministers have realistic expectations about what funding settlements can achieve. These baselines should be independently scrutinised, either by the proposed new OVM or by an expanded OBR. This independent and objective scrutiny would build trust in the spending review process and the credibility of spending plans across government and more widely. It would also help ensure that departments systematically use good quality evidence when bidding for money and are not over-optimistic. The strength of the evidence base for newly agreed programmes should also be subject to this independent scrutiny function.

Reform the mandate and powers of the Office for Budget Responsibility

The OBR was George Osborne's key institutional reform when he became chancellor in 2010, and in the 14 years since it has improved fiscal policy making through independent forecasts and credible, impartial commentary. The OBR should not decide policy itself – that is a political decision that should be made by ministers – but an appropriately empowered OBR can help those ministers stick to their longer term ambitions and address fiscal trade-offs by assessing the government's approach against its objectives and rules.

Reeves has rightly recognised the value of the OBR to policy making, and has already committed to strengthen and expand its role by:[14]

- committing to a 'fiscal lock', requiring that **significant changes to tax and spend will be accompanied by an OBR forecast**, with plans to empower the OBR to be able to independently publish its assessment of new policy even if the Treasury does not request one
- committing to **make the OBR responsible for judging, based on criteria laid out by the Treasury, when there is an economic crisis** and so it would be appropriate to suspend her fiscal rules
- stating an ambition to **encourage the OBR to report on the long-term impact of capital spending decisions**.

These are all welcome moves. They will help to reduce the temptation to announce policy too quickly, or without regard to the fiscal situation, and ensure the rules provide a credible anchor to the government's fiscal policy. Asking the OBR to report on the longer-term effects of capital spending, perhaps over a 10- or even 20-year horizon, as we have recommended,[15] should also help ensure politicians receive more credit for making decisions that could have economic pay-off beyond the usual five-year forecast horizon.

But all could go further. To help ensure the OBR can play the role Reeves envisages for it, and to ensure the reforms she has already committed to are effective, she should go further:[16]

- **The OBR should be given a broader remit to comment on how well the government's fiscal plans accord with its wider fiscal objectives and with longer run fiscal sustainability, rather than simply whether they have met the letter of the fiscal rules.** This will help to guard against the temptation to game the rules and avoid trade-offs, which just store up more problems further down the line. Reeves has already said that, as chancellor, she would report on metrics like public sector net worth at budgets. Empowering the OBR in this way would give even greater prominence to broader measures of government's assets, sustainability and reward long-term growth enhancing policy.
- **The OBR should be asked to assess whether any new rules created are consistent with the government's broader fiscal objectives.** And at the start of each parliament and whenever rules are changed, **the OBR should be asked to advise how much headroom the government should aim to keep against the rule**, taking account of wider economic circumstances. (This mirrors a similar approach taken in the Netherlands.) These changes will help to ensure the rules play an appropriate role within the wider fiscal framework, and guard against governments needing to make hasty changes to policy when forecasts move.
- **The chancellor should encourage the OBR to put more emphasis on the uncertainty surrounding forecasts** in its commentary and presentation, to avoid excessive focus on a single (uncertain) number. This could go hand-in-hand with changing rules from point estimates to ranges and would help the chancellor resist calls to immediately spend any 'good fiscal news' when forecasts improve.

Legislating for change

Many of the changes that the Labour Party has said it wants to make – and other proposals we set out above – can be done without legislation. Some, though, would require changes to the statute book and in these cases the new government faces a choice on implementation. Primary legislation will provide a stronger signal of intent and do more to bind the current and future governments (although any future government with a parliamentary majority would always be able to overturn any acts). Secondary legislation by contrast would leave the government with greater flexibility to respond to circumstances, though makes embedding change less likely.

Potential for primary legislation: a 'Fiscal Lock Act' and public bodies

Reeves' proposed 'fiscal lock' – the requirement that any 'significant' fiscal announcements be accompanied by an OBR assessment of their economic and fiscal impacts – could be incorporated into the Charter for Budget Responsibility. That sets out guidance to the OBR about how it should perform its duties.[17] But there would be value in going further and enshrining it in primary legislation.

