



# The Public Finances: 1997 to 2010

2010 Election Briefing Note No. 6 (IFS BN93)

Robert Chote  
Rowena Crawford  
Carl Emmerson  
Gemma Tetlow

Series editors: Robert Chote, Carl Emmerson and Luke Sibieta

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Robert Chote, Rowena Crawford, Carl Emmerson and Gemma Tetlow<sup>1</sup>

## Summary

- Over the first eleven years of Labour government, from 1997 to the eve of the financial crisis in 2007, the UK public finances followed a remarkably similar pattern to the first eleven years of the previous Conservative government, from 1979 to 1989. The first four saw the public sector move from deficit to surplus, while the following seven saw a move back into the red.
- By 2007 Labour had reduced public sector borrowing slightly below the level it inherited from the Conservatives. And more of that borrowing was being used to finance investment rather than the day-to-day running costs of the public sector. Labour had also reduced public sector debt below the level it had inherited. As a result the ‘golden rule’ and ‘sustainable investment rule’ that Gordon Brown had committed himself to on becoming Chancellor in 1997 were both met over the economic cycle that he eventually decided had run from 1997–98 to 2006–07.
- But over the same ten years the vast majority of other leading industrial countries reduced their borrowing by more than the UK. And most also reduced their debt by more. So while the UK public finances were in better shape when the financial crisis began than they were when Labour came to power, the UK was in a worse position relative to most comparable countries.
- The financial crisis and the associated recession subsequently saw public sector net borrowing balloon to levels not seen since the Second World War – and far higher than was seen in the latter years of the Conservative government, including during the aftermath of the 1990–92 recession (when the previous post Second World War high borrowing occurred).
- Once again, the UK public finances have underperformed relative to comparable industrial countries. The UK is forecast by the OECD to experience the highest level of borrowing in 2010 and the fifth largest increase between 2007 and 2010 out of 26 industrial countries. Only Ireland and Iceland are projected to see a larger increase in debt over this period with the UK sliding further from its ‘mid-table’ position in the international public debt league table.

## 1. Introduction

This general election briefing note looks at how overall levels of borrowing and debt changed between 1997 and 2010. Some discussion is, necessarily, included of trends in taxation and spending; however, readers who are particularly interested in the levels of taxation and spending during Labour’s period in office may also wish to refer to two other notes in this series of IFS Election 2010 Briefing Notes.<sup>2</sup> Section 2 describes how the UK public finances evolved between

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<sup>1</sup> This series of Election Briefing Notes has been funded by the Nuffield Foundation, grant OPD/36607. The Nuffield Foundation is an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. More information is available at <http://www.nuffieldfoundation.org/>. Any views expressed are those of the authors and not necessarily those of the Foundation. The authors are grateful to Luke Sibietta for helpful discussions and comments on earlier drafts. Any errors and omissions are the responsibility of the authors.

<sup>2</sup> For a description of trends in taxation and spending, please see R. Chote, R. Crawford, C. Emmerson and G. Tetlow (2010), *The tax burden under Labour*, IFS Election Briefing Note No. 4 (<http://www.ifs.org.uk/publications/4814>) and R. Chote, R. Crawford, C. Emmerson and G. Tetlow (2010), *Public Spending under Labour*, IFS Election Briefing Note No. 5 (<http://www.ifs.org.uk/publications/4815>).

1997 and 2007 (prior to the financial crisis). It then compares this to the pattern observed during the period of Conservative governments from 1979 to 1997 and to the trend seen in other industrial countries. Section 3 carries out the same analysis, but for the period between 2007 and 2010, when the financial crisis and associated recession adversely affected the public finances of the UK and of many other countries.

## 2. Public finances up to the crisis: 1997 to 2007

When Labour took office in 1997, the public finances were already starting to improve following the deterioration seen during the recession of the early 1990s, thanks to the substantial tax increases and cuts to public spending implemented by the previous Conservative government since 1993. During Labour's first four years in office, the public finances strengthened further, as the new government stuck to the tight public spending plans laid out by the Conservatives. The following seven years, however, were characterised by fiscal drift. By the eve of the financial crisis, this had left the UK with one of the largest structural budget deficits in the developed world.

This section describes the public finance position that Labour inherited from the preceding Conservative administration, the management and path of the public finances during Labour's first eleven years in office and how this compared with the previous Conservative government's first eleven years.<sup>3</sup> This section concludes by looking at where the UK public finances stood on the eve of the financial crisis.

### 2.1 Labour's inheritance and objectives

In an analysis published by the Treasury in 1999, Labour characterised its inheritance from the Conservatives as follows:

“On arrival in office in 1997 the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth. Urgent action was needed. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and Parliamentary scrutiny. The Government therefore took steps to implement a new framework for fiscal policy”.<sup>4</sup>

Up until when Labour took office, the Conservatives were still trying to eliminate the large budget deficit that had opened up in the early 1990s. Adjusting for the degree of overheating or spare capacity in the economy, the underlying 'structural' budget balance<sup>5</sup> was estimated to have deteriorated from a surplus of 1.5% of national income in 1981–82 to a deficit of 5.5% in 1992–93. The impact of the recession on revenues and spending pushed the overall deficit even higher: to a peak of 7.7% of national income in 1993–94.

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<sup>3</sup> For a description of longer-term trends in taxation and spending, please see R. Chote, R. Crawford, C. Emmerson and G. Tetlow (2010), *The tax burden under Labour*, IFS Election Briefing Note (<http://www.ifs.org.uk/publications/4814>) and R. Chote, R. Crawford, C. Emmerson and G. Tetlow (2010), *Public Spending under Labour*, IFS Election Briefing Note (<http://www.ifs.org.uk/publications/4815>). For figures for borrowing and debt historically, please see Figures 2.4 and 2.5 of R. Chote, C. Emmerson and G. Tetlow (2009), 'Public Finances under Labour' Chapter 2 of R. Chote, C. Emmerson, D. Miles and J. Shaw, (eds) *IFS Green Budget: January 2009*, London: Institute for Fiscal Studies (<http://www.ifs.org.uk/publications/4623>).

<sup>4</sup> Page 7 of HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (<http://www.hm-treasury.gov.uk/d/anfiscalp99.pdf>).

<sup>5</sup> The structural budget balance is the estimated difference between government revenues and spending which would be recorded if economic activity were at its sustainable 'trend' level, consistent with stable inflation.

Britain's exit from the European Exchange Rate Mechanism in September 1992 prompted a significant rebalancing of macroeconomic policy. Looser monetary policy – lower interest rates and a weaker exchange rate – was accompanied by a big fiscal tightening. After the 1992 general election the then Chancellor Norman Lamont announced significant tax raising measures in his Spring 1993 Budget. Kenneth Clarke, who became Chancellor in May 1993, continued this process with further tax raising measures in the Autumn 1993 Budget and cuts to public spending as a share of national income. This almost halved the structural budget deficit between 1992–93 and 1996–97. Together with strong economic growth, this helped stabilise public sector net debt, which peaked at 42.5% of national income in 1996–97. Mr Clarke forecast in his November 1996 Budget that revenues would continue to rise and spending would continue to fall as shares of national income. The Treasury expected this to get the budget back into surplus by 2000–01 and to pull public sector net debt back down towards 40% of national income.

