LOMBARD STREET RESEARCH

Monthly Economic Review

No. 97, July 1997

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A new rule-book for fiscal policy

Mr. Brown abandons medium-termism

Medium-Term Financial Strategy ended

Mr. Gordon Brown's Budget speech was full of phrases about the virtues of long-termism and the vices of short-termism. Commentators have overlooked that he is not an enthusiast for medium-termism or, to be more precise, for the Medium-Term Financial Strategy.

MTFS dates back to 1980

The first MTFS was announced in the Budget of 1980, which was the second under the last Conservative Government. It set out multi-year forward targets for money supply growth (on the broad measure, sterling M3) and the public sector borrowing requirement. The aim was to insist that inflation would be reduced by monetary means and to prevent a U-turn on macroeconomic policy (back to fiscal expansionism and incomes policy) of the kind seen under the disastrous Heath Government of 1970 to 1974. While the MTFS was fully endorsed by senior Conservative politicians, the technical input came largely from Mr. (later Sir) Terence Burns, who at the time was the newly-appointed Chief Economic Adviser. (Today he is Permanent Secretary to the Treasury.)

and survived until Mr. Clarke's last Budget

The MTFS had a complex and, some might say, rather chequered history. The monetary side was effectively dropped in the mid-1980s, but the fiscal side continued. Although not much mentioned in the policy discussions of the 1990s, the annual *Financial Statement and Budget Report* kept a chapter two on the MTFS until Mr. Clarke's final Budget. Whatever the conceptual weaknesses of the MTFS, it did restrict fiscal expansionism. (See p. 7 of the accompanying *Research paper*, which shows that the UK today has much the same ratio of public debt to GDP as 20 years ago, whereas in most of the OECD the ratio has risen sharply.) Now Mr. Brown has scrapped the MTFS, which no longer makes any appearance in the *FSBR*. Section 4.31 is called "Medium-Term Projections", but this warns specifically, "spending for later years will be set only after the comprehensive spending review" and "it is impossible therefore to make any central assumptions for the public finances in later years". The ending of the MTFS does not necessarily imply that budgetary control will deteriorate. In fact, Mr. Brown's new so-called "golden rule" - that borrowing can be justified only for capital expenditure - would have led to very tough Budgets over the last few years, if it had been in place. (See the chart on p. 11 which compares the PSBR with the general government current account. The golden rule is that the GGCA should be balanced.) But it was not entirely reassuring that Mr. Brown should use his first Budget to announce a number of new spending programmes, as well as the device of financing his welfare-to-work scheme (which may be permanent and expensive) with the money from the windfall tax (which is once-for-all, as well as being a very disreputable "tax").

"Golden rule" could be tougher,

but will it work?

Professor Tim Congdon 7th July, 1997

Summary of paper on

"Is public debt really under control?"

Purpose of the paper

The first Labour Budget stated new rules for fiscal policy, in addition to raising taxes by over £5b. The purpose of the *Review* - which is similar in format to the August 1995 issue - is to consider whether the UK's public debt is fully under control.

Main points

* **Public debt rose sharply, relative to GDP, in the early 1990s. (See p. 6.) The PSBR is now falling to low levels, in accordance with the usual cyclical pattern. (See p. 5.) A surplus is needed to reduce the debt/GDP ratio to its level in 1990, but this remains uncertain.**

* **Mr. Brown announced a new "golden rule" for fiscal policy, that borrowing is only to finance capital expenditure. The general government current account (GGCA) ought therefore to be in balance.**

* **The chart on p. 11 compares the PSBR and the GGCA over the last 35 years. The contrast between the two measures of fiscal policy is dramatic, with the PSBR now returning to a low figure (or perhaps even a surplus) as economic activity recovers, while the deficit on the GGCA is far higher than in the 1970s and early 1980s, usually regarded as a period of financial turmoil.**

* **The latest *Financial Statement and Budget Report* envisages a surplus on the PSBR and the restoration of balance on the GGCA in the next two or three years. But the Budget announced a number of new spending initiatives and it remains to be seen whether expenditure control will be as tight as threatened.**

* **The new spending initiatives were partly on the capital side, notably the release of council house receipts and the programme of more school building. So public sector capital expenditure will boost the construction sector and economic activity, at just the time that economy is starting to over-heat. (See chart on p. 12.)**

This paper was written by Professor Tim Congdon, with assistance from Mr. Stewart Robertson in the preparation of the charts.

Is public debt really under control?

A post-Budget appraisal of trends in the UK's public finances

Two new rules for the public finances

Mr. Brown's first Budget emphasized the new Government's commitment to sound public finances. In the Budget speech he spelt out, first, the so-called "golden rule" that borrowing will be allowed only for capital expenditure and, secondly, the principle that over the business cycle the ratio of public debt to gross domestic product should be stable. This sounds reassuring, but are the public finances really under control? And will they remain so?

Alleged "black hole" in public finances

Before the Budget Mr. Brown went to some trouble to demonstrate that his fiscal legacy from the Conservatives was unsatisfactory, commissioning a report from the National Audit Office on the assumptions behind his predecessor's medium-term projections for public sector borrowing. The NAO judged that many of the assumptions were implausibly optimistic and commentators started to talk about a "black hole" in the public finances. But this was all rather silly. The truth is that PSBR projections for the current year are always unreliable, with a typical forecasting error of almost 1% of GDP, while the medium-term numbers are aspirations, not hard fact.

