thinking the unthinkable
might there be no way out for Britain?

project armageddon – the final report

Dr Tim Morgan Global Head of Research
The United Kingdom is mired in debt, and her economy is flat-lining. Each side of the political divide has a different take on the best solutions to these problems. The Coalition government believes that the huge fiscal deficit must be eliminated. Its opponents argue that fiscal tightening will undermine the prospects for growth.

Project Armageddon was established to examine the possibility that both sides’ warnings are correct but that neither side’s prescriptions will work. We conclude that Britain’s debts are unsupportable without sustained economic growth, and that the economy, as currently configured, is aligned against growth.

Radical solutions are required if a debt disaster is to be averted. All macroeconomic options have been tried, and have failed. The only remaining options lie in the field of supply-side reform. Unfortunately, public opinion may be inimical to the scale of reform that is required.

mired in debt

The general public are probably unaware of the true scale of Britain’s debts. Public debt, reported at 60% of GDP, rises to 75% on the Maastricht Treaty definition by which countries such as Greece, Ireland and Portugal are measured. Despite optimistic assumptions about growth, revenues and the deficit, the government concedes that debt ratios are set to rise further.

Official debt numbers exclude the net present value of unfunded public sector pension commitments and obligations under PFI contracts. Together, these total an estimated £1.35 trillion, lifting the total of public debt and quasi-debt to £2.46 trillion (167% of GDP). In addition, the potential costs of financial sector interventions total £1.34 trillion. The UK is a debt-saddled European peripheral country, a fact which forex markets alone seem to have recognised thus far.

Private debts, too, are huge. The borrowing binge of the last decade has lifted outstanding mortgage debt to £1.2 trillion, whilst unsecured consumer credit exceeds £210bn. These levels of debt are manageable if – but only if – the economy can deliver growth.

roads to nirvana?

The government is undoubtedly right to assert that the UK must achieve a drastic reduction in the pace at which the public debt is rising. To test this assertion, we have projected the implications of continuing to run primary deficits at the 2009-10 level. Such an approach would drive the public debt ratio to 100% by 2015 and 150% by 2021. The latter number is irrelevant, because it is clear that, on any such debt trajectory, the UK would be forced into some form of default long before then.

Recognising the imperative need to reduce the deficit, the government has set out a plan whereby modest real-terms spending cuts, and a big increase in revenues, will reduce the deficit from 11.1% of GDP in 2009-10 to 1.6% by 2015-16.

The snag with this otherwise admirable plan is that it depends upon some pretty heroic economic assumptions, most notably the delivery of growth of 2.9% by 2012-13. At 2010-11 values, and after allowing for an expected £25bn increase in debt interest, the government plan requires that the gap between revenue and expenditures be narrowed by £159bn. Increases in tax rates will contribute £31bn, and spending cuts a possible £44bn (so long as unemployment falls as the government expects), but the bulk of the deficit reduction is expected to result from a growth-created £84bn increase in tax revenues. If growth were to come in at half of the official target, interest costs and other spending would rise, tax revenues would fall very far short of expectations, and the plan would unravel.
The deficit reduction plan, then, is critically dependent upon the restoration of growth to pre-crisis levels. Is this actually likely to happen?

**the economy – aligned against growth**

Our analysis indicates that the British economy, as currently aligned, is incapable of delivering growth at anywhere near the levels required by the deficit reduction agenda.

In the decade prior to the financial crisis, the UK economy became hugely dependent upon debt. Taking public and private components together, debts have increased at an annual average rate of 11.2% of GDP since 2003. The two big drivers of the economy have been private (mortgage and credit) borrowing, and huge (and debt-dependent) increases in public spending.

Reflecting the growth in debt-funded activities, three of the UK’s eight largest industries (real estate, financial services and construction), which account for 39% of the economy, are incapable of growth now that net private borrowing has evaporated. Another three of the top eight sectors (health, education, and public administration and defence) account for a further 19%, and cannot expand now that growth in public spending is a thing of the past. This means that 58% of the economy is ex-growth, a figure that could rise to 70% if, as seems probable, growth in retailing is precluded by falling real consumer incomes.

**a very British mess**

Together, the severity of Britain’s indebtedness and the challenging outlook for the economy mean that the UK is now mired in a high-debt, low-growth trap. Minimising the inevitable damage requires the clearest possible understanding of how this situation came about.

Britain’s fiscal and economic problems result from grotesque mishandling of the economy under the 1997-2010 Labour administration. Gordon Brown’s reform of the financial regulatory system, and his insistence that the Bank of England determine monetary policy on the basis of retail inflation alone, resulted in a reckless escalation in mortgage lending. The ensuing property price boom spurred unsustainable growth in a plethora of housing-related sectors, and underwrote a rapid expansion in consumer borrowing. Believing that this bubble was real growth, Brown spent up to, and beyond, the apparent expansion in the tax base that had resulted from the property-driven boom. Real public spending increased by 5.3% in a period in which the economy expanded by just 1.7%. As soon as the bubble burst, a chasm rapidly opened up between excessive spending and falling tax revenues.

In addition to skewing the economy towards debt and public spending, Brown and his colleagues imposed ever-increasing regulatory and fiscal burdens on business, and simultaneously transferred resources from private industry into a public sector whose productivity was subject to continuous decline. This weakened the overall productivity of the British economy.

Labour’s period in office was characterised not just by economic and fiscal mismanagement but also by the promotion of a culture of moral absolutism centred around spurious and selective concepts of ‘fairness’. This culture, and the accompanying sense of individual and collective entitlement, is the biggest obstacle in the way of effective economic reform.

**damage limitation and the need for supply-side reform**

Courtesy of massive and unsustainable public borrowing, the British public has been shielded thus far from the pain of recession. This exercise in damage limitation was necessarily time limited. What comes next is going to be unpleasant.

The widespread assumption that the right blend of macroeconomic policies alone can overcome Britain’s economic and fiscal problems is fundamentally mistaken. Governments have tried low interest rates (which have been close to zero for 28 months), devaluation, £390bn of fiscal stimulus and £200bn of quantitative easing, all to no effect.

The so-called ‘plan b’, which could be better labelled ‘Brown lite’, is not worthy of serious consideration. In the years prior to the recession, Britain borrowed £21.8bn for every £1 of growth. Continued high borrowing would be nothing more than a pain-deferral exercise leading inevitably to a full-blown economic crisis.

As Britain’s debt-driven economic misalignment unavels, property prices can be expected to fall sharply, unemployment to remain high, sterling to remain weak, and real incomes to continue to fall as inflation continues to out-price earnings.

An early objective for government should be to put an end to the state of national denial over the true condition of the economy, and to undercut the delusory sense of individual and collective ‘entitlement’ that was fostered in the Labour years. Britain has no automatic entitlement to high living standards or a welfare state. Rather, these benefits have to be earned, not borrowed.

With all macroeconomic options exhausted, the best way to restart growth would be to implement supply-side reforms designed to free small and medium enterprises (SMEs) from the onerous burden of regulation which blights their expansion.

Such reforms, whilst imperative if a full-blown economic crisis is to be averted, will be opposed by interest groups, and will also cut across much of the moral absolutism that was promoted so successfully by Labour. In many instances, choices will have to be made between economic efficiency on the one hand and spurious concepts of ‘fairness’ on the other.

The outstanding questions where Britain’s economic future is concerned lie in the mechanics of reform than in the ability of government to secure support for reforms which both challenge preconceived notions and offend vocal interest groups.

The best way for government to offset material pain would be to promote a ‘liberty agenda’ which, whilst freeing up SMEs to invest and to grow, would also begin to liberate the public from the results of Labour’s predilection for surveillance and coercion.

At present, we see very little sign that the Coalition government is prepared to promote economic growth and individual liberty by tackling Labour’s notions of morality, fairness and entitlement.
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contents

<table>
<thead>
<tr>
<th>section</th>
<th>title</th>
<th>page</th>
</tr>
</thead>
<tbody>
<tr>
<td>executive summary</td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>introduction</td>
<td>is this the end of the road?</td>
<td>7</td>
</tr>
<tr>
<td>part one</td>
<td>the scale of the problem: mired in debt</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>much worse than it looks</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>is bankruptcy possible?</td>
<td>13</td>
</tr>
<tr>
<td>part two</td>
<td>case studies: roads to nirvana?</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>let rip – route one to disaster</td>
<td>17</td>
</tr>
<tr>
<td></td>
<td>forget ‘plan b’</td>
<td>18</td>
</tr>
<tr>
<td></td>
<td>showing resolve – the government plan</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>the achilles’ heel – dependency on growth</td>
<td>21</td>
</tr>
<tr>
<td>part three</td>
<td>the economic outlook – aligned against growth</td>
<td>27</td>
</tr>
<tr>
<td></td>
<td>a borrowed boom – the impact of debt addiction</td>
<td>29</td>
</tr>
<tr>
<td></td>
<td>the undermining nexus – high borrowing, low growth</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>the nature of addictive borrowing</td>
<td>31</td>
</tr>
<tr>
<td></td>
<td>what happens next?</td>
<td>35</td>
</tr>
<tr>
<td>part four</td>
<td>a very British mess – the delivery of failure</td>
<td>39</td>
</tr>
<tr>
<td></td>
<td>laying the foundations for failure</td>
<td>40</td>
</tr>
<tr>
<td></td>
<td>spend, spend, spend</td>
<td>41</td>
</tr>
<tr>
<td></td>
<td>declining productivity</td>
<td>44</td>
</tr>
<tr>
<td></td>
<td>the high price of moral absolutism</td>
<td>46</td>
</tr>
<tr>
<td></td>
<td>the gravest problem – the concept of entitlement</td>
<td>46</td>
</tr>
<tr>
<td></td>
<td>the distorted economy</td>
<td>48</td>
</tr>
<tr>
<td></td>
<td>nemesis – the squeezed middle</td>
<td>50</td>
</tr>
<tr>
<td>part five</td>
<td>the search for pain mitigation – no way out?</td>
<td>53</td>
</tr>
<tr>
<td></td>
<td>meanwhile, back in the real world...</td>
<td>55</td>
</tr>
<tr>
<td></td>
<td>limiting the pain, building the foundations for recovery</td>
<td>57</td>
</tr>
<tr>
<td></td>
<td>as others see us</td>
<td>58</td>
</tr>
<tr>
<td></td>
<td>fixing the obvious</td>
<td>59</td>
</tr>
<tr>
<td></td>
<td>the high value of low-cost reforms</td>
<td>62</td>
</tr>
<tr>
<td></td>
<td>do we want economic viability?</td>
<td>63</td>
</tr>
<tr>
<td></td>
<td>needed – a liberty agenda</td>
<td>64</td>
</tr>
</tbody>
</table>
is this the end of the road?

