THE TREASURY VIEW: A TESTAMENT OF EXPERIENCE

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Some years ago, I was asked by a senior colleague whether the Treasury was that most political of institutions, willing to embrace the latest political fad and blow with the wind of the prevailing orthodoxy. Or was it unbending and unchanging, forever wedded to the "Treasury view", much maligned by Keynes and others from the 1920s to the present day.

It was a good question. But like many good questions it contained a false dichotomy. The Treasury exists to serve the Government of the day: to promote and achieve its objectives in the financial and economic field. In doing so, it needs to understand, interpret and apply the philosophy and agenda of the governing party (or parties). But it will inevitably also bring to the process the experience and insights of the officials who work within it – an understanding of what works and what does not and an appreciation of previous successes and failures in economic policy.

I entered the Treasury in early 1985, as the recovery was gaining momentum from the recession of the early 1980s, and Nigel Lawson was embarking on a programme of tax reform rarely seen before or since. As I begin my 30th year at the Treasury, I would like to set out some propositions on economic policy, drawing partly on my own experience and partly on the Treasury's longer history as the nation's leading economic and financial institution. The propositions partly reflect the age in which we live. And to each of them a greater or lesser ideological spin or emphasis could be applied. But I would like to think they also reflect a certain timelessness. A Treasury view for our time.

First, a belief in free trade links seamlessly the Treasury of William Gladstone to that of George Osborne. The Treasury has always taken the view that the United Kingdom is a small country with few natural resources. Its prosperity rests on trade. And the fewer the impediments there are to trade, the more the economy will grow and the greater the prosperity of the nation.

The Treasury has always been opposed to protectionism and mercantilism. From the repeal of the corn laws to the present day, it has tended to favour consumers over producers, supporting a cheap food policy and thus the living standards of the ordinary citizen. But there is a wider reason for the Treasury's adherence to free trade: a level playing field for trade reduces distortions, enhances competition and weakens special interest groups.

Historically, the Treasury opposed bilateral trade deals: in the 1890s, the Treasury supported the view that tariff bargains with the likes of Spain and Portugal, promoted by the Foreign Office, were a “commercial sin”. As Chamberlain’s proposals for tariff reform gathered momentum in 1903, my distinguished predecessor Francis Mowatt (1) “was literally in despair … [claiming that] half the cabinet did not appear to understand basic economics.” (2)

And when that great Chancellor, Philip Snowden, finally resigned from the National Government of Ramsey MacDonald, it was over the policy of Imperial Preference and protectionist tariffs agreed at the Ottawa conference. As he had written to MacDonald the previous winter: “some of us are perturbed about the rapidity with which we are drifting into a full protectionist policy … including food taxes … I cannot go on sacrificing beliefs and principles bit by bit until there are none left.”

Since the 1930s, trade policy has become more nuanced, not least because of our membership of the European Union, where the UK has had to accept the vagaries of the common agricultural policy in exchange for being able to shape and access the single market. The Treasury has continued to be a strong advocate of free trade within Whitehall, resisting the siren calls for greater mercantilism and protectionism. The abolition of exchange controls in 1979 was one of its greater triumphs. In recent years, the department has used its influence to advance the case for free trade internationally and in Europe, whether through a stronger focus on trade liberalisation or CAP reform or in the debates around commodity price spikes and what to do about them. And Britain has played a critical role in resisting modern forms of protection, in the form of regulation, and in setting out the case for better functioning international markets and the critical importance of trade.

And just as the Treasury has played a leading role in setting out the implications of Scotland leaving the free trade area that is the United Kingdom, so would I expect it to play a critical role in setting out the economic implications of the options of staying in or leaving the EU, should there be a referendum on our membership in the next Parliament.

My second proposition is really the flip-side of the first, and it is that markets generally work. This may appear a brave proposition following the worst financial crisis in eighty years. And I am happy to acknowledge that there is a legitimate role for the state to step in to correct market failure. The challenge for the Treasury of course is to be clear where intervention will change things for the better.

Now is not the time to give a lecture in classical economics.

