

The Resolution Foundation's proposed method for endin...

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For reasons I am not sure of, I missed the publication by the Resolution Foundation [of its report entitled 'Built to last: Towards a sustainable macroeconomic policy framework for the UK'](#) on 19 October this year.

The recommendations in that report are now repeated in its new book, '[Ending stagnation: A New Economic Strategy for Britain](#)'.

Summary

This is a longish post, so let me summarise what I will say in advance.

The Resolution Foundation says in this report is that the UK government must run its affairs as if it is a household expecting to endure hard times and, as a result, it must save up in most years (three in four, they suggest) by putting money aside by running fiscal surpluses so that when that proverbial rainy day arrives the funds to deal with it might be available.

In response, I suggest that the assumptions inherent in this would have been familiar in the gold standard era of the 1930s, and the outcome would be similar: this is a recipe for economic disaster for the UK that is built on the basis of almost total macroeconomic illiteracy. Far from ending stagnation, this report prescribes recession.

Resolution Foundation key findings So bad are the Resolution Foundation's comments that I think they are best summarised [using their own words in the Key Findings section of their post supporting this report](#):

* **Since the financial crisis, public sector net debt has nearly trebled, rising from just 36 per cent of GDP to around 100 per cent, an unprecedented peace-time rise. A key driver has been the role played by fiscal policy in supporting the economy a series of major economic shocks.**

* **If fiscal policy continues to support the economy each time the UK goes through a downturn, governments will need to run a budget surplus in good times to ensure a stable level of debt in the long run. Based on the average size of fiscal support in post-war recessions, this would require a primary**

surplus of 3 per cent in three out of every four years, something that has only been done in three out of the past 50 years.

- * If we return to a world of low average interest rates, the Bank of England's headline policy rate is estimated to hit the zero lower bound once a decade. Raising the inflation target from 2 per cent to 3 per cent, and paving the way for negative rates of up to -1 per cent, could reduce our chances of hitting the lower bound to once a century.**
- * Better-targeted fiscal support would have saved £35 billion through the pandemic and cost of living crisis, saving the Government around £1 in every £5 spent on support during that period.**
- * Our analysis suggests that avoiding the lower bound, slightly reducing the average size and frequency of fiscal interventions through better-targeted fiscal policies and improved risk management, would mean that a 1 per cent surplus, rather than 3 per cent, would be sufficient to put debt on a gently downward path in the long-run. This would still be challenging, but would be much more in line with the experience towards the end of the 20th century, when we ran a surplus of 1 per cent or more in three out of every five years.**

Commentary

Let's be clear what this means. The Resolution Foundation authors clearly think:

- * That the government cannot create money, or must not do so. The net effect is the same.**
- * That the government must be managed as if it is a household that has been denied credit.**
- * The government must save in advance of spending so that deficits are avoided.**
- * Deficits must be avoided.**
- * Fiscal surpluses are themselves without economic consequence.**

I could expand that list, but I do not think I need to do so to show just how dangerous this proposal is. They might not be explicit about those assumptions in the way I am, but they are all implicit in their work. Those claims must be rebutted.

a. Money creation

As a matter of fact, a government with its own currency and central bank (as is the situation in the UK) can create money whenever it is required and take it out of use if it so wishes.

As a matter of fact, new money creation in the UK happens whenever a government spends more into the economy than it collects through tax revenues raised.

A very important caveat is required, however. That is that if the excess funds injected into the economy as a result of a government running a deficit are then placed on deposit with that government in structured savings accounts, whether represented by bond issues or deposit accounts, then the excess funds created are taken out of circulation within the economy, resulting in no significant inflation risk arising. This is most especially the case if the deposits made are of a long-term nature. Private wealth might have increased as a result of the deficit spending but the actual quantity of money in active circulation might not have done so, depending on multiplier effects.

There can, then, only be an inflation risk arising from deficit spending not matched by deposits made. This happened during the quantitative easing programmes from 2009 until 2016, and again from 2020 to 2021. This point being made, there is no evidence that those quantitative easing programmes did result in inflationary pressure arising within the economy of the UK.

The Resolution Foundation is wrong in that case to think that government created money is ever in short supply. The whole logic that underpins its work, that is premised on this being the case, is simply untrue.

b. Household analogy

The idea that a government must run its economy as if it were a household is absurd. Households, by definition, have to settle the liabilities that they owe to third parties as they fall due making use of money that they can themselves secure from third parties either by earning income or by borrowing. The same is true of all business entities and other organisations, except for a central government with its own currency and central bank. A government in that position is entirely unlike any other organisation within an economy for three reasons.

Firstly, such a government can always create any sum of money that it requires to settle any liability that it owes whenever it wishes by issuing an instruction to its central bank to create the funds in question. That is a legal action on its part that is only available to it within any jurisdiction that sets it apart from all other organisations in that place. To pretend that this exceptional capacity does not exist is to propose that economics be based on false assumptions.

Secondly, such a government not only can create money at will to settle liabilities it owes, but it must also do so as a matter of fact. The only way in which government-created currency enters circulation within an economy is when the government in question makes expenditure in excess of its income and leaves some of that resulting currency in circulation for use within the economy for which is responsible as a means of exchange. If government does not provide this essential liquidity to the

banking sector within that economy, private sector transactions will necessarily be constrained either as to their extent or value in ways that are likely to prejudice the growth of the economy in question.

