



BRIEFING

Debts and Deficits

How much is Labour to blame?

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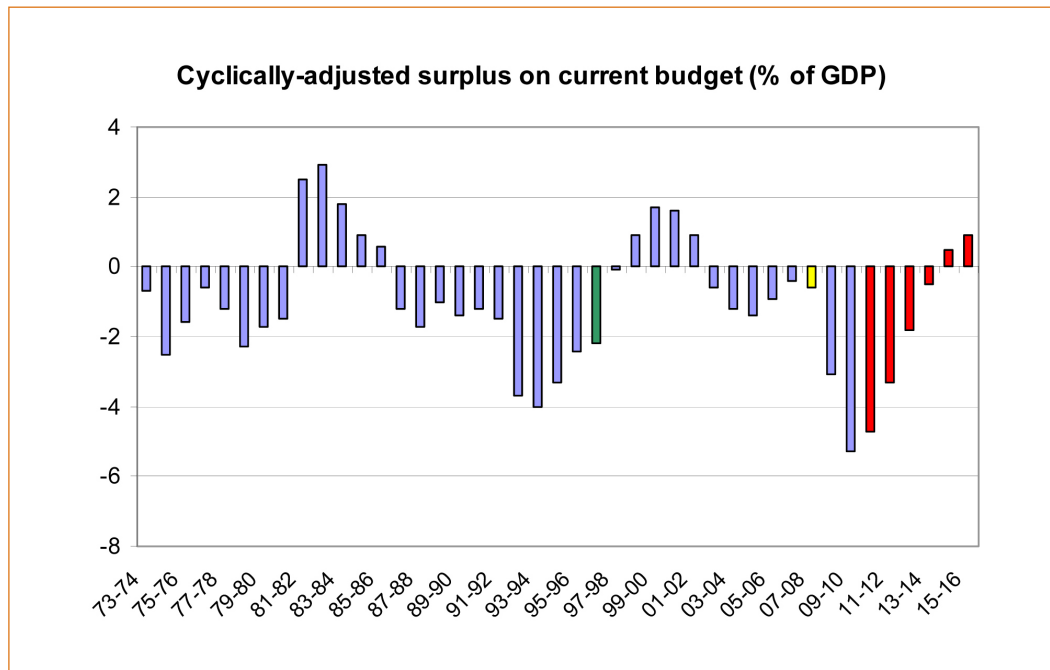
About the author

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Summary

- Analysis of the historical data on debts and deficits shows the UK's fiscal position in 2007–08, immediately ahead of the recent recession, was reasonably sound.
- On George Osborne's preferred deficit measure – the cyclically-adjusted current budget – there was a deficit of just 0.6 per cent of GDP (less than £10 billion) in 2007–08.
- On this same measure, the deficit between 1997–98 and 2007–08 averaged precisely zero – in line with the target set by George Osborne for 2015–16.

Figure 1



- Labour's mistakes ahead of the financial crisis were to underestimate the risk of a recession and not to realise how much reliance it was placing on revenues from sources associated with rampant lending.
- The vast bulk of the current deficit arose in the recession as a result of the loss of a significant portion of these revenues, discretionary measures taken by the Labour government to reduce the length and depth of the recession, and the loss of tax revenues and increases in welfare spending normally associated with economic downturns.

Context

The Coalition government has sought to blame its Labour predecessor for Britain's current fiscal position by referring persistently to 'Labour's debts' and 'Labour's deficit' and accusing it of 'not fixing the roof while the sun was shining'. More recently, there have also been accusations that the deficit was, at least in part, due to excessive spending by the last Labour government even before the recession of 2008 and 2009.

The Labour opposition refuses to accept the blame. Reports of a recent shadow cabinet meeting suggest its strategy is to insist the deficit was not caused by overspending or fiscal carelessness. It will continue to argue that deficits have increased in all developed economies as a result of the financial collapse and recession, and that the government's finances were in a healthy position before the crisis began. However, Labour will take responsibility for inadequate regulation of the banks and allowing the economy to become unbalanced.

