Commentary

The politics of the deficit

Rachel Reeves

Since its formation in May, the Coalition government has made the reduction of the budget deficit a key priority. It started in June by taking a £6bn axe to programmes including the Future Jobs Fund, Regional Development Agencies, the loan to Sheffield Forgemasters, free school meals extensions and Building Schools for the Future, to name but a few. This was followed by an 'emergency budget' of regressive tax increases and welfare cuts, and will be followed in the autumn by a Comprehensive Spending Review which might slash departmental budgets by up to 40 per cent.

While it is right to make reducing the deficit a priority, there is a clear choice in terms of how to achieve it. This government have chosen to pursue an approach that is damaging to growth, highly regressive and fundamentally unfair. They have cobbled together various justifications – the 'out-of-control' spending of the last Labour government and the mythical 'Greek defence', for example. But these arguments simply do not stack up. And because the justifications do not hold up to scrutiny, it has become increasingly clear that the underlying motivations are not economic, but are instead political and ideological.

Labour's legacy

It goes without saying that the financial crisis and recession have pushed up government borrowing and debt. But, before we go any further, it is important to consider the facts about government finances in the UK.

Analysis by the Institute of Fiscal Studies has concluded that on the eve of the financial crisis '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 per cent in 1996–97 to 41.1 per cent in 2007–08, over the same period revenues grew by 2.3 percentage points, meaning that total borrowing fell by 1.0 percentage point over this period. With more being spent on investment in 2007–08 than in 1996–97, the current budget strengthened even more – from a deficit of 2.7 per cent of national income in 1996–97 to a deficit of just 0.3 per cent of national income in 2007–08. Meanwhile, public sector net debt fell from 42.5 per cent of national income to 36.5 per cent, as the UK economy grew faster than the accumulation of new borrowing. (Chote et al, 2010)

Hardly the statistics of a government whose spending is 'out of control'.

The current focus is on the size of the budget deficit, which is forecast to peak this year at 11 per cent. There is no denying that this is high, by comparison both historically and relative to other OECD countries. But let us look at the structural component. This is the component of the deficit that gives an indication of the deficit that would exist if the economy is at 'trend' growth, therefore stripping out the cyclical effects on the economy. Current estimates suggest a structural deficit in the region of 7.2 per cent in 2010-11 which, as in the case of the budget deficit as a whole, is relatively high. Yet, while the government claim that this is due to Labour's 'reckless' spending, the truth is that this structural component was estimated to be 2.5 per cent in 2008, and going into the recession the UK had the second lowest debt-to-GDP ratio in the G7.

The budget deficit that we are tackling now is predominantly the result of the financial crisis. In particular, the fall in GDP has, by definition, caused the deficit as a share of GDP to rise. But to bring down the debt and deficit burden requires not a 'slash and burn' approach, but a strategy for growth. If the government rebalances the economy by pursuing a robust growth strategy, we will generate both the jobs we need and the deficit reduction that the government claims is its priority. The government act as if the only way to reduce the structural deficit is through austerity. That is economically false and misleading. The structural component of the deficit is not an independent variable, it is a function of the strength and sustainability of the economy. Get the economy out of recession and you eliminate the cyclical component of the deficit. Deliver a stronger, more durable economy and you can bring down the structural component too.

The 2008-9 recession was the worst, here and globally, in sixty years, and it was predicted by no one – not even Vince Cable! The Labour government responded to the crisis with fiscal stimulus and support for the banks. This, combined with the usual effects on GDP of a recession, meant that the budget deficit rose. But without swift action we simply would not have even the tentative recovery that we see today. This recovery is not guaranteed, and ensuring growth is the key to the reduction of the deficit – an issue that I return to later.