Earlier this year, when we began our research for ‘Project Armageddon’, the working title certainly wasn’t intended for publication. The initial proposition was that, whilst the Coalition government was right about the imperative need to reduce the United Kingdom’s frightening fiscal deficit, its opponents, too, might be right about the impact that fiscal tightening could have on growth. We expected to discover that Britain was in for a protracted period of low (1.5-2%) growth, and that the road to fiscal sustainability might, therefore, prove to be a long and hard one.

Early research conformed to this picture, revealing that the debt numbers for the UK are frighteningly larger than are generally realised. Public sector debt, reported at £900bn, or 60% of GDP at end-March, rises to £1.1 trillion (75%) on the Maastricht Treaty basis on which countries like Greece and Ireland are assessed. The reported number excludes the potential costs of the financial interventions (£1.3 trillion), and also excludes two big ‘quasi-debt’ obligations, which are the commitments to pay public sector pensions (about £1.18 trillion) and payments due under PFI obligations (perhaps £170bn). Excluding the potential costs of financial intervention, we estimate the true scale of British public debt and quasi-debt at £2.46 trillion, or 167% of GDP. Outstanding private sector debt includes £1.2 trillion of mortgage obligations and £230bn of consumer credit.

Britain is truly mired in debt then. But the absolute scale of debt is far less important than the ability to service it. The United Kingdom’s debt mountain is manageable if – and only if – strong economic growth is to be anticipated.

The discovery which stripped any remaining hyperbole from the ‘Armageddon’ title was our realisation that, far from delivering strong growth, the UK economy is likely to do little better than mark time. Though we believe that we may have been the first to have spotted it, the logic behind the implausibility of strong growth is pretty simple, and rests upon two calculations.

First we discovered, by combining public and private borrowings, that the UK has, since 2003, borrowed an annual average of 11.2% of GDP. When the Labour administration ramped the fiscal deficit from 2.4% of GDP in 2007-08 to 11.2% in 2009-10, all that government was really doing was replacing private borrowings, which had dried up overnight.

Second, sector-level analysis of economic output reveals that the commanding heights of the British economy are almost entirely dependent upon private borrowing and public spending, the latter also debt-dependent in that the massive ramp-up in government spending after 2000 was predicated on a tax base that never really existed.
thinking the unthinkable: might there be no way out for Britain?

Three of the eight largest sectors of the economy – real estate, construction and financial services – have enjoyed huge growth fuelled overwhelmingly by private borrowings. These three sectors alone account for 39% of economic output. Another three of the ‘big eight’ sectors (accounting for a further 19%) are health, education, and public administration and defence, each of which has grown as public spending has ballooned.

Now that private borrowing has evaporated and the age of reckless expansion in public spending is over, these sectors, accounting for 58% of the economy, are poised to shrink, not grow. Declining disposable incomes suggest that retailing, which accounts for a further 21% of output, may also be poised to contract. All told, then, the UK is in an ‘ex-growth lockdown’, with as much as 70% of the economy incapable of growth and very probably poised to shrink.

This report is concerned with past events and trends only in so far as they reveal how Britain got itself into the crippled periphery and may thereby suggest the possible outlines of a reform agenda designed to minimise the forthcoming pain and avert a debt disaster. The conduct of the economy under ‘Team Brown’ was a tale of grotesque incompetence which began in hubris and ended in blame-shifting. Just as pertinently, where the future outlook is concerned, New Labour peddled a spurious moral absolutism and created an almost surreal sense of individual and collective entitlement, and it is this blend of moralism and entitlement which is the largest single stumbling-block on any road to economic viability.

A combination of high debt and low growth means that the UK is a fully-fledged member of Europe’s debt-shackled periphery, and this puts a wholly new complexion on the outlook for what is still one of the world’s largest economies. Unless growth is restored briskly (which we regard as highly implausible), it can be only a matter of time before the markets and the rating agencies start to put serious upwards pressure on British debt yields. When that happens, sterling will be very much at risk.

The reality is that the cupboard is bare where macroeconomic policy is concerned. Massive stimulus, totalling £590bn and equivalent to 40% of GDP, has been tried, and has failed to deliver any growth at all. Interest rates are already at rock-bottom. Fiscal stimulus looks impossible with Britain boxed in to a high-debt, low-growth trap.

If an escape route does exist at this very late stage, it lies not in macroeconomic policy but in supply-side reform. Businesses in the UK are crippled by government interference and by the excessive demands of the state machine. The only way to deliver growth would be to unshackle enterprise and transfer resources to the private sector, a process which would require reductions in public spending which go much further than anything thus far contemplated by the government.

Logical though this is, we fear that such reforms could be blocked by vested interests and by the ‘must-have’ entitlement culture built up on a foundation of spurious moral absolutism.

Is there a sufficient sense of realism left in the body politic? If there is, a return to viability might be possible even at this late stage.

But if, as we strongly suspect, there is not, then this may be the end of the road, and there really may be no way out for Britain.

Dr Tim Morgan
Global Head of Research
Tullett Prebon plc
July 2011

The ex-growth lock-down – the commanding heights of the UK economy*  

<table>
<thead>
<tr>
<th>Sector</th>
<th>£bn</th>
<th>%**</th>
<th>Key factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Real estate</td>
<td>299</td>
<td>23.8%</td>
<td>Mortgage issuance has collapsed</td>
</tr>
<tr>
<td>4 Finance</td>
<td>126</td>
<td>10.0%</td>
<td>Significantly linked to borrowing</td>
</tr>
<tr>
<td>5 Health</td>
<td>94</td>
<td>7.5%</td>
<td>Public sector – spending flat</td>
</tr>
<tr>
<td>6 Education</td>
<td>77</td>
<td>6.1%</td>
<td>Public sector – spending down</td>
</tr>
<tr>
<td>7 Construction</td>
<td>73</td>
<td>5.8%</td>
<td>Mortgage collapse, spending cuts</td>
</tr>
<tr>
<td>8 Public administration and defence</td>
<td>65</td>
<td>5.2%</td>
<td>Public sector – spending down</td>
</tr>
<tr>
<td>2 Retail</td>
<td>140</td>
<td>11.2%</td>
<td>Declining consumer incomes</td>
</tr>
<tr>
<td>3 Private sector</td>
<td>873</td>
<td>69.6%</td>
<td></td>
</tr>
</tbody>
</table>

Source: * Tullett Prebon UK Economic & Fiscal Database  
** Shares of the economy by GVA, 2009

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Significantly linked to borrowing
much worse than it looks
At different times, American investment gurus Jim Rogers and Bill Gross have both expressed ultra-bearish views on the prospects for Britain, the former opining that the UK is “finished” and the latter commenting that British public finances (and, by extension, sterling) rest on “a bed of nitro-glycerine”. Allowing for the hyperbole in both statements, the reality is that the UK is indeed mired in debt, even though the true extent of British indebtedness is sometimes less than obvious in published data. Though the hidden nature of much of the British debt mountain has helped prevent markets from bracketing the UK with other European peripheral economies such as Greece, Portugal and Ireland, it would be folly to assume that this immunity can continue.

At first sight, fears such as those articulated by Rogers and Gross can seem melodramatically overblown, since official public debt is a significantly smaller fraction of GDP in Britain than in known basket-cases such as Greece and Ireland. According to official figures, UK government debt currently stands at £900bn, equivalent to 60% of GDP. Government projections (which assume that the deficit will be reduced from 9.7% of GDP last year to 1.6% by 2015-16) show the nominal level of debt continuing to rise (reaching £1.28 trillion by 2016).
though both inflation-adjusted debt and the debt/GDP ratio should top out in 2013 at £1.2 trillion, or 70% of GDP. For the foreseeable future, then, British public debt is expected officially to remain at historically high levels, but to stay well short of the 100% barrier at which, at least in theory, some form of bankruptcy begins to look a distinct possibility.

Even if the published debt figures were a realistic representation of public sector indebtedness (which they are not), alarm bells should be ringing at the sheer pace at which this debt has been accumulating – 43% (£390bn) of outstanding commitments under PFI (private finance initiative) contracts. Nor is this all. The increase in the public sector wage bill over the last decade has caused a rapid escalation in unfunded pension obligations. The British system of providing pensions for government employees has always been something of a Ponzi scheme, the pensions of retirees being paid for each man, woman and child in the generations that followed. This, of course, excludes private debts such as mortgages (£1.2 trillion) or the consumer debt that escalated under easy money conditions of the financial crisis.

