Policy Exchange

research note
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# The cost of inaction:

## Why cutting spending will boost recovery, even in the short term

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- Much of the media commentary around the deficit is informed by a crude and out of date view that higher borrowing will always and everywhere have a stimulatory effect on the economy. In fact a large body of economic evidence has accumulated in recent decades that reducing government borrowing leads to higher growth, at least in situations where borrowing is high.

- As a useful (if not entirely fair) shorthand, we can describe the view that cutting deficits should be expected to reduce growth at least in the short term as the "Keynesian" view, and refer to mechanisms whereby reducing deficits promotes growth even in the short term as "non-Keynesian".

- There are broadly three channels through which these non-Keynesian effects take place: (1) signalling effects concerning the growth rate of the economy; (2) other wealth effects on consumption; and (3) credibility effects on interest rates. All of these channels can operate at once, although they have often been analysed in isolation.

- We argue that, since consolidations based on tax rises often fail, resulting in large falls in output in the short-term and rises (not falls) in deficits, whilst those based on spending cuts are most likely to be successful, it is very important to signal, early and credibly, that the consolidation will be largely spending-cuts-based. One mechanism for doing this is the making of some early spending cuts, right at the beginning of the consolidation programme. Another mechanism is the announcement of modest tax cuts.

- Looking at the interest rate channel, evidence from academic work suggests that a 12% budget deficit should be expected to raise government bonds costs by around 2% from where they might otherwise have been. However, this is likely to be an underestimate, as most academic research has examined deficits that are far smaller than that of today's UK; we might expect the interest rate premium to rise

more steeply the larger the deficit is. Below, we have conducted our own small study to illustrate this point.

- Rises in bonds turns into effects on mortgages. In the UK a rise of 1%-2% in mortgage rates would add some £700-£1400 to the average annual mortgage bill.

- Although there is disagreement about the balance of Keynesian and non-Keynesian effects, there is a consensus in the literature that the non-Keynesian effects become relatively more powerful where budget deficits are larger. Much of the literature finds that the non-Keynesian effects dominate *even at much lower levels of borrowing than the UK is now undertaking*.

## 1) The theory

A large body of economic evidence has accumulated in recent decades that reducing government borrowing can leads to higher growth, in situations where borrowing is high. Being in contrast to conventional Keynesian wisdom, these effects are called non-Keynesian effects.

### The interest rate channel

If the government borrows more, it bids up the cost of credit, in particular pushing up real interest rates. This will typically reduce investment as the availability and affordability of credit to businesses is squeezed. At a low level of government borrowing the effect may be limited, particularly if resource utilization in the private sector is low. However, once government borrowing reaches very high levels, it is likely that the multiplier effect will be negative as private spending is displaced or 'crowded out'.

Further to this, an increase in public debt and in the level of annual borrowing tends to increase the risk premium associated with public debt, again raising interest rates.

These interest rate effects are likely to be relatively more significant when debt levels (or other government obligations such as backing for nationalised bank debt or unfunded public sector pensions) are high or deficits are high and growth low (meaning that the risks that deficits spiral out of control are greater). They are likely to be relatively less significant when there is spare capacity in the economy, investment opportunities are very high, and there is excess appetite for government bonds (e.g. because of deflation).

### Growth and wealth effects

If a change in current fiscal policy is taken to as a signal for future fiscal action, fiscal adjustments may affect aggregate demand in a different way than the conventional Keynesian view would suggest. According to this view, a fiscal contraction that is perceived to imply a permanent reduction in government spending as a share

of GDP will fuel expectations of lower taxes in the future than might otherwise have been feared. If taxes are not going to be as high as feared in the future, the total lifetime post-tax income of households will be higher — that is to say, in a sense they will become wealthier if the economy moves to a credibly lower-tax path even if the economy is going to experience the same overall growth. Since they have become wealthier, households will tend to raise their current consumption, boosting output even in the short-term. This increased demand may create increased short-term opportunities for profits, driving up investment, also.

If spending cuts are efficient, tending to raise the growth rate of the economy, then households will feel wealthier because their pre-tax (as well as post-tax) income will be higher. This too might result in increased demand even in the short-term. And in this case, because the economy will grow more rapidly over the long-term, even longer-term investment projects will become more profitable, driving up investment now.