But efficient product markets create the competitive pressures to help keep prices down, encourage firms to innovate and to minimise their costs of production – combining factor inputs in the form of labour, capital and land in the most efficient way.

Well functioning capital markets ensure that firms have access to the capital they need, enabling them to finance investment and to expand operations to meet demand. They enable shareholders to place incentives on firms to maximise the efficiency of their operations, and people to maximise their productive potential by borrowing against their future earnings to pay for the acquisition of skills and training.

Well functioning labour markets are also vital for generating growth. Increased labour supply allows employment to rise to meet the demands of a growing economy for increased output. The more flexible the labour market is, the more easily the economy is able to adjust rapidly to take advantage of new opportunities. And well functioning labour markets reward workers according to their performance and skills.

In short "fair and efficient product, capital and labour markets provide the best means of ensuring that as many of the economy's resources as possible are available to generate economic growth and well being". (3)

Most change in recent decades has been in the direction of making markets work better. If I compare the market for telecommunications now with when I first moved to London in 1981 – when I had to wait several months to get a telephone installed – it really is a different world. Enhancing competition in other regulated sectors – for example, rail and energy – has posed a greater challenge. However, even in these sectors the extent of competition is significantly greater than it was thirty years ago.

But perhaps the best example of greater efficiency is the labour market. When I joined the Treasury the alternation between Incomes Policy and "free collective bargaining" was firmly embedded in the department's consciousness. It did not seem to matter which policy was in place: at the end of each cycle, the equilibrium rate of unemployment was higher. The trades union reforms of the 1980s, the move to more active labour market measures in the 1990s, as well as wider structural changes to the composition of the economy, have changed all that. Moreover, there is greater awareness of work incentives at the lower end of the earnings distribution. Over the last fifteen years, the increase in the personal allowance, national insurance changes and the introduction of tax credits and the national minimum wage have all played their part in making work more attractive than welfare. The UK now has one of the most dynamic labour markets in the developed world, reflected in a transformation in the relationship between output and employment.

Employment has held up much better in the recent downturn than it did in the 1980s and 1990s.

For me, the lesson of the financial crisis is not that we had too much competition but that we did not have enough. For example, the lack of a suitable bank resolution regime led to the “too big to fail problem”. Barriers to entry led to oligopolistic practices, not least the “LIBOR” scandal and a suboptimal approach to remuneration, itself compounded by a lack of shareholder pressure. And market failures and a lack of competition in the provision of individual current accounts and SME lending have led to a lack of effective consumer pressure. Throw in Government failure – the collective underestimation of the build up of risk in the financial system by the Bank of England, FSA and Treasury and the inability of the authorities to work cooperatively to address the crisis as it began to emerge in 2007 – and it is easy to see with the benefit of hind-sight how the crisis came about.

My third proposition relates to an abiding Treasury obsession: the provision of sound money. Price stability enhances citizens’ ability to plan their lives, facilitating basic economic decisions around whether to consume now or to consume later via saving. It enables people to plan their retirement with a degree of certainty. It makes it easier for firms to plan whether to expand or contract, to invest or to save. And at a macro level, it minimises the risk of devaluation of the currency.

It may be that I was excessively influenced by my late teenage years. It is certainly etched in my memory that prices rose 16 per cent in 1974, 24 per cent in 1975, 16 1/2 per cent in 1976 and 16 per cent in 1977. For me the provision of price stability is tantamount to a moral issue; it goes to the heart of the fundamental duties of the state. And it is for this reason I disagree with those economists who have argued in recent years that the authorities should seek to encourage consumption by generating excess inflation.