Data and key points

This briefing looks at the numbers on debt, deficits and spending (relative to GDP) – over time in the UK and comparing the UK with other developed economies – in an attempt to establish which side is right.

The data are sourced as follows:

- Fiscal year data for the UK up to 2008–09: from the *June 2010 Budget*, Tables C15 and C16
- Fiscal year data for the UK from 2009–10 onwards: from the Office for Budget Responsibility's *Economic and fiscal outlook*, November 2010, Tables 1.2, 4.2, 4.14 and 4.23
- Calendar year data for central government spending: from the ONS public sector finances time series database
- Data on developed countries: from the *OECD Economic Outlook 88* (December 2010) statistical annex.

Time series charts highlight 1996–97 (or 1996) as the position inherited by Labour when it took office in 1997 and 2007–08 (or 2007) as the pre-crisis position.¹

The key points that emerge from the charts are:

1. There were two distinct periods for fiscal policy under Labour.
2. Debts, deficits and spending were cut quite aggressively relative to GDP during the first four or five years that Labour was in power.
3. Subsequently, deficits widened and debt increased, though in 2007–08 they were smaller than in 1996–97.
4. Current spending relative to GDP in 2007–08 was little different from 1996–97 but investment spending, and thus total managed spending, was higher.
5. Spending on interest and social benefits fell; other current spending, particularly on health, education and policing, increased.
6. Other countries also reduced their debts and deficits between 1996 and 2007, and the UK moved up the ranking of developed countries in terms of debt and spending, and down the ranking in terms of its financial balance.
7. The recession led to a significant drop in revenues (by 2.0 per cent of GDP) and increase in spending (by 6.6 per cent of GDP). These were partly discretionary (such as the temporary cut in the standard rate of VAT and higher investment spending) and partly the result of 'automatic stabilisers' (the effect of lower economic activity on tax revenues and benefit spending).
8. The effect of the recession on the UK's public finances appears to have been relatively large, due to the economy's reliance on financial services for growth and government revenues ahead of the banking crisis.
9. The cyclically-adjusted current budget balance – which George Osborne has set himself the target of reducing to zero over rolling five-year periods – was in deficit by 0.6 per cent of GDP in 2007–08. (The actual balance was in deficit by 0.3 per cent). Over the 11 years of Labour government prior to the recession, the average balance on this measure was zero.

The position in 2007–08 can, therefore, be summarised as follows:

- Government receipts were higher than in 1996–97 (relative to GDP).
- Current government spending was at the same level as in 1996–97 and a little less than government receipts, so the deficit on the current budget was smaller.
- Given the position in the economic cycle, it is arguable that spending should have been a little less than receipts.²
- Investment spending was significantly higher than in 1996–97 and had been increasing for seven years.

1 The run on Northern Rock was, of course, in 2007 – so the crisis could be said to have started during 2007–08. However, the recession began in the second quarter of 2008.

2 In money terms, spending would have to have been £9 billion lower or receipts £9 billion higher (or some mix of the two) to achieve cyclically-adjusted current balance.

- As a result, public sector net borrowing averaged 2.7 per cent of GDP between 2002–03 and 2007–08 and public sector net debt was increasing.
- Public sector net debt remained below 40 per cent of GDP and below its level in 1996–97.

Conclusion

On the basis of these numbers, Labour's 'fiscal profligacy' just ahead of the recession would seem to have been on a very limited scale. Current spending might have been about £10 billion lower (or revenues £10 billion higher). And, while it was reasonable to borrow to finance a high level of investment spending at the time, within a few years either this spending would have had to have been reduced or receipts would have had to have been increased to fund it.

