"Credit Card Maxed Out?" How UK debt statistics have been misrepresented

Howard Reed

"If you have maxed out your credit card, if you put off dealing with the problem, the problem gets worse." (David Cameron, June 2010)

The UK is now just over two years into an experiment with fiscal austerity without parallel in its recent history. Faced with a deficit of just under 8 percent of Gross Domestic Product in the public finances in fiscal year 2009-10, of which just over 5 percent of GDP was deemed to be "structural"[2], the Conservative-Liberal Democrat Coalition Government elected in May 2010 has embarked on an attempt to eliminate the structural deficit in just four years[3]. Furthermore, over three-quarters of this 'fiscal consolidation' is being accomplished through cuts to public spending rather than tax rises. Not since the infamous "Geddes axe" of the 1920s[4] has the government attempted to cut this deep into state provision in so short a time.

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2 A "structural" deficit is defined as one which would still exist even if the economy was operating at full employment. See Office for Budget Responsibility, Pre-Budget Forecast, June 2010, Table 4.1. http://budgetresponsibility.independent.gov.uk/wordpress/docs/pre_budget_forecast_140610.pdf

3 Note that if Gordon Brown's Labour Government had won the 2010 election they also planned a fiscal consolidation to eliminate the structural deficit, but over eight years rather than four, and with a two-thirds/one-third split between spending cuts and tax increases.

4 The 'Geddes axe' was a programme of severe spending cuts named after the businessman Sir Eric Geddes, who was appointed head of a "Committee on National Expenditure" by then Prime Minister David Lloyd George after the UK's debt-to-GDP ratio rose substantially during World War I. Between 1921 and 1922 Geddes recommended spending cuts amounting to 10 percent of GDP, most of which were implemented soon afterwards.

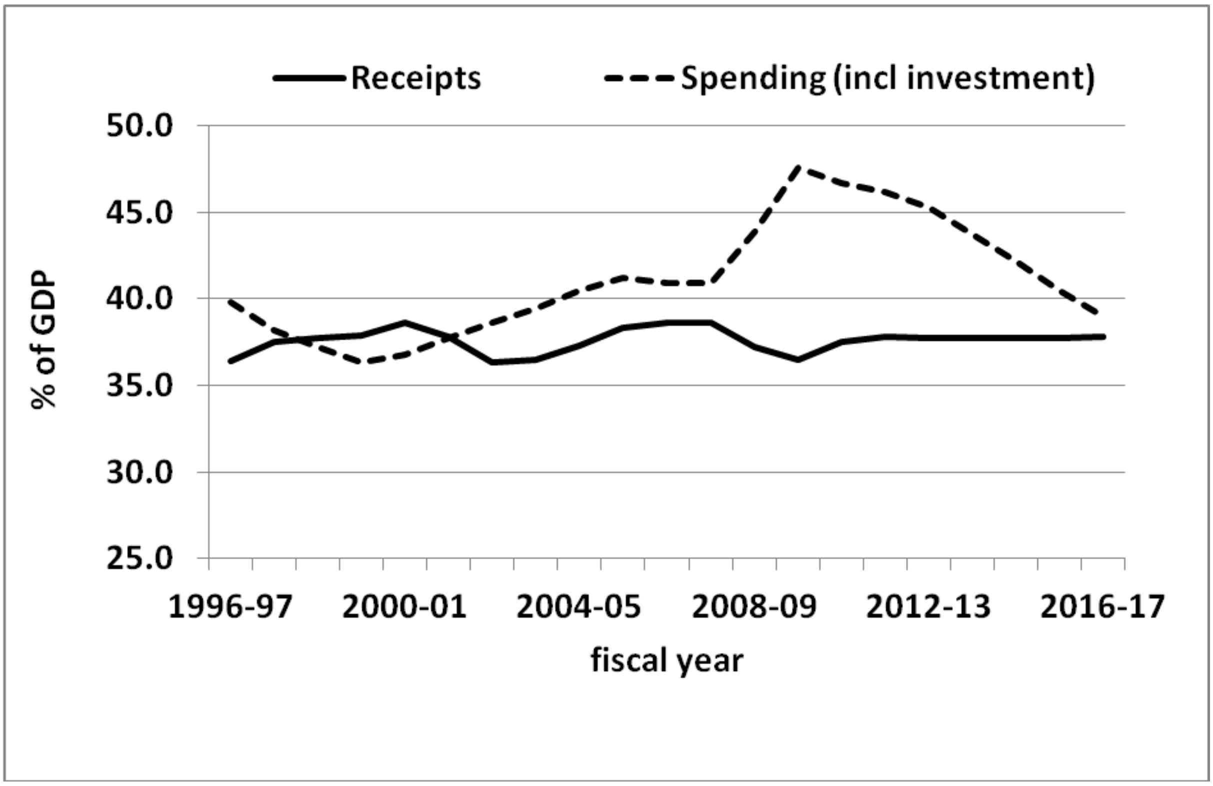
In its attempt to "sell" this austerity package to the electorate, the Coalition Government has made great play of the idea that the UK has reached the limits of its borrowing; that its "credit card" is "maxed out", and hence there is no alternative to austerity. The credibility of the Coalition's story relies on two key assertions: first, that the UK deficit and public debt were out of control by 2010 due to overspending by the previous Labour Government, and that this was risking an unsustainable increase in government borrowing costs (along the lines of what we have seen in Greece, Ireland and Portugal, and most recently in Spain and Italy). Second, that this means that a severe dose of austerity measures, eliminating the "structural" deficit in the public finances, is the only course of action left to the UK. The plan is that austerity will enable private-sector led growth in place of the unsustainable debt-fuelled growth, which occurred under Labour.

