class
Centre for Labour and Social Studies

Think Piece

Budget 2015: *The budget surplus rule scam*

Malcolm Sawyer

University of Leeds

July 2015

Author

Malcolm Sawyer is Emeritus Professor of Economics at the Leeds University Business School, the Managing Editor of International Review of Applied Economics and Principal Investigator for a 5 year, 15 partner research project Financialisation, Economy, Society and Sustainable Development.

Malcolm has authored 12 books (most recently (with Philip Arestis), *Economic and Monetary Union Macroeconomic Policies: Current practices and alternatives*) and edited over 25 books including the recent co-edited with Philip Arestis, *Finance and the Macroeconomics of Environmental Policies*. He has also published over 100 papers in refereed journals including papers on fiscal policies, alternative monetary policies, path dependency, public private partnerships and financialisation.

In a speech to at the Mansion House, London on 10th June 2015, the UK Chancellor of the Exchequer announced his intention “that, in normal times, governments of the left as well as the right should run a budget surplus to bear down on debt and prepare for an uncertain future”, and that “in the Budget we will bring forward this strong new fiscal framework to entrench this permanent commitment to that surplus, and the budget responsibility it represents.”[i] This ‘fiscal surplus’ law is ill-defined and is essentially unenforceable. It appears without **any** economic rationale as to why a budget surplus would be either desirable or indeed achievable in a sustainable manner.

Mr Osborne meets Mr Micawber

The rationale for a ‘budget surplus’ would appear to be along the lines of Mr Micawber’s approach in Dickens’ *David Copperfield*. "Annual income twenty pounds, annual expenditure nineteen [pounds] nineteen [shillings] and six [pence], result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." (Dickens).

Mr Micawber did not have to consider the implications of his dictum, and it would seem that Mr. Osborne has not either. The excess of income over expenditure may bring Mr Micawber happiness, but is there someone to whom he can lend his sixpence; Mr Micawber may wish to save but there has to be someone willing to borrow from him. Mr Micawber may achieve happiness through his sixpence excess, but at the expense of someone else who has a sixpence deficit and suffers misery. Mr Micawber did not have to consider the effects which his actions have on employment through his failure to spend. He did not consider whether he would have been well advised to spend more on investing for the future.

The government should, of course, take note of the effects of their actions on public services, people’s incomes, unemployment etc. And the government has to take into account what is happening in the private sector: if the private sector wishes to save (and according to Mr Micawber experience happiness), then the public sector has to borrow. In order for there to be a budget surplus there has to be, as a simple matter of accounting, a private sector deficit. Any sensible discussion of having a ‘budget surplus’ rule has to involve discussion of having a ‘private sector deficit’ rule.

Mr Osborne's own objections to his 'budget surplus' rule

In a speech on 5th January 2010 in the House of Commons debate on the second reading of the Labour government's Fiscal Responsibility Bill, George Osborne said:

> "Let us look at clause 4, which relates to accountability. Let us see what terrible fate will await the Treasury if it fails to comply with the order imposed on it by the Treasury. Will the Chancellor be hauled off to the Tower? Will he be forced to hand in the great seals of his office? Will his pay be docked for poor performance? Will he at least have to apologise?"

> "Of course we have to debate this vacuous and irrelevant legislation, but why did the Chancellor feel the compelling need to introduce it? Why is he the first Chancellor in history to feel that he needs an Act of Parliament on top of a Budget statement? There can be only two explanations: either he does not trust himself to secure sound public finances, or he knows that the public do not trust him to secure them. Neither is exactly a ringing endorsement; both are a reflection of the catastrophic, disastrous state to which this Government have reduced the finances of this country."[ii]

George Osborne, of course, as Chancellor went on to claim that the budget deficit would be virtually eliminated during the last Parliament but, in his words in his Mansion House speech "we have a budget deficit that remains, at just shy of 5% of national income, one of the highest in the developed world." It is tempting to consider Osborne's question as to why the Chancellor feels the need for an Act of Parliament incorporating the 'budget surplus' when he so spectacularly failed to keep to his promise of deficit reduction last time round. Could it possibly be that he is seeking to set a political trap for the opposition parties? He would be putting into law a 'budget surplus' rule which has little prospect of applying during this Parliament as on current Office for Budget Responsibility (OBR) forecasts which incorporate public expenditure cuts the budget position would just creep into surplus in 2019/20.