At very high levels of indebtedness or if deficits are extremely large and appear out of control, even tax increases might promote growth in the short term. That is because if debt and deficit levels are very high, households and businesses might fear that the government will default on its debts, leading to sharp recession and a significant reduction in wealth. In contrast, if a tax-rises-based fiscal retrenchment programme appears to be a credible attempt to reduce public sector borrowing requirements, this fear of default might diminish, leaving households feeling wealthier and businesses more confident.

However, raising taxes will have many of the opposite effects to the spending cuts indicated above. Specifically, if consolidation proceeds through tax rises households may become more certain that spending will not be cut in the future, so their assessment of their future post-tax income will fall. Furthermore, at permanently higher levels of government spending economic growth may be retarded, so even pre-tax income expectations might fall.

The result is that tax-rises-based fiscal consolidations often fail — growth falls so much in the short-term, for the reasons explained above, that tax revenues fall, spending on welfare increases, and deficits increase instead of diminishing.

## The value of signals

As we have discussed, when spending levels have risen very significantly, it is natural for consumers and financial markets to fear that high spending will become entrenched and deficit and debt issues addressed through tax rises, entrenching lower growth and imply significant tax rises in the future as well as in the short term. Under such circumstances, it can be particularly valuable to signal, early, that the key mechanism for deficit reduction will be cuts in spending.

One way to signal this is through making some spending cuts at an early stage. Another mechanism is to offer some tax cuts. This latter mechanism is most likely to be successful when the commitment to eliminating the

deficit is less in doubt than the means chosen for reducing it (spending cuts versus tax rises). Indeed, recent research by Alesina and Ardagna[1] suggests that the most growth-promoting mechanism overall is to combine modest tax cuts (i.e. no tax rises at all) with large spending cuts.[2]

## 2) The evidence for non-Keynesian effects

In addition to the theoretical considerations spelt out above, there is also extensive empirical evidence that fiscal contractions can indeed lead to growth in the short term, some of which we quote in Table 1. Broadly speaking in the 1950s and 1960s it was assumed that deficit spending was strongly stimulatory. Later, the size of this stimulus was increasingly challenged. But it is only in more recent decades that evidence has accumulated suggesting that reducing deficits might be stimulatory. Though now quite well established in economic literature, this work is still feeding its way into the consciousness of journalists and policy makers.

**Table 1: Empirical studies of non-Keynesian effects**

| Study | Methodology, coverage, time-frame | Main findings |
|---|---|---|
| McDermott and Westcott (1996). | Descriptive, 20 OECD countries, from 1970 – 95. | Successful consolidation leads on average to increased growth. Size and composition both important to identify successful consolidations. |
| Giovanni and Pagano (1996)<br>19 OECD countries, 1970 – 92. | Panel data estimation of consumption functions, 19 OECD countries from 1970 – 92. | Size of adjustment is relevant to identify episodes exhibiting non-Keynesian features. |
| OECD (1996). | Descriptive, 18 OECD countries from 1975 – 95. | There were fiscal consolidations during which growth was above potential. Accommodating monetary policy seems to matter to limit output contractions. |
| Cour et al. (1996). | Descriptive and estimation of consumption functions, 17 OECD countries from 1970 – 94. | Size of adjustment is relevant to identify expansionary episode. |
| Alesina, Perotti and Tavares (1998). | Descriptive, 19 OECD countries from 1960 – 95. | Successful consolidations are more likely to lead to expansions. Composition more important than size to identify expansionary episodes. Labour market structure also matters. |

[1] Alesina, A. & Ardagna, S. (2009), *Large changes in fiscal policy: taxes versus spending*, NBER Working Paper 15438

[2] We note that though this research is interesting, it remains provisional, and we believe that its message is most relevant to the signals provided early rather than the overall mix of the consolidation, where we continue to favour the 80% spending cuts : 20% tax rises mix we have argued for previously. See Policy Exchange paper, "Controlling Spending and Government deficits: Lessons from History and International Experience", November 2009.