This article argues that the UK Coalition Government has consistently misrepresented UK debt statistics over the last two years to bolster its case for austerity. As I demonstrate below, each component of the Coalition's narrative outlined above is either partially or wholly wrong, and the breakneck austerity which the UK Government is currently pursuing is likely to do more harm than good. Despite this, the austerity narrative has been pervasive in current debates about UK economics policy since the 2010 election. In the second part of this article I address the reasons for this.

Did Labour overspend?

Supporters of the UK's current austerity policies often use a diagram along the lines of Figure 1 (below) to make the case that spending had run out of control under the previous Labour Government. Figure 1 shows receipts and public spending since 1996-97 (the last fiscal year before Labour came to office in the UK) as a percentage of UK Gross Domestic Product (GDP). Tax receipts are fairly steady at around 37 percent of GDP over the entire period of Labour government between 1997 and 2010. Meanwhile, spending rose slowly from 36 percent of GDP in 1999 to 41% by 2007 before increasing much more quickly to 47% of GDP by 2010/11. The implication of Figure 1 is that spending was completely out of control by the end of the New Labour period. Hence (we are told), the need for the austerity measures, which will reduce spending below 40% of GDP by 2016-17.

Figure 1. Spending and tax receipts as a percentage of UK GDP, 1996-97 – 2016-17



Source: HM Treasury, Public Finances databank, January 2012; HM Treasury Autumn Statement, November 2011

However, Figure 1 is a misleading representation of the UK public finances over the period since 2008 in particular, as it completely ignores the impact on public finances of the "Great Recession" of 2008-09, which had two crucial effects:

1. The recession resulted in a huge fall in GDP of around 7 percent - the worst fall in UK economic output since the Great Depression of the 1930s;
2. As unemployment rose from just over 5 percent of the working age labour force in 2007 to 8 percent in 2010, public spending rose (due to increased benefit spending) while tax receipts fell due to lower economic activity[5].

