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December 2010

The Big Question:

A Full Fact guide to the economy

Introduction

In the second quarter of 2008, UK Gross Domestic Product (GDP) – the indicator used to measure the country's economic output - declined by 0.3 per cent, bringing to an end a sequence of 63 consecutive quarters of growth that stretched back to 1992. What followed was the longest and deepest recession since records began in 1948.It is perhaps with this in mind that recent economic policy was described by the Governor of the Bank of England Mervyn King as “extraordinary”. Successive nationalisations of banks such as Northern Rock, RBS, HBOS and Lloyds TSB and 'quantitative easing' has contributed to increasing national debt, which in turn has sparked a debate about the sustainability of public spending. In such uncharted waters, the distinction between economic fact and conjecture has become increasingly blurred. This report aims to clarify which claims are supported by the facts and figures, and which are not.

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-The Debt-

Two measures of national debt are used in a policy context: Public Sector Net Debt, which is published by the Office for National Statistics (ONS)[3] is the figure used by Government in fiscal policy, although the European Union also compiles General Government Gross Debt for its Protocol on Excessive Debt Procedure.

In September 2010, Public Sector Net Debt stood at £842.9 billion. It is often reported that this is a record, and indeed it is. However it was also a record when it featured in a Times headline last year[4], and a Guardian article two years before that.[5] Indeed debt has reached record levels in 46 of the last 64 years, even in today's prices.

This is because, as the economy grows, so does the Government's capacity to borrow money and the scale of the services that it provides. For this reason, when comparing debts levels over time, most economists will use the Public Sector Net Debt as a share of GDP.

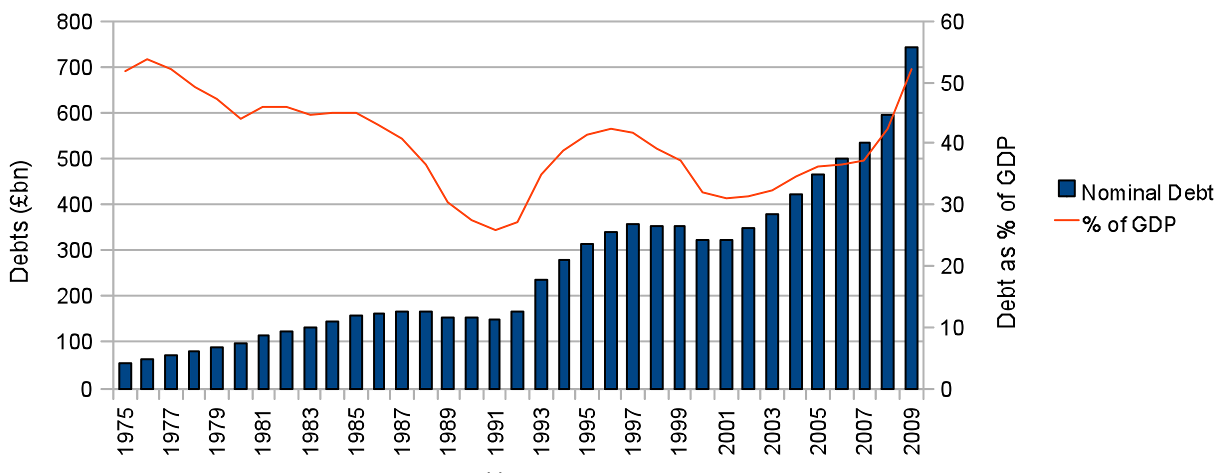
In 2009, the UK's debt stood at 52.2 per cent of GDP, its highest recorded level since 1976 when it stood at 53.8 per cent, although monthly data suggests that this threshold has now been breached. Following World War 2, debt was as high as 238 per cent of GDP (1948), although the level declined steadily between then and the 1970s.
Public Sector Net Debt includes the accounts and liabilities of Central Government, Local Government and Public Corporations, but excludes those of the nationalised banks, which are considered assets, and the Bank of England.

Labour's Record

New Labour Leader Ed Miliband has made a point of arguing that the Labour Government had reduced the national debt in the years before the financial crisis and recession. This has, however, been a point of contention between the two parties, and the subject of much debate in the media.

