

MEASURING THE UK FISCAL STANCE SINCE THE SECOND WORLD WAR

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The macroeconomic ‘fiscal stance’ is usually assessed by looking at the scale of the public deficit – the gap between state income and expenditure. High levels of borrowing increase demand and are therefore generally held to stimulate economic activity; low levels of borrowing (or, on occasion, actual repayment of debt) decrease demand, and so are generally thought to depress economic activity.¹ The strength of these effects will depend on the size of the surplus or deficit in relation to the economy as a whole, so they are best measured as a proportion of GDP.

Public borrowing can be measured in a number of ways depending (amongst other things) on the treatment of one-off receipts such as asset sales and on whether the borrowing that public corporations undertake is included. Over most of the post-war period, the different measures have followed similar paths.² For years after 1963, we will focus on public sector net borrowing (PSNB), which includes public corporations as well as the government itself and which is designed to avoid one-off receipts having a dominant effect. For earlier years, PSNB is unavailable, so we use the National Accounts measure of the public sector financial balance. Figure 1, which shows both series together for a number of years, suggests the discontinuity is unimportant.

So how can the path of the deficit best be summarised? The immediate aftermath of the Second World War saw the steady closure over 1946 and 1947 of the huge wartime deficit, producing a few years of surplus as government expenditure was reined in by demobilisation. But, in 1950, military

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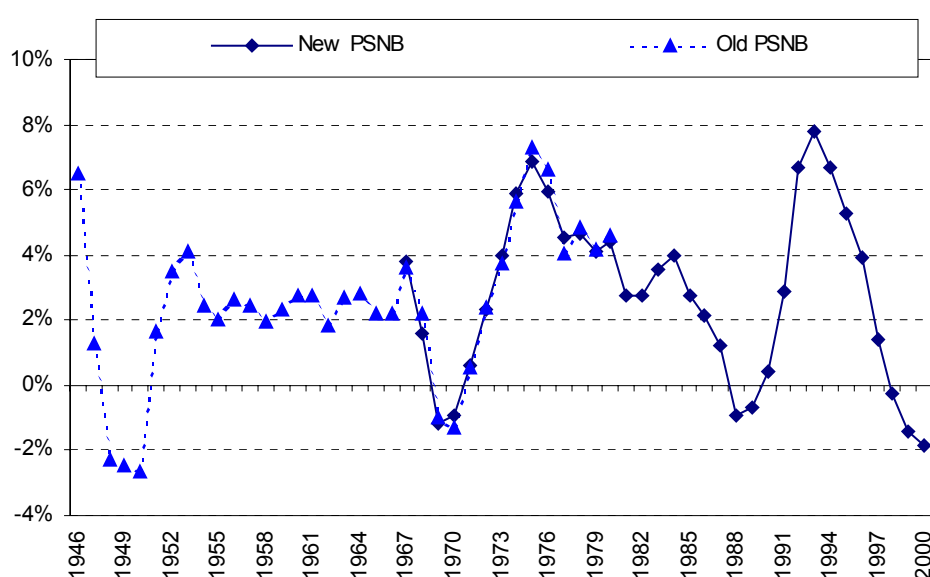
¹ The doctrine of Ricardian equivalence, revived by R. J. Barro, ‘Are government bonds net wealth?’, *Journal of Political Economy*, 1974, vol. 82, pp. 1095–1117, lays down a theoretical challenge to the idea that expansionary fiscal policy will affect the real level of economic activity at all. In practice, except in peculiar circumstances, it is not contentious that there will be at least some short-term effect on output from a fiscal expansion or contraction.

² The notable exception is the late 1980s and early 1990s, when widespread privatisation receipts produced a number of one-off receipts which strengthened the public finances significantly on some measures but not on those from which asset sales were excluded.

commitments again arose, in Korea, and the deficit reached 4 per cent in the final year of that conflict, 1953.

At this point, Britain finally entered a prolonged period of peace. Although the years between the early 1950s and late 1960s are those most associated with fiscal activism and macroeconomic ‘fine-tuning’ in policy-making, it is apparent that the deficit followed a remarkably steady course over these years compared with what has occurred in more recent decades. The deficit fluctuated in the region of 2–3 per cent of GDP in every year after 1953 until 1967. The deficit increased to almost 4 per cent in 1967, but this was immediately followed by a fiscal tightening visible from 1968, which eventually produced surpluses in both 1969 and 1970.

Figure 1. Public sector deficit as a percentage of GDP since the Second World War



PSNB = public sector net borrowing.

Note: The new series is produced on a fiscal-year basis and has been adjusted to a calendar-year basis by the authors.