Public debt under fair control during Conservative period,

Viewed objectively, the Conservatives did a fairly good job keeping the public finances under control. According to the Organization of Economic Cooperation and Development, the UK's ratio of debt to gross domestic product rose from 54.3% in 1979 to 61.3% in 1996 and is expected to be 60.8% in 1997. By contrast, the ratio for the OECD countries as a whole climbed over the same period from 39.7% to 72.6% and for the European Union from 40.3% to 72.6%. ("Debt" is to be understood here as the general government's gross financial liabilities. See Annex Table 34 in the OECD's *Economic Outlook.*)

but this partly due to squeeze on capital spending and privatization

New Labour's doubts about the last Government's record relate not to the bare statistics, but to the broader political meaning of the policies pursued by the Conservatives. As explained in the August 1995 issue of this *Monthly Economic Review*, the Conservatives were able to hold down public sector borrowing, and hence the growth of debt, in two ways - by squeezing capital expenditure and by their privatization programme. Different measures of both the annual budget balance and the outstanding stock of debt can be calculated, to adjust for these influences. The Conservatives wanted investment to be carried out in the private sector and assets to be shifted out of the public sector, whereas Labour has a bias against private ownership. Labour therefore prefers the adjusted measures of the deficits and debt, not the original PSBR and gross debt figures.

New Labour has different preferences,

These preferences come through clearly in the latest *Financial Statement and Budget Report*. A concept of the deficit which adjusts for the squeeze on capital expenditure is the "public sector's current balance", as it excludes both capital expenditure and receipts. A comment on p. 10 reads, "Over the last economic cycle, 1985/6 to 1996/7, the public sector current balance averaged a deficit of over 1 1/2% of GDP. Performance thus did not accord with the [golden] rule". Meanwhile a debt measure which adjusts for privatization is the "public sector's net wealth". (Privatization has no effect on this, because the public sector has less assets as well as less debt.) The *FSBR* notes on p. 11, "Public sector net wealth fell from over 65% of GDP in the late 1980s to 14% in 1995...The Government's fiscal framework will ensure this deterioration is halted."

being worried about public sector's net wealth

No immediate crisis, with low PSBR expected in 1998/9, but with three worries

The charts on the next few pages review trends in the UK's public finances. Obviously, there is no immediate crisis, while the next few years are likely to see further declines in the PSBR. The PSBR is expected to drop to about £5b. in 1998/9. But this owes much to the cyclical buoyancy of the economy and, hence, of tax revenues. Indeed, a note on p. 14 of the *FSBR* states that - on the Treasury's best estimate of the "output gap" (i.e., the divergence between trend and actual output) - the structural budget PSBR deficit in 1996/7 was over 2% of GDP, which is too high. Three further criticisms can be made, each raising concern about the medium-term outlook for the UK's public finances.

i. Presentation of welfare-to-work costs is unconvincing

First, the Budget documents are complicated by a distinction between, on the one side, the underlying position and, on the other, the combined effect of the windfall tax and the welfare-to-work programme. The underlying position is intended to be the same as under the Conservatives, while the welfare-to-work programme is financed by the windfall tax. But the welfare-to-work programme could be permanent, whereas the windfall tax is not to be repeated. The relevant numbers are laid out in Table 2.1 on "Financing Welfare to Work", with the sum of expenditure on welfare-to-work in the five years to 1997/02 equal to the £5.2b. receipts from the windfall tax in 1997/8 and 1998/9. But is the real world such a neat and tidy place?

ii. Public expenditure *has been increased*

Secondly, despite his promises, Mr. Brown has not kept expenditure within the totals set by the previous Government. Three large new spending initiatives were announced - welfare-to-work, the release of local authority money for more housebuilding and a £2.2b. allocation from the 1998/9 reserve for health and education. Public expenditure next year could well be 1% of GDP higher than it would have been under the Conservatives.

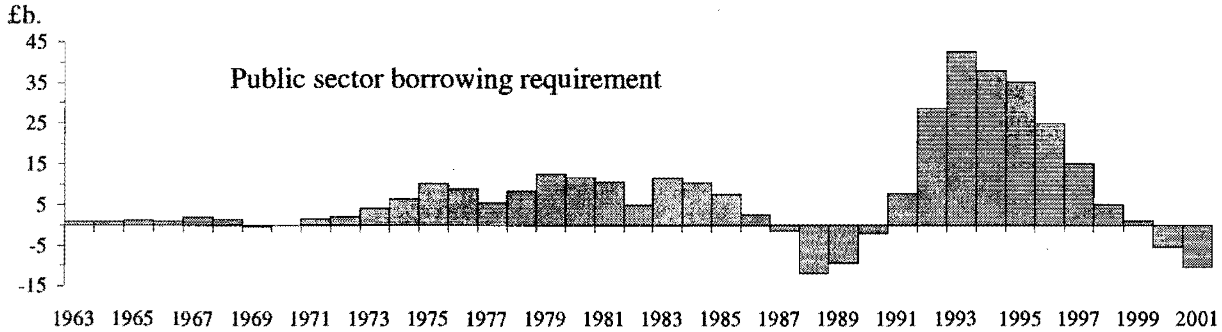
iii. Mr. Brown's new debt rule is less rigorous than Mr. Clarke's old rule