Why the UK is not Greece

Having blamed the high level of the deficit on excessive spending, the Coalition government then used the Greek debt crisis to justify their austerity budget. But the 'Greek defence' used to justify the Liberal Democrats' dramatic U-turn on their view of the timing of cuts just doesn't stack up, and is plain and simple scaremongering. The UK has a more sustainable fiscal position, more policy flexibility and a stronger economy than Greece. Because of this, it is not regarded by financial markets in the way Greece is, despite our government's scare stories.

First, on the sustainability of our fiscal position, a nation's solvency critically depends on the amount of its outstanding debts; this is common sense. And as a percentage of GDP, national debt in the UK in 2009 was 72 per cent while in Greece it was 119 per cent. In other words, the amount of debt the UK bears in relation to the size of its economy is simply much smaller in the UK than Greece. Of course, this fact alone does not give a complete picture, as it is the budget deficit that gives us the all-important information as to which direction the national debt is travelling. But there is no getting away from the fact that the UK is a long way off being close to Greece in terms of its national debt.

On top of a smaller debt burden, the UK is also much better placed to finance its borrowing, because not only does Greece have a higher level of debt, but it has more pressure to continually refinance that debt. The *Financial Times* puts the average UK debt maturity at 13.5 years, which compares with 7.9 years for Greece, 6.4 years for Spain, and 5.4 years for Ireland (Oakley, 2010). And Gillian Tett has noted that 'the UK is a stark outlier: the average maturity of the gilt market is currently fourteen years, longer than almost anywhere else in the world' (Tett, 2010). Further, UK debt is easier to finance because a large proportion, indeed the majority, is held and bought domestically, by pension funds and the like. By contrast, Greece has to find foreign buyers for the majority of its debt – a position that inherently makes the country more at the whim of the global markets. The UK current account deficit is small as a percentage of GDP (around 2 per cent), while that for Greece exceeds 10 per cent. So the overall external financing pressure on Greece is much greater.

Second, from a flexibility of policy response perspective, the UK, unlike Greece, has control of its own financial affairs, with our own currency and a central bank that can set interest rates in the interests of the domestic economy. Since 2007, the pound has depreciated by nearly 25 per cent, making our exports more competitive and offsetting some of the effects of the recession. And the Bank of England has cut interest rates to 0.5 per cent and added a further £200bn into the economy through 'quantitative easing'. Greece has not had – and does not have – these advantages. The previous Labour government were right to keep us out of the Euro and we should not enter for the foreseeable future.

The ability of Greece to reduce its large deficit is further constrained by their ongoing recession. The UK is forecast by the OECD to experience growth of 1.3 per cent and 2.5 per cent in 2010 and 2011 respectively. In Greece, the figures are -3.7 per cent and -2.5 per cent (OECD, 2010). The implication, of course, is that while the UK's deficit will start to fall as a result of increased tax revenues and reduced benefit expenditure as the economy expands, in Greece, the debt crisis is only set to deepen. More generally, Greece also has less discretion over its ability to raise tax revenues. With a low level of tax compliance, raising tax rates has a proportionately low effect on actual revenues. The UK does have some problems with tax avoidance and evasion, and the cuts to HMRC staffing are likely to make compliance worse. But while more could indeed be done, we are no Greece.

Third, the problem of debt in Greece is long-standing – the credit crisis was the final straw, but it was certainly not the cause of the debt crisis there. The UK has not once defaulted on its debt – unlike Greece, who has defaulted five times over the last two hundred years.

Instead of comparing Britain to Greece, this government should be learning the lessons of Japan in the 1990s and the US in the 1930s. Without decisive and swift action to ensure growth, Japan was in and out of recession for over ten years, as the debt-to-GDP ratio increased to almost 200 per cent. And in the US, the Great Depression was allowed to happen because the government was too cautious in terms of its policy response.

The impact on growth

Rather than pursuing policies that threaten to choke off growth as these ill-thought-through cuts will do, the government should acknowledge that the surest way to bring down the deficit is to ensure strong and sustainable growth that results in a new, rebalanced economy. This, along with tax measures and spending restraint, is the third leg of the stool that will bring down the deficit. It is the missing component in this government's economic strategy.

