



# UK fiscal policy before the crisis

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# Overview

- Currently in middle of biggest fiscal consolidation since the war
  - Borrowing hit 11% of GDP
  - Debt heading from 40% to 85% of GDP
  - Consolidation of 9% of GDP

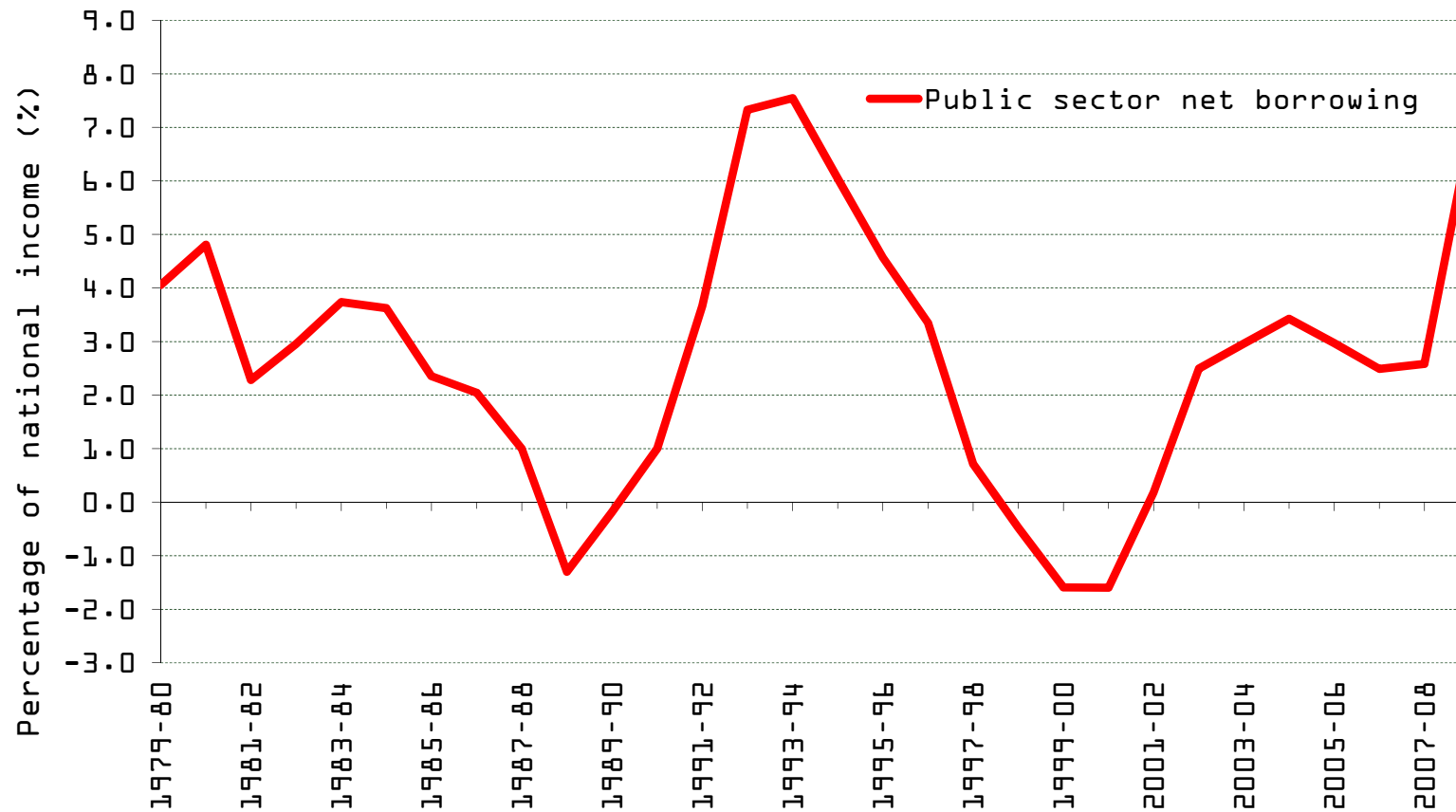
# Overview

- Currently in middle of biggest fiscal consolidation since the war
- UK entered recession with a large structural deficit by international standards
  - But smaller than in 1996
- Period from 2001-08 saw historically big spending increases
  - Accompanied by some tax increases
- Fiscal rules were only partially effective
- As in the 1980s the Chancellor and Treasury assumed growth would continue unabated
  - Spending decisions made on that basis
- Hard to see how we could have entered recession in a qualitatively different fiscal situation

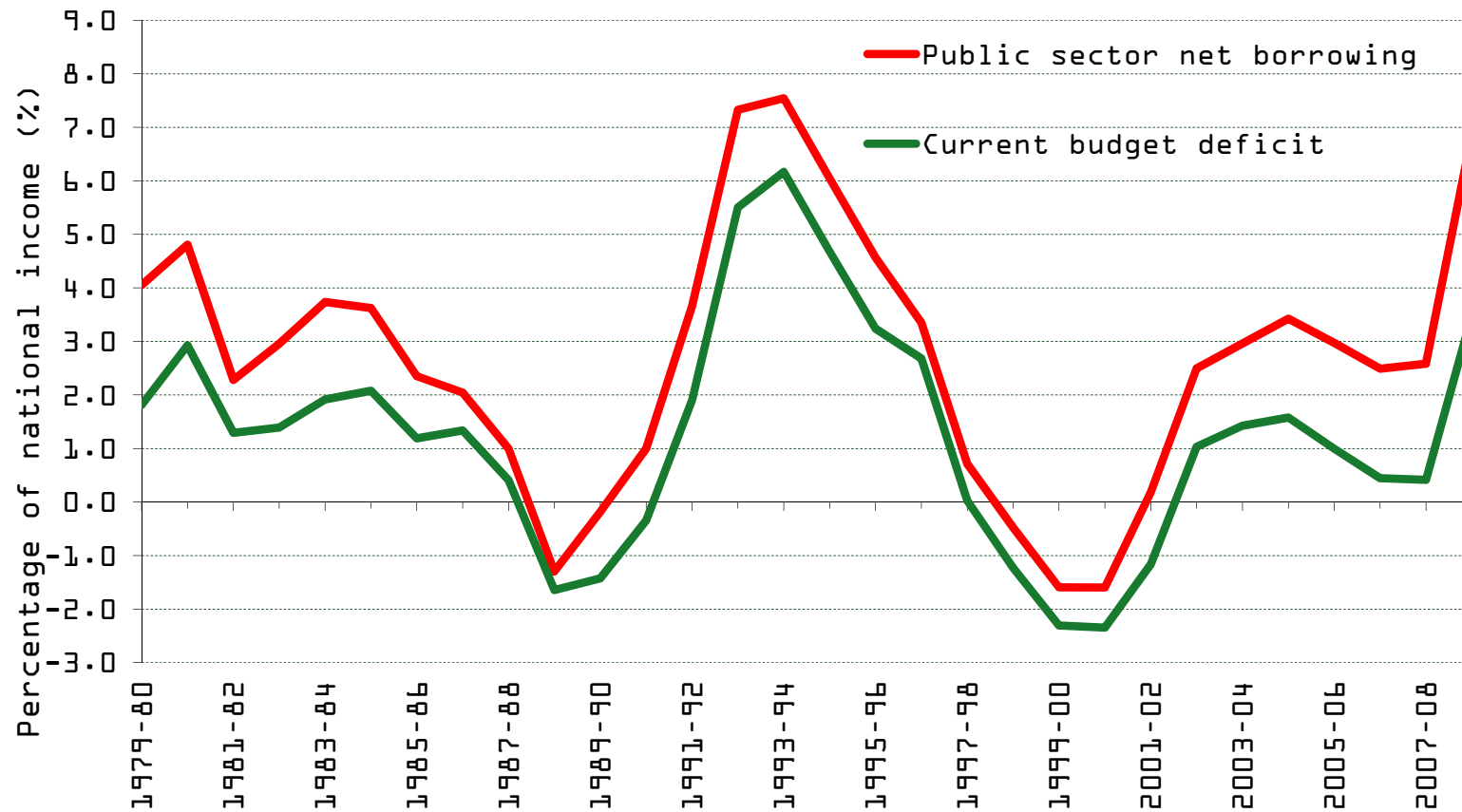
# Borrowing strongly cyclical (of course)

- Rose dramatically in the early 1990s
- Falling rapidly from mid 1990s
- Then rising from early 2000s

