The UK public finances: ready for recession?

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Summary

Neither the current Labour government nor the previous Conservative one can look back over their respective terms of office as periods of great success in fiscal management. Both started by strengthening their underlying budget balances for three years after taking office, but both then allowed them to drift steadily back into the red. This meant that they were already borrowing significant amounts when the onset of recession required them to borrow more.

Labour is entering this recession with a similar structural budget deficit to the one that it inherited from the Conservatives, but with a smaller underlying debt. It remains to be seen whether the structural budget deficit will deteriorate as far under Labour as it did under the Conservatives, but debt is very likely to rise above the peak it recorded under the Conservatives (even without the impact of recent bank nationalisations and recapitalisations).

Labour recorded a similar structural budget deficit in the year before this recession to that which the Conservatives recorded in the year before the last. However, the structural deficit appears to have deteriorated more sharply in the early phase of the downturn than it did under the Conservatives and as a result is set to be higher in the first year of recession than it was under the Conservatives. This largely reflects the particular impact of the credit crunch and falls in the stock market and housing market, rather than budget decisions. Labour is also going into the recession with a significantly higher level of debt than the Conservatives did.

Turning to the international context, we are entering the current recession with one of the largest structural budget deficits in the industrial world and a debt level that may be among the smallest in the G7 but which is larger than that of most industrial countries. We have done less to reduce our structural budget deficit and less to reduce our debt than most other industrial countries since Labour came to office.

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The public finances: ready for recession?

As the UK economy begins to shrink for the first time in 16 years, the two main political parties have been arguing over whether the public finances are stronger or weaker now than they were at the outset of the last recession in 1990 and when Labour came to power in 1997. This Briefing Note looks at a couple of key indicators of the health of the public finances in historical and international perspective to assess this.

Claim and counterclaim

Gordon Brown and David Cameron set out contrasting views of the state of the public finances in a debate in the House of Commons on 20 October.[1]

- Mr Brown said: 'The United Kingdom cannot insulate itself from this global downturn, but with interest rates low and falling and inflation expected to come down over the next year, these underlying economic indicators, particularly interest rates, make us stronger than at any other previous downturn. Debt has been considerably lower than a decade ago, and lower than that of all G7 countries except Canada, enabling the Government to increase borrowing at the right time to support the economy.'

- Mr Cameron responded: 'Is it not the case that Britain is heading for a record budget deficit, contrary to what he said, put by some independent forecasters as high as £64 billion? Will he confirm that that has happened after 14 years of economic growth and when half the OECD countries are entering the downturn with a budget surplus? Is not the £64 billion question this: why, when business and families need more help, has he left the cupboard so bare?'

Perhaps not surprisingly, both are selective in the picture they draw.

Indicators of the health of the public finances

There are a wide range of indicators that can be used to assess the strength of the public finances. For simplicity here we focus on two:

- **Government borrowing:** The government borrows when it spends more than it raises in tax and other revenues. In comparing the evolution of borrowing under Labour and the Conservatives, we use the Treasury's estimate of cyclically adjusted public sector net borrowing as a share of national income – the so-called structural budget deficit. This is the amount

[1] http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm081020/debtext/81020-0004.htm#0810203000512.

that the Treasury estimates it would have had to borrow if activity in the economy had remained at a sustainable level consistent with stable inflation. Adjusting the figures for the ups and downs of the economic cycle ensures that we do not overstate the health of the public finances when economic activity is strong and understate it when economic activity is weak. For international comparisons, we use the OECD's cyclically adjusted measure of the general government balance. This measure differs from the Treasury's for at least two reasons. First, the OECD looks only at general government, whereas the Treasury looks at the whole public sector (which, for example, also includes public corporations). Second, the OECD and Treasury differ in their estimates of the output gap, which is used to decompose borrowing into its structural and cyclical components.

- **Government debt:** As well as looking at the amount of borrowing the government undertakes in any one year, we look at the amount of debt it accumulates over time. In comparing performance under the current Labour and previous Conservative governments on this dimension, we use the Treasury's measure of public sector net debt (excluding the impact of Northern Rock) as a share of national income. For international comparisons, we use the OECD's measure of general government net financial liabilities as a share of national income. The OECD figures differ considerably from the Treasury figures. Whilst this is to be expected given the different definitions used by the two organisations, this difference is not constant over time. In particular, the OECD estimates are significantly lower than the Treasury estimates in 1990 and 2007, whereas the two sets of figures are similar in 1996. Unlike the structural budget deficit, the debt figures are not adjusted for where we stand in the economic cycle.

Figure 1.1 shows how the structural budget deficit and public sector net debt have evolved over the course of the Conservative and Labour governments. Labour is entering a recession in its 12th year in office; the Conservatives also entered one in their 12th (having already suffered a recession in their 1st and 2nd years in office).

Figures 2.1 to 2.3 and 3.1 to 3.3 show the OECD measures of borrowing and debt for 2007 (the year before the current presumed recession got under way), 1996 (the year before Labour came to office) and 1990 (the year the last recession began).