Figure 2 shows that spending tracked tax receipts very closely right up until 2008/09; to the extent that spending exceeded receipts over this period, this was a consequence of public investment (e.g. infrastructure spending), which was entirely allowable under the Labour Government's fiscal "Golden Rule", which stated that the

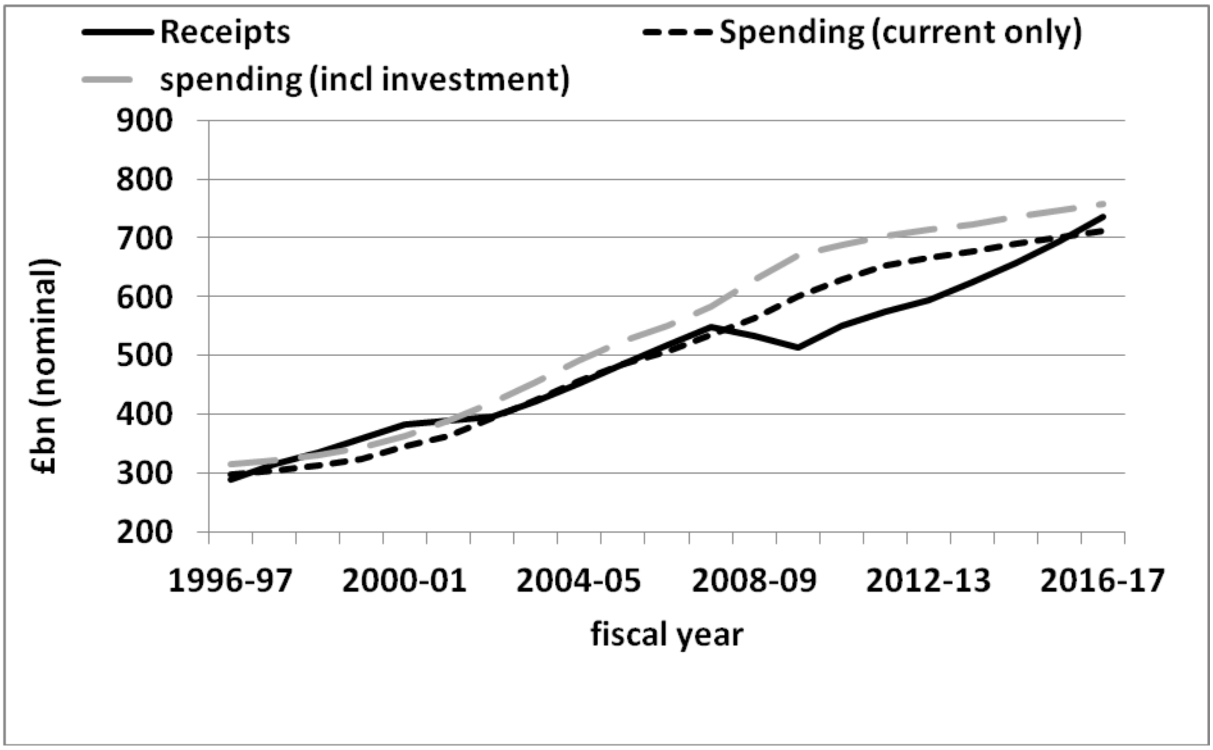
5 Economists refer to these effects as "automatic stabilisers" as they help ameliorate the severity of the economic cycle by increasing consumer demand during recessions and dampening it during booms.

Government should balance current spending and tax receipts over the cycle, but that additional borrowing to fund capital investment was permissible.

The path of spending and receipts after 2008/09 shows that tax receipts collapsed. This was, however, entirely a consequence of the fall in GDP and the weakness in the economy in the wake of the great recession. *Any* government in power in the UK in the period after 2008 would have found itself with a substantial short-run fiscal deficit. The notion that spending was out of control by 2010 because of the Labour Government's "profligacy" does not hold water under close scrutiny.

A variation on this argument sometimes used by critics of Labour's economic management is to claim that although spending in the run up to the 2008 crash looked sustainable in the short term, it was particularly high as a share of GDP in the context of longer term UK economic history, and hence was unsustainable. Table 1 below addresses this issue by looking at averages for current spending and spending including investment as a share of GDP over the 1970s, 1980s, 1990s and the 2000s.