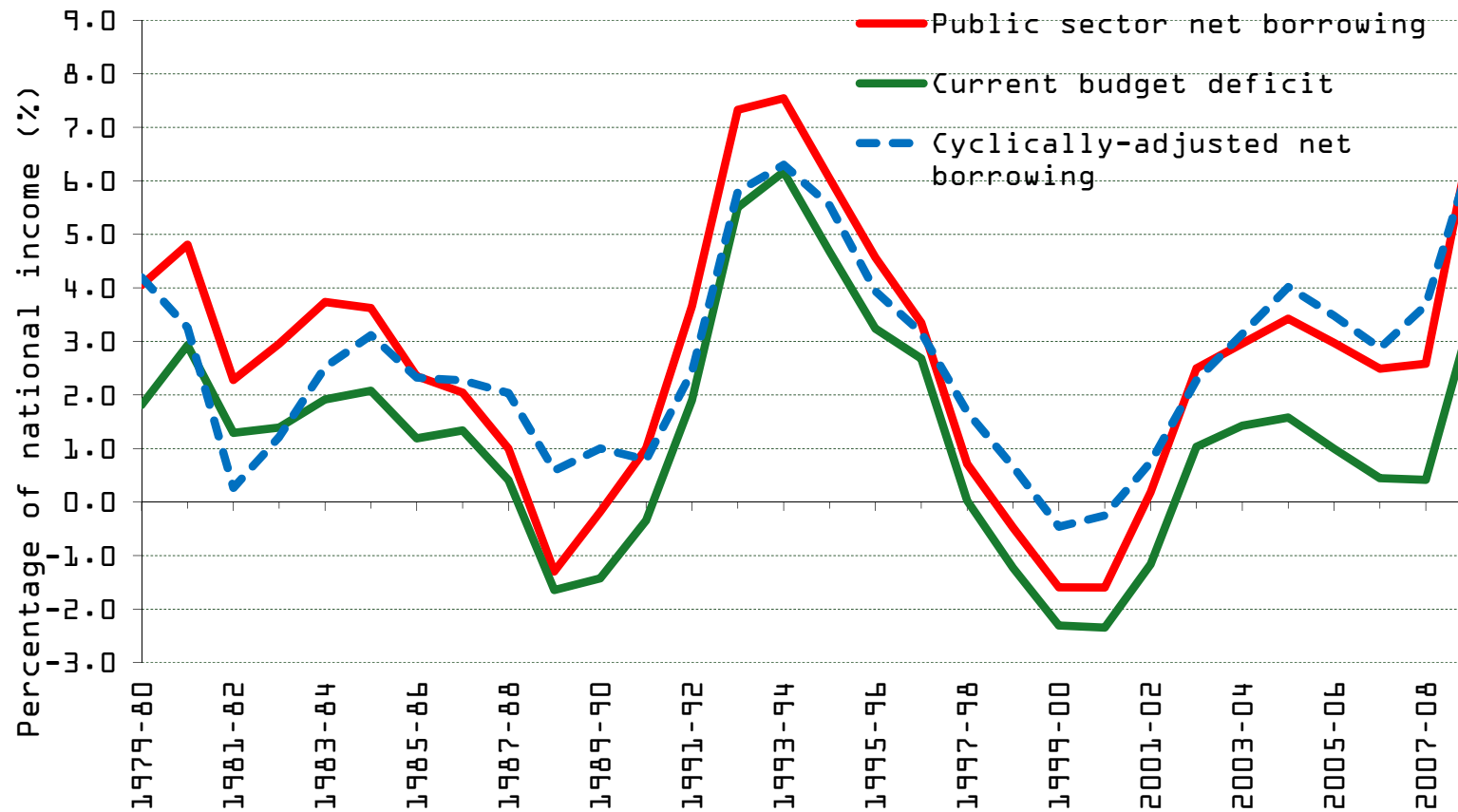
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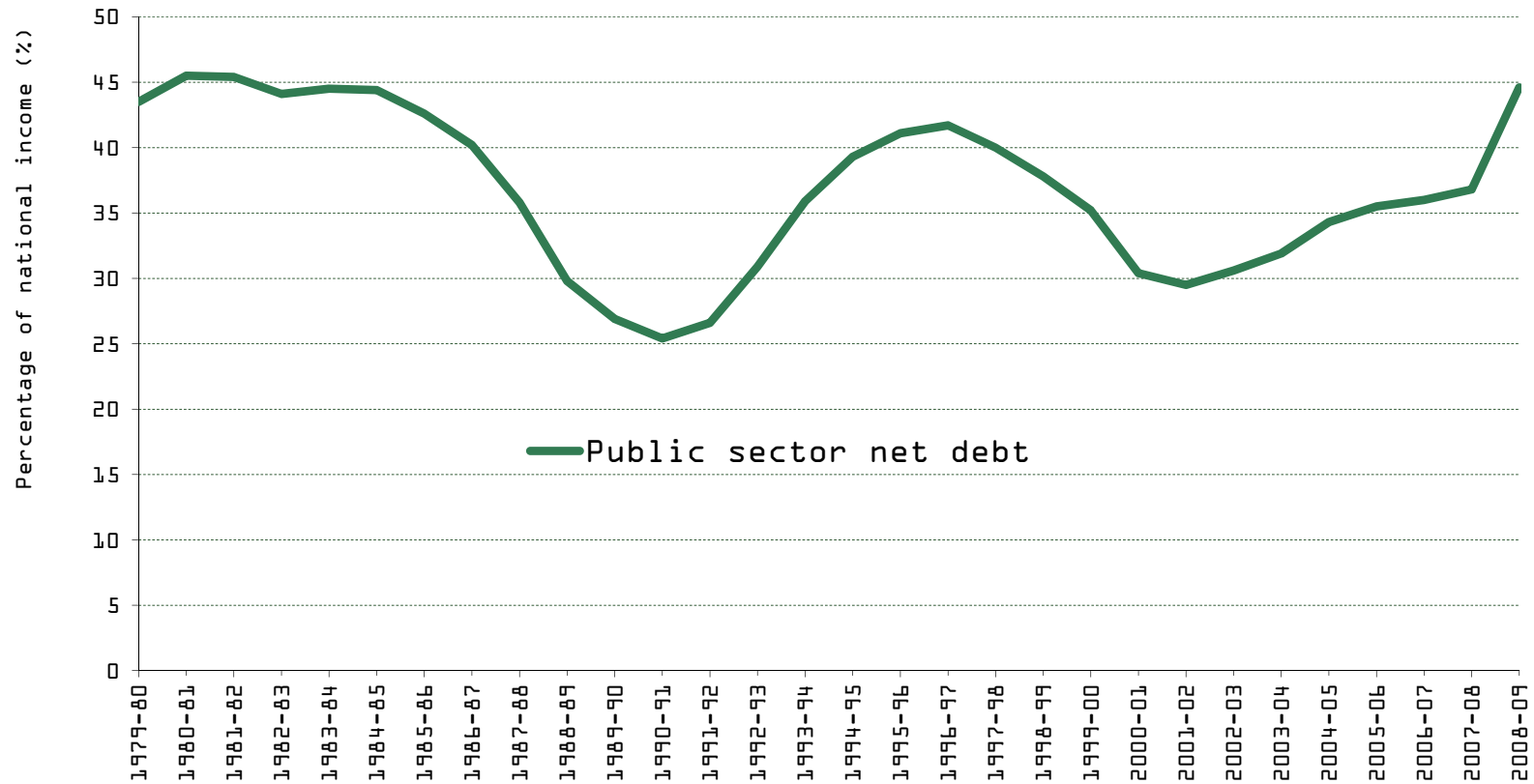


