Developing a Conservative Macroeconomic Framework

CONSERVATIVES

Change to Win

Win for Britain

A TRIPLE-LOCK ON STABILITY

A strong macroeconomic framework

The Conservative Party supports a strong macroeconomic framework that promotes and safeguards economic stability.

A strong macroeconomic framework consists of institutions that guarantee independent monetary policy and a sustainable, credible and transparent fiscal policy based on sound economic judgments.

The Conservative triple-lock on stability consists of:

- An independent Bank of England
- Independent assessment of fiscal rules
- Independent statistics

This paper outlines the Conservative approach to incremental improvements to the macroeconomic framework that has been developed by both political parties since the early 1990s.

The current framework

The current macroeconomic framework has evolved since the early 1990s. The introduction of inflation targeting, and of the independent **Inflation Report** in 1992 the basis of the current system. During 1993-7, fiscal policy followed a 'growth rule' to ensure that the public finances were sustainable and that interest payments were reduced.

This framework led to the so-called "golden economic inheritance" that greeted Gordon Brown on his arrival at HM Treasury in 1997. That inheritance consisted of healthy public finances, a budget surplus, low and falling debt, low interest rates, and inflation of just 1.5%.

The framework was built on by Labour through the operational independence of the Bank of England in 1997, and the introduction of the fiscal rules in 1998.

The "golden rule" states that over the economic cycle borrowing can only be used to fund investment, rather than current spending. The "sustainable investment rule" states that net debt should remain at less than 40% of GDP.

Even at the time, the rules contained a theoretical weakness. Because HM Treasury retained control over key assumptions that underpin them – for example the length of the cycle and the definition of investment – the potential existed for the rules to lose credibility due to political interference.

Credibility of the Golden Rule

It is now clear that this theoretical weakness has become reality.

The current fiscal rules now suffer a serious and growing problem of public credibility. Citing data revisions, in July the Chancellor of the Exchequer announced a change in the timing of the economic cycle at a meeting of the Treasury Select Committee, in an ad-hoc manner without prior discussion or consultation, and without a formal statement to the House of Commons. This was an inappropriate way to announce such a sensitive change.

The effect of this change was to make it unlikely that the golden rule would be broken in the present cycle, thus preventing political embarrassment for the Chancellor. On the following day, data on the Public Finances were released showing that the UK was in deficit on the golden rule under the old definition.

Chart 1 shows the cumulative current deficit under the golden rule before and after the changes made in July.

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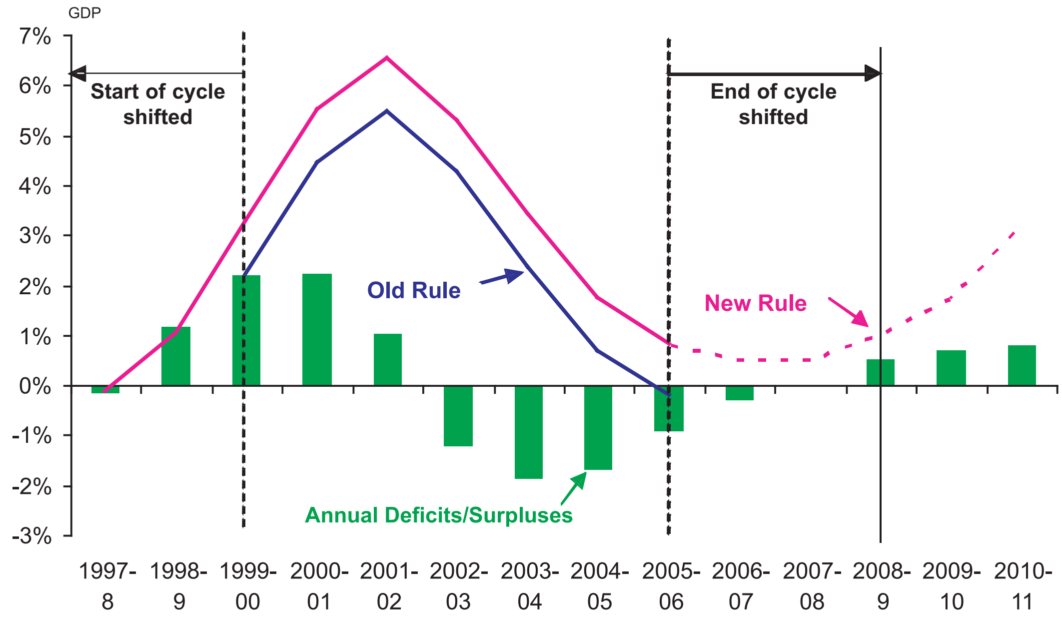
Given that the current assumption is that the cycle will end in 2005/06, the Chart shows that the golden rule would be broken if the underlying assumptions had not been changed.

