A RAINY DAY FUND

Why Britain needs a financial sector revenue stabilisation account

Victoria Barr and Nick Donovan

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Fabian Society
11 Dartmouth Street
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www.fabians.org.uk

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About the authors

Victoria Barr is an economist at FTI Consulting. She has previously worked at Frontier Economics, the World Bank and as the Economy and Welfare Policy Officer at the Labour party during the 2010 general election.

Nick Donovan is campaign director at Global Witness, an anti-corruption NGO. Previously he was assistant director at the Royal British Legion - following military service in a bomb disposal team in Iraq. He is also director of Plane Saver Credit Union and owner of his own small business. Earlier in his career he worked as a civil servant in the Prime Minister's Strategy Unit and ran an NGO programme building legal cases against criminals and génocidaires. He writes in a strictly personal capacity.

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Summary

Since 2008, the UK, like many other countries, has experienced high budget deficits and a rapid rise in public debt. The Conservative party has largely succeeded in laying the blame for this, misleadingly, on irresponsible overspending by the Labour government before the crisis. In reality, Labour spending was a very minor factor, dwarfed by other dynamics.

The primary cause of the country's current fiscal problems was the global financial crisis, which caused a deep recession and a prolonged period of economic stagnation. The fiscal legacy of the crisis has been exacerbated by the fact that the UK's structural deficit is much larger than was thought before the crisis, when all political parties and most independent forecasters shared an overly optimistic assessment of the fundamental strength of the UK economy.

The UK was hit particularly hard by the financial crisis, because it has a large financial sector relative to the size of the economy. The City is a great economic asset for Britain, but it is also a source of fragility and risk. In this regard, it shares some of the characteristics of the so-called 'natural resource curse', where the discovery of, say, oil brings great wealth to a country, but also undesirable side effects. Countries often seek to mitigate these risks by creating a revenue stabilisation fund, which aims to smooth income over time and insulate the rest of the economy from the impact of natural resources exploitation.

Given the difficulty of predicting financial crises and the inevitability of errors in fiscal forecasting, the UK should establish a financial sector revenue stabilisation fund: a 'rainy day fund'. Once such an account has built up over time, it would act as a contingency fund in the event of a future financial crisis. The stabilisation fund would reduce the vulnerability of the UK's fiscal position that results from its large financial sector, and would ensure that the government is better placed to take action during future crises.

The UK should also adopt the proposal by the Institute of Fiscal Studies for a 'sustainable commitments rule'. Instead of focusing on the stock of debt, this rule would target the affordability of debt and encompass a wider definition of future commitments, potentially including Private Finance Initiative (PFI) payments and public sector pensions, as well as debt interest.

Today's economic stagnation requires a renewed fiscal stimulus to get growth started again. But once the recovery is well under way, tough new fiscal rules and a rainy day fund will help to put the public finances on a sustainable footing once more.

1 DIAGNOSIS

In the UK, as in many other developed economies, the financial crisis and ensuing recession have resulted in high budget deficits and a rapid increase in public debt.[1] Public sector borrowing reached a post-war high of 11 per cent of GDP in 2009-10, while public debt stood at 66 per cent of GDP in June 2012 and continues to rise.[2] If the various financial interventions associated with stabilising the UK banking sector are included, public debt totaled 145 per cent of GDP in June 2012.[3]

The Conservative party has sought, misleadingly but successfully, to paint irresponsible overspending by the Labour government before the crisis as the main cause of the budget deficit and the rise in national debt. In reality, this played only a trivial role. While this misrepresentation might be politically expedient, only a correct diagnosis of the cause of the deficit and rise in debt will allow us to identify ways to avoid similar problems arising in future.