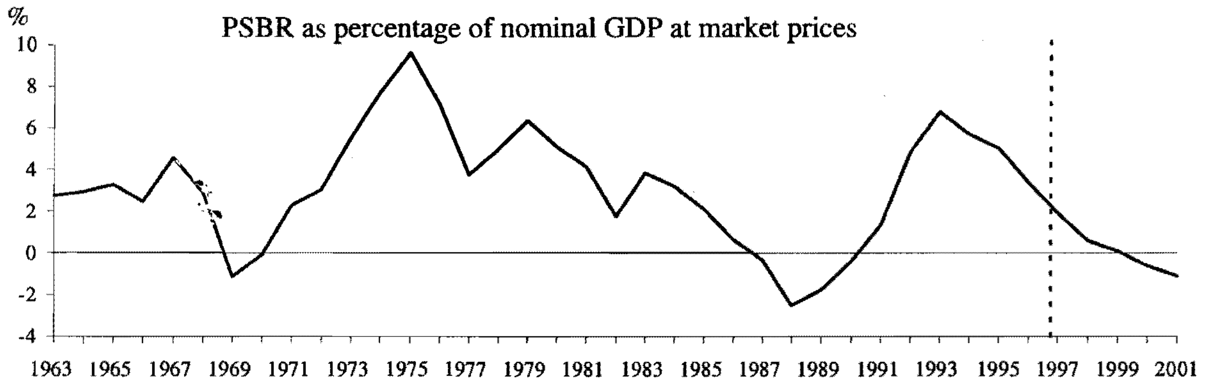
Thirdly, if all the tiresome rhetoric about prudence and stability is cut out, the substance of the Budget is towards the relaxation of restraint. For example, the new rule that the debt/GDP ratio is to be stable over the cycle is less tight than Mr. Clarke's rule that the budget should be balanced over the cycle. (The effect of balancing the budget over the cycle would be to reduce the debt/GDP ratio, because the debt would not change while GDP would have increased.) Perhaps most important of all, the Government's mood is to spend more where it is sensible and prudent, not to cut expenditure wherever possible.

The next five years may see stability, or even a fall, in the ratio of debt to GDP. But the next trough in the debt/GDP ratio will be much higher than the previous trough of 35% in 1990/91. In that sense the public sector's finances are not wholly satisfactory.

The public sector borrowing requirement since 1963

Is a surplus likely to be achieved in this cycle?





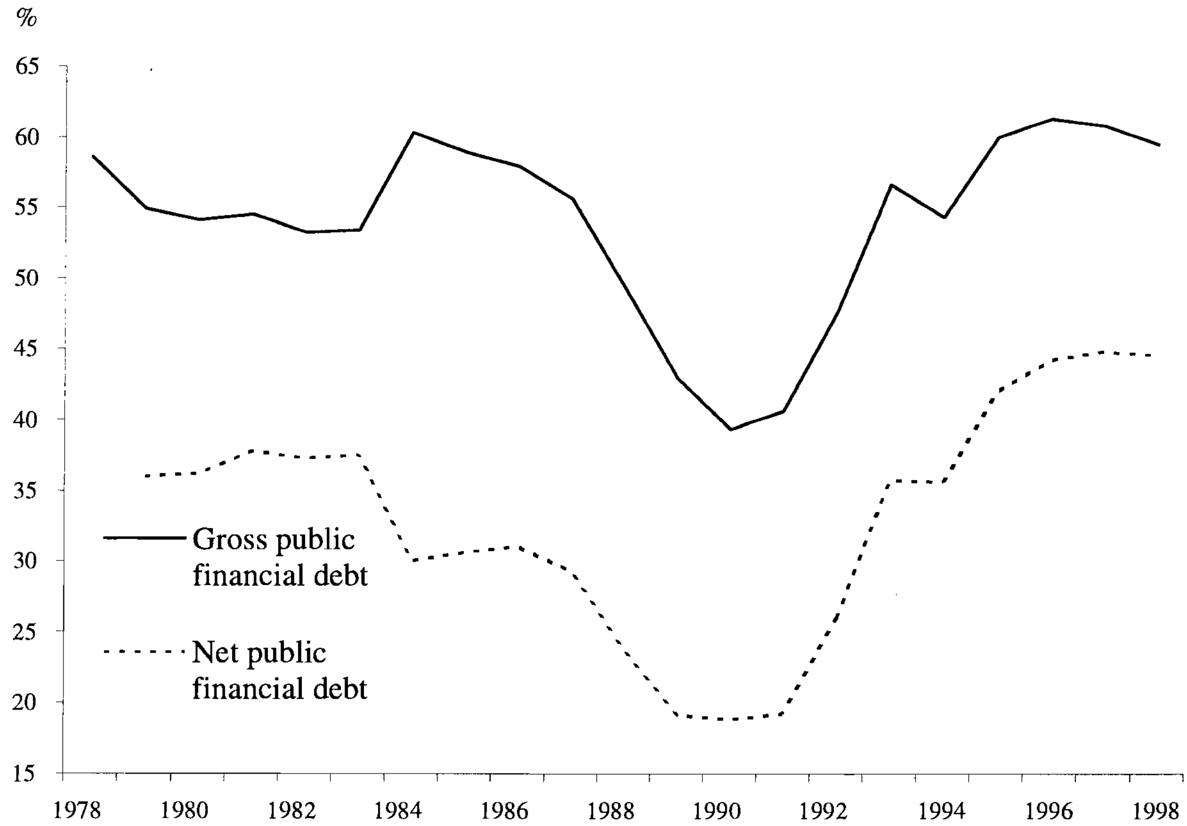
Source: Office for National Statistics, Financial Statistics *and 1997* Financial Statement and Budget Report (FSBR)

PSBR is on a calendar, not financial year basis, for easier comparison with GDP. Numbers after 1996 reflect official intentions in 1997 FSBR, *but with adjustments to bring them to calendar year basis. The data for 1999 and beyond are based on the central projection for public spending growth in the 1997* FSBR. *This assumes that the control total will grow by 1½% a year in real terms.*

The *Financial Statement and Budget Report* with the 1980 Budget included a section on the Medium-Term Financial Strategy, with a multi-year forward projection of public sector borrowing and money supply growth. Every subsequent *FSBR* under the Conservatives had such a section, although the projections changed considerably over the years. But Mr. Gordon Brown has scrapped the MTFS. A number of extra spending initiatives were announced in the Budget, while the new principle of stabilizing the debt/GDP ratio over the business cycle is less tight than the Conservatives' principle of balancing the budget over the same period. The present Government seems unlikely to run a fiscal surplus during the next few years, even though the economy will probably be operating above its trend level.