Figures 2.4 and 3.4 show the change in the OECD structural budget deficit and debt measures between 1990 and 1996 and between 1996 and 2007.

Key comparisons

The main facts that emerge from the graphs are as follows:

- The structural budget deficit has evolved in a remarkably similar way under Labour since 1997 to the way in which it evolved over the first 11 years of Conservative government from 1979.
    - Both parties inherited large structural budget deficits from their predecessors: 4.8% of national income in 1978–79 and 2.9% of national income in 1996–97. If left unchecked, structural borrowing of these levels would have left debt increasing rapidly for some time.
    - Both then oversaw a significant tightening in fiscal policy, achieving structural budget surpluses that peaked in their 3rd years in office: 1.5% of national income in 1981–82 and 1.3% of national income in 1999–2000.
    - Thereafter, both governments presided over a steady drift back into the red. By year 11 of their terms in office, both governments were recording very similar structural deficits: 2.6% of national income in 1989–90 and 2.7% of national income in 2007–08.
    - To summarise, both governments presided over a fiscal strengthening in their first three years in office followed by a weakening over the following eight. But we should note that Labour has used more of its borrowing to finance capital investment rather than current spending than the Conservatives did. Under the Conservatives, the structural budget deficit continued to deteriorate until year 14 (1992–93). It remains to be seen when it will reach its trough under Labour.
- If we compare the structural budget deficits in the years immediately before the latest two recessions started, then Labour and the Conservatives faced the downturn in similar fiscal positions – with a deficit of 2.6% of national income in 1989–90 compared to 2.7% of national income in 2007–08. However, the structural deficit appears to have deteriorated more sharply in the early phase of this downturn than it did under the Conservatives and as a result is set to be higher in the first year of recession than it was under the Conservatives. On current trends, the deficit is likely to be 3.6% of national income this year[2] compared with 2.6% of national income under the

[2] Extrapolating the first six months' borrowing figures to the whole year suggests borrowing will be £62.7 billion in 2008–09. In addition to this, the fuel duty freeze and stamp duty suspension are expected by HM Treasury to cost £0.85 billion in 2008–09. This gives total borrowing in 2008–09 of £63.6 billion. Under the assumption that quarter-on-quarter growth in non-oil GVA (gross value added) is –0.5% in 2008Q3 and thereafter follows the Bank of England August forecast for the remainder of 2008–09, the output gap in 2008–09 will be –1.8%, while that in 2007–08 was +0.3%. The cyclical component of borrowing this year is therefore £10.0 billion, which leaves structural borrowing at £53.5 billion (or 3.6% of GDP).

Conservatives in 1990–91. This largely reflects the impact of the credit crunch and the falls in the stock and housing markets, rather than budget decisions.

- The evolution of public sector net debt differs rather more between the parties than the evolution of the structural budget deficit, because of movements in non-structural (i.e. cyclical) borrowing.

  - Labour's move from structural budget deficit to surplus and back again is mirrored by a fall in public sector net debt – from the 42.5% of national income that it inherited in 1996–97 to a low of 29.7% in its 5th year (2001–02), since when debt has risen again to 36.3% of national income in year 11 (2007–08). On current trends, net debt will reach 39.7% of national income this year.[3]

  - By contrast, the Conservatives inherited a higher level of net debt than Labour in 1978–79 (47.1% of national income), but this did not fall as fiscal policy tightened in the early 1980s because the strengthening of the structural balance was offset by higher cyclical borrowing during the first Conservative recession. Net debt remained around 45% of national income until 1984–85, then fell sharply to a low of 26.2% of national income over the following six years (despite higher structural borrowing) as the boom of the mid-1980s generated an unsustainable cyclical surplus and an unsustainably high level of GDP (both of which artificially depressed the debt-to-GDP ratio).

  - So Labour is beginning the current recession with a considerably higher level of public sector net debt than the one with which the Conservatives entered the 1990 to 1991 recession. The Conservative figures are clearly flattered by the Lawson boom. But under Labour it appears likely that over the next couple of years, net debt will rise significantly higher than the peak of 46.2% of national income recorded by the last Conservative government.

- On the OECD measure, the UK had a structural budget deficit of 3.1% of national income in 2007. This is the 2nd biggest structural budget deficit among the G7 large economies (after the US) and the 4th highest of the 26 industrial countries for which the OECD has data. As Mr Cameron highlighted, half these OECD countries are facing the current economic slowdown with structural budget surpluses.

[3] Adding the total extra borrowing projected this year (as explained in footnote 2) to the level of underlying debt (i.e. excluding Northern Rock) as at end March 2008 brings the level of underlying debt at end March 2009 up to £592 billion (or 39.7% of estimated year-end GDP).

- Although the structural budget deficit is slightly smaller than the one Labour inherited on taking office, the UK has slipped down the international league table as 19 of the other 24 industrial countries for which we have comparable data have done more to reduce their structural deficit (or increase their surplus) than the UK since 1996. In 1996, the UK had the 3rd biggest structural deficit in the G7 and the 8th biggest of the 25 countries for which the OECD has data for that year.

