A balancing act: fair solutions to a modern debt crisis

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Executive Summary

Whoever wins the next election will inherit a weak economy, a large budget deficit and a mountain of debt. The incoming government must arrive with a credible plan to balance the books. But this priority cannot swamp all others: it must itself be balanced against the need to keep Britain growing in a difficult economic climate. Finally, in weighing the competing claims of taxpayers and the public services they support, policymakers need to find solutions that fairly reflect how different sections of society have been helped by the government’s expanding debt.

For many Conservatives, the situation they hope to inherit is all too reminiscent of 1979 when Margaret Thatcher came to power. Now, as then, the Tory party is readying itself for an immediate and sustained attempt at reducing the size of the state in order to avert a ruinous debt spiral. For that previous Conservative administration, such an uncompromising approach seemed to work. But David Cameron and George Osborne should be cautious. While the public sector is too large for the size of economy, and needs radical reform, this is not the same as calling for a straightforward re-enactment of the policies of the early 1980s. No two crises are alike, and when comparing 1979 to 2009, the differences far outweigh the similarities. This is why a more balanced approach is needed now.

Above all, a deflationary recession accompanied by a credit crunch demands a very different macroeconomic response than did the post-war slumps caused by runaway inflation. Alistair Darling faces none of the borrowing difficulties that
constrained Denis Healey in 1976, not least because, after years of low inflation, Britain now has a record of monetary credibility. Furthermore, the UK is no longer the only developed nation to be so highly indebted. There is no need, as there was in Margaret Thatcher’s time, to restructure fundamentally an economy crippled by high taxation and trade union power.

Today, the government is wrestling with a quite different set of issues: weak asset prices, near-zero interest rates, high levels of private debt and contracting nominal incomes. For the past year the ‘depression economics’ that inspired Keynes has been threatening to return.\(^1\) This has necessitated a return to active fiscal policy, foreshown by the Thatcher government as a means of maintaining high growth. In 2009, government spending, far from crowding out private sector activity, is in fact critical to a sustained recovery. Any attempt to cut the deficit before the recovery is properly underway risks pitching Britain back into recession.

Once that risk has passed, the government will have to address the public sector deficit and outstanding debt. In doing so, it will need first to reassure the markets that it will not resort to inflation to lighten the burden. This would result in decades of high rates that would cripple the economy and raise the government’s cost of borrowing to unaffordable levels.

Most of the heavy lifting will therefore have to be achieved through fiscal consolidation – cutting spending and raising revenues. When striking a balance between the two, the Conservative leadership may find that what it wants to do, and what it needs to do, may not fit so neatly. Knowing that the current crisis provides a golden opportunity to advance their small state agenda, conservative commentators are clamouring for big cuts in public spending like those of the early 1980s.\(^2\) The government will definitely have to take a lower share of the national product if it is to reach fiscal balance.\(^3\) But cuts are not the whole answer. Despite claims to the contrary, Britain’s record deficits were not caused by a sudden spending splurge so much as by a total collapse in public sector receipts, which, as a proportion of GDP, are now at their lowest point for a generation.
So an urgent priority must also be to rebuild the tax base. This needs to be done in a way that is fair, avoids damaging job creation and enterprise, and helps to lessen destabilising macroeconomic imbalances. With this in mind, the next government should take a fresh look at the way in which property wealth is taxed. The private sector in the UK owns over £3 trillion in housing assets – a figure that dwarfs the national debt. The wealthiest members of society have gained a great deal from the active fiscal policies deployed to protect their assets from the destruction wrought by a much deeper recession. Therefore it is fair that they should help meet the cost of those policies. To do so also addresses a persistent, destabilising inequality that ultimately weakens the economy: an addiction to property speculation that helped bring about the recession.

Policymakers should therefore consider:

- Closing the loophole by which primary residences are not liable for Capital Gains Tax;
- Introducing a flat rate levy to supplement council tax on residential properties above a threshold.

In addition, should the Conservatives win the next general election, they should drop their plan to virtually eliminate inheritance tax; this does little either for economic efficiency or social justice. Nor is their pledge to cut taxes on savings income either appropriate or socially just.

However, it is not only Conservative tax goals that will have to take a lower priority during the forthcoming period of fiscal consolidation. When the economy is strong enough to absorb the blow, VAT will have to rise. This is undoubtedly a regressive step, but it also raises money in a relatively non-distortionary way, and helps to skew incentives further towards more saving, which is in Britain’s long term interests.

After the collapse of Gordon Brown’s fiscal framework, the next government must provide better assurances that it will not dissipate unexpectedly strong tax receipts in future. Hubris affects all Chancellors; like others before him, Gordon Brown believed that temporarily high growth was permanent, and the
resulting revenues could be safely spent. The Conservatives suggest that this might be solved by delegating fiscal forecasts to an Office for Budget Responsibility. However, this blurs responsibility for a fiscal problem that is about more than just optimistic forecasting. Instead, we propose a commitment to hypothecate certain volatile tax revenues above a declared threshold to pay off debt.

This paper is divided into three sections. The first compares the macroeconomic circumstances of the current fiscal crisis to that which greeted the first Thatcher administration and explains why the former demands a different policy response.

The second examines why the budgetary position has deteriorated so rapidly. The simplistic belief that this is a pure consequence of a public spending splurge represents just a portion of the truth. Policymakers will have to address both a structural deficit and also unstable revenues.

The third section sets out policies to increase long term fiscal credibility and to address the structural weaknesses that have led to the current crisis.
1. National debt in the post inflation era

Gordon Brown’s government is not the first to lose control of its borrowing. But the increase in debt will far outstrip earlier periods (see chart 1).

**CHART 1: DEBT RATIOS DURING THE LAST THREE RECESSIONS**

Source: Office for National Statistics, Budget projections
THE LOST ADVANTAGE OF INFLATION

In a matter of two years, Budget forecasts for future debt levels have leapt from below 40 per cent to almost 80 per cent of GDP. But this is not due to a sudden leap in government spending, despite the furore surrounding the government’s use of fiscal stimulus. As chart 2 shows, roughly similar deficits produce very different debt burdens.

CHART 2: SIMILAR DEFICITS LEAD TO DIFFERENT DEBT LEVELS

This is because the 2008-09 economic downturn has been a deflationary recession, with nominal GDP falling in a sustained fashion for the first time since Britain left the gold standard in 1931. The previous two recessions were caused by an overheating economy that required a government-induced slowdown. While government was forced to apply high interest rates, the prior boom in nominal GDP effectively reduced debt levels before the ensuing slowdown.

Source: Office for National Statistics
Debt dynamics – the maths

Suppose a government wishes to choose a primary surplus to stabilise the debt ratio. If $D_t$ is the outstanding debt level in year $t$ and $Y_t$ is the GDP, then its task is to make $D_{t+1}/Y_{t+1}$ equal to $D_t/Y_t$.

$D_{t+1}$ will equal $D_t$ plus the previous year’s deficit, $d$, while $Y_{t+1}$ will equal $Y_t$ plus nominal growth in GDP, $g$.

The deficit $d$ is itself the primary surplus, $s$ minus debt interest. Debt interest is determined by the outstanding debt, $D$, multiplied by the legacy cost of servicing the debt, $r$. Therefore to hold debt steady, the government needs to choose $s$ such that:

$$(D (1 + r) - s)/Y(1+g) = D/Y$$

So, for example, if the debt ratio ($D/Y$) is 40 per cent, nominal GDP growth is 5 per cent and the legacy cost of serving the debt is 10 per cent, the government needs to run a primary surplus of 2 per cent of GDP to keep the debt ratio steady. This is because the cost of funding the past debt is 4 per cent of GDP (10 per cent of 40), which combined with a primary surplus of 2 per cent of GDP produces a deficit of 2 per cent. Since nominal GDP grew by 5 per cent, the debt ratio remains stable at 40 per cent.

If, on the other hand, the legacy cost of servicing the debt was 5 per cent of the outstanding amount, the government could afford to run a primary surplus of zero and still keep debt from growing.\textsuperscript{5}

It follows that the government’s task in keeping the debt ratio steady is easier if legacy debt costs are low, and nominal growth in GDP is high.
To understand the evolution of the public debt ratio one needs not only an estimate of the difference between taxes and spending but also the growth rate of nominal GDP. This last item is determined by inflation plus the real growth of the economy. When nominal growth is high – as it was for Mrs Thatcher in the early 1980s, despite the recession – the government can run big deficits without increasing the debt burden. For example, the surprise inflation of the first Thatcher administration meant that the £88 billion national debt they inherited shrank from 47 per cent to 30 per cent of GDP in three years, as nominal GDP rose from £188bn to £296bn.