When the Bank of England persistently failed to meet its inflation target nothing happened, so it would be when the Chancellor failed to meet the 'budget surplus' target. It is said that there would be embarrassment – but Osborne has been remarkably unembarrassed by his failure to cut the budget deficit as he so firmly forecast back in 2010.

Objections

The ‘budget surplus’ proposal is very loosely formulated at the present – with reference to surplus in ‘normal times’ – do we ever live in ‘normal times’ or perhaps sometimes in ‘interesting times’? Does ‘normal times’ require unemployment to be low and output at or above potential? What would be the ‘new normal’?

It can be readily recognized that the ‘budget surplus’ proposal seeks to bind in future governments and to remove their flexibility and ability to respond to changing economic circumstances, natural disasters etc. – presumably unless the OBR declare that to be ‘abnormal times’.

The ‘budget surplus’ rule seeks to deny the role of ‘automatic stabilisers’ – that if there is a downturn in demand and economic activity, tax revenues decline, unemployment benefit payments rise which modifies the extent of the downturn, and similarly an upturn is to some degree damped down. A downturn which was not severe enough to be a recession (and ‘abnormal times’) could well tip the budget position into deficit – even starting from a significant surplus – would the government then be committed to raising taxes and cutting expenditure at just the time when the government should be reducing taxes and raising expenditure.

Budget surpluses are not sustainable

Why do governments in the UK- and more generally- have budget deficits most of the time, and only on a few occasions have budget surpluses? Is it on a whim of the incumbent Chancellor, and if so, why are those whims so rare? It is clearly evident that there are significant shifts in the budget positions from year to year.

The large rises in the budget deficit from 2007/08 to 2009/10 (2.7 per cent of gross domestic product, GDP, to 10.2 per cent) and from 1990/91 (1 per cent of GDP) to 1993/94 (7.2 per cent) were not due to Alistair Darling and Norman Lamont suddenly going on a spending spree – they were due to the down-turns in the economic activity and in tax receipts. The fall in tax receipts and some (usually modest) rises in public expenditure softened- though did not prevent- the falls in output and rises in unemployment.

We could wonder why it is that there have only been 7 occasions since 1950 (five of which were when Labour was in office) when government has reported a budget surplus, and why the budget deficit has averaged just over 2.5 per cent of GDP. It could be imagined that governments are incurably profligate: though why do they limit themselves to only 2.5 per cent of GDP. A more reasonable explanation is that successive governments have realised that there was a need for public investment funded through borrowing.

