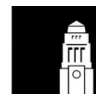
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Fiscal policy under new Labour

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February 2007

Abstract: The paper seeks to provide an evaluation of fiscal policy under the 'new Labour' in the decade from its election in May 1997 to date. It begin with a brief review of macroeconomic performance over that period. It outlines the main features of the approach of Labour to fiscal policy including the 'golden rule' of public finance, and provides a critique of that rule and the general approach to fiscal policy. It considers how far the policy rules have been observed in practice. Finally it argues that the relative macroeconomic stability since 1997 has not resulted from the fiscal policy pursued but rather that changes in the fiscal stance have fortuitously offset variations in private expenditure.

Journal of Economic Literature classification: E61, E62

Key words: Labour government, golden rule, fiscal policy

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Fiscal policy under new Labour*

Malcolm Sawyer

1. Introduction

The Labour government elected in May 1997 came into office stressing that it was 'new Labour' and pursuing a 'third way' in economic policy.[1] In macroeconomic terms, the emphasis was on the avoidance of 'tax and spend' policies, restraints on public expenditure notably in the first two years of office and the adoption of the so-called 'golden rule' of public finances under which the current budget of government would be in balance over the course of a business cycle.[2] There was something akin to a disavowal of a Keynesian approach to macroeconomic policies and specifically the active use of fiscal policy to manage demand, though an emphasis on the operation of fiscal policy as an automatic stabiliser. The reduction of unemployment was to be addressed through labour market reforms and flexibility, which would, in effect, lower the 'non-accelerating rate of unemployment' and thereby lower unemployment.

The paper seeks to provide an evaluation of fiscal policy under new Labour, with a critical review of the main planks of fiscal policy and a consideration of the relationship between that policy and the macroeconomic performance of the UK economy in the past decade.

2. Recent macroeconomic performance

Table 1 summarises some of the aspects of recent macroeconomic performance. In growth terms, GDP has grown at an average annual rate of 2.8 per cent over the period 1997-2005. This can be compared with the previous eight years where growth averaged 1.9 per cent, though over the period 1992 to 1997 growth averaged 3.1 per cent. Comparisons with earlier periods in terms of the rate of growth depend crucially on whether the recession of 1990/1991 is or is not included. Growth has been relatively stable, and specifically there were no periods of negative growth, whereas in the preceding quarter of a century there had been three recessions (1974/75, 1980/1, 1990/1), enabling the Chancellor to boost in December 2006 of

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* This paper arises from joint work with Philip Arestis to whom I am grateful for comments on this paper as well as more general discussions. I am also grateful for the helpful comments from two anonymous referees.

[1] See Arestis and Sawyer (2001a) for a view on the economics of the 'third way', and Arestis and Sawyer (2001b) for some assessments of 'third way' economic policies in a range of countries.

[2] For example, from the 1997 manifesto (Labour Party, 1997), "Save to invest is our approach, not tax and spend", and "We will enforce the 'golden rule' of public spending - over the economic cycle, we will only borrow to invest and not to fund current expenditure."

the "longest unbroken expansion since quarterly records began, with GDP now having grown for 57 consecutive quarters" (Treasury, 2006c, p.1). Inflation has remained low and consistently met the Chancellor's target of 2 per cent plus or minus 1 per cent (though touching the upper limit of 3 per cent in January 2007).[3] Unemployment on the claimant count fell continuously from 1993 until 2004, reaching its lowest level of 2.6 per cent in February 2005 (the lowest since 1974) since when it has been rising to reach 3 per cent late 2006 on the claimant count. On the ILO definition, unemployment is lower at the end of the period than at the beginning, though the decline is proportionately less than on the claimant count. Since 2000 this unemployment rate has been broadly flat though recently rising through much of 2006 to a figure of 5.5 per cent in late 2006.. The current account position has not been generally seen as a matter of concern, though the deficit has averaged (since 1999) at slightly over 2 per cent of GDP. The relative decline of manufacturing industry has continued, and manufacturing output has been flat over the period since 1997.

Table 1 near here

Figures such as those in Table 1 are used to support the view that macroeconomic performance in the past decade or so has been rather good – in the phrase used by the governor of the Bank of England, Mervyn King, the 'NICE' decade – "Non-Inflationary Continuous Expansion" (King, 2003). The government and Chancellor, amongst others, have strongly promoted the idea that macroeconomic performance, in terms of the level (e.g. of inflation, growth) and variability ('stability'), has been particularly good.. Recent endorsements have come from the OECD and IMF[4]. For example, in their report on the UK, the OECD write that:

"Macroeconomic performance over the last decade has been a paragon of stability: GDP growth has remained closer to potential than for almost any other OECD country; the unemployment rate has fallen to its lowest level and has been the least volatile since the 1970s; and inflation has remained stable and close to the official target. Perhaps most surprisingly, in the period since the current monetary and fiscal framework has been in place, not only has the effective exchange rate been more stable than at any time since the Bretton Woods period, but it is also among the most stable in the OECD and more stable than for the

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[3] This refers to the current target set in terms of the HICP to which the figures in Table 1 refer. For much of the time the target was set in terms of the RPI and used the figure of 2.5 per cent.