Between 1975 and 1983, inflation averaged over 12 per cent and nominal GDP increased by over 150 per cent. For 2006 to 2014, the figures are more likely to be 2.5 per cent and around 40 per cent (see chart 3).

**CHART 3: DIFFERENT INFLATION RATES**

![Inflation Chart](chart.png)

*Sources: Office for National Statistics and Bank of England*

The first Thatcher government may have been committed to bringing inflation down, but its failure to do so during the 1980-81 recession meant it never had to wrestle with the debt levels of 80 per cent or more potentially facing the next Chancellor.
THE COST OF POOR CREDIBILITY – HIGH REAL RATES

This dubious advantage of high inflation came at a heavy price. The gain to a government of having its debts wiped away is a loss to its creditors. During the 1970s investors saw the real value of their bonds destroyed by inflation. From 1973 to 1981, yields on government bonds averaged 12.8 per cent, but were surpassed by RPI inflation averaging 14.8 per cent (see chart 4). Moreover, since interest income is taxed, investors’ real losses were far greater.

CHART 4: GILT YIELDS AND INFLATION BEFORE BANK INDEPENDENCE

Consequently, the bond market lost trust in the government. Long term interest rates rose to above 15 per cent in the 1970s, and stayed close to these levels during the early 1980s while inflation was high. Margaret Thatcher’s challenge was not so much the overall level of government debt as the sheer
cost of borrowing. Even though inflation was brought down after 1983, no Conservative government managed to borrow at less than 7 per cent for the rest of their time in power. The difference between the rate charged by the bond market and current inflation was generally at least 4 per cent. However, since inflation fell over the next 25 years, the real cost to subsequent governments of borrowing in the 1980s was much higher. For example, a bond issued in 1981 might have yielded 13 per cent, while inflation averaged 4.3 per cent over the next 25 years.

CHART 5: EFFECTIVE COST OF BORROWING IN THE LAST FORTY YEARS

The real cost of borrowing in 1981 ended up being over 8 per cent
The real cost of borrowing in 2009 will probably be less than 2 per cent

Fiscal hawks are rightly concerned about the size of the debt that a government bestows on future generations. But the cost of the debt is just as important, and is often ignored in
the public debate. It is common to hear the government’s obligations explained in terms of the amount left per household, or even as an inherited debt, as David Cameron did when he explained how every child will be born £17,000 in the red.\textsuperscript{7} By leaving out its cost, this approach obscures rather than explains the real implications of government debt. Household debts typically incur a high real interest rate: £17,000 of credit card borrowing has an annual interest cost of over £2000, or about 10 per cent of the median household income. It is a very bad idea to put off paying down such a debt. Similarly, a government that borrows when real rates are 6 per cent, as they were during Margaret Thatcher’s administration, requires a very good reason for doing so.

Conditions are now very different. The bond market lets the government borrow at a real cost of 2 per cent or less. The public debt amassed during this recession might well leave a smaller interest burden than that paid by the Thatcher government. It is far more rational to allow the fiscal deficit to take the strain during a recession when real rates are 2 per cent than when they are three times that level. Ignoring this advantage does no favours to taxpayers, present or future.

**INTERNATIONAL COMPETITION FOR FUNDS**

Over a third of British government debt is now foreign owned.\textsuperscript{8} International capital chooses between sovereign borrowers, so a relatively poor fiscal position can raise borrowing costs. But since the IMF crisis of the 1970s the UK’s relative position has improved markedly. Over the period, it has gone from being more indebted than its peers to less indebted. Furthermore, as Fitch Ratings observe, it has since twice demonstrated that it is capable of fiscal consolidation, which puts it at an advantage to rival borrowers on the continent.\textsuperscript{9}

**THE SIGNIFICANCE OF LEGACY DEBT COSTS**

Governments in their annual budget planning have to treat debt interest as a given. They have no choice about how much
it will be, since it is determined by the total stock of debt and the terms on which it was issued. Since governments can borrow for terms of twenty or thirty years or longer, the consequences of past borrowing linger far into the future. For example, in 2006 central government debt interest costs were £27.5 billion, exactly the same amount as in 1996, despite the outstanding debt having increased from £345 billion to £495 billion. This is because the bonds issued over the intervening decade had been sold with low yields while the very expensive debt incurred in the 1970s and early 1980s had started to be redeemed.

Given that debt interest costs cannot be escaped, the annual
A balancing act

budget involves aiming for a particular *primary surplus*, which refers to the budget balance after deducting interest payments. For this calculation, it is the legacy costs of existing public debt that matter. Such costs have fallen in line with the lower government borrowing rates, greatly improving the fiscal conditions for subsequent governments. This effect can be seen by estimating the primary surplus that would have been needed to keep the debt ratio stable, and comparing this with actual primary surpluses (see chart 7). Such a comparison produces a far more complete explanation of why the debt ratio has evolved as it has.

**CHART 7: REQUIRED PRIMARY SURPLUS AND ACTUAL/ESTIMATED OUTFURNS, 1975-2012**

![Chart 7: Required Primary Surplus and Actual/Estimated Outturns, 1975-2012](source)

This chart illustrates several points. As discussed above, until 1981 high inflation made controlling the debt ratio itself quite straightforward. However, from 1981 to about 2000, with
inflation under control but before the legacy costs of debt had fallen, the required primary surplus rose above zero, and remained in the region of 0-2 per cent for twenty years. This illustrates how long high borrowing costs can affect future budgets, and gives some idea of the protracted cost of damaging a government’s reputation for being a trustworthy borrower. Nevertheless, Mrs Thatcher’s government consistently ran a primary surplus even higher than this, which greatly lowered the debt burden. For Labour’s first term, Gordon Brown continued this policy, so that outstanding debt fell below 30 per cent of GDP.

From 2001, the Labour government started enjoying lower legacy borrowing costs. This gave them 1-2 per cent more fiscal leeway than the Conservatives had in the 1980s. Labour reaped the rewards of the Conservatives’ earlier austerity by starting to run a primary deficit to fulfil their ambitions for higher public spending. Furthermore, by making the Bank of England independent they lowered borrowing rates by a further 2-3 per cent, a factor of massive significance given the quantities of debt to be issued over the next fifteen years.¹⁰

Finally, the spike in the required primary surplus over 2008-09 illustrates how collapsing nominal GDP has made controlling the debt ratio almost impossible when compared to the early 1980s recession. It would have required unprecedented fiscal austerity through the slump to stop debt from rising. Such austerity would have prolonged the period of falling GDP, ultimately making the debt problem worse.

But if the next government retains a good reputation with the bond markets, it ought to expect a return of the benign conditions of 2000-07. Despite the high level of debt, there is little sign that rates will rise to the levels seen after previous recessions. As the IMF observes, actual debt levels have a small effect on borrowing terms.¹¹ Because most of the debt will have been incurred during an era of low inflation, legacy interest costs could remain at 4-5 per cent of the outstanding amount. Once the economy is recovering, nominal GDP growth might be 5 per cent or more. This should be sustainable for several years as the economy returns to its potential level, and
is 1 per cent less than Treasury estimates. If they achieve these two conditions the next government will stabilise debt with a primary surplus that is 2-3 per cent lower than that required by Margaret Thatcher’s government. Over a full parliament this is worth over 10 per cent of GDP – the equivalent of seven times the savings gained by cancelling Trident.

**A VICTORIAN PRECEDENT?**

Not unnaturally, the Conservatives have started to compare the looming ‘age of (fiscal) austerity’ with the position Margaret Thatcher inherited in 1979. This has led some commentators to suggest that like Dennis Healey in 1976, Alistair Darling’s profligacy has re-awoken the spectre of a call on the IMF, hyperinflation or possibly both.\(^1\)

But as the foregoing discussion illustrates, low inflation and the ease with which large amounts of debt are being sold make a nonsense of this comparison.\(^2\) Those looking for an historical parallel would do better to examine Gladstone’s Chancellorship of 1859-1866, the last time Britain faced both high debt and low nominal GDP growth (see Chart 8).

This is the first serious recession since inflation was defeated. One perverse consequence of this achievement has been an explosion in public debt that easily surpasses that seen in any previous post-war recession. Fortunately, monetary credibility also means historically low government borrowing rates. In effect, the post-inflation era has brought a new bargain between the government and markets. Previously, government borrowing was expensive but wiped away by its subsequent monetary laxity. Now, national debt incurred during a few short years of recession will take many decades to eliminate – but (as the Victorian precedent implies) doing so does not mean a debilitating cost – so long as the government holds unwaveringly to the new doctrine of fiscal and monetary credibility.
CHART 8: HISTORIC GDP GROWTH RATES AND LEVELS OF PUBLIC DEBT

- Debt Ratio
- 5 year nominal GDP growth
2. Why have the deficits exploded?