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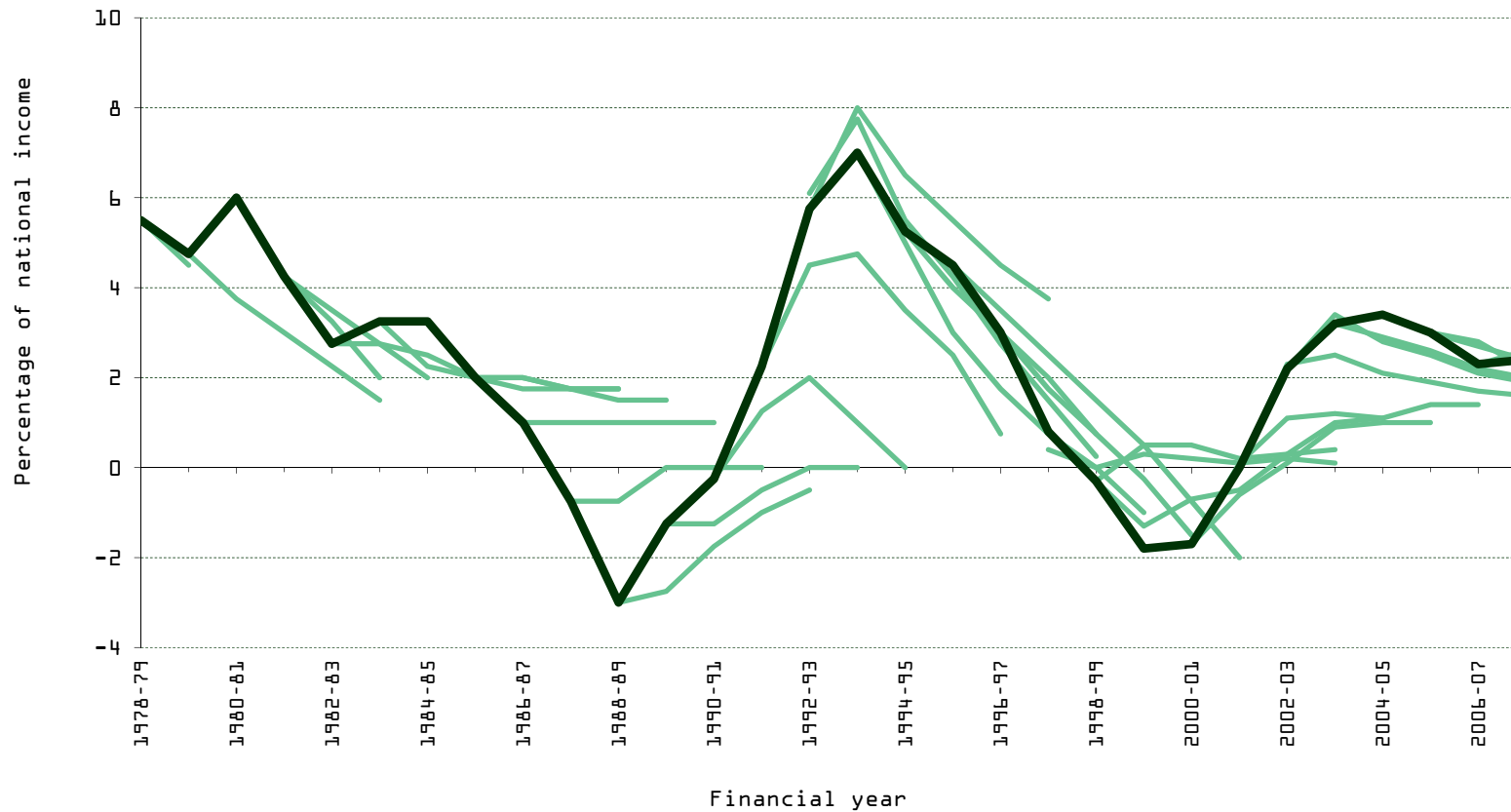
- Rose dramatically in the early 1990s
- Falling rapidly from mid 1990s
- Then rising from early 2000s
  
- The period from 2001 saw significant spending increases
  - But also tax increases
  
- With debt rising



# With debt following a similar pattern



# Persistent under-estimation of change in borrowing



# What was state of public finances pre crisis?

- PSNB 2.4% of GDP
- Current budget deficit 0.4%
- Structural borrowing then estimated at 2.6% of GDP
  - OBR now believe it was at 3.7% of national income
- These measures were all lower than in 1996/97
- But don't look so healthy on international comparisons

<i>% of national income</i> <i>Rankings: OECD member countries</i>	<b>Pre-crisis position</b> <b>(2007)</b>	
<b><i>Spending</i></b>		
General government spending <i>Place in OECD</i>	43.7% <i>12<sup>th</sup>/30 highest spending</i>	
<b><i>Revenues</i></b>		
Tax and other revenues <i>Place in OECD</i>	41.0% <i>18<sup>th</sup>/30 highest revenues</i>	
<b><i>Borrowing</i></b>		
General government net borrowing <i>Place in OECD</i>	2.7% <i>6<sup>th</sup>/30 highest borrowing</i>	
Structural borrowing <i>Place in OECD</i>	4.5% <i>3<sup>rd</sup>/26 highest borrowing</i>	

<i>% of national income Rankings: OECD member countries</i>	<b>Pre-crisis position (2007)</b>	<b>Change, 1997 to 2007 (% points)</b>
<b><i>Spending</i></b>		
General government spending <i>Place in OECD</i>	43.7% <i>12<sup>th</sup>/30 highest spending</i>	+3.3 <i>2<sup>nd</sup>/30 largest increase</i>
<b><i>Revenues</i></b>		
Tax and other revenues <i>Place in OECD</i>	41.0% <i>18<sup>th</sup>/30 highest revenues</i>	+2.8 <i>6<sup>th</sup>/30 largest increase</i>
<b><i>Borrowing</i></b>		
General government net borrowing <i>Place in OECD</i>	2.7% <i>6<sup>th</sup>/30 highest borrowing</i>	+0.5 <i>4<sup>th</sup>/30 largest increase</i>
Structural borrowing <i>Place in OECD</i>	4.5% <i>3<sup>rd</sup>/26 highest borrowing</i>	+2.3 <i>6<sup>th</sup>/26 largest increase</i>

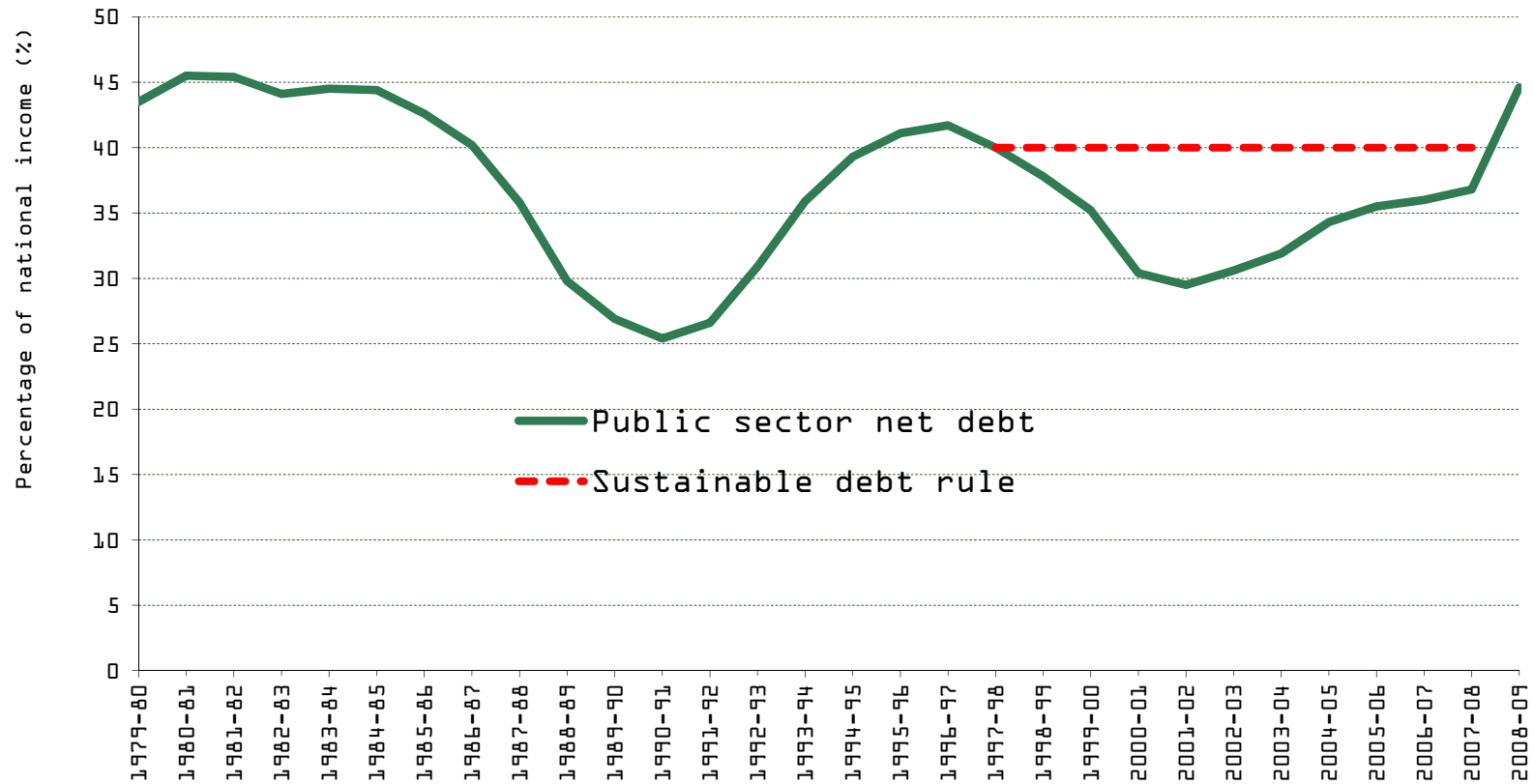
# Fiscal rules

- Were generally unclear pre-1997
  - A broad aspiration to meet budget balance in the medium term
- From 1997:
  - Golden Rule: current budget balance over the cycle
  - Sustainable Investment Rule: keep net debt below 40% of GDP
- For the Treasury to determine whether rules were being met

