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Why people's fears of fiscal forecasts are misleading

It is true that this year the Treasury will need to raise some £130bn in total, but so what?

A TUC protest against the government's austerity measures Photo: Getty Images

By Roger Bootle

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21 Comments

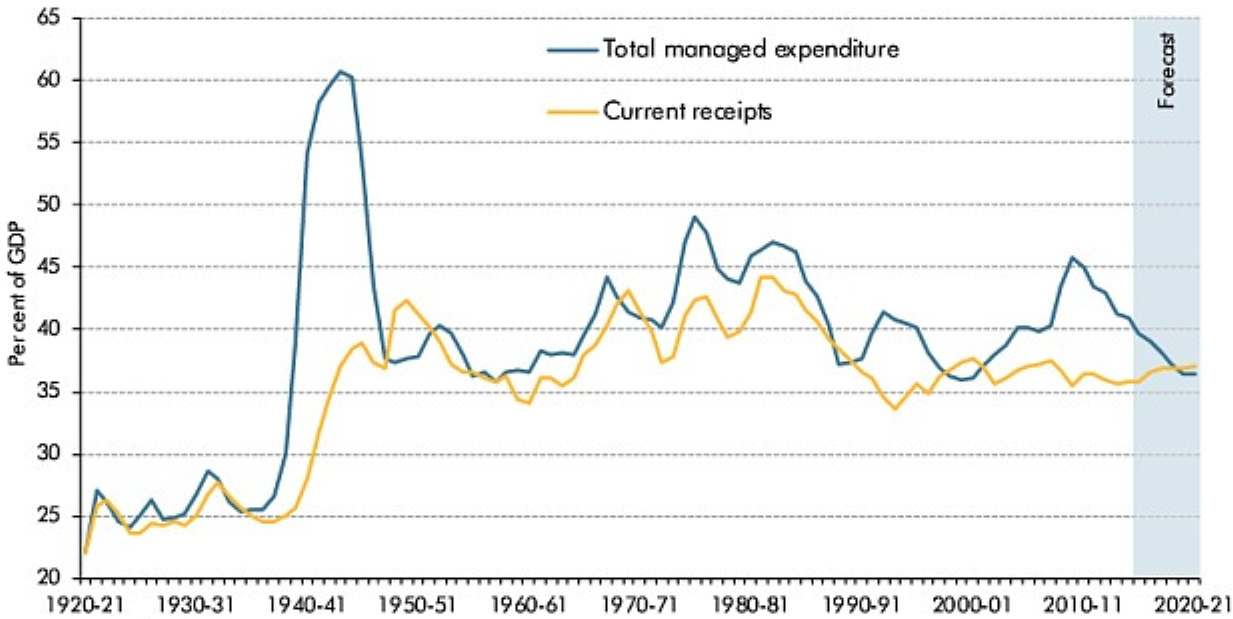
After my comparatively upbeat view of the **Autumn Statement,** I was barraged by readers saying that the underlying position was really much worse than both the Chancellor and I were implying.

One refrain was that the **fiscal forecasts from the Office for Budget Responsibility** (OBR) were incredible and it was surely wrong to go easy on spending cuts on the back of its revenue forecasts. It was certainly a shock that the OBR raised its forecasts by a total of £27bn.

Even so, it is quite wrong to complain about spending plans being based on mere forecasts.

What else are they to be based on? The key thing is that the forecasts should be unbiased. The OBR is not perfect, but no one should imagine that it “found” this £27bn on the Chancellor’s instructions. That is just the sort of thing that happened before the OBR was established – but not now.

Chart 4.10: Total public sector spending and receipts



Source: Bank of England, ONS, OBR

A second refrain from my correspondents was that the deficit figures are just plain wrong.

Why, they ask, do economists and commentators (including me) allow the Chancellor to get away with the idea that the deficit is “only” about £70bn? The true figure, they say, is more like £130bn.

It is true that this year the Treasury will need to raise some £130bn in total, because in addition to financing the gap between income and expenditure, it will have to raise funds to redeem maturing bonds. But so what? This extra amount represents the refinancing of existing debt, not the deficit, which is indeed about £70bn.

A third refrain was that the total government debt is too large and the Chancellor is being complacent in allowing it still to rise. As one correspondent said: “How are my grandchildren going to be able to bear this burden?”

But we don’t need to pay the debt off – ever. A state is not like a person or a household. It has a continuing existence. Moreover, you must be careful about the “we” word. To whom is government debt owed? For the most part, it is owed to ourselves – that is to say, British citizens or institutions who hold gilts. The stock of public debt is a very different thing from net national indebtedness to foreigners.


The growth of public spending needs to be held below the economy?s growth rate for an extended period, and Mr Osborne isn't the man for the job Photo: EDDIE MULHOLLAND

The appropriate way to measure the optimum amount of debt is not by reference to the absolute figures but rather in relation to the size of the economy, its GDP. Here the story is both concerning and consoling. At just over 80pc, the ratio of government debt to GDP is pretty high, but not outrageously so.

Twice before, the ratio has hit 240pc – after the Napoleonic wars and after the Second World War. Both times, we have managed to work the debt down as a share of GDP. For Britain to escape from its current debt worries, the economy needs to keep on growing at a reasonable rate.