Section 1 shows how similar deficits can lead to very different debt ratios, depending on the growth in nominal GDP. But this does not explain the unusually large annual fiscal deficits, which are forecast to exceed anything seen in peacetime. Some commentators straightforwardly blame the deficits on Gordon Brown’s spending ‘splurge’ in the public services. This reinforces the oft-repeated claim that all Labour governments ‘run out of money’, leaving the Conservatives to pick up the pieces.

Although their plans were clearly unsustainable over the medium term, the claim that Labour simply spent its way to a double-figure deficit is disingenuous. Current spending plans in nominal terms were largely set in 2007. At the time they reflected annual growth targets similar to the expected growth in GDP. Since then, spending has risen because of an increase in social security payments caused by the recession. In cash terms, the bulk of the growth in fiscal deficits was almost entirely caused by a collapse in government revenues. This observation fits less neatly into a ‘small government’ worldview that wants to see soaring public debts as a straightforward consequence of out of control spending.

To put these deficits in proper historical context, we compare the different approaches taken by the Thatcher and Brown governments over the course of a recession. Chart 9 illustrates the paths they took in terms of the proportion of GDP taken by taxes and spending.
MRS THATCHER 1979-81: FIGHTING THE DEFICIT DESPITE A RECESSION

The first Thatcher government was obsessed with keeping the public sector borrowing requirement (PSBR) low. This was partly motivated by its attempts to bring down inflation and also from a belief that high government borrowing was ‘crowding out’ the private sector. The Chancellor sought to reduce the PSBR regardless of the knock-on effects in the real economy. So despite its stated aim to cut taxes, the
government froze personal tax allowances in nominal terms, thereby raising considerable revenues through ‘fiscal drag’. The oil companies and banks, which were both having a ‘good’ recession, were also subjected to windfall taxes. In 1981 such measures raised revenues by 2 per cent of GDP, the equivalent of £28 billion in today’s terms.

It is difficult to overstate the outrage caused by the government retrenching while the economy seemed locked into a downward spiral. After decades of planning demand for full employment, this was highly unorthodox. In 1981, after a Budget that raised taxes during a deep recession, 364 economists wrote a letter to The Times rubbishing the notion that deflating demand would bring inflation under control. The Times’ economics editor, David Blake, mocked monetarism:

“By cutting borrowing, the Chancellor hopes to make room for cuts in interest rates .... Instead of an unhealthy, false growth in output, we shall have a natural recovery with the private sector leading the way. Lower inflation will follow from the lower level of public borrowing and slower growth of the money supply. This will increase confidence and thus increase spending, increasing demand ... It would be nice if the world worked like this, just as hydraulic engineers would find it convenient sometimes if water flowed uphill. But it doesn’t. The impact of the Budget will be to push output down and unemployment up.”

The critics also argued that fiscal tightening would be self-defeating, because it would cause lower growth, higher borrowing and further fiscal consolidation, in an endless downward spiral.

The critics were wrong to predict an impending Depression. Economic growth restarted shortly after the Budget, and continued for what was then the longest period since World War II. A new orthodoxy was established, best expressed in Nigel Lawson’s 1984 Mais Lecture, when he argued that macroeconomic policy should target price stability and leave economic growth to microeconomic policies.
GORDON BROWN 2008-10: USING VAST DEFICITS TO FIGHT A RECESSION

The rejection of fiscal policy as a tool of demand management remained in place until recently. Indeed, when Gordon Brown became Chancellor, the Treasury published a number of papers that backed up Lawson’s view, treating volatile deficits as a threat to macroeconomic stability, and set fiscal rules designed to prevent government debt from damaging the smooth running of the economy.\(^{17}\)

However, in 2008 the government returned to active fiscal policy. After the collapse of Lehman Brothers in September, and the Bank of England’s subsequent decision to push interest rates towards zero, it became apparent that ordinary monetary policy would not produce the stimulus needed to boost the economy. Even after the emergency recapitalisation in October, banks were unwilling to lend. With prices falling and the housing market collapsing, demand for investment also fell. The deterioration in the public finances revealed by the November pre-Budget report was widely expected. But far from acting to counter this deterioration, the Labour government announced measures that \emph{increased} the deficit – largely through a temporary VAT cut – to keep consumer demand high.

Much heat has been generated over such discretionary steps, which the Conservatives vehemently opposed. Just a month after its implementation, David Cameron somewhat paradoxically called the tax cut a waste of taxpayers’ money.\(^{18}\) But three months later, the Centre for Economics and Business Research found that it had boosted retail sales by £2.1 billion in its first quarter of operation, thereby halving its effective cost to around £5 billion.\(^{19}\)

Most developed economy governments also carried out a discretionary stimulus, and the UK’s discretionary stimulus was relatively small at 1.5 per cent of GDP, compared to a G20 average of 3.1 per cent (and 4.9 per cent in the USA).\(^{20}\)

However, most of the deterioration in public finances was not
due to new policies but to passively allowing the fiscal deficit to rise without stepping in to fill the gap. Some of this stems from the ‘automatic stabilisers’: for example, social security spending rises as the economy declines. But the major decision was to stick to existing spending plans even though the revenues needed to fund them had declined precipitously.

Some commentators have argued that there has been a surge in public spending unrelated to the recession, just because most of it relates to plans made before the economy slowed down. The ratio of spending to GDP is due to soar, but this is almost entirely because the forecast of nominal GDP has fallen by 9 per cent in a year. Therefore to have kept spending constant as a proportion of GDP would have needed drastic spending cuts in 2008-09 and beyond. In a frictionless economy operating at full capacity, a fall in demand from government would translate into higher private demand through lower interest rates, leaving output unchanged. But only the most blinkered free market idealist could believe that this describes the current state of affairs. With interest rates already low and consumers retrenching, the effect would instead have been an even weaker economy as businesses downgraded their expectations for future demand by tens of billions of pounds. Keeping to the 2007 spending plans represented a conscious policy to combat the recession.

**THE FACTS HAVE CHANGED, NOT THE THINKING**

In allowing the deficit to balloon, Gordon Brown’s government acted in the opposite way to Margaret Thatcher’s. However both were pursuing policies appropriate to the prevailing conditions. As discussed above, in 2008 the Treasury was far better placed to increase borrowing than it was in 1981, because creditors were falling over themselves to lend to governments at record low rates. In 1981, on the other hand, rates were well into double figures, burdening future governments with high debt interest costs and damaging the real economy. In 1980-81 these rates combined with a
soaring oil price to make sterling appreciate, in contrast to the current recession (see Chart 10). The strong pound imposed a squeeze on British industry, which gave the Thatcher administration a further reason to get interest rates down by reducing government borrowing.

**CHART 10: CONTRASTING EXCHANGE RATES OVER TWO RECESSIONS.**

Manufacturing has also suffered in the current downturn, but more because of the weak world economy than a strong currency (see Chart 11). The next Chancellor can neither assume that there will be an immediate recovery driven by private sector demand, nor that there will be an export-led rebound on the back of a weak pound.
There were good reasons to believe that the Conservatives were right, and that public sector borrowing did crowd out the private sector during Thatcher’s first term. Interest rates were far higher. Nationalised industries accounted for 9 per cent of national investment. Local authorities built a third of all housing. Taxes took a much larger share of economic output, and at the margin were punitive – the higher rate of income tax was 83 per cent. Finally, even if the government could boost the economy, the need to repay expensive debts with future tax rises or higher inflation would negate this advantage.

But such reasoning fails when the collapse in demand is brought about by a financial crisis, and interest rates are as
low as they can be. Today, the economy is operating well below capacity. In these circumstances, government spending supports economic growth, rather than competes with it. Even if private finance had not dried up, it is unlikely that private sector demand would be enough to turn the economy around, given that falling prices act as a disincentive to consume or invest. As Martin Wolf writes: “Fiscal deficits are not crowding the private sector out. They are crowding it in, instead, by supporting demand, which sustains jobs and profits.”

Some commentators like to weave the return of active fiscal policies into a wider narrative that describes the financial and economic crisis as proof of the failure of free market policies. Alongside a return to higher marginal tax rates, it (supposedly) demonstrates how Labour never really accepted the economic lessons of the 1980s. But it is a change in circumstances rather than philosophy that explains the use of Keynesian stimulus. Gordon Brown was genuine in his belief that macroeconomic fine tuning is better performed through monetary decisions. Wrestling the economy out of a deflationary free-fall is not ‘fine-tuning’. The threat of a return of Depression-style conditions brings very different policy prescriptions. For the slump of 2008-09, Brown is correct to argue that “you have to grow, not cut, your way out of recession”. As Robert Skidelsky argued recently, it is not a question of whether Keynesian or neoclassical economic models are ‘right’, but a matter of judgement about what current conditions require.