Figure 2. Spending in nominal terms (£bn), 1996/97 – 2016/17



Source: as Figure 1

Table 1. UK public spending as a share of GDP over four decades

Decade	Public spending (% of GDP):	
	Current spending only	Spending including investment
1970s	36.7	45.4
1980s	39.8	44.6
1990s	37.2	40.1
2000s	37.6	40.8

Source: HM Treasury, Public Finances Databank, January 2012.

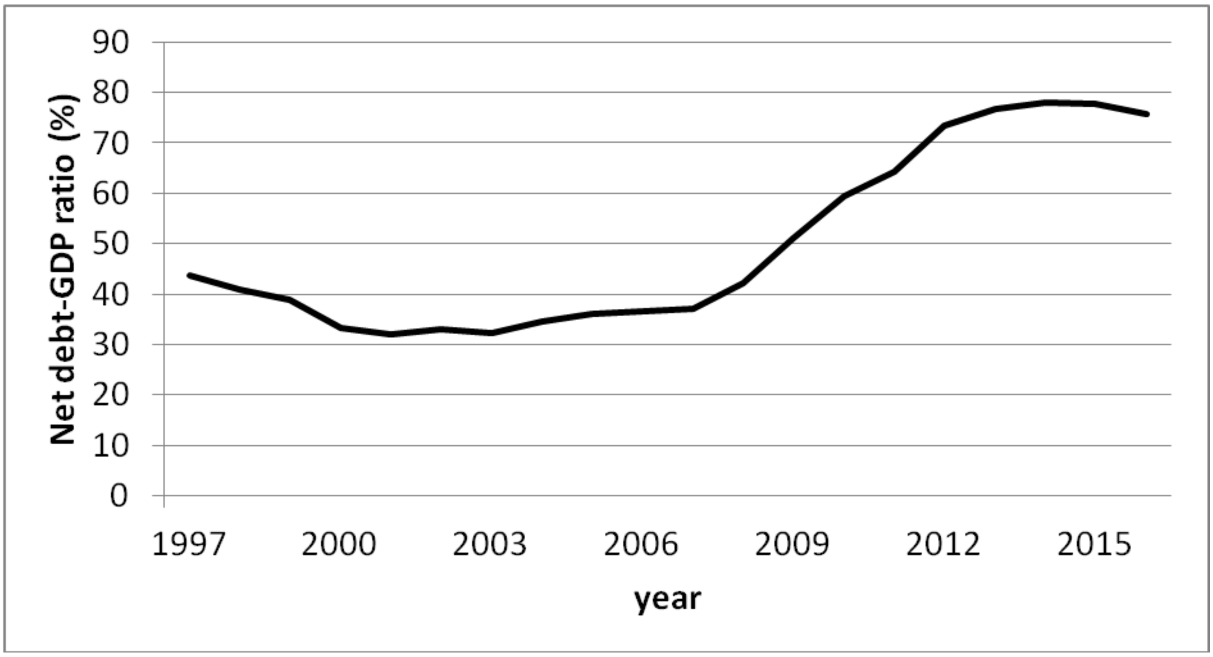
Table 1 shows that in the 2000s, current spending as a share of GDP was only 0.4 percentage points above where it was in the 1990s, less than 1 percentage point above the 1970s average and over 2 percentage points *below* where it was in the 1980s under Margaret Thatcher's Conservative government. Moreover, when investment spending is included, public spending in the 2000s as a share of GDP was several percentage points below the average for the 1970s and 1980s. This is the case even though the spending/GDP figures for 2008/09 and 2009/10 (which were both inflated upwards due to the fall in GDP in the great recession) are included. It would be very difficult to argue from the evidence presented in Figure 1 that spending in the 2000s under Labour was out of line with long-run trends for the British economy.

Had UK debt reached unsustainable levels?