# Sustainable Investment Rule

- In 2008 Budget Treasury was (still) expecting 2% growth
  - the central forecast was for debt to hit 39.8% of GDP in 2010
- At least appeared to drive the structure of many private finance deals
  - Network Rail structure allowed £18 billion of debt not to count against the rule
- “Sustainability” appeared unrelated to future commitments

# With debt following a similar pattern





# Golden Rule

- Effectively backward looking for period after 2001
  - Using up “headroom” created by early surpluses
- Required dating of the cycle
  - Dating which conveniently changed in 2005 when it looked like rule might be breached
  - Start of cycle redated from 1999 to 1997

# Golden Rule

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- Required dating of the cycle
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  - Start of cycle redated from 1999 to 1997
- Leading my predecessor Robert Chote to suggest that it was “not so much a cycle as a stretch limo”

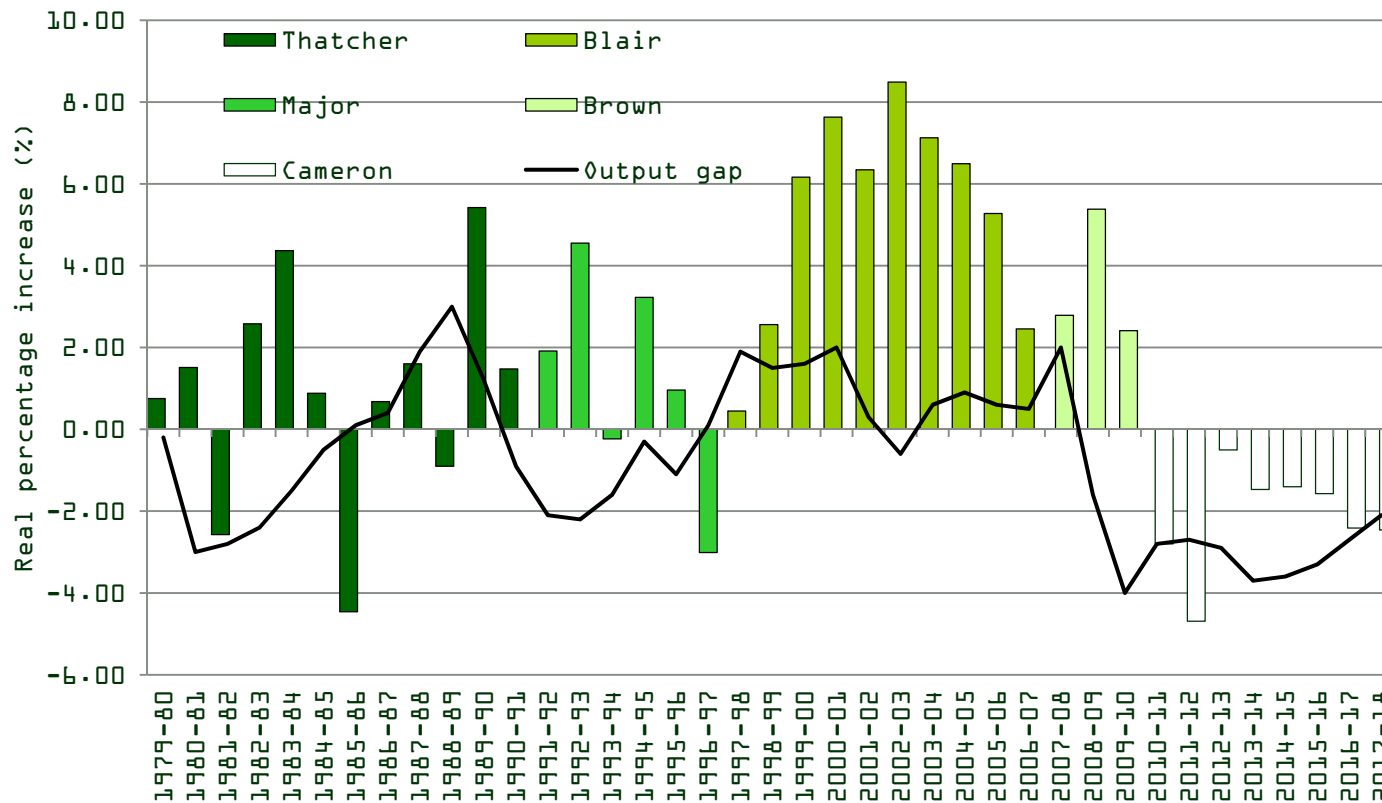
# What future for fiscal rules?

- Current fiscal mandate looks better than the golden rule
  - Forward looking
- And independent OBR acts as arbiter
- But depends on judgments about what is “structural” as well as a five year forecast
- And with the secondary debt rule not turning out to be binding there is no anchor
- Clearly credible fiscal policy is about much more than fiscal rules

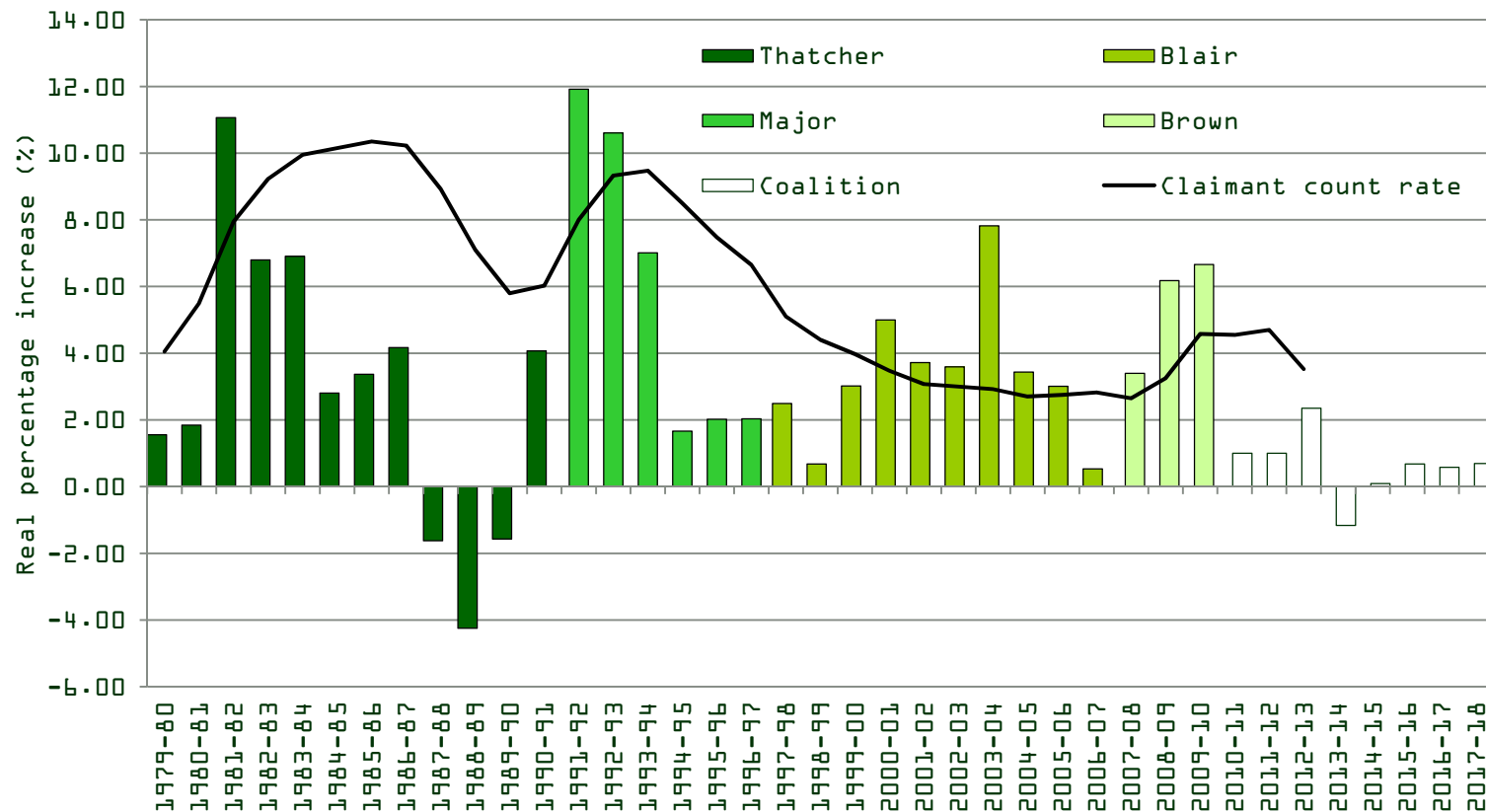
# Spending

- Overall tightly controlled for decade after the 1990 recession
- Rising consistently after 2001
  - Contrasting with volatile year on year changes previously
- Different patterns for public services and social security