[4] See, for example, United Kingdom—2005 Article IV Consultation Concluding Statement of the IMF Mission http://www.imf.org/external/np/ms/2005/121905.htm

major euro area countries.” This performance is ascribed “to the strength of the institutional arrangements for setting monetary and fiscal policy … as well as to the flexibility of labour and product markets” (OECD, 2005, p.24). However, “one area where macroeconomic policy does, however, require attention is fiscal policy” (OECD 2005, p. 34).

How good has the record on unemployment been ? On the ILO measure (said to be the government’s preferred measure), unemployment remained at a higher level and declined less rapidly than on the claimant count. “However, while the unemployment rate has fallen to its lowest level in three decades and by nearly 7 percentage points from a peak in the mid-1980s, there has been little fall in the inactivity rate … Indeed, while the activity rate of women has risen substantially, the male inactivity rate has shown a consistent upward trend accompanied by a similar rise in men reporting long-term sickness or disability as the main reason for inactivity. In 1980 the number claiming disability-related benefits was less than the number claiming unemployment benefit, whereas currently the former are three and half times as great. While increasing numbers on disability-related benefits is common in many OECD countries, the United Kingdom stands out as having a relatively high concentration of disability among prime-age males” (OECD 2005, p.39). “Seven per cent of the 25-54-year-old men are now inactive outside the labour market, many more than three decades ago. Solid growth since the late 1990s has brought down unemployment but not inactivity, with 2½ million currently claiming incapacity benefit” (OECD 2005, p. 99). When regard is given to the inactivity rate (as mentioned above) the record on unemployment is not quite so good.

3. The nature of new Labour’s fiscal policy

In their draft manifesto of 1996 the Labour Party (1996) stated that “We will enforce the ‘golden rule’ of public spending – over the economic cycle, we will only borrow to invest and not to fund current expenditure”. This did not differ substantially from the stated objectives the previous government which had stated that “The Government's fiscal objective is to bring the PSBR [public sector borrowing requirement] back toward balance over the medium term, and in particular to ensure that when the economy is on trend the public sector borrows no more than is required to finance its net capital spending.” (Treasury, 1995, p.18). “The role of fiscal policy is to ensure sound public finances. …. Aiming for budget balance is a prudent objective given the considerable uncertainties about medium term prospects” (Treasury, 1994, p.16)

Early in its term of office, the Government brought in the Code for Fiscal Stability (Treasury 1998) which indicates many of the key features of the approach of new Labour in the area of macroeconomic policy. In the view of the Treasury, “The Code sets out clearly the

Government's commitment to a commonsense and honest approach to managing the public finances in the long-term interests of Britain. It is motivated by three key considerations:

- a stable economic environment is vital if growth and employment are to prosper;
- the conduct of fiscal policy is a critical influence on economic stability; and the framework for fiscal policy inherited by the Government had failed to deliver a stable economic environment. Indeed, fiscal policy had been an important source of instability in the economy.

The Code for Fiscal Stability is designed to address past weaknesses in the fiscal policy framework. In particular, it strengthens the openness, transparency and accountability of fiscal policy, features that also characterise the framework for monetary policy following the introduction of the Bank of England Act 1998. It improves the quality of information given to the public, the lack of which in the past was an important factor underlying policy mistakes." (Treasury, 1998, p. 2).

The operation of fiscal policy has been subject throughout the period to the operation of:

"the golden rule: over the economic cycle, the Government will borrow only to invest and not to fund current spending; and

the sustainable investment rule: public sector net debt as a proportion of GDP will be held over the economic cycle at a stable and prudent level. Other things being equal, net debt will be maintained below 40 per cent of GDP over the economic cycle" (Treasury, 2006a, p.18).

This refers to public sector net debt: the gross debt figure calculated according to the Maastricht Treaty rules is around 6 per cent of GDP higher.

The appeal of the 'golden rule' appears to come from two aspects. First, it highlighted an apparent commitment to higher levels of public investment. "The previous fiscal policy regime concentrated on various targets, usually expressed in terms of what is now called the public sector net cash requirement. This regime made no formal distinction between capital and current spending. A significant shortcoming of this approach was that it created a bias against capital spending. Current and capital spending could be offset against each other, making capital projects – where returns appear only in the future – an easy target when it became necessary to tighten the overall fiscal policy stance. The bias against capital contributed to a considerable under-investment in public assets." (Balls and O'Donnell, 2002, p.160) [5].