Labour did, however, make two mistakes. First, the rhetoric around 'no more boom and bust' left it unprepared to acknowledge that, after 15 uninterrupted years of economic growth, it might be sensible to have some margin of error in its plans for the possibility of an economic downturn.³ Second, and for similar reasons, it appears to have been blind to the reliance it was placing on revenues from sources associated with rampant lending, such the City and the housing market. Again, greater awareness might have suggested more caution.

But the charges that the Coalition are tackling 'Labour's debt' and 'Labour's deficits', or that Labour let spending run out of control before the recession, do not stack up. Deficits increased and debt soared during the recession, not before it. Ascribe blame for the recession – and there are plenty of candidates to choose from, including governments, central banks, Chinese savings, financial regulators, banks, credit-rating agencies, sub-prime mortgage lenders and greedy householders – and you have also ascribed blame for the vast bulk of Britain's fiscal problems.

³ Although in March 2007, when the last pre-crisis budget was announced, the independent economists monitored by the Treasury were forecasting 2.6% growth in 2007 and 2.3% in 2008.

Appendix: Charts

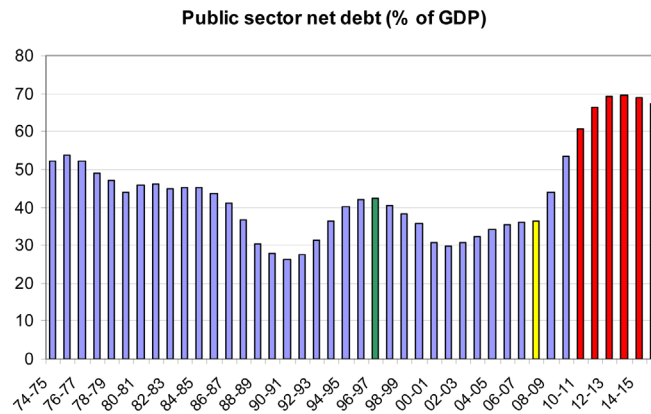


Figure 2

- Debt ratio fell from 43% in 1996–97 to 30% in 2001–02
- It then rose to 36.5% in 2007–08
- Average ratio 38.7% under Thatcher/Major governments; 34.5% under pre-crisis Labour and 36.7% for the whole Blair/Brown period.

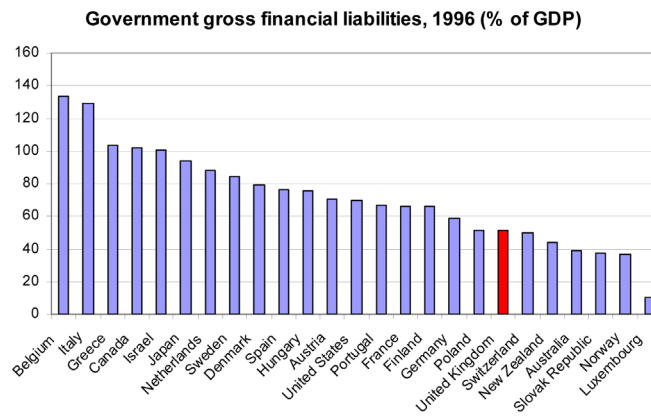


Figure 3

- UK had relatively low public debt in 1996 – ranked 19th out of 25 developed economies.

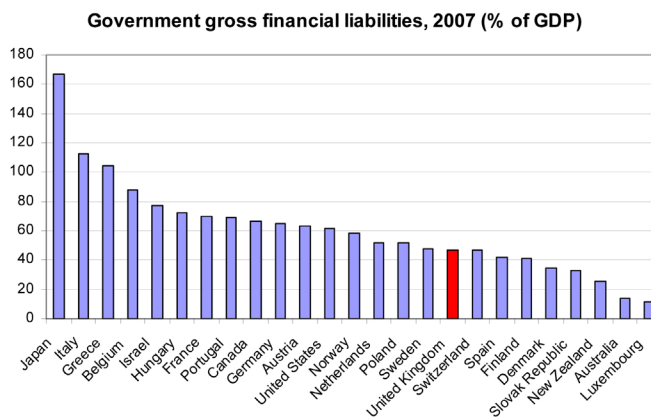


Figure 4

- UK still had relatively low public debt in 2007 – ranked 17th out of 25 developed economies
- OECD forecasts suggest UK will have 9th highest debt ratio by the end of 2011.

