CENTRE *for* ECONOMIC PERFORMANCE

ELECTION ANALYSIS

Macroeconomic Assessment: Interest Rates, Taxes and Spending

- The UK economy has performed well in recent years. Between 1997 and 2003, the UK had the highest and most stable per capita income growth of the G-7 countries. The government claims that monetary and fiscal policy innovations played a role in this comparative success.

- In the monetary area, since 1997, the Bank of England has been allowed to set interest rates in pursuit of a government-dictated target for inflation. In the fiscal area, the government introduced two rules in 1998: (i) the 'golden rule', which requires borrowing only for investment over the economic cycle; (ii) the 'sustainable investment rule', which limits net debt to 40% of national income.

- The monetary policy framework has performed well by historical standards. Inflation has remained close to its target level. Inflation expectations have also converged to the target, suggesting that policy is credible. This has probably contributed to a drop in unemployment, by moderating wage demands.

- Fiscal policy is more controversial. The golden rule seems likely to be met over the current cycle but it is vulnerable to claims of 'fudging' because the government maintains several degrees of freedom in assessing compliance. Nevertheless, it seems to have aided fiscal discipline compared with previous periods.

- Whether the golden rule is narrowly met or narrowly missed in this cycle, or whether there is a degree of 'fudging', is largely unimportant from a macroeconomic perspective. This is because any deviation from the rule is likely to be small. In a world of uncertainty and external economic 'shocks', any government would be unwise to set policy to hit the golden rule with 100% certainty.

- The Labour government's monetary and fiscal policy frameworks have contributed to the current stable economic climate. But the structural reforms introduced by the previous Conservative administration also played a positive role.

- The difference between the two parties' plans up to 2007/08 is small: the Conservatives propose a tax burden equivalent to 40.1% of GDP compared to 40.4% under Labour. The Conservatives propose deeper 'cuts' in the subsequent four years, equivalent to two percentage points of national income by 2011/12. This is the source of the '£35 billion cuts'.

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Introduction

The UK economy has performed well in recent years by international and historical standards (see Figures 1 and 2). Growth in average income (GDP) per person between 1997 and 2003 was higher in the UK than in any other G-7 country except Canada. The UK's growth was also the most stable of all the G-7 countries.

Comparison with previous periods (1992-96 and 1979-91) confirms the improvement over time. Figure 2 shows that the UK enjoyed the lowest rate of unemployment in the G-7 between 1997 and 2003, again an improvement on its previous performance. UK inflation was higher than in the other countries, but inflation was very low in all countries.

Numerous government policies – including tax and labour market reforms, business regulation and education policies – will have shaped performance over time.[1] This analysis focuses on monetary and fiscal policies.

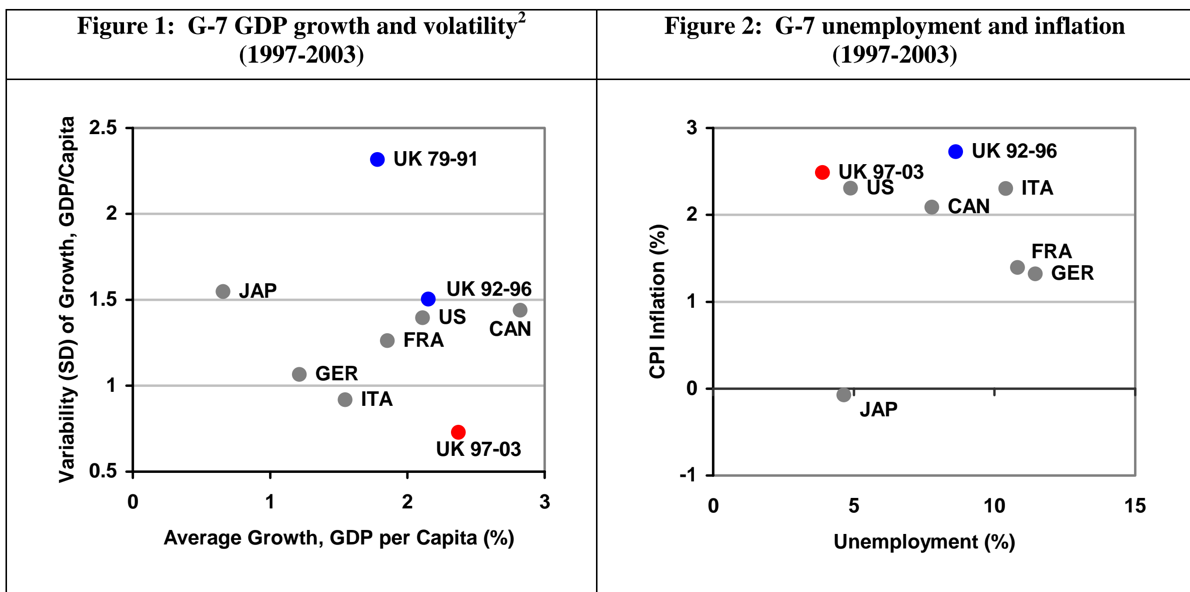


Figure 1: G-7 GDP growth and volatility[2] (1997-2003)

Figure 2: G-7 unemployment and inflation (1997-2003)

Source: International Monetary Fund, *International Financial Statistics*. Data for G-7 countries for 1997-2003.

