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

Robert Chote, Carl Emmerson and Gemma Tetlow
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

<table>
<thead>
<tr>
<th>% national income</th>
<th>1996–97</th>
<th>2007–08</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total spending</td>
<td>40.6</td>
<td>42.0</td>
<td>+1.4</td>
</tr>
<tr>
<td>Net investment spending</td>
<td>0.7</td>
<td>2.1</td>
<td>+1.4</td>
</tr>
<tr>
<td>Current spending</td>
<td>39.9</td>
<td>39.9</td>
<td>0</td>
</tr>
<tr>
<td>Revenues</td>
<td>37.1</td>
<td>39.2</td>
<td>+2.1</td>
</tr>
<tr>
<td>Net borrowing (PSNB)</td>
<td>3.5</td>
<td>2.7</td>
<td>−0.8</td>
</tr>
<tr>
<td>Net debt</td>
<td>43.3</td>
<td>37.6</td>
<td>−5.7</td>
</tr>
<tr>
<td>Net debt interest payments</td>
<td>3.0</td>
<td>1.7</td>
<td>−1.3</td>
</tr>
</tbody>
</table>
Among OECD countries for which we have data

• In Labour’s first decade in power, the UK had the:
  – 2\textsuperscript{nd} biggest increase in spending of 28
  – 3\textsuperscript{rd} biggest increase in tax burden of 28

• Revenues rose more than spending, but the UK still had the:
  – 6\textsuperscript{th} smallest reduction in structural borrowing of 25
  – 10\textsuperscript{th} smallest reduction in government debt of 25
  – 9\textsuperscript{th} smallest reduction in debt interest payments of 25

• So by 2007–08, the UK had the:
  – 3\textsuperscript{rd} biggest structural budget deficit of 26
  – 11\textsuperscript{th} biggest public sector debt of 28
  – 10\textsuperscript{th} biggest public sector debt interest bill of 28
The Treasury’s 2008 Budget forecasts

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<tbody>
<tr>
<td>Economic growth</td>
<td>3%</td>
<td>1.75%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Net borrowing (share of GDP)</td>
<td>2.6%</td>
<td>2.9%</td>
<td>2.5%</td>
<td>2.0%</td>
<td>1.6%</td>
<td>1.3%</td>
</tr>
<tr>
<td>Net debt (share of GDP)</td>
<td>37.1%</td>
<td>38.5%</td>
<td>39.4%</td>
<td><strong>39.8%</strong></td>
<td>39.7%</td>
<td>39.3%</td>
</tr>
</tbody>
</table>

- 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
The PBR: the policy response

Percent of national income

Loosening

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The PBR: the credit crunch and policy response

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  – Total cost £25bn
  – 1.1% of national income in 2009–10
  – Roughly half accounted for by temporary VAT cut

• 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 graph shows the percent of national income from 2008-09 to 2015-16. The years are labeled on the x-axis, and the y-axis represents the percent of national income ranging from -2 to 3. The bars indicate whether the policy response is tightening or loosening. Tightening bars are orange, and loosening bars are yellow.
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

Graph showing public sector net debt in percent of national income from 1975-76 to 2010-11. The graph includes bars for PBR forecast and outturns, with a upward trend in the late 2000s and early 2010s.
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

- 40% ceiling
- Outturns
- PBR forecasts
- Illustrative path - PBR fiscal plans
- Illustrative path - no long-run tightening

Percentage of national income

- 1980-81
- 1990-91
- 2000-01
- 2010-11
- 2020-21
- 2030-31
- 2040-41
- 2050-51
Interest payments: with and without the squeeze

- Outturns
- PBR forecasts
- Illustrative projection - PBR fiscal plans
- Illustrative projection - no long-run tightening

Percentage of national income

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Net debt: with and without fiscal stimulus

- 40% ceiling
- Outturns
- PBR forecasts
- Illustrative path - PBR fiscal plans
- Illustrative path - no fiscal stimulus

Percentage of national income
Net debt: with different average interest rates

- 40% ceiling
- Outturns
- PBR forecast
- 7%
- 4.32%
- 3%

Percentage of national income

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Net debt: with different average interest rates

Percentage of national income

- 40% ceiling
- Outturns
- PBR forecast
- 7%
- 4.32%
- 3%

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Interest payments: with different interest rates

Outturns
PBR forecast
7%
4.32%
3%

Percentage of national income


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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…?