The veracity of the claim is dependent upon the terms of reference used. If we define the start of the financial crisis as September 2007, when Northern Rock's application for liquidity support from the Bank of England exposed difficulties in the money markets, then it is possible to justify this claim.

Clearly in cash terms, the debt has risen significantly



over Labour's tenure, from £352 billion in May 1997 to £514 billion in September 2007. However as a share of GDP, debt fell from 42.5 per cent to 36.2 per cent between May 1997 and September 2007.

However these figures only tell half the story. A closer look at the debt as a share of GDP figures reveals that the ratio tends to go up following times of economic hardship – in the early 1970s and 1990s for example - and down after years of prosperity. Labour inherited power at a time when growth was picking up after the recession of the early 1990s, and Public Sector Net Debt had peaked.

Arguably therefore, a fairer comparison between Labour and the Conservatives' handling of debt is made by comparing it as a share of GDP in 1990 and 2007, the points at which the country entered the last two recessions.

This paints a different picture. At the beginning of 1990, UK net debt stood at 27.5 per cent of GDP, much lower than the 36.2 per cent achieved by Labour in September 2007, and just shy of the record low of 26 per cent achieved in 1991.

International comparisons

Of the G7 group of industrialised economies, the UK is forecast to have the third lowest level of debt for the whole of 2010. OECD figures[6] show that the UK's projected debt levels of 59 per cent of GDP compares favourably to those in the Japan (104.6 per cent), Italy (100.8 per cent), the United States (65.2 per cent) and France (60.7 per cent), but is higher than those of Germany (54.7 per cent) and Canada (32.6 per cent). The UK also has a lower level of debt than the G7 average, which stands at 70.1 per cent.

Compared to peers in the Organisation for Economic Co-operation and Development (OECD), the UK fares slightly worse. Average debt amongst OECD nations stands at 57.6 per cent of GDP for 2010. Furthermore only eight of the 33 member states are burdened with greater debt than the UK, with Greece (94.6 per cent of GDP), Belgium (85.4 per cent), Portugal (62.6 per cent) and Hungary (62.1 per cent) adding to the four G7 nations outlined above. Of the European countries in the OECD, the average debt for 2010 is 57.9 per cent of GDP, again, a shade below the level in the UK.

The fact that the UK's debt levels lie close to the average of its economic peers has led some former members of the previous Government to claim that Conservative and Liberal Democrat attacks on Labour's record are groundless. Ed Balls, for example, argued during Labour's leadership campaign that prior to the financial crisis "we had lower debts than France, Germany, America and Japan."

Again however, this is a selective analysis of the facts. For example, an IFS report[7] assessing the Labour Government's record between 1997 and 2007 noted: "We [the UK] 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."

It is worth noting however that international comparisons of debt levels are hamstrung by the fact that different countries may be at different points in their economic cycles in any given year.