# Annual change in public service spending



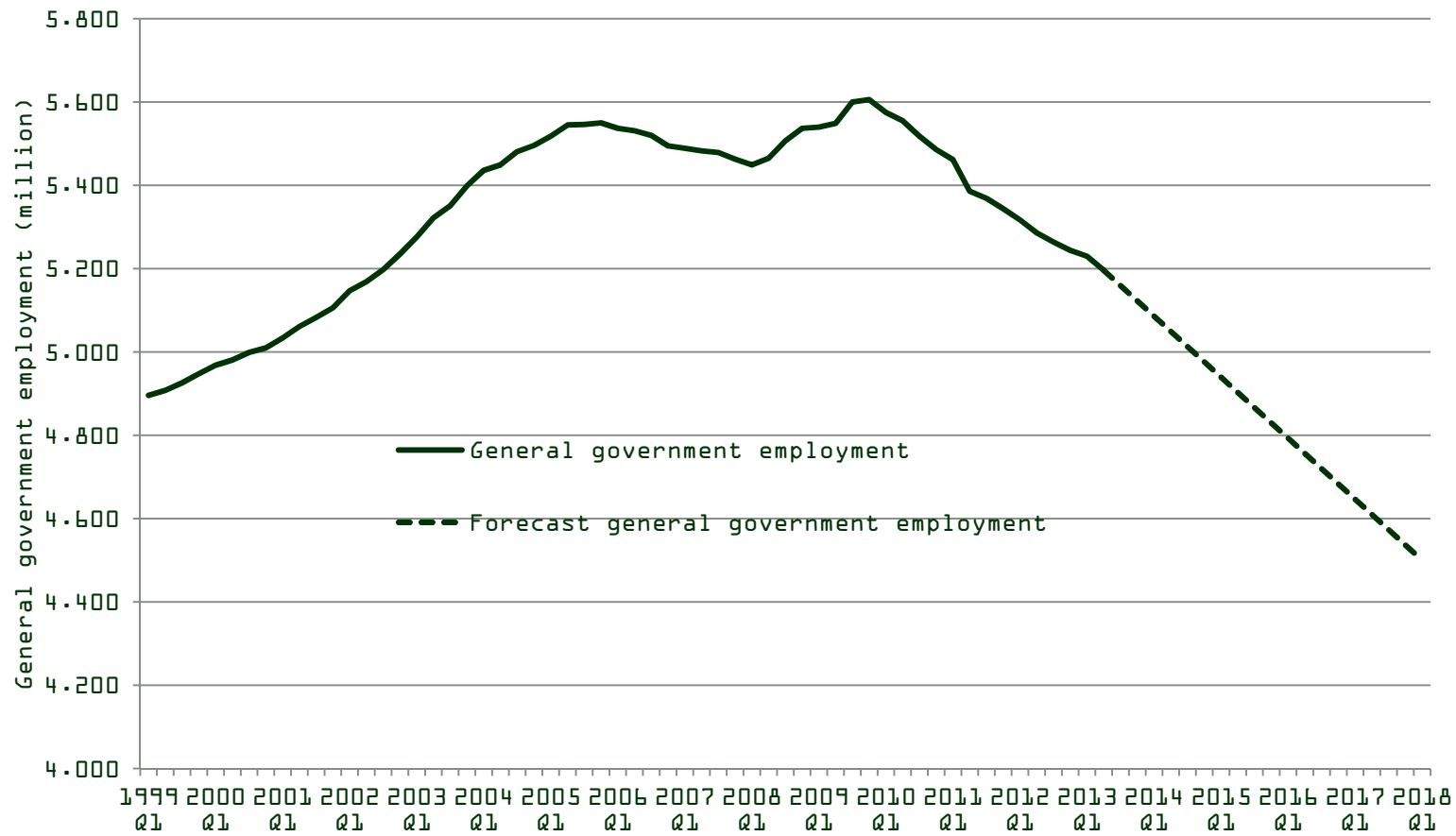
# Annual change in social security spending



# Spending

- Overall tightly controlled for decade after the 1990 recession
- Rising consistently after 2001
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- Different patterns for public services and social security
- Was adequate caution built in?
- Is the process of three year spending reviews adequate?
- Are inefficient cycles avoidable?

# The Grand Old Duke of York





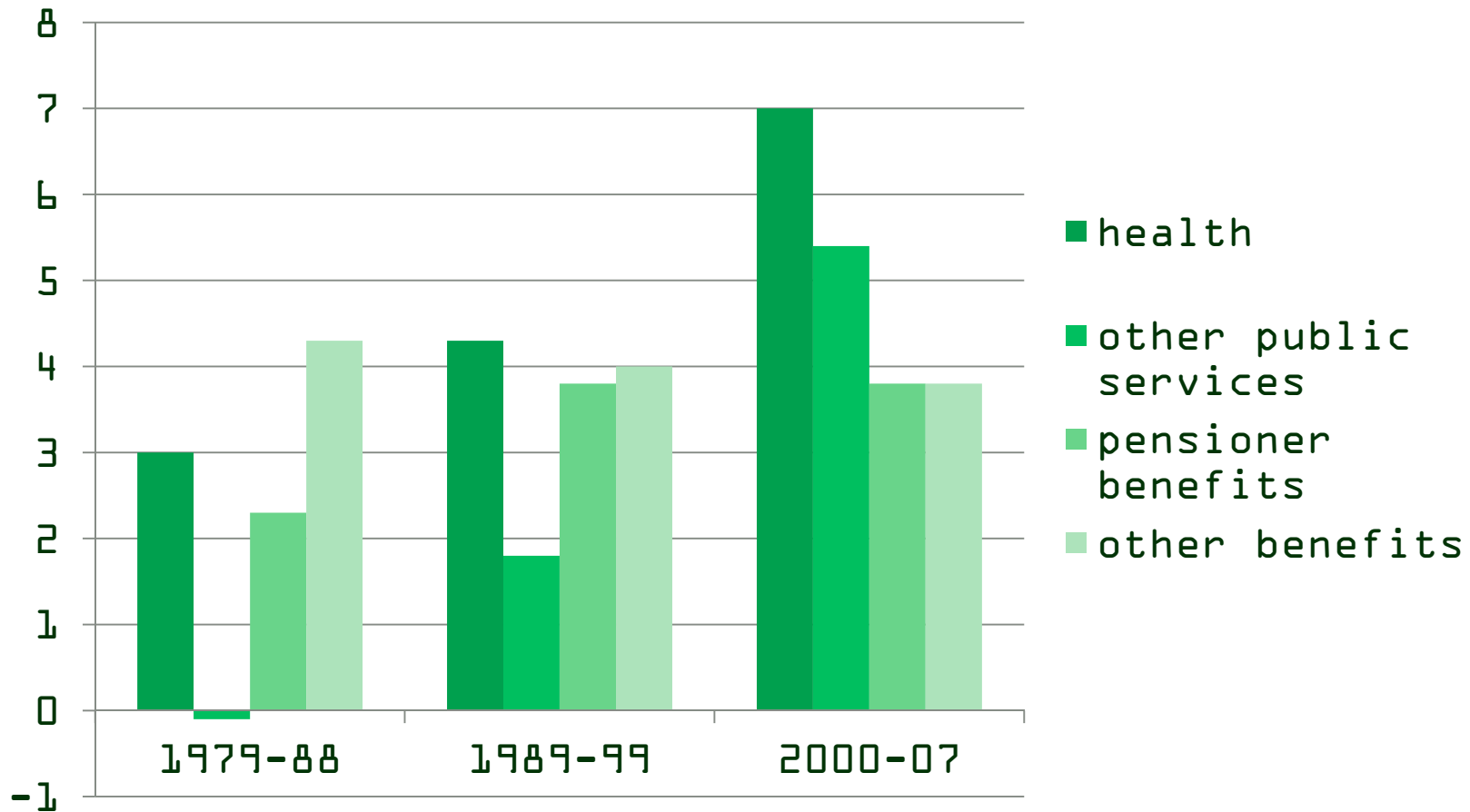
## Spending cuts

- Substantial cuts in spending from 2010 will only serve to return spending as a share of GDP to its 2004 level by 2018
  - But with a very different pattern of spending
- Annually managed expenditure (including debt interest) continues to rise in real terms
- Public service spending is due to fall by nearly 20% in real terms
  - By a third in “unprotected” areas