The reality, moreover, is that published numbers very materially underestimate true indebtedness (Fig. 1). For a start, public debt on the stricter Maastricht Treaty definition (on which the debts of Eurozone members such as Greece and Ireland are judged) is already £1113bn, or 75% of GDP. And, according to the ONS, debt including the effects of financial sector interventions now stands at £2.24 trillion (147% of GDP).

For the foreseeable future, then, British public debt is expected officially to top out at 100% of GDP and the debt/GDP ratio should top out at 60% of GDP. The third, equally-critical point is that the UK economy and public finances have been managed with hubris, we know of no modern mismanagement, profligacy, and hubris, we know of no modern financial services industry would be about as rational as Saudi Arabia downsizing oil, or Iceland downsizing fish. As for selling assets, the state cupboard is all but bare, and a huge swathe of private sector assets (such as water suppliers, power generators and airports) is already foreign-owned. When considering the question of what is colloquially called ‘bankruptcy’, it is necessary to distinguish between insolvency (when liabilities exceed assets) and illiquidity (when the borrower becomes unable to meet ongoing funding requirements, which has recently reached new highs. The trade deficit exacerbates the problem of servicing Britain’s huge external debts. Britain’s greatest asset, in terms of earning the foreign exchange with which to pay for imports of food, energy and other essential goods and services, is the City of London, but the political climate for the sector is adverse. Bankers have been blamed for the financial crisis (for which the real culprits were the policymakers who crippled regulatory oversight), and criticised because they earn too much (which, as we have remarked before, is about as rational as supporters of a football club demanding the sale of their top goal-scorer because he earns so much more than they do).

Even so, three things are already abundantly clear. The first is that the UK economy and public finances have been managed with staggering incompetence – for sheer mismanagement, profligacy, and hubris, we know of no modern parallel for the mishandling of the British economy in the decade prior to the financial crisis.

Second, it is equally clear that government cannot go on adding to its debt pile at anything remotely like the rate that has occurred in the period since 2008, when net new borrowings of £390bn were incurred in the space of three financial years, pushing the reported debt ratio up from 37% to 60% of GDP.

The second, equally-critical point is that national solvency is dependent upon generating sufficient economic output and government revenue to service what are, by any standards, uncomfortable levels of government and wider national debt.

For reasons which will be explored later, we very much doubt whether the real possibility of national bankruptcy has yet entered the collective psyche. But, and as we shall also see, the era of comforting self-delusion is nearing its expiry date. Unless drastic action is taken – and, critically, unless a satisfactory level of economic growth can be restored – markets are likely to wake up to the reality that Britain has more in common with Greece than with Germany. And, when markets do reappraise Britain’s viability, a number of significant adverse factors are likely to be taken into account.

Britain’s external debt is a particularly acute problem because of the UK’s persistent trade deficit, a problem which has not been fixed by the sharp devaluation of sterling. The cushion formerly provided by exports of North Sea oil and gas has long since gone, and energy imports are set to rise further as domestic production tails off. Britain is also heavily dependent upon imports of food, the price of which has recently reached new highs. The trade deficit exacerbates the problem of servicing Britain’s huge external debts.

Britain’s greatest asset, in terms of earning the foreign exchange with which to pay for imports of food, energy and other essential goods and services, is the City of London, but the political climate for the sector is adverse. Bankers have been blamed for the financial crisis (for which the real culprits were the policymakers who crippled regulatory oversight), and criticised because they earn too much (which, as we have remarked before, is about as rational as supporters of a football club demanding the sale of their top goal-scorer because he earns so much more than they do).

The emotional debate over banking tends to obscure the reality that for Britain to downsize its financial services industry would be about as rational as Saudi Arabia downsizing oil, or Iceland downsizing fish. As for selling assets, the state cupboard is all but bare, and a huge swathe of private sector assets (such as water suppliers, power generators and airports) is already foreign-owned. When considering the question of what is colloquially called ‘bankruptcy’, it is necessary to distinguish between insolvency (when liabilities exceed assets) and illiquidity (when the borrower becomes unable to meet ongoing funding requirements, which has recently reached new highs). The trade deficit exacerbates the problem of servicing Britain’s huge external debts.
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National or government illiquidity, however, is all too real a possibility under certain conditions, and has in the past impacted many countries whose behaviour has been no more reckless, and whose governments have been no more inept, than those of the UK over the last decade.

When looking at the issue of illiquidity, we need to bear in mind that national economic viability is really an issue of credit, a matter of trust and belief. Currencies such as sterling are fiat money, which means that their value lies not in intrinsic worth or convertibility (into, say, gold), but in the faith that is placed in the ability of the issuing government to meet its commitments.

Much the same applies to national debt and, by extension, to private debt as well. The UK government is able to borrow from abroad because international lenders trust it to repay what it has borrowed, and to do so in a currency whose value has not been ravaged by excessive inflation. British banks are able to operate in global markets because it is assumed that they are viable, and it is further assumed that government would bail them out if it turned out that they were not. Businesses and citizens can undertake international transactions because international markets trust sterling, which really means that they trust the British government.

Everything, then, hinges on belief. A key assumption made by the current government is that continuing with the debt trajectories of recent years would put that belief into jeopardy.

The heralds of bankruptcy, though difficult to combat, are relatively easy to predict. First, we would anticipate ratings downgrades if Britain fails to deliver progress both on deficit reduction and on economic growth within a timescale that may now have shrunk to as little as twelve months.

A second sign of impending illiquidity would be a ‘strike’ in both domestic and international debt markets, and a third would be a further sharp fall in the value of sterling.

If this process were to occur, interest rates would climb rapidly (which would itself undercut economic performance very severely), the cost of vital imports would soar, inflation would escalate and Britain could be subjected to a huge flight of capital.

At present, these risks have been averted, in no small part because of the change of government in May 2010. There have, however, already been some disturbing signs, such as the creation in 2009 of £200bn through quantitative easing (QE), the current euphemism for the printing of money. When QE was used, the Treasury vigorously denied that it was monetising debt (which is forbidden under the terms of the Maastricht Treaty), but the use of virtually all of the £200bn to purchase gifts made the difference between QE and debt monetisation little more than technical fig-leaf.

Any repetition of QE could have extremely serious repercussions in the bond markets.

Perhaps the single most worrying feature of the current situation is that persistent minimal growth may cause global market participants to gravitate towards a new perspective in which Britain is seen not as a weaker version of Germany but rather as a peripheral country in the mould of Greece, Ireland or Portugal.

Having established that bankruptcy is by no means inconceivable for a country which has mired itself in debt whilst persistently living far beyond its means, we need to look at some case studies of what might happen if the UK does, or does not, get its deficit under control. We start with the ‘route one’ journey to bankruptcy:

Currency independence aside, the single most significant difference between Britain and these known basket-cases is the sheer scale of the public debt. The quantum of British public debt dwarfs those of Ireland, Greece or Portugal. Many observers believe that a Spanish debt crisis could be a bridge too far for the bailout mechanisms, yet Spain’s public debt (of about £550bn) is very much smaller than that of Britain.
roads to nirvana?
- The Coalition government rightly believes that continuing to run deficits at anything remotely similar to recent levels would be a recipe for disaster.
- But the deficit reduction plan can only work if the British economy achieves very rapid real rates of growth.

let rip – route one to disaster
Cognisant of the risks which would be posed by any further escalation in public debt, the Coalition government has laid out a programme of fiscal tightening which is designed to reduce the budget deficit from 11.2% of GDP in 2009-10 to 1.6% by 2015-16, a 9.6% reduction which is equivalent to £134bn at current values. Before looking at how this might or might not work, we need to consider the implications were Britain to go back on this programme and, instead, to continue to run deficits at the reckless levels of recent years.

During 2009-10, the primary deficit (which excludes interest paid on public debt) was £125bn, or 8.9% of GDP. To evaluate the concept of sustaining growth by continuing to run large deficits, we have projected this primary deficit forwards. We further assume, perhaps somewhat generously, that growth conforms to the OBR forecasts.

Under this scenario, the total deficit rises, because interest costs surge as debt escalates (fig. 5). From 3% of GDP in 2010-11, interest absorbs 5% by 2014-15, 7% by 2018-19 and 10% by 2021-22. Needless to say, public debt soars, rising from 75% of GDP today to 100% in 2014, 150% in 2020 and 200% in 2025 (fig. 6).

Long before the latter date, the government would have been forced into some form of default. On this projection, by 2014-15 the DMO (Debt Management Office) would be trying to raise (at current values) a net £250bn, of which £90bn would be required simply to pay interest on outstanding debt.
Once debt begins to take off in this way, the borrower – in this instance, the British government – rapidly finds itself being drawn into a vortex. Even without increases in interest rates, deficits and total debt take off exponentially as a result of the compounding effect of accumulated interest commitments. The reality is that this process would be exacerbated by rises in interest rates which would inevitably be imposed by the market as the vortex process gained recognition. As rates rose, the spending capability of consumers would slump, whilst inflation would surge in response to a crumbling of sterling.

Various shifts and expedients would, no doubt, be employed in an increasingly desperate attempt to keep the fiscal ship afloat. The monetising of debt through resumed QE would doubtless be tried, with an acceleration in inflation accepted as a necessary evil because it would destroy the real value of outstanding debt. The interest rates paid by government would escalate, the pound would crash, and so would property markets as soaring rates savaged affordability. A large proportion of Britain’s 11.4 million mortgage-payers would be reduced to penury by the resulting combination of unaffordable monthly payments and deep negative equity. Britain’s public debts are orders of magnitude larger than those Greece, Ireland or Portugal, which would in all probability make an outside rescue impossible.

We have described here the implications of sustained high primary deficits at some length, but one word would suffice – catastrophe.