Public debt as % of GDP, 1978-98

Debt/income ratio has to fall in upturn for long-run stability



Source: OECD Economic Outlook

Chart shows general government gross and net financial liabilities as a percentage of nominal GDP at market prices. The data comes from OECD publications and uses OECD projections for 1997 and 1998

The ratio of public debt to GDP fell sharply in the 1970s, but the explanation was not a benign sequence of budget surpluses, but the malign erosion of the real value of the debt by rapid inflation. Since 1981 investors in gilt-edged securities have consistently required a yield well above inflation. The Government has therefore had to keep a tight rein on its budget position to prevent debt rising relative to GDP. Strictly, to stablize the debt/GDP ratio it needs over the cycle to run a primary surplus (i.e., excess of revenue over non-interest expenditure) which averages about 2% of GDP. The primary surplus is about 2% of GDP at present, which appears satisfactory. But a much higher surplus is needed during the next few years of above-trend economic activity to offset the deficits and the huge jump in debt in the early 1990s.

International comparisons of public debt, 1978-96

UK not as virtuous as it seems

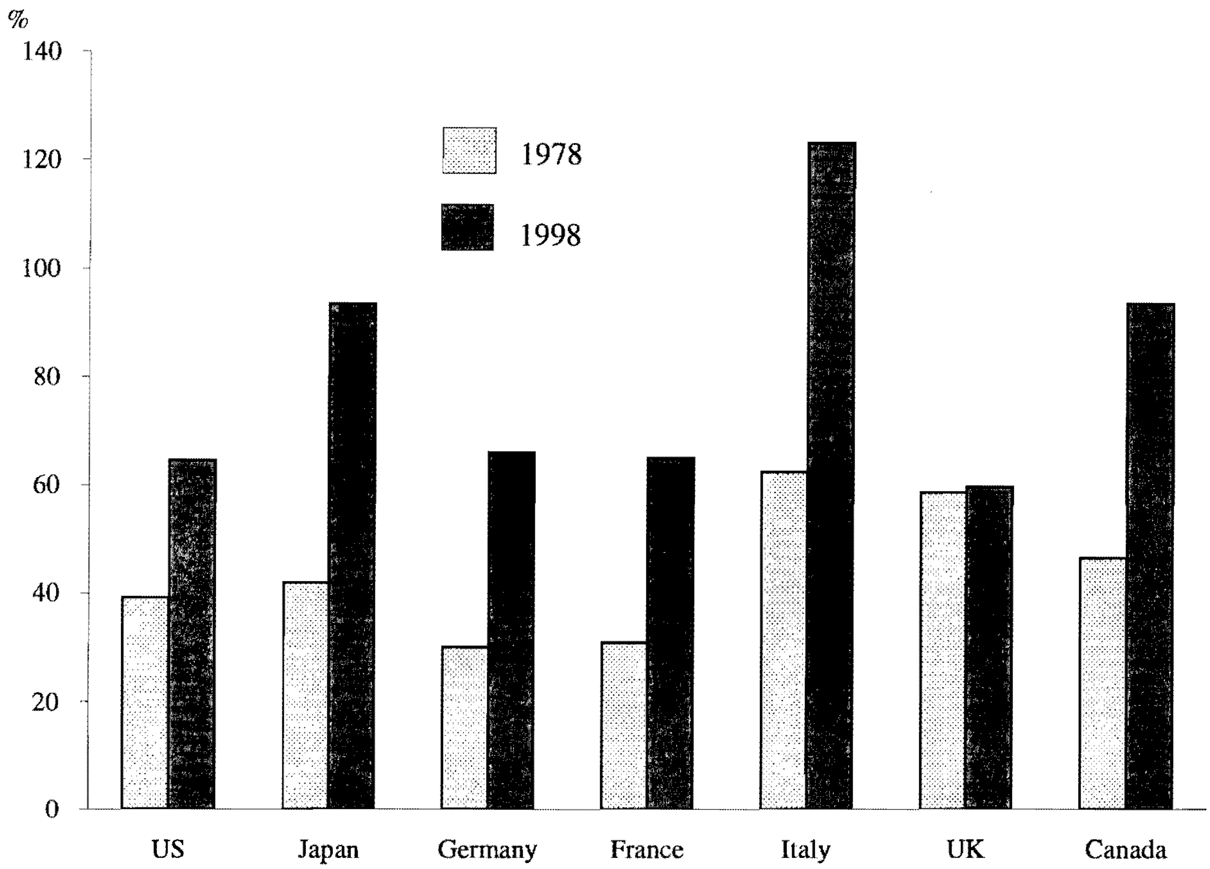
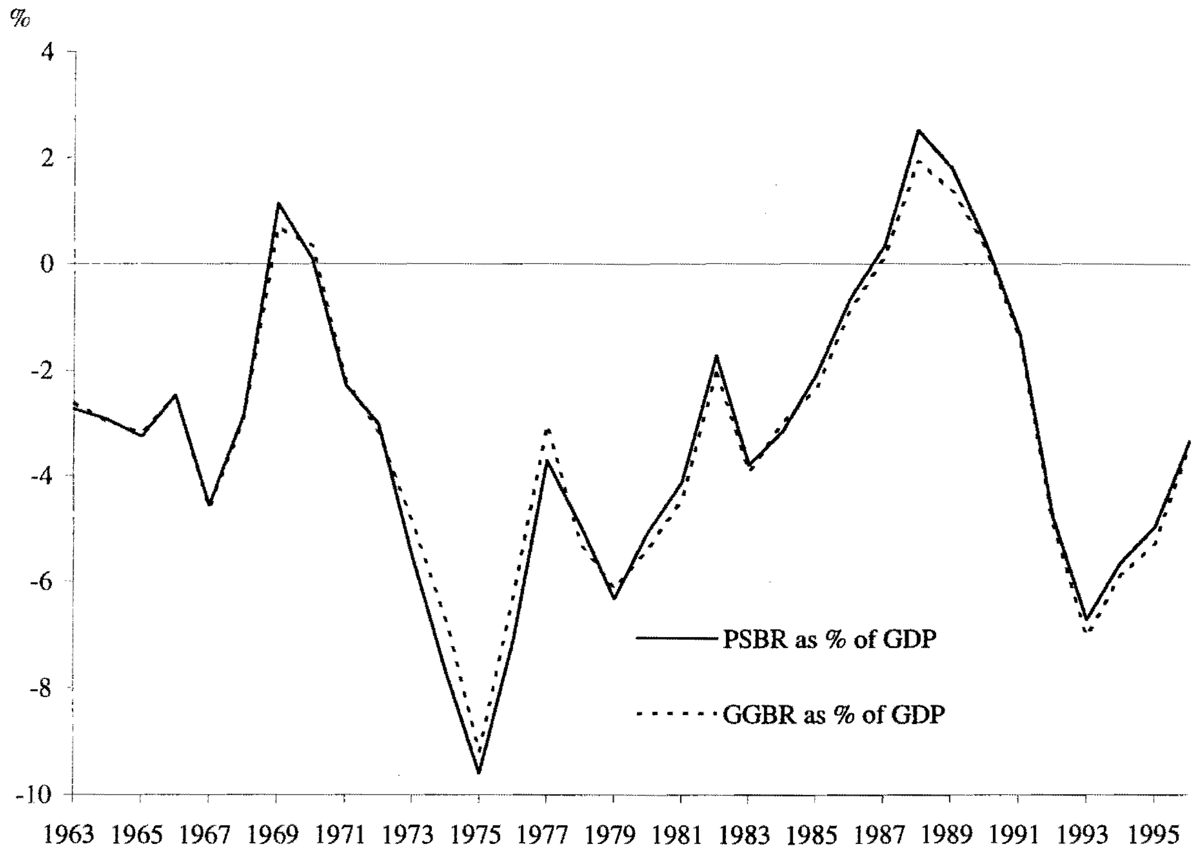


