

Institute for  
Fiscal Studies



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## The public finances under Labour: before and after the credit crunch

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# Outline

- Before the crunch
  - What happened between 1996–97 and 2007–08?
  - Comparison with other countries
  - Comparison with the Conservatives

# Outline

- Before the crunch
  - What happened between 1996–97 and 2007–08?
  - Comparison with other countries
  - Comparison with the Conservatives
- After the crunch
  - The picture in Budget 2008
  - The cost of the crunch and the policy response in the PBR
  - Paying the price for a generation?
  - What if borrowing costs change?

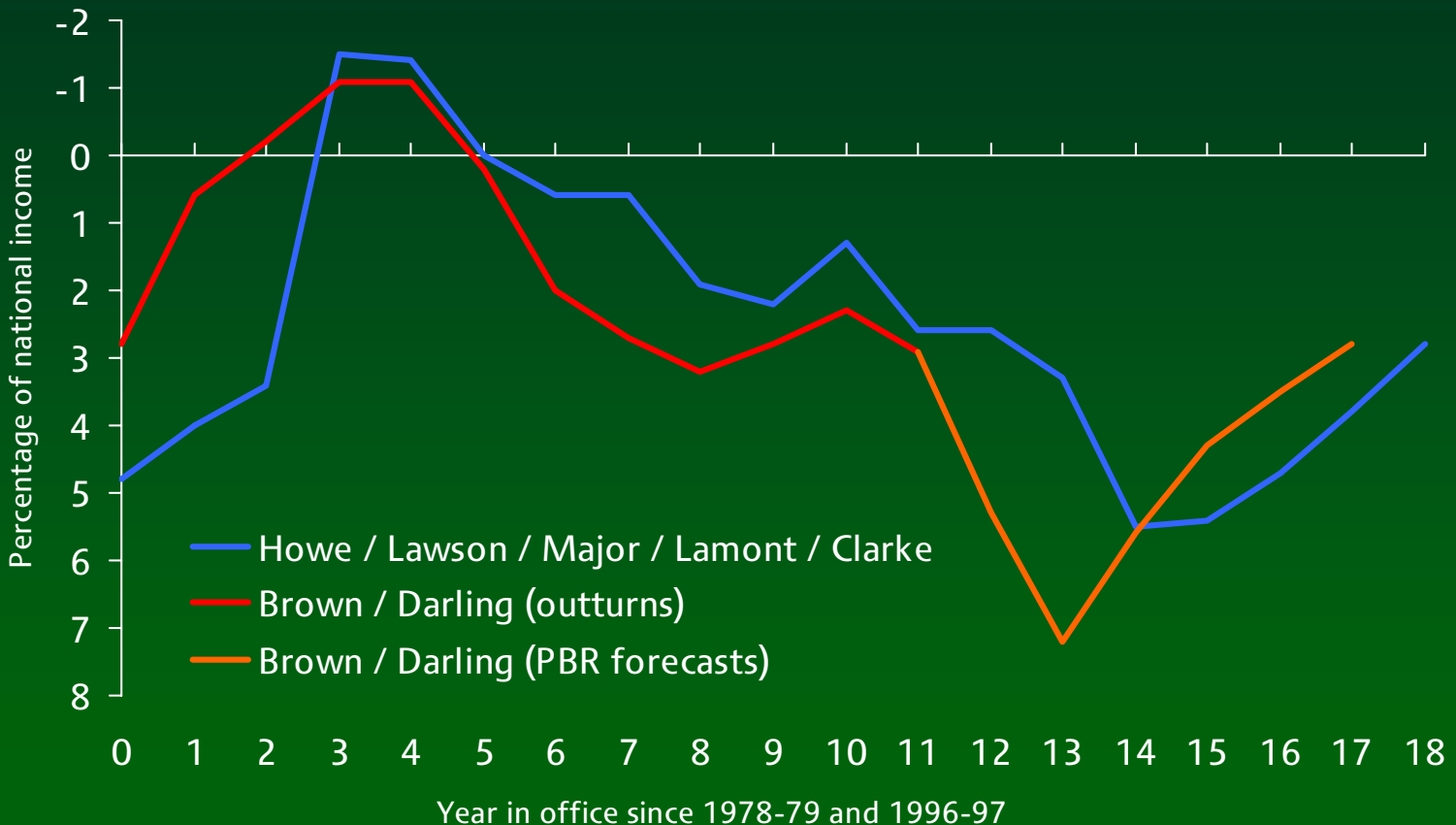
## From inheritance to the eve of the crunch

<i>% national income</i>	1996–97	2007–08	Change
Total spending	40.6	42.0	+1.4
Net investment spending	0.7	2.1	+1.4
Current spending	39.9	39.9	0
Revenues	37.1	39.2	+2.1
Net borrowing (PSNB)	3.5	2.7	-0.8
Net debt	43.3	37.6	-5.7
Net debt interest payments	3.0	1.7	-1.3

# Among OECD countries for which we have data

- In Labour's first decade in power, the UK had the:
  - 2<sup>nd</sup> biggest increase in spending of 28
  - 3<sup>rd</sup> biggest increase in tax burden of 28
- Revenues rose more than spending, but the UK still had the:
  - 6<sup>th</sup> smallest reduction in structural borrowing of 25
  - 10<sup>th</sup> smallest reduction in government debt of 25
  - 9<sup>th</sup> smallest reduction in debt interest payments of 25
- So by 2007–08, the UK had the:
  - 3<sup>rd</sup> biggest structural budget deficit of 26
  - 11<sup>th</sup> biggest public sector debt of 28
  - 10<sup>th</sup> biggest public sector debt interest bill of 28

# Structural budget balance: Labour v Conservative



## The Treasury's 2008 Budget forecasts

	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Economic growth	3%	1.75%	2.5%	2.5%	2.5%	2.5%
Net borrowing (share of GDP)	2.6%	2.9%	2.5%	2.0%	1.6%	1.3%
Net debt (share of GDP)	37.1%	38.5%	39.4%	<b>39.8%</b>	39.7%	39.3%

- Short and shallow slowdown
- Borrowing peaks at less than 3% of national income
- Net debt peaks below 40% of national income