Forget ‘Plan B’

Of course, the government’s opponents would argue, quite rightly, that they would not for a moment suggest prolonging a primary deficit of anything like 8.9% of GDP. If the
opposition were in office, we believe that they would seek to reduce the budget deficit from the 9.6% recorded in 2010-11 to perhaps 5% by 2015-16. This, the so-called “plan b”, would not work, for three main reasons. First, even the very modest real-terms spending reductions planned by the government have provoked hostile responses based almost entirely on naked self-interest, and a government following the opposition plan, having given way once, would be subjected to severe pressure from selfish interest groups. Second, a more gradual approach to deficit reduction would create rises in interest costs over and above those already anticipated, and these costs would exert a crowding-out effect on other categories of public spending. In any case, it is highly probable that a gradual reduction of the deficit to 5% simply would not be enough to head off ‘vortex risk’. Third, it is by no means certain that continuing with higher public spending for longer would deliver the growth that its advocates ritually claim. For a start, a pattern which has emerged since 2001, and is discussed later in this report, is for economic growth to fall a long way short of increases in debt (fig. 7). The debt data shown in fig. 7 is a combination of private and public borrowing but, as private borrowing has now dried up, government would have to carry the entirety of any borrowing burden going forward. There is no point whatever in borrowing £2.18 to create £1 of growth, which is precisely what happened between 2001-02 and 2007-08. The inability of the economy to respond to stimulus has been demonstrated in spades since the onset of the banking crisis in 2008. During 2008-09 and 2009-10, the Labour administration incurred deficits of £250bn and injected a further £200bn through QE, but this truly massive stimulus (equivalent to 32% of GDP) delivered extraordinarily modest returns in terms of growth. In the Coalition’s first year in power, a further £140bn was borrowed, lifting the total stimulus to £590bn, but the economy is currently doing no more than flat-lining.

showing resolve — the government plan

Given the potentially lethal characteristics of a ‘debt vortex’, the government’s decision to bear down on deficits through big increases in tax revenue and more modest cuts in public expenditure obviously makes a good deal of sense. The government is right in its analysis of the problem but, wrong, we believe, in how it believes that the numbers will actually pan out. The outlook, as presented by the government, is for a period of painful adjustment followed by much-improved economic performance. The Coalition administration argues, quite correctly, that it inherited a wholly unsustainable fiscal mess. Between 1999-2000 and 2009-10, the Labour government had increased real-terms public spending by 53%, from £440bn (at 2009-10 values) to £669bn. Once the financial crisis burst the ‘Brown bubble’, the result was a deficit of £156bn (11% of GDP) and an unsustainable surge in borrowings.

This project has required us to assess timescales that are a great deal longer than those set out in official forecasts. Where the official-basis outlook is concerned, we have assumed that the 2015-16 projections both for growth (2.8%) and for the nominal rate of expansion of GDP (5.6%) continue throughout our forecast period. We further assume that revenue remains at the same (38.4%) proportion of GDP projected for 2015-16, and that public spending (other than interest expense) is held constant in real terms.

On this extrapolated basis, the fiscal deficit falls rapidly, with the budget moving into surplus by 2017-18 (see fig. 8) and public debt falling rapidly thereafter. If this very rosie scenario were to eventuate, it is highly probable that government would moderate its plans to something closer to fiscal neutrality, gradually reducing taxes, and/or increasing spending, once the debt ratio started to decline (fig. 9).

Government argues that this optimistic scenario more than justifies a period of adjustment in which the pain has, in any case, been exaggerated by critics who are stretching credulity when they describe as ‘massive’ planned real-terms spending reductions of just 3%. Later in this report we look more closely at the issue of public spending, but we turn next to critics’ accusations that the government’s fiscal policies are tied to a growth scenario that, particularly given the scale of retrenchment, is far too optimistic.

the achilles’ heel – dependency on growth

Opponents of the government make many different criticisms of the budget tightening programme, but by far the most telling is that fiscal adjustment on the scale planned by the administration will undercut growth because it will take far too much demand out of the economy.
It is certainly true that the government's fiscal calculations are hugely growth-dependent. In figure 10, we break out our estimates of contributions to the planned reduction in the budget deficit, expressed at constant 2010-11 values.

The government’s plan is to reduce the real-terms deficit from £160bn in 2009-10 to £26bn in 2015-16, a targeted reduction of £134bn which increases to £159bn when the anticipated £25bn real-terms increase in debt interest is taken into account.

Our calculations suggest that the overwhelming bulk of this is expected to be delivered by growth. This comprises revenue expansion (of £84bn) created by growth in the size of the economy and some declines in ‘automatic stabiliser’ spending resulting from lower unemployment and household benefits dependency.

Tellingly, the government plans to increase the incidence of taxation by 1.9% of GDP (which is worth about £31bn) but expects revenues to increase by a total of £115bn at 2010-11 values, the balance of this increase being delivered by economic growth.

To its lasting credit, the Coalition government has created the independent Office for Budget Responsibility (OBR), so that chancellors can no longer make the numbers add up by the simple expedient of plucking the necessary growth projections from the ether. In a report which accompanied the recent Budget, the OBR set out its economic assumptions in considerable detail.

Principally, the OBR expects real economic growth to reach 2.9% by 2012-13, with CPI inflation falling back to the target rate of 2% over the same period. Supported by the assumed achievement of strong growth, unemployment is expected to

Fig. 10: Contributions to planned deficit reduction

*Source: Tullett Prebon calculations*
thinking the unthinkable | might there be no way out for Britain?

decline briskly, a factor which would ease the pressure on government welfare spending.

Unfortunately, these forecasts appear to be extremely optimistic. We believe (and explain in the next chapter of this report) that the British economy simply is not capable of growing at anything like the rates which are predicted by the OBR and are critical to the government’s deficit reduction calculus.

In order to assess the deficit implications of lower growth, we have assumed that annual rates of growth are half of those projected by the OBR. On this basis, trend growth is 1.4%, and real economic output is 8% higher in 2014-15 than in 2009-10, in comparison with the 16% assumed by the government.

If this were to happen, the government’s fiscal plans could indeed begin to unravel in pretty much the manner that its opponents predict. Instead of expanding by a real-terms £115bn, tax revenues would increase by only £50bn, putting a £65bn hole in the deficit reduction objective. Higher-than-expected spending on benefits could cost £11bn, and higher interest expense could absorb an additional £13bn. Instead of reducing the deficit at a real-terms £115bn, tightening of only £45bn would be achieved, leaving the deficit over 8% of GDP (fig. 11). Treaty debt would have risen to over 100% of GDP and, critically, would still be increasing (fig. 12), putting interest costs on an upwards trajectory.

Such a scenario poses a clear threat of ‘vortex risk’, which involves (a) borrowing to meet debt service costs, and/or (b) cutting other spending by more than is currently intended in order to accommodate higher interest payments within previously-planned levels of expenditures. As debt escalates, the cost of borrowing can be expected to rise, turning the debt problem into a vortex.

The government’s plan, then, depends upon the delivery of robust growth. Can this happen?

Fig. 11: Growth risk – the deficit

Deficit as % GDP

2006 2011 2016

Budget Low growth

*Source: Tullett Prebon calculations

Fig. 12: Growth risk – debt

Debt as % GDP

2006 2011 2016 2021

Budget Low growth

*Source: Tullett Prebon calculations
the economic outlook

aligned against growth

• Expectations for a return to strong growth ignore the fact that the British economy has become dependent upon private borrowing and public spending. Since 2003, annual additions to aggregate private and public debt have averaged 11.2% of GDP, whilst public expenditures have escalated.

• The combination of private borrowing and public spending has skewed the economy to the point where between 58% and 70% of output is dependent on these inputs, both of which have now gone into reverse. This means that delivering significant economic growth has become very difficult indeed.

The Coalition government and its opponents differ on many issues, but they seem to agree over the general outlines of Britain’s parlous economic and fiscal condition. Conventional logic states that government deficits only really took off in 2008-09, when there was a very sharp downturn in economic output. The Coalition and Labour disagree on why the downturn happened — was it domestic mismanagement, or was Britain battered by global events over which it had no control? — and they further disagree on the necessary pace and scale of deficit reduction. But the general consensus seems to be that, whilst deficits at recent levels are unsustainable, a return of growth will in due course resolve Britain’s problems.

What needs to be borne in mind from the outset is that a return to satisfactory levels of growth is simply an assumption, not a demonstrable fact.

Assessment of purely public borrowing seems to bear out the consensus interpretation. During the period 1999-2000 to 2007-08, when trend growth was 2.8%, deficits averaged just 1.8% and only once exceeded 3%. Not until the economy deteriorated sharply during 2008 did the deficit escalate. It looks like a classically Keynesian picture.

But this widely-accepted interpretation is fundamentally flawed, because it leaves a critical component out of the equation. That component is private borrowing, shown in fig. 14 as secured part three: thinking the unthinkable | might there be no way out for Britain?

Fig. 13: Keynesian? Deficits and growth, 1996-97 to 2009-10*

![Graph showing deficits and growth from 1996-97 to 2009-10](image)

*Source: Tullett Prebon UK Economic & Fiscal Database
What really happened in 2008, then, was less a matter of intervention per se but of government stepping in to sustain the aggregate level of borrowing once mortgage and credit expansion collapsed. The expedient of replacing private with public borrowing was always time-limited and has now reached end-point, but there has been no recovery at all in private borrowing.

Taking government and private components together, it becomes apparent that borrowing has become a way of life over the last decade. During 1996-2002, aggregate public and private borrowing averaged 4.9% of GDP. Between 2003 and 2010, however, aggregate borrowing averaged 11.2% of GDP and, with the single exception of the 2008-09 crisis year (7.8%), annual borrowing never fell below 10.4%.

