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Mythbusters

from **nef** and the Tax Justice Network

"Excessive government borrowing got us into this mess"

Charlie Cooper and Simon Wren-Lewis

The Coalition's austerity narrative rests on a tale of supposed overborrowing by a profligate previous government.

In this Mythbuster, Charlie Cooper from the Independent and Simon Wren-Lewis from the University of Oxford point out that the last government did not borrow excessively and remind us of the true cause of the recession: the banking crisis.

The myth

In these grey days of continued economic stagnation, there is a fun game you can play to fend off the gloom. The game is called "Labour mess bingo". The way you play is to watch the news or listen to the radio and every time you hear a Coalition politician say something about "clearing up the economic mess left by the last government" you score a point.

If you'd been playing since 2010, when the Coalition came to power, you could have scored thousands by now. The central plank of the Government's austerity narrative – the story that they have told the British people about who they are and why they were elected – has been that of the Coalition broom sweeping up the Labour mess, to borrow Boris Johnson's memorable image[1].

It is a compelling narrative and it makes sense in an easily understood, homespun way: "the other lot were very well-meaning, but they borrowed too much and spent all the money, so we're going to have to cut back." It is a story that, if true, justifies every cut the Government has made since coming to power: cuts to welfare payments; cuts to the NHS; cuts to libraries; cuts to universities. It is vitally important to the Government that voters believe this story, because few people would tolerate all those cuts if they didn't believe that they were absolutely necessary.

But is the story true? Is it really as simple as that? If we cast our mind back to the financial crisis of 2007/2008 which plunged Britain and the world into recession, was anyone telling this story? It is more likely that you remember something called a credit crunch, and big banks like Lehman

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Brothers collapsing[2]. Those were the events that made the news, that analysts told us spelt doom for national economies. As the UK got used to new, bleak economic realities in the winter of 2008, you would have been hard-pressed to find anyone saying: "it's government borrowing and overspending what's done it".

In fact, government borrowing did not get us into this mess. As we shall see, the last government did not borrow excessively, whilst the recession was a consequence of overleveraged banks and the collapse of the US housing market. The banks overextended themselves in poorly regulated financial markets, indulging in high-risk lending in the belief that a housing bubble would never burst. Why does this story matter? Because knowing how we got here is the surest way of knowing how to get out again, and if the current Government succeeds in spinning us a false story about how we got here, they will get away with leading us down the path of unnecessary, crippling austerity.

The reality

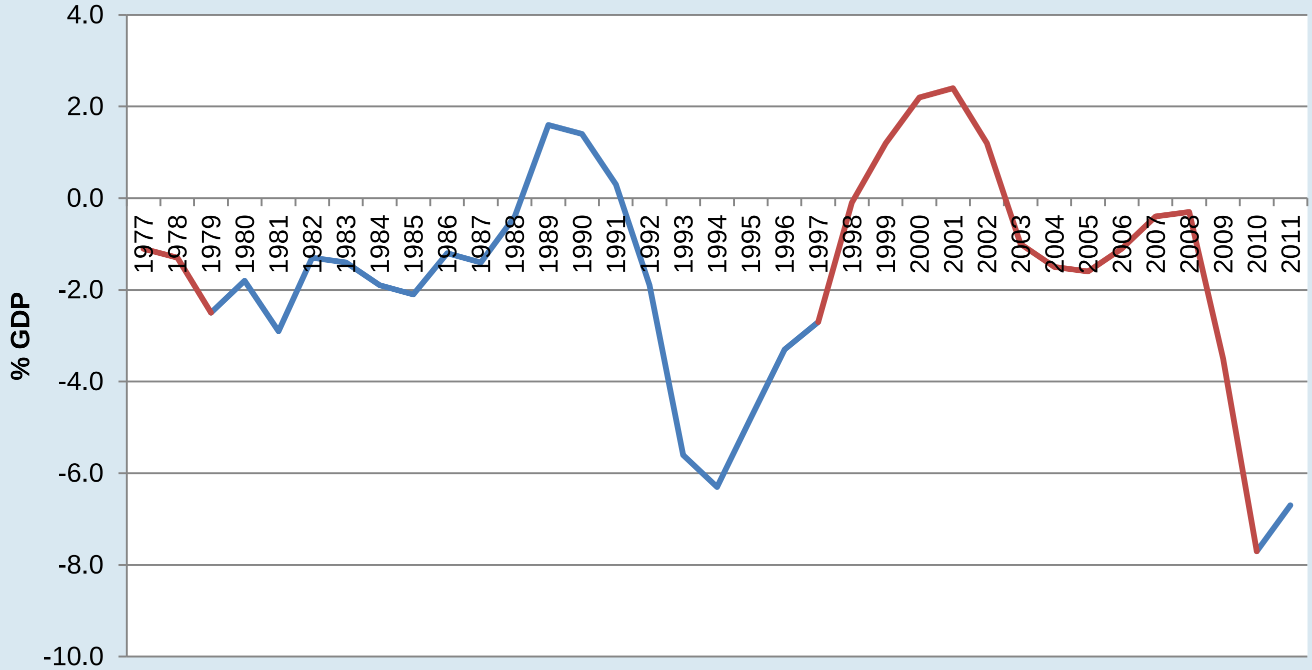
The last government did not borrow excessively