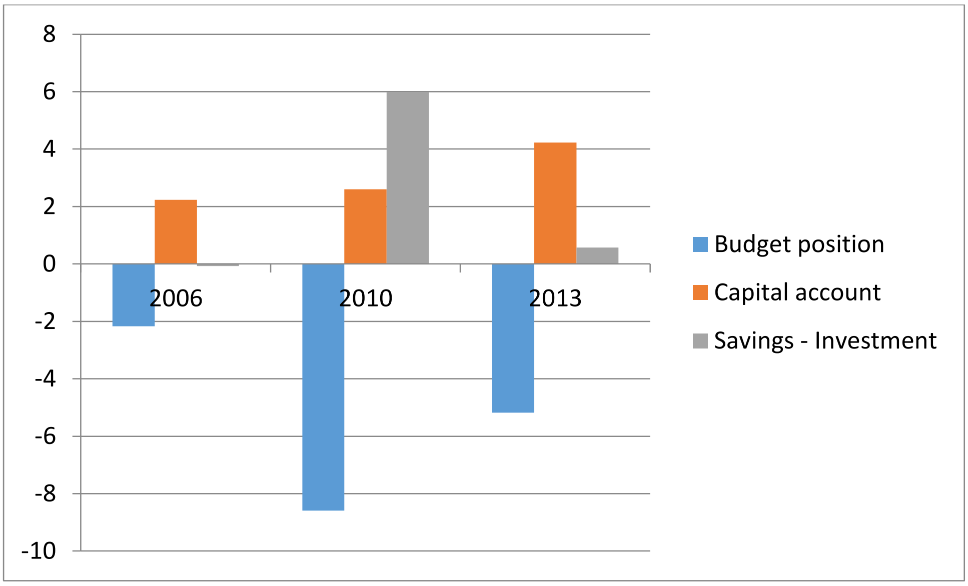
Another thought is that there is a realisation that there is often a need for budget deficit to support the level of demand in the economy to maintain a reasonable level of employment. There is often a need in accounting terms for a budget deficit to balance against the trade deficit and low levels of investment. In now aiming for a budget surplus, the Chancellor needs to explain how circumstances have changed. Is there no longer a need to borrow in order to undertake public investment? Is it that now there will be an investment and export boom of unprecedented proportions?

There is a sectoral balance relationship coming from the observation that one person's borrowing is another person's lending. At the sectoral level this becomes:

Budget Deficit = (Private Savings – Private Investment) + Capital Account Inflow = (Private Savings – Investment) + Current Account Deficit. It is then simple to observe that if the budget deficit is to be zero or negative (balanced budget or surplus) then there has to be some combination of investment exceeding savings and capital account in deficit (current account in surplus).

In Figure 1 (below), some data for 2006, 2010, 2013 on these three terms is illustrated. It is not by chance that the blocks above the line and the blocks below the line cancel out, as that is a reflection of the sector balance which has just been discussed.

Figure 1: Sectoral balances as percent of GDP[iii]



Calculated from National Income Blue Book

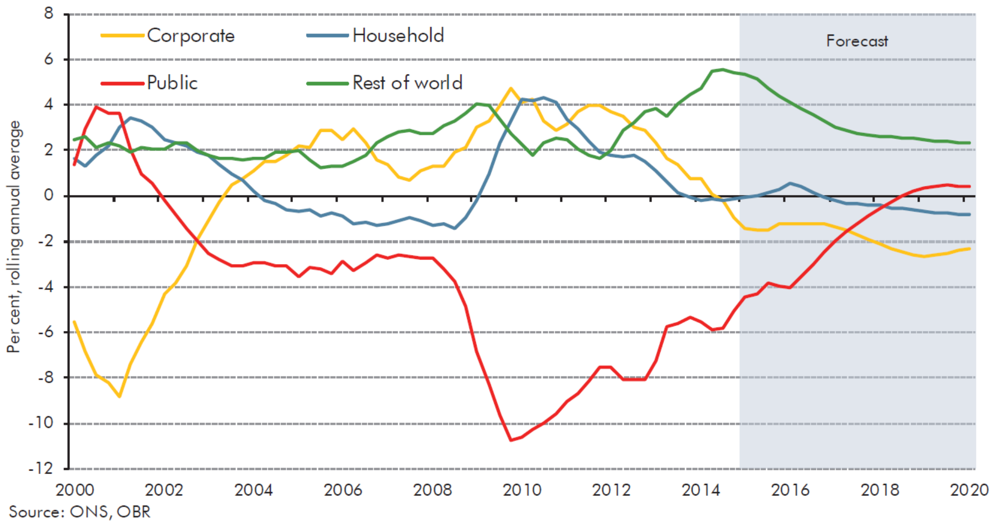
The move from a budget deficit to a budget surplus has to be associated with some combination of lower savings, higher investment, lower imports, higher exports (and net income). A change which comes from lower savings and lower imports is likely to involve lower income; a change which comes from higher investment and higher exports and net income higher income.