# The PBR: the cost of the crunch

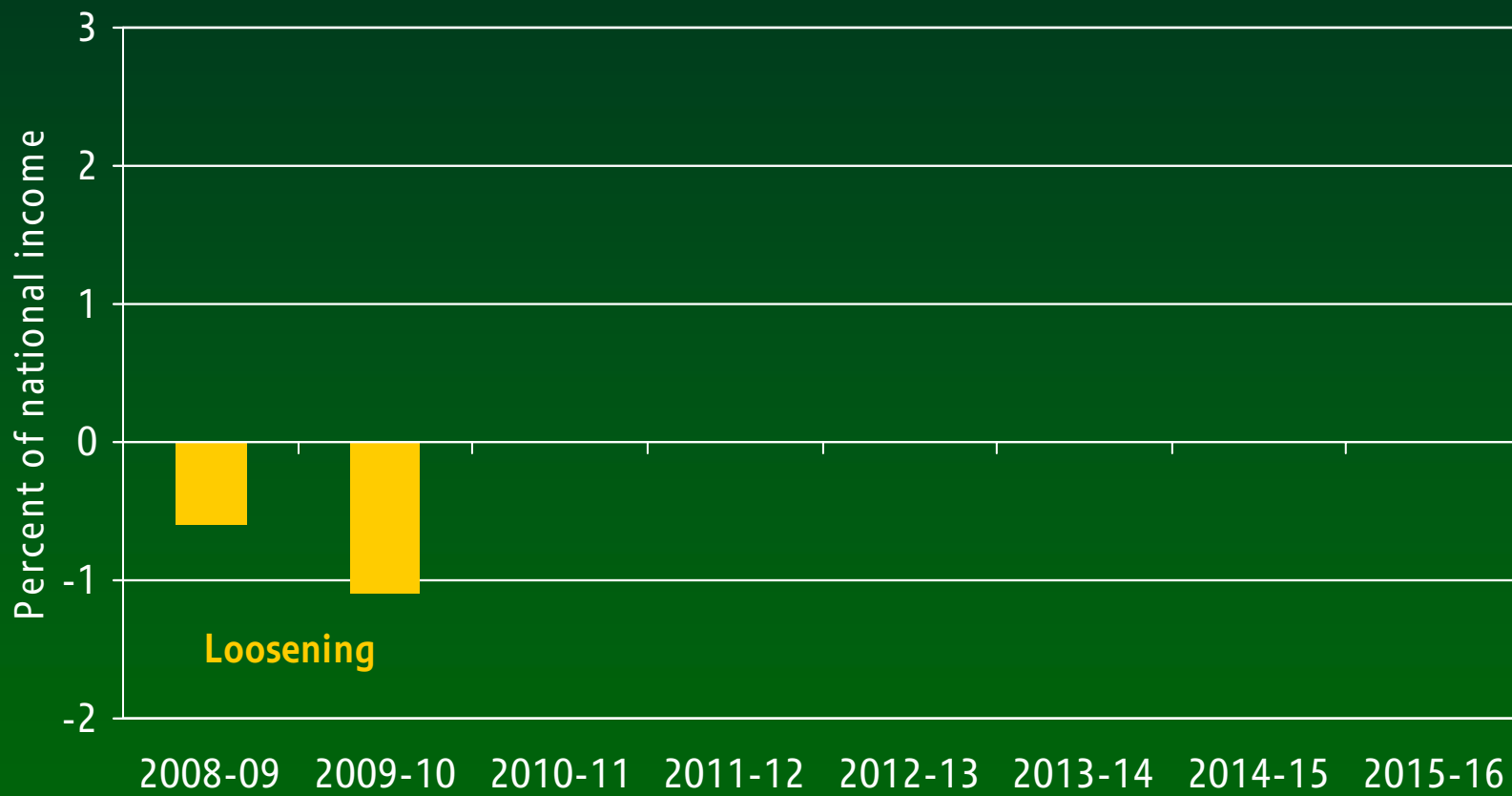
- Credit crunch costs Exchequer 3.5% of GDP or £50bn a year
  - 4% fall in productive potential of the economy
  - Equity and house prices to stay below levels assumed in Budget
  - Small legacy cost of cyclical borrowing and fiscal stimulus
  - No cost factored in for financial sector intervention



# The PBR: the policy response

- Fiscal stimulus this year and next
  - Total cost £25bn
  - 1.1% of national income in 2009–10
  - Roughly half accounted for by temporary VAT cut

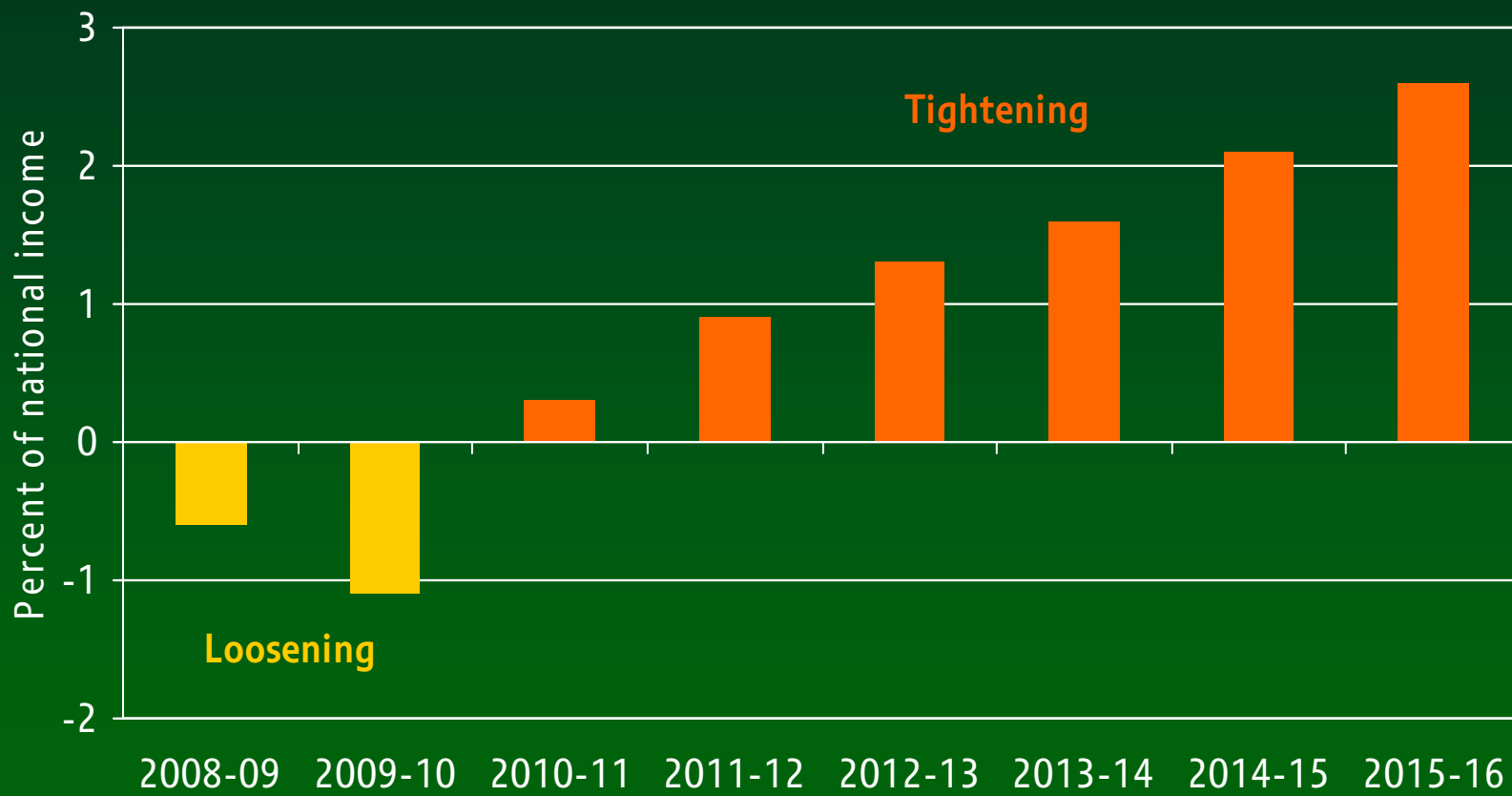
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# The PBR: the credit crunch and policy response