| Study | Methodology, coverage, time-frame | Main findings |
|---|---|---|
| Alesina and Ardagna (1998). | Descriptive with prohibit regressions and case studies, 20 OECD countries from 1960 – 94. | Composition more important than size to identify expansionary episodes. Wage agreements and exchange rate devaluations are also relevant accompanying factors. |
| Perotti (1999). | Dynamic estimation of consumption functions, 20 OECD countries from 1960 – 94. | High debt levels are associated with higher probability for fiscal policy to have non-Keynesian effects. |
| Giavazzi, Jappelli and Pagano (2000). | Panel data estimation of savings functions, 18 OECD countries from 1970 – 96. | Size of adjustment is relevant to identify episodes exhibiting non-Keynesian features. Non-Keynesian effects more likely for tax changes than expenditure changes and for fiscal consolidations than for fiscal expansions. |
| Von Hagen, Hughes-Hallet and Strauch (2001). | Descriptive analysis with probit regressions, case studies, estimation of output equations and monetary and fiscal policy response functions, 20 OECD countries from 1960 – 98. | Fiscal policies exhibit in general Keynesian effects, but in the 1990's in the EU there is no evidence in favour of either Keynesian or non-Keynesian effects. |
| Alesina et al. (2002). | Descriptive analysis with estimation of investment equations, 18 OECD countries from 1960 – 96. | Cuts in public expenditure, particularly in public employees' compensations, boost investment. Expansionary consolidations are associated with acceleration in investment growth. |
| European Commission (2003). | Descriptive with model simulations (QUEST), 14 EU countries over 33 years (1970 – 2003) | Expenditure cuts may exhibit non-Keynesian features (through consumption and investment channels) even in the short and medium run. These effects likely to be enforced with a favourable monetary stance and have an effect on risk premia on interest rates. |
| Afonso, Antonio (2006). | Panel data estimation of consumption function, EU15 from (1970 – 2005). | Non-Keynesian effects of fiscal consolidations exhibited, particularly if there is high indebtedness. |

The European Commission 2003 study[3] is of particular interest. In that case, about half of fiscal consolidations promoted growth even in the short term – and in the vast majority of these cases the initial deficits were very considerably lower than 12%. Specifically, from 49 consolidations considered, 24 exhibited non-Keynesian features — i.e. growth was promoted even in the short-term following a consolidation. (Note that we have argued that theory suggests that when deficits are greater, the likelihood of non-Keynesian effects dominating (i.e. of the consolidation promoting growth even in the short term) is correspondingly greater.)

[3] Giudice, G., Turrini, A., in 't Veld, J. (2003) "Can fiscal consolidations be expansionary in the EU? Ex-post evidence and ex-ante analysis", European Commission DG ECFIN, http://ec.europa.eu/economy_finance/publications/publication806_en.pdf

The common idea in the academic and policy literature for developed economies is that fiscal consolidation programmes are more likely to be successful if, at least in the initial stages, they are coupled with loose monetary policy. (A common form of IMF intervention programme will involve spending cuts and a large devaluation of the currency.)

This is not, however, because significant fiscal contractions *must* be combined with monetary easing in order to promote growth in the short term. The same European Commission study quoted above found the following:

> ***[R]oughly half of the episodes of fiscal consolidations that have been undertaken in EU countries in the past three decades exhibit non-Keynesian features, i.e. are followed by an immediate acceleration in growth. Moreover, roughly half of these consolidations that turned out to be expansionary were what we label 'pure expansionary', meaning that the expansionary effect on output cannot be attributed to concomitant expansionary monetary policies or exchange rate devaluations.***
>
> ***These results seem to be quite robust with respect to both the criteria used to identify the consolidation episodes and to classify such episodes as expansionary. As for the distinguishing features of expansionary consolidations, it is found that consolidations started in low phases of the cycle and based on expenditure cuts are more likely to be followed by higher growth.***

Here, a pure expansionary episode is one where the growth has occurred through direct of effects of consumption and investment on aggregate demand, as opposed changes in interest rate. Of the 24 cases, mentioned earlier, in which consolidations promoted growth even in the short-term, 11 were "pure expansionary" episodes, i.e. growth was driven through changes in aggregate demand and not through interest rate changes

Whatever the mechanism, an assessment of the overall impact of any fiscal policy must take into account monetary policy; even in a standard Keynesian model a fiscal contraction can be expansionary, or neutral if it is accompanied by sufficiently loose monetary policy (in the case of small open economies this can take the form of an exchange rate devaluation).

## 3) Interest rate effects

One way in which fiscal consolidations might promote growth is because they will tend to reduce (or reduce rises in) interest rates. One source of expansionary effects of fiscal contractions is the credibility argument on interest rates. At high (or rapidly increasing) levels, public debt may face an interest rate premium due to the inflation or default risks. Default risk may be trivial for relatively low debt countries, but are significant for high debt ones. Inflation risks may apply more broadly.

By reducing their budget deficits, governments signal to markets their willingness to switch to 'sound finances'. If this signal is taken as credible, interest premia or risk premia on government bonds will fall (or if the markets had already priced in the consolidation, will not rise).