Figure 1 shows the current budget balance over the whole period of the last government. A positive balance (a surplus) means the government received more in taxes than it spent that year. A negative balance (a deficit) means the government spent more than it received, and had to borrow the difference.

We can see the surpluses in the early years of the Labour government, followed by the deficits around 2002/3. In the final years before the recession, we can see how policy tightened, so that just before the onset of the recession the deficit was very small. This is hardly the story of a profligate government creating a crisis. Compare the tiny budget deficit in 2006/7 with the much larger deficits under the Conservative government in 1992-4.

A potential caveat would be if this benign fiscal position was the result of exaggerated tax receipts caused by an economic boom. To assess

Figure 1. Public sector current budget



Source: Bank of England Financial Stability Report, June 2012

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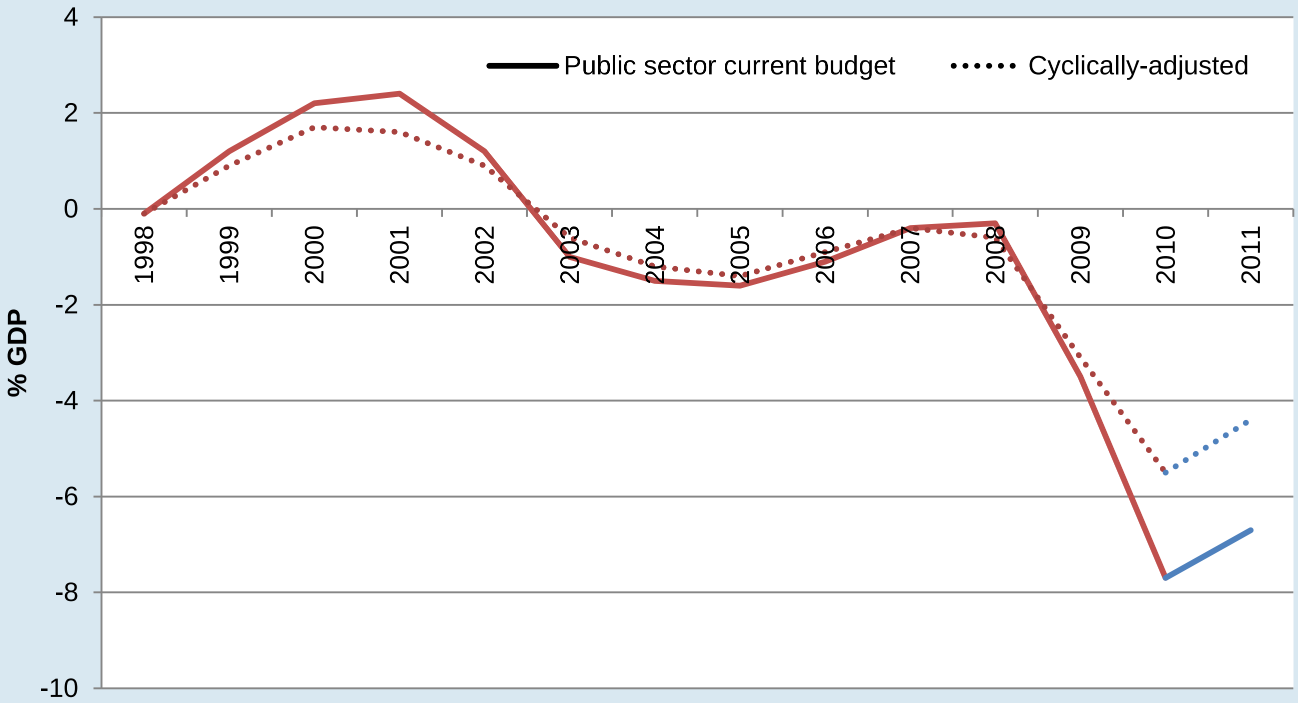
Figure 2. Cyclically-adjusted public sector current budget



Source: Bank of England Financial Stability Report, June 2012

this, economists calculate the 'cyclically adjusted' budget deficit, which is an estimate of what the deficit would be if the economy was on trend. Figure 2 shows the Office for Budget Responsibility's (OBR) estimate of the cyclically adjusted current balance. In 2007/8 it gives very similar numbers to the published deficit, reinforcing the view that the government at the time was not borrowing excessively.