"It's like with a credit card… the longer you leave it, the worse it gets. You pay more interest. You pay interest on the interest. You pay interest on the interest on the interest." (George Osborne, Conservative Party Conference October 2010)

Supporters of George Osborne's austerity budgets and spending review often argue that the UK's debt had reached "unsustainable" levels by 2010. Figure 3 (below) is an example of the kind of graph which is used to back this argument up – it shows the UK debt to GDP ratio from 1997 up to 2011 (and for 2012 onwards, the OBR projections in the 2011 Autumn Statement). From 1998 onwards the debt/GDP ratio was below the 40% level specified in Gordon Brown's "sustainable investment rule", but then exploded upwards in the wake of the Great Recession to reach almost 80% by 2012. Presenting the data in this way makes the 2011 debt burden look very large by historical standards.

Figure 3. UK Net debt-GDP ratio, 1997-2016

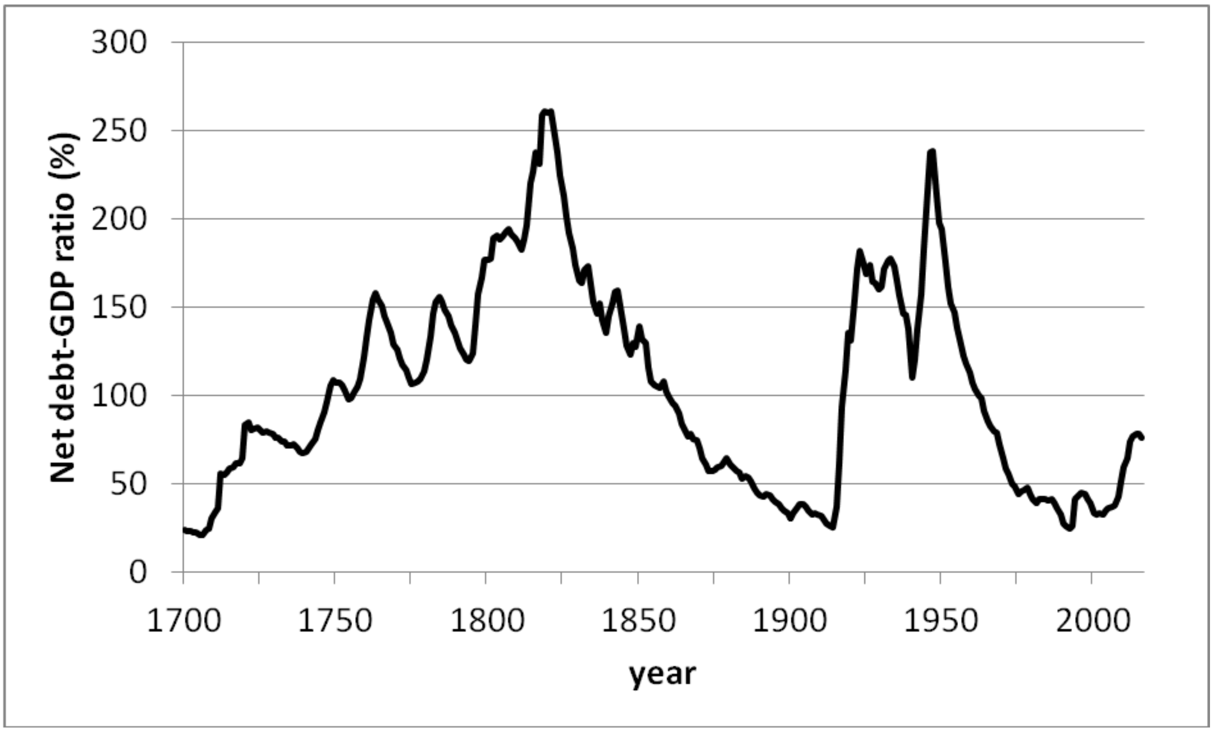


Source: 1997-2011: Office for National Statistics (2012), *Public Finances Statistical Bulletin.* 2012-2016: projections from Office for Budget Responsibility *Autumn Statement 2011*.

However, if a much longer time period is used – say, from 1700 rather than 1997 – we see that UK debt/GDP was above 80% for the majority of the last three hundred years (as shown in Figure 4 below). On two occasions – the Napoleonic Wars and the Second World War – UK debt/GDP rose to well over 200 percent, and it remained above 80% until the 1960s. Given that a debt ratio was *the norm* rather than the exception for the last three centuries, it seems absurd to say that an 80% debt/GDP ratio is "unsustainably high". Once again we find that a key pillar of the argument for austerity collapses under close examination.