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- Stimulus withdrawn and then fiscal tightening from 2010–11
  - Building to 2.6% of GDP or £38bn a year by 2015-16
  - Roughly 80% spending cuts and 20% tax increases
  - Spending on services £22bn lower in 2013–14 than in Budget

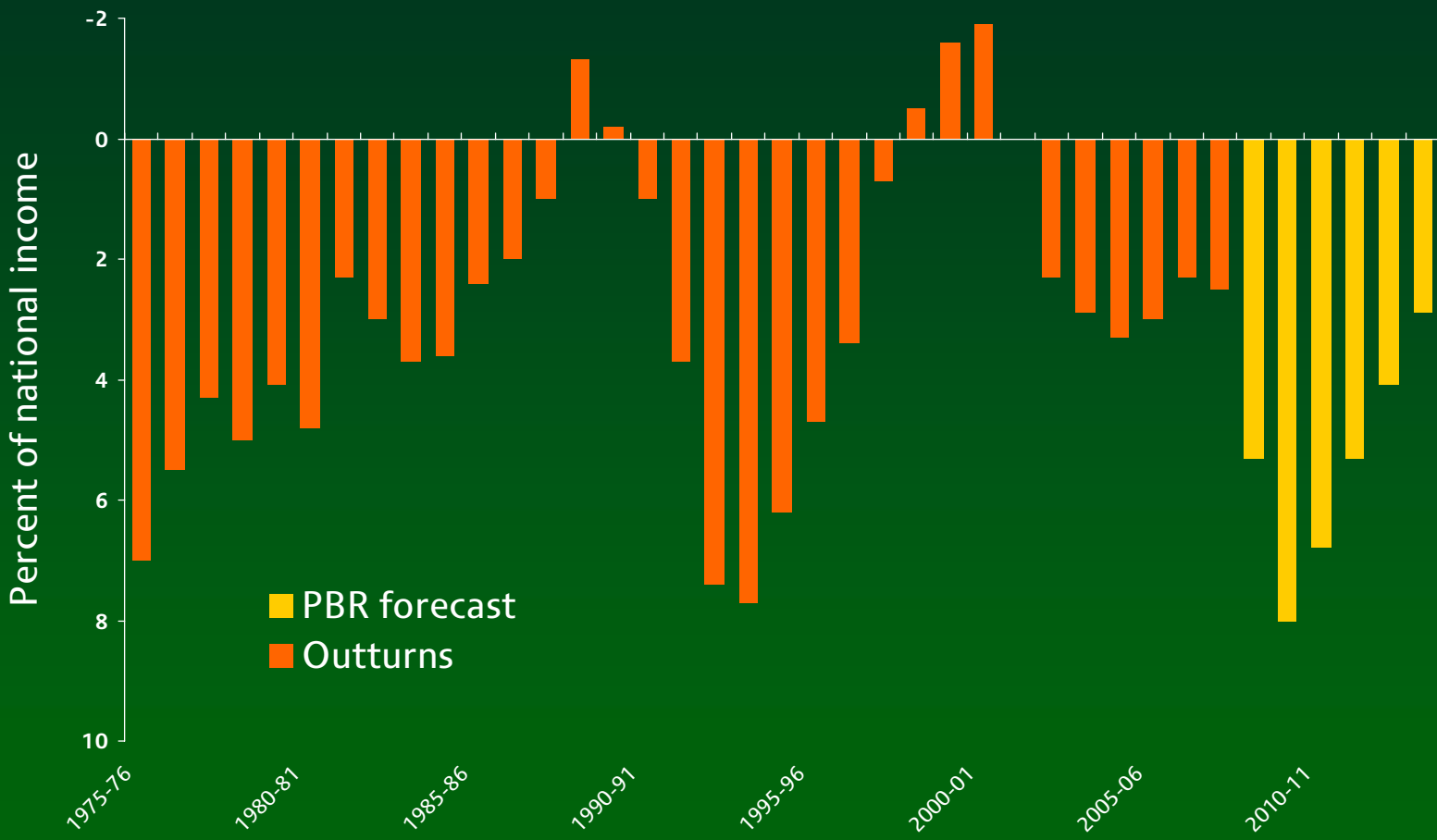
# The PBR: the policy response



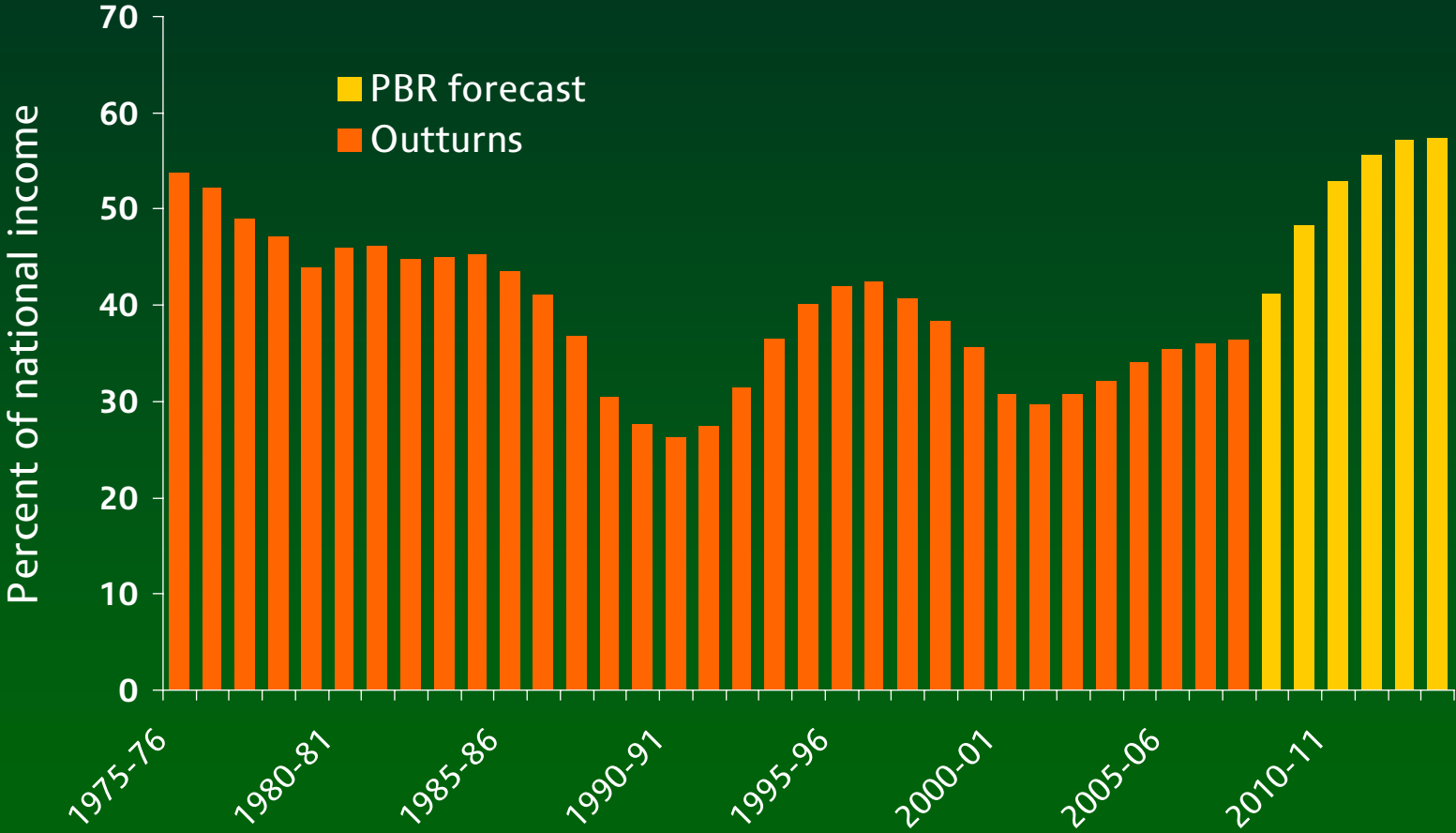
# The PBR: the credit crunch and policy response