First, this would do more to bind future chancellors. The experience of the 'mini budget' showed how easy it was for a prime minister and chancellor to sideline the OBR. And while a future majority government could overturn this legislation in the Commons, doing so would be far more onerous than revising the charter. Second, the charter provides 'guidance' to the OBR: as became clear during the pandemic in relation to social distancing rules, there is legal ambiguity about the distinction between guidance and law and the degree to which the former is enforceable. Putting the fiscal lock into primary legislation would remove this uncertainty.

However, in legislating for the fiscal lock, the new government would need to specify three key things:

- **What type of policy announcements does the fiscal lock apply to?** In our view, the fiscal lock should apply if the absolute (not only the net) size of measures being announced is sufficiently large in any one year or cumulatively over time. The size threshold needs to be set lower than the magnitude of the 'mini budget' (which, at 1.7% of GDP, was clearly large enough to spook the markets) but not too low. A threshold of around 0.5–1% of GDP (around £14–28bn in today's terms) may be about right.
- **How frequently can the government require a new OBR forecast?** The OBR has limited resources. The government requesting numerous forecasts a year in response to ad hoc policy announcements would put an unsustainable burden on it, reducing the rigour of the analysis produced and diverting resources that should be devoted to the other functions, such as assessing fiscal risks and fiscal sustainability. The fiscal lock legislation must make clear a maximum limit on the number of OBR assessments of significant new policy announcements the chancellor can ask for each fiscal year. Setting this at one would help embed not only the fiscal lock but also Reeves' commitment to a single fiscal event in primary legislation.
- **When can the fiscal lock be disapplied?** There will be circumstances in which the government needs to take temporary, emergency action more quickly than the OBR can produce a new forecast. The pandemic was a clear example of this. The fiscal lock legislation must provide the government with sufficient flexibility to respond in emergencies.

If the new government wanted to set up a new body, such as the OVM or an Office for Tax Reform, there is a strong case for doing this through primary legislation to put the body on a statutory footing. The value of such bodies would come from their perceived and actual independence from government. That independence would be substantially reinforced by placing the body on a statutory footing. The abolition of the OTS – announced by Kwarteng but enacted by his successor Jeremy Hunt – shows that this does not offer complete protection. But it would help to embed these organisations into the fiscal policy making landscape.

Potential for secondary legislation: the Charter for Budget Responsibility

Many of the other changes described above could be enacted through a revised Charter for Budget Responsibility:

- changes to the fiscal rules
- asking the OBR to report to parliament on whether any proposed new set of rules is consistent with the government's broader fiscal objectives, before parliament votes on the new rules
- asking the OBR to comment on how well the government's fiscal plans accord with its wider fiscal objectives, rather than simply whether they are consistent with at least a 50% chance of meeting the letter of the fiscal rules
- asking the OBR to advise (at the start of each parliament and whenever the fiscal rules are changed) how much headroom the government should aim to keep against its fiscal rules.

Making these changes through the charter would provide appropriate flexibility for these rules and requirements to be updated as needed.

The new government could also describe in the charter the approach it intends to take to multi-year spending reviews, setting out that these should set plans for spending for five years and be conducted every three years and the approach that the government will take (for example, governance of targeted policy reviews, set-up of negotiations, length of time the process should run for). Setting out the process in this way would be valuable because it would establish a set of norms, making the process more predictable and better enabling departments to plan for it.

It would also put pressure on the government to run spending reviews well, allowing sufficient time and agreeing multi-year settlements where appropriate (which was not the case, for example, in 2019). Setting out the details of the approach in a charter rather than in primary legislation gives the government an appropriate degree of flexibility to deviate from norms; for example, in the case of crises, as was necessary in 2020.

Conclusion

From an independent Bank of England to the establishment of the Office for Budget Responsibility, some of the most enduring legacies of chancellors have been changes to economic policy making structures. Rachel Reeves has high ambitions for improving fiscal policy making and, as the first Labour chancellor in 14 years and at the start of a new parliament, she has an opportunity to do this.

Many changes can be made without primary legislation, providing useful flexibility to ensure that economic policy can respond quickly to shocks. At the same time, embedding some of the changes we propose in legislation would help to bind successors to these new, improved ways of working, and should be explored. Reeves can also use her chancellorship to make enduring changes to the culture and practice of fiscal policy making by leading by example – committing to following these good processes for as long as she is in post, and demonstrating the benefits of doing so.

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