This dependency on borrowing would be even more pronounced were it possible to identify the purely domestic component of escalating corporate indebtedness in the era of leverage and private equity. The tax system favoured debt capital over equity because interest expense was (and remains) tax-deductible, whereas dividend payments are not.

Even without the corporate component, however, a key feature of the British economy since 2003 has been the emergence of long-term dependency on borrowing at least 10% of GDP, year after year.

Moreover, the overwhelming majority of this borrowing came from overseas, because the domestic savings ratio collapsed under the double onslaught of the pensions tax grab and interest rates which remained far too low to provide any incentive to save rather than to borrow. During the boom years, British banks customarily funded their domestic lending from international wholesale markets, a process which not only contributed to a massive escalation in gross external debt (from £1.9 trillion at the end of 1999 to £6.4 trillion by end-2008) but put the banking system into an immediate crisis when, in 2007, the supply of wholesale debt dried up virtually overnight.

The critical economic role played by debt is reflected in divergences between the performances of different business sectors. By the 2007 high-point of the ‘Brown bubble’, the real-terms economic contribution of the financial services industry had
increased by 91% in just seven years, whilst manufacturing output had declined by 14%. Two other borrowing-related sectors, construction and real estate, increased their output by 47% and 31% respectively. Tellingly, of the six fastest-growing sectors, the other three were all in the public sector – health (+29.6%), education (+26%), and public administration and defence (+23%).

In practical terms, it is not possible to draw a hard and fast distinction between ‘bubble’ and ‘non-bubble’ industries. But, in an endeavour to draw some very general ‘bubble’ and ‘non-bubble’ distinctions, fig. 16 strips out construction, real estate and finance (‘CREF’), and the principal public spending sectors, from all other industries, and indexes the real value of output between 2000 and 2009.

Over that period, CREF output increased by 42%, and the public sector component by 28%, compared to a 5% decline for other industries within overall economic expansion of 15%. As we explain later, we estimate that compound growth of 2.8% between 2000 and 2008 would have been barely 3.4% in the absence of ‘Brown bubble’ borrowing.

More importantly when looking ahead, six of the eight largest sectors of the UK economy are dependant either on private borrowing or on public spending. Three of these (accounting for 18.8% of the economy) are in the public sector, and have been powered by an era of spending growth which is well and truly over. Real estate and construction (29.6%) are leveraged to net mortgage lending, which collapsed from £113bn in 2007-08 to just £3bn last year. Financial services, though not wholly dependant on private borrowing, are nevertheless linked to private financial activity. Collectively, this means that 58% of the economy is accounted for by sectors which are, at best, ex-growth. With real disposable incomes declining, retailing – another 11% of output – will struggle even to stand still, lifting the ‘ex-growth’ proportion of the economy to 70%. The mathematical implausibility of growth poses major problems given that the government’s fiscal rebalancing plan is entirely dependant upon growth reaching at least 2.8% in less than two years from now.

If this doesn’t happen – and we are convinced that it can’t – the deficit reduction plan will come apart at the seams.

the undermining nexus – high borrowing, low growth

In fig. 17, we revisit annual increments to government and private debt by superimposing real GDP growth rates onto the chart. The disturbing feature of this chart is that, just as incremental borrowing escalated (from 4.9% of GDP during 1996-2002 to 11.2% between 2003 and 2010), growth rates dropped rather than improving.

The implication, which is that borrowing-addicted Britain gained ever less growth from each successive increase in debt, is amply borne out by fig. 18, which shows a huge divergence between real rates of growth in aggregate debt and in GDP.

After 2000-01, and just as borrowing began to escalate, growth stagnated, showing no gains whatsoever over the preceding (1996-2001) period. Indeed, trend growth was a lot lower during 2002-08 (2.6%) than it had been in the earlier period (3.5%).

If Britain’s economy had indeed become dependent upon annual debt increments exceeding 10% of GDP, why was there not at least some improvement in growth rates? The conundrum is one that asset managers call ‘returns on capital employed’ – Great Britain plc has increased its capital (debt) base very markedly without generating any improvement at all in income growth. Why?

the nature of addictive borrowing

To understand the conundrum posed by a growing capital (debt) base and diminishing growth, we need to distinguish between two types of debt. These are termed ‘self-liquidating’ and ‘non-self-liquidating’ debt.

*Source: Tullett Prebon UK Economic & Fiscal Database. ‘Public sector’ = Education + Health + Public Administration & Defence*

*Fig. 16: Disparate growth, 2000-09*

*Fig. 17: Borrowing and growth #1 – opposite directions*
If the owner of a successful restaurant borrows to invest in additional seating space, the debt is self-liquidating because it will be serviced and paid off from the higher income that the expanded restaurant will generate.\(^4\) But borrowing to pay for a new car or a foreign holiday is non-self-liquidating, because it is a form of consumption which does not leverage the borrower’s income. Though the parallels are necessarily less than exact, the sharp fall in Britain’s return on capital reflects the fact that the overwhelming bulk of new borrowings have been non-self-liquidating.

Government has been guilty of over-consumption, and very little has been invested in self-liquidating projects such as the improvement of the country’s road, rail, power or telecommunications infrastructure. But the biggest problems have been caused less by government than by individual borrowers.

The biggest single debt increment during the period between 2002 and 2009 was mortgage borrowing, which increased by £590bn between those years. Many borrowers saw this as investment, a view which was profoundly mistaken even though many policymakers and even bankers managed to delude themselves otherwise. As average property prices soared from £121,000 in 2002 to £197,000 in 2007 (a real terms increase of almost 70%), escalating mortgage debt looked like an investment, and a good one at that. But to believe this was to overlook two critical points.

The first point that was generally misunderstood was that property prices, whilst realisable on an individual basis, are not realisable in the aggregate. Therefore, and as borrowers and lenders alike were to discover, property prices, far from being an absolute, are an example of ‘notional value’.

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*Fig. 18: Borrowing and growth #2 – a dangerous divergence (Source: Tullett Prebon UK Economic & Fiscal Database, Bank of England, ONS)*
The second reason why the escalation in mortgages was not an investment was that a steadily diminishing proportion of new issuance was actually going into the purchase of homes – by 2007, only 35% was being used for this purpose, with the balance going into buy-to-let (BTL) (26%) and equity release (39%).\(^5\) Whilst BTL might have looked like an investment, the reality was that it was a low- or negative-yield punt on property prices continuing to rise ad infinitum. Equity release, meanwhile, amounted to the direct leveraging of balance sheets into consumption.

That the property market could not go on rising indefinitely was demonstrated in dramatic fashion when average prices fell by 19% between 2007 (£197,000) and 2008 (£160,000). Despite this correction, property prices still look very exposed in terms of earnings multiples, which remain far above historic norms (fig. 19).

The problems facing the UK today are the direct result of reckless consumption by individuals and government alike, the former funded by equally reckless lenders. Now, and although the public are not yet aware of it, the bill for this era of unheeding greed has turned up. To put it colloquially, many of the imported gadgets might already be in landfill, but the debt incurred to buy them remains.

what happens next?

As we have seen, a pattern has been established in which the British economy has become hugely dependent upon borrowing, both private and public. But we have also established that borrowing at recent levels is simply not a sustainable option. The critical issues, therefore, must be the probable outlook for borrowing, and the implications of that outlook for the delivery of growth.

Annual borrowing averaged 11.6% of GDP between 2002-03 and 2007-08, comprising mortgage borrowing of 7.9%, credit of 1.0%, and government deficits of 2.7%. To see what might happen to the economy going forward, we need to look at where each of these borrowing levels may go in the future.

The government has already set out the trajectory of its own future borrowing, determining that the deficit will decline from 11.1% of GDP in 2009-10 to just 1.6% by 2015-16. Achieving this, of course, is critically dependant on the assumption that tax revenues will be driven sharply upwards (by 22% in real terms) by strong economic growth.

Private borrowing, which accounted for 77% of the private and public aggregate during the boom years, has already collapsed. In 2007-08, net mortgage and credit borrowing totalled £114bn, but this crashed to £16bn in the following year before actually turning negative in 2010-11.

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\(^5\) Source: FSA

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**Fig. 19: Dysfunctional – property prices, 1996-2010**

- Property prices
- Earnings
- Price/earnings multiple (RH scale)

**Fig. 20: The squeezed middle – how the price of essentials has outpaced incomes**

- Gas +131%
- Property +90%
- Council tax & rates +69%
- Water +59%
- Petrol price +41%
- Food +36%
- Rent +30%
- Consumer durables -13%
- CPI +23%
- Wages (private sector) +40%
- Wages (public sector) +46%
- Net mortgage +53%
- Council tax & rates +40%
- Water +30%
- Energy +30%
- Rent +30%

*Sources: Tullett Prebon UK Economic & Fiscal Database and ONS. Compares 2010 with 2000*
The likelihood of mortgage borrowing increasing materially must be rated at close to zero, at least until property prices fall to a level at which affordability (which we regard as a price/earnings multiple of less than 3.5x) is restored. This would require prices to fall by a further 22% from their 2010 average, which was itself 23% below the 2007 peak.

Unsecured (credit) lending has already turned negative, and is likely to remain so unless consumers are sucked into using credit to pay for necessities (rather than for discretionary purchases) as real incomes decline. That this may well occur is implied by the past rate at which the cost of necessities (such as utility bills and fuel) has consistently out-paced both earnings and reported CPI (fig. 20).

A combined outlook for public and private borrowing is set out in fig. 21, which shows that borrowing is set to be drastically lower over the coming five years than it was during the bubble.

Given that the UK economy is critically debt-dependant—with between five and seven of the eight biggest sectors directly dependant either on private borrowing or on public expenditures—this outlook suggests that growth is likely to be very low indeed. This, in turn, implies that the government’s deficit reduction plan is unlikely to succeed, because it is critically dependant on revenue expansion driven by strong economic growth.