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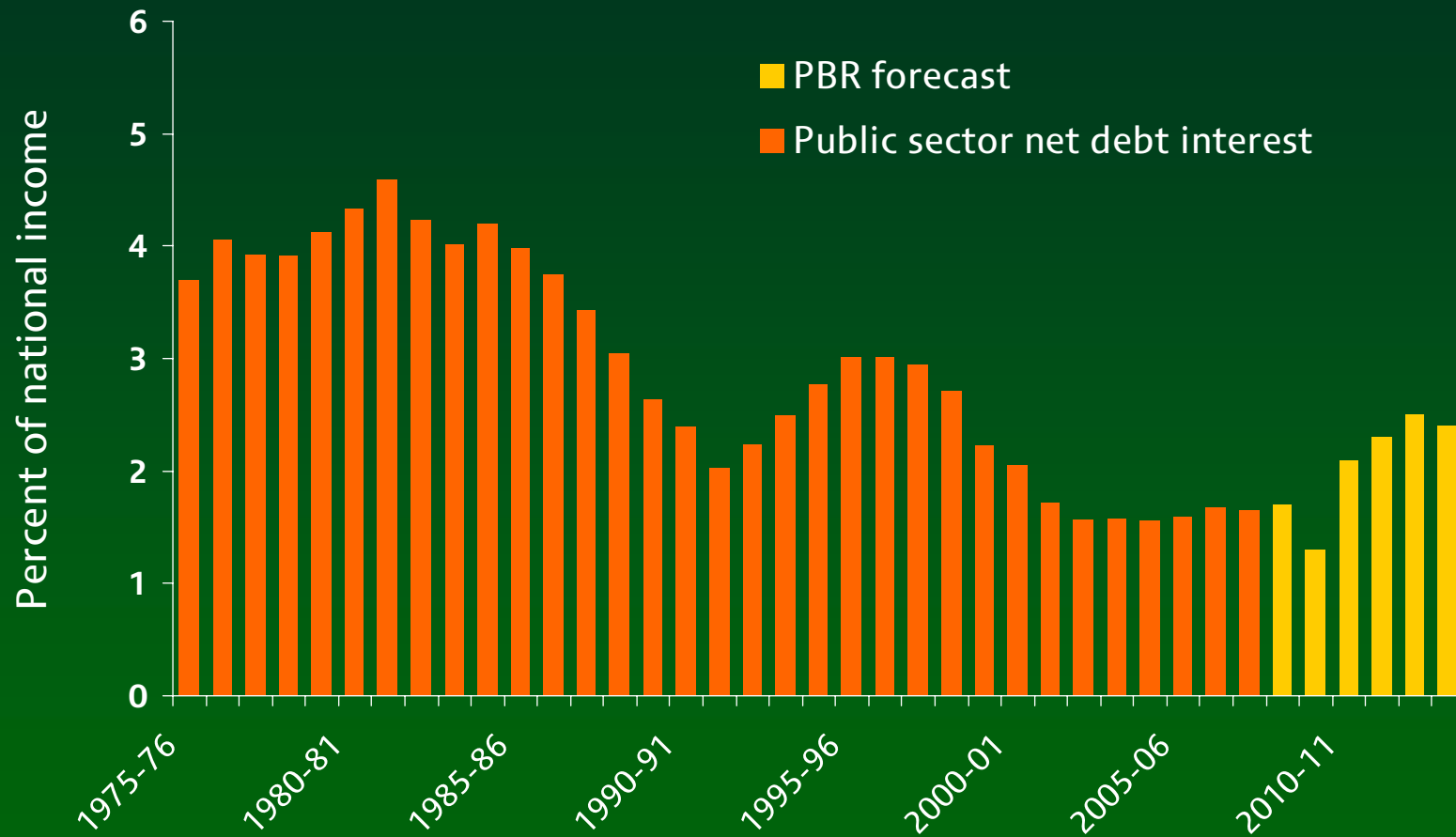
# Public sector borrowing to hit post-war peak