Chart is based on OECD data of gross financial liabilities of general government as a % of nominal GDP at market prices contained in the June 1997 OECD Economic Outlook. *The data for 1998 is based on OECD projections.*

The chart appears to endorse the Conservatives' management of the UK's public finances. Uniquely in the G7 group of countries, the UK prevented public debt rising relative to GDP in the two decades from 1978. Whereas in 1978 the UK had the second highest ratio of public debt to GDP in the G7, today it has the lowest. However, the Conservatives' record can be questioned. The UK benefited in the early and mid-1980s from North Sea oil revenues, and over the whole period it completed the most extensive programme of privatization and state sector asset sales in the industrial world. Without these developments, the UK would have seen a large rise in the ratio of debt to GDP. On the other hand, in one respect the chart understates the excellence of the UK's relative position. It makes no allowance for unfunded state pension liabilities, which are far higher in other countries than in the UK.

Long-run deterioration in the UK's public finances?

1. The public sector as a whole compared with general government

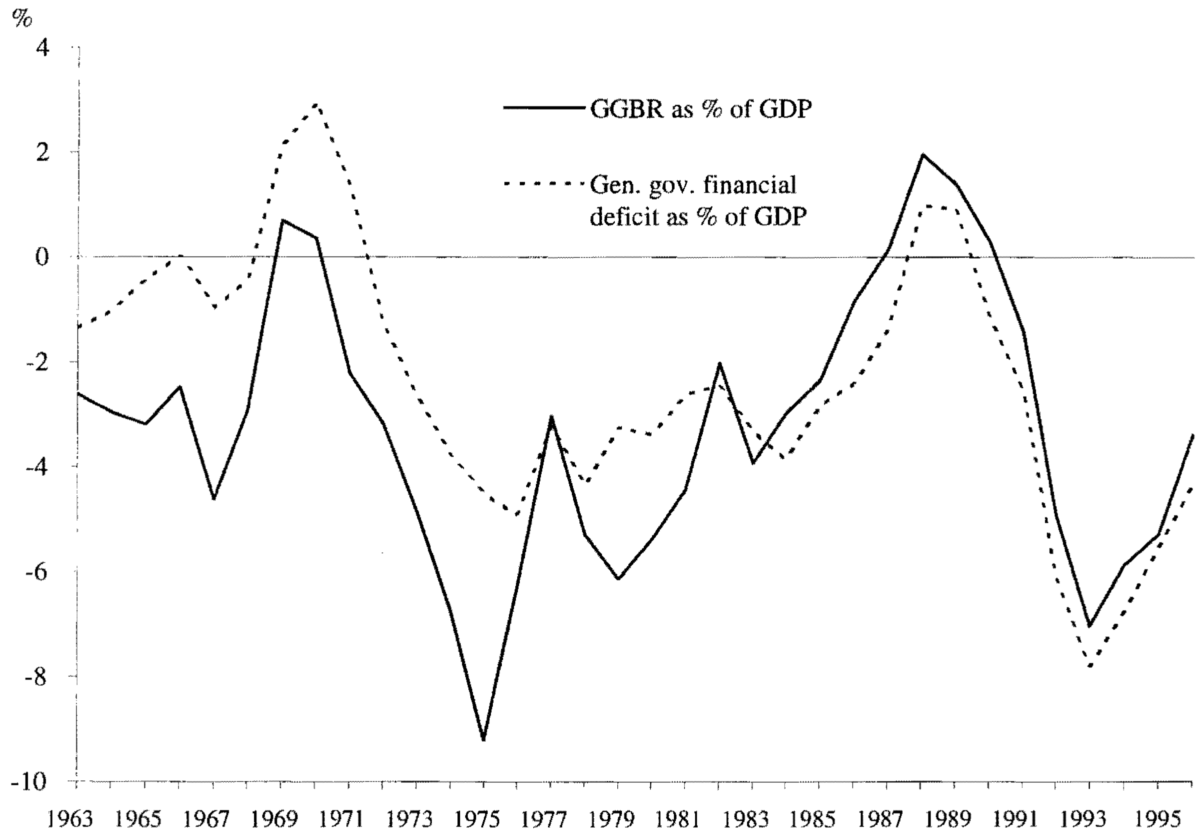


Source: Office for National Statistics

