Economics

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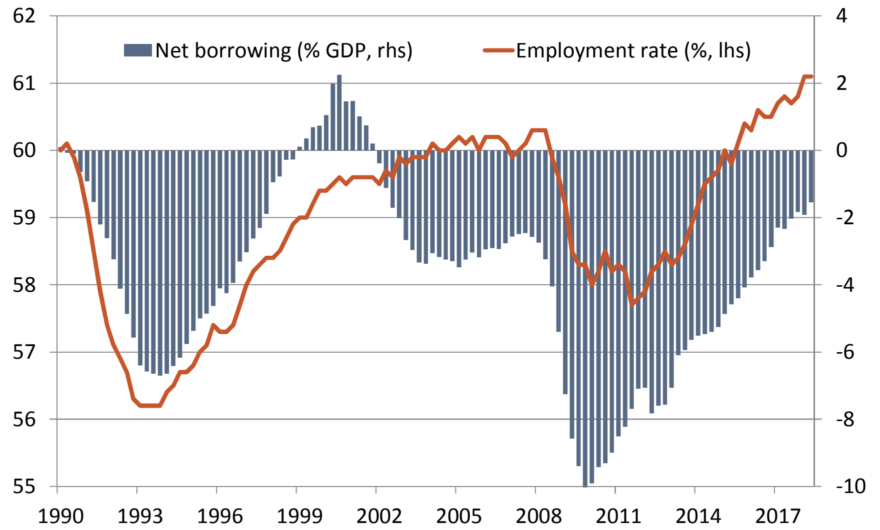
Back to the safe zone: UK fiscal policy

Getting the deficit down – progress yes, but still paying the price for past excesses



Quarterly data. Source: Office of National Statistics. Borrowing data show four-quarter rolling average.

- **Fiscal discipline matters:** When the Labour Party entered office in 1997, UK public finances were on an even keel. Net borrowing as a percentage of GDP was tracking employment over the cycle. That is how it should be. With high employment the UK enjoyed a surplus of nearly 2% of GDP in 1999. Within three years, then-Chancellor Gordon Brown worked up a c3% deficit despite still rising employment. Instead of making the most of the good times and building up defences against a crisis, Brown continued to borrow and spend heavily through the mid-2000s.
- **The UK has paid the price for Brown's profligacy:** When the UK entered recession in 2008, it had little headroom for a major stimulus. Brown tried to double-down with a modest fiscal stimulus (c£25bn) in 2008/09, but this was small-fry relative to the huge hit to demand from the crisis. After the bank bailouts and pre-crisis indiscipline, the UK government was skint. By the time unemployment had risen above 8% in 2009 and the economy had shrunk by c6%, net borrowing (percentage of GDP) had surged to 10% in 2009. After losing the 2010 election, a Labour Treasury Minister left the new Conservative-led government a note. It read: "I'm afraid there is no money." Indeed.
- **The era of austerity:** The aggressiveness of UK austerity since 2010 is often exaggerated in the media. Relative to the Eurozone periphery, where bailouts during the financial and euro crises only came with very strict conditionality of tough fiscal discipline, the UK's fiscal rebalancing has been positively gradual. Since 2010, the UK has reduced its structural deficit by a steady 0.7ppt per year. Not a walk in the park. Not quite wrenching either.
- **Everything comes at a price:** For the most part, economic policy offers trade-offs rather than solutions. Austerity is over in major parts of the Eurozone – government debt to GDP increased by just 20ppt during the tough years and has started to fall recently. However, the Eurozone is still some way off from full employment with an unemployment rate of now 8.3%. The more gradual rebalancing in the UK has allowed unemployment to fall to a record low of 4.0%. Unemployment would be higher now had the UK rebalanced its fiscal accounts more aggressively. But gradualism has come at a price. Public sector debt to GDP has increased by nearly 50ppt since 2008 (currently c90% of GDP).
- **Heading back to the safe zone:** Despite a modest slowdown since the Brexit vote, the UK continues to make nice progress on the fiscal front. Thanks to healthy growth in tax receipts and weaker-than-projected spending, recent fiscal data show steady improvement. The deficit should come in below 2% this year – the lowest since 2001. If the Conservatives remain disciplined in their stewardship of public finances, public debt as a percentage of GDP can begin to fall quickly in the coming years. Germany is way ahead on this count. Although the UK should be in better shape to lean against the next downturn, the risks to this outlook are obvious: 1) a hard Brexit (20% risk); 2) and/or a Labour government led by far-left Jeremy Corbyn (25% risk). The first would deliver a major economic shock and set progress back. The second would return the UK to the Brown days, or worse. Better to avoid both risks.

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