For much of the post war period price stability has proved remarkably elusive. I have seen a number of anti-inflation regimes come and go. First, incomes policy. Then monetary targets. Then shadowing the Deutsche Mark informally in the late 1980s and then formally through membership of the exchange rate mechanism of the European monetary system. Each regime had its advantages and arguably represented an improvement on the one before. But each turned out to have its flaw. The relationship between monetary aggregates and inflation broke down the moment the Treasury targeted them (what came to be known as Goodhart’s law). Exchange rate targeting, even when fully supported by the Prime Minister, ultimately had interest rate consequences which undermined the credibility of a policy designed to improve credibility. An unwillingness of the authorities to contemplate realignment within the ERM added to the problem. And the rapid growth of international capital and foreign exchange markets meant that interventions which still just about worked in the 1950s and 1960s became increasingly ineffective, meaning that exchange rate targeting became impossible without much greater economic and political integration. (4)

In the end, the Treasury hit upon a regime which would deliver price stability through inflation targeting. A regime which was developed almost on the hoof in response to Black Wednesday has proved remarkably durable: first, through the monthly monetary meetings chaired by Norman Lamont, Ken Clarke and Gordon Brown, and then through the creation of the Monetary Policy Committee under operational independence of the Bank of England.

Of course, one of the lessons of the financial crisis is that price stability on its own will not deliver stability in output. With the benefit of hindsight a greater focus on credit might have prevented the build up of risk in the system before 2007: the creation of the Financial Policy Committee at the Bank of England with new macro-prudential tools should certainly make the macroeconomic framework more robust in future.

But looking back to the last decade, I think senior Treasury officials – myself included – became mesmerised by the length of the upswing – a record 66 quarters of unbroken growth – and overestimated the power of macroeconomic policy to reduce the amplitude of the trade cycle. As Sir Steve Robson has argued there was “a failure of imagination” (5).

That takes me to my fourth proposition, which is that there are limits to what the state can do to regulate demand. The fact is the United Kingdom is a very open economy. And Sterling long ago stopped having the reserve status now enjoyed by the US dollar. If the economy deviates from trend, the authorities should of course act and they do. But a degree of realism is necessary: the British economy is unlikely to grow rapidly for a sustained period if its main trading partners (the US and EU) do not.

Under successive governments, the Treasury has tended to see monetary policy as the first port of call when it comes to demand. This is because monetary policy is set monthly and can respond quickly, as demonstrated in the financial crisis when the base rate was cut by 475 basis points over the course of a year followed by a programme of quantitative easing worth some 25 per cent of national income.

Monetary policy's effectiveness has been much enhanced when buttressed by interventions to address credit conditions, whether through the credit guarantee scheme, or more significantly the funding for lending scheme. This reinforces another conclusion, drawn from my time at the Treasury, which is that you can become too hung up on "money" when it is "credit" which matters.

That does not mean the Treasury denies a role for fiscal policy. Successive Governments have acknowledged a role for the "automatic stabilisers" – those tax receipts and areas of expenditure, primarily social security, which tend to vary with the economic cycle. In the late 1990s, one of "the key objectives for fiscal policy [was] to allow the automatic stabilisers to play their role in smoothing the path of the economy" (6). And more recently, the current Chancellor, George Osborne, has told the Treasury Committee: "by not chasing the debt target we have allowed the automatic stabilisers to operate and that is a sensible economic decision, in my view. That supports the economy in that sense, during a cyclical downturn." (7) And I would emphasise that the automatic stabilisers in the UK have a greater impact than in many advanced economies: the OECD estimates that their impact is over a third greater in the UK than in the United States.

And so fiscal policy can be effective. But in setting it, I would high-light two points.

First, as with many other economic variables, it is important to take into account the stock of debt as well as the flow of borrowing. The last Government recognised this by setting a debt rule of 40 per cent of GDP; the current one by seeking to get debt on a downward path. Capital markets may be more open than they used to be and so at the margin an increased public sector deficit may be less likely to crowd out private sector borrowing and investment. And it is a long time since the UK experienced a 'gilts strike'. But in my view there will always be inflection points where a further increase in borrowing will result in a much bigger increase in funding costs as a number of Eurozone countries have found to their cost. Ex ante it is difficult to know where these inflection points are, which makes the case for erring on the side of caution.