In 1996–97, the last year of the previous Conservative government, the structural current budget deficit – that is, the amount of borrowing that was being done neither for investment nor to cover the temporary costs of below 'trend' economic performance – stood at 2.2% of national income.<sup>6</sup> By international standards Labour inherited relatively low levels of borrowing and 'mid-table' levels of debt when compared with other industrial countries. OECD data show that in 1997 the UK had the 7<sup>th</sup> highest structural borrowing out of 25 countries, and the 11<sup>th</sup> lowest (or 14<sup>th</sup> highest) level of debt out of 24 countries, for which comparable data are available.<sup>7</sup>

Faced with this inheritance, Labour set out four main goals for its own management of the public finances:<sup>8</sup>

- to avoid an unsustainable and potentially damaging rise in public sector debt;
- to ensure future taxpayers are not left to pay for spending that does not benefit them;
- to avoid a bias against investment when public spending has to be squeezed;
- to 'support' monetary policy in keeping inflation on target.

With no track record of his own, the then Chancellor Gordon Brown saw a new policy framework as the best way to convince people that he would avoid what he saw as the fiscal laxity and bias against investment of previous Chancellors. The key elements were:

- The **Code for Fiscal Stability**, which set out the broad principles of fiscal policy, as well as requiring the Treasury to be transparent about its goals and record; and
- Publicly stated **fiscal rules**, which turned broad principles of 'sound' fiscal policy into specific operational targets against which success or failure could be judged. These were:
  - The **golden rule**, which required the public sector to borrow only to pay for capital investment. This was judged on average over the economic cycle, rather than every year.

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<sup>6</sup> In addition, the government was borrowing 0.7% of national income to finance net investment and a further 0.6% of national income because of temporarily weak revenues and high spending as the economy was operating below trend; meaning that total borrowing stood at 3.4% of national income in 1996–97. (These numbers do not sum due to rounding.)

<sup>7</sup> Information on structural borrowing (cyclically-adjusted balances) and debt (net financial liabilities) from, respectively, Annex Tables 28 and 33 of OECD Economic Outlook no. 86 database, November 2009 ([http://www.oecd.org/document/61/0,2340,en\\_2825\\_32066506\\_2483901\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/61/0,2340,en_2825_32066506_2483901_1_1_1_1,00.html)).

<sup>8</sup> Page 7 of HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (<http://www.hm-treasury.gov.uk/d/anfiscalp99.pdf>).

- The **sustainable investment rule**, which required the Government to keep the public sector's debt (net of its short-term financial assets) at a 'stable and prudent' level. The Treasury defined this as less than 40% of national income (GDP) at the end of each financial year of the economic cycle.

Labour's performance against these fiscal rules between 1997 and 2007 is discussed briefly below. With the onset of the financial crisis in 2008, these fiscal rules were suspended and a new framework put in place. This is discussed in the next section. The fiscal plans proposed by Labour, the Conservatives and the Liberal Democrats for the future will be discussed in a separate IFS Election Briefing Note. Chapter 11 of the February 2010 IFS Green Budget discusses the merits of the main three UK parties' proposed reforms to fiscal institutions, in particular Shadow Chancellor George Osborne's proposal for an Office for Budget Responsibility.<sup>9</sup>

## 2.2 Labour's record prior to the crisis

### *Four years of fiscal improvement*

In its 1997 manifesto, the Labour Party promised to keep to the tight public spending plans laid down by Mr Clarke for two years. Mr Brown broadly kept that promise and reduced spending further in his third year at the Treasury, thanks partly to unintended departmental under-spending. Despite beginning to spend more in the run-up to the 2001 election, public spending (Total Managed Expenditure, or TME) ended Labour's first term 3.1% of national income lower than it started (Figure 2.1). Most of the decline was in current spending, but public sector net investment also dropped, from 0.7% of national income to just 0.5% of national income. Notwithstanding Mr Brown's complaints about Conservative underinvestment, public sector net investment was lower on average in Labour's first term – at 0.6% of national income – than in any other four-year period since the Second World War.

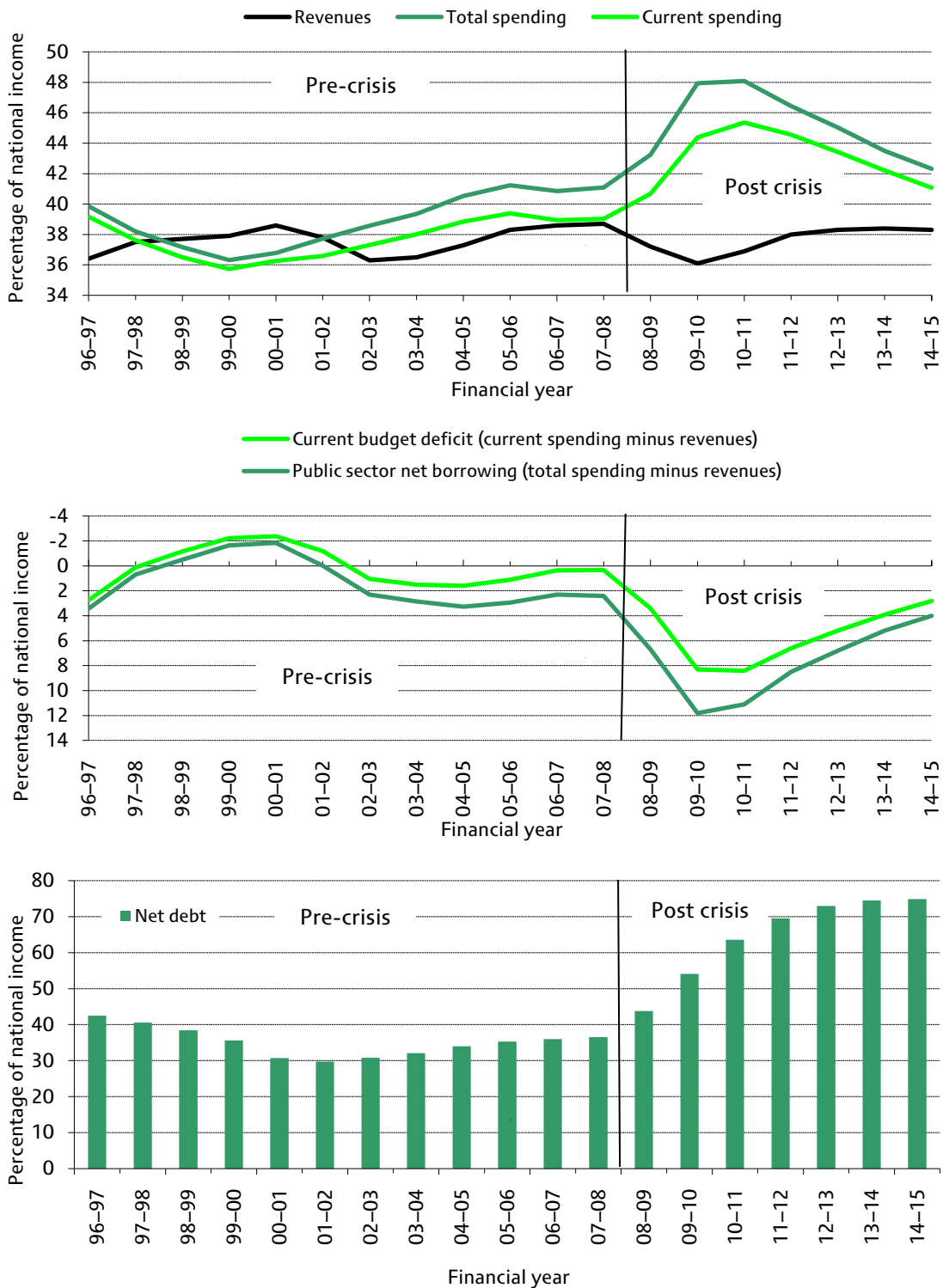
Over the same four years, government revenues rose by 2.2% of national income. This was thanks to: (i) real increases in fuel and tobacco duties (initiated by the Conservatives and then accelerated and maintained by Mr Brown until the November 1999 PBR), (ii) new Budget measures, such as the abolition of repayable dividend tax credits, and (iii) above-average economic growth. Mr Brown also decided not to raise income tax thresholds as quickly as incomes, which meant that a growing proportion of people's incomes was taxed at higher rates ('fiscal drag').