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[5] This book carried a forward by the Chancellor and described on the Treasury web-site as a book of the Treasury, and at the time of writing Balls was Chief Economic Advisor to the

Public sector net investment had fallen dramatically in the preceding three decades, and the figures in Balls and O'Donnell (2002, p. 161) indicate from over 7 per cent of GDP in mid 1960s to well below 1 per cent in late 1980s and again in the second half of the 1990s. How far the golden rule rectifies that situation may be questioned. It is well-known that an overall budget deficit to GDP ratio (d) would lead to debt to GDP ratio (b) stabilising at: $b = d/g$, where g is the nominal growth rate. Hence for a nominal growth rate of around 5 per cent (real growth of 2.5 per cent, inflation of 2.5 per cent), a 40 per cent debt to GDP ratio would be consistent with a 2 per cent average budget deficit. As the OECD remark "the share of government investment in GDP has risen, and there are plans for it to rise further. Nevertheless, even after it rises to just under 2½ per cent of GDP next year, it still remains relatively modest compared with many other OECD countries and may be inadequate to correct years of neglect." (OECD, 2005, pp.14-15). Further, the use of the private finance initiative (PFI), further discussed below, in effect turns what would be capital expenditure by government into current expenditure : building a school under 'conventional' finance involves a capital cost in the present, followed by interest payments on the borrowing. Under PFI, the school would be financed by the private sector and then leased back to the government, and the leasing charges appear as current expenditure.

Second, the 'golden rule' appeared to place clear limits on the size of the budget deficit, and to counter charges of profligacy and 'tax and spend'. It focuses on the role of fiscal policy as an automatic stabiliser "[F]iscal policy can help to stabilise the economy through the operation of the 'automatic stabilisers' … These movements [in the budget balance] will support monetary policy by dampening economic cycles without putting at risk the long-term sustainability of fiscal policy" (Balls and O'Donnell, 2002, p. 158). It is further argued that "the chosen fiscal rules must also allow for sensible discretionary adjustments to fiscal policy" and gives the example of fiscal tightening in the early years of the Labour government "to support monetary policy and restore the structural integrity of the public finances" (Balls and O'Donnell, 2002, p 158). It is noteworthy that fiscal policy appears in a subordinate role to monetary policy (see Arestis and Sawyer, 2004a, 2004b and 2006 for doubts on the effectiveness of monetary policy). Although discretionary adjustments are permissible, there is no role ascribed in, for example, Treasury (2000, 2006b) or Balls and O'Donnell (2002), for active fiscal policy directed towards demand management.

Treasury (subsequent elected member of Parliament and appointed Economic Secretary to the Treasury, and O'Donnell was head of the Government Economic Service (and subsequently Cabinet Secretary and Head of the Civil Service).

One of the main arguments put for the 'golden rule' concerned inter-generational 'fairness' 'The Government is committed to the principle of fairness, both between and within generations. When making fiscal and debt management policy decisions it is important that governments take into account the financial effects on future generations. It would be unfair to make future generations meet the cost of policies that primarily benefit the current generation. Similarly, the current generation should not be expected to pay unduly for policies that will only benefit future generations. Fairness within broad groups of the current generation is also important.' (Balls and O'Donnell, 2002, p. 139)

It is though recognized that the matching of costs and benefits cannot be exact. 'It is not practical, of course, to match the timing of the streams of costs and benefits for each and every spending proposal. But, in aggregate, the Government takes the view that current spending, which mainly provides benefits to existing taxpayers. Similarly, because capital spending produces a stream of services over time, it is fair that this form of spending is financed initially through borrowing. This behaviour should ensure that, to the extent practicable, each generation pays for the benefits of the public services that it consumes.' (Balls and O'Donnell, 2002, p.162). The distinction is made between present generation and future generations, but not between the generation in say 5 years hence and the generation in say 10 years hence. It is not readily apparent that it is more unfair for say group A* in generation 1 to pay for benefits which accrue to group A in generation 0 (where A and A* may substantially overlap in membership) than it is for group B in generation 0 to pay for the benefits accruing to group A.

'The key feature of this definition is that it equates capital spending with future benefits. The definition excludes some items of spending which have some, but not all, the characteristics of investment. Although education gives rise to a stream of benefits over time, the capital value and its depreciation rate is not something which can be estimated easily or reliably' (Balls and O'Donnell, 2002, p.167). The distinction between policies (and expenditure) which primarily benefit the current generation and policies (expenditure) which primarily benefit future generations does not correspond to the distinction between current expenditure and capital expenditure. The benefits from current expenditure on education accrue in the future. Investment in the application of the golden rule is limited to (net) fixed capital formation. The rhetoric of increased public investment has often been extended much more widely and applied to general expenditure on education and health (reflected in, for example the titles of Treasury, 2005, 2006a, 2006c). Indeed such expenditure may rightly be regarded as investment in the sense that they involve expenditure in the present which yields future

benefits. It is then far from clear as to why the costs of investment in physical capital should be spread over the future, but the costs of education and health not. Further, the resource costs of government expenditure however financed accrue in the present in so far as investment (or other forms of government expenditure) has the opportunity cost of reduced consumption.

The PFI also have inter-generational consequences. The use of PFI rather than bond finance imposes greater costs on the future generations (of taxpayers) since the effective cost of finance is higher under PFI than under 'conventional' financing.

In fiscal policy terms the impact of a budget deficit on the level of economic activity does not depend on the division of expenditure between current and capital budgets. Current and capital expenditure are essentially similar in that they involve expenditure in the present and are paid for by a combination of tax revenue and borrowing. Public capital expenditure, in general, does not generate future revenue streams in any direct sense since any output derived from that investment is not marketed. Public capital expenditure may, directly and indirectly through positive effects on private investment (cf. Aschauer, 1989 for example) raise future supply potential and thereby raise future tax revenues. But, as mentioned above, some current public expenditure (notably on education and health) is also likely to do so.