Chart compares PSBR with the general government borrowing requirement (GGBR), both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

As is well-known, the state of the public finances is highly cyclical. To judge long-run trends, the correct procedure is to compare the level of the budget deficit at comparable points in the business cycle. Output today is rising faster than trend and has probably returned to its trend level. The last comparable point in the cycle was in 1986. The chart shows the PSBR/GDP was somewhat higher last year than in the mid-1980s. The latest *FSBR* estimates the PSBR/GDP will be 1 1/4% in 1997/8, compared with 1% in 1986/7. If there has been some slippage on the PSBR, the change is not that great. (However, on other measures of the budget position - such as the general government's financial deficit or current account - the deterioration compared with the mid-1980s is very marked. See p. 9 opposite and p. 10.) The tax/GDP ratio has dropped since 1986/7, partly because of the loss of North Sea revenues.

2. General government's borrowing compared with its financial deficit



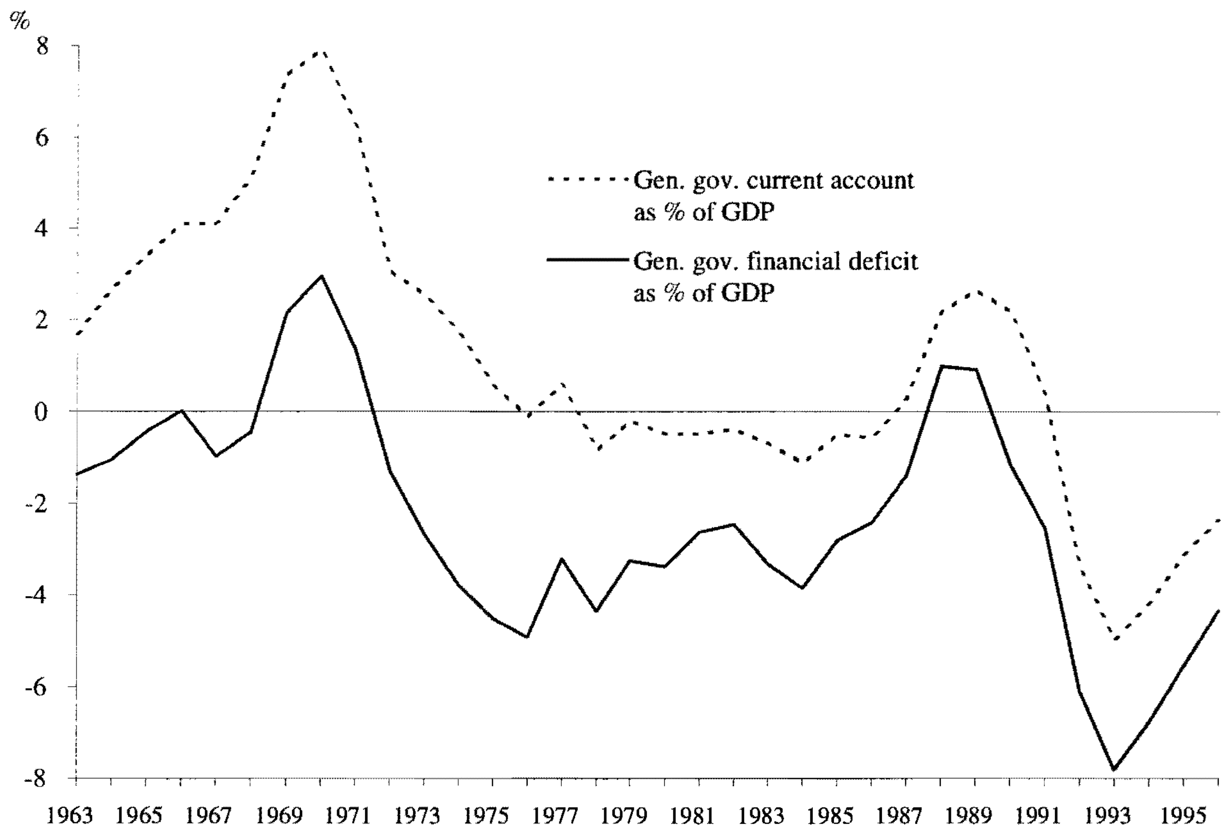
Source: Office for National Statistics

Chart compares general government borrowing requirement (GGBR) with its financial deficit, both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

