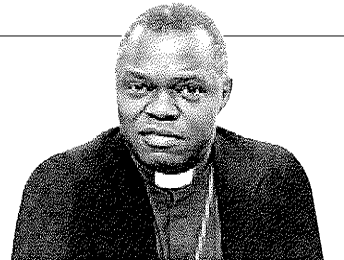


Opinion

The Church agonises
over trivia while the
poor are still dying

The Archbishop of York, page 28



The Treasury needs a new golden rule fast

Abandoning Gordon Brown's framework for fiscal prudence is no bad thing. It made no sense at all

Anatole
Kaletsky



Now that the Treasury has admitted that it will revise (for that, read "abandon") Gordon Brown's golden rules for "fiscal prudence", all three supposed pillars of the Government's economic policy have crumbled to dust.

The other two supports for what Mr Brown called his "institutional framework for market credibility and public trust" in *Reforming Britain's Economic and Financial Policy*, the sententious pseudo-academic tome that he issued shortly after the 1997 election, were the Bank of England's 2 per cent inflation target and the "financial stability" that the newly created Financial Services Authority was meant to guarantee.

But does the collapse — or more accurately, the tinkering dismantlement — of Mr Brown's economic framework matter?

The answer will probably be much the same as the last time that a British government suffered the collapse of its economic framework. The expulsion of sterling from the European Exchange Rate Mechanism in 1992 was a terrible political blow for the Major Government. But it proved fatal only because of the Prime Minister's crippling combination of indecisiveness and inflexibility in the political aftermath. However, the Government's loss was the country's

gain. Far from unleashing the widely predicted economic chaos, Black Wednesday laid the foundations for the longest period of uninterrupted prosperity the country has known.

Something similar, if less spectacular, could happen again if Mr Brown's framework is gradually replaced by new policies that retain the Treasury's good intentions but are better thought-out.

This has already begun with the reforms of financial regulation after the Northern Rock debacle — and further improvements are likely if Alistair Darling has the sense to listen to some of the constructive criticisms voiced by Mervyn King, the Governor of the Bank of England, and others at the Treasury Select Committee last week.

Some useful, although modest, changes in the inflation-targeting regime may be open for debate in the coming months as it becomes apparent that Mr Brown made a serious mistake in capriciously switching from the trusted retail price index to the potentially misleading euro-harmonised consumer price index.

But it is in fiscal policy — the balancing of taxes and public spending — that really important and controversial decisions lie ahead.

If we disregard the embarrassment to Mr Brown and look at the abandonment of his fiscal rules from a strictly economic standpoint, there is good news and bad.

The good news is that the rules never made much sense anyway. The first, the so-called Golden Rule, said that the Government would borrow only to invest in assets such as hospitals and school buildings. Apart from such capital investments, Mr

Brown promised to balance income and expenditure over the course of an economic cycle.

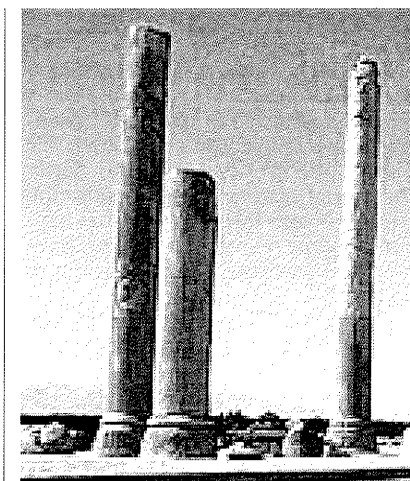
His second rule, the "sustainable investment rule", stated that the borrowing permitted by the Golden Rule would be strictly limited to ensure that Britain's total public sector debt never exceeded 40 per cent of national income.

While these two rules seemed sensible to many economists and financiers in 1997, closer inspection revealed at least three serious flaws. Probably the most damaging was the false dichotomy created between investment and current spending. This has seriously distorted spending priorities for the past ten years — channelling money into buildings, computer projects and warships, instead of training more teachers, doctors and soldiers.

The 40 per cent debt rule created a related distortion, as the Treasury forced spending departments to invent ever more outlandish (and expensive) Public Private Partnerships to keep borrowing off the Government's books.

The third objection was even more fundamental. The supposedly hard statistics that Mr Brown promoted as inviolable limits were as soft as jelly, impossible to measure and open to manipulation, and made no economic sense.

Why, for example, did Mr Brown set the public debt ceiling at 40 per cent of GDP, rather than 30 per cent or 50? The most plausible answer is that this ratio was falling so quickly under the fiscal plans he inherited from the Tories that 40 per cent seemed a nice round number, low enough to project an image of prudence, but high enough not to



All three pillars of the Government's unwisdom have crumbled

impose any real constraints on future public spending and borrowing.

Similarly, balancing current budgets "over the cycle" seemed an attractive objective, since Mr Brown's main ambitions for the public sector were directed at "investment" rather than current spending — and anyway, the timing of the cycle could be redefined by the Treasury more or less at will.

For all these reasons, the demise of Mr Brown's rules will be no great loss. But the bad news is that even arbitrary and illogical rules about public borrowing are better than no rules at all — and the danger of the rules being abandoned is that an open season for unlimited deficits and spending will be declared.

Mr Brown has already decided to borrow an extra £2.7 billion to defuse the row over the 10p tax rate and last week Mr Darling raised public

borrowing by a further £1.5 billion to buy off motorists incensed about the rising price of fuel.

The next, far bigger, fiscal challenge will come from the public sector pay round. It will be hard for comfortably-off ministers and Treasury mandarins to refuse decent pay increases to low-paid public sector workers, now that the rules have been exposed as a meaningless totem.

It could, of course, be said — and will be by trade union leaders — that a bit more government spending and borrowing is just what the doctor ordered. After all, the economy is on the brink of recession, house prices and consumer spending are in a downward spiral and unemployment is rising. So stimulating the economy with lower taxes and higher government spending would make eminent sense. This is exactly what the US Government has recently done and the fiscal stimulus seems to have helped the US economy to avoid recession.

Higher government borrowing does usually boost growth in the short term. And there is no economic theory to prove that a country will suffer by increasing its public debt from 40 per cent of GDP to 45 or 50 per cent. At some stage, however, a point is reached when ever-rising public borrowing begins to fuel inflation, when overspending becomes an addiction and the growth of government gets out of control.

Nobody can say for sure where the safety limit for government borrowing may be in today's Britain. But the precedents from the 1970s are fairly horrific. The Treasury had better work overtime to invent some credible fiscal rules.