As we have seen in Part Two of this report, the UK cannot continue to increase its public debt, so the government cannot displace the private borrowing which, prior to the financial crisis, had become the corner-store of economic growth. But, as we have also seen, Britain cannot reduce its dependence on borrowings unless economic growth recovers. In short, past dependence on substantial levels of annual incremental borrowing has put Britain into a high-debt, low-growth trap. Because growth was feeble even when fuelled by the continuous injection of debt-funded demand, the outlook, now that the country’s borrowing capacity has been maxed out, may be for extremely low economic growth.

Before looking at what (if anything) might be done to get Britain out of its high-debt, low-growth trap, we need to understand how the country got itself into this trap in the first place.

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*Fig. 21: Running out of steam – the end of the debt-based economy*

*Source: Tullett Prebon UK Economic & Fiscal Database*
The delivery of failure

• The responsibility for putting Britain into a high-debt, low-growth trap lies firmly with the 1997-2010 Labour administration. "Team Brown" bungled the reform of the financial regulatory system, mistook the ensuing property-driven bubble for real growth, irresponsibly ramped up public spending to unaffordable levels, and throughout remained blithely ignorant of its mistakes.

• By pursuing policies based on selective moral absolutism and spurious notions of 'fairness', the Labour government created a psychology of individual and collective entitlement which is the biggest single obstacle on the route to economic viability.

This report has been compiled from a pragmatic and politically-neutral standpoint. We agree with the view of the Coalition government that deficit reduction is imperative, and that Britain cannot go on adding to its debt mountain in the reckless way that it has been doing for more than a decade. We also share the view of the government's opponents that lack of growth is likely to derail the Coalition's plan.

But we cannot concur with any analysis which endeavours to shift the blame for Britain's current economic plight from the 1997-2010 Labour administration. That government, and in particular "Team Brown" at the Treasury, behaved with a blend of recklessness, arrogance and incompetence for which we can find no parallel in modern British history. This, of course, need not translate into a burden for the Labour party itself, so long as Ed Miliband and his colleagues disavow the Blair-Brown legacy completely.

The indictment of the Blair-Brown government is comprehensive and, in sum, utterly damning. The administration's appalling conduct of foreign and defence policy lies outside the scope of this report, though the party's supporters were entitled to wonder why a Labour administration was tagging along with the overseas adventures of the most right-wing administration in modern American history.

At home, Team Brown undertook a disastrously bungled deregulation of the banking system, thereby sparking a property bubble which could only ever have ended in disaster. Along the way, the UK economy became debt-dependent – sectors driven either by private borrowing or by public spending prospered in an unsustainable way, whilst other industries withered.

Far from recognising the bubble for what it was, Brown proclaimed the abolition of "boom and bust" (together, presumably, with the general economic laws of cyclicalit). With the laws of economics conveniently abolished, Brown ramped up public spending by more than 50% in real terms, far outpacing even the bubble growth of the period, let alone the much more modest growth in the tax base.

Together with this incompetence went an almost messianic drive towards selective moral absolutism based on spurious concepts of 'fairness'. This moral fervour brought with it ever greater arrogance in the upper echelons of the public sector, and also helped to create a dangerously delusional belief in individual and collective entitlement.

The real tragedy at the heart of Labour's disastrous conduct of the British economy was that Brown and his Treasury team remained in denial even after the myth of their economic genius had exploded. Perhaps intoxicated by the concept of "neo-endogenous growth theory", and even with the economy crashing around his ears, Brown continued to believe that there had been "no return to" boom and bust. Throughout his tenure at the Treasury, Brown continued to preach "prudence" and "golden rules" even as he was creating the largest deficit in British peace-time history. When the banking crisis impacted in 2008, he continued to insist, ludicrously, that Britain was "best placed" to weather the storm. Ministers seem to have
been forbidden to refer to the financial crisis without the obligatory word “global” being tacked on to it.

The scale of the deficit, and Britain’s consequent inability to use stimulus to good effect, apparently had nothing whatsoever to do with Team Brown’s reckless expansion of public spending since 2000. The crisis in the British public finances, it seemed, was entirely of foreign origin, and the genius which had made Britain best placed in the global economy could now be applied to “saving the world”.

This is not simply a chapter of historical regret, because one of the most striking features of the current economic and fiscal mess is a national state of extreme denial over the severity of the problems facing the UK. Politicians and the general public alike have refused to face up to the reality of the scale of the deficit, and Britain’s economic and fiscal mess is a national state of denial, and the sense of ‘entitlement’ plays a major role in this state of denial, and the severity of the problems facing the UK.

Thinking the unthinkable: might there be no way out for Britain?

Second, the Bank was required to look only at retail price inflation when setting monetary policy. The concept of asset price inflation, it seemed, had never even crossed Team Brown’s radar.

Since a number of factors (such as generally benign commodity markets, and an influx of cheap manufactured imports from emerging economies in Asia) were depressing retail inflation, interest rates were kept low even when an unmistakable asset bubble began to emerge in the property market. Any claim that the emergence of a property price bubble could have been neither observed nor countered would be disingenuous, since rates of price expansion, and the relationship between property prices and average earnings, supplied real-time evidence of unmistakable overheating in the housing market.

The bungled reform of financial regulation triggered a classic property market bubble. Hitherto, lenders had worked to a set of long-established criteria. The purchaser of a property would fund a brand new welfare state as a monument to the wisdom of the New Orthodoxy. Labour also seems to have believed that debt doesn’t actually matter very much, a view to which many individuals and businesses also came to subscribe. We now know better.

In 1997, Labour made two disastrous mistakes with its reform of the regulatory system. First, although the Bank of England was given a degree of independence, its regulatory role was fatally undermined by the creation of the tripartite system, which handed many of the Bank’s previous responsibilities to the Treasury and the FSA.

Nowhere was Team Brown’s complete detachment from reality more evident than in public spending. During Labour’s first term, the government had been constrained by an electoral commitment not to exceed the spending plans of the outgoing (Conservative) administration. Once this constraint had lapsed, Brown began to undertake the largest ever peace-time expansion in public spending.

Fig. 22: Spending – the ‘Brown binge’*

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*Spending at constant 2010-11 values. Source: Tullett Prebon UK Database, HM Treasury and ONS

Fig. 23: ‘Cuts’ are modest in context*

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</table>

*Spending at constant 2010-11 values. Source: Tullett Prebon UK Database, HM Treasury and ONS

spend, spend, spend

How, then, can Team Brown’s complete detachment from reality more evident than in public spending. During Labour’s first term, the government had been constrained by an electoral commitment not to exceed the spending plans of the outgoing (Conservative) administration. Once this constraint had lapsed, Brown began to undertake the largest ever peace-time expansion in public spending.

Although Labour’s conduct of the economy in the decade before the banking crisis was fundamentally flawed, a combination of arrogance and
ignorance prevented the government from recognising the essentially illusory nature of the apparent growth of that period. As a result, Labour made dangerously inept assumptions about tax revenues, and about sustainable levels of public spending. All that was required to complete the disaster was for government to believe that the debt-fuelled bubble was real growth – to believe, that is, that “boom and bust” really had been abolished – and to spend up to it. The Labour government did even more than that. Between 1999-2000 and 2009-10, when reported real GDP increased by 17%, real public spending soared by 53% (fig. 22), creating an enormous deficit which, at £156bn, equated to 11% of GDP.

During 1999-2000, the government spent £343bn. If this sum had simply increased in line with inflation, it would have reached £440bn by 2009-10. In fact, spending in that year was £670bn. Such a spending hike had only ever been affordable on the bizarre assumption that the economy could continue its bubble-driven expansion indefinitely, and that tax revenues would escalate on the back of superheated growth.

Government largesse was spread across the board, with big real-terms increases recorded in health (+89%), in education (+60%) and, needless to say, in the general cost of government (+99%). (By contrast, planned spending cuts by the coalition government are extremely modest, amounting to an overall reduction of just 3% between 2009-10 and 2015-16 (fig. 23)).

The reckless expansion in public spending had at least four very unpleasant consequences. First, it created unprecedented arrogance in the upper echelons of the state apparatus, an arrogance which was reflected both in the pay and perks of senior managers and in a relentless encroachment on the rights and liberties of the individual. Second, the seemingly endless flow of increases in public spending (which rose by average of 4% per annum, in real terms, throughout the 2000-08 period) was reflected in a steady decline in public sector productivity – after all, who needs to budget carefully when there will always be more Treasury largesse coming down the line? Third, a mentality of individual and collective entitlement flourished in an environment in which, it seemed, public spending could provide the answer to all ills. Fourthly, and as we have seen, the economy was distorted towards sectors driven either by debt or by public expenditures.

Labour’s assumption of moral absolutism drove a wedge between the state and the public, and the resulting cynicism about the country’s political leaders will prove a major handicap as the Coalition government endeavours to make the case for collective sacrifice. Even before the Parliamentary expenses scandal of 2009, there was unmistakable evidence of a growing rift between governing and governed – the government apparatus seemed to be becoming relentlessly more arrogant as the power and resources of the state expanded, and the ever-increasing use of surveillance, not just at national but even at local government level, caused no less a figure than then Information Commissioner Richard Thomas to warn that Britain was “sleepwalking into a surveillance society”. Laws which may have begun with good intentions resulted in the banning of the traditional game of conkers, a schoolgirl being banged up in a police cell for a purely technical transgression of the equality laws, parents being subjected to undercover surveillance to ensure that they really lived where they claimed they did, the greatest density of CCTV camera coverage in the world, plans to install surveillance cameras in dustbins, and the arrest of opposition MP Damian Green for the supposed crime of receiving (not leaking) information which, whilst embarrassing to the Home Office, had no relevance whatsoever to national security.
By 2010, more than 1,000 categories of officials had an unrestricted right of access to individuals’ homes to check on such vital matters of national security as the cultivation of pot plants and the sale of squirrels.