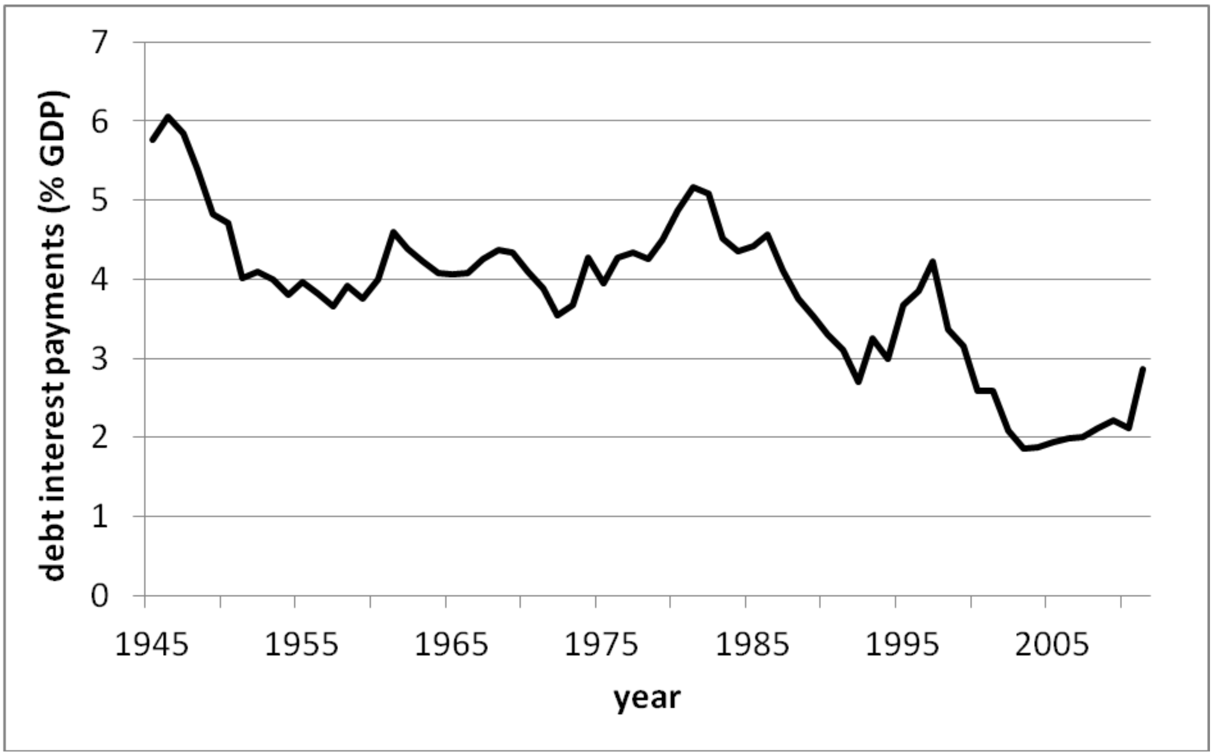
A variation of the "debt burden" argument involves arguing that the debt payments are unsustainable because it is "wasted expenditure". However, in fact the UK burden is extremely *low* by historical standards. This is mainly because of extremely low interest rates, which all developed countries outside the Eurozone (and hence with their own central banks and the ability to set their own monetary policies) have enjoyed during the current depressionary period, *regardless* of debt burden. Figure 5 shows UK debt interest payments as a percentage of GDP since 1945 and reveals that the debt "burden" now is actually lower than at any point up to the year 2000.

Figure 4. UK net debt/GDP ratio, 1700-2016



Source: 1700-1996, C. Reinhart & K. Rogoff (2011), "From Financial Crash to Debt Crisis", *American Economic Review.* 1997-2016: as Figure 3.