With revenues rising and spending falling as shares of national income, after four years in office the total budget balance and the current budget balance had both moved into surplus. The total budget surplus reached 1.9% of national income in 2000–01, comprising a structural surplus of 1.1% of national income and a cyclical surplus of 0.8% of national income. Meanwhile, public sector net debt fell from 42.5% of national income in 1996–97 to 30.7% of national income in 2000–01, aided in part by using the £22½ billion raised from auctioning 3G mobile phone licences (2.3% of national income) to pay off debt.

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<sup>9</sup> R. Chote, C. Emmerson, L. Sibieta and G. Tetlow, 'Reforming UK fiscal institutions', Chapter 11 in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget 2010* (<http://www.ifs.org.uk/budgets/gb2010/10chap11.pdf>).

Figure 2.1. Revenues, spending, budget balances and debt



Note: The vertical line indicates the end of the 'pre-crisis' period. Figures from 2008-09 onwards exclude the temporary impact of financial interventions.

Sources: HM Treasury, *Public Sector Finances Databank*, March 2010 ([http://www.hm-treasury.gov.uk/d/public\\_finances\\_databank.xls](http://www.hm-treasury.gov.uk/d/public_finances_databank.xls)). Forecasts from HM Treasury, *Budget 2010*, March 2010 ([http://www.hm-treasury.gov.uk/budget2010\\_documents.htm](http://www.hm-treasury.gov.uk/budget2010_documents.htm)).

### Seven years of drift

Mr Brown had described his determination to reduce borrowing in Labour's early years in office as 'prudence for a purpose'.<sup>10</sup> The purpose became clear after 1999. The Government reversed its earlier cuts in public spending, with health, education, and lower-income pensioners and families with children the main beneficiaries.<sup>11</sup> However, as spending rose (by 3.8% of national income over Labour's second term, as shown in Figure 2.1), tax revenues weakened unexpectedly when the stock market fell in 2000 and 2001, reducing tax payments by financial sector firms and their employees.

The first Budget after the 2001 general election contained significant tax raising measures which were designed to help reverse the decline in revenues and finance increased spending: in particular on boosting the incomes of lower income pensioners, lower income families with children, and to increase spending on public services. The largest tax raising measure – an increase in National Insurance contributions – was rhetorically hypothecated to increased spending on the National Health Service. Further tax raising measures followed shortly after the 2005 general election to boost revenues further.<sup>12</sup> But other factors – such as the weak performance of the stock market that was associated with poor performance in the financial sector – offset these increases. By 2007–08, government revenues were 38.7% of national income – approximately the same level they had been in 2000–01. However, over this same period, spending had grown consistently as a share of national income – from 36.8% of national income in 2000–01 to 41.1% by 2007–08.

The failure to match this higher spending with commensurately higher tax revenues unwound the improvement in the public finances seen during Labour's first term. The current budget balance moved from a surplus of 2.4% of national income in 2000–01 to a deficit of 0.3% of national income by 2007–08 (and was even higher in 2004–05, at 1.6% of national income). As the economy moved from operating at its trend level in 2000–01 to slightly above that level in 2007–08, the deterioration in the structural position of the current budget was even worse: from a surplus of 1.6% of national income in 2000–01 to a deficit of 0.6% in 2007–08. The swing in the overall budget balance was even larger, reflecting the fact that public sector net investment had at last begun to increase. The return to sizable overall budget deficits began to push public sector net debt up again, reaching 36.5% of national income in 2007–08.

Some of this deterioration in the public finances resulted from weak performance of tax revenues that was unanticipated by both the Treasury and most independent observers. However, some of the deterioration reflected excessive optimism in the government's fiscal projections, which the government used to justify its decision not to raise taxes further. Between 2002 and 2007, the Treasury's initial forecasts for borrowing were consistently lower than borrowing actually turned out to be. This did not solely reflect unforeseeable events; even at the time many of these forecasts were made, external observers believed that the Treasury was being unduly optimistic. Particularly in the run-up to the 2005 election, IFS and other commentators argued that the government would

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<sup>10</sup> Mr Brown's 1998 Budget Speech: 'I said that this would be a Budget based on prudence for a purpose and that guides us also in our approach to public spending' ([http://www.hm-treasury.gov.uk/budget/budget\\_1998/bud98\\_speech.cfm](http://www.hm-treasury.gov.uk/budget/budget_1998/bud98_speech.cfm)).

<sup>11</sup> Another in this series of General Election 2010 IFS Briefing Notes looks in more detail at the impact on households of Labour's tax and benefit policies: Browne and Phillips (2010), *Tax and benefit reforms under Labour* (<http://www.ifs.org.uk/publications/4807>).

<sup>12</sup> For further details on the tax implications of each Budget since Spring 1985, see R. Chote and C. Emmerson, *Taxes and elections: are they by chance related?*, IFS Observation (<http://www.ifs.org.uk/publications/4793>) 15<sup>th</sup> March 2010.

have to announce further tax raising measures or cut spending as a share of national income if it wished to meet its fiscal rules with the degree of comfort it had sought in the past.<sup>13</sup>

Mr Brown rejected any such suggestion at the time, claiming during the 2005 election campaign that: 'People say we won't meet our fiscal rules. Once again, with the public finances strong, we will prove them wrong'.<sup>14</sup> But, with the election out of the way, it became clear that the Government was indeed on course to breach its rules and Mr Brown duly announced net tax increases in the 2005 Pre-Budget Report (PBR), the 2006 Budget, and the 2006 PBR. Taken together, these post-election tax increases were sufficient to raise an estimated extra £6.9 billion last year (£200 per family). These, along with a slow-down in the growth of public spending, contributed to the improvement in the fiscal position seen between 2004–05 and 2007–08.

### ***Compliance with the fiscal rules***

Within the confines of its own definition of the start and end dates of an economic cycle, the Government complied with its fiscal rules over the one and only complete economic cycle that it judged had taken place prior to the economic crisis – that is, the one which ran from 1997–98 to 2006–07. But in the November 2008 PBR it conceded – with some understatement – that it would not meet them over the next cycle: “the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full”.<sup>15</sup>

### ***Comparison with the previous Conservative administration***

To put Labour's stewardship of the public finances before the financial crisis in some historical context, it is interesting to compare how the public finances evolved over Labour's first eleven years in office with how they evolved over the first eleven years of the previous Conservative administrations. As Figure 2.2 illustrates, there are some notable parallels and differences in the way in which the public finances evolved under the current and previous governments.

The structural budget deficit evolved in a remarkably similar way. Both parties inherited large structural deficits from their predecessors: 4.8% of national income in 1978–79 and 2.8% of national income in 1996–97. If left unchecked, these would have seen debt continuing to rise considerably. So both governments began their terms with a significant tightening of fiscal policy, achieving structural budget surpluses that peaked in their 3rd years in office, at 1.5% of national income in 1981–82 and 1.1% of national income in 1999–2000. Thereafter both presided over a steady drift back into the red. By year 11 of their terms in office, both governments were recording exactly the same structural deficits: 2.6% of national income in both 1989–90 and 2007–08.