Lower interest rates mean more investment, and also may mean more willingness for households to consume. It also may means that households feel wealthier overall since their 'permanent income' has risen as they will be discounting their future income streams at a lower rate. At the same time, lower interest payments may also imply lower taxes, as government spending on debt is accordingly reduced.

The crucial ingredient of this explanation for the emergence of non-Keynesian effects is the credibility of government action to make public finances sustainable. This can be emphasised by the size of the adjustment, small consolidations may be believed to be short-lived, major retrenchments may signal the willingness of the government to face the political costs associated with the shift to sound public finances.

The interest rate channel can also have an effect on consumption. The effect of the interest rate on spending out of a given income is conventionally assumed to be rather small. In this view of consumption and saving, the income effect will offset the substitution effect linked to interest rate changes, but the net effect is generally assumed to be negligible. However, if there are large enough changes in the interest rate, the income effect may not offset the substitution effect associated with interest rate changes. For example, if the interest rate is significantly below its normal level in one period, this provides strong reasons to anticipate consumption to not be offset by the income effect. Moreover, when wealth takes the form of capital assets yielding a fixed income, a decrease in the interest rate causes an increase in the capital value and thus in the value of wealth, raising consumption.

As a generalisation, periods of fiscal consolidation tend to occur most often during difficult economic times. Budget deficits most often begin to be cut when such deficits are large, inflation is high, the currency is depreciating and recessions have reached their nadirs. It is thus common for monetary policy to be fairly loose during periods of significant fiscal consolidation. This leads us to an interesting question of how monetary and fiscal policies interact in such periods.

| **Study** | **Methodology, data and coverage** | **Main findings** |
|---|---|---|
| Watchel and Young (1987) | Econometric estimation, | Results imply an increase in interest rate of the order 6 – 16 basis points in response to a percentage point increase in the deficit to GDP ratio for the US. |
| Cohen and Garier (1991) | Econometric estimation, US data from OECD and Office of Budget Management | 1% increase in the deficit to GDP ratio on interest rates are in the order of 40 to 55 basis points. |
| Gale and Orszag (2002) | Econometric estimation, US Congressional Budget Office data, | Each percentage of projected deficits as a % of GDP raises interest rates by |