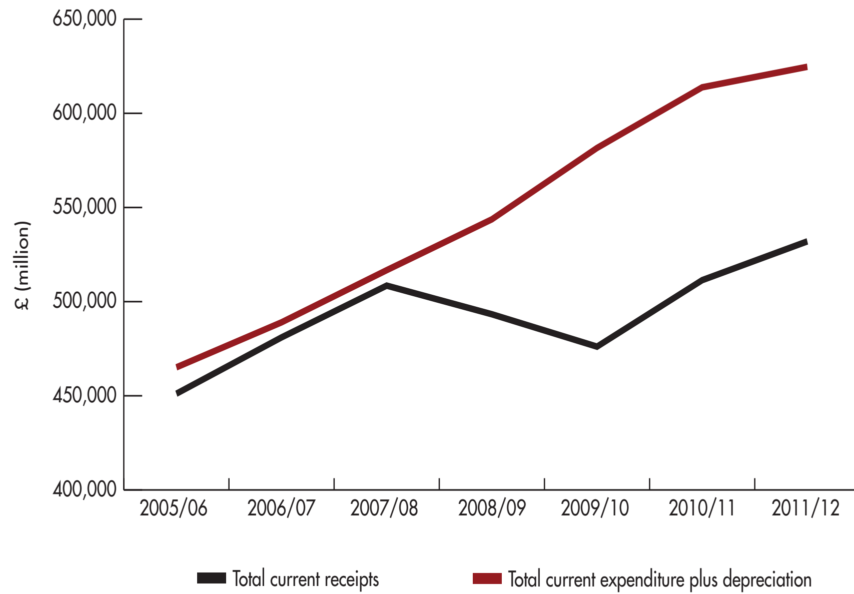
The global financial emergency which began in 2007 is the most serious financial crisis since the 1930s. It is worth re-emphasising the severity of the crisis. The UK suffered its first bank run in 150 years in 2007. The collapse of Lehman Brothers, the largest bankruptcy filing in US history, triggered panic. The US experienced its fastest rate of job losses in over 60 years, as over a million jobs were lost in the final two months of 2008.[4]

As the financial crisis deepened in 2008/09, UK output declined steeply and tax revenues collapsed (as can be seen in Figure 1 overleaf).

In response, the Labour government deliberately stuck to the spending plans set out in the 2007 Comprehensive Spending Review and took additional measures, such as cutting VAT, as part of a fiscal stimulus package. These were conscious choices by the Labour government, and they prevented the recession turning into a depression. However, the resulting budget deficit reached a peak of 7.7 per cent of GDP in 2009/10.[5]

This pattern (financial crisis, recession, budget deficit) affected almost all of the developed economies, which have all seen large rises in the ratio of debt to GDP as a result. However, the impact of the crisis on the UK was particularly severe, because of the size of the financial sector relative to the rest of the economy and the decline in tax revenues from the financial and housing sectors.[6] Research estimates that tax receipts from the financial sector fell from £67.8bn in 2007 (almost 14 per cent of all government revenue), to £53.4bn in 2010 (11.2 per cent).[7] When receipts from the housing sector, closely connected to the financial sector, are taken into account, this stream of revenue is even more volatile.[8]

Figure 1: Central government revenue and spending (£ million)



The financial crisis has left a legacy of weak economic performance and exposed a much larger structural deficit than was estimated before the crisis

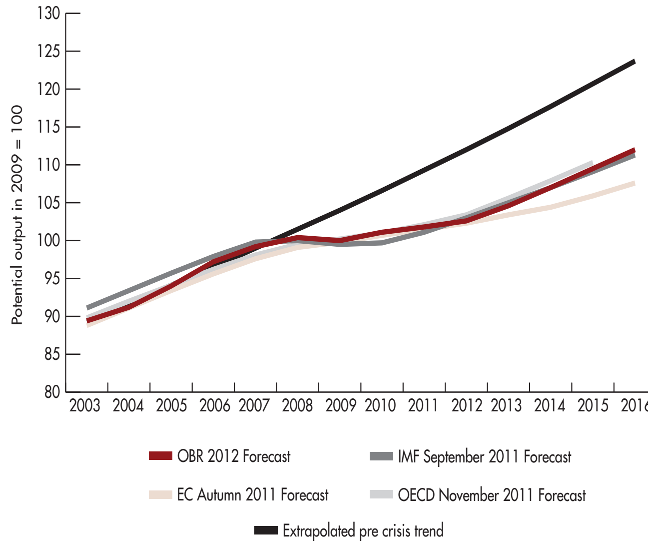
When the economy returns to growth, elements of the deficit will disappear: revenues will rise; social security spending will fall with unemployment. What remains is the so-called structural deficit: the portion of the deficit which is not related to the recession and persists even when the economy is growing again at its long-term trend rate. Current estimates of the structural deficit suggest there is a substantial gap of 4.6 per cent of GDP to be closed.[9]

Estimation of the structural deficit is an attempt to calculate the extent to which the government is spending more than it will receive in income over the longer term. As such, it is the correct measure to target in terms of the sustainability of government borrowing, to allow flexibility to smooth public spending over the economic cycle (borrowing when the economy is weak, paying down debt when it is growing). However, the structural deficit is not a simple calculation, it is a subjective construct that requires an estimation of the economy's long-term growth path. As a result, the estimation process is prone to error.