In this case, the government’s judgement was right. Much of the large fiscal deficit arose because Labour accepted the Keynesian policies needed for such a crisis. This deserves some praise, although it was not miraculously insightful: the IMF advocated fiscal stimulus, and it has been followed in numerous countries, most notably the US.

**CONSERVATIVE POLICIES FOR A SLUMP**

The Conservatives’ approach to fiscal policy is less clear, and hovers somewhere between knee-jerk opposition and economic reality. David Cameron and his shadow chancellor
George Osborne have used every opportunity to attack the government’s stimulus, but stopped short of advocating a pre-Keynesian balanced-budget philosophy. In contrast to the Thatcher government’s approach, Osborne has admitted that “today, we must let the automatic stabilisers function”. This suggests he thinks the public balance sheet *can* act as a useful counterweight to private sector retrenchment.

In addition, the Conservatives have called for a series of ad hoc measures which would increase the deficit:

- Allowing smaller companies to delay VAT payments
- A cut in national insurance and corporation tax for smaller firms
- Abolishing all tax on savings income for basic rate taxpayers
- A £2.5 billion tax break for businesses hiring during the recession, which they suggested would save 350,000 jobs

These plans have a different emphasis to those of the government. Like the Thatcher reforms, they are intended to free up the supply side of the economy rather than boost demand. But GDP did not collapse in autumn 2008 because of a drop in economic capacity. It happened because demand suddenly evaporated, as a result of plummeting expectations following a financial market meltdown. In the 1970s, the supply side was the problem: real growth excluding the oil industry was stuck at 0.75 per cent from 1973 to 1979, and efforts to boost demand merely resulted in more inflation.

There is nothing wrong with affordable ideas to improve productivity. But such policy suggestions indicate that the Conservatives have fundamentally misunderstood the nature of the economic crisis. They have sought to vanquish old foes rather than face the current problem. Their policies would have had little positive effect on the real economy during the slump: a firm facing collapsing sales does not invest or hire, regardless of tax breaks, which would have just diverted funds to firms already planning to expand. As a result the claim that the £2.5 billion tax break would pay for itself is highly doubtful.
tax break for savings would probably have *damaged* demand by reducing the incentive to consume. The only difference is Conservative policies would have created different winners and losers: people with plentiful savings would have benefited, as would small business owners looking to hire staff.

It is unlikely that the Conservatives believed their own rhetoric about Britain “drowning in red ink”. Had they followed Thatcher and tried to cut the budget deficit during the recession, there would have been an even worse fall in nominal GDP, incomes and asset prices, and even higher unemployment, as evidence from the Depression and the Asian financial crisis of 1997-98 suggests. Expectations of deflation might have become entrenched, leading to higher real debt costs, a further freezing up of the financial system and further damage to the economy and government revenues. Given the state of the financial sector and the world economy, a recovery driven by a re-energised private sector is difficult to imagine. It is doubtful that the government would have eventually emerged with less debt.

In reality, with many other developed countries stimulating their economies, a Conservative government would probably have followed a similar approach to Labour. On the limited evidence available, Osborne is a closet Keynesian, just one determined to limit the government’s use of counter-cyclical deficits to those that happen to arise automatically.

Opponents of Brown’s activism seem either to believe that the UK economy was operating at capacity, or that the government’s credit was close to being exhausted. Clearly, neither of these conditions applied. But Labour did grossly mismanage the government finances leaving its fiscal position far worse than it should have been, and actually limiting the possible extent of its actions to fight the recession. Labour’s reaction to the slump may have been correct, but their preparation for such an eventuality was woeful. Gordon Brown allowed the UK to enter this crisis with a significant structural deficit, and revenues that were dangerously dependent on benign economic conditions.
THE STRUCTURAL DEFICIT

During his ten years as Chancellor, Gordon Brown emphasised fiscal stability. The key to his approach was the ‘golden rule’, by which Brown promised to balance the budget over the economic cycle. According to Treasury reports before the credit crunch, the government was due to meet its golden rule, albeit with relatively strong growth and tight future spending plans. In other words, there was no structural deficit in prospect.

The rule was intended to allow surpluses from good years to be spent in bad years. But it required the Treasury to make a very difficult estimate of where the economy stood relative to its economic potential. A small difference in the perceived ability of the economy to grow sustainably made a huge difference to the outcome. To demonstrate this point Chart 12 presents two different versions of the UK’s cyclical position since the mid 1990s:

CHART 12: ALTERNATIVE ACCOUNTS OF THE ECONOMY’S CYCLICAL POSITION

The two lines display different assumptions about the gap between the economy’s actual performance and the trend level of sustainable growth. The unbroken line assumes this...
to be 2.5 per cent since 1985. This is in fact the average up until 1997, and will probably turn out to have been close to the average over 1985-2015.

The dotted line supposes that that sustainable growth was 3 per cent from 1997. It roughly resembles the account of the cycle that the Treasury produced each year. 35

The recession and recovery now predicted will end up bringing the unbroken line back towards zero. Over 30 years it will turn out that the UK economy was able to grow sustainably at an average rate of 2.5 per cent per annum. Because the growth that occurred for much of Gordon Brown’s Chancellorship was higher, the economy now appears to have been in a long above cycle period. 36

CHART 13: CYCLICAL POSITION AND PUBLIC SECTOR DEFICITS

Source: budget and author’s calculations
An alternative is to assume that the Treasury’s version was right, but that the events of 2007-09 suddenly wiped away a large chunk of Britain’s economic potential. A final, extremely optimistic version is to state that the Treasury was right all along, and expect economic recovery to be rapid and inflation-free until the dotted line reaches zero. Few analysts, including the Treasury, are willing to suggest this.

Britain’s economic potential cannot be scientifically proven; there will never be a consensus on which of these versions is correct. But there is no doubt which would have been the more prudent assumption to make. Chart 13 illustrates the outcome if governments had used this prudent view to calculate the primary surplus needed compared to the actual primary balance achieved.

Until 2000, Gordon Brown followed the pattern set by the Conservatives, with a fiscal position shadowing movements around a prudent assumption of sustainable economic growth (see chart 13). But from 2001, the surplus dropped. It reflected a conscious political choice to divert resources to the public sector – but without raising tax revenues to pay. As we observed above, low debt costs and steady nominal GDP growth meant that this was achieved without debt ratios increasing significantly. But a conservative fiscal policy would have recognised the high probability of a subsequent period of low growth and even higher deficits. This recognition (under the fiscal rules, or any prudent fiscal policy) would have required a realistic plan to cut the structural deficit by around 3 per cent, through higher taxes or lower spending. Such plans were not made.

This analysis benefits from considerable hindsight. Few economists or policymakers thought the UK had an overheating real economy for much of this decade, although some were willing to raise concerns about financial imbalances.\(^37\) But economists did warn the government that it was being too optimistic about future revenue growth, and the Institute of Fiscal Studies recently estimated that there was a structural deficit of 3 per cent of GDP to be closed.\(^38\)
The financial crisis also laid bare the mistakes the Treasury made when surveying the economy. In general, it concentrated on the real rather than financial economy, surveying indicators related to productivity, employment conditions, and inflation. The biggest error was underestimating the risk posed by the bloated nature of the household sector’s balance sheet: the word ‘debt’ cannot be found in Treasury documents assessing the cycle. In this way the Treasury’s mistake was remarkably similar to that made by the financial sector as a whole: to disregard high levels of debt as a potential limit on future growth. Had the government been aware of this limit, it might have recognised that the economy had grown faster than its sustainable rate, and that it needed a smaller budget deficit to be assured of balance over the cycle.

INSECURE REVENUES

The problem of insufficient revenues was compounded by an unusual dependence on receipts that relied upon an unstable financial bubble.

The deterioration in the UK’s fiscal position is much worse than in other developed countries even though many are suffering a worse recession. The principle cause of this phenomenon is not a rise in spending but a collapse in revenues.

