green alliance...

Green liberalism: Reforming the Treasury for long term policy

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Summary

"The UK's enormous household and government debts may point to a tendency to favour short term consumption over long term prudence."

At times it seems that short termism lurks behind many of our national failings. The UK's enormous household and government debts may point to a tendency to favour short term consumption over long term prudence. Our woeful lack of corporate investment may partly reflect a focus on quarterly financial reports for city analysts, in preference to patiently constructed, long term business strategies.

The consequence of excessive short termism in environmental policy is particularly significant. We have already made irreversible changes to many of our terrestrial ecosystems, and are changing the physics of the atmosphere as a result of rising carbon pollution. Maintaining stable conditions for life is a precondition of a prosperous society and a strong economy, and good policy making can help to reduce climate change, resource depletion and local environmental damage.

The UK has made progress on the environment. Political consensus led to the 2008 Climate Change Act and the establishment of the Committee on Climate Change, injecting legally backed, long term thinking into at least one area of environmental policy. The coalition government also created the Natural Capital Committee to advise on the sustainable use of vital natural assets.

Nevertheless, there is still insufficient long term thinking in UK environmental policy. We are failing to prepare adequately for the risks stemming from increased pressures on the world's natural resources. Even the protection provided by the Climate Change Act may not withstand infrastructure planning mistakes, which can lock in high carbon road and air transport and do not deliver adequate renewable energy.

Many critics of short termist policy making lay much of the blame at the doors of the Treasury.[1] Being the most powerful government department, it controls not only the purse strings, but also economic policy. The Treasury has shown that it is capable of big long term thinking, such as its commissioning of the *Stern Review* on the economic impacts of climate change. Therefore, it is not always clear what critics are most concerned about: is it the conflicting interests in the role of the Treasury as a guardian of the nation's finances and economic strategy, an inherent institutional orthodoxy, or simply a particular occupant of number eleven Downing Street?

This pamphlet considers the issues, whilst recognising that the Treasury has a key role to play. It then looks at what might be done to promote greater long term thinking, particularly in relation to the environment, without sacrificing the Treasury's role in controlling the public finances.

1

What's wrong with the Treasury?

> "The Treasury takes it as given that costs or benefits experienced now are worth more than those expected in the future."

The starting point for any critique of the Treasury is the potential conflict of interest between being in charge of the nation's finances and its economic growth. This runs the risk that the next few years' budget management considerations may dominate and militate against projects with short term costs but long term pay-offs. The budgetary logic also means that benefits which are not easily quantifiable in cash terms, such as avoiding environmental damage, may carry less weight than monetary costs.

Reflecting this emphasis on the public finances, the Treasury could be viewed as using analytical tools best suited for short term budgetary policy, to control spending on projects with pay-offs long in the future. This can matter, particularly for environmental policies which often come with short term costs but long term benefits. This problem can be illustrated with the following examples.

The Treasury takes it as given that costs or benefits experienced now are worth more than those expected in the future. Discounting in this way is, of course, fairly standard practice in business, but it can create some striking anomalies when applied to the very long term consequences of public policy. The Treasury discounts future impacts by 3.5 per cent a year for the first 30 years and three per cent up to 75 years. This test implies that £100 spent now would have to generate benefits of at least £281 after 30 years or £1,061 after 75 years (in real terms). Many would question whether we would really want to keep £100 in our pockets today at the expense of, for instance, more than £1,000 cost in damage to the natural environment that our grandchildren would inherit.

Subsequent supplementary guidance from the Treasury now allows for sensitivity analysis using slightly lower discount rates in cases which involve very long term, substantial and irreversible wealth transfers between generations.[2] Yet a big part of the justification for the level of the discount rate is the assumption that economic growth will be maintained at around two per cent, so future generations will be rich enough to pay for the costs of climate change. Given that global warming carries significant risks to future UK growth, there must be a significant chance that such a benign outlook will not materialise, thereby undermining the case for the significant discount rate.[3]

> "At times, it does seem that the Treasury knows the price of everything but the value of nothing."