The acceptable budget deficit (over the course of the business cycle) is determined under the 'golden rule' by the scale of public net capital expenditure. The figures in table 4 below indicated a figure for public sector net investment of something under 2 per cent of GDP and above we argued that the figure compatible with the 40 per cent debt ratio was of the order of 2 per cent of GDP. But there is little reason to think that this is the appropriate scale of public investment in terms of the needs of the economy for infrastructure and other investments. In fiscal policy terms, there is little reason to think that an average budget deficit of this size is the right one to achieve high levels of employment. The counter part of a budget deficit is, of course, the sum of private net (of investment) savings plus the capital account surplus. It would need to be established that the sum of those two terms will turn out to be 2 per cent of GDP at a high level of economic activity.

The fiscal rules of new Labour are significantly less restrictive than those imposed by the Stability and Growth Pact (SGP) of the Economic and Monetary Union (EMU) : an overall budget deficit of the order of 2 per cent of GDP compared with the balanced budget or small surplus envisaged in the SGP. Further whilst the SGP places an upper limit of 3 per cent of GDP on the budget deficit, the fiscal rules of new Labour do not place any upper limit on the size of budget deficit during a recession.

There is an underlying notion of a fairly regular business cycle of the order of 4 to 8 years in length. In policy discussions, the identification of the business cycle has been treated as unproblematic though (as noted below) in practice its dating has encountered some difficulties. The Treasury has adopted the approach of estimating whether the 'golden rule' has been met by reference to the start of the cycle and calculations relating to the complete cycle rather than using some form of moving average covering a complete cycle (centred on say the current time). This could have particularly constraining effects on the budget deficit towards the end of the cycle striving to meet the 'golden rule' in so far as deficits had accumulated in the earlier phases of the cycle. It can be seen that the 'golden rule' seeks to build in the notion of a balanced current budget position over the business cycle, which runs counter to the precepts of 'functional finance' which 'rejects completely the traditional doctrines of "sound finance" and the principle of trying to balance the budget over a solar year or any other arbitrary period' (Lerner, 1943, p.355). The current budget is to be balanced over the cycle, though not on annual basis which permits the operation of the 'automatic stabilisers'. This approach presumes that an average a balanced (current) budget is consistent with the achievement of high levels of economic activity and that there is sustained issue of a lack of effective demand.

4. Meeting the 'golden rule'

There has been considerable debate as to whether the government has met the 'golden rule'. In December 2006, the Chancellor claimed on the basis that the business cycle began in 1997-98 and would be ending in early 2007 that '[t]he projections show that the Government is meeting the golden rule, on the basis of cautious assumptions, with an average annual surplus on the current budget over this economic cycle of 0.1 per cent of GDP. On this basis, and based on cautious assumptions, the Government is meeting the golden rule and there is a margin against the golden rule of £8 billion in this cycle' (Treasury, 2006c, p.218). However at around the same time the OECD suggested that '[r]ecent fiscal outturns suggest that the government may find it difficult to meet its golden rule fiscal objective without additional revenue or expenditure measures, although this also depends in large part on the dating of the business cycle, which is uncertain.' (OECD, 2006, p.67)

Judging whether the 'golden rule' has been met has not been straightforward. The precise measurement has been one (relatively minor) issue : how should the budget deficits be cumulated, e.g. in nominal or real terms and then summed, or in percentage terms. More significantly has been the issue of the dating of the business cycle. Institute for Fiscal Studies (2007) list the recent changes in the cycle as identified by the Treasury with Treasury (2005)

identifying the cycle as 1999Q1 to 2006Q1, Treasury (2006a) as 1997Q1 to 2009Q1 and Treasury (2006c) as 1997Q1 to 2007 Q1. This feeds into a major criticism that 'the Code [for Fiscal Stability] leaves the government to decide whether or not to set itself any operating rules and, if it does, to decide whether those rules have been kept to or not. There is no penalty (other than potential reaction of voters and financial market participants) if they are missed. This has contributed to suspicions that the government has applied the rules in such a way as to make them easier to meet while avoiding having to make painful policy adjustments at politically inconvenient times. This in turn has prompted calls for greater independence in judging adherence to the rules so that the Treasury no longer 'marks its own exam paper'' (Institute of Fiscal Studies, 2007, p.33).

Table 2 near here

The historic record on budget deficits and debt since 1990 is given in Table 2. It can be seen that judged on a cyclically adjusted basis fiscal policy was tight in the first years of 'new Labour' but with a significantly loosening in the subsequent years. The fiscal policy in those early years of 'new Labour' was also tighter than under the preceding Conservative government. The surpluses on the current budget which accrued in the four years beginning 1998/9 under the impact of restraints on government expenditure, falling savings and booming investment were the major factor in enabling the 'golden rule' to be met (or nearly met) over the cycle. With that background, the 'golden rule' may well have had little constraining effect on the operation of fiscal policy in the latter years. However, from the present position that may no longer hold in the sense that as a new cycle is set to begin the current budget is in deficit (for 2006/07). Table 3 indicates that the current budget is projected to return to surplus from 2008/09 onwards, with a tightening of the fiscal stance as judged by the cyclically-adjusted surplus. This return to surplus comes from a combination of a forecast rise in receipts by government of 0.7 per cent of GDP and a decline in expenditure of nearly 1 per cent of GDP by 2011/12 (implying a growth rate in public expenditure in real terms of just under 2 per cent per annum).