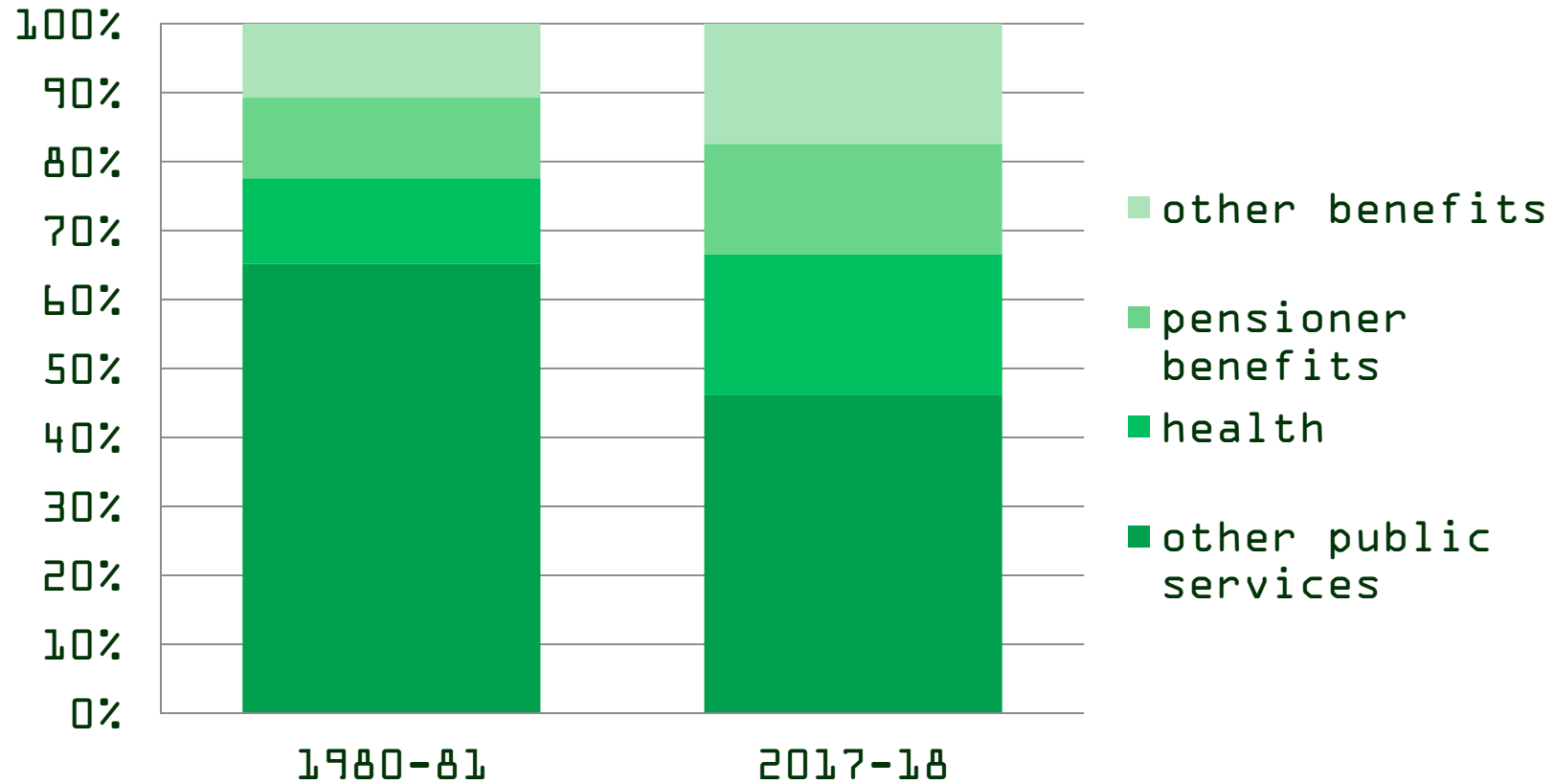
# Composition of spending has changed

- Partly driven by demographics
  - Number of pensioner rose by about 1.2% a year from 1980
- With a particular increase in the share of health spending
- Also driven by increased spending on working age welfare
  - Despite falls in claimant count over much of the period
- Continual move towards a welfare state
  - Maintained since 2008

# Annual real spending growth



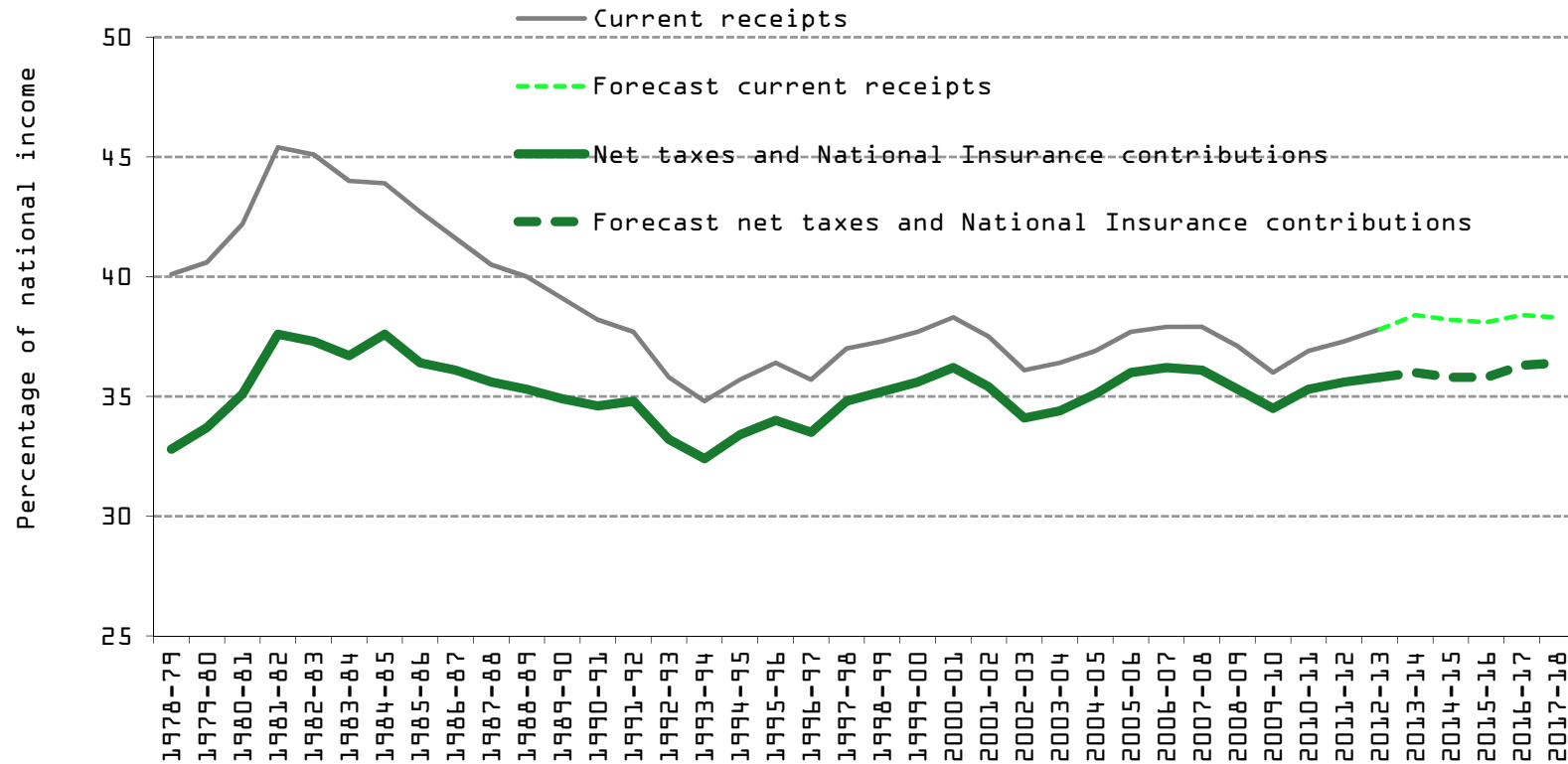
# Changing composition of spending



# Taxes

- Overall revenues respond quickly to economic activity
  - So appear less cyclical than spending