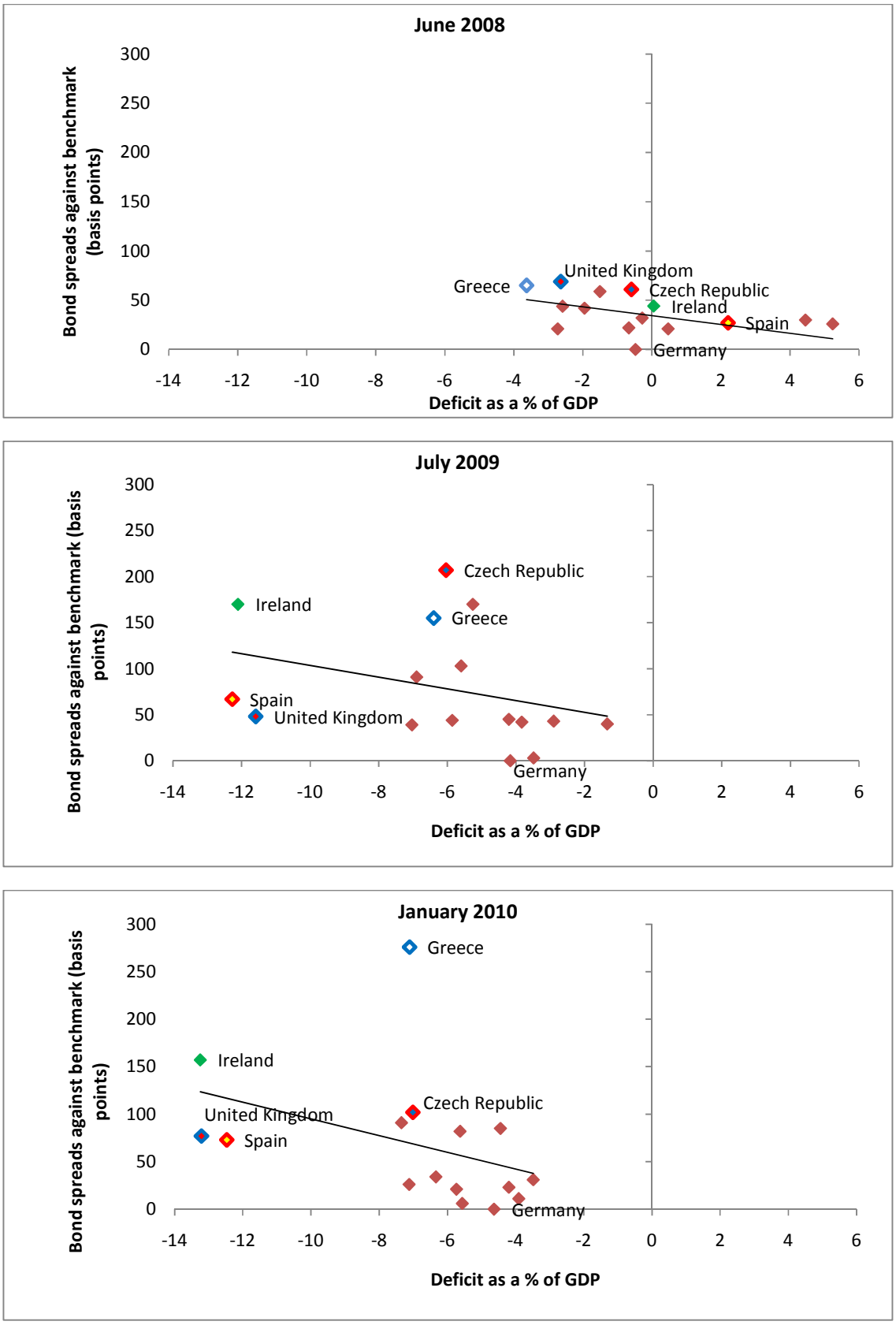
| Study | Methodology, data and coverage | Main findings |
|---|---|---|
| | 1954 -2002 | 40 and 70 basis points in the US. |
| Laubach (2003) | Econometric Estimation, US Time Series data, 30 year sample | 1 % increase in the deficit to GDP ratio raises interest rates by 20 – 29 basis points and for a debt to GDP ratio by 3 – 4 basis points |
| Ardragna, Casselli and Lane (2004) | VAR estimation of 16 OECD countries, 1960 – 2002 | A 1 percentage point increase of the primary deficit to GDP ratio is associated with a 10 basis point rise in the nominal interest rate on 10 year gilts. |
| Engen and Hubbard (2004) | Reduced-form and VAR estimation, US Treasury Time Series data, 1970 – 2004 | A 1% increase in government debt as a % of GDP increases gilt yields by 0.03 percentage points, whilst a deficit of 12% of GDP would be expected to raise interest rates by 0.181%. |
| Faini (2006) | Panel data estimation, 11 EMU countries, from 1979 - 2002 | A 1 percentage point increase in the deficit to GDP ratio raises short term real interest rates by 55 basis points in the Eurozone area. |
| Schuknecht, von Hagen and Wolswijk (2010) | Panel data estimation, ECB data from 1991 – 2009 | An additional percent of deficit relative to the German bond benchmark, resulted in an increase of the spread of 3.49 basis points before the crisis and an increase of 12.64 basis points after the crisis. For debt this number was 0.16 basis points before the crisis and 1.25 basis points after the crisis. |

It should be noted, however, that there is little past precedent in developed economies for deficits on anything like this scale – before this recession, Finland and Sweden in the early 1990s were the key past examples – so there is a natural concern as to whether the data basis for these models is adequate for the purpose. We might expect that the interest rate penalty increases in a non linear way. In other words, moving from a 1% deficit to a 2% deficit is not likely to raise interest rates by as much as a shift from an 11% to a 12% deficit.

To examine this point, we have gathered data on deficits and bond spreads versus German bunds for 10-year bonds for 20 EU Member States[4] for June 2008, July 2009 and January 2010. Figure 1 compares bonds spreads versus Germany with deficits (under IMF definitions), showing how these have evolved over time, with best-fit lines produced for each of the three months.

[4] …with the exception of Belgium, where it is the six-year bond, since that was the highest maturity available.