Before 2008, it was believed that the UK economy would continue to grow at around 2.5 per cent each year.[10] This figure underpinned the Treasury's public finance forecasts and decision making on levels of taxation and spending. The latest estimate of what the UK's average annual growth rate will have been between 2007/08 and 2016/17 is less than half that, at 1.2 per cent.[11] As Figure 2 demonstrates, the financial crisis has inflicted permanent damage on the economy. Even when the UK returns to its long-term trend level of economic growth (now estimated by the Office for Budget Responsibility (OBR) to be 2.3 per cent [12]), it will do so at a lower level of GDP and the economy is not expected to return to the growth path that was projected in 2008.

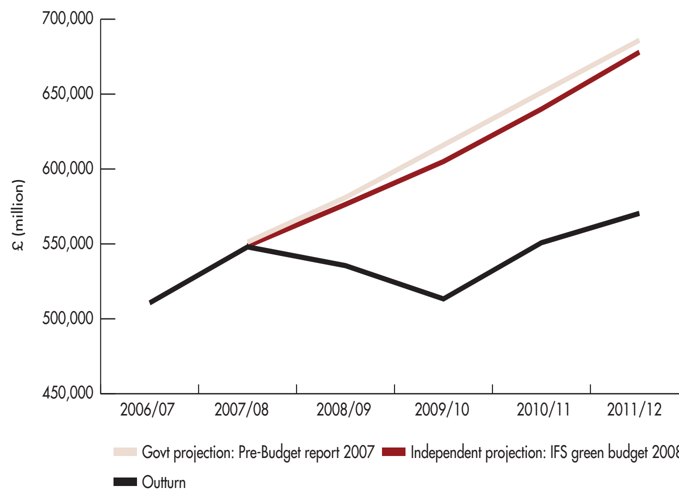
What the Treasury and other forecasters took to be business-as-usual growth was actually a long but temporary boom. And the tax receipts associated with that growth were not solid revenue streams that would continue to flow in future years but a temporary windfall. Today's structural deficit is therefore primarily the result of an over-optimistic assessment before the crisis of Britain's trend rate of growth and a tax and spending structure built on the basis of those erroneous projections.

Figure 2: Permanent damage to the economy caused by financial crisis



However, these errors were not the result of politically-fuelled interference; Alistair Darling's forecasts were very much in line with the consensus view. Figure 3, overleaf, shows how pre-crisis forecasts of government revenue, by both the Treasury and the independent Institute of Fiscal Studies (IFS), turned out to be too optimistic.[13] Remember too that in 2007 the Conservatives were committed to matching Labour's spending plans until 2010/11. The delegation of responsibility for macroeconomic forecasting to the independent OBR will therefore not prevent this problem occurring again in the future.

Figure 3: Government and independent forecasts of tax revenues before the crisis



2 FINANCIAL SECTOR REVENUE STABILISATION ACCOUNT

In the run up to the crisis that began in 2007, financial fragility steadily accumulated during a long period of apparent stability. The widespread availability of cheap credit led to a buildup of debt. Leverage exploded, fed by financial innovation and an over-confidence in the ability of markets to hedge risk, and the ability of regulators and central banks to manage the economy. Commentators and policy makers suggested that we were experiencing a 'great moderation' in which the business cycle had been tamed.

In the light of subsequent events, the belief of many in the developed world that we had conquered the business cycle was clearly hubristic. However, the idea that 'this time is different' is a recurrent belief through economic history.[14] The work of the economist Hyman Minsky gives a compelling account of how financial fragility builds over the business cycle, culminating in crisis.[15] Long periods of stability sow the seeds of their own destruction by encouraging financial deregulation, excessive optimism and ever-greater risk taking.

With the benefit of hindsight, we can now observe a long trend (or perhaps a super-cycle) in political economy in which the lessons of the 1930s were forgotten over time. Depression-era restrictions separating investment from retail banking were eroded in the US, while in the UK, a 'light-touch' approach to financial sector regulation was pursued by Labour and Conservative governments.

It is a mistake to think that a financial crisis could never happen again. Over time, new cohorts of personnel will staff central banks, who have learned about this crisis from textbooks rather than personal experience, and who will be influenced by new intellectual agendas. Within the financial sector, a new generation of bankers will emerge, confident about the merits of their financial innovation and impatient with the fussiness of their compliance departments. Finally, future politicians, mindful of the importance of the City to British economic performance, may be swayed by persuasive arguments to relax capital adequacy requirements, to allow economies of scale to be exploited through a greater fusion of retail and investment banking, or to celebrate a merger which turns a national champion into an international behemoth, ignoring that the bank may have become too big for one sovereign to bail out alone. These processes are not inevitable, but they are not impossible to imagine over, say, the next 70 years.