And secondly the Treasury has tended to be sceptical about the efficacy of "fiscal fine tuning". It is all too aware of the practical obstacles to switching fiscal demand on and off. The mythical "shovel ready" infrastructure project is precisely that – a myth. The lead times in getting public investment up and running are long and variable. Increases in current spending are even more difficult to switch on and off, not least because they involve increases either in public sector employment or in entitlements which are notoriously difficult to reverse. And although some taxes can be changed through the flick of the “regulator” switch, the vast majority have a longer lead time. For example, it can take over six months to implement a 1 per cent change in the rate of national insurance. There is also an economic cost to using fiscal programmes as a regulator of demand: investment projects generally provide a higher return if planned over the medium term as part of a wider infrastructure programme. There is at least a theoretical risk that economic agents see through temporary measures anticipating the future tax increases or cuts in spending needed to reverse them: so called Ricardian Equivalence. And there is a tendency towards asymmetry: democratically elected governments find it easier to loosen policy than to tighten it, just as they did with monetary policy when they were responsible for it.

All of this is a long way of saying that fiscal policy is a blunt instrument, and if used actively it is better to use it to support monetary policy from a position of strength, when public debt is low or non-existent.

In this respect, Treasury orthodoxy has come a long way since the Treasury view of the 1920s. But it has also moved on from the high water mark of post war Keynesian orthodoxy when Sir Edward Bridges could say: “The [Annual] Budget is second to none in importance, since by its influence on the flow of income it can be used both to sustain a high level of employment and keep total demand within the limits of total supply”. (8)

Just as the modern Treasury never embraced mechanistic monetarism, so has it never been comfortable with naïve Keynesianism.

That takes me to my fifth proposition which is that governments in the United Kingdom find it difficult to raise revenues beyond a certain point. This is not a value judgement about the size of the state, on which the official Treasury does not have an opinion. It is purely an empirical point. Over my working life I have seen all sorts of tax regimes. When I joined the Treasury, the top rate of tax was 60 per cent. Now it is 45 per cent. The basic rate was 30 per cent. Now it is 20 per cent. The combined rates of employer and employee national insurance contributions has risen from 19.45 per cent to 25.8 per cent. The main VAT rate was 15 per cent; now it is 20 per cent. I have seen new taxes introduced; old ones abolished. Reliefs and allowances have come and gone.

But over that period the share of national income accounted for by taxes and national insurance contributions has remained stubbornly stable: 36.4 per cent in 1985-86 and 34.9 per cent in 2012-13. Its lack of variation is particularly remarkable. Never higher than the 36.4 per cent it was in my first year at the Treasury, and never lower than the 31.8 per cent it reached in 1993-94. Perversely, over the last decade when we have witnessed the biggest economic and financial crisis in generations, the tax take has been more stable than ever: with a low of 33.9 per cent in 2002-03 and a high of 35.6 per cent in 2006-07. (Of course, there is more to the receipts side of the public finances than tax and NICs – interest and dividend receipts account for a further 2 per cent of GDP and historically have been much more variable, accounting for 6 per cent of GDP in 1985-86. But on the face of it they are in secular decline.)

Now, there are all sorts of explanations for the stability of the tax take. It may simply reflect public choice, with taxpayer resistance setting in above a certain point. It may reflect arbitrage domestically between taxes and internationally between tax jurisdictions. It may reflect diminishing returns, in terms of the effectiveness of the Inland Revenue and Customs and Excise, as was, HMRC, as is. It may just be coincidence.

I don't want to endow the tax take with mystical significance. And certainly other countries have managed to sustain much higher tax takes than the UK, though they tend to be smaller and more cohesive like Denmark.

But to understand the public finances, you need to understand how difficult it is to sustain receipts. Historically, the Treasury tended to overforecast revenue and the OBR is only doing a little better. With growth now accelerating, we are likely to see more occasions where receipts surprise on the upside but, unless we discover the holy grail of locking in tax receipts for good, my guess is that we will be running hard to stand still for many years to come.

That takes to me to my next proposition which is that spending control matters. I covered this issue at length in last year's lecture and so I will spare you repetition. Suffice it to say, that in a world of constrained receipts, the quality of public expenditure matters as much as the quantity, which is why since the Gershon Review in 2004 successive governments have placed so much emphasis on efficiency and productivity. More recently, the Review of Financial Management carried out by Richard Douglas and Treasury Second Permanent Secretary, Sharon White, will help ensure we can "maximise the value secured for every pound we spend" (9).