-The Deficit-

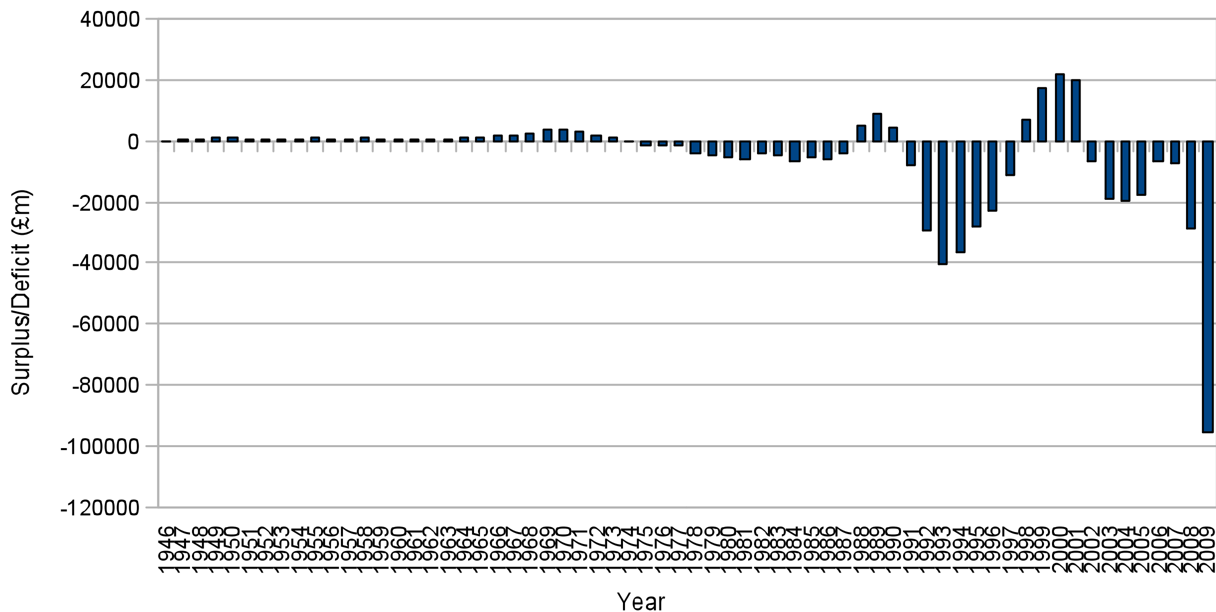
In the years following World War 2, successive Governments consistently ran a budget surplus, receiving more in taxes than was spent, which helped to bring the national debt down from 238 per cent of GDP to around 50 per cent by 1975. Since then, however, it has been common for Governments of all political hues to spend more in a year than they can recoup. In the 35 years between 1974 and 2009, the Government has ended the year in surplus on only seven occasions: between 1988 and 1990, and between 1998 and 2001.

How one interprets this data needs to be grounded in the context of the wider economic environment. This is because both Government expenditure and receipts at any given time are dependent upon economic output: in times of high employment and productivity, tax receipts tend to be higher and social security payments lower, and vice versa during times of economic hardship.

Consequently, a distinction is made between cyclical budget deficits, which are the product of dips in the economic cycle, and the structural deficit, which encompasses that part of the deficit which remains even when the economy is functioning optimally. The structural deficit can also be called the cyclically-adjusted deficit.

Measuring the maximum output of an economy is clearly a difficult thing to do, and therefore estimates can vary depending upon the methodology used. The Office for Budget Responsibility (OBR) estimates that in 2009-10 the UK's structural deficit stood at 8.8 per cent of GDP.[8] This is calculated by measuring current economic output against longer-term trends to determine the proportion of the cyclical deficit that can be accounted for by stunted growth.

The OECD, by contrast, use an estimate of potential economic output to calculate structural deficit. They estimate the current structural deficit to be closer to 10% of the country's potential GDP.



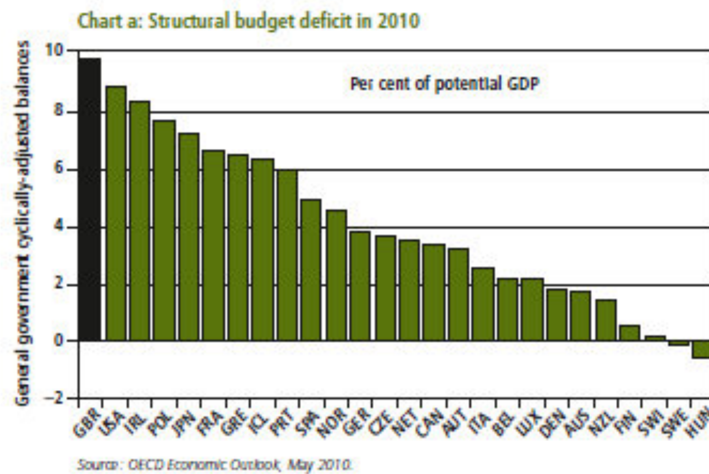
It therefore goes without saying that when making international comparisons of budget deficit estimates, one must be careful to compare like with like. When the Chancellor claims in the June Budget that "by 2007 the UK had the largest structural budget deficit in the G7", it can only be sustained by using the OECD, rather than OBR figures.

Government Gilts

Besides the size of the deficit, much political capital has also been made of the way in which Government borrows its money.