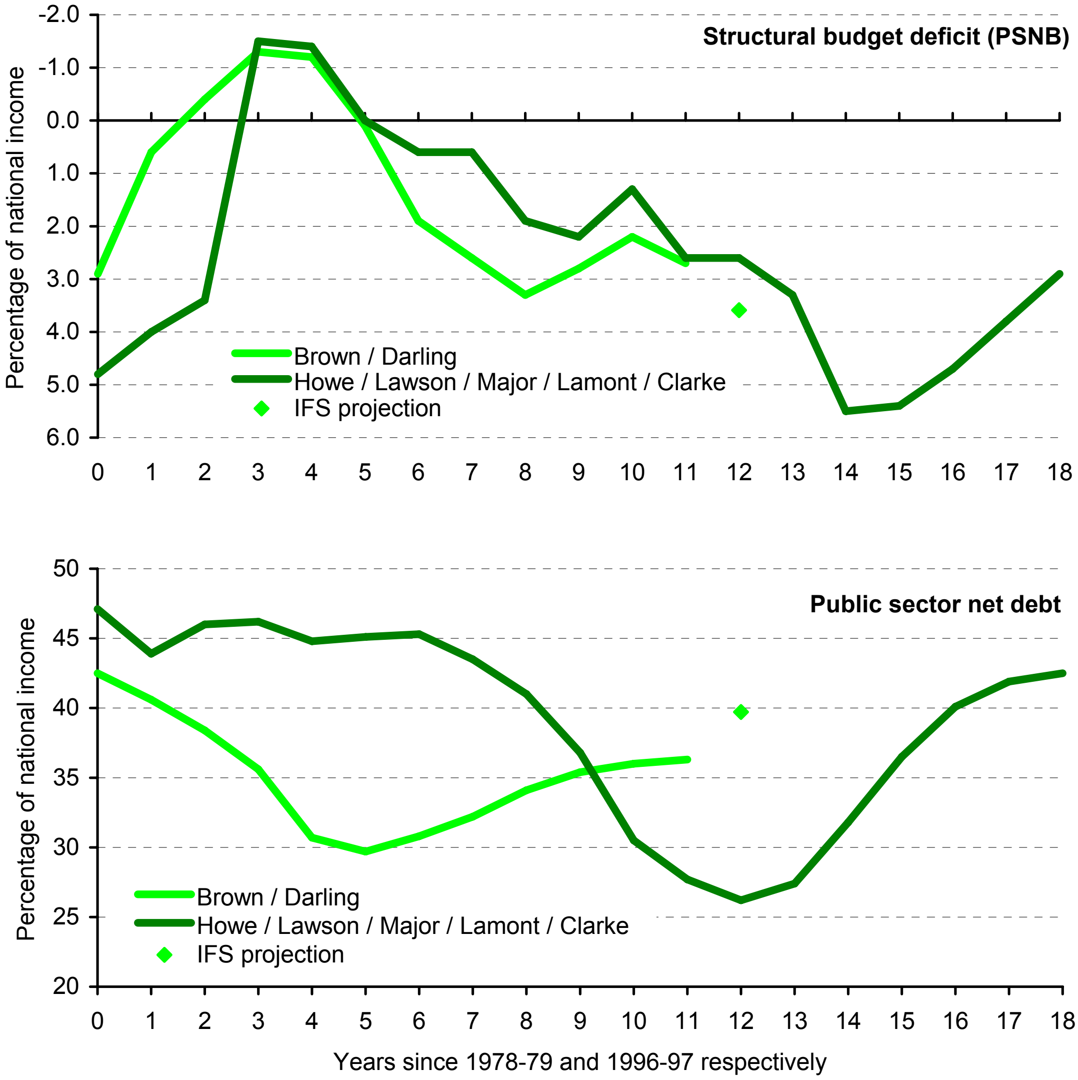
- Our borrowing position looks even weaker in international perspective when we compare it with the position when the last recession began in 1990. Although the deficit was still slightly larger in 1990 than it is today, it was the 2nd *lowest* in the G7 and only the 13th largest of the 23 industrial countries for which the OECD has data for that year.

- Turning to debt, in 2007 the UK had the 2nd lowest debt ratio in the G7 after Canada, as Mr Brown told the House of Commons. But our position in the broader industrial country league table looks less favourable – we have the 11th highest debt ratio of the 28 countries for which the OECD has data for this year. Although the indebtedness of the larger economies matters more than that of the smaller ones in determining the total volume of government debt globally, it is not clear why we should compare ourselves with the G7 economies rather than the broader range of OECD countries in judging how prudently we manage our public finances. One-third of these OECD countries now have net financial assets rather than net debts.

  - In 1996, we had the 3rd lowest debt in the G7 and the 10th highest of 25 OECD countries. So we have moved slightly higher up the G7 league and slightly lower down the broader OECD league under Labour.