Figure 5. UK debt interest payments as a percentage of GDP, 1945-2011



Source: as Figure 4

The arithmetic of austerity

The factors which affect the evolution of a country's debt/GDP ratio over time can be illustrated using the (very simple) equation below:

$$(D_{t+1} - D_t) = d_{t+1} + ((r - g)D_t)$$

This equation simply states that the increase in next year's debt/GDP ratio (D_{t+1}) compared to this year's debt/GDP ratio (D_t) will be equal to the sum of two components:

1. Next year's public finance deficit as a share of GDP (excluding debt interest payments on the current debt), d_{t+1};

2. Last year's stock of debt as a share of GDP multiplied by the term $(r - g)$, where *r* is the real interest rate on government debt and *g* is the real growth rate of the economy.

Starting from year *t*, is clear therefore that the debt to GDP ratio will tend to grow if, either:

- The deficit (excluding debt interest payments) rises; or

- The real interest rate on debt interest payments is higher than the growth rate of real GDP.

The Coalition Government has focused on attempting to reduce the current deficit d_{t+1} , while arguing additionally that this will prevent pressure being placed on the real interest rate *r* by "bond vigilantes" in the financial markets. However, supporters of the austerity measures have completely neglected the impact of austerity measures on *g* – the real growth rate of GDP. In a situation of the worst economic slump since at least the 1930s, austerity measures – particularly when co-ordinated across many, or all, leading economies – can reduce GDP (and increase public spending and reduce tax receipts due to "automatic stabiliser" effects) to such an extent that the debt/GDP ratio *rises* rather than falling. Table 1 shows this effect in action by comparing the forecasts for GDP growth rates and debt/GDP ratios for the UK from the Office for Budget Responsibility from George Osborne's first, "emergency" Budget in June 2010 with the most recent forecasts from the March 2012 Budget[6]. Compared with the 2010

6 The March 2012 forecasts are corrected to remove the effects of the transfer of the Royal Mail's pension fund assets into the public sector as part of the run-up to privatisation of the Royal Mail. This reduces debt/GDP by around 1.8 percentage points in 2012/13 and subsequent years in Table 1, although in the long run the transfer will most likely increase debt/GDP as the estimated present value of future liabilities (future payments to pensioners) exceeds the present value of the transferred assets.

forecasts, the 2012 forecasts show that actual growth in 2011/12 turned out to be much lower than projected, and growth projections for 2012/13 have also been revised downward. This means that the UK debt/GDP ratio is now forecast to peak at 78 percent rather than the 70 percent that was forecast in 2010.

Table 1. UK growth and debt-to-GDP forecasts: June 2010 and March 2012 compared

	June 2010 Budget		March 2012 Budget	
Fiscal Year	Real GDP growth	Debt/GDP ratio	Real GDP growth	Debt/GDP ratio
2011/12	2.3	67.2	0.8	67.5
2012/13	2.8	69.8	0.8	73.3
2013/14	2.9	70.3	2.0	76.6
2014/15	2.7	69.4	2.7	78.0
2015/16	2.7	67.4	3.0	77.7
2016/17			3.0	75.8

The result of two years of grinding austerity is that the UK's medium-term economic performance is now worse than even in the 1930s Great Depression: evidence from the National Institute for Economic and Social Research shows that after the 1929 crash, it took four years for real GDP in the UK to regain its 1929 level, whereas real GDP in 2012 is still stuck around 4 percent below its 2008 level – and currently showing no signs of further recovery[7]. The picture in the Eurozone, which also embraced austerity in 2010, is even worse; in April 2011 the IMF was forecasting that the Eurozone would grow by 1.8 percent in 2012 and, but by July 2012 it was forecasting a *contraction* of 0.3 percent for 2012, and growth of only 0.7 percent in 2013.

Along with the macroeconomic failure of austerity economics in the UK goes extremely regressive distributional outcomes, as outlined in a paper by Tim Horton and myself in last year's *Radical Statistics* journal[8] and in a recent report by Landman Economics for a number of children's charities which highlighted the impact of austerity on Britain's most vulnerable families and children[9].