The evolution of public sector net debt differs rather more between the parties, because of movements in non-structural (i.e. cyclical) borrowing. Labour's move from structural budget deficit to surplus and back again was 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), thereafter it rose again to 36.5% of national income in year 11 (2007–08). 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

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<sup>13</sup> See, for example, R. Chote, C. Emmerson and C. Frayne (2005), “Green Budget public finances forecasts” in R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds.), *The IFS Green Budget: January 2005* (<http://www.ifs.org.uk/budgets/gb2005/05chap4.pdf>). See also Channel 4 Fact Check, *Will taxes go up?*, 14<sup>th</sup> April 2005 (<http://www.channel4.com/fc/quote.jsp?id=81>) which concludes that “Most, but not all, experts think so”.

<sup>14</sup> ‘Row over £11bn black hole’, *Guardian*, 22 April 2005.

<sup>15</sup> PBR 2008, p.15.



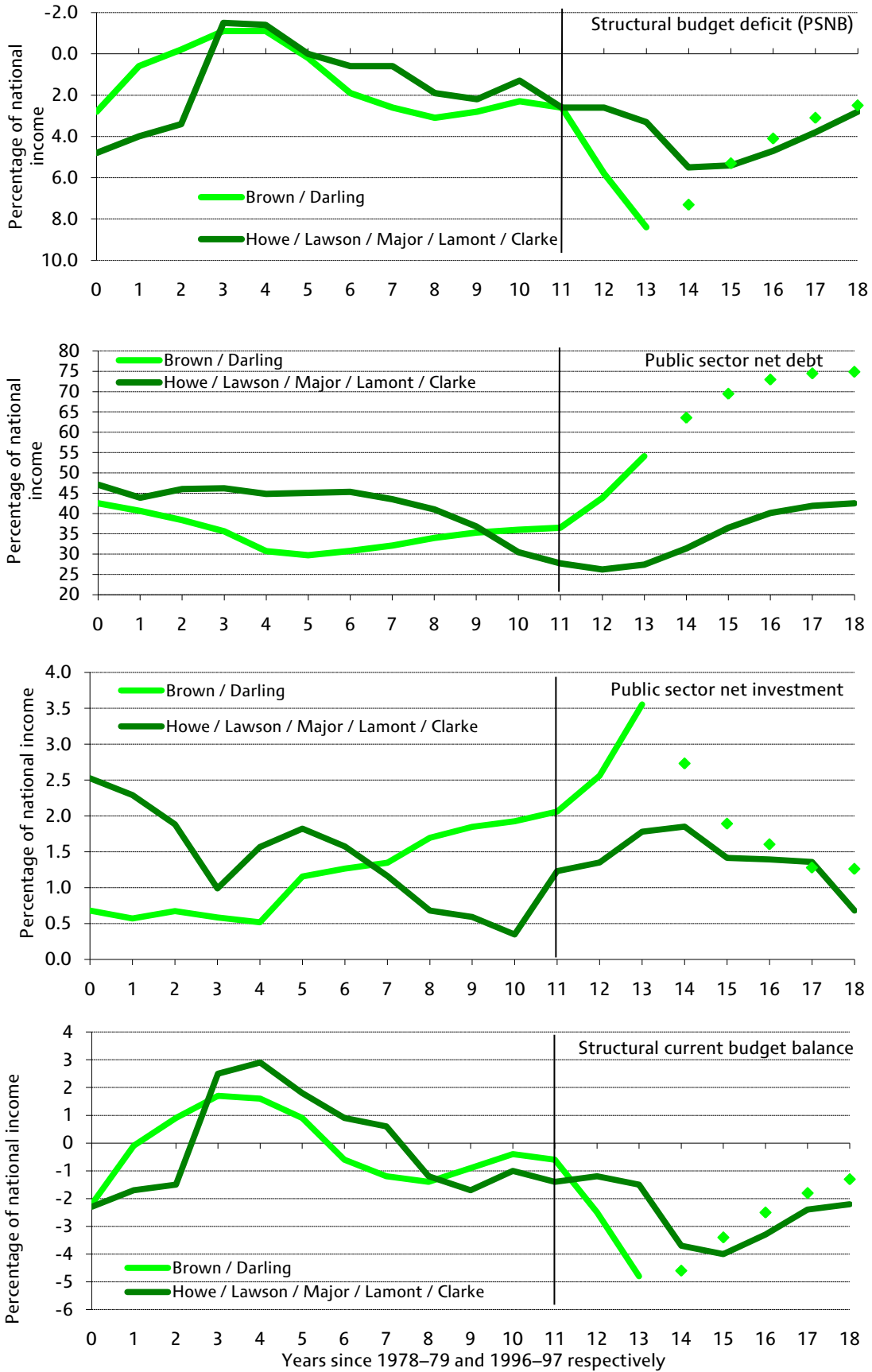
balance was offset by higher cyclical borrowing during the first Conservative recession. Net debt remained around 45% of national income until 1984–85, then fell sharply to a low of 26.2% of national income over the following six years (despite higher structural borrowing) as the boom of the mid-1980s generated an unsustainable cyclical surplus and an unsustainably high level of national income (both of which temporarily depressed the ratio of debt to national income).

The similarity in the paths of the structural budget deficit in part reflects Labour's willingness to borrow more to increase net investment. As we discussed above, and as Figure 2.2 shows, net investment actually fell over Labour's first term, but thereafter it increased strongly and by 2007–08 net investment was three times higher than the level inherited from the Conservatives. In contrast, investment fell sharply during the Conservatives' first decade (although this in part reflected privatisation of capital-intensive nationalised industries). In their 11<sup>th</sup> year in office Labour was investing 67% more as a share of national income than the Conservatives did in their 11<sup>th</sup> year in office, or 0.8 percentage points higher as a share of national income.

If we exclude borrowing to finance investment, both parties inherited very similar structural current budget deficits in 1978–79 and 1996–97. Labour then achieved a smaller swing into surplus than the Conservatives during their first three years, followed by a smaller swing back into deficit over the next eight. But the patterns remain similar.

So, on the eve of the financial crisis, the public finances were in a very similar position to where they had been after 11 years of the previous Conservative administrations.

Figure 2.2. Debt, deficits and investment: Labour versus Conservatives



Sources: HM Treasury, *Public Sector Finances Databank*, March 2010 ([http://www.hm-treasury.gov.uk/d/public\\_finances\\_databank.xls](http://www.hm-treasury.gov.uk/d/public_finances_databank.xls)). Forecasts from HM Treasury, *Budget 2010*, March 2010 ([http://www.hm-treasury.gov.uk/budget2010\\_documents.htm](http://www.hm-treasury.gov.uk/budget2010_documents.htm)).

## 2.3 The public finances on the eve of the crisis

One of the key questions since the financial crisis and recession began has been whether the public finances were in 'good repair' and whether they were well or poorly placed to deal with the large increase in public borrowing that has followed. The previous subsection suggests that the evolution of the public finances during Labour's first eleven years in office (1997–98 to 2007–08) was strikingly similar to that seen under the Conservative administrations between 1979–80 and 1989–90. However, such comparisons fail to take account of broader macroeconomic differences between these two periods. An alternative approach to addressing this question is to ask how the evolution of the fiscal position in the UK between 1997 and 2007 compared with that in other similar, industrialised countries. Table 2.1 compares the UK's level of spending, revenues, borrowing and debt in 1997 and 2007 with that of other OECD countries in each of these years. How the UK's ranking has changed over time gives an indication of our performance relative to other similar countries.