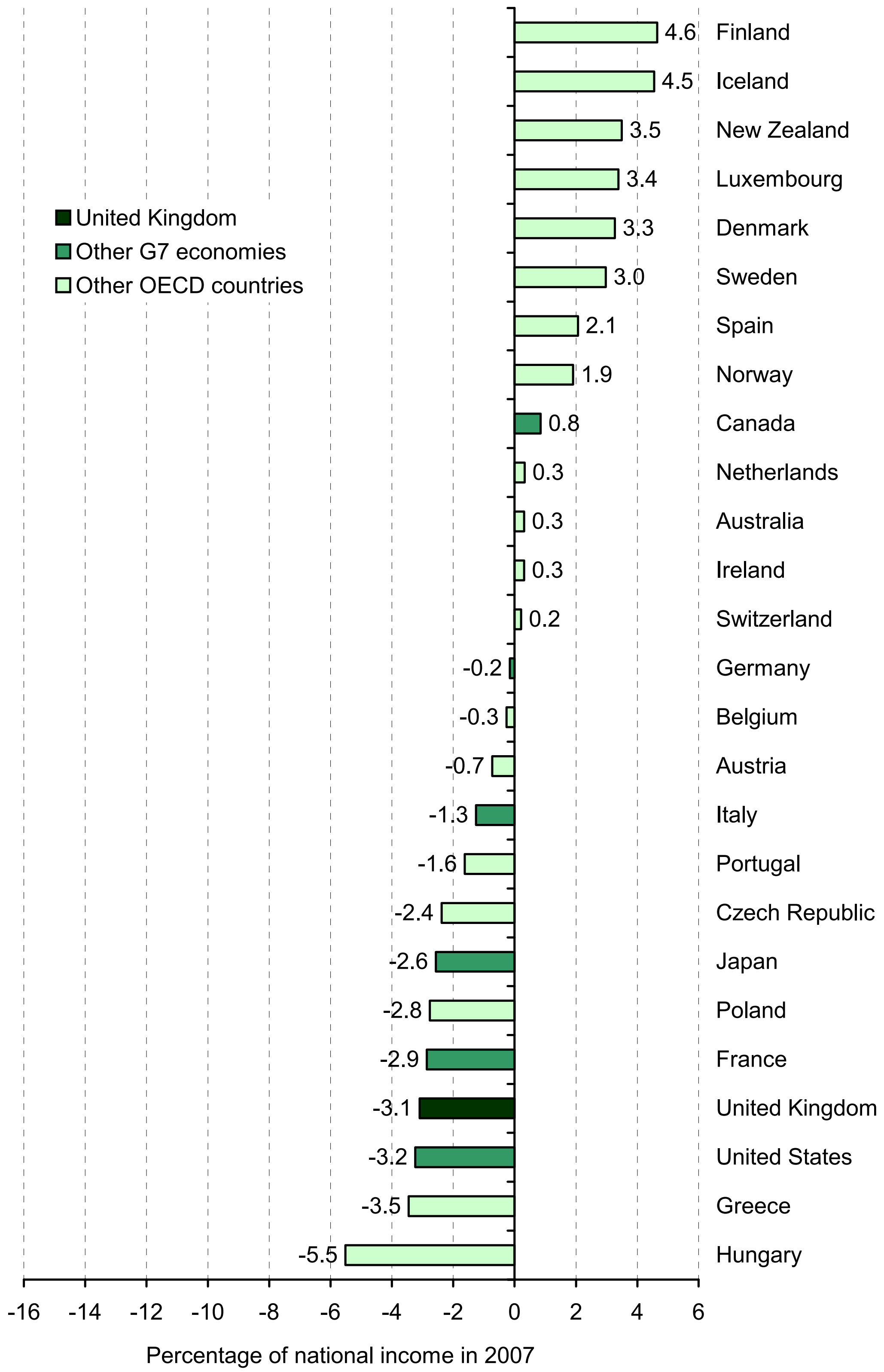
  - Our debt level is markedly higher now than at the outbreak of the last recession on this measure – at that point, our debt was also lower than that of most other OECD countries as well as most of the other G7 countries. So in that sense we do appear to have moved down the international league table since the last recession, although it should be borne in mind that – unlike the structural budget deficit figures – comparing debt levels internationally is hampered by the fact that different countries will be at different points in their economic cycles.