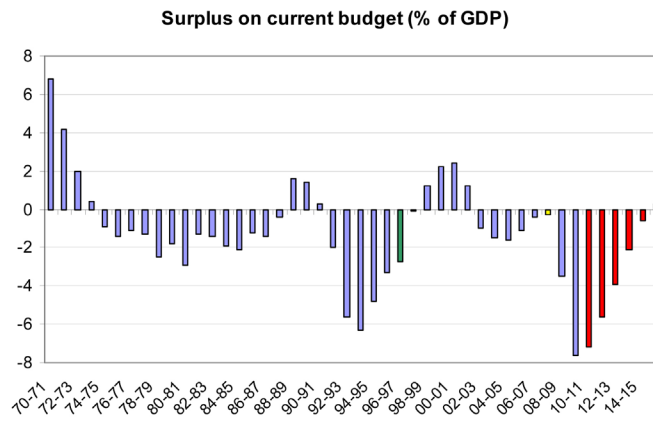


Figure 5

- The current budget showed a deficit of 0.3% of GDP in 2007–08, compared to 2.7% in 1996–97
- There were surpluses between 1998–99 and 2001–02
- The average balance under Thatcher/Major was –2.0%, under pre-crisis Labour +0.1%, and under Blair/Brown as a whole –0.8%.

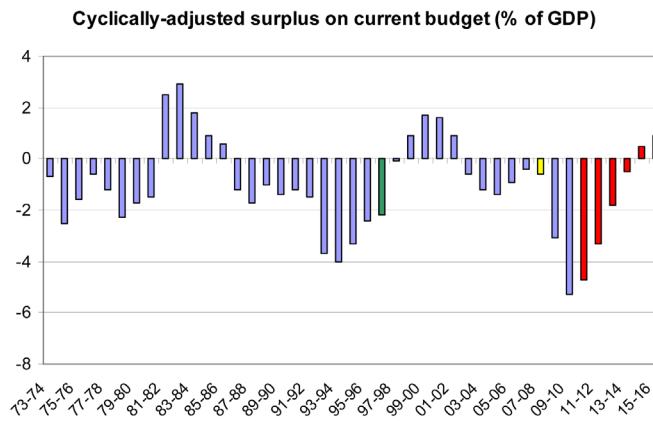


Figure 6

- The cyclically-adjusted current budget showed a deficit of 0.6% of GDP in 2007–08, compared to 2.2% in 1996–97
- There were surpluses between 1998–99 and 2001–02
- The average balance under Thatcher/Major was –1.0%, under pre-crisis Labour 0.0% and under Blair/Brown as a whole –0.7%.

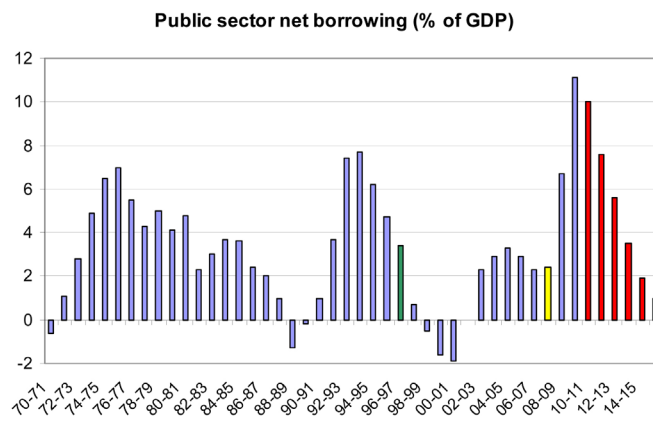


Figure 7

- Public sector net borrowing was 2.4% of GDP in 2007–08, compared to 3.4% in 1996–97
- Borrowing was negative between 1998–99 and 2000–01
- Borrowing averaged 3.3% under Thatcher/Major, 1.2% under pre-crisis Labour, and 2.4% under Blair/Brown as a whole.