In the Pre-Budget Report in December, the Chancellor reduced his credibility even further by redefining the cycle again – a change described by the Institute for Fiscal Studies as "arbitrary". Figures in the PBR showed that had Brown not changed the timing of the cycle in July he would have broken his golden rule by £2.5billion.

Chart 1: Cumulative current budget surplus



The effect of this change has been evident. In October, the independent National Institute of Economic and Social Research (NIESR) described the fiscal rules as "discredited", and announced that they would no longer continue to assess the golden rule because of "the arbitrary redefinition of the cycle."[1]

Press commentary has increasingly focused on the lack of credibility in the golden rule due the redefinition of the length of the cycle. The **Economist** said on July 21st in relation to the redefinition that "this [change] is all about politics: Mr Brown made a totem out of his rules and, now they have become inconvenient, he is sacrificing them." This underlines the extent to which the credibility of the golden rule, and of the broader framework, has been undermined by the redefinition.

On 5 December the National Audit Office expressed reservations about the change to the cycle, saying there is "considerable uncertainty" over how the economic cycle is measured. HM Treasury had failed to provide the NAO with detailed papers relating to the background to the change.

From a purely economic perspective, however, the redefinition was cosmetic and made no difference to the fundamental fiscal performance of the economy. As the Governor of the Bank of England remarked in August: "If you change your view of what happened seven or eight years ago, it doesn't change the underlying fiscal position." [2]

The redefinition does not improve the credibility of the UK's fiscal position with the financial markets, with industrial companies or with independent commentators. On the contrary, it weakens credibility, since it shows a previously unsuspected willingness to alter a clear, accepted and stable framework for short-term political advantage.

1 National Institute for Economic and Social Research, Economic Review number 194, October 2005

2 Speaking at the August Inflation Report press conference:
http://www.bankofengland.co.uk/publications/inflationreport/2005.htm#

Credibility of the Sustainable Investment Rule

The credibility of the sustainable investment rule has also been brought into question because of off-balance sheet accounting treatment of some major contingent liabilities. There is currently over £138 billion of PFI debt, of which Capital Economics estimate that a further £25 billion of PFI liabilities should be brought onto the balance sheet, as well as £17 billion of Network Rail liabilities. Together these total over four per cent of GDP.[3] The Institute for Fiscal Studies estimates that without a change in policy, the sustainable investment rule "is likely to be breached in 2008-9".[4] But were the additional off-balance sheet liabilities to be included, the rule would be breached sooner. Morgan Stanley estimate that net debt will be 39% of GDP by the year end, "even without assuming that more 'off-balance sheet' financing is reclassified as public sector investment – thus adding to public debt."[5]

Further, once public sector pension liabilities are added, research estimates that total Government liabilities amount to 1.3 trillion, or more that 100% of GDP.[6] The sustainable investment rule covers under two fifths of total Government liabilities – only a part of total Government debt.

A Conservative approach

The Conservative Party supports a strong macroeconomic framework that promotes and safeguards economic stability, including low inflation, low interest rates, high employment, and high and sustainable income growth. A strong macroeconomic framework consists of institutions that guarantee independent monetary policy and a sustainable, credible and transparent fiscal policy based on sound economic judgments.