Figure 1: Bond spreads against benchmark country (Germany) and deficits (IMF definitions) for 20 EU Member States



There are two important points to note. First, we can see vividly in these graphs the way that the steepness of the relationship between bond spreads and deficits becomes steeper as deficits have increased — the best-fit line for more modest deficits in June 2008 is only half as steep as that for the much larger deficits in January 2010. This illustrates the way in which non-Keynesian effects become more significant as deficits increase. Indeed, if we take as our dataset all three months and consider the best-fit curve (as opposed to straight line) we find that a rise of 1% in the deficit from 11% of GDP to 12% of GDP adds more than twice as much to interest rates as a rise from 2% to 3% adds.

Next, it is worth highlighting a few of the cases labelled. First, Ireland sits just slightly above each of the best-fit lines, with Irish bond spreads increasing broadly as expected as its deficit increases. In the case of Greece, by contrast, we see that Greek bond spreads rise much more rapidly than the IMF's figure for the Greek deficit — so Greece becomes further and further away from the line. We believe that this is significantly affected by market views and government statements concerning the deterioration in the Greek deficit running markedly ahead of IMF data — a current IMF figure would be likely to suggest a deficit of 13-16%.[5]

In the Czech republic the July 2009 value is far further above the line than is the case for either June 2008 or January 2010. The Czech government fell in March following a vote of no confidence and brought in a caretaker Prime Minister from May. During the period of political turmoil the deficit rose very sharply, widening during first seven months of 2009 to $4.24 billion in July; up 11.6% (presumably this partly explains the elevated bond yields in July 2009 as being associated with political risk). Subsequently, the government implemented an austerity package through a state budget approved by Parliament in October 2009. The Ministry of Finance estimated an improvement in the structural balance of 2% of GDP in calendar year 2010, bringing the total down to a 5.3% GDP deficit. The clear downward move, subsequently, in Czech bond spreads illustrates some of the potential benefits of a consolidation package including early cuts in the deficit.

Finally, we see the similarities between Spain and the UK. Each sits materially below the best-fit line. In the UK's case this is probably significantly attributable to the effects of quantitative easing, which has probably reduced gilt rates by about 100 basis points.[6] Spain, by contrast, may have been protected by a belief that it

[5] The technically-minded might be interested to note that this problem with the Greek data means that the non-linearity which we quote is dampened in our graphs compared with the underlying reality. If Greece were allocated a 13% deficit in January 2010, the best-fit line for January 2010 would be nearly twice as steep again.

[6] As of the time of writing, there has been about £200 billion in QE. Though the precise mechanisms and degrees of effect are hotly debated, Bank of England policymakers estimate that the QE programme has reduced gilt yields by about 100 basis points (about 1%). For example

- Spencer Dale stated (12 March 2010): *"Although precise estimates vary according to the maturity of the gilts and the size of the window, summing movements in gilt-OIS spreads following our announcements suggests that the portfolio balance effect may have reduced gilt yields by around 100 basis points."* (http://www.bankofengland.co.uk/publications/speeches/2010/speech428.pdf)
- Charles Bean stated (16 March 2010): "following each successive announcement about the scale of the asset purchase programme, the movements in: average gilt yields; the expected average level of Bank Rate over the same maturity (from Overnight Indexed Swap rates); and the spread between

was "too big to fail" within the Eurozone and hence was subject to some measure of implicit bailout protection from France and Germany.

A recent study published in February 2010 from the ECB suggests that the crisis has caused a significant change in the markets' assessment of governments' fiscal performances, and the cost of irresponsible fiscal behaviour has increased greatly. This indicates that if governments were to signal a serious commitment to cut the deficit, we could anticipate a fall risk premiums in the short-term, potentially leading to expansionary effects from the fiscal consolidation. Their research shows that a 1% increase in the deficit relative to German bonds (the benchmark in the euro-dominated bond market) increase by 9.16 basis points after the start of the financial crisis. In the case of debt, a 1 percentage point increase in government debt relative to the benchmark country (Germany) increased by 1.09 to 1.25 basis points after the crisis.[7]

## Understanding the baseline

Some commentators argue that with nominal interest rates already low, there is no scope for deficits to have an effect upon interest rates. But this is to miss the point. For the question is not solely whether a fiscal consolidation might lead to a monetary *loosening*. If credible action prevents gilt rates from going up in the way experienced by Ireland and Greece they can prevent a marked monetary *tightening*. Secondly, the use of quantitative easing illustrates that the zero bound on nominal interest rates is not the absolute limit on monetary loosening often formerly assumed — even if short-term rates are not cut, a fiscal tightening could enable further QE which would not otherwise have been possible without causing excessive inflation.