My seventh proposition, the importance of the supply side, is a long standing Treasury obsession, and not surprisingly, if you take the classical economist's view that in the long run the nation's income is determined by the supply of labour and capital and the productivity of each. However, in the modern era it is an area in which the Treasury has played an increasing role. The senior structure of the department itself recognises this with John Kingman, Second Permanent Secretary, heading up the Economics Ministry function.

I have already mentioned the importance of the labour market and competition – the two areas where probably the biggest achievements of supply-side policy have been made in recent decades. But the modern Treasury also sees itself as having a critical role in terms of encouraging enterprise and entrepreneurialism, for example through changes to the corporate tax system. The Treasury has also prioritised innovation – reflected in the priority attached to science spending over the last decade, and new reliefs to support research and development.

And it has also sought to support interventions to improve the skills base of the country – generally, by seeking to encourage policies which promote choice, encourage access and improve functioning of markets. Looking back over thirty years, I would not want to exaggerate the Treasury's influence – education has tended to be dominated by the Department of Education, under various guises, and by the professionals. However, the Treasury's influence has perhaps been greatest in relation to changes in funding of higher education, an area where the UK still has a comparative advantage. The Treasury may no longer directly fund the universities, as it did up until the early 1960s, but it can still change the rules of engagement: for example, the Chancellor's recent removal on the cap on student numbers.

But perhaps the supply side area where there has been the greatest change in attitude during my time at the Treasury is investment in the nation's infrastructure. I would highlight a number of changes. First, the separation of the capital and current budgets, and the decision of successive governments to target the current budget. Secondly, persistent Treasury pressure to free up the planning process. A further change has been the decision in the 2010 and 2013 spending reviews to allocate a growing proportion of capital spending according to the economic return of individual projects. And finally there has been the institutional change of setting up Infrastructure UK in the Treasury. IUK's role in drawing up the National Infrastructure Plan, supporting projects through guarantees and advising departments on individual projects has begun to have a real impact on the delivery of new infrastructure.

That brings me to my next proposition which is that institutions matter. The granting of operational independence to the Bank of England has done much to enhance the credibility of macro-economic policy. The Debt Management Office is much acclaimed internationally and has sold £1.35 trillion of debt since it came into existence. The independent UK Statistics Authority has enhanced the credibility of economic statistics, while the independent Office of Budget Responsibility has improved the quality of economic and fiscal projections. All these changes have strengthened the macroeconomic policy framework and therefore the Treasury. Thus, the Bank of England's operational independence both over monetary and macro-prudential policy has enabled the Treasury to concentrate on its 'principal role', whether in setting the monetary policy remit, for example through the publication of the new monetary policy framework at last year's Budget, or substantive changes to taxes and spending. This has been much on my mind in recent weeks. In previous times, with an impending date with the electorate, all the pressure from Number 10 and even Number 11 would have been to come up with reasons why underlying growth was higher and thus the deficit lower, the better to justify a letting up on consolidation.

My penultimate proposition is that you need rules but you should never become fixated by them. Over the last thirty years, I have seen a number of monetary and fiscal rules come and go. All have been well intentioned, and based on observed relationships between one economic variable and another. Historically, the Treasury has tended to become mesmerised by the framework it has created, whether the Gold Standard or monetary targets or more recently the "Golden Rule". Of course, rules are there to be observed and targets are there to be hit. But there is also a risk that economic policy makers become so fixated by the intricacies of targetry, that they cease to see the woods for the trees. Treasury officials should never become evangelists or missionaries; they should always retain a healthy scepticism, the better to see when a policy framework is producing perverse results. That is why it is important to focus on the substance. Is the deficit too high or too low? Is it falling at a credible speed? Are prices broadly stable? That is not to deny a role for economic concepts such as cyclical adjustment. Quite rightly, successive Governments have tried to incorporate the cycle in the setting of policy. But ultimately economic policy will be judged by real world results rather than statistical or economic constructs. This is one reason why I subscribe to a Gladstonean (10) way of measuring economic activity: the receipts which come into the Treasury day by day do not lie.