Table 3 near here

The Private Finance Initiative (PFI) has been given a substantial role in stimulating public investment. For example, Paul Boateng, then Financial Secretary to the Treasury argued that 'it is this sustained improvement in our public finances that makes possible the prospect of sustained investment in our public services. In our latest three-year spending review we embarked on a wholesale modernisation of public services. … The Private Finance Initiative and Public Private Partnerships are essential tools for delivering this investment. Since May

1997, over £16bn and around 400 signed deals. And there are another 300 projects in various stages of procurement, worth an estimated £16 billion, which will take us to a total of around £30 billion. This is a key contribution to investment in public services and the regeneration of our country.' (Boateng 2001) I have discussed elsewhere (Sawyer, 2003, 2005) the desirability or otherwise of the PFI, and specifically pointed to the spurious nature of the argument that PFI increases public investment. The implications for the budget deficit and public debt are particularly noted. The PFI in effect replaces expenditure financed by debt with the consequent future interest payments by expenditure undertaken by private firms for which they are repaid by leasing agreements over a period of up to 30 years. At the time at which the investment in capital equipment is undertaken by a private firm, there is no public expenditure incurred, but rather the future stream of public expenditure is increased (by the leasing and management charges). The overall effect of a move from 'traditional' public sector investment to PFI is to increase public expenditure over the life time of the project (essentially because the implicit cost of finance under PFI is higher than the cost under 'traditional' financing through sale of bonds) and to understate the scale of public liabilities. The obligation to make future payments (for leasing, maintenance etc.) under PFI is a liability of the public sector and as such should be included in the public debt (as it would be in a comparable situation in the private sector). "The Government's Private Finance Initiative ... attempts to inject expensive private finance into a residual public sector. The merit, in the government's eyes, is that this [PFI] reduces, in the short run, its need to raise finance in its own name either by taxation or through a higher PSBR. To be precise, the PFI ... will affect the time pattern or composition of public expenditure by removing present capital investment outlays and subsequently adding the payments needed to furnish the privately owned capital with its normal remuneration." (Fleming and Oppenheimer, 1996, p.62). Treasury (2006b) Table B24 reports the outstanding commitments under PFI though to 2031/32 (i.e. a 25 year period though many contracts are for 30 years): the outstanding obligation under PFI as of March 2006 amounted to £161.4 billion, and applying a real rate of discount of 2 (3) per cent the present value would be £131.4 billion (119.6)[6]. The public sector net debt position at the end of 2005/06 was £462.7 billion (and £529.1 billion when calculated on the Maastricht Treaty basis of general government gross debt).

On the other side, the PFI capital expenditure has often been 'off budget', and hence that expenditure has not been included as part of public expenditure and hence not as part of the

[6] Calculated from Treasury (2006a), Table B25

budget deficit. The PFI capital expenditure has fluctuated around the order of 0.3 per cent of GDP. The budget deficit would have been recorded as higher if conventional finance had been used. But as the current expenditure associated with PFI builds that is adding to public expenditure and raising the budget deficit. It is though likely that the use of PFI has over the past decade reduced the recorded budget deficits, even if the reverse is likely to be the case in the future.

Table 3 shows that the net debt position is currently around 37½ per cent of GDP and is projected to rise toward 38½ per cent over the next few years, against a ceiling of 40 per cent. The inclusion of the debt obligations under PFI would raise the public debt position by the order of one quarter and put the debt to GDP ratio closer to 50 per cent (and the gross debt under the Maastricht Treaty definitions a further 6 per cent higher). The government's ability to limit the debt to GDP ratio below 40 per cent has depended heavily on the accounting rules used for PFI.. The debt including PFI ratio would also be getting close to the 60 per cent limit under the Maastricht Treaty definitions.

Fiscal policy has been operated since 1997 in a clear framework with an underlying view that fiscal policy should be operated subject to constraints on budget deficits, and specifically the current budget position balanced over the cycle. The close-to-achievement of the 'golden rule' owes much to the surpluses generated in the late 1990s by the investment boom and lower savings, to reduction in nominal interest rates lowering interest payments on public debt, to use of the PFI and to the re-dating of the cycle. Whether the budget deficit has been actually constrained by this framework is probably impossible to say. But it can be argued that the budget deficit since 1997 differs little from earlier periods. For the current budget, over the period 1974/75 to 1996/97, the deficit had averaged 1.9 per cent of GDP, whereas between 1997/98 to 2005/06 it was very close to zero (0.1 per cent).[7] The public sector borrowing requirement had averaged 3.1 per cent of GDP over the former period and 1 per cent over the latter period. However, in real terms (after allowance for the effects of inflation on the real value of public debt) over both periods the borrowing requirement was close to zero. This is reflected in the net public debt to GDP ratio which fell from 52 per cent in 1974 to 26 per cent in 1990, to rise back to 41.4 per cent in 1997 and fall to 36.4 per cent in 2005 (and noting here that this figure is distorted by the treatment of PFI as discussed above).