From the start of the financial crisis, Labour took decisive and clear action (including temporarily cutting VAT to boost demand), and it has become increasingly clear that it was this decisive action that brought about the green shoots of recovery (Radeke, 2009). But this recovery is only very fragile, and the risk of a double-dip recession remains. The most recent GDP figures reiterate this point, indicating that without the public spending plans of the Labour government, the UK would already be back in recession (Allen, 2010).

Even the government's own numbers admit this. In May, the government established the Office for Budget Responsibility to provide independent forecasts. The latest version of their forecasts suggest that the policies being pursued by the government will reduce growth when compared to the forecasts without their plans – by 0.1 percentage points in 2010 and 0.3 percentage points in 2011, and will increase unemployment by around 100,000 next year and the following three years (Office for Budget Responsibility, 2010). This is clear proof that our economic future is being put at risk.

But even to achieve this reduced rate of growth, the government is assuming that private spending will replace the public spending that is being removed from the economy. But there are no guarantees that this will happen, and in fact while the private sector is still dealing with the debt they built up in the boom years these forecasts look extremely ambitious. The weakness of private spending will be further compounded by the rise in VAT from 17.5 per cent to 20 per cent, which is likely to further depress demand at a time when it is already restrained.

This government are failing to think long-term and strategically, with no clear coherent vision for tomorrow's economy. What they should be striving to build, with the private sector, is an economy based on our strengths in high-end manufacturing, creative industries and our great university and research traditions (Clifton, Dolphin and Reeves, 2009). This will require investment in skills, apprenticeships, infrastructure, science and technology. It should be regionally and industrially diverse, and it will require a responsible banking sector to provide finance and stability and a supportive government that works with business to realise this vision (see Reeves, 2010b).

But the government are cutting the very measures that would ensure not only growth in the short-term, but economic security in the future too. They are portraying their cuts as eliminating 'waste' where in fact they are risking our future economic prosperity: cuts in funding for Regional Development Agencies; scrapping the Future Jobs Fund which got 200,000 people back to work through the recession; withdrawing industrial support, including a loan to Sheffield Forgemasters to develop high-tech nuclear components. And there seems to be very little evidence to support their decisions. No facts, no consultation. Just the ideology of the small state being pursued by the Tory right and the *Orange Book* Liberals.

Focusing on the abolition of the RDAs for example, a recent Pricewaterhouse Coopers report found that they represent excellent value for money. For every £1 spent by RDAs, £4.50 is gained by the economy as a whole. This rises to more than £8 for the Advantage West Midlands RDA (PricewaterhouseCoopers, 2009). To make cuts in areas of spending that have the most bang for their buck, and those that are focused on securing the nation's long-term economic future, is nothing short of madness. And most worryingly, there is no method to their madness – or to state it another way, no evidence whatsoever. The government consistently cite 'affordability' as the reason. Yes, we must be frugal in order to reduce the deficit, but surely it is in times of frugality when value for money becomes the absolutely critical decision factor? To scrap RDAs that are highly successful when we should be aiming to strengthen our local economies risks our future prosperity because of political hostility to regional policy.

The impact on equality

But this is not the only significant problem with the budget. As well as weakening the recovery and risking double-dip recession, the budget is also highly regressive, hitting the poorest hardest while asking for very little from those at the top. This has been quite clearly and independently demonstrated by figures from the Institute of Fiscal Studies, which showed that the budget will cost poorer households more than four times more as much as the richest ones as a proportion of their income (Browne and Levell, 2010) – and that is even before counting the swingeing cuts to public services that will inevitably come from this government in October's Comprehensive Spending Review (Horton and Reed, 2010).