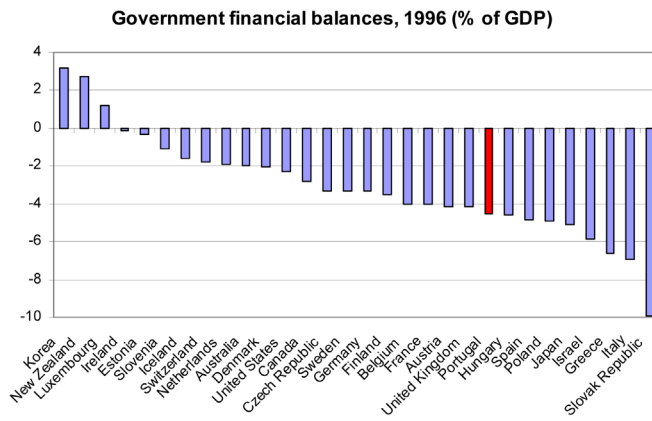


Figure 8

- UK had a relatively large financial deficit in 1996 – ranked 23rd out of 31 developed economies on its financial balance (note Norway, which has a very large surplus, is excluded from the chart).

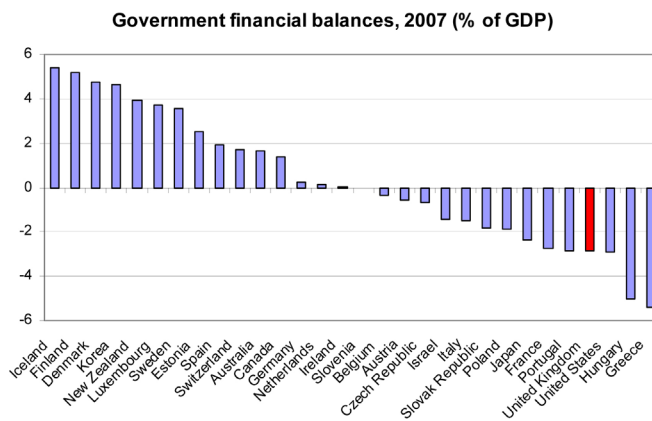


Figure 9

- UK also had a relatively large financial deficit in 2007 – ranked 28th out of 31 developed economies on its financial balance
- OECD forecasts suggest UK will rank 29th in 2011 (only the US and Ireland are larger).

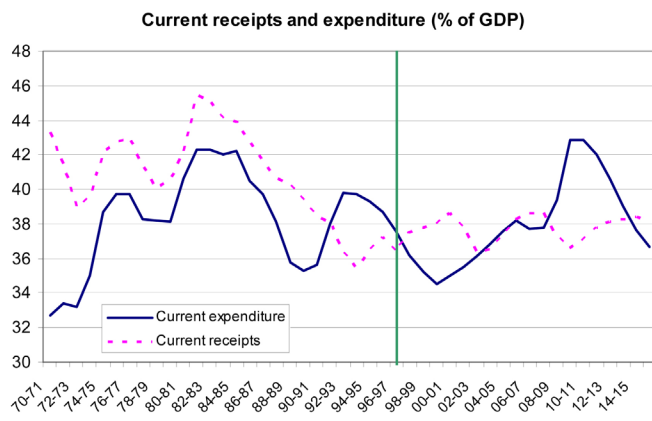


Figure 10

- Current spending was 37.8% of GDP in 2007–08, compared to 37.6% in 1996–97
- Current receipts were 38.6% of GDP in 2007–08, compared to 36.4% in 1996–97
- Spending averaged 39.2% under Thatcher/Major, 36.4% under pre-crisis Labour, and 37.2% under Blair/Brown as a whole.