Given that the UK's deficit is much larger than most historical case which have been studied, and that spending has risen much fast and productivity growth was presumably correspondingly poorer, it is very natural to suppose that in the UK's context there would be a boost to growth even in the short term from reducing the deficit, provided that action to reduce the deficit focused mainly on spending cuts.

## Impacts on mortgages

One way to illustrate how increases in bond rates would feed through to effects on consumers is to consider the impact on mortgage rates. An extended period of rise in bond rates would raise mortgages. We have argued that an extended period of deficit at 12% might be expected to add more than 2% to bond rates versus a no-deficit bond cost. That would not immediately turn into a rise of 2% in mortgage rates unless it became very extended. Let us consider a 1% rise in mortgage rates.

The average outstanding mortgage in the UK is about £110,000.[8] The average rate on outstanding loans was 3.67% in March 2010.[9] Assuming the average period left on a mortgage is 12 years, the difference for a

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them… suggests gilt yields are lower as a result of the programme by a total of around one percentage point." (http://www.bankofengland.co.uk/publications/speeches/2010/speech429.pdf)

[7] Schuknecht, Von Hagen and Wolswijk (2010) "Government Bond and Risk Premiums in the EU Revisited: The Impact of the Financial Crisis" *ECB Working Paper Series* No. 1152

[8] Council of Mortgage Lenders, http://www.cml.org.uk/cml/media/press/2579

repayment mortgage between a 4.67% rate and a 3.67% rate would be about £57 per month, £684 per year. If matters really did deteriorate and a 2% rise in mortgage rates were the result, the difference between a 5.67% rate and a 3.67% rate would be £116 per month, or £1,392 per year.

## 4) Growth and wealth effects

Government spending in the UK has increased enormously over the past three years, to an extent unprecedented in peacetime. There are a number of ways that spending can be measured, but for our purposes here their message is broadly the same. Spending has risen by about one quarter relative to the economy over just three years, by some 8-10% of GDP, from just over 40-42% of GDP in 2007/8 to 50% or more of GDP in 2010/11.[10]

This huge rise in spending will, if sustained, damage growth over the longer term. As explored in previous Policy Exchange studies, a rise of 10% in the spending to GDP ratio should be expected to be associated with a fall of 1-1.5% in the growth rate of the economy. In a previous paper we catalogue a large body of academic research on this issue.[11]

That threat of lower long-term growth currently hangs over the economy, with many negative impacts for growth in the short term that are even more pronounced than the negative long-term impacts. Consumers fear that much of the higher spending might be sustained, so that growth will be lower and hence their salary rises lower in the future. If their future salary rises will be lower, then they will struggle to service the high debts they accumulated when the outlook seemed brighter. That means consumers will be less willing to take on debts and to consume, retarding growth in the short term.

All these factors mean that if growth is expected to be lower over the medium term, that should be expected to make recession worse and recovery slower in the short term. Contrariwise, if the longer-term outlook for growth can be improved, that should be expected to improve growth in the short term, also. The key means the British government has, in the short term, for improving the longer term growth outlook is to reduce spending. Reducing spending early will promote recovery in the short term.

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[9] Council of Mortgage Lenders, http://www.politics.co.uk/opinion-formers/press-releases/economy-and-finance/cml-comments-on-bank-of-england-mortgage-data-$1368061$364298.htm

[10] As discussed in *Controlling Public Spending: The Scale of the Challenge*, the considerable majority of this spending rise (now up to £125 billion) was nothing directly to do with the recession. Instead, the government persisted with spending plans from 2007 that had involved rapid rises in growth (indeed, had involved rapid rises in growth relative to GDP), but had assumed rapid growth in the economy (and hence tax revenues) as well.

[11] See Table 2.1 on page 20 of *"Taxation, Employment and Growth" (2010)*

## 5) Why is 12% the 'right' level of borrowing?

The 2010 Budget pledged the government to reducing the budget deficit to 4% of GDP over five years, still well above a sustainable level with a structural deficit of 2.5% of GDP. This is far slower than other countries are planning – Greece has pledged to reduce its deficit to below 3% by 2012 (starting from a slightly higher levels) while several other countries, such as France, have pledged to borrow less than 3% (the official eurozone limit) by 2013; Ireland has pledged the same for 2014. This makes Britain as an outlier – having both one of the highest deficits and, of those countries with very high deficits, one of the slowest plans to reduce it.[12]

If the deficit were to be cut in 2010/11 by perhaps £10 billion more announced in the Budget, borrowing would still be some 10-11% of GDP, larger than had ever been done in peacetime in the UK, well above the borrowing of the mid-1970s or early 1990s, and considerably larger than almost any deficit recorded in peacetime in a developed economy prior to the current recession. It is the scale of the deficit that, on the Keynesian story, provides the "injection" into the economy, boosting demand in the short term. So even on our proposal, there would be more "injection" than in any previous peacetime event.