By 2007–08, the public finances were in a stronger position than they had been when Labour came to power in 1997. Though public spending increased from 39.9% in 1996–97 to 41.1% in 2007–08 (an increase of 1.2 percentage points), over the same period revenues grew by 2.3 percentage points, meaning that total borrowing fell by 1.0 percentage point over this period (figures do not sum due to rounding). With more being spent on investment in 2007–08 than in 1996–97, the current budget (that is, the difference between current revenues and spending on non-investment items) strengthened even more – from a deficit of 2.7% of national income in 1996–97 to a deficit of just 0.3% of national income in 2007–08. Meanwhile, public sector net debt fell from 42.5% of national income to 36.5%, as the UK economy grew faster than the accumulation of new borrowing.

However, this fall in public sector borrowing occurred during a period when most other industrial countries were doing much more to strengthen their public finances. On the OECD measure, the UK had a structural budget deficit of 3.5% of national income in 2007. This was the third highest among the G7 countries and the sixth highest among the 26 OECD countries for which comparable data are available (behind – from highest to lowest – Hungary, Greece, Japan, France and Poland). Eleven of these 26 countries actually had structural budget surpluses in the run up to the global financial crisis. Furthermore, the UK saw only the 18<sup>th</sup> largest reduction in its structural budget deficit between 1997 and 2007 – in other words, the vast majority of other OECD countries did more to strengthen their public finances during Labour's first eleven years in office than Labour did in the UK.

Looking at the UK's debt levels, in 2007 we had the second lowest level of debt in the G7 (behind Canada), as Mr Brown has been fond of pointing out.<sup>16</sup> However, if we look at a broader set of countries, the comparison is less flattering: we had the eleventh highest level of debt (or seventeenth lowest) when compared with the other 26 OECD countries for which data are available. Between 1997 and 2007, 16 OECD countries (out of 23 for which data are available) experienced larger declines in their ratio of debt to national income than the UK (using the OECD's

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<sup>16</sup> For example, "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." Prime Minister's Questions, 20<sup>th</sup> October 2008, Hansard, Column 23 (<http://www.publications.parliament.uk/pa/cm200708/cmhansrd/cm081020/debtext/81020-0004.htm#0810203000512>).

measure of “general government net financial liabilities”, which differs somewhat from the Treasury’s preferred measure, “public sector net debt”).

Table 2.1. Key fiscal indicators: 1996–97 versus 2007–08

<i>Values: % of national income for 1996–97 and 2007–08 Rankings: OECD member countries for 1997 and 2007</i>	<b>Labour’s inheritance</b> (1996–97 / 1997)	<b>Pre-crisis position</b> (2007–08 / 2007)	<b>Change,</b> (% points)
<b>Spending</b>			
Total public spending <i>Place in OECD league table</i>	39.9% 22 <sup>nd</sup> /28 <i>highest spending</i>	41.1% 12 <sup>th</sup> /28 <i>highest spending</i>	+1.2 2 <sup>nd</sup> /28 <i>largest increase</i>
Public sector net investment	0.7%	2.1%	+1.4
<b>Revenues</b>			
Tax and other revenues <i>Place in OECD league table</i>	36.4% 21 <sup>st</sup> /28 <i>highest revenues</i>	38.7% 15 <sup>th</sup> /28 <i>highest revenues</i>	+2.3 5 <sup>th</sup> /28 <i>largest increase</i>
<b>Borrowing</b>			
Public sector net borrowing: total	3.4%	2.4%	–1.0
Public sector net borrowing: structural <i>Place in OECD league table</i>	2.8% 7 <sup>th</sup> /25 <i>highest borrowing</i>	2.6% 6 <sup>th</sup> /26 <i>highest borrowing</i>	–0.2 18 <sup>th</sup> /25 <i>largest reduction</i>
Current budget balance: total	–2.7%	–0.3%	+2.4
Current budget balance: structural	–2.2%	–0.6%	+1.6
<b>Net worth, debt and debt interest</b>			
Public sector net worth	17.7%	28.9%	+11.2
Public sector net debt <i>Place in OECD league table</i>	42.5% 14 <sup>th</sup> /24 <i>highest debt</i>	36.5% 11 <sup>th</sup> /27 <i>highest debt</i>	–6.0 17 <sup>th</sup> /23 <i>largest reduction</i>
Public sector net debt interest <i>Place in OECD league table</i>	3.0% 9 <sup>th</sup> /28 <i>highest debt interest</i>	1.6% 10 <sup>th</sup> /28 <i>highest debt interest</i>	–1.4 19 <sup>th</sup> /28 <i>largest reduction</i>

Note: OECD figures relate to general government rather than public sector and relate to calendar years 1997 and 2007.

Sources: Values (% of national income) are from HM Treasury, *Public Sector Finances Databank*, March 2010 ([http://www.hm-treasury.gov.uk/d/public\\_finances\\_databank.xls](http://www.hm-treasury.gov.uk/d/public_finances_databank.xls)) and Office for National Statistics; Rankings (OECD member countries) are from OECD, *Economic Outlook* No. 86, November 2009 (<http://www.oecd.org/oecdEconomicOutlook>).

On the eve of the financial crisis, the UK had one of the largest structural budget deficits among either the G7 or the OECD countries and a higher level of public sector debt than most other OECD countries, though lower than most other G7 countries. Most OECD governments did more to reduce their structural deficit during the period from 1997 to 2007 than Labour did. This fiscal position formed the backdrop to the financial crisis.

### 3. Public finances through the crisis: 2007 to 2010

The financial market turmoil and economic recession that followed the collapse of Lehman Brothers have had a large adverse effect on the UK's public finances. This section provides a brief discussion of this impact – for a fuller discussion see Chote, *et al* (2010).<sup>17</sup> The figures presented in this section exclude the direct impact on borrowing and debt of the interventions in the financial sector. The short- and long-term impacts of these are discussed separately in Box 3.1.

As shown in Figure 3.1, in 2007–08 the public sector borrowed 2.4% of national income (or £35 billion in 2010–11 terms). This comprised 2.6% of national income of structural borrowing (most of which was used for investment), slightly offset by the fact that (as a result of the economy operating slightly above its trend level) tax receipts were temporarily buoyant and spending temporarily depressed to the tune of 0.2% of national income.

The story over the following two years (2008–09 and 2009–10) was of a worsening fiscal position as the full effects of the financial crisis and recession began to be felt on the public finances. Furthermore, additional borrowing was undertaken in these years in order to implement the temporary fiscal stimulus measures that the government thought necessary and sensible to insulate the UK economy from the full force of the global recession.

In 2008–09, the government borrowed a total of 6.7% of national income, which includes: 5.2% of national income to cover a structural (i.e. permanent, if unaddressed) gap between public spending and revenues (about half of this was spent on investment), 0.6% of national income to fund the temporary fiscal stimulus measures (such as the VAT cut), and 0.9% of national income as a result of the economy operating below trend and thus spending being temporarily high and revenues temporarily low. This is shown in Figure 3.1. In 2009–10, all three components of borrowing increased further, meaning borrowing in 2009–10 is estimated to have been 11.8% of national income (£166.5 billion in 2009–10 terms, or £173 billion in 2010–11 terms). This is the highest level of annual borrowing, as a share of national income, since the end of the Second World War.