# Public sector net debt to exceed mid-90s peak

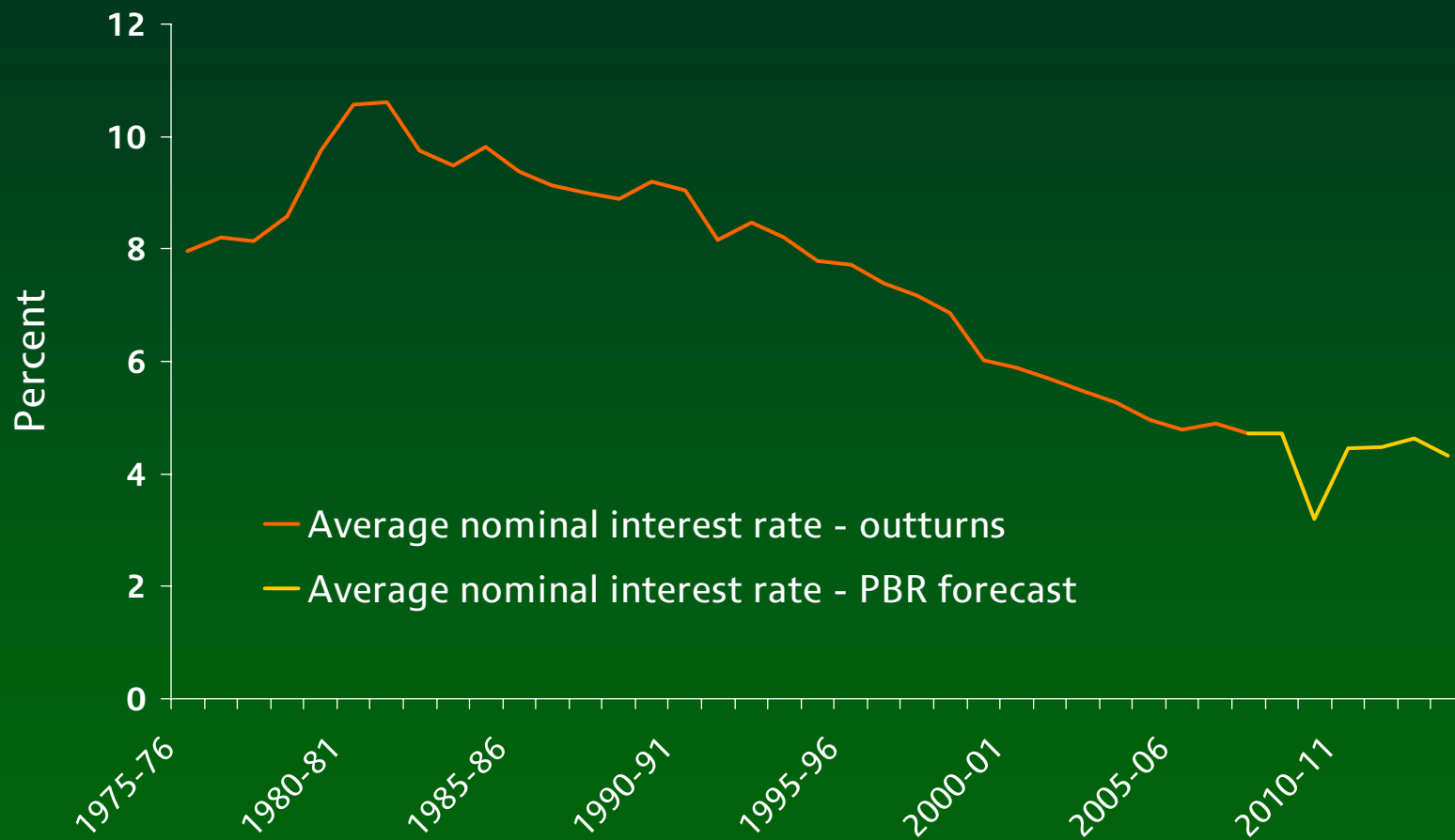


## But debt interest to stay below mid-90s peak





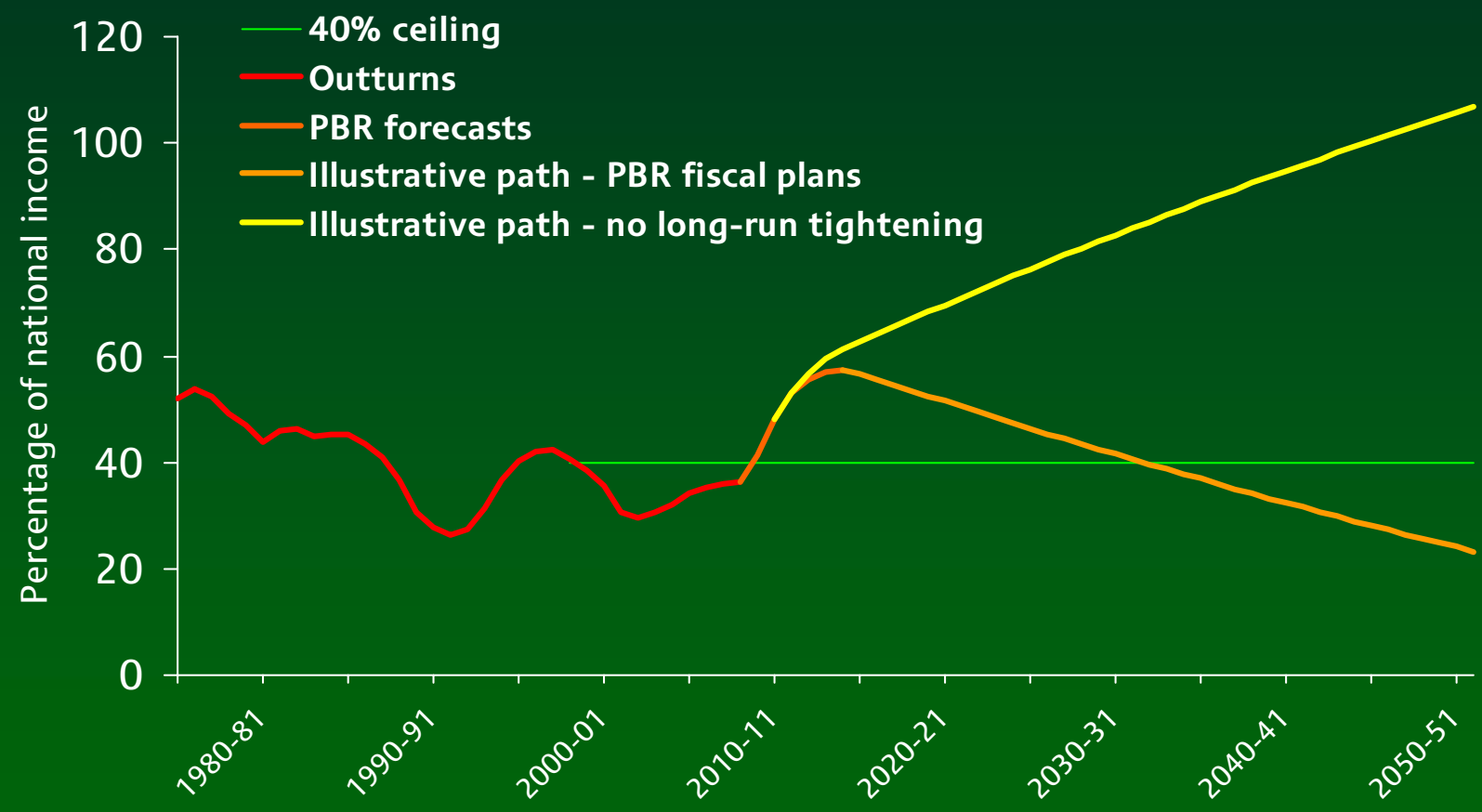
# Because cheaper for Government to borrow