A comparison of the pre-Budget report of 2007 with the Budget of April 2009 reveals the extraordinary collapse in the tax receipts. In 2007 the government expected to gather £581 billion in 2008-09; by April 2009, this has fallen to £530 billion, with a further fall to £500 billion in 2009-10, which was originally expected to yield over £600 billion. Income tax, national insurance, stamp duty and corporation tax account for nearly all of the lost revenues. On the other hand, expenditure taxes (once the temporary VAT cut is factored out) and various duties on alcohol, tobacco and gambling have held up well.
**CHART 14: DETERIORATION IN PUBLIC FINANCES (NOT INCLUDING DISCRETIONARY MEASURES) COMPARED TO LOSS OF ECONOMIC OUTPUT**


**CHART 15: EVOLVING GOVERNMENT REVENUES**

Source: Various Budgets and Pre-Budget reports
The tax-by-tax analysis in the 2009 Budget shows how vulnerable government revenues were to the sort of recession we are now suffering. The government relied too much on financial sector bonuses, housing transactions, and corporate taxes, which are highly sensitive to underlying GDP and asset values. As a result, they fell much faster than the rest of the economy when the recession struck.

Although the Treasury diligently estimated the sensitivity of the public finances to the economic cycle, they failed to consider the impact of such a financial collapse. They expected a 10 per cent movement in asset prices to be associated with a change in receipts from inheritance tax, capital gains tax and stamp duty equal to 0.14 per cent of GDP. But in 18 months the estimate for these taxes has dropped by £15 billion, or over 1 per cent of GDP. Even after the credit crunch had begun, and house prices started falling, the 2008 Budget was too optimistic about the recession’s effect on revenues. For example, it expected a fall in stamp duties of just 6 per cent. In fact, they fell by more than 50 per cent and look unlikely to recover for years.

**EXPENDITURE REMAINING HIGH**

Between the pre-Budget report in the autumn of 2007 and the Budget in the spring of 2009, estimates for 2008-09 spending in cash terms did not change significantly, rising from £617.4 billion to £620.7 billion. The estimate for 2009-10 grew from £646.6 billion to £671 billion, an increase of £25 billion. Most of this occurred within the Annual Managed Expenditure (AME) budget, which, in the words of the Treasury, “consists of programmes which are large, volatile and demand-led”. Social security benefits and tax credits account for all of this increase.

Current spending within Department Expenditure Limits (DEL), which includes budgets that can be planned on a flexible, multi-year basis like health and education, increased only marginally, mainly due to higher defence expenditure. Capital spending increased from £54.1 billion to £63.4 billion, partly as a result of the government’s decision to bring some capital projects forward.
### TABLE 1: EXPENDITURE PLANS FOR 2009-10 (£ BILLIONS)

<table>
<thead>
<tr>
<th></th>
<th>PBR 07 projection 09-10 (£bn)</th>
<th>Budget 09 projection 09-10 (£bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CURRENT EXPENDITURE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Department Expenditure Limits</td>
<td>338.8</td>
<td>342.1</td>
</tr>
<tr>
<td>Annual Managed Expenditure</td>
<td>253.7</td>
<td>265.9</td>
</tr>
<tr>
<td>of which</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social security benefits</td>
<td>152.3</td>
<td>164.7</td>
</tr>
<tr>
<td>Tax credits</td>
<td>18.8</td>
<td>21.7</td>
</tr>
<tr>
<td>Net public service pensions</td>
<td>2.9</td>
<td>4.1</td>
</tr>
<tr>
<td>National Lottery</td>
<td>0.6</td>
<td>0.9</td>
</tr>
<tr>
<td>BBC domestic services</td>
<td>3.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Other departmental expenditure</td>
<td>1.3</td>
<td>2.5</td>
</tr>
<tr>
<td>Net expenditure transfers to EC institutions</td>
<td>5.7</td>
<td>5.6</td>
</tr>
<tr>
<td>Locally-financed expenditure</td>
<td>27.4</td>
<td>27.9</td>
</tr>
<tr>
<td>Central government gross debt interest</td>
<td>31.2</td>
<td>27.2</td>
</tr>
<tr>
<td>AME margin</td>
<td>1.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Accounting adjustments</td>
<td>8.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Public sector current expenditure</td>
<td>592.5</td>
<td>608</td>
</tr>
<tr>
<td><strong>CAPITAL EXPENDITURE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public sector gross investment</td>
<td>54.1</td>
<td>63.4</td>
</tr>
<tr>
<td>Depreciation</td>
<td>-20.2</td>
<td>-19.6</td>
</tr>
<tr>
<td>Public sector net investment</td>
<td>33.9</td>
<td>43.8</td>
</tr>
<tr>
<td><strong>TOTAL MANAGED EXPENDITURE</strong></td>
<td>646.6</td>
<td>671.4</td>
</tr>
</tbody>
</table>

A £15 billion increase in transfers to people hit by the recession is not surprising. In 1980-82, social benefits rose from £22.8 billion to £33.5 billion, a far larger increase as a proportion of GDP. But the increase in capital spending stands in stark contrast to the approach of the Thatcher government which actually cut public sector net investment from £4.7 billion to £3.3 billion between 1980 and 1982 – a decision which may nevertheless have been rational in the light of high prevailing interest rates. Today, capital programmes incur a relatively low interest cost and are being used to cushion the impact of falling company investment.
**EXPLAINING THE GROWTH OF THE DEBT**

Only a major war has ever produced a national debt as large as that which will confront the next government. Although the accusation that this all stems from excessive spending has some truth to it, this misses out more direct causes – collapsing nominal GDP and even faster collapsing revenues. Most developed countries are suffering from the same combination; according to IMF figures, the advanced G20 countries will see government debt increase between 2007 and 2014 from 79 to 103 per cent of GDP. The UK has deteriorated faster, as a result of its structural deficit and unwise reliance on insecure revenues.

In the box below we attempt, very roughly, to calculate how much of the debt can be traced to various causes. Perhaps a quarter stems from bad government decisions - i.e. the structural deficit and insecure revenues. Had these errors been rectified, the growth in debt would have been approximately the same as our international peers. This is clearly a significant policy mistake, resulting in public debt being £300 billion higher and a significant structural deficit to work off.

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**Apportioning blame for the debt**

A year ago, the government expected the debt in 2012-13 to be £731 billion. This year, it expects it to be £1,262 billion, plus an indeterminate amount for the cost of its various financial rescue schemes. If we take the latter item to be 9 per cent of GDP, or £130 billion, then there is about £660 billion of increased debt to explain.

Any explanation can be divided into two elements: increases due to bad fiscal policy, and increases due to the effect of a sudden recession.

Calculating how much is due to policy errors means estimating what ideal fiscal policy would have looked like. We take a hawkish view, and assume that an ideal fiscal policy would have:

- eliminated a 3 per cent structural deficit
ensured that revenues were not as sensitive to the economic cycle as they turned out to be. This means supposing that they would fall by 50 per cent of GDP in the recession, instead of the 70 per cent that has in fact occurred.

Between the 2008 and 2009 Budgets, the cumulative spending expected from 2008-09 to 2012-13 increased by about £50 billion, and cumulative revenues fell by £481 billion. The cumulative expected loss of GDP was £694 billion. If revenues had fallen at a rate of 50 per cent of GDP, the fiscal loss would have been £347 billion. The rest – £134 billion – can therefore be apportioned to the policy error of being too dependent on the windfall gains from a financial bubble.

**Chart A: dissecting the debt for 2012/13**

Therefore, in increasing order of significance, the debt for 2012-13 can be explained by:

- about 4 per cent per cent from increases in spending stemming from the recession, most of them automatic responses via the benefits system
- about 9 per cent from the banking rescues
A balancing act

- another 9 per cent from over-reliance on volatile ‘bubble’ revenues
- about 16 per cent from the government failing to fix the structural deficit
- about 25 per cent from a loss in revenues from the recession, which includes those deliberately foregone through the VAT cut
- the rest (about 37 per cent) from the debt that would existed had there been neither a recession nor a structural deficit.

The government deserves criticism both for the large structural deficit and the fragility of its revenue base. It will take a long period of austerity to restore fiscal balance. But the Conservative’s claims that the government has acted irresponsibly to cushion the real economy from the recession are wrong. For Margaret Thatcher, high real interest rates, punitive tax levels, soaring inflation and a bloated public sector made controlling public spending a clear priority. For the current government, none of this applies: rates are at rock-bottom, inflation is threatening to turn negative and the state no longer controls swathes of nationalised industry. Applying Thatcherite policies during the current downturn would have been a serious mistake.
3. Restoring the public finances to health

The most recent Budget forecasts that public sector net borrowing will peak at 12.4 per cent of GDP in 2009-10, before declining to 5.5 per cent in 2013-14. This will result in overall public debt reaching 76 per cent of GDP. Even then, a further tightening of 2 to 3 per cent of GDP will be required to stabilise the debt ratio.