5. Good policies or good fortune ?

[7] Figures calculated from Table C25, 1.1. and 2.4 of Treasury (2006a).

The discussion in section 2 suggests a relatively good macroeconomic performance since 1997 with economic growth reasonably stable around 2 ¾ per cent per annum, inflation close to its target and unemployment initially declining though broadly flat after 2000. For the near ten year period under review, Gordon Brown has been the Chancellor of the Exchequer, and our remarks can be seen as a preliminary assessment of his record. For this purpose we will accept that macroeconomic performance has been reasonably good, but noting that how good the performance has been depends on the criteria applied and the comparisons made[8]. Here we consider whether the 'good' economic performance has resulted from the policies pursued and/or from good fortune. The government itself has made much of the contribution of new macroeconomic framework put in place in the early days of the new Labour government, notably the operational independence of the Bank of England and the Code of Fiscal Stability and the associated adoption of the 'golden rule', as is readily apparent from any Budget Statement or Pre-Budget Report (e.g. Treasury (2006a, 2006c).

One source of good fortune arises from a combination of good inherited economic conditions and a generally favourable world economic climate. In terms of inflation that has clearly been the case. The inherited economic conditions (cf. Table 1) were generally good and rather better than the conditions which previous Labour governments had inherited. Inflation on a world-wide basis has also been low.

A further source comes from policy decisions taken for essentially political reasons which turn out to be good decisions from a macro-economic perspective. The new Labour government came into office with a commitment to maintain the previous Conservative government's spending plans for the first two years, even though those spending plans were very tight[9]. It is likely that the Conservative government would not have kept to those spending plans if they had continued in office[10]. The Chancellor boasted that 'Public

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[8] The significant current account deficit, the continuing decline of manufacturing and the absence of any significant reductions in inequality should also be brought into the assessment.

[9] In the words of the manifesto, "**Stick to planned public spending allocations for the first two years of office.** Our decisions have not been taken lightly. They are a recognition of Conservative mismanagement of the public finances. For the next two years Labour will work within the departmental ceilings for spending already announced. We will resist unreasonable demands on the public purse, including any unreasonable public sector pay demands." (Labour Party, 1997, bold in original).

[10] "In his November[1996] Budget he [Kenneth Clarke] announced minuscule increases in spending in the hope that his Labour shadow, Gordon Brown, would lose public credibility by refusing to swallow the poisoned pill. Mr Clarke was wrong. Mr Brown not only swallowed the pill, he swallowed it with relish. In order to prove his Iron Chancellor

borrowing has been reduced by £31 billion over the past two years [i.e. 1997 to 1999]- a cumulative fiscal tightening of 3¼ per cent of GDP, the largest fiscal tightening since 1981 - and the March Budget continues to lock in that fiscal tightening by keeping the public finances under control, while allowing fiscal policy to continue to support monetary policy in the next stage of the cycle.'[11]

The effects of restraining public expenditure in macroeconomic terms depends on the buoyancy or otherwise of private expenditure, and we argue that Brown was fortunate in that the tight restraints on public expenditure in the early years came when private expenditure was booming. As will be seen from Table 5, strong investment and export demand in 1997 and 1998 meant that the tight constraints on public expenditure did not lead to an economic slowdown. In a similar vein but in the opposite direction, public expenditure, particularly on education and health was boosted from 2001 onwards. 'An expansionary fiscal policy has been an important factor supporting demand since the global downturn; between 2000 and 2004 the cyclically-adjusted balance declined by 4½ per cent of GDP, which was only exceeded by the United States. Over the same period over half of new jobs have been created in the public sector, which has experienced average employment growth of 2% per annum (about six times the growth rate in private sector employment).' (OECD, 2005, pp. 29-30).

The idea of fiscal policy as acting as an automatic stabiliser implies that the levels of public expenditure on goods and services and structure of tax and transfer payments are held relatively stable with respect to the business cycle, and the budget deficit varies counter-cyclically as tax receipts and transfer payments rise and fall with the cycle. The difficulty of judging in practice whether fiscal policy has been used in this way is, of course, that public expenditure and tax structure will change for a variety of reasons unconnected with the business cycle.

The final column in Table 4 indicates substantial shifts in ratio of total public expenditure to GDP : over the new Labour period initially falling by 3.7 percentage points (1999/2000 over 1996/97), and then rising by 5.1 percentage points (2005/06 over 1999/2000). The growth of

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credentials, he not only kept to Mr Clarke's hideously tough plans but managed to cut public spending in inflation-adjusted terms during Labour's first two years…. Mr Clarke, who admits that he would have torn up his plans had John Major won in 1997, says that there was no economic reason to justify the squeeze on public spending in Labour's first two years" (Elliot, 2001).