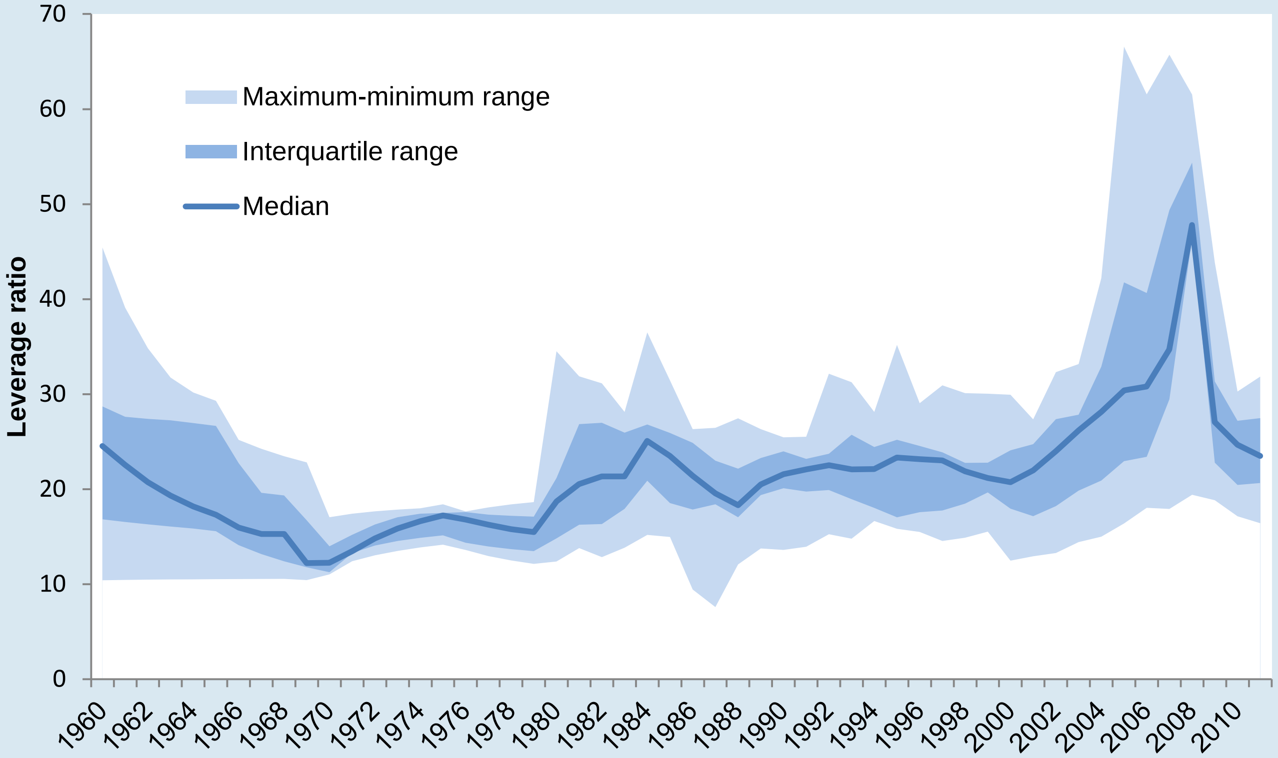
It is true that both the OECD and IMF have recently estimated much larger numbers for the UK cyclically adjusted deficit in 2007/8. Some commentators have used these numbers to try and confirm the narrative that Labour's fiscal policy was irresponsible. However the reason the IMF and OECD calculate these large cyclically adjusted deficits is their current view that the UK economy was experiencing a substantial boom in those years. That was not their view at the time: their 2007 estimates for cyclically adjusted deficits in that year were very similar to the OBR's. Their change of mind just reflects how they calculate trend output, which is strongly influenced by the subs equent recession. As none of these organisations, or indeed almost anyone, was suggesting at the time that the UK economy was experiencing a large boom, it makes no sense to criticise policy based on these numbers.

It was the banking crisis that caused the recession

Figure 3 shows 'leverage' in the UK banking system. Leverage is essentially the ratio of bank lending to its equity. You can think of bank equity as the cushion they can fall back on to absorb any losses on their lending. The larger the leverage, the more risk the bank is taking, and the lower its ability to absorb losses.