Privatisation proceeds reduced government borrowing under the Conservatives, but they did not reduce the financial deficit. (The financial deficit is the net change in financial liabilities.As privatisation reduces the Government's assets as well as its debts, the net effect is nil.) The chart shows that, expressed as a ratio of GDP, the general government financial deficit last year was similar to its level in the years from the mid-1970s to the early 1980s, usually regarded as a period of high deficits and fiscal irresponsibility. In the latest *FSBR* the GGFD is given as £30.4b. in 1996/7 and estimated at £11.2b. in 1997/8. This welcome fall reflects cuts in capital spending implemented by the Conservatives in their final year. The latest *FSBR* notes the capital spending will rise in 1998/9 because of the release of local authorities' council house receipts.

Long-run deterioration in the UK's public finances?

3. General government's financial deficit compared with its current account

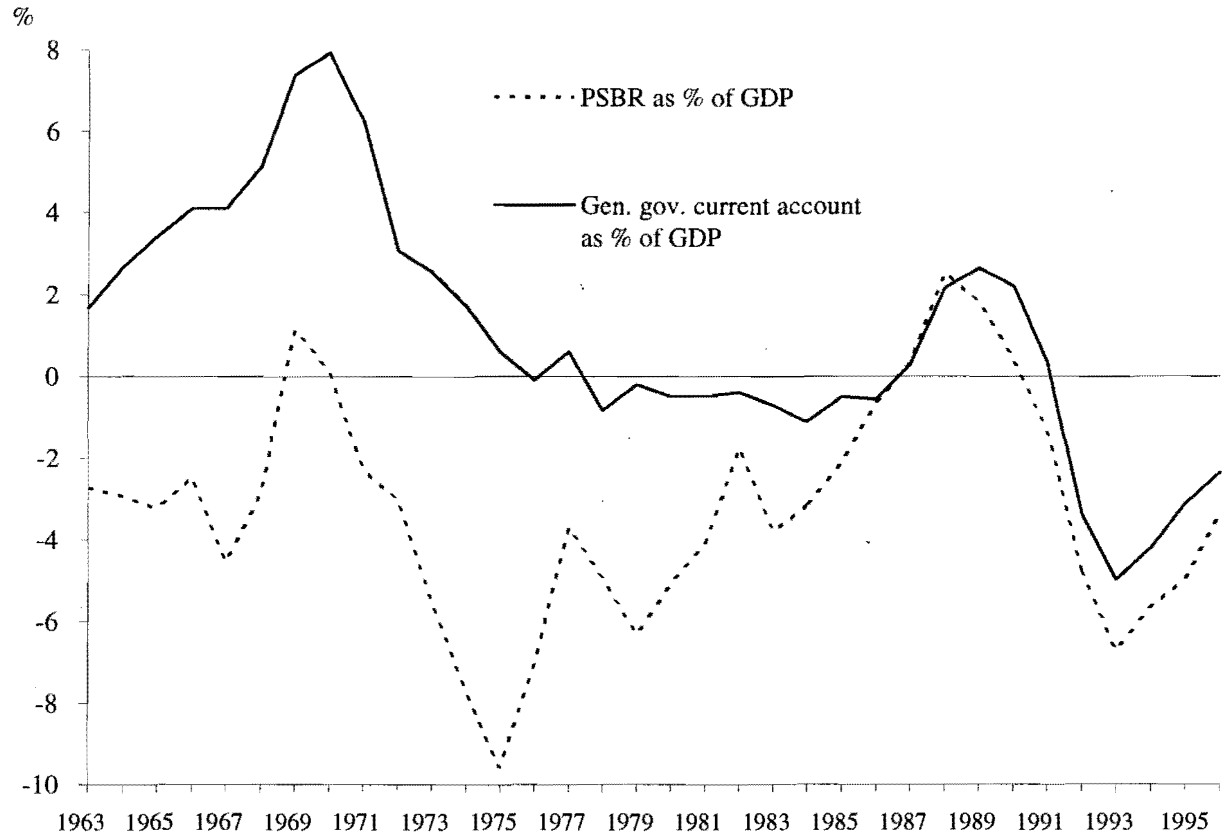


Source: Office for National Statisitcs

Chart compares general government financial deficit with general government current account, both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

This chart shows the general government current account, which is not reduced by cuts in capital expenditure, and is the most alarming representation of the UK's public finances. The GGCA was still in deficit last year, to the extent of 2% of GDP, and this deficit was larger than during the period of financial turmoil in the 1970s. The GGCA is in fact the deficit concept to which the golden rule applies. In the words of the latest *FSBR*, "The 'golden rule' is met when the current balance is zero or positive, and the public sector borrows only to finance its investment." It continues, "the current balance, which was in deficit by 2 3/4% of GDP in 1996/7, will be slightly in surplus by 1998/9." Logically, Mr. Brown should change the emphasis to the GGCA in the monthly press release on the public finances, as well as in key policy statements.