Figure 1.1. Borrowing and debt: Labour versus Conservatives



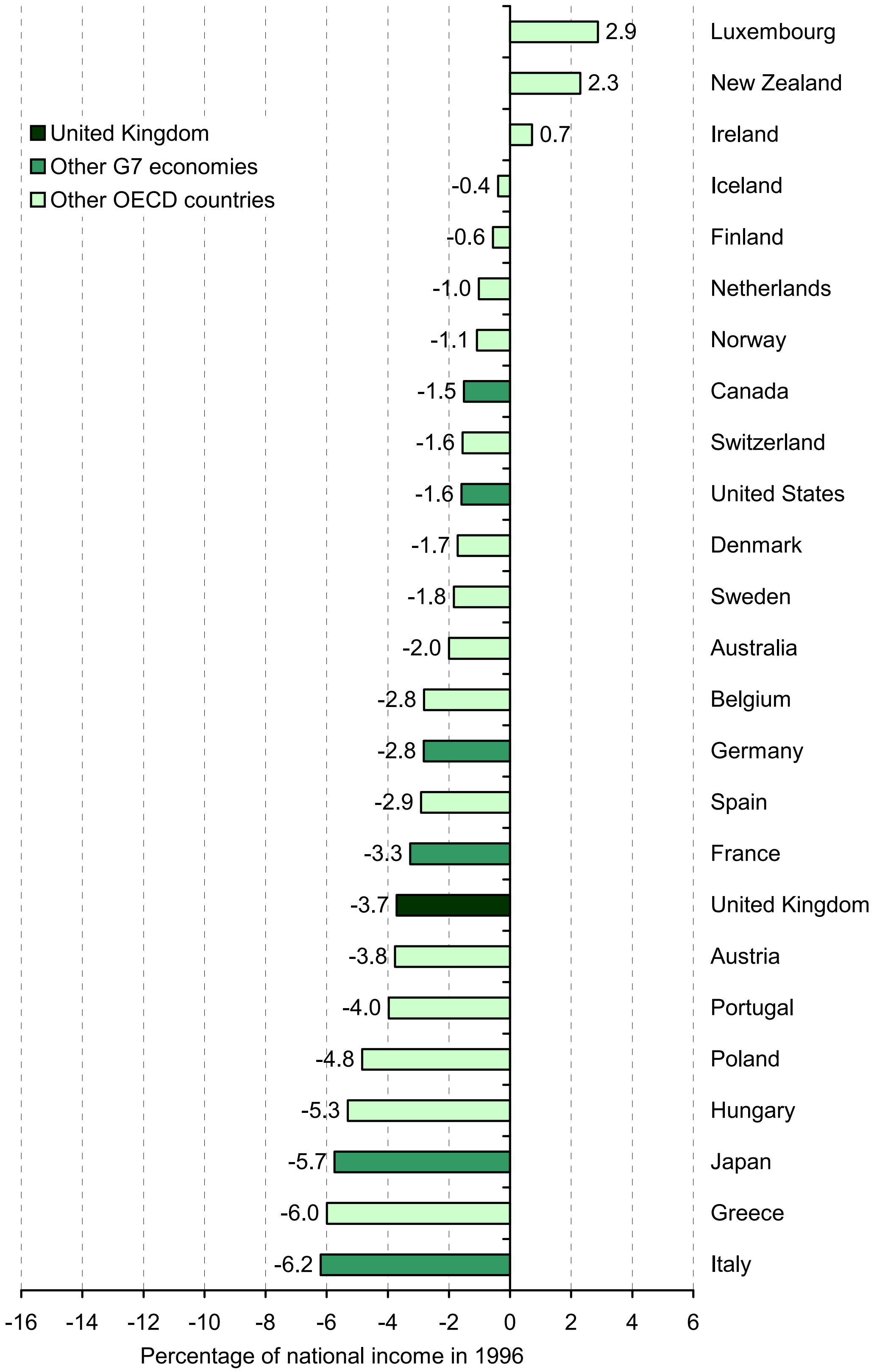
Note: IFS projection based on central government receipts and spending for April–September 2008, Bank of England estimated GDP growth rates from August Inflation Report and HM Treasury costings of tax policies announced since Budget 2008.
Source: HM Treasury Public Finances Databank, October 2008 (http://www.hm-treasury.gov.uk/5552.htm).

Figure 2.1. Cyclically adjusted general government balance in OECD countries in 2007



Source: Annex table 28 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 2.2. Cyclically adjusted general government balance in OECD countries in 1996