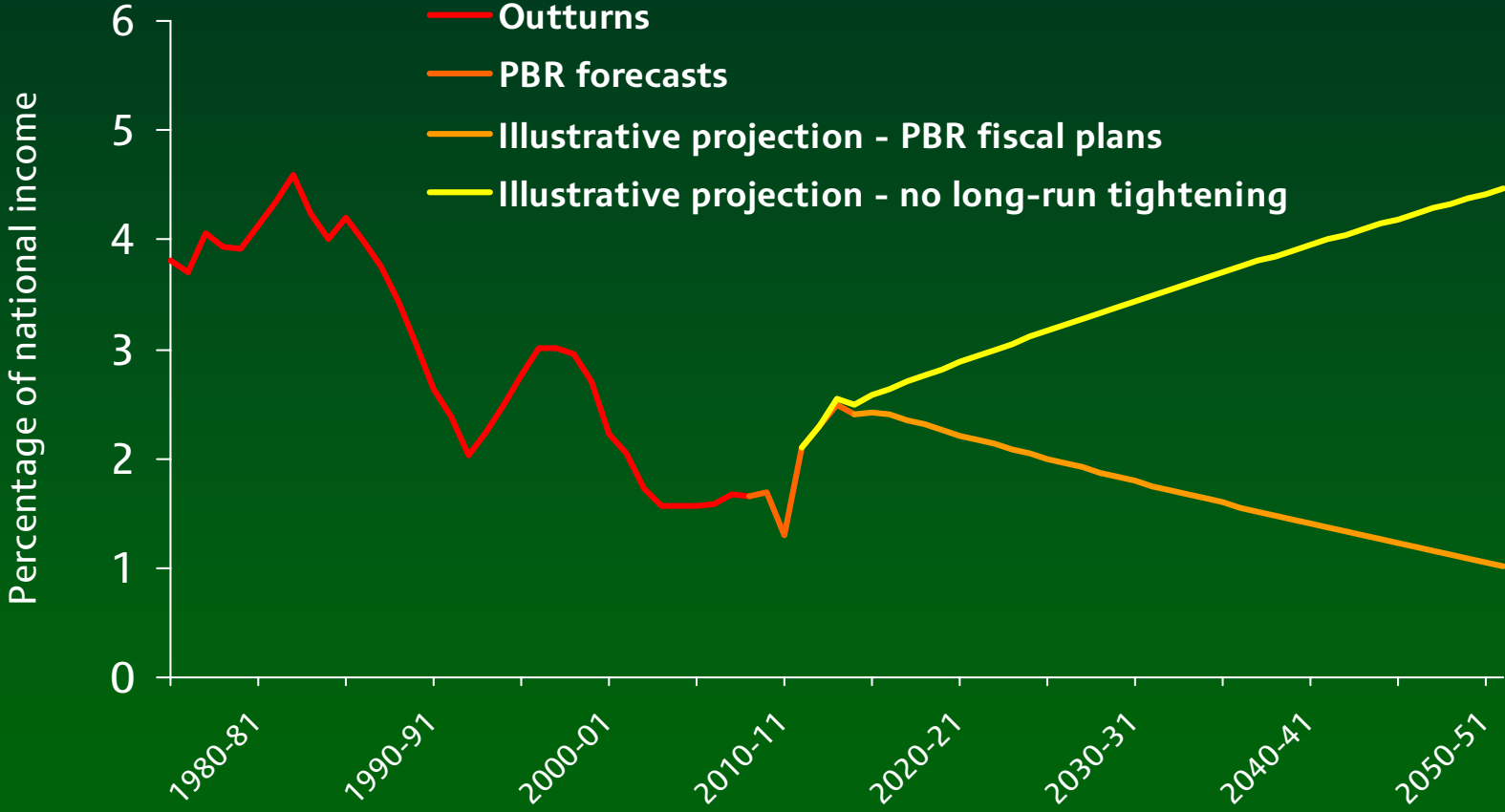
# So what might happen in the longer term?

- George Osborne wrote in the *Independent* in December:
  - “As David Cameron and I have been doing throughout this financial crisis, Mr Steinbrück pointed out that the fiscal stimulus will achieve nothing except to ‘raise Britain's debt to a level that will take a whole generation to work off’”.
- So let us assume that:
  - Fiscal tightening remains 2.6% of national income beyond 2015–16
  - Revenues, investment and non-interest current spending all remain constant at their 2015–16 shares of national income
  - Nominal national income grows 5.25% a year as in PBR

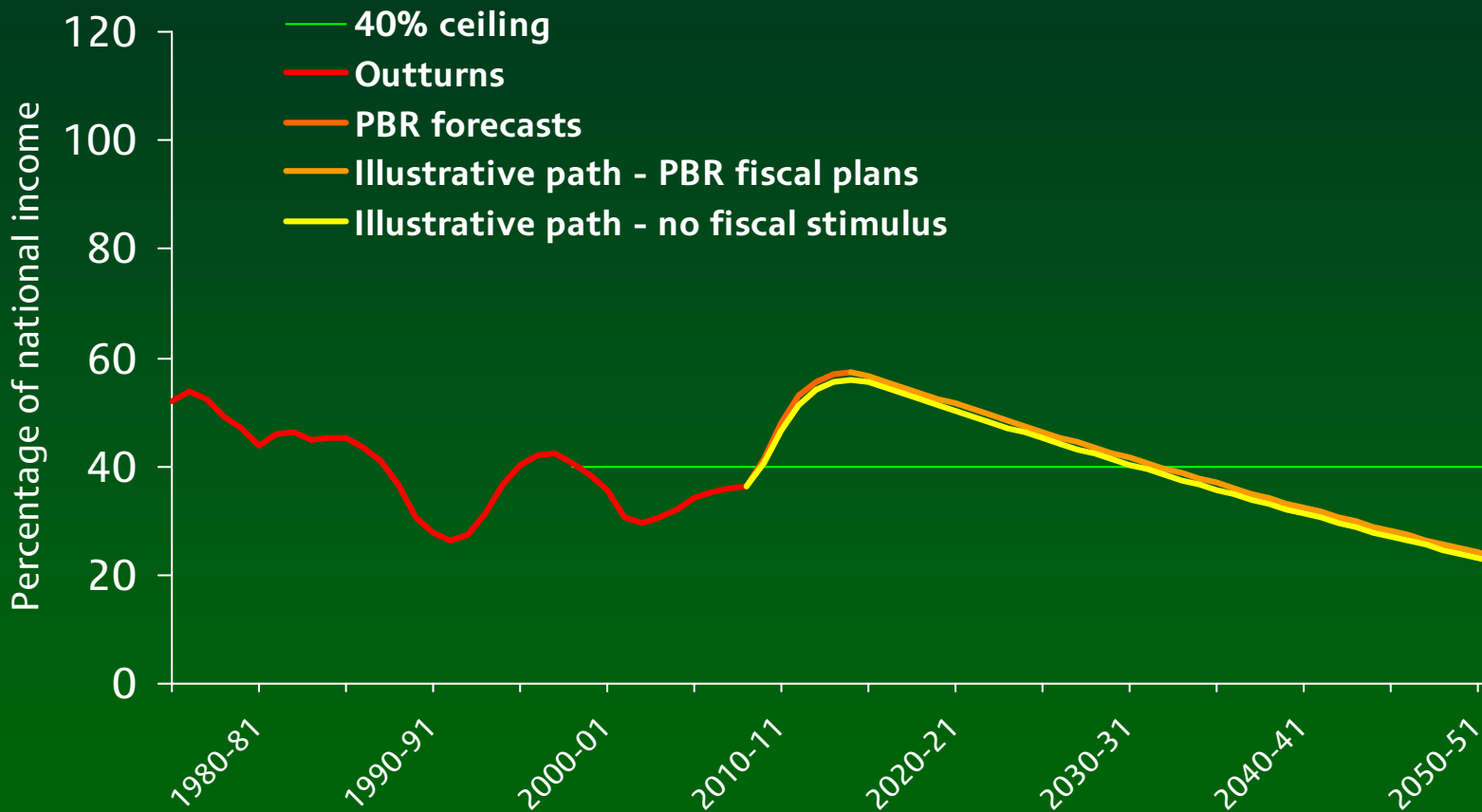
# Net debt: with and without the PBR squeeze