But should growth stutter again, and the large output gap lead to further deflation, it is important that the next government is not so ideologically committed to fiscal tightening that it tries to pursue a balanced budget with no regard to the consequences for the economy. Christina Romer, the chair of Barack Obama’s Council of Economic Advisors, has recently issued a reminder of the mistakes made in 1937, when fiscal and monetary policy became contractionary after four years of strong growth. This brought about the ‘mini-Depression’ in 1937-38, accompanied by a 5 per cent increase in unemployment. She warns against removing support from the economy too soon, a warning echoed by the OECD.

This creates a difficult challenge: to balance short term economic support against long term fiscal sustainability, without damaging economic efficiency. The answer is to implement ways in which the next government can credibly commit to future prudent macroeconomic behaviour, and by introducing new tax revenues that help stabilise both the economy and the fiscal situation, without damaging long term growth.
RESISTING INFLATION – GREATER USE OF INDEXED BONDS

Gilt issuance is already at record peacetime levels and will be high for at least four years; a recent Morgan Stanley presentation predicted £130-150 billion annually to 2013. As section 1 illustrated, the terms on which such debts are incurred has a huge effect on Budget arithmetic for decades. Every possible effort should be made to retain the recently acquired advantage of low borrowing costs.

Governments can default in one of two ways: explicitly, through outright repudiation of the original borrowing terms, or implicitly, via inflation. Explicit default is almost unheard of British history. Despite dramatic movements earlier this year in the credit default swap market, an outright default on UK debt is unlikely. It is the prospect of inflation that is most likely to drive borrowing rates higher. The temptations are great. As well as lowering the real value of government debt, inflation lightens the pressures on indebted households and companies. Its wide-ranging effects deal more comprehensively with excessive leverage than specific government interventions ever could.

But inflation would drive up government borrowing costs. There is no credible way a central bank could commit to having a higher inflation target for just five years, say. Much of the job of the Monetary Policy Committee is about influencing expectations, which operate with a long lag. As Financial Times commentator Wolfgang Münchau points out, a pre-commitment to reverse an inflationary policy would act against the original inflation taking place at all. The alternative – a surreptitious increase in inflation without explicitly changing the target – would damage credibility even more.

Regardless of how it is brought about, unanticipated inflation results in a transfer of wealth from creditors to debtors. As such it resembles a retrospective change to contract terms. Currently, bond investors are lending on the understanding that the monetary regime is committed to low inflation. If it were allowed to rise, such investors would surely demand much
higher interest rates in the future, particularly as they now have a wide choice of sovereign borrowers. The result would be a return to the dynamic of the 1970s and 80s – lower debt levels perhaps, but higher long term rates that punish both the government and private enterprise. It took decades to wring the effects of the system last time. Given how vital it is that economic growth resumes at a vigorous pace, this is a risk that cannot be taken.

How can the government reassure markets that it will not inflate its way out of debt? In theory, the independence of the Bank of England should guard against this possibility. As we have argued elsewhere, monetary policy should remain in the hands of the central bank. But the advent of quantitative easing and the return of fiscal policy to macroeconomic management have led to suggestions that the Bank of England should share its control over economic management. There is plenty of scope left for the government to interfere. What is needed is a real financial incentive not to do so.

The answer lies in a greater use of index-linked bonds. They cost more to service if inflation rises, or less if it falls. There is a considerable demand for such bonds from pension funds, one which is probably unfulfilled at the current rate of issuance. It was a little noted bright spot in the last Budget that the forecast for debt interest in 2009-10 was £3 billion lower than the year before, despite overall debt levels climbing by £150 billion; this is largely due to lower charges on index-linked debt.

The next government should announce an intention of increasing the amount of debt issued in this way – perhaps to 40 per cent or more. Doing this will reassure the market that it does not intend to inflate its problems away. It may lower the risk premiums on all forms of government debt, and throughout the economy. It will also help to stabilise the fiscal position in the event of another deflationary episode, as deflation lowers their cost. Finally, the strong demand for these instruments makes them a cheap source of funds for the government – they have recently been issued with real yields below 2 per cent.
SPENDING CUTS DON’T PROVIDE THE WHOLE ANSWER

The Budget scenario already assumes considerable steps to restore fiscal balance. These include an increase in national insurance, a new higher rate tax band, unspecified ‘efficiency gains’ of £5 billion per year, big cuts in capital expenditure and a further spending squeeze. According to the government, current spending will grow at just 0.7 per cent per annum from 2011-12. Such spending plans already bear comparison with the last two periods of fiscal retrenchment (see Chart 16).

CHART 16: REAL SPENDING INCREASES OVER THE LAST THREE RECESSIONS

The chart shows how Labour allowed spending to increase much more than the Conservatives did during the early 1980s recession, but to a similar degree to John Major’s government in 1990-92. However the rate at which spending growth is
expected to drop is extremely ambitious compared to either of these episodes. In fact, Labour’s most recent Budget requires public spending to be more tightly controlled than Margaret Thatcher achieved for her entire first term.

As discussed earlier, the Conservative government in the early 1980s took the importance of keeping the fiscal deficit under control very seriously, even during the recession. Nevertheless, total spending grew until the fiscal year 1984-85, four years after the recession ended. This is despite possessing several advantages that will not be enjoyed by the next government. Public investment and the defence budget were much higher and so could more easily be cut. There were significant assets that could be sold, including the nationalised industries, which reduced costs; the government cut the Trade and Industry budget by 40 per cent in real terms from 1979-80 to 1989-90. From the early 1980s there was also a programme of council house sales under the ‘right to buy’ scheme – such sales counted as negative council spending, and saw the housing budget decline by 66 per cent.

John Major’s administration in the 1990s also struggled to cut total expenditure in real terms until several years after the recession ended: in fact, the fiscal year 1996-1997 was the first to have lower real expenditure than the year before. This is despite successive Chancellors introducing what were then regarded as extremely tight budgets, which included a virtual freeze in the education and health budgets.

Current government plans imply that current spending growth will barely outstrip inflation a year after the recession has ended. This is extremely ambitious. Given unavoidable increases in areas like social security and debt interest, it implies real terms cuts for many departments that are larger than any since the 1970s. If political commitments to protect spending on the £100 billion NHS budget are to be kept, cuts in other areas will be larger still. A dawning recognition of this fact has precipitated a public row about which party is planning the greatest cuts, one that is unnecessarily obscured by the prime minister’s refusal to recognise that Labour’s own spending plans render such cuts inevitable.
To expect an even greater retrenchment of public spending in the near term ignores the lessons of similar attempts in the past. For example, during the financial emergency of 1976 the Labour government had a huge struggle to cut spending quickly to meet the loan conditions demanded by the IMF. Sometimes legislation has to be changed. Cutting staff involves making redundancy payments. Contracts need to be renegotiated. In the end, the burden had to be spread across many different departments just to reduce spending by 1 per cent of GDP in 1977.

This is not to deny that spending will need to carry on falling after 2014 as a share of the national product. Even before the crisis, public spending was clearly too high to be sustained without an implausibly long economic expansion or further tax rises. Current government forecasts put it at 43.5 per cent of GDP in 2013-14. Although this is broadly in line with...
the average since 1970, the comparison is not fair: for most of the 1970s and 1980s the state controlled swathes of the economy that are now privately owned. This means that a lower medium-term target is more appropriate – perhaps 40-41 per cent of GDP, which is just above the average level for the 1990s. So public spending should still grow more slowly from 2014 than the economy as a whole. Over this timescale plans can be drawn up in the light of a proper political debate about what the state should and should not do.

**AN INCREASED ROLE FOR WEALTH TAXES**

With a tough but ambitious medium term target for public spending of 40-41 per cent of GDP, tax receipts will need to reach 38.5-39 per cent of GDP. At this point, the primary surplus will be 2 per cent of GDP and the debt ratio ought to stabilise. This will require some further steps to increase tax receipts. The Labour government’s plans so far amount to a new higher rate tax band and the phasing out of allowances for the rich. These changes will not be sufficient - in fact, they risk further complicating the tax system without significantly raising revenues. The Conservatives have announced no significant tax raising plans since their controversial proposal in 2007 to tax non-domiciled residents, the returns of which are highly uncertain but clearly insufficient even to fund their inheritance tax proposals.

After the trauma of the financial crisis and ensuing recession, there are serious worries about the long term growth potential of the economy. A collapse in investment and a rise in unemployment risks undermining the UK’s physical and human capital. Given this risk, it is essential that fiscal plans do not further undermine incentives to invest and innovate. The OECD has carried out research on this question. They find that consolidations based upon lower spending help boost GDP growth. However, they also argue that it will be difficult to achieve all the fiscal consolidation necessary with spending cuts alone. Discussing revenues, the OECD finds: “That among taxes, corporate taxes are the most harmful for growth, followed by personal income taxes, then consumption taxes,
with recurrent taxes on immovable property having the least impact.”