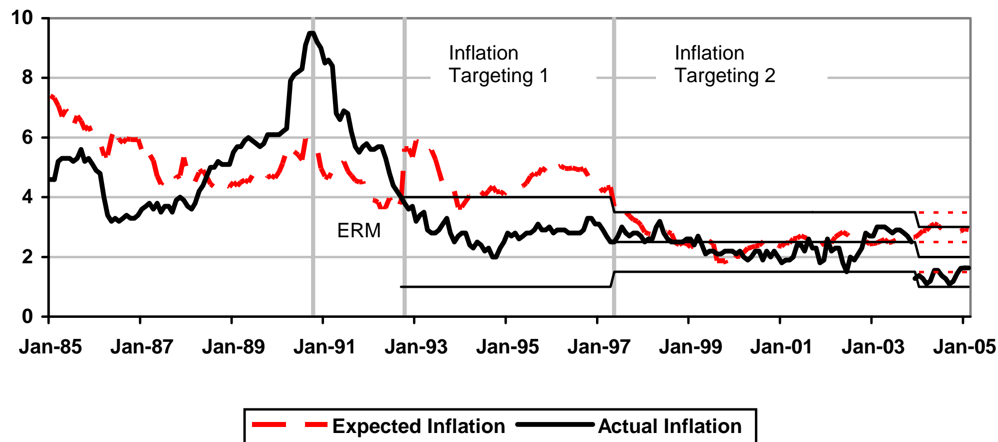
Monetary policy

In the 1970s, unemployment and inflation rocketed up together. This 'stagflation' demonstrated that policy-makers should set some credible target to achieve price stability. In the 1980s and 1990s, the Treasury experimented with targeting the money supply, the exchange rate and finally inflation itself.

The incoming Labour administration introduced the present framework in May 1997: a symmetric inflation target set by the Treasury; and a fully independent Monetary Policy Committee (MPC) charged with setting interest rates.

[1] Pissarides (2003), however, argues that tax policies – in particular, taxes on wages – have had little impact, at least on unemployment, in OECD countries.
[2] UK data for other periods also shown for comparison (1979-1991 not shown in Figure 2 as it is a significant outlier in terms of inflation at 7.9% per year).

Figure 3: Inflation, inflation targets and inflation expectations 1985-2005[3]



Source: Bank of England and National Statistics (http://www.statistics.gov.uk/rpi).

Figure 3 illustrates inflation performance over time. Prior to 1990, *ad hoc* policy-making was associated with high and variable inflation. Despite a costly recession in the early 1980s, inflation was higher when the UK joined the ERM[4] in 1990 than it had been during the 'winter of discontent' of 1978/79. ERM membership drove down inflation. Crucially, expected inflation also fell, suggesting that the policy enjoyed credibility.

The inflation targeting regime introduced in 1993 following the UK's exit from the ERM succeeded in reducing inflation further, even while the economy expanded strongly. Yet inflation expectations – measured by the difference between the expected interest rates on nominal and inflation-indexed government debt – largely remained above the 1-4% target range. This suggests that the policy lacked credibility.

Compared with these previous periods, the post-1997 period has seen the lowest and most stable inflation, within the target range throughout the period. Moreover, the crucial contribution of the current arrangements is the greater credibility associated with the independent MPC, reflected in the steep fall in expected inflation.

The Conservatives promise to keep the existing system. The Liberal Democrats propose to allow the Bank to choose its own inflation target rather than merely setting interest rates in pursuit of a Treasury-dictated target. This enhanced independence for the Bank would bring it in line with its European and US counterparts. But there is no evidence that this 'target independence' delivers lower inflation or more stable growth. Having the Bank choose the policy target could also make it harder to co-ordinate monetary and fiscal policy,[5] and would reduce democratic accountability.

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[3] The inflation target is defined in terms of the retail price index minus mortgage interest payments (RPI-X) except for December 2003-February 2005, following the move to the harmonised index of consumer prices (HICP). Note that the target for the HICP measure is 2% ± 1%, compared to 2.5% ± 1% for RPI-X. The 1997-2003 target bands are also shown for the later period to compare against expected future inflation, which continues to be measured via RPI-X.

[4] The ERM – or the Exchange Rate Mechanism of the European Monetary System – is a system of fixed exchange rates for European currencies, which has largely been superseded by the creation of the euro.