Attempting to reduce budget deficit through expenditure cuts and tax rises is likely to involve lower income; attempting to reduce budget deficit through stimulation of investment and exports higher income. In terms of Figure 1, in order for one of the columns to change there has to be balancing changes in the other columns. It is simply not possible to have the outcome of the budget position change without that being accompanied by a change in at least one of the other sectoral balances.

It is clear that the achievement of a budget surplus requires some combination of a deficit of savings over investment and a current account surplus. What the government borrows (budget deficit) comes from borrowing from abroad and borrowing from the private sector. The UK (firms, households) is borrowing from abroad to cover the current account deficit.

Starting from the actual outcome in 2013, which could be regarded was a 'normal year' (output grew), then to achieve a small budget surplus of 1 per cent of GDP would have required a 'swing' of 6.17 per cent of GDP budget balance, and would have required some combination of the balance of investment over savings rising by over 6 per cent of GDP (if that came just from investment, then investment would have to be 40 per cent higher; if from savings then 40 per cent smaller), or the current account moving from a deficit of just over 2 per cent of GDP deficit to an unprecedented surplus of close to 4 per cent of GDP.

Figure 2: Sectoral net lending[iv]



Source: Office for Budget Responsibility (2015)

Figure 2 portrays the net lending and borrowing by broad sectors since 2000 with the OBR's forecast through to 2020. The red line ('public') corresponds to government borrowing ('budget deficit'). The dive in 2008 to 2009 is clearly evident, as is the sharp rise in household lending as the household sector moves away from very low savings rates. The corporate sector moved from being a net lender (to fund its investment) to a net borrower (as its profits rose and investment slowed), and is now forecast to become a net lender in the next five years as investment rises. Net lending from the rest of the world (green line) has been rising in recent years as the current account deficit worsened, and is now forecast to decline in the next five years. Here again the sum of the net lending of the four sectors will be zero – if one sector is lending another has to be borrowing.

In 2010, the newly elected Coalition government 'recognise[d] that deficit reduction, and continuing to ensure economic recovery, is the most urgent issue facing Britain'. It committed to 'significantly accelerate the reduction of the structural deficit over the course of a Parliament, with the main burden of deficit reduction borne by reduced spending rather than increased taxes' (Cabinet Office, 2010, p.15). It introduced an emergency budget in June 2010 and further fiscal adjustments announced in November 2010. Following from those budgets, plans were put in place to reduce the budget deficit which in 2009/10 had been 11.1 per cent of GDP, and was forecast to be 10 per cent in 2010/11 to reach 1 per cent in 2015/16, using a combination of 80 per cent of the reduction of the deficit to come from expenditure cuts and 20 per cent through tax increases. The Office of Budget Responsibility (OBR) which had been newly formed in June 2010 produced forecasts in November 2010 that the deficit reduction would indeed be reached in 2015/16. This reduction in the budget deficit was forecast to be accompanied by growth each year in excess of 2 per cent, and the output gap falling to 0.9 per cent. Table 1 produces a summary of some of the key features of that forecast.

Table 1: Comparison of November 2010 forecasts and outcomes[v]

2015/16 over 2010/11	Growth of Investment (%)	Growth of Exports (%)	Growth of Imports (%)	Growth of GDP (%)	Budget deficit/GDP ratio (%)	Trade balance/ GDP (%)	Current account/ GDP (%)
Forecast	37.9	35.2	20.3	13.7	10.0 to 1	Deficit: 3.6 to 0.8	Deficit: 2.4 to 0.6
Actual	19.0	10.0	11.8	9.4	4 per cent	Deficit: 1.4	Deficit 4.1

Source: Calculated from Office for Budget Responsibility spread sheets

There was forecast to be an investment boom, taking the investment to GDP ratio from 15.5 per cent to 18.8 per cent (a peak level in the past two decades or more); exports would grow nearly twice as fast as imports and the trade account moving close to balance. These forecasts did not come to pass as the third line in Table 1 illustrates. But even if they had the budget position would have been close to balance, and not in surplus. Yet to reach a small deficit would have recorded major changes in investment and export performance as compared with earlier years.