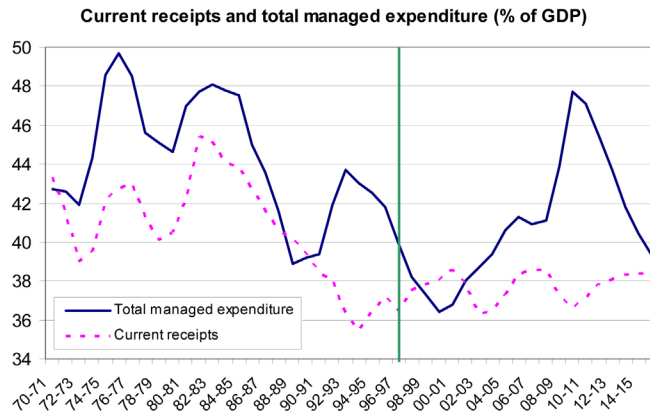


Figure 11

- Total spending was 41.1% of GDP in 2007–08, compared to 39.9% in 1996–97
- Spending averaged 43.5% under Thatcher/Major, 39.0% under pre-crisis Labour, and 40.0% under Blair/Brown as a whole.

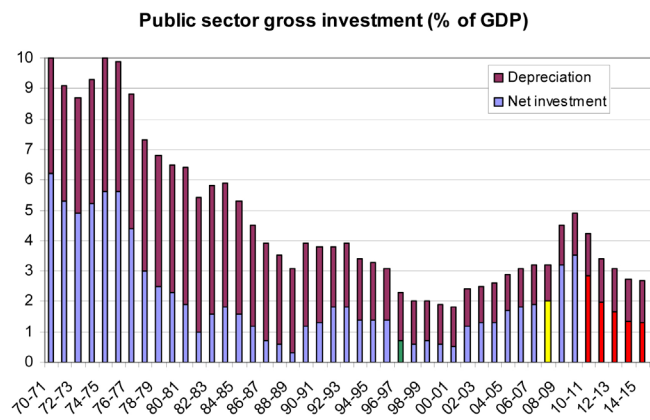


Figure 12

- Public sector gross investment fell from 2.3% of GDP in 1996–97 to 1.8% in 2000–01 before increasing to 3.2% in 2007–08
- Net investment was 0.7% in 1996–97, 0.5% in 2000–01 and 2.0% in 2007–08.

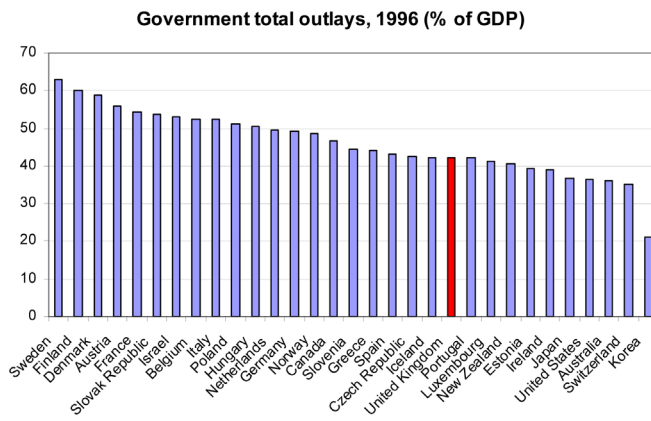


Figure 13

- UK had relatively low level of public spending in 1996 – ranked 21st out of 31 developed economies.