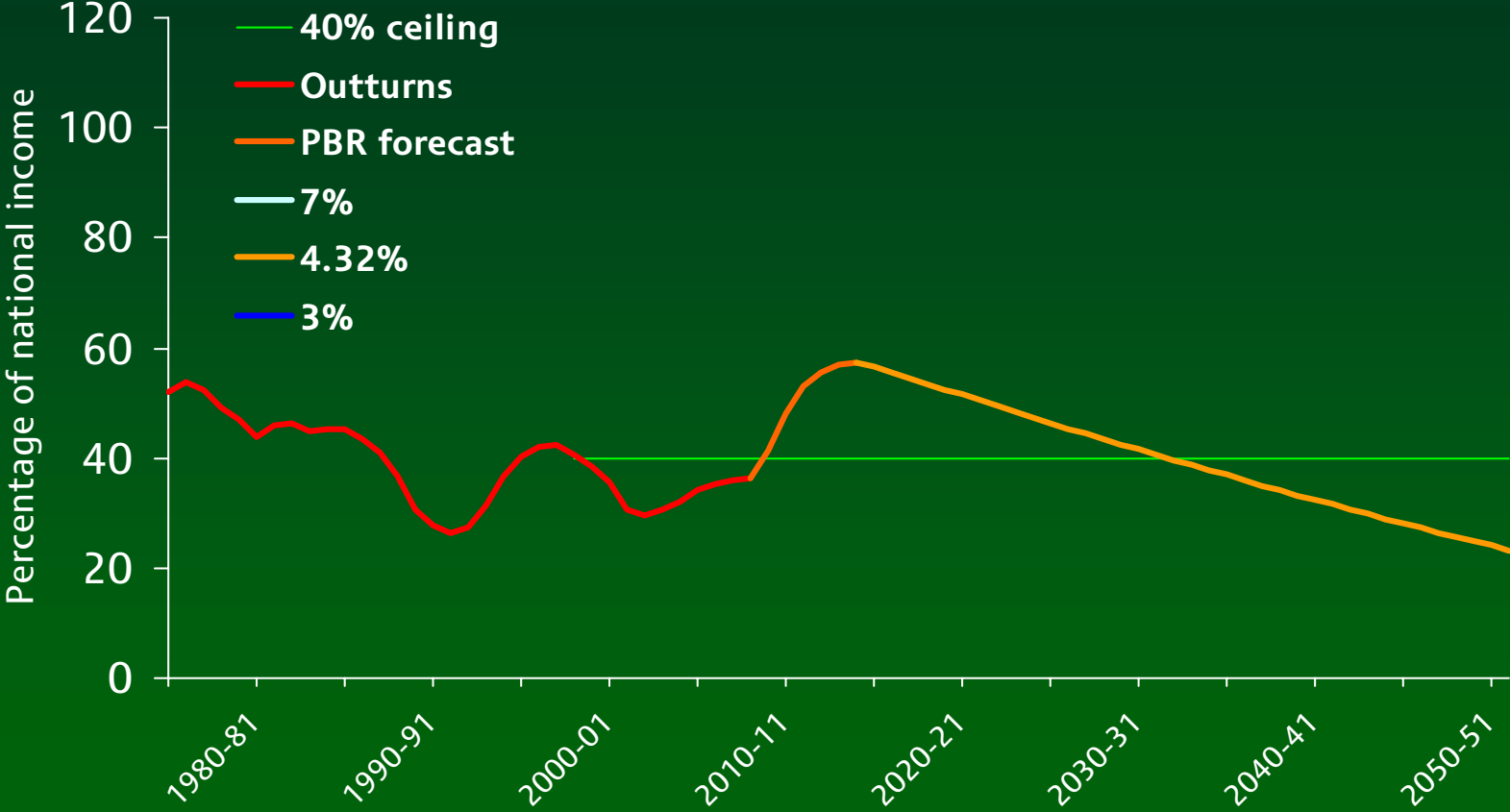
# Interest payments: with and without the squeeze