In 2010–11, almost the entire temporary fiscal stimulus is being withdrawn, the direct impact of which is to reduce total borrowing. However, the cyclical component of borrowing is set to rise slightly to 3.8% of national income (as the full impact of the recession and crisis on tax receipts is felt), while the Treasury estimates that other structural borrowing 2010–11 will rise to 7.2% of national income, of which 2.7% will be spent on investment.

High levels of borrowing since 2007–08 mean that public sector net debt is expected to increase substantially by the end of 2010–11. Public sector net debt (excluding the impact of financial sector interventions<sup>18</sup>) is forecast by the Treasury to be 63.6% of national income (or £952 billion) by the end of 2010–11 (Figure 3.2).

The structural gap between government spending and government receipts increased substantially between 2007–08 and 2009–10 and this largely reflects the Treasury's assessment that the

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<sup>17</sup> R. Chote, R. Crawford, C. Emmerson and G. Tetlow (2010), 'Fiscal Tightening: Why and How?', in Chapter 2 of R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, London: Institute for Fiscal Studies (<http://www.ifs.org.uk/budgets/gb2010/10chap2.pdf>). Some updated analysis, which takes into account the new forecasts and measures contained in the March 2010 Budget can be found in G. Tetlow (2010), *Public finances: less to repair, a bit more done*, Presentation at IFS Post Budget 2010 Briefing, 25<sup>th</sup> March (<http://www.ifs.org.uk/budgets/budget2010/tetlow.pdf>).

<sup>18</sup> For a detailed description of how measures of public sector net debt and public sector net borrowing "excluding the temporary impact of financial interventions" are defined see ONS, *Public sector finances excluding financial interventions*, 18 March 2010 (<http://www.statistics.gov.uk/cci/article.asp?ID=2380>).

financial crisis and recession has both permanently damaged the productive potential of the UK economy and permanently reduced long-run price levels. Both of these factors feed through into weaker government receipts and higher public spending relative to nominal national income, in the absence of further policy changes. Prior to the financial crisis, the government already had in place measures which were set to deliver a reduction in structural borrowing of about 1½% of national income between 2007–08 and 2012–13. In other words, these would have perhaps been sufficient to reduce long-term structural borrowing from 7.2% of national income in 2010–11 to just below 6% of national income in the medium-term. Therefore, in the absence of further measures to cut public spending or increase tax revenues, the UK public sector would have been on course to continue to borrow close to 6% of national income (or about £90 billion in 2010–11 terms) every year forever more. Governments have historically tended to borrow something each year. For example, under the golden rule, Mr Brown aimed to borrow only as much as he invested, which was roughly 2% of national income a year just before the financial crisis (as shown in Figure 2.2). However, borrowing as high as 6% of national income permanently would have left debt on an unsustainable upward path.

Figure 3.1. Composition of borrowing, 2007–08 to 2010–11

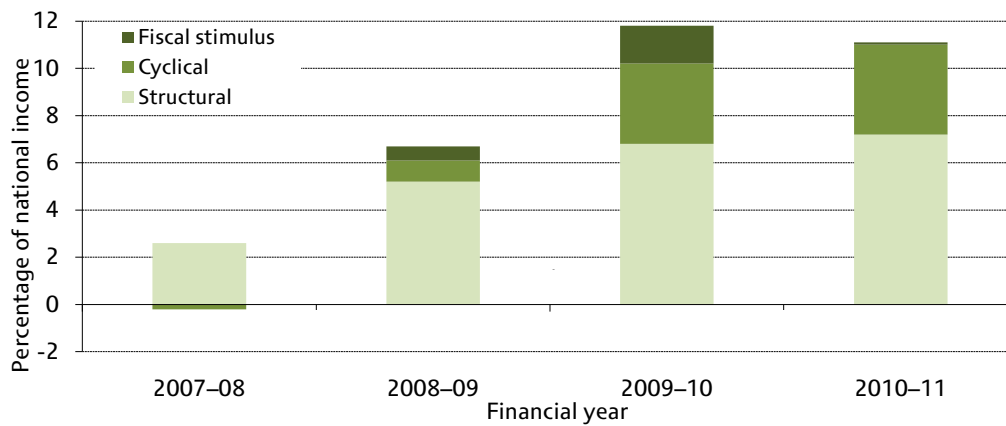
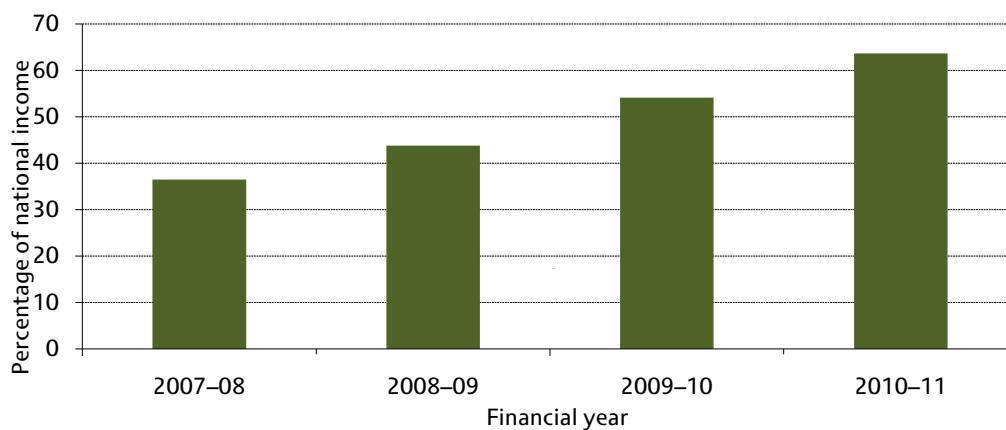


Figure 3.2. Public sector net debt, 2007–08 to 2010–11



Therefore, all three main political parties are pledging to eliminate most of this structural borrowing – and eventually return to a position where they are borrowing only to invest – over the next few years. The exact size and timescale of the borrowing reduction varies somewhat between

the main political parties and details of these plans will be discussed in more detail in a separate IFS Election Briefing Note.

### Box 3.1. The impact of financial sector interventions on the public finances

In autumn 2007, as inter-bank lending started to dry up and Northern Rock struggled to raise finance to continue carrying out its day-to-day activities, the Bank of England extended Northern Rock additional credit facilities. This heralded the start of an unprecedented (at least in modern times) period of UK public sector involvement in the financial sector. Since late 2007, in order to help shore up the UK's banking industry – and avoid the calamitous consequences for the whole economy that would have resulted from the collapse of a number of large UK banks – the government has purchased large stakes in a number of banks and extended various other forms of support to many more.

In the short-term, the government has purchased shares in a number of financial institutions and loaned money to, or underwritten the lending of, many more. These actions have worsened the UK public sector's balance sheet in the short term and have temporarily changed the pattern of cash flows between central government, the Bank of England, the public banks and those banks that remain in the private sector.

In particular, these interventions have substantially worsened measured public sector net debt (PSND) in the short-term, as the liabilities (net of the short term financial assets and, crucially in this instance, not net of long-term financial assets such as their mortgage books) of the public banks are (or at least should be) included in PSND. Due to the complexity of assessing the liability position of Royal Bank of Scotland (RBS) and Lloyds Banking Group (LBG), the ONS have so far only incorporated the net liabilities of Northern Rock and Bradford and Bingley into PSND. As of the end of December 2009, the ONS estimated these at £109.3 billion. As the balance sheets of RBS and LBG are much larger the inclusion of these will add considerably more to the headline measure of debt.<sup>b</sup>

Many of these short-term effects on debt and borrowing will, however, be unwound as the government starts to sell its stake in the banks. The important factor, from a public finance perspective, is what the long-term impact will be. In particular, once the government has unwound its temporary financial sector interventions, how much higher (or lower) will government debt be? And what, if any, additional borrowing will be required each year to maintain any residual financial sector involvement and/or service the additional debt?