Sources: Old series – public sector deficit from *Economic Trends Annual Supplement*, 1982, divided by latest GDP figures from the Office for National Statistics website; new series – public sector net borrowing from HM Treasury, *Public Finances Databank*, October 2001.

After 1970, fluctuations in the deficit became increasingly marked. The PSNB increased each year in the early 1970s, so that by 1973 the deficit was back to 1967 levels, in spite of an economic boom. It increased further when the first significant post-war recession struck in 1974–75, and it reached a post-war high in 1975, standing at 7.3 per cent of GDP on the old measure (6.9 per cent on the new measure). There then followed what can be seen as a very prolonged – if faltering – period of deficit reduction, culminating in the surpluses of 1988 and 1989.

Finally, the 1990s saw the most violent swings in this measure of the fiscal stance in the entire post-war era. The decade started with an extremely rapid rise in borrowing, so that in just a few years the surpluses of the late 1980s had turned into a deficit of unprecedented peacetime proportions – in 1993, the PSNB reached 7.8 per cent of GDP. The subsequent tightening of the fiscal stance was almost equally dramatic – borrowing dropped every year until, in 1998, a surplus was once again recorded, and by 2000 the surplus reached almost 2 per cent of GDP, a level not even approached since the close of the 1940s.

In general, the graph apparently suggests that the fiscal stance has been expansionary since the Second World War. The government has engaged in borrowing in most years since the war, repaying debt only in a few brief periods.

How useful is the deficit as a measure of discretionary fiscal policy? One obvious problem concerns the economic cycle – even where there are no discretionary changes in policy, an economic downturn will depress government receipts (as falling household and corporate incomes reduce the tax base) and at the same time increase expenditures (notably, on unemployment-related social security benefits). Together these effects mean that the onset of a downturn will produce a deficit under policies that would previously have achieved balance. Conversely, the onset of a boom can produce a surplus on the basis of policies that previously produced balance.

On these grounds, if the aim is to isolate the stance of *policy*, then it can be argued that apparent fluctuations in the fiscal stance should be discounted to the extent that they merely reflect variation in the actual growth rate around its trend.³ How does this insight colour our interpretation of Figure 1? The absence of a serious recession in the UK over the 1950s, 1960s and early 1970s means that the picture is not dramatically changed over these years. Estimates of a cyclically-adjusted general government deficit for this era suggest a slightly more volatile pattern than the ‘raw’ numbers, but the required adjustment never reaches as much as 1 per cent of GDP and is generally less than 0.5 per cent, so the pattern seen over these years barely changes.⁴

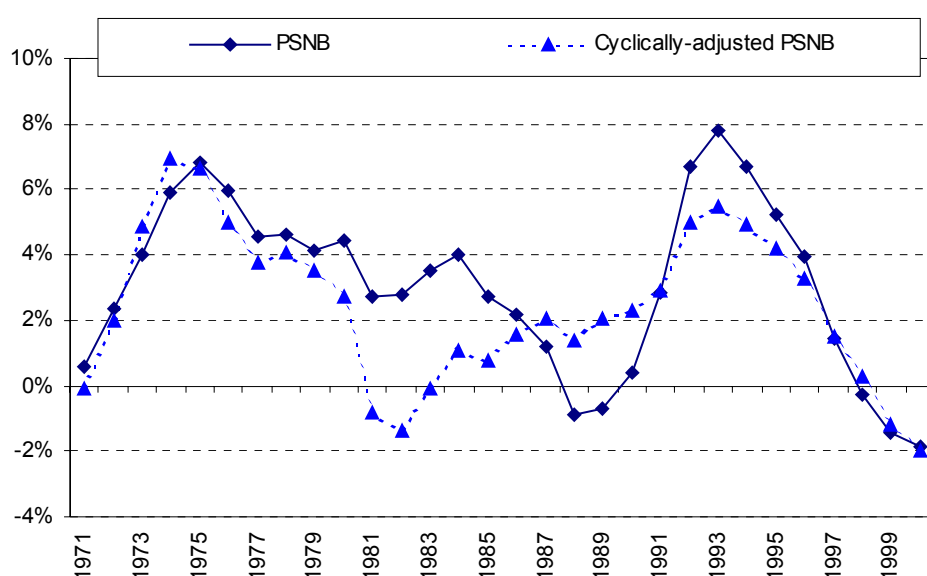
After the 1970s, however, cyclical adjustment does produce marked effects as economic growth became more volatile. The official estimate of the cyclically-

³ The ‘cyclically-adjusted’ deficits that we refer to in this Briefing Note are calculated by assuming that the economy follows a particular long-run growth path. This allows estimation for each year of what the policies in place during that year would have meant for the tax burden and for aggregate expenditure had the economy been on its long-run growth path. The difference between these magnitudes gives the adjusted deficit.