For example, George Osborne asserted in his statement to the Commons when announcing the Spending Review in October that "we all know that that money would far better serve the needs of our own citizens than those of the foreign creditors we borrow from."

This is, at best, a selective interpretation of the facts. According to the UK Debt Management Office, which tracks the gilts issued by Government by way of borrowing, 29.9 per cent of holdings are held by foreign creditors, as at June 2010.[9] This is roughly the same proportion that is held by



UK-based pension funds and insurance firms, and only marginally more than the 21.8 per cent held by the Bank of England. To suggest that foreign creditors are the exclusive beneficiaries of UK debt – or even that they account for the majority of it - is inaccurate. By way of contrast, approximately 74 per cent of Greek debt was foreign owned during the country's sovereign debt crisis in May.

However as Full Fact discovered when we looked at the issue, the relevance of this information is dubious. Richard Wellings, Deputy Editorial Director at the Institute of Economic Affairs, told us that: "The identity and location of creditors is only really relevant if the Government defaults on its debt, and if that happens then its economic policy will have already failed. The external versus internal debate sounds convincing, but it is nonsense"

Arguably of greater relevance is the fact that UK gilts have an average maturity of 14 years, compared to 7 years in Greece and many other European countries. This gives the Government greater leeway in financing its spending plans, and makes it possible to repay debts at a more favourable point in the economic cycle.

-The Outlook-

Since the Coalition Government took office on 11 May, the spectre of cuts has dominated political discourse. Austerity measures have been fleshed out in increasing levels of detail following the Chancellor's Budget of 22 June and the Spending Review of 20 October, however there remains enough uncertainty to sustain several competing claims.

Chief among these has been the scale of the impending cuts. Indeed Tory MP John Redwood has questioned whether there is going to be any reduction in spending at all. "There aren't going to be any cuts" Mr Redwood told Newsnight's Kirsty Wark, adding "if you look at the Budget figures, there is going to be a £90 billion increase in current spending over the five years of the Parliament."

The Budget Red Book[10] does show the sort of cash increases Mr Redwood identifies. In 2009/10 total public sector expenditure was estimated at £600.6 billion, which rises to £692.7 billion in 2014/15. This equates to an increase of £92.1 billion across the five years of the current Parliament.

However to suggest that this means that there won't be cuts is misleading. As the Budget documentation notes (clause 2.12), once inflation is factored into these calculations, a real terms cut of four per cent can be seen in total managed expenditure. Public sector current expenditure is to fall by one per cent, whilst public sector gross investment is to decrease by some 31 per cent by 2015. As a spokesperson for the Institute for Fiscal Studies told us: "Any sensible analysis has to take account of inflation, as spending doesn't mean much in nominal terms."

The relative size of the cuts has however been downplayed by some. Deputy Prime Minister Nick Clegg has noted that public spending will be at the same level as it was in 2006, whereas George Osborne claimed that it would be at a similar level to that in 2008. Both are right.

Spending as a share of GDP will, by the end of the Parliament, return to 2006/07 levels, whilst in real cash terms, it will fall back to 2008/09 levels.

Whilst in this light the scale of the cuts may seem fairly modest, it is worth getting some perspective. Since 1967, public sector expenditure has only been cut in real terms on four occasions, and has not fallen in three consecutive years before over this period.

Growth

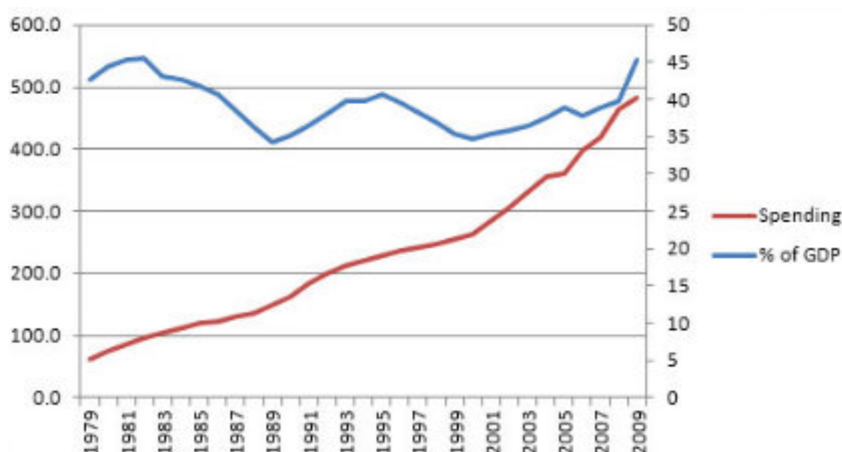
Many of Labour's criticisms of Coalition economic policy have centred around the accusation that it precludes or damages the prospects for growth. For example, Labour Leader Ed Miliband told Channel 4 News in October that "their [the Government's] deficit plan is dangerous and the government doesn't have a wider economic plan for growth and jobs."[11]