In addition, analytical frameworks, such as economic models, are largely focused on the public finances but are sometimes mistakenly applied to other domains. For instance, the Treasury uses the HMRC Computable General Equilibrium model as a tool for analysing the effects of fiscal policy. This model has also been used to calculate the costs of the fourth carbon budget.[4] While this model includes the financial costs of environmental policies, it misses the benefits such as improvements to health from better air quality, lower congestion, accelerated innovation or reduced risk to future UK growth from anthropogenic climate change. The shortcomings of this modelling approach were also shown by a recent analysis which purported to show the growth benefits of reducing fuel duties, but has been heavily criticised for missing many important impacts.[5]

At times, it does seem that the Treasury knows the price of everything but the value of nothing. But these examples also point to a departmental silo mentality and a lack of joined up government. It is difficult to explain, for example, why health costs (or potential savings to NHS spending) are not routinely used as a proxy for some environmental costs in policy option appraisals. For instance, projecting the increased cost to the NHS of failing to combat air pollution in big cities could capture at least part of the environmental damage.[6]

Another criticism relates to the concentration of power in the Treasury, which is seen by some as having an undue influence over the policies of other departments. Such control can be used to block initiatives, such as a recent attempt by chief economists across Whitehall to undertake a comprehensive review of resource depletion and climate change risks to UK economic growth.[7] More fundamentally, those in other government departments might reasonably argue that, while the Treasury holds them to account for their budgetary sustainability, there is no-one to hold the Treasury to account for its record on environmental sustainability.

Why do we need the Treasury?

Ever since the chastening experience of 1976 when the UK could not balance its books and needed a loan from the IMF, the Treasury has played a vital role in keeping a lid on the public finances. Without its strictures it is likely that the UK would have found itself descending into fiscal indiscipline with much greater frequency. It has played a key role in ensuring that the UK has a long record of not formally defaulting on its public debt, even if this ignores the effective partial default through high inflation in the 1970s and 1980s.

Indeed, the ability of the Treasury to keep the public finances under control was severely tested in 2008-10, with the perfect storm of rapid increases in structural spending hitting the largest cyclical downturn since the 1930s. Once it became clear that the political will existed to adopt austerity policies there was little doubt in the financial markets of the Treasury's ability to deliver. If the Treasury's role had been noticeably weaker at this point, then investors in UK gilts may well have taken fright, raising the otherwise very low cost of financing UK government debt.

2

What can be done to encourage long termism?

© HM Treasury

“In pursuing debt control, the Treasury has, in some ways, a challenge similar to protecting the environment.”

In pursuing debt control, the Treasury has, in some ways, a challenge similar to protecting the environment. Both involve keeping an eye on a long term goal, the achievement of which sometimes involves short term pain. Given the similarity of this challenge, it is surprising that a structure to incorporate them both has not yet been found. So what are the options?

Break up the Treasury:

One solution could be to break up the Treasury. A new finance ministry could focus on ensuring the health of the public finances, while an extended Department for Business, Innovation and Skills could be given control of the longer term economic strategy. A similar separation already exists in many countries, including Germany. This would break the power base of the Treasury and ensure that its two roles were not in conflict. However, it seems unlikely that any of the potential occupants of number eleven Downing Street would see merit in diminishing the power of the chancellor of the exchequer in this way.

Change the Treasury:

A second option would be to reform the Treasury and deal with some of the precise manifestations of short term thinking. For a start, it could be given a clear objective in its business plan to ensure a low carbon, resource efficient UK economy, perhaps championed by a dedicated junior minister. It could then adopt a longer budget planning horizon and, instead of focusing on the next five years, it could make plans for the next 25 years.

It could also review its use of the discount rate, particularly when applied to areas where there are potentially catastrophic long term costs such as climate change. It could initiate a comprehensive review of the tools it uses for assessing the costs and benefits of environmental policies, such as a new modelling framework for the evaluation of the Committee on Climate Change recommendations.

Finally, it could increase openness and transparency in its analysis of these issues, so that it is required to defend its work and be open to critique.

“A new office for environmental responsibility could review the suitability of current policies for climate change, resource efficiency and local noise, water and air pollution.”

Make the Treasury more accountable:

Another, potentially complementary, approach could be to increase oversight of the Treasury. The Climate Change Act offers some degree of constraint on the Treasury’s room for manoeuvre. However, with long time horizons it is possible for it to implement policies which, while not rendering it impossible to meet carbon budgets, certainly raise the political costs of doing so.

A new office for environmental responsibility could review the suitability of current policies for climate change, resource efficiency and local noise, water and air pollution. It could examine the business risks from growing pressures on the world’s resources and propose prudent risk management approaches to deal with them.

The chancellor could be required to report against the Treasury’s environmental objectives, appearing before the Environmental Audit Committee on a regular basis. In addition, a high level cabinet committee chaired by the prime minister could work to break down departmental silos on environmental issues and encourage joined up thinking across government.

3.

Conclusion

All of these ideas offer routes to developing greater long termism in UK government policy, depending on the degree of ambition. Yet, some may argue that, by weakening the power of the Treasury, its ability to manage the public finances will be diluted.