4. The PSBR compared with the general government's current account position



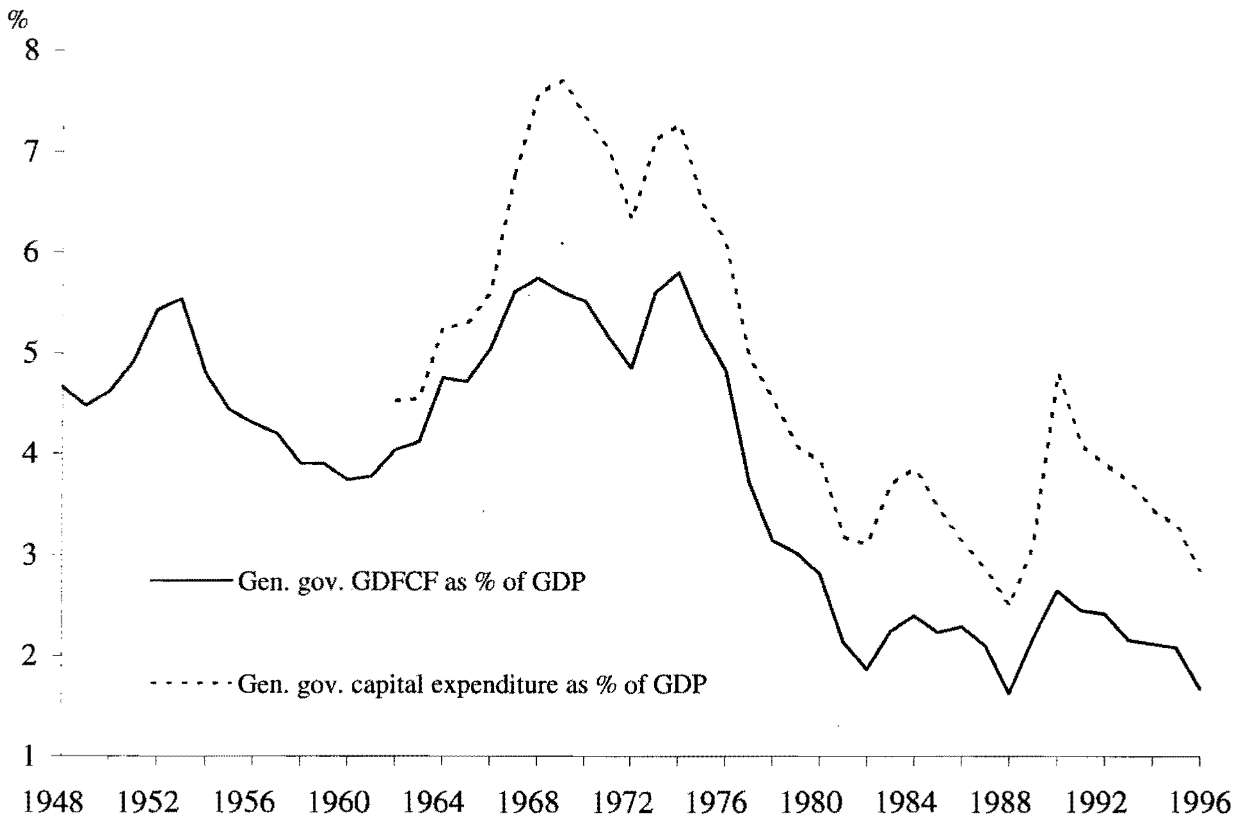
Source: Office for National Statistics

Chart compares general government current account with PSBR, both expressed as a % of nominal GDP at market prices. A minus sign indicates a deficit.

This chart contrasts the PSBR, the principal measure of fiscal policy over the last 25 years, with the GGCA, which may become the focus if the golden rule sticks. The contrast is dramatic. The PSBR/GDP ratio deteriorated in the recession of the early 1990s, but never returned to the levels of the 1970s. By contrast, the deficit on the GGCA was far higher, relative to GDP, in the early 1990s than in the 1970s and it was still higher even in 1996. With his commitment to the golden rule, Mr. Brown has pledged to bring the GGCA back to balance, but his definitions and arithmetic need to be monitored critically. According to the latest *FSBR*, the GGCA is to be in deficit by £8.0b. in 1997/8 and to return to surplus in 1998/9, if the windfall tax and associated expenditure are excluded from the calculation. If they are included, the GGCA deficit in 1997/8 is estimated at £5.5b., less than 1% of GDP.

Trends in the Government's capital spending

Will New Labour increase public sector capital expenditure?



Source: Office for National Statistics

Chart shows the ratio of general government GDFCF and capital expenditure to nominal GDP at factor cost.

As noted on p. 7, one reason for the UK's excellent standing in the international league table of public debt is that public sector capital expenditure has been squeezed in the last 20 years. The chart shows that the squeeze began not with the Conservatives, but at the end of the last Labour Government. It was reversed in the late 1980s, but then resumed when the PSBR ran out of control in the early 1990s. Part of the explanation for the fluctuations in capital spending may be that big projects seem affordable when the public finances are in small deficit or surplus, and so they are initiated when the economy is operating at an above-trend level. (This is perverse, being the opposite of Keynesian fine-tuning.) The present Government may be following the traditional pattern, with its announcements of more spending on council houses and school building just as the economy is on the brink of over-heating.