The realisation that the financial crisis may reoccur lies behind many of the current regulatory reforms. However, the risk of reoccurrence also has implications for the management of public finances. If financial fragility

builds up, unnoticed or ignored, during stable economic periods, then it is possible that economic and fiscal forecasts could be out by a wide margin. In a country with a large financial sector, and with a history of housing booms and busts, we can learn from countries seeking to manage volatile natural resource revenues. Financial services have been a source of great economic strength for the UK, but they have also created volatility and risk. As such, the role played by the City in the UK economy shares some of the characteristics of a 'natural resource curse' (see Box 1).

BOX 1: NATURAL RESOURCE CURSE

While the discovery of, say, oil can be a source of great wealth for a country, it can also adversely affect economic performance in a number of ways. The term 'natural resource curse' encompasses several characteristics often present in an economy reliant on the exploitation of natural resources:

- 'Dutch disease' whereby appreciating exchange rates make other exporters less competitive, and imports cheaper, eventually leading to the shrinkage of other industries, leaving the economy ever more dependent on the natural resource.

- Volatile commodity prices can pose challenges for the management of public finances. Some developing countries find it difficult to absorb extra revenues and spend them well. Further, temporary windfalls can be confused with permanently higher revenues, leading to unsustainable increases in public expenditure.

- The presence of a natural resource can also affect a country's political economy. First, the presence of, say, oil revenues lessens the need for a government to tax its people, reducing the state's accountability to taxpaying citizens. Second, access to natural resource revenues becomes a prize for the ambitious, diverting entrepreneurial energy away from innovative business start-ups towards a rent-seeking search for political office or opportunities to dole out patronage. Even without corruption, a well-paid petroleum sector, such as Angola's national oil company Sonangol, may attract the country's best and brightest, diverting talent away from other business sectors or public service. Finally, a dominant sector may shape a country's political institutions (the 'rules of the game') to suit its sectional interests.

Many countries have attempted to avoid the natural resource curse through the introduction of revenue stabilisation funds, whereby the proceeds of oil and mining exploitation are typically invested in an array of assets to diversify income away from a single source and to extend returns after a non-renewable natural resource is exhausted. They can also play a role in mitigating the negative fiscal effects of natural resource exploitation, insulating the budget from commodity price volatility and smoothing in-

come over time.

Fiscal stabilisation funds are also used in countries and sub-national regions without natural resources or large foreign exchange reserves. Akin to contingency reserves, such funds are frequently found in American states and Canadian provinces. Virginia's Fiscal Stabilisation Fund (discussed in Box 2) was specifically established to cope with unforeseeable errors in economic forecasting. Sweden and Germany (also discussed in Box 2) have established bank stabilisation funds to pre-fund the anticipated costs of any future financial crisis.

For the UK, the government establish a Financial Services Revenue Stabilisation Account, or 'rainy day fund', with the following characteristics:

- The purpose of the stabilisation account is to create a contingency fund to help meet the costs of a future financial crisis. However, unlike the Swedish Stability Fund (see Box 2), the monies in the account could also be used for general purposes (such as measures to boost aggregate demand, for example tax cuts, or to avoid cuts to public services) rather than restricted to support for ailing financial institutions;

- The account should be only be accessed in the event of a serious financial crisis. Rather than proposing a particular formula that would allow a government to access the account (such as a certain number of quarters of negative growth or a particular definition of a bank run), the decision to access the fund should be left to the government's judgment. However, the government should be required to set out its justification in a statement to parliament and the decision should also be subject to scrutiny by the OBR and the Treasury select committee;

- The fund is intended to improve the management of tax revenues in a country with a large financial sector. However, for simplicity, payments into the account need not be explicitly hypothecated from particular revenues from the financial services sector;

- The planned size of the fund should be subject to further analysis. If the fund is only intended for use in serious financial crises, then it should be possible to allow the fund to build up slowly over time;

- The monies in the fund should be invested conservatively in counter-cyclical and liquid assets, able to withstand the asset price volatility which accompanies financial crises and which can be accessed quickly without the liquidation of the fund itself causing market turmoil.

The main downside of such a stabilisation account is the opportunity cost of locking tax revenues away. The funds invested in the account could otherwise be used for other purposes, such as investment, tax cuts or paying down the national debt. These are not trivial concerns. However, the capability to respond to a serious crisis that a rainy day fund would give a future government is sufficiently important to warrant foregoing other expenditure in the short-term. In terms of the alternative of paying down debt, it is impossible to predict the terms on which the UK may have to borrow during a future financial crisis. While current interest rates are at

record lows, during a future crisis, the UK may have difficulty borrowing or only be able to borrow at very high rates, limiting the government's room for manoeuvre in responding to any future crisis.