[11] From a speech by the Chancellor of the Exchequer to the CBI annual dinner, 18 May 1999 (available at http://www.hm-treasury.gov.uk./newsroom_and_speeches/press/1999/press_80_99.cfm)

public expenditure on goods and services has varied between -0.38 per cent (1997) and around 3 ½ per cent (1999, 2002, 2003). Table 3 indicates movements in the cyclically adjusted borrowing requirement from -1.5 per cent of GDP in 1999/2000 and 2000/01 to +3.2 per cent in 2004/05. Fiscal policy was substantially tightened from 1997/98 to 2000/01 (as judged by the cyclically adjusted public sector net borrowing) by 2.2 percentage points of GDP and significantly loosened through to 2004/05 by 4.7 percentage points. These variations do not fit easily with fiscal policy acting solely as an automatic stabiliser, and gives the impression of marked shifts in the fiscal stance. The question here is whether these variations which are not seen as arising from attempts to fine tune the economy through fiscal policy have nevertheless acted in a stabilising manner.

Tables 4 and 5 near here

It can first be noted that the variability of GDP is considerable smaller than the variability of its various components : measured by the standard deviation of growth rate, GDP was 0.641 over the period 1997 to 2005, whereas standard deviation for investment growth was 4.266, exports 2.837 and government expenditure on goods and services 1.318. The substantial variability of the different components offset one another to lead to a much lower variability in GDP. Has public expenditure itself become more stable ? In terms of total public expenditure, the standard deviation of annual growth rate of expenditure (in real terms) over the period 1971/72 to 2004/05 was 3.02, a period which included growth of around 10 per cent in 1973/74 and 1974/75. Omitting those years, over the period 1975/76 to 1996/97 the standard deviation was 2.23 whereas over the new Labour years the standard deviation was 2.45.[12] That limited comparison does not suggest that the stability of public expenditure growth has risen. The contribution of public expenditure to the relatively stable picture for GDP then does not appear to have arisen from a passive stance over public expenditure. It may have come from the fortuitous variation of public expenditure in the face of private expenditure variations. For example, the correlation between the growth of public expenditure and the growth of total private expenditure was -0.57, indicating some offsetting variation in public expenditure for variations in private expenditure.

The fiscal policy rules in the Code for Fiscal Stability appeared to place significant constraints on the size of budget deficits. However, in the outturn there does not seem to have been an effective constraint on the fiscal deficit as compared with what would be required to sustain a high level of employment. The budget deficits in 2004 and 2005 were at levels

[12] Calculated from expenditure figures given in Treasury (2006a) Table C26.

(relative to GDP) comparable to those of the 1980s and were only low by comparison with the figures of the early 1990s. The test for the 'golden rule' is likely to come over the next few years. Starting from the present position of a budget deficit exceeding 3 per cent of GDP with output gap close to zero suggests that over the whole of a cycle with the present fiscal stance the budget deficit would average close to 3 per cent, and significantly away from zero. Further, any significant slow down in economic activity would lead to substantial increases in the budget deficit. A budget deficit position compatible with the 'golden rule' would require some combination of rise in investment, fall in domestic savings, or improvement in the current account.

There is another way in which fortune has smiled on the Chancellor, namely that the UK has not been a member of the Economic and Monetary Union. The actual budget deficits and indeed the golden rule implying, as argued above, an average budget deficit of 2 per cent of GDP would have breached the terms of the Stability and Growth Pact. It could, of course, be argued that since France and Germany similarly ran budget deficits outside of the rules and no effective action was taken against them – though they were censured, and a smaller country Portugal was forced to cut public expenditure with a consequent rise in unemployment. However, at the same time, the UK would have gone through a round of embarrassing pressures to lower the budget deficit. Evidence of this is that the UK was declared to have an excessive deficit and 'invited' to bring the deficit below the 3 per cent of GDP level (European Commission, 2006). This despite the UK Treasury insistence that "This year we expect to have a treaty deficit of 3%, falling to 2.7% next year, and down to 1.5% by 2010", and that "The UK continues to have the lowest average debts and deficits of any other major European economy"; also "We make no apologies for investing in vital public services" (reported in Gow and Seager, 2006). If the 'golden rule' continued to be applied in its present form which, as we argued above, implies an average budget deficit of the order of 2 per cent of GDP, this would be in clear conflict with the Stability and Growth Pact which requires balance or small surplus of the budget position over the course of the business cycle.

6. Conclusions

The fiscal policy of 'new Labour' could be described as stressing "the importance of prudence and transparency" (Treasury, 2000, p. 9, and many other documents), with the aim of a long-run budget deficit around 2 per cent of GDP and debt to GDP ratio of 40 per cent. We have cast doubt on the validity of the 'golden rule' as a guiding principle for macroeconomic policy. There has been debate as to whether the 'golden rule' has been achieved, and we have argued that the debt to GDP ratio has only met the 40 per cent rule

through the accounting practices associated with the private finance initiative. Whilst there has been a welcome reduction in unemployment, the fall on the ILO count is far from impressive : the unemployment rate in late 2006 represents a fall of one quarter on the rate in mid 1997. There has been a relative stability of the UK economy, and notably an avoidance of recessions. We have argued that largely by luck fiscal policy has in practice operated in a stabilising manner with substantial shifts in the fiscal stance, and that the latitude allowed by the 'golden rule' has not in practice constrained the ability of the government to run budget deficits of an appropriate magnitude.