**declining productivity**

At least, it might have been assumed, the massive real-terms increase in spending must have resulted in a comparable improvement in the quality of public services. Available data very strongly suggests that this did not happen, because the productivity of the public sector seems to have fallen very markedly throughout the period in which the dramatic increase in spending took place. The decline in public sector productivity was bad news, of course, both for taxpayers and for the users of public services, but it also had adverse implications for the overall efficiency of the economy.

Because commercial outputs have a market value, the measurement of productivity in the private sector is a relatively straightforward matter, but the same does not apply to the public sector, where outputs are not priced. Prior to 2005, virtually no attempt was made to measure productivity in the public sector, the wildly naïve assumption simply being that output matched inputs.

Since 2005, the ONS has put commendable efforts into measuring the outputs (and hence the productivity) of the public sector. This process seems to show that overall public sector productivity declined between 1997 and 2007, but only by about 3%, the implication being that the quality of public services pretty much kept pace with the sharp increase in inputs over the same period.

Unfortunately, there are very serious shortcomings on both sides of the input/output equation as measured by the ONS. For a start, inputs are measured volumetrically, which excludes from the calculation the very material rises in the real unit costs of those inputs.

Our recalculation of public sector productivity differs from the ONS version in two key respects. First, we use real spending data instead of volumetric inputs and, second, we exclude the tripling in prescription numbers from our measurement of health sector output.

Falling productivity meant, of course, that taxpayer costs rose in relation to the quality of services being enjoyed by the public, but it also meant that overall national productivity was undermined in a period in which public sector spending climbed to 48% of GDP.

Together, then, the Labour era left Britain with a debt-dependent economy and with a situation in which overall productivity had been

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**Fig. 24: Public sector productivity**

**Fig. 25: Health sector productivity**

**Fig. 26: Public sector productivity**

**Fig. 27: The productivity gap**
undermined by the shift of national resources into a public sector whose productivity had deteriorated from a private sector in which efficiency had been increasing.

the high price of moral absolutism

If the Labour administration failed on two of its stated aims – economic competence and ethical foreign relations – then it succeeded, rather horrifically, on the third, which was to change ‘hearts and minds’.

Perhaps the most intractable part of Britain’s economic problem is the mind-set engendered by Labour. This mind-set, which is a compound of entitlement (both personal and national), financial irresponsibility and spurious moral absolutism, makes it difficult for the public to perceive the nature of the national problem, let alone resolve it.

Not since the days of William Gladstone10 has a government come to power with a greater sense of moral fervour, and it is at least arguable that Tony Blair and (in particular) Gordon Brown were even more prone than ‘the Grand Old Man’ to treat the despatch box as a pulpit. The essential difference between Gladstone and New Labour, however, was that Blair and Brown peddled an essentially secular moral absolutism, albeit with at times a distinctly nonconformist flavour.

A selective concept of ‘fairness’ was at the very heart of Labour’s secular theology, so much so that an entire chapter of the 2009 budget was entitled “helping people fairly“ (when helping them effectively might have been a much better idea). The problem with this was (and is) that ‘fairness’ is an extraordinarily vague concept, one to which everyone can subscribe and then interpret as suits them best. For example, a rich person might argue that fairness involves every working person paying the same amount of tax, or at any rate paying the same percentage of his or her income, whilst a person on a low income might believe that the system should take far more from the better off. The reality is that, beyond basic rights as outlined in documents as varied as the American Constitution and the European Convention on Human Rights, there are very few moral absolutes in a secular society. Labour’s solution simply was to declare ‘ex-cathedra’ principles and to demonise those who had the temerity to disagree.

Even by its own standards, Labour’s secular morality was full of holes. Where, critics asked, was the ‘fairness’ in plundering private pension schemes, piling gigantic debts onto future generations, or invading Iraq? Where was the ‘fairness’ in imposing rigid uniformity on everyone, banning minority activities (such as fox-hunting), leaving the income tax threshold a long way below the minimum wage, enforcing multiculturalism as a secular religion which no-one was allowed even to question on pain of arrest, or granting national and local government ever greater coercive and surveillance powers over individuals?

Labour’s creed of moral absolutism had multiple negative spin-offs. But from a purely economic perspective, Labour pursued disastrous policies (such as ‘light touch’ deregulation) to the point of recklessness because it believed that it had the moral inside-track on all issues.

the grvest problem – the concept of entitlement

Despite the appalling mismanagement of the New Labour years, Britain remains the world’s eighth largest economy (though it has now fallen to 37th in terms of per-capita income)11. Reflecting this, British citizens enjoy high quality health, education and welfare systems, combined with strong provision of other basic services. The problem which has emerged over the last decade, and can in large part be traced to Labour’s doctrine of moral absolutism, is the widespread assumption that individuals and, by extension, Britain as a whole, have an entitlement to these advantages, when the reality, of course, is that they have to be earned on an ongoing basis.

Arguably the single biggest problem that the Coalition inherited from Labour – more serious even than the deficit, the national debt or the proliferation of wasteful agencies and quangos – is this belief in personal and, by extension, national entitlement. Individuals, it is widely assumed, are ‘entitled’ to claim perpetual benefits, and the country is ‘entitled’ to its current standard of living, whether it actually earns it or not.

If accepted (as, by New Labour, it was), this sense of ‘assumed entitlement’ leaves government free to burden industry in whatever way selective moral absolutism dictates, confident that the damage to output doesn’t really matter because the world somehow owes Britain its current standard of living and its current level of welfare provision.

How this sense of entitlement translated into economic aggregates is set out in fig. 32, which compares real-terms changes between 1999 and 2009. Although real GDP only increased by 16% over that period, public spending increased by 53% and public debt rose by 73% (not including financial interventions). Although household consumption increased by 18% (thanks in large part to soaring personal indebtedness), government final consumption (which is not the same as public spending) rose by 52% – again, dramatically outpacing GDP – whilst the value of manufacturing output slumped.

The scale of dependency is evident, too, in the numbers claiming out-of-work benefits. As of August 2010 (the latest month for which fully detailed data is available), the claimant count totalled 2.74% of the workforce.

Fig. 33: Bubble swings*

\* Source: *Tullett Prebon UK Database

\* Financial interventions
4.9 million, including 2.4 million receiving Jobseekers’ Allowance, 0.67 million claiming single parent benefit and an astonishing 2.6 million on various forms of incapacity benefit. These are very large dependency rates when compared with total employment of 29.1 million (22.9 million in the private sector and 6.2 million in the public sector). The recently-introduced eligibility tests for incapacity benefits applicants revealed that three quarters of the applicants were found to be ineligible, the economy continued a culture of moral absolutism and entitlement, the economy towards sectors linked either to private borrowing or to public spending.

A gamut of trades ranging from construction to legal services via estate agencies, white goods suppliers, builders’ merchants, plumbers and electricians benefited from the brisk pace of expansion in the property market. Consumer spending surged because inflated housing equity made consumers unduly relaxed about leverage, such that annual equity release peaked at over £50bn and unsecured debt soared from £120bn in 1999 to £230bn in 2008. Like mortgage lenders, credit providers behaved recklessly but, ultimately, it was Labour’s dysfunctional regulatory system which allowed them to do so.

Together, these factors injected unsustainable expansion into the economy. Meanwhile, the savings ratio had virtually disappeared under the triple onslaught of low rates, adverse tax treatment (notably the notorious 1997 tax “raid” on pension funds), and a general perception that debt was not a matter of concern. Consequently, the illusory growth of the period was fuelled almost entirely by borrowings from overseas. Britain’s external debt climbed from £1.89 trillion in 1999 to £2.94 trillion in 2008, huge real-terms gains were discerned from sectoral contributions to economic output. Between 2000 and 2008, huge real-terms gains were delivered by financial services (+109%), construction (+43%) and real estate activities (+30%), whilst manufacturing output shrank by 19% and value added in the broader production category declined by 11%. As a result, manufacturing fell as a proportion of the economy from 17% in 2000 to 12% in 2008, whilst the share attributable to the aggregate of real estate, construction and financial services climbed from 32% to 39%.

These trends were reflected, too, in employment patterns. Between 1999 and 2007, employment in real estate activities and construction increased by 58% and 22% respectively, whilst the number of manufacturing jobs fell by 28%.

What, then, was the real growth track-record of the British economy in the decade before the crisis, and what is the economy’s current trend growth potential? If official figures were to be believed, the economy delivered annual real growth of 2.8% between 1998 and 2009. And, if official (OBR) forecasts are to be believed, an even higher (2.9%) rate of growth can be achieved within two years from now, despite fiscal tightening.

The reality is that these numbers, both historic and projected, are completely delusional. Stripped of bubble effects, we calculate that average annual growth during 1998-2009 was certainly less than 1.5%, and may have been as little as 1.3%. And, as we have seen,
dependency on private borrowing and public spending renders the possibility of the economy delivering growth rates above 2% extremely remote.

**nemesis – the squeezed middle**

The political sting in the tail for New Labour was the emergence of the “squeezed middle”, roughly analogous to the “middle England” which had obsessed an earlier generation of political analysts. As a minority prospered, people on second- and third-quartile incomes found that their debts had escalated whilst their spending power was being squeezed by inflation-busting increases in food and travel costs, electricity, water and gas prices, and the levies imposed by national and local authorities.