A stabilisation account would mitigate problems associated with forecasting errors in predicting future tax revenues from a financial services sector in which fragility may build up unnoticed or ignored. The danger of 'groupthink', when both government and independent forecasters are drawn from the same intellectual milieu, is real. However, the stabilisation account should be a complement to robust fiscal rules, rather than a substitute. These rules are therefore discussed in the next section.

BOX 2: SOVEREIGN WEALTH FUNDS AND REVENUE STABILISATION ACCOUNTS

CHILE

With a strong fiscal position due to copper mining, Chile operates a revenue stabilisation fund alongside a fiscal rule mandating that the central government budget be balanced or in surplus.

In 1985, as revenues from copper mining rose, the Chilean government introduced the Copper Stabilisation Fund. The aim was to help stabilise the exchange rate and government revenues. A rule based on estimations of the long-term copper price versus the current copper price was established to transfer a proportion of excess copper revenues into the fund (or vice versa).

Chile's Fiscal Responsibility Law (2006) authorised Chile's surpluses to be spent on recapitalisation of the central bank and created two funds: the Economic and Social Stabilisation Fund (ESSF), which replaced the Copper Stabilisation Fund, and the Pension Reserve Fund. The Pension Reserve Fund is aimed at covering future pension liabilities and is mandated to receive 0.2 per cent of GDP annually (regardless of whether the government runs a surplus or deficit). The ESSF is designed to compensate for drops in revenue, and to finance future budget deficits as an alternative to borrowing. In addition the ESSF can fund contributions to the Pension Reserve Fund when the overall central government balance is negative.[16] The ESSF is invested in low risk, liquid assets, such as bonds.

VIRGINIA, USA

Virginia operates a small Revenue Stabilisation Fund, akin to a contingency reserve.[17]

Even though the US state of Virginia has an AAA credit rating enabling it to borrow cheaply[18], following revenue shortfalls and budget cuts in the early 1990s Virginia established a Revenue Stabilisation Fund. The fund, often known as the rainy day fund, is designed to help the state manage its public finances. In the debate leading up to the fund's establishment in 1993, it was explicitly stated that, despite best efforts to improve forecasting, "given the inevitability

of forecast error, Virginia needs a strategy to cope with shortfalls which periodically result. The Revenue Stabilisation Fund, or rainy day fund proposed in this report, would be such a mechanism."[19]

Transfers into the fund are governed by a rule stating that the balance of the fund cannot equal more than a certain percentage of average annual tax revenues. A recent referendum increased that cap from 10 per cent to 15 per cent. The fund built up to about US$1.2bn in 2007, enabling the fund to play a small but significant part in responding to the fiscal challenge of the financial crisis. Analysts have calculated that drawdowns from the fund contributed seven per cent of the money used to close the budget gap which opened up when the recession hit Virginia.

SWEDEN

Sweden has a stability fund, whose purpose is strictly limited to supporting financial institutions during a financial crisis.[20]

Following the global financial crisis (and building upon Sweden's experience of dealing with an earlier banking crisis in the early 1990s), the Swedish government established a Stability Fund in 2009. The purpose of the fund, run separately from the general budget, is to pre-finance any measures to support financial institutions in the event of a future financial crisis. The fund is built up through a 'stability fee' levied on all credit institutions as a proportion of their liabilities. The fund is run by the National Debt Office, which places funds in an interest bearing account. The aim is to build up the fund's reserves to be equivalent to 2.5 per cent of GDP, the amount estimated by the government to be equivalent to the cost of a banking crisis to the economy. As the actual costs of recapitalising banks may be higher, the National Debt Office can grant the Stability Fund unlimited credit.

3 SUSTAINABLE COMMITMENTS RULE AND FISCAL MANDATE

The Labour government introduced two fiscal rules. The 'golden rule' dealt with the deficit. It stated that the current budget should be in balance or surplus as a share of national income over the economic cycle, and was described as "only borrowing to invest". In other words, the public sector could only borrow for the purposes of capital investment; current spending, for example welfare benefits and public sector wages, had to be financed from taxation and other revenues. Rather than trying to make current spending match revenues each year, the balance or surplus had to be achieved over an economic cycle.

The second rule – the 'sustainable investment rule' – dealt with the stock of debt. Public sector debt had to be kept below a certain level. This level was defined, somewhat arbitrarily, as 40 per cent of GDP.