Admittedly, this might not happen. But I think the omens are pretty good.

The official figures, and my own forecasts, show the debt ratio has peaked and will continue on a downward path for the foreseeable future.

How low does it need to go? This is highly contentious, but three key considerations mean it is better for debt to be lower. The first is that the interest on the debt has to be financed. Other things equal, this means higher tax, which will blunt incentives and curb economic growth.

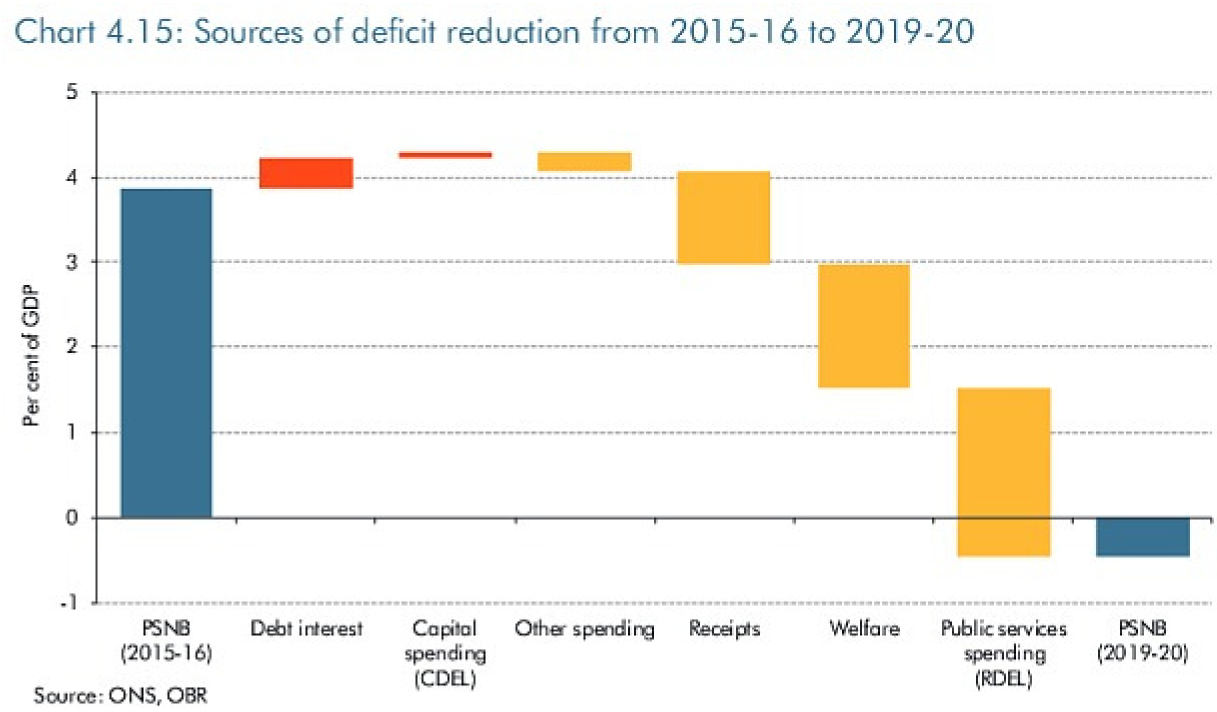
Second, unless it finances sensible real investment, such debt absorbs savings that could more usefully be used in the private sector.

Third, the debt ratio needs to be low enough to be able to rise substantially in a crisis – such as a war or the financial crash of 2008-09. If it is not low enough, then when the crisis comes, either the debt will be sent to unsustainably high levels, which may increase the cost of government finance and/or tempt the Government to drive up inflation, or the Government will be forced into a very tight fiscal policy just when the economy needs it to run a substantial deficit.

Even so, the debt ratio does not need to be zero. Public investment should probably be financed by bonds rather than taxes. Moreover, having a stock of public debt provides a valuable service to the private sector in establishing the risk-free bond yield as a benchmark.

So what is the right ratio? One of Gordon Brown's fiscal rules was that the debt ratio should be below 40pc over the economic cycle.

That sounds about right to me.



But in answer to my correspondents who think that if we need a much lower debt ratio then we should get it down quickly, reducing the debt ratio is not the only desideratum and it may come with substantial costs. We also need to keep the economy growing, and too fast a pace of fiscal contraction would hinder that objective, or even send the economy into recession.

It's all about balance. I reckon that the forecast path for debt reduction is about right.

Yet there is a more significant issue. Not only has George Osborne been obsessed by debts and deficits, but he seems to have led most of the commentariat and the public into this obsession. More important than his forecasts for debt, the Chancellor's plans suggest that something like 36pc is the target for the ratio of government spending to GDP.

This implies that the overall tax rate across the economy will also be about 36pc.

Of course we are not there yet, but is this the right objective for taxes? I think 36pc is too high.

To achieve a lower figure there may not need to be much more outright “austerity” but, at the very least, the growth of public spending needs to be held below the economy’s growth rate for an extended period.

Unfortunately, in his new role as prime minister in waiting, it looks as though Mr Osborne isn’t the man for the job.

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