Thus there is no question of a "tight" fiscal policy for 2010/11. Even with a £10 billion further cut in the 2010/11 deficit, it would still be the loosest fiscal year ever for the UK in peacetime, with the sole exception of 2009/10.

Is it really plausible that this, highest period of borrowing since the second world war, will not be loose enough to deliver all fiscal injection – all that activity of the government borrowing on the public's behalf as a second-best intermediary during a financial-crisis-induced recession – that is actually valuable? When we study Keynesian theory in the textbooks, what the writers had in mind were the sort of scale of deficits Keynes envisaged (some 1-3% of GDP). And we have seen that the non-Keynesian effects tend to increase as deficits increase, reducing the stimulus deficits provide and eventually meaning that deficits impede short-term growth rather than promote it.

It is not clear on what basis the government argues that about 12% is the "right" rate of borrowing. (It cannot even be argued that the deficit primarily reflects the operation of the "automatic stabilisers", as the majority of the deficit is structural.) Why not *more* than 12%? 15%, perhaps? Or 20%? If it is argued that higher borrowing will always and everywhere have a stimulatory effect on the economy it is not clear what the limit should be.

The practical reality is not that there might be spending cuts so "savage" that they would risk plunging the economy back into double dip. The practical reality is that the spending cuts that can be delivered, given that

[12] It has been suggested that outlier status may make Britain bonds and sterling vulnerable to speculative attack.

the effort to achieve spending cuts is unlikely to commence until well into the fiscal year, will almost certainly be much less than would be optimal, and may not even be adequate to prevent the need for policy to tighten more and more rapidly in later years than would have been necessary had proper and credible spending cuts been arranged at an earlier stage.

Policy Exchange

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# The work of the Economics unit at Policy Exchange

## What we stand for

**Rebuilding the British economy.** Even as we manage our way through the recession, we need to think about how to transform the British economy so that we are ready to face the future.Our research looks at how to restore financial stability, and also how to reform government spending and regulation.We believe that with radical reform of the budget, tax, welfare, and the supply side of the economy, Britain will be able to enjoy sustainable and faster growth in the future.

## What we are working on

F**inancial services reform:** We need to avoid a knee-jerk response to the financial crisis, and instead introduce the right regulatory and structural reforms. Do we need to reform central bank mandates or the inflation target? Are financial markets socially useful? And if they are, how can we make them sustainable and competitive in the UK, without placing the nation's balance sheet at risk?What can be done about asset price bubbles?

**Innovation and industry:** Retaining a dynamic industrial base is essential to maintain a balanced economy. Governments can't pick winners, but they can create the conditions for winners to emerge. Policy Exchange will consider how government policy might better support manufacturing by reforming tax and regulation; encouraging innovation, science and technology; and ensuring that the necessary building blocks in education and skills are in place to put Britain at the forefront of the industries of the future.

**The future of public services:** How can we shift resources from unproductive to productive government spending and find scope to reduce the tax burden? How can Government achieve more with less?

**Public sector pay and staffing:** We are looking at pay, conditions and staffing in the public sector and considering what changes to remuneration, staffing levels and working conditions might be appropriate to achieve the savings necessary in the coming period of fiscal consolidation.

**Welfare reform:** We are looking at the disincentives for people on benefits to seek work; analysing the potential for reform in the Housing Benefit system and what people have to do to qualify for welfare on health grounds; and developing a philosophy for what a modern social security system should look like.

If you would like to find out more about our work, please contact:

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## About Policy Exchange

Policy Exchange, an independent educational charity. Our mission is to develop and promote new policy ideas which will foster a free society based on strong communities, limited government, national self confidence and an enterprise culture. In contrast to many other think tanks Policy Exchange is committed to an evidence-based approach to policy development. Our impact speaks for itself: from housing to policing reform, education to the NHS, our proposals have been taken on board by the main political parties. Registered charity number 1096300.

For more information please contact us at: Clutha House, 10 Storey's Gate, London, SW1P 3AY. Alternatively we can be contacted on 020 7340 2650 and at info@policyexchange.org.uk

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