As the scale of the response to the financial crisis became clear, the chancellor, quite sensibly, suspended these fiscal rules. They were replaced with a temporary operating rule: "to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full".[21]

The coalition set itself a 'fiscal mandate' to deal with the deficit, and a temporary 'supplementary target' for the direction of travel of public debt.

The current administration has set itself two rules: one focused on the deficit, and another covering debt (or rather, the direction of travel of the debt).

The first, termed the 'fiscal mandate', is similar to the previous government's golden rule. The fiscal mandate requires that the structural current budget must be forecast to be in balance or surplus by the end of a rolling five year forecast period. Whereas determining whether the golden rule had been met required a (hotly disputed) retrospective assessment of when the economic cycle began and ended, the fiscal mandate is forward looking and based upon a (similarly contestable) forecast of the economy and public finances in five years time.

The second, termed the 'supplementary target', is a temporary rule which states that public sector debt should be falling as a share of national income by the fixed date of 2015-16. Rather than being a ceiling on debt like Labour's sustainable investment rule of 40 per cent of GDP, the supplementary target merely states that the debt to GDP ratio should be on a downward trend by the end of this parliament.

The Institute for Fiscal Studies (IFS) has proposed that, once the supplementary target has expired in 2015-16, it should be replaced by a 'sustain-

able commitments rule'. Instead of focusing on the stock of debt, this rule would target the affordability of debt and encompass a wider view of future commitments, potentially including Private Finance Initiative (PFI) payments and public sector pensions, as well as debt interest payments. Such a rule would state that future public sector liabilities, however defined, must be kept at or below a certain ratio of GDP. The appropriate ratio would clearly depend on what commitments were covered by the rule. As an illustration, research by the IFS suggests that, if PFI payments and public sector pensions were included, a cap at around 4 per cent of GDP might provide a similar level of constraint as the former Labour government's old sustainable investment rule.[22]

Placing a ceiling on debt stems from a concern about intergenerational fairness: it limits how much future taxpayers will have to pay for the current population's spending and investment decisions. The IFS has asked two pertinent questions. First, if we are worried about the burden of payments facing future generations, shouldn't we focus directly upon the cost of servicing debt, rather than the amount of debt itself? Second, future generations also have to meet the cost of PFI commitments and public sector pensions, therefore shouldn't we include a wider set of future payments when designing fiscal rules?

A key advantage of the sustainable commitments rule is that it allows the level of public investment to be influenced by the cost of borrowing, as determined by the interest rate. When long-term interest rates are low, the cost of servicing debt falls and it is possible to borrow more to invest without incurring crippling repayments. Conversely, higher interest rates mean that the same investment project will saddle future taxpayers with a greater debt service burden.

It is currently possible for the government to lock in long-term borrowing at very low interest rates. If the government wished to borrow to invest in, say, infrastructure projects to provide a counter-cyclical boost to demand and also improve the economy's long-term growth potential, it could do so cheaply. Note that such investment spending would not increase the structural deficit, which is determined by current spending. The sustainable commitments rule, which focuses on the cost of servicing debt, would allow such decisions to be taken, whereas the current supplementary target discourages investment, as it simply requires that public sector debt be on a downward path in 2015-16. Note however, that if the government's long-term interest rates were high, then the sustainable commitments rule would discourage government investment.

Including other future commitments alongside the costs of servicing debt exposes 'hidden' repayments and is therefore fairer to future generations. It would also have a secondary advantage of minimising the distorting effect of previous and current fiscal rules on decisions about whether investment projects should be undertaken using the PFI. Decisions on how to finance investment should be based on the costs, benefits and risks of the different approaches, and not influenced by a desire to keep investment spending off the public sector balance sheet.

BOX 3: OTHER COUNTRIES' FISCAL RULES

CHILE

Chile has a single fiscal rule targeting the annual budget; coupled with a revenue stabilisation fund.[23]

Chile's most important fiscal challenge is coping with the growth and volatility of revenues from copper mining. As detailed in Box 2, the Chilean government first introduced a Copper Stabilisation Fund in 1985. Building on its experience with the fund, in 2001, Chile adopted its 'structural balance rule'. This was later codified in the 2006 Fiscal Responsibility Law as "the balance that the central government would have achieved if the economy was operating at potential, i.e. excluding the effect that the cyclical fluctuations in economic activity, the copper price, and other factors of a similar nature, may have on government revenues and expenditure".[24]