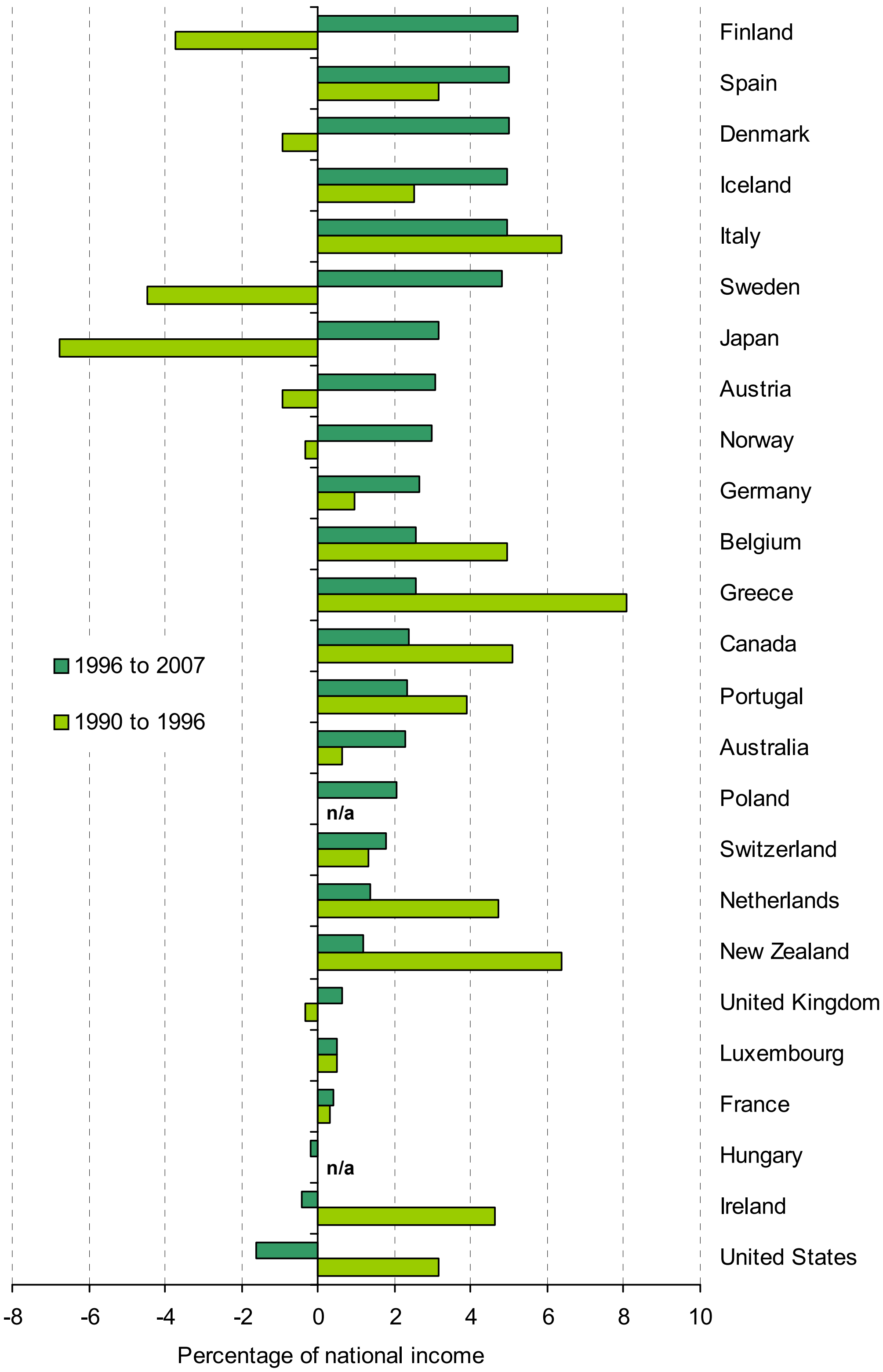


Source: Annex table 28 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 2.3. Cyclically adjusted general government balance in OECD countries in 1990

Source: Annex table 28 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 2.4. Change in cyclically adjusted general government balance in OECD countries over 1990 to 1996 and 1996 to 2007