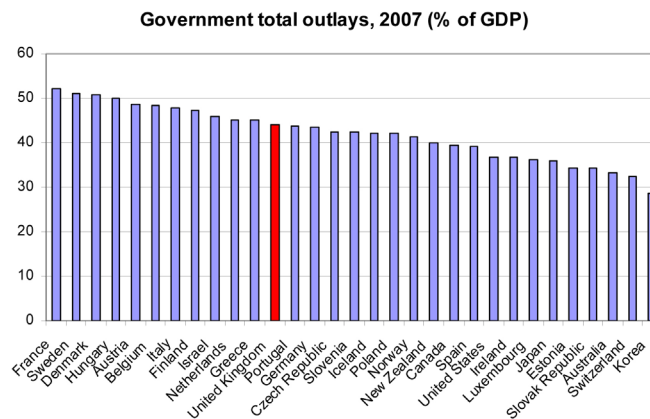


Figure 14

- UK had higher level of public spending in 2007 – ranked 12th out of 31 developed economies
- OECD forecasts suggest UK will have 8th highest spending ratio in 2011.

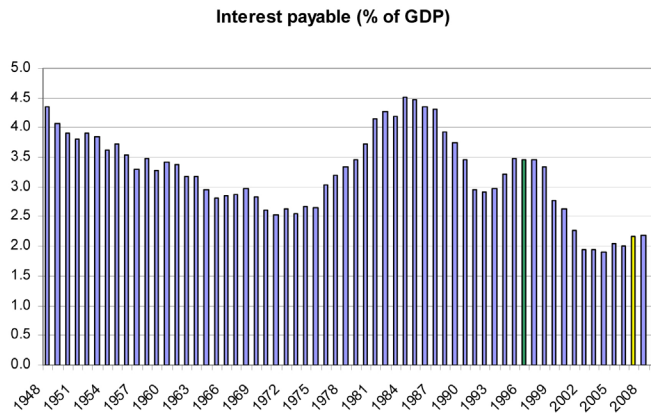


Figure 15

- Spending on interest payments fell from 3.5% of GDP in 1996 to a post-war low of 1.9% in 2002–2004 before edging up to 2.2% in 2007.

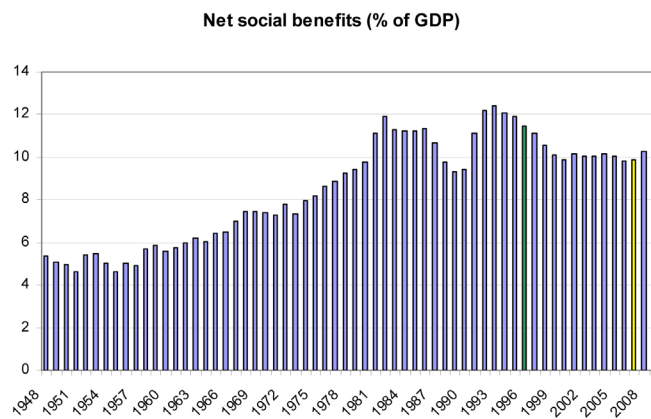


Figure 16

- Spending on social benefits fell from 11.4% of GDP in 1996 to 9.9% in 2007.

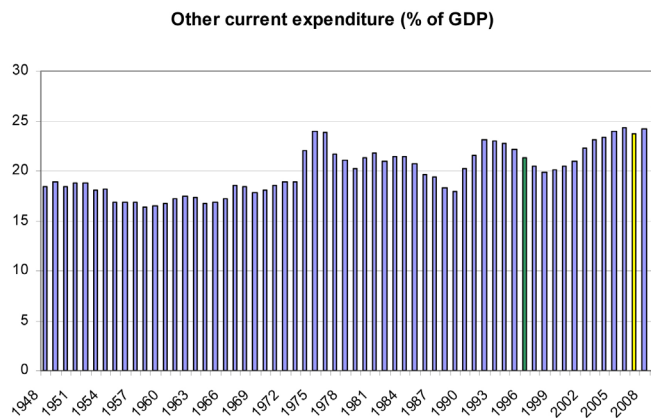


Figure 17

- Other spending (ie excluding interest and social benefits) fell from 21.3% of GDP in 1996 to 19.9% in 1998
- It then increased to 23.7% in 2007 as more money was spent in areas such as health, education and policing.