The structural balance rule does not mean that Chile seeks to achieve a balanced budget: the government has set several targets over the course of the rule's lifespan. At first, a surplus target of one per cent of GDP was set, in order to accumulate financial assets, pre-finance contingent liabilities, and re-capitalize the central bank. In 2007-08, the target was reduced to a surplus of 0.5 per cent of GDP after it was announced that the government had reached its objective for the accumulation of financial assets. The target was reduced further to 0 per cent of GDP in 2009 to allow for a counter-cyclical fiscal response to the global financial crisis. The rule was temporarily suspended in 2010 after the earthquake (estimated to have caused £20bn worth of damage[25]). The government is currently running a budget deficit, and in the 2012 budget it announced a goal of reducing the structural deficit from 1.5 per cent of GDP in 2012 to 1 per cent of GDP by 2014.[26]

SWEDEN

Sweden has two fiscal rules targeting first, the annual budget and second, central government spending, coupled with an independent fiscal policy council.[27]

Following a banking crisis and accompanying recession in the early 1990s, Sweden adopted a new fiscal policy framework comprised of the following elements:

- A 'surplus target' rule requiring a budget surplus equal to 1 per cent of GDP on average over the business cycle. This is measured using a number of indicators with a particular focus on structural net lending and is therefore adjusted for the economic cycle.[28]

- A central government spending ceiling, covering all central government and public pension expenditure. Each year this ceiling is fixed three years in advance, so that budgeting for each current year

is constrained by the target set three years previously. The aim of the ceiling is to counteract any temptation to spend extra tax revenues during cyclical upswings.

- The establishment of the Swedish Fiscal Policy Council in 2007. This body independently evaluates the government's fiscal position, makes forecasts and assesses whether the government is sticking to the fiscal rules. Note that in 2009, the council recommended additional stimulus measures over and above those proposed by the Swedish government, and also itself proposed temporary breaching of the government expenditure ceiling in exceptional circumstances.[29]

EU EUROZONE

The eurozone has two fiscal rules: one focusing on annual budgets, the other on debt.

The EU's Stability and Growth Pact came into force in 1997. It has infamously been honoured mostly in the breach. The two main fiscal rules of the pact state that:

- Government budget deficits shall not exceed 3 per cent of GDP except in particular circumstance.

- Consolidated gross government debt shall not exceed 60 per cent of GDP, or if the ratio is larger, it shall be "sufficiently diminishing" and approaching the debt limit "at a satisfactory pace".

On 2 March 2012, 25 of the 27 EU states (not including the UK and the Czech Republic) agreed a 'fiscal compact' whereby signatories need to work towards a country-specific medium-term objective with a structural deficit limit of 0.5 per cent of GDP, or 1.0 per cent of GDP for member states with a debt ratio significantly below 60 per cent of GDP.[30]

4 CONCLUSION

The City is a source of great economic strength for Britain, a sector in which we excel internationally and which, in good times, provides a healthy stream of revenue for the Exchequer. However, as recent events have clearly demonstrated, it also brings with it fragility and risk.

In addition to regulatory reform to reduce the likelihood of a financial crisis occurring again, Labour should acknowledge that crises are difficult to predict and economic forecasting prone to error. Labour should therefore commit to establishing a rainy day fund over the medium term, to reduce the vulnerability of the UK's fiscal position to risk from the financial sector and ensure that any future government is better placed to take action during a crisis. Such a commitment would send a clear political signal that the Labour party is committed to securing Britain's long-term economic future and maintaining fiscal and financial stability.

Retaining the fiscal mandate for the deficit is also important. The fiscal mandate is essentially a forward-looking version of Labour's golden rule. While it has certain weaknesses (for instance, it is possible to keep pushing meeting the target forward to the end of the five year horizon without ever reaching it), no rule is perfect, and independent forecasting by the OBR should help to give the rule credibility.

The next government should also replace the temporary supplementary target with a sustainable commitments rule, as suggested by the IFS. Detailed work would be required to determine which future commitments should be included within the scope of the rule, the level of the target (as a percentage of GDP), and the date by which the target should be reached. However, such a rule has the potential to promote better borrowing and investment decisions and to reveal more clearly the burden being placed on future generations.

Finally, in the short term, we remain in the middle of a financial crisis. It may be necessary to suspend the fiscal mandate temporarily in order to jump start the economy out of the current stagnation. Fiscal rules are intended to enhance fiscal credibility for the wider purpose of promoting economic prosperity, not to undermine the economy by artificially reducing the UK's room for manoeuvre during a time of crisis.