Thirdly, and given that most governments seek to promote both real and nominal growth within their economy, i.e. they wish to grow the actual volume of trade undertaken in their jurisdiction in real terms, as well as promoting modest increases in the prices at which that trade is undertaken over time, a government has to inject additional funds into the economy for which it is responsible by deficit funding unless it wishes that the whole of the additional funding required will be provided by private sector borrowing from commercial banks, which is an ultimately unsustainable trajectory for fiscal stability.

For these reasons to promote the idea that governments must as a matter of policy withdraw money from the economy in most years is not just unnecessary, but recklessly irresponsible.

c. A government must save before it can spend.

This suggestion, which is deeply implicit within the recommendations of the Resolution Foundation, is profoundly mistaken. There are three consequences.

The first is that the Resolution Foundation thinks that a government must extract a surplus out of the private sector economy of the jurisdiction for which it is responsible before it might spend that surplus for private benefit. This is straightforwardly wrong. Not only can a government with its own currency and own central bank by definition fund its expenditure without extracting any value from a private sector economy if it wishes (which it would rationally seek to do if that economy had reached a position of less than full employment) but it also implies that at no time should a government borrowed to invest when this is a completely normal course of action in the rest of a modern economy. Why a government should be denied access to the option of borrowing when the rest of the modern economy functions on the basis of the availability of credit is hard to work out.

Secondly, this idea imposes the constraint upon the government that it should not seek to fiscally intervene within its economy to stimulate economic activity even though this stimulus has been the normal basis on which growth has occurred in the entire post 1945 era. The suggestion does, therefore, necessarily take the economy back to the pre-war era by effectively imposing ideas derived from gold standard thinking. That standard assumed that money supply was necessarily constrained by the artificial requirement that a currency be capable of translation into the gold reserves of the jurisdiction. That limited the quantity of spending a government could undertake out of the available currency available for that purpose. The result of that policy being pursued at that time was the Great Recession of the 1930s. The policies that the Resolution Foundation are now proposing would likely have exactly the same effect,

with the government acting as a continual drain on the private sector by seeking to withdraw value from it in most years, rather than enhancing its role within the active economy.

Thirdly, and rather bizarrely, this policy would both reduce the amount of government-created money circulating within the economy and simultaneously reduce the availability of secure, government-backed savings opportunities available within the economy, upon which the banking, insurance and pension markets are entirely dependent for their stability. It would also reduce the opportunity for overseas governments to save in sterling in the UK. The resulting risk of financial instability is high. Why any government would choose to create this risk is hard to work out.

Deficits must be avoided

For all the reasons already noted, this policy makes no sense at all. The suggestion that a government runs a surplus the majority of the time has implicit within it the idea that a government should continually extract value from the private sector economy rather than add to it. Why anyone would wish a government to impose a burden of this sort on a society, meaning that the society in question will necessarily be significantly constrained by that chosen action by the government, is very hard to work out, most especially when it is wholly unnecessary.

Fiscal surpluses are without economic consequences.

There is a very good reason why very few governments run fiscal surpluses, and all of them are good. The government running a fiscal surplus:

- * Deflates its economy.
- * Reduces private wealth within the economy.
- * Creates the risk of financial stability in that economy by reducing the availability of credit within it.
- * Refuses to supply the services that it might make available for the people of the jurisdiction for which it is responsible even though it is possible to supply them.
- * Creates the risk of unemployment.
- * Denies pension funds and other critical financial institutions the opportunity to save their funds in the way that they need to do so denying them the chance to fulfil their obligations within society.

There is no reason for any government to take the risks that fiscal surpluses create. They have the freedom to run a deficit whenever they wish. What is more, the compelling evidence of UK government deficit funding is that the resulting outcome is financial stability, growth, long-term periods of controlled inflation, high employment,

and the provision of essential government services as well as a vital social safety net.

Conclusion

The proposal that the Resolution Foundation has made is based upon a classical view of the economy that is well to the right of most neoliberal economic thinking. It reveals almost no understanding of the nature of money, the role of government with regard to money, the nature and function of a central bank, the positive contribution of government to an economy, or the need for deficit creation to inject essential liquidity to minimise risk in any growing modern fiat currency based economy. In fact, the policy does in itself imply that the Resolution Foundation is not even sure that we should have a fiat-based currency and does instead prefer the idea that the money supply should be constrained by some form of artificial constraint on credit creation.

Whatever the reason for this extraordinary lack of economic understanding, the Resolution Foundation's credibility is fundamentally undermined by the recommendations that it makes because they are deeply dangerous. If adopted by any government, this policy suggestion would cause profound harm to the well-being of the people of this country.

It is rare to see anything so ill through being proposed by a supposed centre/left-of-centre tank, although after making this proposal it is hard to see how any such label might be attached to the Resolution Foundation ever again. I sincerely hope that Resolution Foundation will have the sense to withdraw this report as soon as possible. If they do not do so, their credibility will be in tatters.