⁴ C. J. Allsopp and D. G. Mayes, ‘Demand management in practice’, in D. Morris (ed.), *The Economic System in the UK*, 3rd edition, OUP, Oxford, 1985.

adjusted deficit is shown in Figure 2 alongside that of the ‘headline’ measure (which is the same as the measure in Figure 1). The adjustment does not hugely change the picture over the 1970s, but its effect is pronounced in the 1980s. In particular, once adjusted for the cyclical effect of the severe recession of the early 1980s, the discretionary fiscal stance of the time appears contractionary. The total contribution of policy over 1981 and 1982 was to impose a cyclically-adjusted surplus that approached 2 per cent of GDP. In the boom of the late 1980s, the opposite is true. In spite of the surpluses achieved in 1988 and 1989, the effect of budgetary policy was actually expansionary. Once allowance is made for the excess of output over trend in these years, the fiscal surplus becomes a deficit, which by 1989 was 2 per cent of GDP.

Figure 2. Public sector deficit as a percentage of GDP since 1971



PSNB = public sector net borrowing.

Note: Series have been converted from a fiscal-year to a calendar-year basis by the authors.

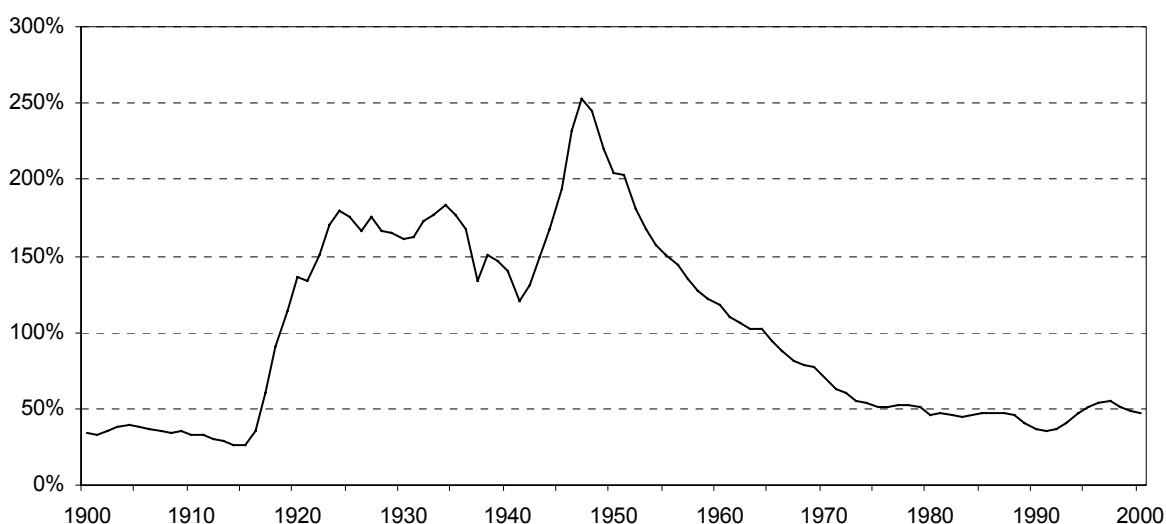
Source: HM Treasury, *Public Finances Databank*, October 2001.

Over the 1990s, the two measures diverge less, especially in the second half of the decade. Over the years 1992–95, output remained below trend as the economy recovered from the 1991 recession. As a result, the deficits appear more modest than on the unadjusted count. The adjustment leaves the deficits of these years looking somewhat smaller than the peak reached in the 1970s. Still, there can be no doubt that the effect of discretionary policy was significantly expansionary – an adjusted deficit worth 5.5 per cent of GDP is shown for 1993, a degree of discretionary expansion unmatched at any point in the post-war era except during the mid-1970s.

The cycle aside, another potential objection to relying on the PSNB as the only measure of fiscal policy is that it fails to convey the path of the true strength of the government’s fiscal position. This is because it captures only the *cash flow* of borrowing, and so ignores two potentially crucial determinants of how

economically important public borrowing really is: first, (unanticipated) inflation, which erodes the real value of the government's outstanding debt and so effects a redistribution from the private sector (bondholders) to the state, which could be thought of as equivalent to a tax which strengthens the government's true financial position; second, real economic growth, which increases government income (by expanding the tax base) and therefore reduces the relative burden that outstanding debt imposes on the public finances.

Figure 3. National debt as a percentage of GDP over the twentieth century



Source: Bank of England Statistical Abstract, Part 1, 2000 edition, Table 15.2 (cited in HM Treasury, Public Finances Databank, October 2001).