This is why we propose that the government increases the amount of revenue raised through property taxes. Wealth is much more unevenly distributed than income, and the majority of it comes from housing. In 2007, the total value of housing was put at £4.3 trillion from a total stock of UK wealth of £7 trillion. Even after two years of falling house prices, it probably still exceeds £3.5 trillion, and total wealth in all forms probably more than £5 trillion. It would take a levy averaging just 0.4 per cent of housing values to raise 1 per cent of GDP annually.

Opponents of all wealth taxes complain that they diminish incentives to invest and innovate. Past efforts at wealth taxes have foundered on practical difficulties. Certainly, great care should be taken over the design of any new wealth taxes to avoid unforeseen negative consequences. For example, a levy on all assets above a threshold, such as that found in France, would undoubtedly prove distortionary and encourage evasion.

But a significant proportion of current wealth is accumulated either through benefiting passively from rising house prices or via inheritance. Neither of these activities is either related to entrepreneurship or easy to shift across borders. The United States raises a considerable amount through property taxes at a state level, without a noticeable diminution of entrepreneurial activity in the economy as a whole. So taxing immovable property – in other words, housing – ought to be practical and leave economic incentives broadly intact, as the OECD’s findings suggest.

We suggest two approaches. The first would be to phase out the exemption of owner-occupied houses from capital gains tax. This will introduce another large and volatile element to the Exchequer’s tax receipts, and so should be treated with prudence (see below). It ought to yield an amount of between a quarter and a half of stamp duty receipts, depending on the state of the market, or £3-6 billion pounds annually.
The second method would be to allow a flat rate levy of up to 1 per cent on property values above a threshold, as a supplement to the council tax: currently, a £2 million house pays the same tax as one worth £500,000. We recommend that the actual level of the tax and threshold are decided by councils, with central government gradually lowering the block grant in order to force councils to make up the difference. The complaint that council taxes are particularly regressive carries less weight if the bulk of any increase is born by higher value properties. If the average levy were 0.5 per cent, this might raise £3-4 billion annually.\(^6\)

The effect on someone paying 0.5 per cent on a £1 million property above a £500,000 threshold will be 0.25 per cent – or, if he had taken a 75 per cent mortgage, the equivalent of a higher mortgage rate of 0.35 per cent. Without the government’s interventions last autumn, mortgage rates would be a great deal higher than that – if they were available at all.

Conservative plans for a large cut in inheritance tax should also be shelved. At present, any supposed disincentive to work for the person bequeathing wealth is more than outweighed by the reduced incentive to work for the inheritor of that wealth.\(^6\) Furthermore, the wealthy benefit most from cuts in inheritance tax.

The Conservatives’ plans to abolish taxes on savings incomes for lower-rate taxpayers are also regressive and unnecessary. The people who would benefit most from this proposal are those near the top of the wealth distribution who already enjoy a range of incentives to save.\(^6\) An OECD study has found that tax-incentive schemes like ISAs fail to induce significant new saving. Therefore, to a great degree they just represent a transfer of wealth to a favoured interest group.\(^6\) Finally, savings rates are increasing anyway, without a further incentive, as households choose, or are forced, to reduce their debts or build up their assets after the credit crunch. The problem of poor households not saving enough should be addressed by redirecting existing schemes rather than producing new ones that will largely benefit the rich.
The Conservatives have recently described people with significant savings as “innocent victims” of the recession, punished for their prudent behaviour with unfairly low interest rates. As such they imply that the wealthy have a lesser duty to help repay the national debt. But there is no case for asserting that taxes on wealth are unjust. The expensive but necessary steps taken to prop up the financial system, using public spending to absorb the shock of the recession, have benefited owners of wealth as much as anyone, and not just those dependent on the public sector. Had the government tried to limit the growth of public debt, the consequences would have been dire for *everyone*, including savers whose deposits would have been at risk. A further refusal to consider broad and significant tax rises would more likely lead to inflation than the spending cuts hoped for by the right. This would have a far more devastating effect on savers than a year or two of low rates.

None of these tax changes would significantly undermine the incentive to work as much as a rise in marginal income tax. It therefore makes sense for the government to introduce them in combination with a plan to remove the 50p tax band. This ought to be cheap given its low yield, and will make the politically difficult task of selling the tax changes easier. In total, such a switch towards taxes on property would achieve the multiple aims of improving economic incentives and stability, making the tax system fairer and putting the public finances on a sounder footing.

**OTHER PROGRESSIVE FISCAL AMBITIONS NEED TO BE TEMPERED**

An increased role for wealth taxes challenges a future Conservative government to confront one of its core constituencies. But the other parties will need to do the same. The issue of VAT is a case in point. Putting VAT up to 20 per cent has several advantages to recommend it. Most obviously, it raises a lot of revenue quickly: perhaps £13 billion or almost 1 per cent of GDP. It is not charged on investment goods, and so does not damage entrepreneurial incentives. Insofar
as it changes economic behaviour, it encourages saving over consuming, which is in the long term (though not short term) interest of the country.

Most of the big increases in VAT have been introduced by Conservative governments against opposition from Labour and the Liberal Democrats, who argue that the tax disproportionately hits families on low incomes. This is true: a rise in VAT would have a negative effect on income inequality. However, some of this will be counteracted by other tax rises which have generally hit high earners more. It is also to be hoped that the lowest income decile, which pays the most VAT, will be more shielded from the income effects of the recession, because it receives over 50 per cent of its income from benefits.

Poverty fell more during Labour’s first, fiscally prudent term than it did in the period of high public spending that followed.\(^{65}\) For the fiscally constrained period ahead, governments will again have to concentrate on improving employment prospects for the poor, rather than redistribution through the tax and benefit system, if they are to make inroads into eradicating poverty.

Taken altogether, new wealth taxes and a higher rate for VAT ought to raise taxes equivalent to 1.3-1.5 per cent of GDP – or much more when compared to Conservative plans that actively propose cutting inheritance and saving taxes.\(^{66}\) Taking this route ought to allow the next government to scrap the inefficient 50p tax band while still bringing tax revenues above 39 per cent of GDP. At this level, and with public spending trending down towards 40 per cent, public debt should be put on a declining path during 2014-18. But to remain sustainable it is important that future governments prevent themselves from unbalancing the public books during the next boom.

**FISCAL PRUDENCE CANNOT BE DELEGATED**

In a previous pamphlet, we argued that good fiscal policy is that which “leans against” the economic cycle.\(^{67}\) With the possible exception of Germany, few governments in the
developed world have problems with expanding government debt to counteract a sudden economic slowdown.\textsuperscript{68} The problem has always been that those same governments fail to save sufficiently during an upswing.

Despite the ‘golden rule’, this was clearly beyond Gordon Brown, as the UK’s large structural deficit shows. However, this weakness pre-dates the Labour government. It is quite likely that the Conservatives would have also dissipated the windfall revenues from the financial boom, but on tax cuts, as they did in the early 1970s and late 1980s booms.

At some point in the future, tax revenues that are highly sensitive to economic growth will pick up again. The next government needs somehow to commit to saving enough during the above trend period to secure itself against the next cyclical downturn.

**CHART 18: THE BEHAVIOUR OF VARIOUS REVENUES, 2003-2013**

![Chart showing the behaviour of various revenues, 2003-2013](image)

*Source: various Budgets, HMRC. 2003 = 100*
Gordon Brown thought he had found a method for achieving this when he brought in his “Code for fiscal stability”. Instead, this served to obscure an already difficult subject, by throwing awkward decisions about the sustainability of his plans into a black box marked “fiscal rules”.

The Conservatives now claim to have the answer to the problem in the form of an Office for Budget Responsibility (OBR). Its scope, and therefore significance, is still unclear. If its purpose is merely to provide unbiased forecasts, it only solves part of the problem; the United States has had a highly respected Congressional Budget Office for decades, which has not prevented the recent slide into structural deficit. Moreover, the OBR could succumb to political pressure, and even if it resisted, fiscal forecasts are intrinsically difficult. No economist anticipated the scale of the collapse of the government’s revenues until very shortly before it happened. Any errors will undermine its objectivity and competence, making it easier for governments to ignore it in the future.