The Conservative triple-lock on stability consists of:

- An Independent Bank of England
- Independent assessment of the fiscal rules
- Independent statistics

These three measures together will ensure that the key macroeconomic policy decisions are taken for the best long term interest of the UK economy.

An Independent Bank of England

Conservatives support the independence of the Bank of England.

Inflation targeting by an operationally independent Bank of England is the first pillar of macroeconomic stability. We will ensure that decisions are wholly independent of political influence, are transparent and taken in Britain's long term economic interest.

Fiscal stability is the second pillar of macroeconomic stability. However, confidence in fiscal stability has been undermined by the discredited fiscal rules, and the lack of transparency in Government accounts.

Independent assessment of the fiscal rules

Conservatives will set up an independent panel to judge the golden rule.

To ensure stable, sustainable and credible fiscal policy, low debt, and therefore low interest payments, we will make the golden rule meaningful. A credible golden rule would ensure that the Chancellor operates a sustainable fiscal policy, and so ensure that fiscal policy retains the confidence of investors. This confidence in turn serves to keep the risk premium on Government debt, and hence the level of interest payments low.

Judgments of the assumptions behind the fiscal rules will therefore be performed by a Fiscal Projections

3 Capital Economics ***UK Economic Focus*** 10 March 2005
4 Robert Chote, "Is Brown dropping the ball?" Public Finance Magazine 11 November 2005
5 Morgan Stanley Fiscal Outlook, Vincenzo Guzzo and David Miles, 15 November 2005
6 UK Public Sector Net Debt, ***The Conservative Party***, 5 December 2005

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Committee. So economic assumptions such as the start-date and end-date of the cycle and the growth forecasts implicit in the projection would be made independently of the Chancellor of the Exchequer. This would go some way to restoring credibility to the rule.

Gordon Brown called for this himself when in 1995, he called for a "panel of independent forecasters" to assess the proposed golden rule.[7]

Independent statistics

On 24 November, George Osborne wrote to the Chancellor of the Exchequer calling for independent National Statistics. We therefore welcome the Chancellor's announcement on 28 November that HM Treasury will take up our proposal and we will monitor carefully that statistics are granted full independence from political interference.

Five questions remain following the Chancellor's announcement of the Framework for National Statistics:

- Who will appoint the National Statistician?
- Will the National Statistician, like the Comptroller and Auditor General, be an officer of the House of Commons?
- Who will appoint the external members of the Governing Board and will they be in a majority?
- Will the National Statistician be given responsibility for preparing the National Accounts, so that an independent view is taken of things such as PFI, Network Rail and public sector pension liabilities?
- Will the National Statistician be given responsibility for labour market analyses?

Genuine independence will bring credibility to Government statistics. This will in turn improve the standing of the Sustainable Investment Rule, which is discredited by the Government's use of off-balance sheet financing.

As HM Treasury has stated: "the credibility of a policy framework depends on clearly defined long-term policy objectives, a high degree of openness and transparency and policymakers' accountability to Parliament and the public. Accountability, openness and transparency all work together in a mutually reinforcing way to enhance the credibility of the policy framework."[8]

Furthermore, in HM Treasury's Code for Fiscal Stability, the first principle calls for: "transparency in the setting of fiscal policy objectives, the implementation of fiscal policy and in the publication of the public accounts."[9]

The independent ONS should publish a fully transparent Government Balance Sheet. Research has estimated that a full balance sheet would show net Government debt of £1.3 trillion, including public sector pension liabilities of £650 million.

Transparency will not change the economic fundamentals—these liabilities must still be met by the exchequer in due course. But in this crucial dimension the national accounts do not now convey a true picture, and this lack of transparency damages the fiscal framework overall.

7 Speech to Labour Party Finance and Industry Group, May 17 1995
8 Budget 2000, HM Treasury
9 The Code for Fiscal Stability, 1998, HM Treasury

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