In the budget of March 2015, the Government's intention was expressed in terms of the elimination of the budget deficit by 2019/20. The OBR's central forecast was for a small surplus of 0.3 per cent of GDP. Alongside that the forecast included continuously rising household debt. This had peaked in 2008Q1 at 188.7 per cent of income; having fallen to just over 140 per cent in 2013/14, rises continuously (according to the forecast) to surpass the previous peak level in 2019Q3. Investment income from abroad moves investment income is forecast to move from a deficit of £41.0 billion in 2014/15 to a surplus of £5.4 billion in 2019/20, and the overall current account deficit of £96.1 billion in 2014/15 moves to a deficit of £49.5 billion by 2019/20.

Investment is forecast to increase by 29.5 per cent between 2014/15 and 2019/20. Exports and imports are forecast to growth at much the same rate (around 24 per cent), but the current account deficit falls sharply through a forecast rebound of investment income. GDP is forecast to grow over the period by 12.4 per cent. These events may happen, and if they did then indeed there would be a small budget surplus. But, even according to the OBR, there is around a 45 per cent chance that there will not be a budget surplus. Indeed on their estimates there is a 10 per cent chance that the deficit will be greater than 4.1 per cent of GDP, and also a 10 per cent chance of a surplus greater than 3.5 per cent of GDP.

These forecasts raise two major issues. First, are the private sector developments which are forecast plausible and sustainable: if they are not then the small budget surplus forecast is neither plausible nor sustainable. Household debt would have reached record levels. Investment (relative to GDP) would be at its highest for many years, and previous experience would suggest that high level would not be maintained. The fall in UK's borrowing from the rest of the world rests to a great extent on investment income moving from substantial deficit to small surplus.

Second, if there is deemed to be a 55 per cent chance of a budget surplus and a 45 per cent chance of a budget deficit, would the 'budget surplus rule' be satisfied?. This points to a serious issue – to have any bite a 'budget surplus' rule would need to be applied with regard to the future. Discerning whether there could be a budget surplus in one, two or more years hence requires forecasting the future. But any forecast for the budget position is inherently uncertain and has to reflect forecasts for the private sector (in terms of investment, consumer expenditure, exports, imports etc.).

It is also rather strange that although the OBR recognizes the uncertainties surrounding their forecasts that in both 2010 and 2015 they have managed to come up with central forecasts that in five years' time the government will have achieved its budget targets and that the private sector behaviour will have evolved in ways which are consistent with that.

There are only two ways through which a 'budget surplus' could be reached from where the economy is at present (and with growth of 2 per cent or thereabouts, inflation below target and unemployment falling are we not in 'normal times'?). The first would be a boom of expenditure based on investment, an export miracle (without corresponding rise in savings and imports), and a debt-fuelled consumer boom. The second would be the suppression of output and income so that savings and imports fell (without corresponding falls in investment and exports). The first looks rather unlikely to say the least – and it is not just a matter of investment booming for a few years, but that boom continuing indefinitely. The second could result from the attempts to reduce government expenditure and raise taxes.

What the effects of a perpetual budget surplus would be? The interest bearing government debt would decrease with some implications for the operation of open market operations. There would be a withdrawal of safe financial assets in which pension funds and the like can invest. The debt to GDP ratio would fall, and would eventually reach zero (a brief calculation starting with a 80 per cent debt to GDP ratio, 2 per cent GDP budget surplus, 2 per cent real growth and 2 per cent inflation would lead to the debt falling to zero after around 25 years). After that time, the government would start to buy financial assets from the private sector.