The sharp increase in bank leverage from around the beginning of 2000 is both dramatic and historically unprecedented. Banks were lending more and more money, without doing anything to increase their ability to absorb losses. As a result, the banking system in the UK was becoming much more fragile. Similar increases in leverage were taking place in the US.
This was not the only development that was making the banking system both here and abroad more fragile. Banks and other financial institutions were replacing their investments in traditional safe

Figure 3. UK Bank Leverage



Source: OBR, http://bit.ly/13CIVwk

assets, like government debt, by higher yielding assets such as repackaged US mortgages, assets which the credit rating agencies rated AAA. The idea behind these new products was that, because they contained mortgages from many different sources, they spread risk much better than any individual mortgage.

It turned out that these AAA assets contained a large proportion of 'subprime' (meaning unusually risky) mortgages. When housing prices in the US started falling, many of these subprime borrowers defaulted, and the banks that owned these assets had to write down their value. However, their ability to cover such losses had been severely diminished as a result of the increase in leverage that had occurred in the preceding five years. Furthermore, no one was sure which banks were most at risk from these losses, because so many banks had bought them. As a result, the entire financial system froze, and the world was thrown into what some have called "the first truly global recession"[3].

Once the recession began, the budget deficit rose rapidly. It did so for two reasons. First, government expenditure automatically rises when there is a downturn. This is because in a downturn tax receipts tend to fall, while government spending on items like unemployment benefit tends to rise. Exactly the same thing happened to most governments over this period. Second, the Labour government, like the Obama administration in the US, implemented temporary tax cuts and spending increases to help offset the impact of the recession. Both factors were a *result* the recession, and not the cause of it.

The increase in the deficit since the start of the recession has reduced the severity of the downturn

If government borrowing did not *cause* the recession, did it make it worse by rising so much *during* the recession?

As we have already discussed, some of this rise happens automatically. Economists are almost universally convinced that this is a good thing, which is why they call this effect the 'automatic *stabiliser*'. If government tried to cut back this borrowing, it would mean lower spending or higher taxes. This would take income and demand out of the economy, making the recession worse.[4]

The government did also attempt to stimulate the economy, by for example cutting VAT for a year. The other major economy to undertake a similar attempt to moderate the impact of the recession was the United States. There have been many subsequent studies that have tried to assess whether this fiscal stimulus achieved its aim, and almost all suggest it did. There is less analysis of the UK measures, but what there is comes to a similar conclusion. So far from making the recession worse, the large budget deficits that occurred at the end of Labour's period in office helped reduce the size of the economic downturn. It should not be forgotten that in 2010 the UK economy had begun to recover, growing at over 2%, only for austerity and the Euro crisis to create a second recession.

In summary

The overall picture is of a pre-recession Labour government whose borrowing and spending were sustainable and a post-recession Labour government that made more or less the right moves to stave off an even more calamitous downturn.

This is not to say that Gordon Brown et al got everything right. The Labour government presided over an era of irresponsibility in UK banking. However, the numbers show that their approach to spending and borrowing was actually sound. The irony is that Labour gets a lot of criticism for a crime of which they are innocent (spending too much) and hardly any at all for one of which they are guilty (not regulating the banks).

Reckless government borrowing and spending can indeed pitch countries into an economic crisis. But to co-opt this narrative to explain the UK's current situation is economically illiterate.

The striking figures on leverage in the UK banking system show that the ones taking historically unprecedented risks with their finances were not politicians, but banking chiefs.

Excessive government borrowing did not get us into this mess. Falsely believing that it does covers all manners of sins when it comes to government spending cuts. Understanding the real causes behind the recession frees our political conversation. No longer should we be arguing about how deep the cuts should be, but whether we should be cutting at all.

Borrowing more and spending more are not the kamikaze strategies the Government would have us think. More government borrowing and spending now won't make things worse. In fact, the numbers suggest, there's a good chance it's the only thing likely to make things any better.

Endnotes

1 http://www.telegraph.co.uk/news/politics/9596282/Boris-Johnson-If-I-am-a-mop-then-Dave-you-are-a-broom.html

2 http://www.telegraph.co.uk/finance/financialcrisis/6173145/The-collapse-of-Lehman-Brothers.html

3 http://www.guardian.co.uk/business/2009/apr/17/global-recession-policy

4 Across the whole economy, what one individual spends is necessarily what another individual earns. So if someone cuts their spending, it means someone else is earning less, and will in turn cut their spending. This process, whereby an initial fall in spending is magnified across the economy is known as the multiplier effect. With both households and firms reining in their expenditure it is foolish for government to behave likewise.

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