The strength of the government's financial position can be assessed in a way that deals with both issues by looking at its stock of debt relative to (nominal) national income. Figure 3 shows this for the whole of the twentieth century.⁵ The dominant effect of the two World Wars is immediately obvious: in each, vast borrowing massively increased the debt burden. The Second World War took the debt burden to its highest point in the era: it reached over 250 per cent of GDP during demobilisation. The stories in the aftermath of each war are

⁵ The national debt is the chosen measure of public debt because it has been recorded over a long period; public sector net debt (PSND) is now the officially preferred measure of debt position, but it is unavailable for earlier years. In practice, the two series have followed very similar courses. From 1970 to the mid-1980s, PSND and the national debt were consistently extremely similar; in the late 1980s, privatisation transferred much debt from the former nationalised industries outside the public sector, which reduced PSND but not the national debt, so PSND fell faster as a share of GDP in these years. Since the early 1990s, the two series have run roughly in parallel, with PSND representing around 5–10 fewer percentage points of GDP than the national debt.

strikingly different. The debt burden left by the First World War was not rapidly reduced. Indeed, in 1934, 16 years after the Armistice, the debt burden stood at 182 per cent of GDP, higher than in the immediate aftermath of the war. By contrast, the large debt run up during the 1939–45 war started declining almost as soon as demobilisation was underway: the debt burden fell in each of the 30 years after 1947, after which it stabilised at around 50 per cent of GDP, a fifth of its 1947 peak.

This way of looking at the fiscal stance, then, radically changes the picture of the post-war period from that obtained by looking at a measure of the cash flow of borrowing, such as PSNB. The 1950s, 1960s and even the 1970s are now revealed as years during which the government steadily but very substantially improved its financial position, suggesting fiscal policy is better described as fairly tight rather than expansionary in these decades. The comparison with the inter-war years suggests that policy may have been important in this, as it is not necessarily something that happens automatically in peacetime. The century's last two decades look rather different, with debt being generally stable as a share of GDP. The only exceptions are the late 1980s, during which there was a visible reduction, and the early 1990s, when the debt burden rose appreciably for the first time in the post-war world.

Why, then, did the debt burden fall continuously over the first 30 years after the war, and why did it stop trending downwards after that point? The decline in the first three post-war decades reflects a number of factors working in the same direction. First, the very high level of the debt ratio left by the Second World War meant that significant borrowing would have been required to avoid eroding it, given that national income growth was positive.⁶ Second, post-war inflation persistently turned out to be higher than anticipated. Little inflation was factored into interest rates when bonds were sold mid-century, as Britain was emerging from an era in which prices fell as often as they rose. But in the 1950s, prices trended upwards, and this movement accelerated during the 1960s. As a result, the real value of the (cash-denominated) stock of debt eroded.⁷ Third, real economic growth was high by historical standards in these years, so the relative importance of a fixed stock of debt to national income tended to decline rapidly. Finally, as we have seen, measured by comparison with what came next, deficits tended to be modest in these years.

⁶ For any rate of nominal national income growth, the greater the debt ratio, the higher the level of borrowing that is consistent with stability in this ratio.

⁷ The fact that the rate at which the government could borrow remained low right through the 1960s, even once inflation started rising, may seem surprising. It could be taken as indicating a delay in expectations of investors adapting to inflation, but it may also have followed from government intervention in the gilt market, which was widespread until 1971.

The cessation of the withering of the debt ratio reflected all these factors ceasing to operate as they had done earlier: the debt ratio had fallen to a far lower level, making a lower rate of borrowing compatible with its stability; expectations had adjusted to higher inflation; growth had slowed down; and borrowing was, on average, higher. The increasing debt ratio of the early 1990s reflected a mix of all these things, together with the fact that sustained disinflation was finally achieved, leaving inflation lower than had been expected during the (mostly high-inflation) years when the national debt stock was sold. This meant that the interest on the outstanding debt was now more than compensating for inflation, increasing the real debt burden.

Is there anything we can learn from all these alternative measures apart from concluding that measuring the fiscal stance is complicated? Well, whether we assess the fiscal stance through the national debt burden, the actual deficit or the cyclically-adjusted deficit, it seems that fiscal policy was tighter through most of the 1950s and 1960s than it has tended to be since. This is, perhaps, in contrast to what might have been expected, given that the 1950s and 1960s are often associated with especially expansionary (and perhaps unsustainable) policies.

One possible interpretation of this apparent puzzle is that the autonomous and underlying strength of the economy in the so-called ‘golden age’ was sufficiently strong to ensure healthy public finances in spite of expansionary policies, and that since that time its underlying weakness has had the opposite effect. Another view would be that the strength of the economy itself in part flowed from the fact that the government was committed to expansion, an interpretation that could have the curious implication that the government’s willingness to countenance substantial borrowing actually helped contain the scale of borrowing that was eventually required.