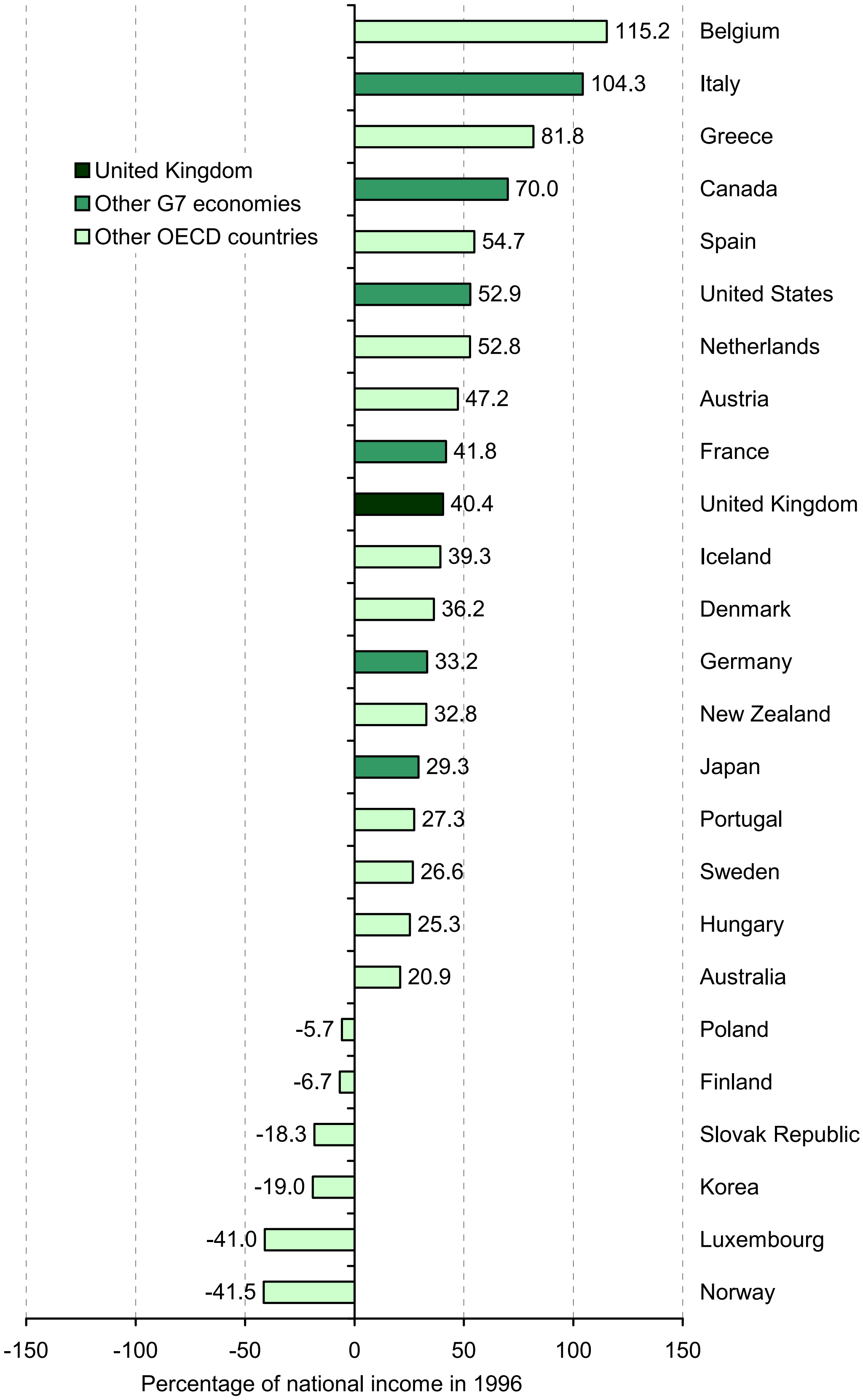


Source: Annex table 28 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 3.1. General government net debt in OECD countries in 2007

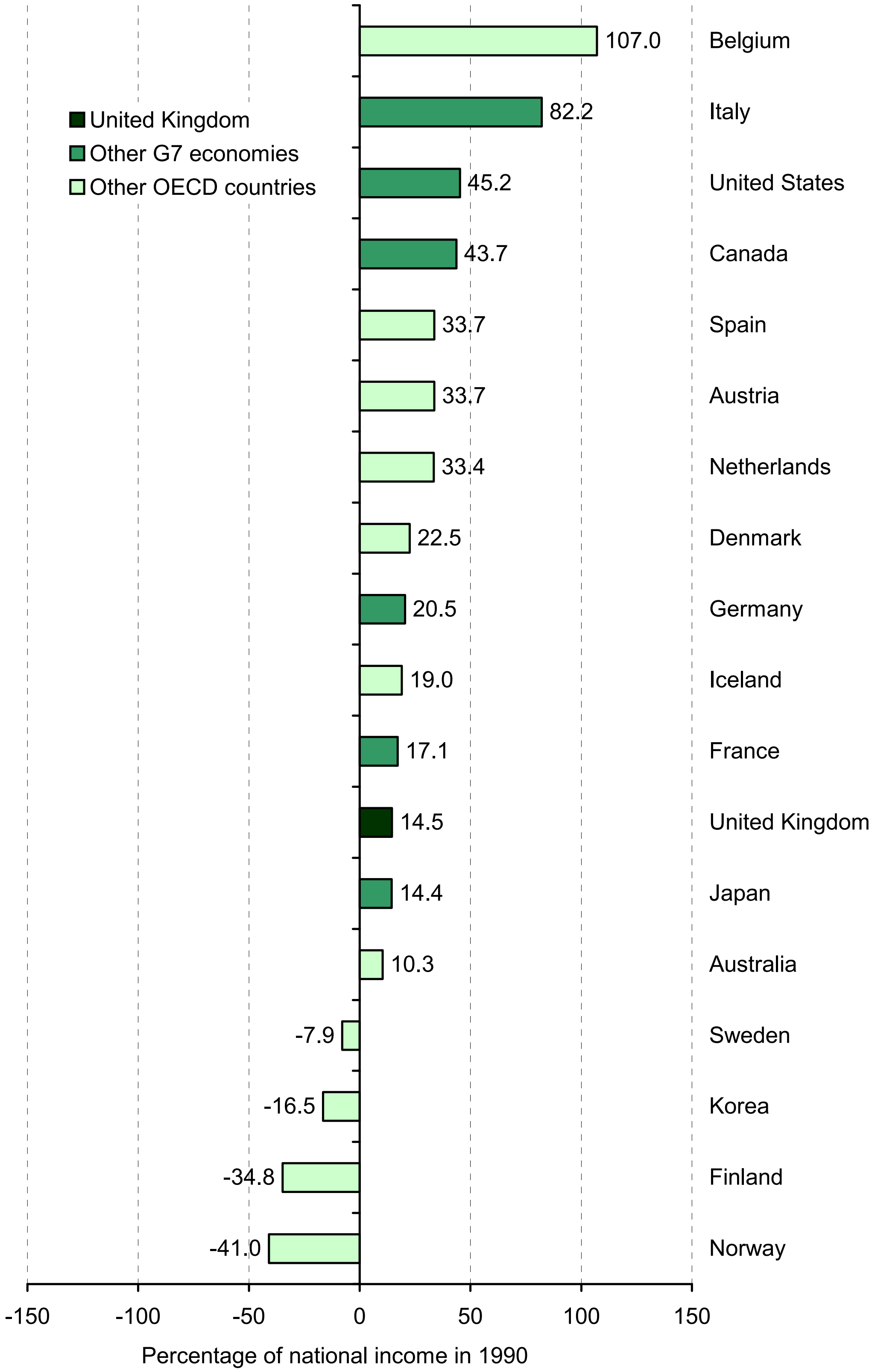
Source: Annex table 33 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 3.2. General government net debt in OECD countries in 1996