Fiscal policy also serves more than one goal. One goal is to reduce the size of the public debt, but another is to support the economy appropriately during a slump. To favour just one of these is not “improving fiscal policy” – it is launching a new lobbyist for just one side of the fiscal argument, while dressing up its recommendations as “apolitical”. If the OBR took a genuinely even-handed approach, it would have to balance competing objectives. But this requires skills and political judgements that cannot be guaranteed in advance, any more than past Labour administrations were able to guarantee wise economic decisions through organisations like the Department of Economic Affairs that were set up to manage the economy.

**TYING THE GOVERNMENT’S HANDS**

Another method for preventing the government from acting imprudently in the future might be simply to commit to tough spending plans – for example, limiting annual spending increases to just 1 per cent per annum. This paper has previously
indicated general aspirations for the level of spending in the economy. But such aspirations are too vague to count as a useful commitment to fiscal prudence. Moreover, it would still leave a risk of a future government dissipating surpluses through under-funded tax cuts.

Instead, the problem should be attacked at its source – by preventing positive surprises to certain tax receipts from playing a part in long term fiscal plans.

To achieve this, the next Chancellor should voluntarily give up discretion over certain cyclically sensitive revenues above a preset limit. The Chancellor should set the task of stabilising the debt ratio while being unable to count receipts from those sources above the limits. Any cash generated above the limits should automatically go towards debt reduction. Below the limits the revenues are treated normally.

This proposal provides a credible means to implement the IMF’s recent recommendation that the UK should be “allocating any upside surprises to growth or revenue to reduce deficits more aggressively and limit the accumulation of public debt”.  

To help illustrate how it would work, let us imagine that Gordon Brown had applied a similar technique to stamp duty in the years before the recession. In his 2005 Budget, Brown estimated that 2004-05 would yield £8.9 billion in stamp duties, up from £7.5 billion the year before, and that 2005-06 would yield £9.7 billion. Let us suppose that he had decided not to use revenues that were structurally uncertain in his future Budget plans. He might have sets his limit at £10 billion. His targets for future deficits and debt levels would only include receipts up to that point.

In the next few years, stamp duties turned out to be strong, at £10.9 billion for 2005-06; £13.4 billion for 2006-07; and £14.1 billion for 2007-08. However, with a £10 billion limit, Gordon Brown would have designed spending plans that were roughly £4 billion lower than those he in fact produced. In this scenario, the excess stamp duty would have been treated like a windfall and used to pay down outstanding debt – just like the surprise revenues that were received from a buoyant
auction of the mobile phone spectrum in April 2000.\textsuperscript{72}

As a result, the government’s fiscal position would have been stronger in two ways. First, the structural deficit would have been £4 billion smaller, because the government’s plans would have been forced to assume a lower level of stamp duty. Secondly, there would have been approximately £8 billion less outstanding public debt. A similar approach to other cyclically sensitive revenue streams, such as corporation tax and the receipts from higher rate income tax, might have prevented Brown’s budget plans from becoming unbalanced by £10 billion or more.

This mechanism makes it more difficult for a government to spend windfalls on favourite schemes, be they tax cuts or spending projects. It introduces a deliberate asymmetry into the process of making the Budget: if matters turn out better than expected, the Chancellor has to ignore his good fortune; but if revenues turn out worse, he still has to find other taxes or spending cuts to make up the difference. This asymmetry deliberately counters the normal asymmetry endemic to all finance ministers - a ‘deficit bias’ that sees them acting against the cycle in a downturn but failing to save during the upturn.

No scheme is politically foolproof. After a year or two of above-limit revenues, there would be political pressure to “give the money back”, and raise the limits. However, this would carry a considerable cost: the original commitment to such hypothecation would probably produce a favourable reaction in the bond market, which any Chancellor should be nervous of undoing. For a similar reason, few politicians could happily contemplate suspending the independence of the Bank of England, even if they had been against the idea in the first place.
Conclusion

The unprecedented deterioration in the UK’s fiscal situation has undermined the basis for the New Labour strategy of solving every problem through increased public spending. It is now clear that there will have to be a long period of austerity to restore the public finances. However, the dramatic scale of the government’s escalating debt levels is partially a reflection of an environment of low inflation. A straightforward application of the deficit-averse policies of the 1980s would be unwise. Cheap borrowing terms have diminished the urgency with which the government has to approach paying down the debt. While the economy is still rendered fragile by highly indebted households and lingering deflation, this is just as well; a blind rush towards fiscal balance could bring back the recession with a vengeance.

Soon the economy will be able to cope without growing public expenditure, and, rejecting the temptations of inflation, the government will have to address its persistent deficits. Spending has to fall as a share of the national product. But to place emphasis solely on cutting spending would be to ignore the greater role that collapsing revenues have played in blowing a hole in the finances. Gordon Brown relied too much upon the fruits of an unsustainable bubble. The Labour government’s attempts to plug the gap have complicated the tax system and damaged economic incentives. A better approach is to increase the contribution made by property taxes. Despite its previous mismanagement, the government’s fiscal activism during the recession benefited everyone with an economic stake in Britain. All will have to contribute towards paying the debts back.
Notes

2 J Randall, ‘Budget 2009: now we are all up to our ears in it’, Daily Telegraph, 23 April 2009.
3 CentreForum will publish research on how this has been done internationally.
5 This is what a recent IMF treatment on the subject assumed: see The Economist, ‘The big sweat’, 11 June 2009.
6 In contrast, since 1997, no Labour government has paid as much as 7 per cent to borrow in the gilt market.
8 Source: Debt Management Office, figures as of quarter 4, 2008.
10 Index-linked borrowing rates dropped from 3.5 per cent to 2 per cent over 1996-1999. Nominal borrowing rates fell from 8 per cent to 5 per cent.
13 Although a debt auction in March 2009 was not fully subscribed, the huge success of an auction of 40-year bonds on 2nd June suggests that the former failure was more a reflection of poor market sentiment in a difficult month.
18 Conservatives, ‘Brown’s VAT cut is a £12.5 billion failure’, 14 January 2009.
19 CEBR, ‘Credit where credit’s due – the VAT cut is working’, 13 April 2009.
26 Labour party election broadcast, 5th May 2009.
29 D Cameron, ‘Fiscal responsibility with a social conscience’, 19 March 2009.
32 The IFS also voiced this concern. See BBC News, ‘Cameron makes savings tax pledge’, 5 January 2009.
34 See Table B1 from the 2007 Pre-Budget report.
36 This possibility has been independently suggested in IFS, ‘A boom without a bust?’, April 2009.
37 There were honourable exceptions: see the chapter by Vince Cable MP, in, ‘Britain after Blair’, CentreForum, 2007.
40 The remaining budget is reduced by a fall in the cost of debt interest, largely brought about by declining inflation affecting payments on index-linked bonds.
44 The CDS market enables buyers to hedge against the risk of a borrower defaulting; prices can be interpreted to imply a percentage probability of default. However, as Morgan Stanley argued in their Green Budget presentation, the high prices earlier this year may have reflected poor liquidity rather than rational estimates of this risk.

45 C Odey, ‘Inflation can be your friend in cold world of credit crash’, 28 January 2009.


50 Budget, 2009.

51 H McRae, ‘We must seize the opportunity to radically rethink our government’, The Independent, 7 June 2009.


53 The IFS concurs, writing: ‘Veterans of past Whitehall spending squeezes hands fear it will be very difficult to achieve even the spending plans in the Budget, let alone more ambitious ones. If they are right, a Government wishing (or having) to get debt down more quickly may need to rely more on tax increases’, ‘Squeeze harder, says the IMF’, May 2009.


55 CentreForum plans a series of publications to explore how this can be done without sacrificing important goals.


61 From HMRC data, the gross value of the 600,000 estates with property worth over £500,000 was £786 billion in 2003. Despite recent house price falls, this is now likely to be higher.


63 Assuming long term interest rates of 4 per cent, you would need to enjoy currently taxed cash wealth of £125,000 to have savings income of £5000 per annum.


66 Estimates of the cost of the inheritance tax pledge are controversial; a Parliamentary question put the cost at £1.3 billion. Pledges on savings taxes and an associated rise in tax thresholds for the elderly were costed at £4.1 billion.


68 Although Germany launched a significant fiscal stimulus in January 2009, they have also passed a balanced budget law into the constitution, making it illegal for the federal government to run a significant fiscal deficit.

69 G Osborne, ‘A new British economic model’, 9 June 2009, says that plans are ‘advanced’.

70 As an illustration, see F Nelson, ‘How the Tories will cut’, Spectator 25 June 2009. This article anticipates the OBR demanding that the government repay debt more quickly than its current plans allow and calls for it to include higher growth projections for scenarios where taxes are cut. This clearly right-leaning agenda is nevertheless described as ‘apolitical’.