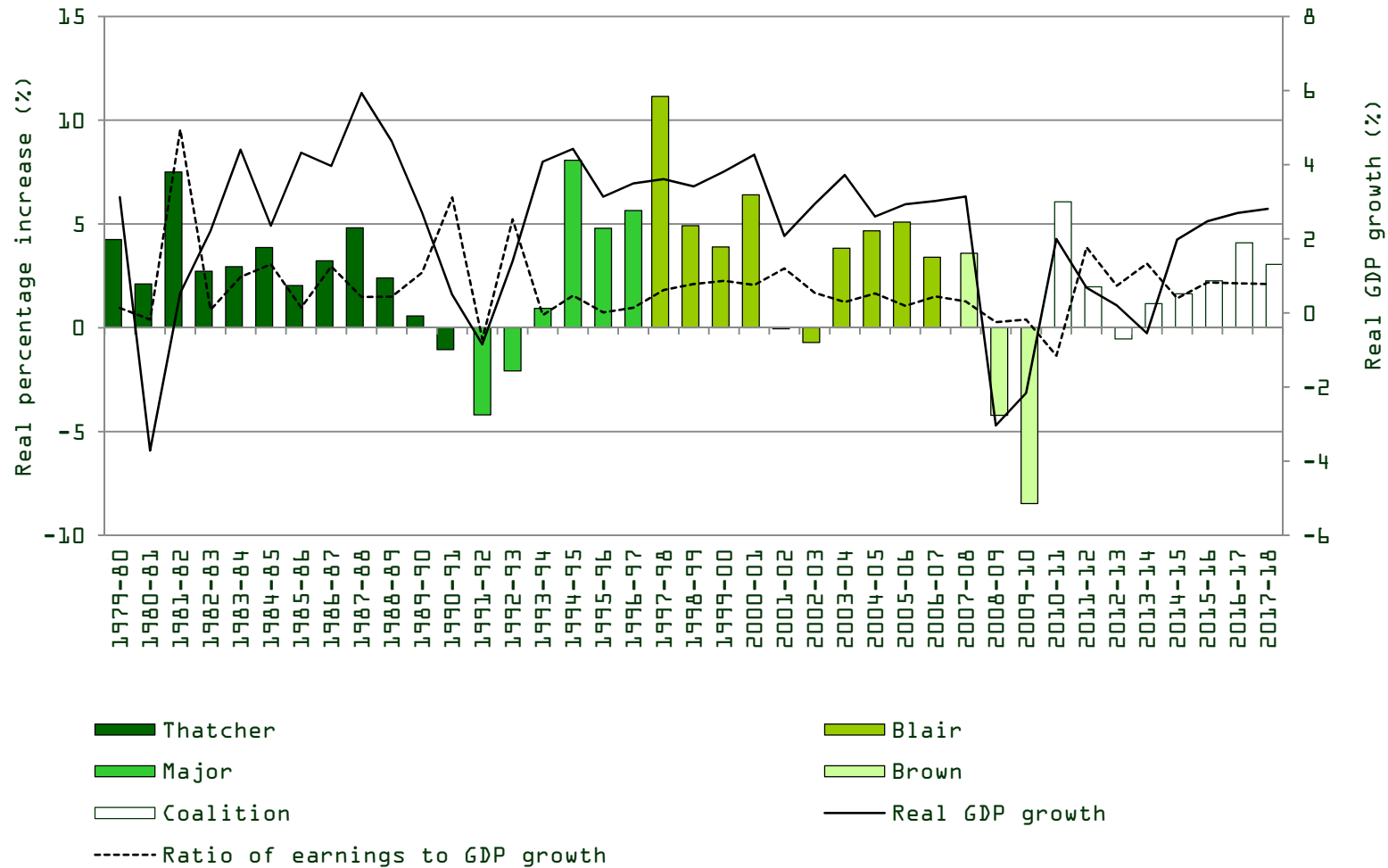
# Tax revenues over time



# Taxes

- Overall revenues respond quickly to economic activity
  - So appear less cyclical than spending
- Considerable reforms over the period
- Some, like big cuts in income tax rates in in 1980s stuck
  - Even if they had to be paid for eventually by raising other taxes
- 1990s consolidation considerably more focussed on tax increases than is this one

# Annual increases in net taxes and NICs

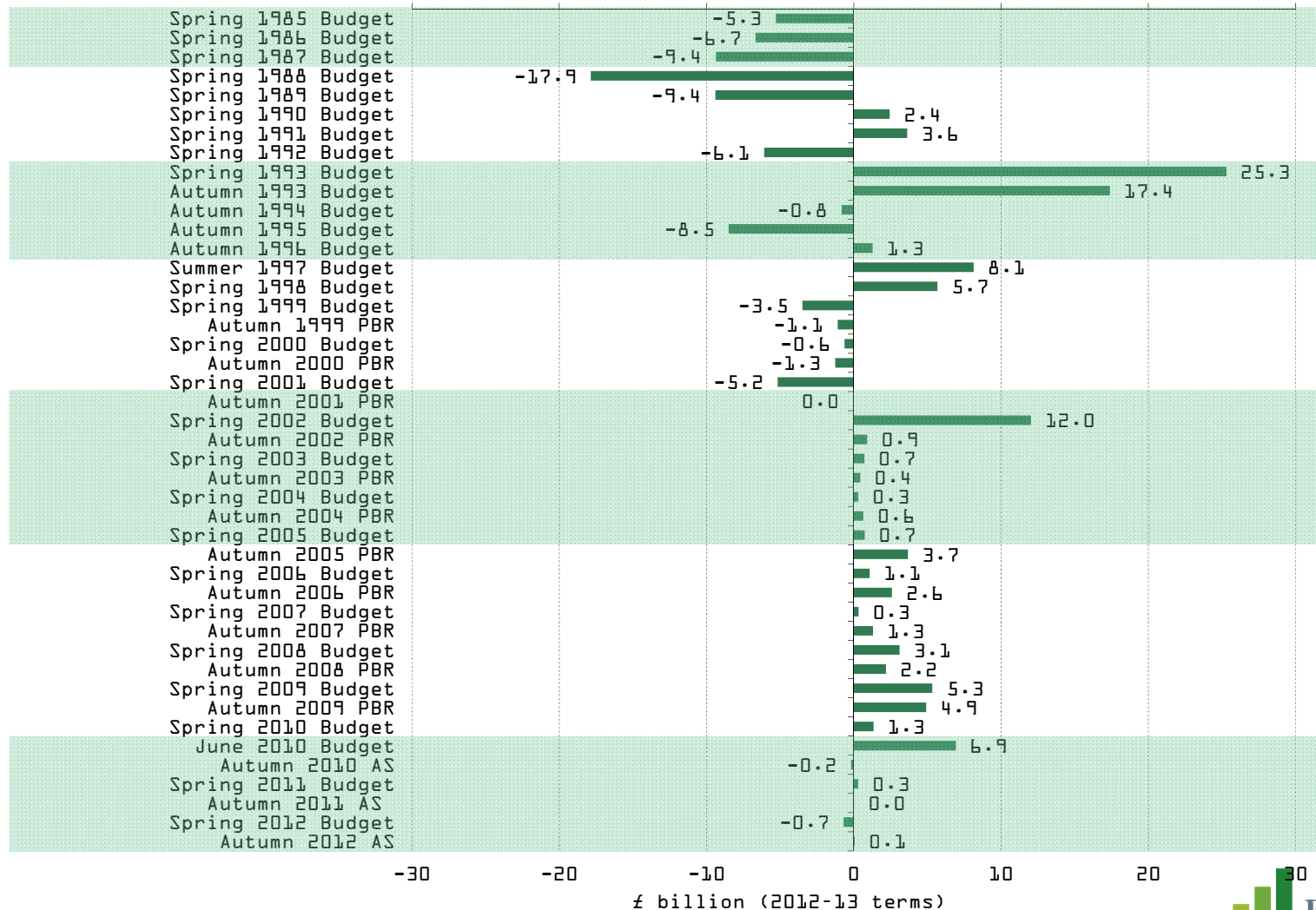




# Tax policy

- Heavily influenced by the *electoral* cycle
  - Big increases announced immediately after each election
- 1992 pre election Budget was a giveaway
  - 1993 post election Budget a huge takeaway.