Labour

There is little doubt that Labour lost a reputation for economic competence when the economy went into recession following years of boasting that there was an end of 'boom and bust' and regular updates on the number of consecutive quarters of growth. All serious commentators accept that the cause of the recession and the cause of the rise in the budget deficit to over 10 per cent of GDP in 2009/10 was the global financial crises centred in the USA, but with strong domestic elements in UK (as well as countries like Ireland and Iceland).

No serious commentator believes that it was due to the profligacy of Alistair Darling. In office, Labour had kept fairly close to its own fiscal rules (borrow to investment, debt ratio below 40 per cent of GDP).

Some issues in the pre-crisis budget deficit under the Labour government should though be acknowledged. The budget deficit had been restrained through the high tax receipts from property dealings (stamp duty), profits of the financial sector and high consumer expenditure alongside rising debt level, with Labour in effect riding a property and financial boom. The light touch approach to regulation combining with regulators often being asleep on the job had aided an unsustainable financial boom. The financial crisis, the slump in the housing market, the sharp decline in profits of the financial sector ensured that tax receipts fell sharply. The budget position in 2007 could have been difficult to sustain—but because the private sector behaviour which was helping to boost tax revenues were unsustainable.

The recorded budget deficit was also kept down through the accounting tricks of the Private Finance Initiative (PFI) where borrowing for public investment did not immediately appear as government borrowing though PFI payments stretching into the future added to budget deficits with the overall costs of a PFI project being considerable greater than as well as costing a great deal more than conventionally funded public investment.

Some in the Labour Party would claim that Labour should regain credibility by locking into some form of 'budget surplus rule'[vi]. It is difficult to believe that credibility is to be regained through commitment to achieving a budget surplus which is rarely feasible. It is difficult to believe that credibility is to be regained without demonstrating how there will be a sustainable increase in investment, how the trade account can be improved and how to limit ballooning household debt which would have to accompany a budget surplus. It is the height of irresponsibility to accept the straight jacket of a 'budget surplus' rule without confronting those issues. It is the height of irresponsibility to commit to a 'budget surplus' which leads to unnecessary cuts in socially useful public expenditure.

In writing of *'The misleading comparison'* in 'policy –based evidence-making', Giles Wilkes argues that 'a worse sin, in my view, is how "debt interest" is set against any other item of spending in order to condemn it[vii]. Education spending is the most common comparator.

The two numbers have nothing to do with one another, and certainly offer no guide as to whether one or the other is too large or small. The lazy implication that debt interest is by definition waste - omitting all of what incurring the debt may have helped past governments achieve - is another attempt to short circuit a complex argument.’ And one might add omitting that debt interest forms someone’s income. Unfortunately there are those within Labour’s ranks who commit this sin.[viii]

The position to argue for is **not** there should always be a budget deficit for some macho Keynesian reason; nor is it to argue for a balanced budget or budget surplus for macho fiscal austerity reasons. It is to argue that the budget position (deficit or surplus) should be arrived at as far as possible to support employment and economic activity and to counter the imbalances of the private sector, of which the current account deficit is the most glaring. It is to argue that a phoney imperative for a budget surplus should not be used as cover for an attack on public expenditure.

Preparing for the next crisis?

One argument which is heard is that a surplus is needed in order to swiftly reduce outstanding government debt in order to be ready for the next crisis and recession when a substantial budget deficit will be required to limit the fall in demand. It appears that fiscal policy is helpful in the face of a major crisis but not in the face of a minor crisis.

It would be rather more useful to address the causes of economic and financial crisis. Appropriate regulation of the banking and financial system, and also policies designed to damp down asset price bubbles and rapid growth of credit and debt. The path to a budget surplus can itself be a contributory factor to such growth of credit and debt. It was remarked above that, according to the OBR forecasts, the path to a budget surplus in 2019/20 would be accompanied by and indeed enabled by a continuously rising household debt. That is a recipe for a downturn in the economy when the debt to income ratio becomes unsustainable.