[5] Buiter (2000)

Fiscal policy

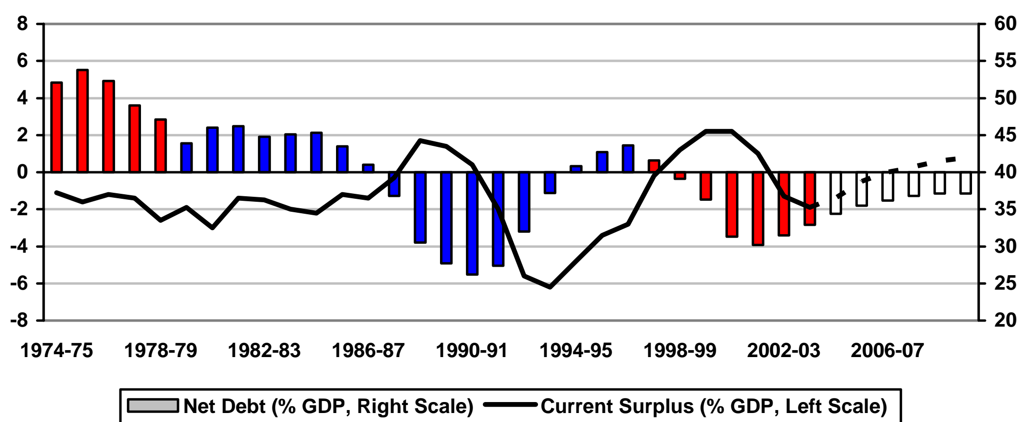
Having introduced a rules-based framework for monetary policy in 1997, the Labour government introduced a similar approach to fiscal policy in 1998. Policy is framed around two rules:

- The **golden rule**: government should borrow only to invest over the economic cycle.
- The **sustainable investment rule**: public net debt should be maintained at a 'stable and prudent level', defined as 40% of national income (GDP).

The sustainable investment rule is fairly uncontroversial, largely because there is little chance of it being breached in the near future (see Figure 4 and Table 1). The golden rule implies that, over the course of the economic cycle, the average current surplus (the excess of revenue over expenditure) as a percentage of GDP should be positive. Its purpose is twofold: to remove any bias against capital spending; and to ensure fairness between generations by ensuring that today's consumption is not funded by tomorrow's taxpayers.

The golden rule is more controversial as there is a non-negligible chance that it may be missed.[6] There is also more suspicion that the rule provides excessive 'wiggle room' (in defining the economic cycle, for example), which will let the government 'fudge' the question of whether the rule is breached.

Figure 4: Fiscal performance 1974/75-2009/10[7]



Source: HM Treasury, Public Finances Databank
(http://www.hm-treasury.gov.uk/media/C62/B0/March05WEB.xls)

The fiscal rules have been criticised by both the Conservatives and the Liberal Democrats on the grounds of 'fudgability'. The Conservatives have promised to create an independent body to implement the rules, so that 'the Chancellor will no longer be able to hide behind fudged figures.'[8] Liberal Democrats propose greater powers of scrutiny for the National Audit Office (NAO), 'so that no Chancellor can fiddle the figures.'[9]

Options for delegating some of the Treasury's powers to an independent institution range from the present situation, where the NAO assesses the key forecasting assumptions that lie behind the fiscal estimates, through to full delegation of all tax and spending decisions.

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[6]The IFS estimated in March 2005 that the government should meet the rule with £6 billion to spare, corresponding to a 63% chance of meeting the rule.
(http://www.ifs.org.uk/budgets/budget2005/pubfin.ppt).

[7] Debt is colour-coded according to the party in power (red/blue) or projections (white). Downwards pointing bars indicate net debt below the 40% target. Current surplus is a Treasury projection for fiscal year 2005/06 onwards.

[8] 'Action on the Economy', Conservative Manifesto 2005, Chapter 4.

[9] 'Prosperity at Home and Abroad', Liberal Democrat Policy Briefing 9.

The proposal to create an independent fiscal body with a purely advisory forecasting role is reminiscent of the mid-1980s monetary policy regime, under which the Bank made public its outlook for inflation but the Chancellor retained responsibility for setting interest rates. Under the 1993-97 monetary regime, inflationary expectations consistently overshot the target. It was the 1997 decision to delegate control over policy, rather than merely the power to advise or evaluate, which delivered credibility. A fiscal 'Ken and Eddie Show' is unlikely to yield significant credibility gains.[10]

Table 1: Fiscal performance 1979/80-2005/06[11]

	Fiscal rules 1998-2005	Current cycle 99/00-05/06	Previous cycles 79/80-85/86	86/87-96/97
Current surplus/deficit (% GDP)	≥ 0.0	0.0	-1.9	-2.1
Net debt (% GDP)	≤ 40.0	33.2	45.0	35.0

Source: HM Treasury, Public Finances Databank (http://www.hm-treasury.gov.uk/media/C62/B0/March05WEB.xls).