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7 See http://www.niesr.ac.uk/gdp/GDPestimates.php for further detail

8 T. Horton and H. Reed (2011), "The distributional impact of the 2010 Spending Review", Radical Statistics 103: 13-24.

9 H.Reed (2012), In The Eye of the Storm: Britain's Forgotten Children and Families. Action for Children/The Children's Society/NSPCC.

How are they getting away with it?

Given the misrepresentation of UK debt statistics as explained in this article, coupled with the substantial economic costs imposed by austerity, it may be hard for casual observers to see how the Coalition Government is getting away with dictating the austerity narrative in this way. In closing I offer four reasons why austerity has dominated debates in the UK, and in doing so, suggest the outlines of an effective strategy to oppose it.

Firstly, it is undeniable that the "maxed out credit card" line *seems* logical at first glance. It is essentially a restatement of Margaret Thatcher's "handbag economics" – the idea that the public finances are just the same as a household budget. The analogy is false because, if a single household cuts back on spending, the impact on demand for goods and services is negligible, whereas if a whole country – or worse still, the entire European continent – cuts spending at a point where the economy is already in a weakened state, the feedback effects can produce a deflationary spiral. But this argument, about the critical difference between households and states, was different to get across immediately after the election in 2010, when most commentators dismissed talk of a "double dip recession" as scaremongering by Labour.

Secondly, the austerity narrative has had a great deal of airtime. Conservative and Liberal Democrat politicians alike have repeated the mantras that austerity is inevitable and that the UK's fiscal deficit is "all Labour's fault" at every available opportunity over the last two years. These messages find a willing echo in much (although by no means all) of the UK print and broadcast media. Being consistently "on message" helped the Conservatives (although not their Liberal Democrat coalition partners) to stay relatively popular in the opinion polls until spring 2012, when the Labour opposition began to open up a double-digit lead. Nonetheless, the austerity narrative continues to resonate with a large proportion of the electorate. For example, a majority of the public still appears to believe that spending cuts are necessary (57% in the most recent YouGov poll[10]), although this proportion has fallen somewhat since the 2010 general election. There are, however, increasing signs that voters are having second thoughts: a majority of the public now believe the cuts are unfair (62%) and bad for the economy (51%) and just under half believe they are being done too quickly (49%).

10http://d25d2506sfb94s.cloudfront.net/cumulus_uploads/document/txctzock67/YG-Archives-Pol-Sun-results-020712.pdf

Finally, the parliamentary opposition to austerity has been relatively weak. Although Shadow Chancellor Ed Balls has been increasingly effective in critiquing the policies of his opposite number George Osborne, the Labour Party continues to lack a well-thought-out alternative to austerity; its recommended policies amount to doing the same thing, but more slowly, and with a slightly greater reliance on tax rises to plug the deficit compared to spending cuts. While “austerity lite” is preferable to austerity, it hardly represents a compelling alternative. Moreover, the protracted Labour leadership contest in the summer 2010 allowed the Government to set the austerity narrative while the opposition were distracted.

It is only now, with the slide back into recession in 2012, that the scale of the failure of austerity as a policy is becoming clear and space is starting to open up for alternative approaches, An example is Compass’s *Plan B*[11], which calls for a short-run fiscal stimulus combined with medium-term economic reforms to move the UK away from the unsustainable private sector growth model characteristic of the 1990s and 2000s (an out-of-control financial sector, extreme asset bubbles and household debt accumulation).

The economic failure of the Coalition Government’s deficit reduction plan means that there is new chance for the critics of the current approach to develop a clear alternative to the economics and politics of austerity. Tackling and rebutting the myth of Britain’s “maxed out credit card” is an important first step – but only a first step – towards the development of an alternative policy vision.

Howard Reed, Director Landman Economics

Email: howard@landman-economics.co.uk

11 Compass (2011), Plan B: A good economy for a good society. http://clients.squareeye.net/uploads/compass/documents/Compass_Plan_B_web.pdf