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Table 1 : Summary macroeconomic data

	Growth rate	Inflation rate	Unemployment (claimant count)	Unemployment (ILO)
1992	0.28	3.76	9.18	
1993	2.43	1.57	9.80	10.38
1994	4.41	2.49	8.88	9.50
1995	2.85	3.41	7.63	8.63
1996	2.73	2.41	6.95	8.05
1997	3.16	3.16	5.30	6.95
1998	3.24	3.42	4.50	6.25
1999	3.03	1.51	4.13	6.05
2000	4.03	2.97	3.58	5.45
2001	2.36	1.78	3.18	5.08
2002	2.06	1.69	3.08	5.18
2003	2.66	2.90	2.98	5.03
2004	3.26	2.98	2.75	4.75
2005	1.86	2.84	2.75	5.0

Source: Calculated from *National Income Blue Book,* various issues, Economic *Trends Annual Supplement* and *Economic Trends* June 2006

Table 2 Budget deficits

All expressed as per cent of GDP

	Public sector current budget	Cyclically adjusted surplus on current budget	Public sector net borrowing	Cyclically adjusted public sector net borrowing
1989/90	1.5	-1.4	-0.2	2.6
1990/91	0.3	-1.2	1.0	2.6
1991/92	-2.0	-1.5	3.8	3.4
1992/93	-5.7	-3.8	7.6	5.7
1993/94	-6.4	-4.2	7.8	5.6
1994/95	-4.8	-3.4	6.3	4.9
1995/96	-3.4	-2.5	4.7	3.9
1996/97	-2.8	-2.3	3.5	3.0
1997/98	-0.1	0.0	0.8	0.7
1998/99	1.2	1.1	-0.5	-0.3
1999/2000	2.3	2.0	-1.8	-1.5
2000/01	2.5	1.9	-2.1	-1.5
2001/02	1.0	0.9	0.1	0.3
2002/03	-1.1	-0.7	2.3	1.9
2003/04	-1.7	-1.3	3.0	2.7
2004/05	-1.6	-1.6	3.3	3.2
2005/06	-1.2	-1.0	3.0	2.8

Source : Treasury (2006c), Table B30

Table 3: Meeting the fiscal rules

(All figures are per cent of GDP)

	2005-06 Outturn	2006-07 Estimate	2007-08 Pro-jection	2008-09 Pro-jection	2009-10 Pro-jection	2010-11 Pro-jection	2011-12 Pro-jection
Golden rule							
Surplus on current budget	-1.2	-0.6	-0.1	0.3	0.5	0.6	0.8
Average surplus since 1997-1998	0.1	0.1	0.0	0.1	0.1	0.1	0.2
Cyclically-adjusted surplus on current budget	-1.0	-0.4	-0.1	0.3	0.5	0.6	0.8
Sustainable investment rule							
Public sector net debt	36.4	37.5	38.2	38.6	38.7	38.7	38.5

Debt at end March; GDP centred on end March.

Source: Treasury (2006c) Table 1.1

Table 4 Trends in public expenditure

(all expressed as percent of GDP)

	Public sector current expenditure	Public sector net investment	Public sector gross investment	Total managed expenditure
1989/90	36.0	1.3	4.0	39.7
1990/91	36.4	1.4	3.9	40.0
1991/92	38.7	1.8	3.9	42.6
1992/93	40.5	1.9	3.9	44.5
1993/94	40.4	1.4	3.4	43.8
1994/95	39.4	1.4	3.3	43.3
1995/96	39.4	1.4	3.2	42.6
1996/97	38.5	0.7	2.3	40.8
1997/98	37.0	0.6	2.1	39.2
1998/99	36.0	0.7	2.1	38.1
1999/2000	35.3	0.5	1.9	37.1
2000/01	35.8	0.4	1.7	37.5
2001/02	36.3	1.1	2.4	38.7
2002/03	37.0	1.2	2.5	39.5
2003/04	37.8	1.4	2.6	40.4
2004/05	38.4	1.7	3.0	41.5
2005/06	39.1	1.8	3.1	42.2

Source : Treasury (2006c), Table B31

Table 5 Growth of components of demand

	Growth of consumer expenditure	Growth of investment expenditure	Growth of public expenditure on goods and services	Growth of exports	Growth of final expenditure	Growth of private expenditure
1996	3.80	3.04	0.85	8.85	4.33	4.84
1997	3.48	8.13	-0.38	8.22	4.58	5.27
1998	3.95	14.30	1.16	2.96	4.66	5.25
1999	4.51	3.72	3.57	3.75	4.09	4.20
2000	4.62	1.93	3.05	9.12	4.96	5.25
2001	2.97	3.17	2.41	2.91	2.91	2.99
2002	3.45	1.68	3.44	0.97	2.70	2.57
2003	2.90	1.20	3.49	1.78	2.51	2.36
2004	3.37	6.21	3.19	4.87	4.01	4.16
2005	1.42	2.05	2.64	6.47	2.72	2.73

Source: Calculated from *National Income Blue Book*, Table 1.3