Endnotes

1 The terms 'debt' and 'deficit' are sometimes used interchangeably, leading to some confusion. Debt is a stock while a budget deficit or surplus is a measure of flow. Each annual budget is either in surplus, therefore leading to a reduction in the total stock of debt, or in deficit, adding to the total stock of debt.

2 ONS, Public Sector Finances Statistical Bulletin, June 2012, http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/june-2012/stb–june-2012.html

3 ONS, Public Sector Finances Statistical Bulletin, June 2012, http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/june-2012/stb-–june-2012.html

4 It is worth re-emphasising the severity of the crisis. The UK suffered its first bank run in 150 years. The collapse of Lehman Brothers, the largest bankruptcy filing in US history, triggered panic. There was a dramatic fall in economic confidence around the world. In Japan, industrial production declined by 8.5 per cent in just one month in November 2008, while German exports fell by over 10 per cent. The US experienced its fastest rate of job losses in over 60 years, as over a million jobs were lost in the final two months of 2008.
Source: Mervyn King, Speech to Nottingham CBI, 20 January 2009 available at
www.bankofengland.co.uk/publications/Pages/speeches/2009/372.aspx

5 ONS, Public Sector Finances Statistical Bulletin, June 2012, http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/june-2012/stb–june-2012.html

6 Financial and insurance services in the UK grew from below 6 per cent of output (Gross Value Added) in the early 2000s to a peak of around 10 per cent in 2009.
Source: Broughton, N., The financial sector's contribution to the UK economy, (2012) House of Commons library briefing paper, http://www.parliament.uk/briefing-papers/SN06193.pdf).
Among EU countries, only Luxembourg and Ireland had larger financial sectors as a proportion of GDP.
Source: Table 2.8 in The Value of Europe's International Financial Centres to the EU Economy, City of London, available at http://bit.ly/SLrw0K

7 PwC/City of London, The Total Tax Contribution of UK Financial Services, December 2011, Figure 2.
In addition to corporation tax, other taxes paid by the financial sector include business rates, employer's national insurance contributions (NICs), income tax and NICs paid by employees, and irrecoverable VAT. The PWC data is based upon extrapolations from a survey, rather than actual receipts. However the results are not inconsistent with the pattern from receipt-based analysis by HMC of PAYE and Corporation Tax receipts from

the banking sector: Pay As You Earn and Corporation Tax receipts from the banking sector, HMRC, August 2011, available at http://www.hmrc.gov.uk/stats/banking/intro.pdf.

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11 OBR estimates, quoted in IFS, Green Budget 2012, p.52

12 Office of Budget Responsibility, Economic and Fiscal Outlook, March 2012, p.5

13 While independent fiscal forecasters, such as the Institute for Fiscal Studies, did identify a small structural deficit, with the benefit of hindsight, they admit that their own estimates were also too optimistic: "The judgment of IFS researchers in the January 2008 Green Budget was that the Treasury's forecasts for public borrowing at that time were actually a little optimistic given its expectations of economic growth. However, the size of the structural hole identified by IFS researchers then was only about one-tenth of the size of the structural hole that is now thought to exist."
Source: Footnote 1, Chapter 2 IFS Green Budget, 2011, p.33. Available at http://www.ifs.org.uk/budgets/gb2011/11chap2.pdf

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About the Fabian Society's Next Economy programme

With the British economy still in the doldrums, the Fabian Society's Next Economy programme is asking how to revive economic growth? But it also poses a far more fundamental challenge; what kind of economy we want to build for future generations?

We need to address how the economy can deliver not only growth but also fulfil social democratic aims and ensure a fairer society where opportunity and prosperity is distributed more widely.

A RAINY DAY FUND

WHY BRITAIN NEEDS A FINANCIAL SECTOR REVENUE STABILISATION ACCOUNT

Victoria Barr and Nick Donovan

The UK was hit particularly hard by the financial crisis, partly because it has a large financial sector relative to the size of the economy. The City is a great economic asset for Britain, but it is also a source of fragility and risk. In this regard, it shares some of the characteristics of the 'natural resource curse' where the discovery of natural resources, like oil, brings great wealth to a country, but also fiscal volatility and other undesirable side effects.

Countries often seek to mitigate these risks by creating a revenue stabilisation fund, which aims to smooth income over time and insulate the rest of the economy from the impact of natural resources exploitation.

This report proposes that the UK should establish a financial sector revenue stabilisation fund or a 'rainy day fund'. Once such an account has built up over time, it would act as a contingency fund in the event of a future financial crisis.

The stabilisation fund would reduce the vulnerability of the UK's fiscal position that results from its large financial sector, and would ensure that the government is better placed to take action during future crises.

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