My tenth and final proposition is that the Treasury is only as effective as the people within it (or, as Lord Bridges somewhat archaically put it, "in the end men matter more than measures" (11). The financial crisis placed a high premium on expertise and experience. And, although Treasury staff did a great job, after a faltering start with Northern Rock, the crisis has led us to review how we recruit and retain talent. The Treasury continues to attract very high quality recruits. The last graduate recruitment attracted over 1000 applicants for some 40 posts. But, as Sharon White's review of the Treasury's management of the financial crisis made clear, we need to be better at developing and then retaining the professional expertise needed to wrestle with challenging issues, for example around tax, financial services and corporate finance; and also economics where Dave Ramsden, the Chief Economic Adviser, has built up a much stronger macroeconomics function than was in place in 2007.

We have sought to place greater emphasis on bringing in expertise at senior levels: I would highlight the recruitment of Charles Roxburgh from McKinseys, and Indra Morris from Accenture. But we can also attract the best from Whitehall. The Treasury is not a monolithic institution. There is an extraordinary level of debate which has always gone on in the Treasury and I hope always will do – there is a long tradition, unusual in bureaucratic institutions, which sees it as healthy to expose debate between officials, irrespective of seniority, in front of Ministers. Staff surveys indicate that officials feel more "safe to challenge the way things are done in the Treasury" than in any other department in Whitehall – a really important barrier to group think. Indeed, the proportion of staff answering positively to this question is a full 10 percentage points higher than the next most positive department, the Department of Energy and Climate Change.

What sort of qualities do we look for in Treasury recruits? A former permanent secretary put it to me that "you need a first rate mind supplement by a certain toughness". A former special adviser, now a front bench politician, once said to me that what he was looking for in an official was "judgement". For my part, I look for a healthy scepticism – but never cynicism – which will challenge anything and everything, while also demonstrating creativity – an ability to come up with solutions on the basis of limited information in conditions of uncertainty. I would also add that you need to handle and manage people, and above all be patient. If you are an official and you have a good idea, you need to be able to sell it. That's partly about the age old art of persuasion. But it's also about knowing when to deploy the idea, and grabbing opportunities when they arise.

Peter Hennessy once put it to me that the lot of the Treasury official is to deal with disappointment. As he put it, consolidation and recovery in the post war period has been "routinely punctuated by the greatest orgy". I am an optimist. Disaster is not inevitable. Treasury officials should always be prepared for the worst. But, drawing on some of the propositions I have set out this evening, they should also hope for the best.

Notes

(1) Mowatt's other claim to fame is that his step son was that extraordinary poet Count Stenbock described by Yeats as "scholar, connoisseur, drunkard, poet, pervert, most charming of men". Stenbock was mentally ill, his condition not helped by his addiction to opium and alcohol. In 1895 he allegedly attacked Mowatt with a poker: Stenbock died in the ensuing struggle.

(2) Free Trade Nation, Frank Trentmann (2008) p86.

(3) Productivity in the UK: the evidence and the government's approach (HM Treasury, 2000).

(4) See also Dave Ramsden on "The Euro: 10th anniversary of the five economic tests" (MEG98).

(5) BBC, Great Offices of State, Episode 3.

(6) Pre-Budget Report, November 2000: Building Long term prosperity for all, p18.

(7) Oral evidence to Treasury Committee, 13 December 2012.

(8) Treasury Control (the Stamp Memorial Lecture) 1950.

(9) Chief Secretary's foreword to the Financial Management Review, December 2013.

(10) "The best mode of making an estimate of the rate of increase in the wealth of the country is to resort to the income tax. No other criterion is comparable to it, for, though it may not be an exact index of the truth in this matter, yet, as between any one period and another, I believe it is an index on which we may safely rely" Mr Gladstone's Budget Speech, 10 February 1860.

(11) The Treasury, The Rt Hon Lord Bridges, 1964.