# Taxes increase after elections



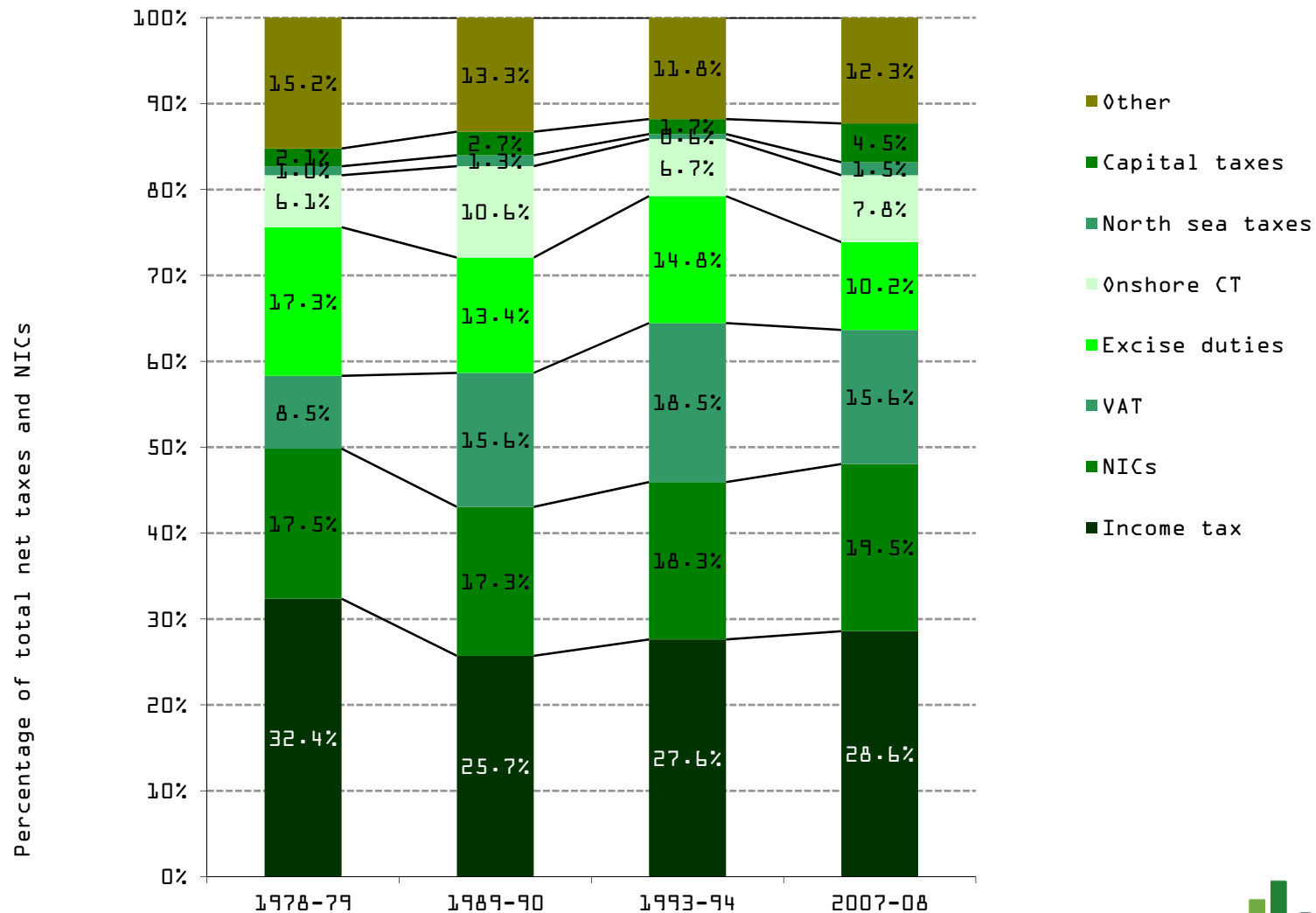
# Tax policy

- Heavily influenced by the *electoral* cycle
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- 1992 pre election Budget was a giveaway
  - 1993 post election Budget a huge takeaway.
- Norman Lamont:
  - 1992 Budget "was not a very good Budget. But it did help us to win the 1992 election
  - 1993 Budget: "helped to lose the 1997 election for the Conservatives, but it was definitely my best budget"

# Revenue composition

- Not changed as much as spending composition
  - Despite dramatic changes in rates

# Changing composition of tax revenues



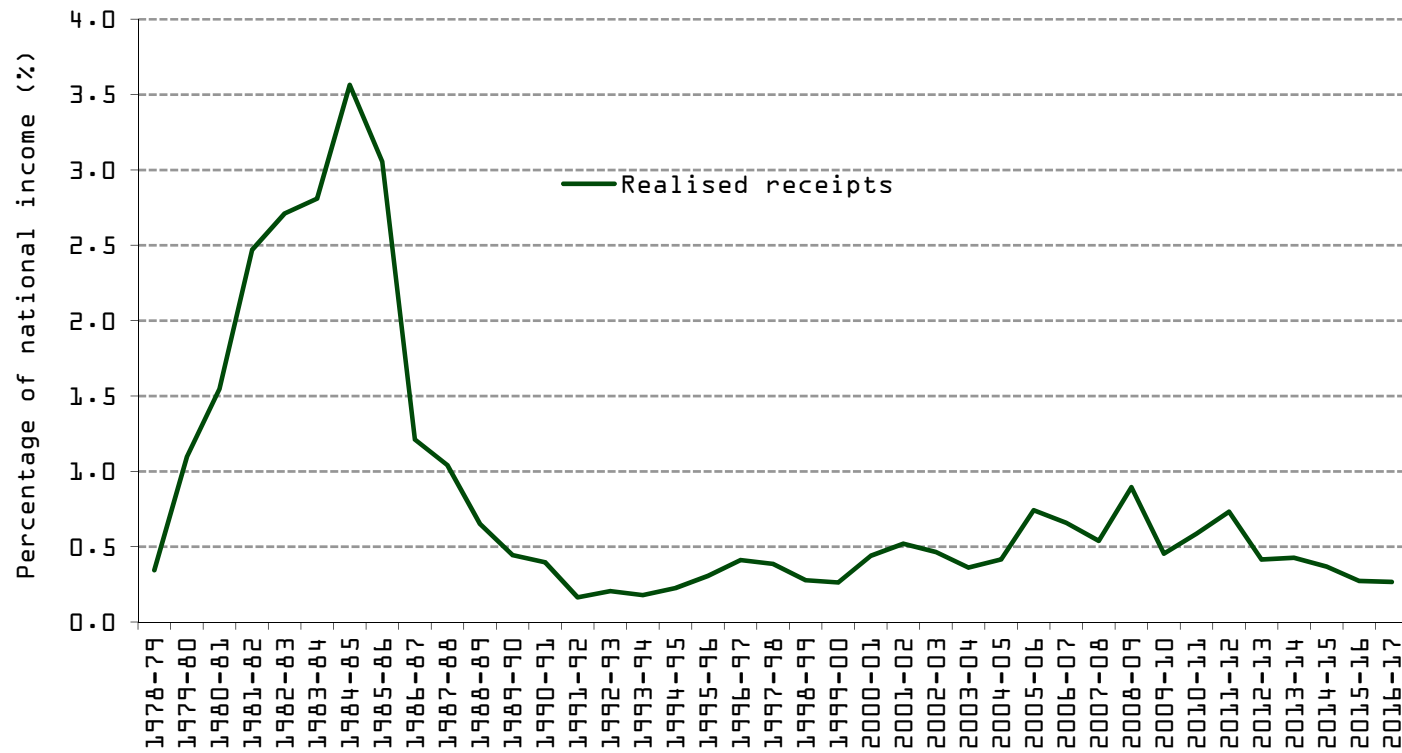
# Revenue composition

- Not changed as much as spending composition
  - Despite dramatic changes in rates
- In part reflecting big increases in taxable incomes
  - Especially towards the top of the distribution
  - Dependence on richest income tax payers has grown dramatically
- Little in the way of consistent reform
  - Savings/pensions
  - CGT
  - Corporate tax
  - VAT
- Failure to implement reform (unquantifiably)  
costly

## Two specific taxes

- 1980s were cushioned by massive revenues from the North Sea
  - Collapse of which made the fiscal problems of 1990s much worse

# North Sea Oil Revenues (%GDP)





## Two specific taxes

- 1980s were cushioned by massive revenues from the North Sea
  - Collapse of which made the fiscal problems of 1990s much worse
- Onshore corporation tax is highly cyclical
  - Unlike other taxes fell significantly in nominal terms after 2008
  - And takes a while to recover

# Onshore Corporation Tax revenues (%GDP)



# Conclusions

- Fiscal policy pre-crisis cannot be described as reckless
  - There were tax increases as well as spending increases
  - We could not have avoided a substantial tightening
- But in both 1980s and 2000s excessive optimism (at least ex post) seems to have been built in
- Spending review processes take inadequate account of long term effects
  - Long term sustainability more generally plays too peripheral a role
- Pre crisis fiscal rules were inadequate
  - And arguably gamed by the government that introduced them