The eventual fiscal cost is uncertain and depends on a number of factors, including the sale price achieved for the shares in RBS and LBG compared to their purchase price. The Treasury estimated in Budget 2010 that, at then current market prices, the cost of the financial sector interventions (net of fees and other income) would be £6 billion.<sup>a</sup> This would be a trivial increase in PSND, which is expected to reach £1,406 billion by the end of 2014–15, and would have little effect on long-term borrowing requirements. For this reason the figures presented in this chapter exclude the direct impact on borrowing and debt of the interventions in the financial sector.

<sup>a</sup> Box C4, page 213 of HM Treasury, *Budget 2010* ([http://www.hm-treasury.gov.uk/budget2010\\_documents.htm](http://www.hm-treasury.gov.uk/budget2010_documents.htm)).

<sup>b</sup> Further details can be found in Table 5.2, and surrounding text, of R. Chote, C. Emmerson and G. Tetlow (2009), 'The fiscal rules and policy framework' in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, London: Institute for Fiscal Studies (<http://www.ifs.org.uk/publications/4417>).

## 3.1 Crisis, recession and the fiscal rules

Having complied with its own fiscal rules (the golden rule and the sustainable investment rule) through the economic cycle that Mr Brown judged to have run from 1997–98 to 2006–07, it became clear with the onset of the financial crisis in Autumn 2008 that the government would not be able to

continue complying with them over the current cycle. In the November 2008 PBR, it was announced that these fiscal rules would be suspended 'until the global shocks have worked their way through the economy in full'.<sup>19</sup>

Sensibly, Mr Brown's Code for Fiscal Stability allowed the government to depart from its stated fiscal rules so long as it specified: the reasons for doing so, the approach and period of time they intend to take to return to the previous rules, and the objectives and operating rules that will apply in the meantime.<sup>20</sup> To comply with the previous fiscal rules over the current economic cycle would have required substantial tax increases or spending cuts while the UK economy was suffering a major recession. Such behaviour would have been extremely unwise and, in fact, the government chose to do exactly the opposite – instead implementing a package of fiscal stimulus measures designed to insulate the UK economy from the full effects of the downturn.

By the end of 2008–09, public sector net debt had moved above the previous 40% ceiling imposed by the sustainable investment rule and by the end of the current financial year (2010–11) is expected to be 63.6% of national income. The cumulative current budget deficit over the period from 2006–07 to 2014–15 is forecast by the Treasury to be 39.4% of national income, or an average of 4.4% of national income (£64 billion in today's terms) per year. If the current economic cycle were to finish in 2014–15, the previous golden rule would have required this figure to be zero.<sup>21</sup>

The government has now implemented a new fiscal framework, legislated through the Fiscal Responsibility Act 2010. This makes it a legal requirement for the government to set out and deliver a plan for sound public finances, with the plan initially having to be approved by Parliament. The government's first proposed plan (the Fiscal Consolidation Plan, FCP) sets three objectives in primary legislation:

- reduce the budget deficit each year between now and 2015–16;
- reduce the headline budget deficit by one-half by 2013–14 compared with its level in 2009–10;<sup>22</sup>
- have net debt falling as a proportion of GDP in 2015–16.

The Act also allows the government to impose further obligations relating to the period 2010–11 to 2015–16 by order. The *Fiscal Responsibility Order 2010* includes the additional obligation to:

- reduce the headline deficit to 5.5% of national income or less in 2013–14.<sup>23</sup>

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<sup>19</sup> Page 15 of HM Treasury, *Pre-Budget Report 2008*, November 2008 ([http://www.hm-treasury.gov.uk/prebud\\_pbr09\\_repindex.htm](http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm)).

<sup>20</sup> HM Treasury, *The Code for Fiscal Stability*, November 1998 ([http://www.hm-treasury.gov.uk/ukecon\\_fisc\\_code98.htm](http://www.hm-treasury.gov.uk/ukecon_fisc_code98.htm)).

<sup>21</sup> In fact, Treasury forecasts suggest that the economic cycle will finish slightly later than 2014–15. There are no official forecasts for the current budget deficit beyond 2014–15. However, Treasury figures suggest that the current budget will only return to surplus in 2016–17.

<sup>22</sup> Borrowing in 2009–10 is expected to be 11.8% of national income. It would therefore need to be cut to 5.9% of national income, or lower, in 2013–14. However, the forecast for borrowing in 2013–14 from the March 2010 Budget (of 5.2%) shows that the government is currently aiming to over-achieve this target.

<sup>23</sup> Borrowing forecasts from the March 2010 Budget show that the government is currently aiming slightly to over-achieve this target.