The Chancellor, by contrast, has argued that Government policy will stimulate private sector growth, which will expand to fill the gap left by reductions in the size of the public sector. Who you believe depends very much on how you see economic growth being driven.

Labour's claims rest upon the assumption that retrenching the state's role as an economic agent too severely and too quickly will hamper the prospects for growth.

Certainly since the financial crisis began public spending has become more important to the economy. As a share of GDP, the state is forecast to account for over half of all output in 2010, higher than at any point in the last 30 years.

Indeed whilst the Government's share of the economy under Labour was for the most part lower than it was under Mrs Thatcher, it had been steadily increasing even before the recession began to bite, as the chart below shows.



The Government forecasts a return in spending to around 40 per cent of GDP, 20 per cent lower than present.[12]

Whilst both Government and Opposition accept that this will involve some pain for the economy, the Coalition argues that this public sector retrenchment will allow for an expansion in the private sector that will "pick up the slack".

Whether or not this private sector boom materialises or not depends upon a number of factors, however a commonly cited measure of private sector health is the extent to which banks are lending to small businesses.

Whilst there have been complaints in some sections of the press[13] that the UK's financial institutions are not making enough capital available to business, figures from the British Bankers Association suggest that this isn't actually the case.

These figures suggest that year-on-year, total lending to small businesses has actually increased every year apart from 2010. Small business lending has risen from £41.7 billion in 2007 to £45.7 billion in 2008 to £46.9 billion in 2009, falling back to just under £46 billion in 2010.

These are net lending figures, and so also account for businesses paying down their debts as well as those borrowing more money. However the broad picture painted of credit availability does seem to be confirmed by the Bank of England's 'Trends in Lending',[14] which has also noted a rise in approval rates for loans.

What does seem to have changed is the terms under which businesses can borrow money. The Federation of Small Businesses (FSB) have noted that stricter checks and terms imposed upon potential borrowers has resulted in fewer applications for credit in recent years, as banks attempt to put the years of bad debt behind them.

So whilst it may now be more difficult for some businesses to attain credit, it does appear to be something of a myth to say that lending itself has dried up.

International Comparisons

The Prime Minister has said that his Government's policy of pursuing an 80:20 ratio for spending cuts to tax increases represents the international "gold standard". Research by the OECD however suggests that historically Government's have not used spending cuts quite so readily.

Their analysis, produced in 2008, of 85 different examples of budget consolidation showed that in two thirds of cases revenue increases accounted for a higher portion of deficit reduction than that achieved by spending cuts.[15]

In the early 1990s Sweden suffered a deep recession and its budget deficit by 1994 stood at over 10 per cent of GDP. Government action meant that within three years the deficit fell to 2 per cent. However, despite determined action to reduce spending it still only accounted for just over half of the savings – 53 per cent, versus 47 per cent achieved through higher taxes.

During the mid-1990s Canada and Finland had a similar pattern of successful fiscal consolidation. In Canada, 60 per cent of savings came through expenditure cuts with 40 per cent tax rises. In Finland the figures were 55 per cent versus 45 per cent.

These figures would again seem to support an alternative interpretation of the evidence.

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Acknowledgements

Full Fact would like to thank all those who have helped in the production of this report, notably Professor Willie Brown at the University of Cambridge, Professor Christopher Cramer at the School of Oriental and African Studies, the Institute for Fiscal Studies and the Institute of Economic Affairs.