However, this ignores the bigger risk that a deteriorating environment and failure to prepare for resource scarcity could present to the productive potential of the UK economy.

Ultimately, the health of our public finances is likely to be more dependent on the strength of our economy than on short term budgetary management. In any event, since the creation of the Office for Budget Responsibility, the political costs of abandoning budgetary responsibility have become much higher. Reforms to the Treasury are hardly likely to lead to an abandonment of fiscal discipline.[8]

It is worth recognising that there is a parallel interest in encouraging long termism in business. A good example of this is the Kay Commission on equity markets and long term decision making set up by Vince Cable, which reported in 2012.[9] Indeed, more and more leading businesses are embracing longer term strategic thinking and it seems it is the government that is being left behind.

“More and more leading businesses are embracing longer term strategic thinking and it seems it is the government that is being left behind.”

Whilst recognising the importance of institutional reform, we should also not underestimate the influence of day to day politics. To a greater or lesser extent, nearly all politicians value short term, headline grabbing policy initiatives over long term plans. That dynamic is actually one of the biggest enemies of both debt and environmental control.

Thankfully, there are ways to increase long term thinking. These include using the right tools to analyse the costs and benefits of environmental policy and adopting institutional structures that enable sensible long term investment to enhance fiscal and environmental sustainability.

Endnotes

[1] See the work of Friends of the Earth www.foe.co.uk/news/transforming-treasury

[2] For instance, for 30-75 years hence, the sensitivity analysis would involve comparing a discount rate of three per cent and 2.57 per cent. See: HM Treasury, 2008, *Intergenerational wealth transfers and social discounting: supplementary Green Book guidance*

[3] It is interesting to contrast the Treasury's approach with that taken in Germany. The finance ministry updates and releases a discount rate on a regular basis, which currently stands at 1.7 per cent. However, this serves merely as guidance and the discount rates applied vary between projects and measures and federal state levels. When it comes to climate related costs and adaptation measures, Germany's Environment Agency recommends a three per cent discount rate for periods of up to 20 years and, thereafter, it is just 1.5 per cent. In addition, when it is decided that intergenerational issues are at stake, a sensitivity analysis with a discount rate of zero per cent is recommended.

[4] H M Government, 2011, *The carbon plan: delivering our low carbon future*, p181

[5] HMRC/HM Treasury, 2014, *Analysis of the dynamic effects of fuel duty reductions*; and *Financial Times*, 15 April 2014, comment by John McDermott, 'Why you should care about dynamic modelling'

[6] D Brack, N Stockley, M Tuffrey and P Burall, 2013, *The green book: new directions for Liberals in government*, Biteback Publishing

[7] *The Economic Voice*, 5 March 2013, 'Threat to economy as treasury ignores expert warning on climate change'

[8] Also, the role of the Office of Budget Responsibility could be strengthened to give more technocratic oversight of public finances. The most extreme solution is to enshrine budgetary discipline more formally by giving it legal stature. This is the approach followed by Germany which now has a balanced budget law called the 'Schuldenbremse' (or debt brake). This requires that, from 2016, the state cannot run a structural deficit – what is left after the effects of the economic cycle are taken out – of more than 0.35 per cent of GDP. At the federal state level, this will fall to zero by 2020.

[9] GOV.UK, 22 November 2012, 'Government responds to the Kay Review'

"It's important that political parties not only develop polices to protect our environment but ensure the institutional framework is able to deliver them. This is a thoughtful and provoking contribution to that debate."
Baroness Kate Parminter

"Treasury orthodoxy has long been a barrier to holistic policy making, regardless of which parties are in government. It's time that narrow approach is challenged, to allow a wider assessment of long term costs or benefits and help build a more sustainable future."
Duncan Hames MP

"It has been said that the Treasury knows the price of everything and the value of nothing. While neither of these is quite true, it does focus too much on the next few years, to the neglect of the next decades; it is time to change that."
Dr Julian Huppert MP

"This pamphlet advocates many good proposals to reform the way the Treasury operates. Ultimately, however, achieving better long term outcomes requires ministers to make that the priority in their decision-making over short term expedients."
Mike Tuffrey, co-founder, Corporate Citizenship

"The Treasury has a crucial role to play in the UK's transition to a sustainable, low carbon and resource efficient economy, but at present its role is almost entirely negative. This welcome pamphlet sets out the options for reforming the Treasury which should be debated as a matter of urgency."
Duncan Brack, vice chair of the Liberal Democrats' Federal Policy Committee