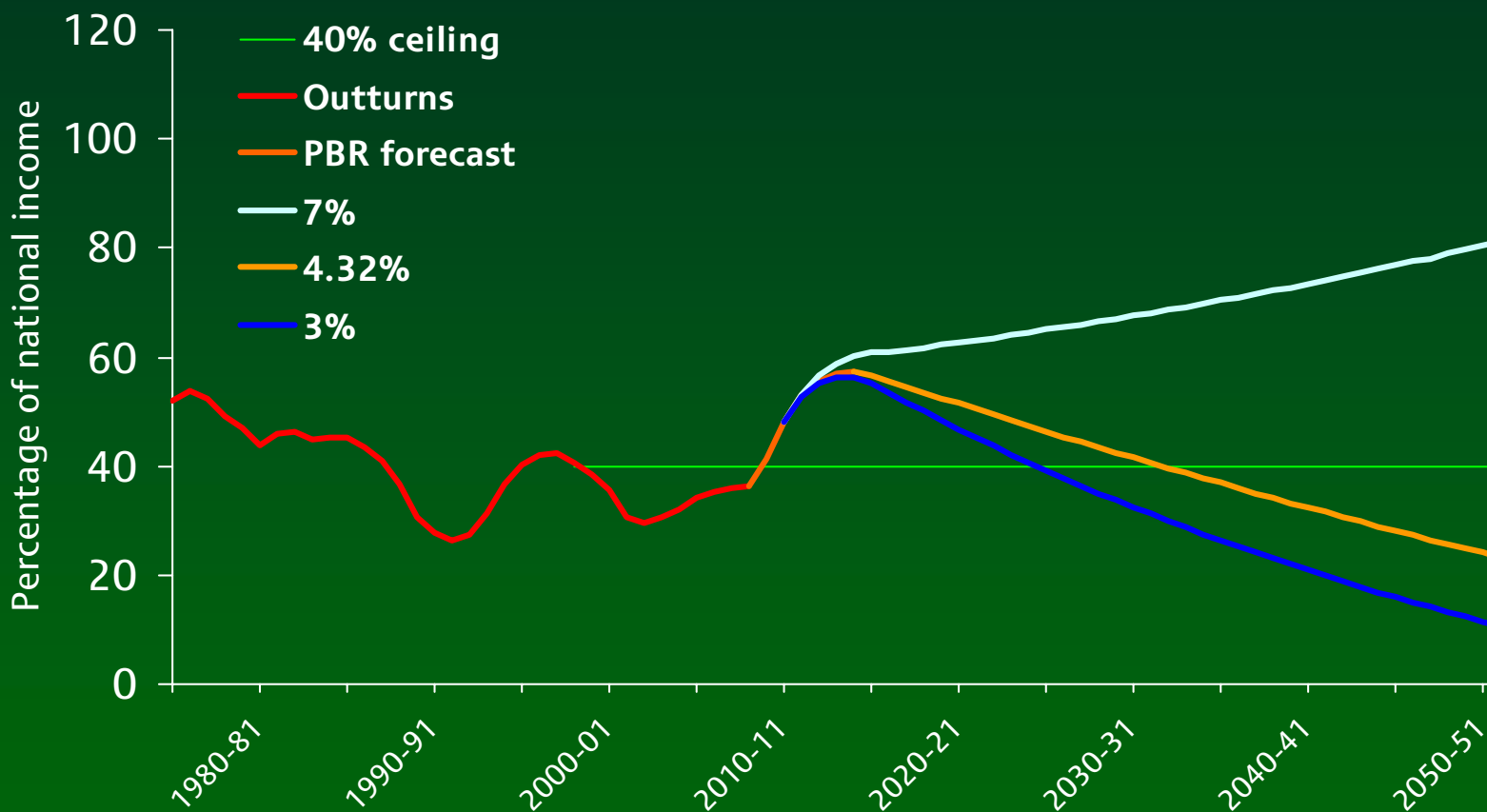
# Net debt: with and without fiscal stimulus



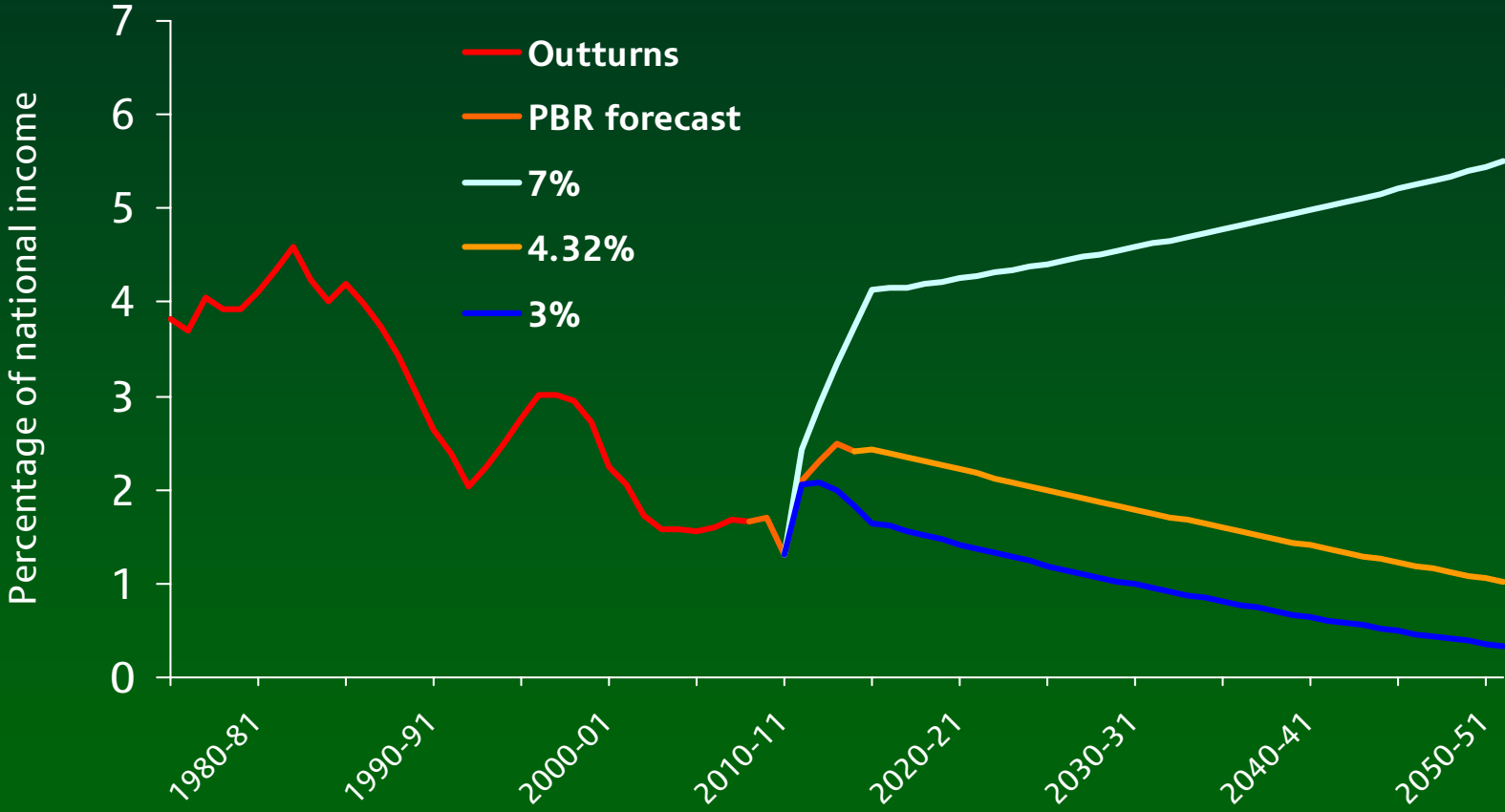
# Net debt: with different average interest rates



# Net debt: with different average interest rates



# Interest payments: with different interest rates





# Conclusion

- Before the crunch
  - Spending and the tax burden higher pre-crunch than in 1997
  - Labour cut borrowing, debt and debt interest payments
  - But by less than most other industrial countries
  - Path of structural budget balance eerily similar to Tories post 1979
- After the crunch
  - PBR tightening needed to stop debt exploding
  - Debt unlikely to return to pre-crisis levels until 2030s
  - Debt interest payments to remain below 1997 level
  - But if borrowing costs rise, further tightening may be needed
  - And what if PBR forecasts too optimistic...?