Does it matter if the golden rule is breached?

The most frequently heard criticism of the government's fiscal performance is that the golden rule will be breached over the current economic cycle. But how much does this really matter? The 'safety margin' for meeting the rule has certainly declined over time, making a breach more likely. But in a world of uncertainty, to reduce the probability of breaching the rule towards zero, the Treasury would need base its projections on a 'worst case scenario'.

Generally speaking, this worst case would not arise, and the government would be left with a massive current surplus over the cycle. In fact, an estimated average current surplus of 2¼% of national income would be needed for a 1% probability of breaching the rule, which could be 'very costly from macroeconomic and intergenerational perspectives.'[12]

Taking a worst case scenario,[13] assume a deficit of 2.2% of national income in the current fiscal year (there is a 90% chance that the actual out-turn will be better than this). Even with this pessimistic assumption, the golden rule will only have been breached by 0.2% of total national income over the cycle. In macroeconomic terms this is small beer. It compares well with the two previous cycles, when the rule (had it been in place) would have been breached by around 2% of GDP. Whether the rule is narrowly met or narrowly breached is largely immaterial, what matters is the enhanced fiscal discipline it appears to have delivered.

[10] The regular press conferences featuring then Bank Governor Eddie George and Chancellor Ken Clarke – a feature of the 1993-97 policy framework – soon earned it this colourful title.
[11] Identification of current cycle: IFS (2004). Previous cycles identified by author using HM Treasury methodology – see IFS (2004) and HM Treasury (1999) (http://www.hm-treasury.gov.uk./media/415/CB/cycles.pdf)
[12] IMF (2005b)
[13] This worst case scenario is based on the IFS analysis of the 2005 Budget (http://www.ifs.org.uk/budgets/budget2005/pubfin.ppt).

The parties' budget proposals

Meeting the golden rule in the *next* economic cycle, without increases in tax rates after the election, will be difficult. The Treasury forecasts that revenue will grow by two percentage points of GDP between fiscal years 2004/05 and 2007/08 without raising rates, due to 'fiscal drag' (taxpayers moving up tax brackets as average incomes grow) and a recovery in financial sector profitability.

But independent commentators, such as the IMF, view these revenue forecasts as 'overly optimistic'[14] The IMF predicts that tax rates will need to rise after the election to meet the golden rule over the next economic cycle. Although the IMF is not explicit about the magnitude of the tax changes required, its projections for fiscal years 2005/06 to 2009/10 imply an average additional fiscal tightening of 0.6% of GDP from fiscal year 2006/07 onwards in order to meet the golden rule.

The Liberal Democrats' budget proposals are broadly similar to Labour's, at least in macroeconomic terms. The Conservatives' proposals differ only modestly from Labour's in 2007/08. They propose a net spending cut of £12 billion, with £4 billion returned to taxpayers in lower taxes. This would make meeting the golden rule more likely, even if the Treasury's forecasts turn out to be over-optimistic.

But the difference between the two parties' plans up to 2007/08 is small: the Conservatives propose a tax burden equivalent to 40.1% of GDP, compared to 40.4% under Labour. The Conservatives propose deeper 'cuts' (compared to Labour's proposed spending plans) in the subsequent four years, equivalent to two percentage points of national income by 2011/12. This is the source of the '£35 billion cuts' attacked by Labour. But it is more of an aspiration than a policy, and should be treated as an indicator of political philosophy rather than a meaningful fiscal projection.

Conclusions

Assessing whether the UK's improved macroeconomic performance is down to the policies of the present government, the previous administration or external circumstances, is very difficult. External conditions have been propitious: trade liberalisation has lowered import prices, reducing inflationary pressures, and the global economy has been relatively robust, promoting UK growth.

But most independent commentators seem persuaded that the policies developed by the current government should take some of the credit. For example, the IMF (2005a) argues that: 'the [UK's] fiscal and monetary policy frameworks remain at the forefront of international best practice. … The continuing success of the UK economy reinforces [the IMF's]… long-held view of the powerful effects of good institutions and policy frameworks.'

The evidence suggests that the more credible monetary policy regime in particular lowered expectations of future inflation, an area in which the Conservatives' policies (with the exception of the ERM membership) were less successful. This allowed for less inflationary wage demands and lower unemployment.[15]

But lower unemployment has also stemmed from supply side reforms such as reductions in union power and a tougher benefit regime, reforms that began under the Conservatives but have not been reversed under New Labour.[16]

For further information

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[14] IMF (2005a)
[15] Pissarides (2003)
[16] Pissarides (2003)

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