The measures in the June budget will, by 2014-15, reduce the income of the bottom 10 per cent of the population by 4.3 per cent, that is £8 a week. Given that the bottom 10 per cent of the income distribution, on an average of £190 a week, already struggle to make ends meet this reduction in incomes will hit families hard and plunge more children in to poverty. For those fortunate enough to be in the top 10 per cent of the income distribution, incomes will fall by a mere 0.9 per cent, or £13 a week. On incomes averaging £1,600 a week this is likely to be more than manageable.

Moreover, a recent paper published by the TUC and UNISON highlighted the fact that estimates to date only take account of tax and benefit changes, and that once the impact of spending cuts are included, the picture of just how regressive this budget is becomes even more stark. The report finds that,

> assuming the cuts outlined by the government fall evenly across non-ringfenced departments, when the impact of the Government's cuts is combined with the Government's own analysis of the budget's tax and benefit changes, the overall combined average annual loss in income and services for the poorest tenth of households is £1,514, equivalent to 21.7 per cent of their household income. For the richest tenth of households, the annual loss in income and services is £2,685, equivalent to just 3.6 per cent of their household income. (Horton and Reed, 2010)

There are choices facing this government about how to reduce the deficit, and the previous government demonstrated an alternative, fairer way to make the adjustment. In March 2010, Alistair Darling introduced a budget that included £19bn of tax increases and £38bn of spending cuts. Of those tax increases, the bottom 10 per cent of the income distribution saw absolutely no change in their weekly income. Those in the top 10 per cent saw their incomes fall by 6.8 per cent.

While Labour introduced a new top rate of tax of 50 per cent and a tax on bankers' bonuses of 50 per cent, ensuring that those with the broadest shoulders contributed most to bringing down the deficit, the priority of the new government was an increase in VAT, which cuts the income of the poorest by 2.25 per cent, while only reducing the income of the richest by 1 per cent and welfare cuts that will plunge more families into poverty.

The 'Red Book' published by the government shows exactly where the pain falls and priority rests. Benefit cuts will save £11bn by 2014-15; the regressive VAT increase will save £13bn; and the bank levy will raise £2.4bn. It is grossly unfair that the banks and those at the top of the financial institutions, which are largely responsible for the recession, have been made to pay just a fraction of what those at the bottom are asked to contribute. Doubly ironic, then, that banking analysts are suggesting that the cut in capital gains tax could cancel out the banking levy, leaving some banks better off than they would have been before the budget (Murphy and Burgess, 2010). Moreover, hedge funds and other financial institutions will not even be covered by this banking levy, so they can continue to go about their business paying no more tax than they did before.

Conclusion

The budget deficit in the UK needs reducing, but there are choices about how to do this. There has been a lot of misinformation, exaggeration and scaremongering on the part of the government – about the size of the deficit and stoking fears that without far-reaching cuts, the UK will follow the path of Greece. Yet the biggest risk we face is that of a double-dip recession or a lost decade of growth as experienced in Japan in the 1990s. The economy is only in recovery mode because of the decisive actions to boost demand from the previous Labour government and through co-ordinated global action.

What we need instead is twofold. First, we need a strategy to get the economy going again – and by more than the 1 to 1.5 per cent that is forecast for this year. This requires a government that actively intervenes: it means investment in infrastructure; apprenticeships; long-term commitment to renewable energy; tax incentives for small and innovative businesses; a graduate tax; and much greater demands on the banks to support the jobs and industries of the future.

Second, Labour need to provide an alternative to the regressive policies being prioritised by the Conservatives and their Lib Dem accomplices. The banks and those earning more than £100,000 could quite easily contribute a little bit more – and unless they do, inequality and poverty will inevitably soar in the months and years ahead.

We have a choice about how to tackle the deficit. The government's choice has been ideologically, and not economically, driven. In a drive to roll back the state, this government is putting our economic future, in both the short and the long term, in jeopardy. And worse than that, they are pursuing highly regressive measures that will hit the poorest people in society the hardest, making them even worse off and further and deliberately increasing the gap between the rich and poor. That has been their choice for this country.

Rachel Reeves was elected Labour MP for Leeds West in May.

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