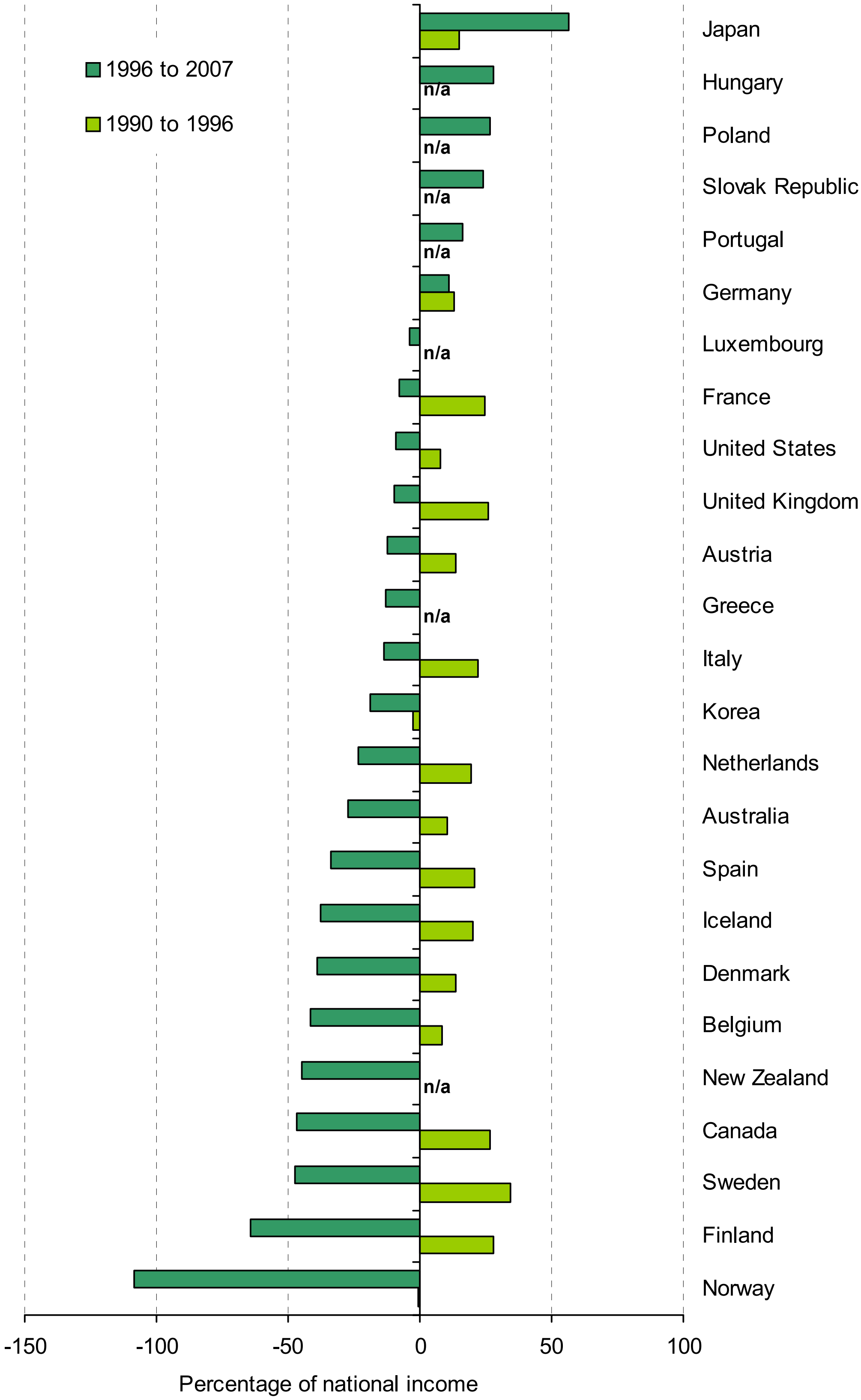
Source: Annex table 33 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 3.3. General government net debt in OECD countries in 1990



Source: Annex table 33 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).

Figure 3.4. Change in general government net debt in OECD countries over 1990 to 1996 and 1996 to 2007



Source: Annex table 33 of OECD, *Economic Outlook No. 83*, June 2008 (http://www.oecd.org/document/61/0,3343,en_2649_201185_2483901_1_1_1_1,00.html).