### 3.2 How does the increase in borrowing and debt seen in the UK compare to other countries?

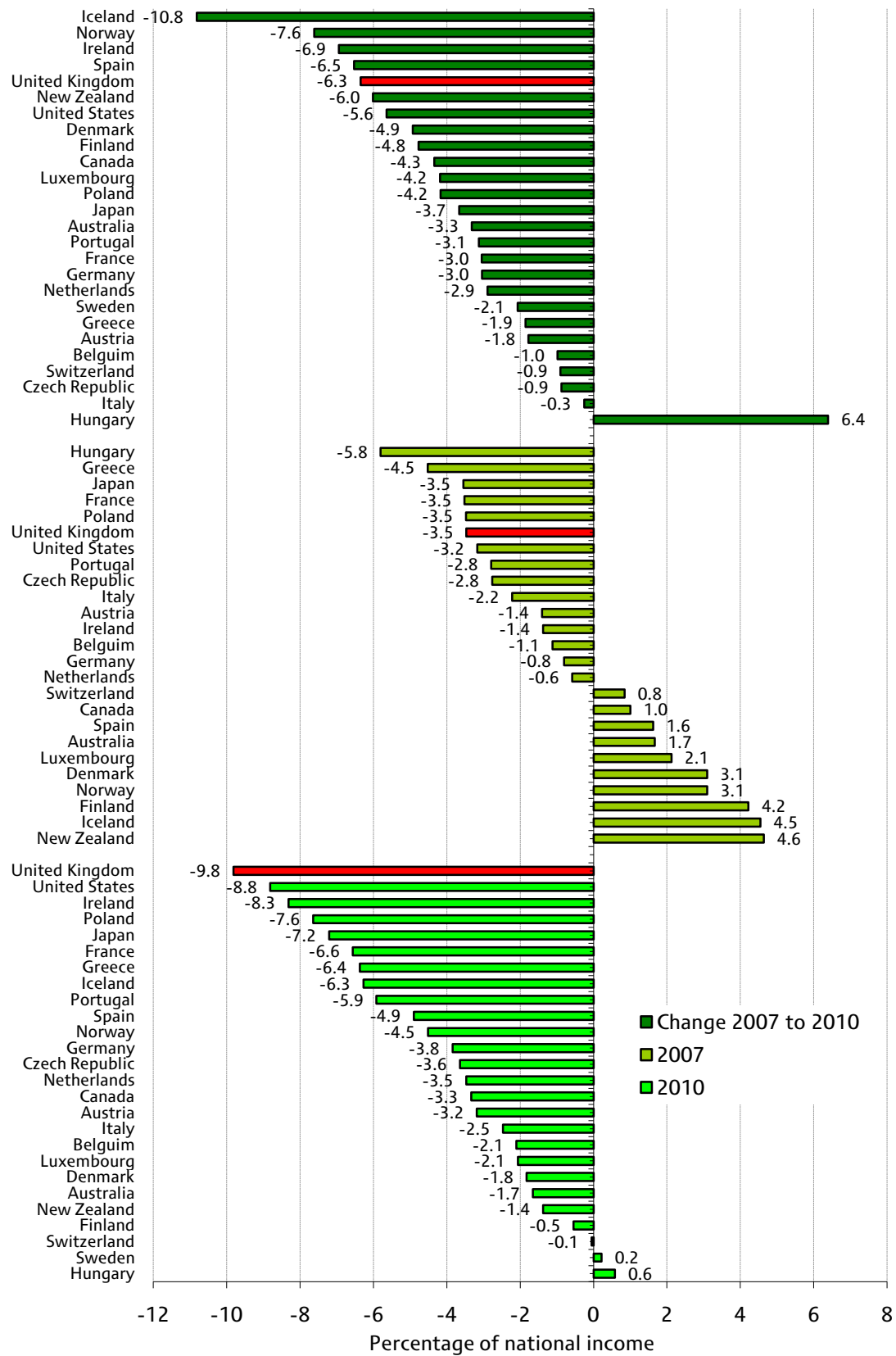
Mr Brown is fond of reminding us that this has been a global financial crisis. However, the UK – at least partly because of the relative importance of the financial sector for our public finances – has experienced a worse deterioration in its fiscal position than many other industrialised countries. Figure 3.3 shows an internationally comparable measure of government borrowing for 26 industrial countries in 2007 and 2010 and the size of the change over this period. Unfortunately, these figures date from November 2009, prior to Budget 2010 which presented a slightly rosier outlook for borrowing 2010 than had been thought at the end of last year.<sup>24</sup> Based on these figures, the UK had the sixth highest level of structural borrowing in 2007, was set to experience the fifth largest weakening of its structural fiscal position between 2007 and 2010, and was set to have the highest level of structural borrowing in 2010. While the slightly better figures published by the Treasury in March's Budget may change this picture slightly, it is unlikely to affect the broad conclusion that the UK will have experienced one of the largest increases in structural borrowing through the recession and thus will have one of the weakest fiscal positions in 2010.

As a result of this higher level of borrowing, the UK is also expected (as shown in Figure 3.4) to see the third largest increase in government debt over this period, with only Ireland and Iceland experiencing a bigger deterioration. This would see the UK move slightly down the league table of debt from its 'mid-table' position in 2007.

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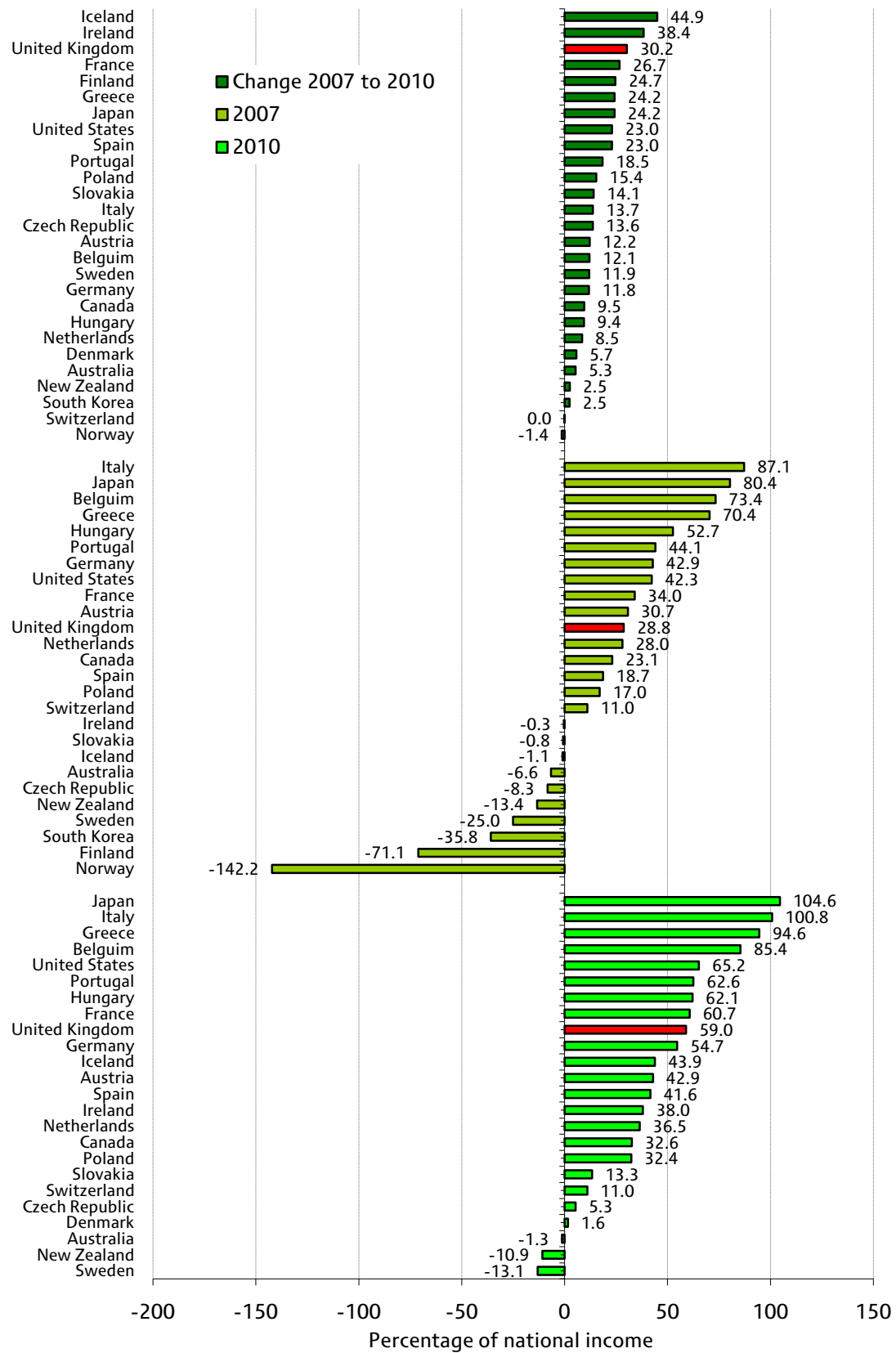
<sup>24</sup> For a discussion of the change in outlook for borrowing that occurred between the Pre-Budget Report published in December 2009 and the Budget of March 2010, see G. Tetlow (2010), *Public finances: less to repair, a bit more done*, Presentation at IFS Post Budget 2010 Briefing, 25<sup>th</sup> March (<http://www.ifs.org.uk/budgets/budget2010/tetlow.pdf>).

Figure 3.3. Structural balances 2007 and 2010



Source: Annex Table 28 of OECD, Economic Outlook No. 86, November 2009 (<http://www.oecd.org/oecdEconomicOutlook>).

Figure 3.4. General government net financial liabilities, 2007 and 2010



Source: Annex Table 33 of OECD, Economic Outlook No. 86, November 2009 (<http://www.oecd.org/oecdEconomicOutlook>).