In the background there is the view that beyond some level debt to GDP ratio is harmful, and that a large increase in the budget deficit which would come from a crisis would push the debt ratio beyond its harmful limit. The academic work on which such views were based has now been largely discredited, yet the idea lingers. Mention can be made of the 250 per cent debt to GDP ratio with which the UK exited World War II enabling it to launch the National Health Service, nationalise key industries and embark on a period of sustained growth and low unemployment.

The basic objections

The objections to ‘budget surplus rule’ are:

- (i) It is put forward without any economic rationale: there is simply no reason to think that a long term budget surplus is appropriate for the economy, desirable or even achievable;
- (ii) It is unachievable without major and dramatic changes to investment, savings, exports and imports: there is sparse evidence that those changes are on the horizon or would be sustainable. If those changes did occur, then the budget deficit would diminish by itself;
- (iii) It is advanced to be a political trap seeking to lure Labour into committing to such a rule where there is scant possibility that it can be achieved in this Parliament and it would undermine the economic plans for the next Labour government;
- (iv) It seeks to bind future governments and to prevent them from responding to changing economic, political and social circumstances;
- (v) It would limit the government’s ability to borrow funds in order to invest;
- (vi) It is an attempt at a public relations exercise with the introduction of a law which would lack any clarity, be unenforceable, and lack any effective sanctions if the law were not adhered to.

The central purpose of government fiscal policy should be provision of high quality public services and a progressive tax system with the balance between public expenditure and tax revenues designed to secure high levels of employment. It should not be the purpose of fiscal policy to meet some arbitrary budget rule which is drawn more by plucking numbers out of the air than any serious analysis.

Notes

Cabinet Office (2010), *The Coalition: our programme for government*

Kendall, L. (2015) 'Labour will be out of power for a decade if it fails to change, Liz Kendall says'

Osborne, G. (2010), Speech, Hansard 5 January 2010, Column 72 http://www.publications.parliament.uk/pa/cm200910/cmhansrd/cm100105/debtext/100105-0012.htm#10010540000094

Osborne, G. (2015), 'Mansion House 2015: Speech by the Chancellor of the Exchequer', https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer

Umunna, C. (2015), 'It's not 'Tory lite' to recognise that Labour's problem is economic credibility'

Wilkes, G. 'Free Lunch: Policy-based evidence-making', *Financial Times* (July 2015)

The statistics from the Office for Budget Responsibility (OBR) on which calculations reported here are based are taken from:

- Economy Supplementary Tables 29110
- Economy Supplementary March 2015
- OBR, *Economic and fiscal outlook* HMSO Cmnd 7979

References

[i] Osborne, G. (2015), 'Mansion House 2015: Speech by the Chancellor of the Exchequer', https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer

[ii] Osborne, G. (2010), Speech, Hansard 5 January 2010, Column 72 http://www.publications.parliament.uk/pa/cm200910/cmhansrd/cm100105/debtext/100105-0012.htm#10010540000094

[iii] ONS National Blue Book http://www.ons.gov.uk/ons/rel/naa1-rd/united-kingdom-national-accounts/the-blue-book--2014-edition/index.html

[iv] OBR Economic and Fiscal Outlook https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/414159/March2015EFO.pdf

[v] The statistics from the Office for Budget Responsibility on which calculations reported here are based are taken from: Economy Supplementary Tables 29110; Economy Supplementary March 2015; OBR, Economic and fiscal outlook HMSO Cmnd 7979

[vi] Kendall, L (2015) 'Labour will be out of power for a decade if it fails to change, Liz Kendall says', http://www.theguardian.com/politics/2015/jun/30/abour-leadership-liz-kendal-out-of-power-decade-fails-change

[vii] Wilkes, G. 'Free Lunch: Policy-based evidence-making', Financial Times (July 2015)

[viii] Umunna, C (2015), 'It's not 'Tory lite' to recognise that Labour's problem is economic credibility'