This trend played a major role in the overthrow of the Brown government. Real average earnings appeared to improve by 15% between 2000 and 2010 – by 14% in the private sector and by 19% in the public sector[12] – but this calculation rests on official measures of inflation which do not seem to reflect everyday experience. Over the same period, for example, whilst CPI increased by 23%, average electricity bills rose by 69%, gas bills by 131%, council tax and rates by 69%, water by 59% and petrol by 60%, all of which are far greater increases than the 42% rise in nominal weekly earnings.

With the Brown era thankfully consigned to history, what remains is a country which is hugely indebted, has a government which spends much more than it can afford, and has an economy geared towards low growth.

Worse still, the legacy of moral absolutism and entitlement has created a political landscape of warring interest groups which gravely compromises Britain’s ability to find unified solutions to its problems.

If Labour is to play a constructive role in the quest for national economic viability, Ed Milliband needs to disavow the Brown legacy in its entirety, and to turn the page on a deeply unedifying chapter in the history of the party.

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[12] Public sector wages excluding financial services

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*Fig. 34: Property price/earnings multiples*
no way out?

• There are no pain-free solutions to Britain’s economic and fiscal problems, but supply-side reforms can start to build the foundations for longer-term revival.

• The biggest obstacles to recovery are spurious moral absolutism, an unrealistic belief in ‘entitlement’, and the division of the economy into warring interest groups.

Thus far in this report we have established, first, that Britain is gravely mired in debt and, second, that the levels of growth necessary to carry this debt are most unlikely to be delivered, because the economy has become far too heavily skewed towards private borrowing and public spending.

What happens next can only be bad, of course, but the critical questions have to be “how bad?”, and “what can be done to minimise the damage?” The answers to these questions will depend less on policy choices than on rational cohesiveness, and this in turn will depend upon ending the state of denial that has gripped public and policymakers alike since the onset of the financial crisis in 2008, and bridging the gap between warring self-interest groups.

One of the most striking characteristics of Britain’s current economic and fiscal malaise is a sense of almost total denial about the true state of the economy and the public finances. The general assumption, and one which has been given official sanction both by the government and by the OBR, is that economic growth will return, regaining the superheated levels of the ‘Brown boom’ by 2013, when the official projection is that GDP will grow by 2.9%. This being so, the argument runs, Britain’s hefty public debts are not a matter of major concern (although it is conceded that they will continue to increase) and, with the exception of the official hope that banks will lend an extra £76bn annually to businesses, there appear to have been no official comments at all on private debt.

Indeed, the authorities seem extremely ambivalent about the whole subject of debt. The government accepts the need to reduce the deficit, but this does not amount to a plan actually to reduce the public debt. The opposition does not even accept the need to go this far, seeming to see no necessity to eliminate the structural deficit over any realistic timetable. Where private debt is concerned, the official message, such as it is, seems to be that borrowing can alone “get the economy moving”, a view which does not take into account the uncomfortable fact that consumers are already burdened by more than £1.4 trillion of secured and unsecured debt.

Official economic forecasts seem to have been constructed on the basis of some kind of economic “flat earth” in which neither absolute debt levels nor the skewing of the economy towards private borrowing and public spending are taken into account.

A point which we have endeavoured to make throughout this report is that both of these erstwhile economic drivers are dead. The government cannot continue to ramp up its spending, and individuals cannot and, if they are wise, will not, continue to go ever further into debt.

This fundamental dislocation seems blithely to have been ignored in the framing of official economic and fiscal projections. Despite reductions in public sector employment, the total number of jobs in the economy is expected officially to increase by one million, with total employment climbing to 30.0 million by 2015, compared with 29.0 million today. The rate of unemployment will fall from 8.2% to 6.4%, and the claimant count, after rising slightly to 1.54 million next year, will fall back to 1.18 million by 2015. CPI inflation, though now at 4.5%, will fall back to the 2% target by 2013.

Reflecting this optimistic economic outlook, government tax receipts are expected to rise from £549bn in 2010-11 to £735bn by 2015-16, a real-terms increase of 27%. The expectation that
Speaker A: The official, optimistic outlook for Britain may be barely keeping up with the very deep trouble.

Speaker B: The real outlook, as we see it, begins with the observation that, by definition, there can be no such thing as a pain-free recession. Over the last three years, Britain’s real economic output has fallen by more than 5%, but this, until very recently, had had remarkably little impact on most members of the public. The rise in unemployment has been modest, inflation to fall back to 2%, and believe growth and low inflation, the markets place. The promised land of strong long-term forecasts for growth are revised or “pas devant les enfants”. Near-term forecasts for growth are revised downwards, and predictions for near-term inflation are raised, because credibility demands nothing less, but longer-term optimism remains in place. The promised land of strong growth and low inflation, the markets and the public are told, has not been misled, but simply pushed out into the future. The probable intention is the bolstering of confidence in the face of the clearest possible evidence that official projections are proving wildly optimistic. After all, the last thing that fragile international market confidence needs at this time is to be told that one of the world’s biggest economies is in very deep trouble.

Speaker A: The forex markets, it seems, are almost alone in their immunity from this psychology of denial. If, as we believe to be the case, Britain’s psychology of denial about the true state of the economy and the public finances is about to suffer a rude awakening, where is this likely to become evident? When considering each possible theatre of deterioration, we need to distinguish between “bad” and “very bad”. We conclude this report by explaining how the pain might be restricted to the former rather than the latter. There are many possible theatres for denouement, but let’s start with property. As it has been so often in...
thinking the unthinkable: might there be no way out for Britain?

In the past, the state of the property market is likely to be something of a bellwether for the broader economy. Though annual average house prices have declined by 17% since their 2007 peak, the ratio of prices to earnings remains at 4.5x, far higher than historic averages in the 3.2x-3.5x range (Fig. 34). Property market participants are reporting extremely subdued levels of activity, and this combines with still-very-extended price multiples to suggest that further sharp falls may be imminent.

There are at least three further reasons to suppose that property prices may be heading for a very big fall. First, net mortgage lending has virtually dried up, declining from £113bn in 2006-07 to just £30bn in 2010-11 (Fig. 35). Second, even the official forecasts concede that interest rates are likely to rise, which will further under-cut affordability. Third, it is clear that real incomes are declining, which is another adverse indicator for property markets.

Given this combination of factors – minimal market activity, negligible net mortgage issuance, declining real incomes and the probability of rate rises – it seems highly implausible that the property price/earnings ratio can remain about 40% above its historic trend. One of the characteristics of the unfolding downturn in the British economy, therefore, is likely to be a sharp fall in property prices.

If the mitigation measures described later are put into place, the restoration of normality in the property markets may take place over a relatively protracted period. But if the psychology of denial continues, property markets could be heading for a sharp fall, taking the price/income multiple down to its 3.2x-3.5% baseline over a period of less than twelve months. Downwards momentum could cause the fall in multiples to overshoot, involving a slump of at least 30% in average prices that would take the multiple down to about 3x.

Any such fall would, of course, have some pretty drastic knock-on implications. The proportion of Britain’s 11.4 million mortgage payers, which is in negative equity would rise very sharply (though it is to be hoped that the banks would recognise the total futility of large-scale repossessions in such circumstances). The banking system’s reserve ratios would suffer a battering, as, of course, would consumer spending.

Just as a sharp downturn in property prices could be one form of denouement for the collective denial about the true state of the British economy, unemployment could be another. As remarked earlier, the official expectation that the private sector can add 1.4 million net new jobs over the coming five years looks pretty implausible. It is far more likely that, as public sector cutbacks enter their stride, unemployment levels will rise. Quite how far these levels rise will depend upon the preparedness of the authorities to implement mitigating measures designed to make it more attractive for businesses to take on extra employees.

Meanwhile, we also expect tax revenues to fall successively further admitt of official targets, not drastically so this year (because the current-year growth assumption is relatively restrained, and the VAT increase can be counted upon to boost revenues), but in subsequent periods. Allowing for the increases in tax rates (and most notably in VAT), the target for 2011-12 revenue gains is not particularly demanding, but the increases forecast for future years may be impossible to deliver if, as we believe to be the case, the growth assumptions upon which they are predicated are far too optimistic.

The way in which this process might impact debt and the deficit is set out in the table. If growth were to come in at 0.9% this year, 1.3% in 2012-13 and 1.4% in subsequent periods, debt will hit 100% of GDP by 2014, and will continue to rise thereafter, whilst the deficit could still be close to 9% of GDP by 2015-16.

If this process were to gain momentum, it would become a vortex in which the UK’s economic situation could very rapidly become perilous. If the markets and the rating agencies decided that Britain was another debt-shackled, low-growth economy at the periphery of Europe, interest rates would rise sharply, exacerbating fiscal strains, and the government might even encounter significant difficulties in raising the huge and rising sums that it would need to borrow.

limiting the pain, building the foundations for recovery

The question, then, is whether all pain can be avoided – that is clearly impossible – but whether the pain can be minimised and the foundations created for a subsequent recovery. If Britain is to craft an eventual route out of the high-debt, low-growth trap, no less than six critical points need to be grasped from the outset.

1. The British public appears to be unaware of the true scale of the economic and fiscal malaise, the widespread belief seeming to be that it will ‘turn up’. The public needs to be made aware of the reality, which is that, unless radical corrective action is taken, what will ‘turn up’ will be a full-blown economic crisis.

As we have seen, the assumption that, sooner or later, the economy will stage a brisk recovery is simply an exercise in wishful thinking of which Pollyanna would have been proud.

2. It needs to be appreciated that there can be no such thing as a pain-free recession. Together, low interest rates and enormous fiscal deficits have, for millions of people, deferred the true cost of the downturn, but this was only ever a limited-duration delaying tactic. Only now is the reality of declining living standards beginning to bite.

3. It must be understood also that there is no magic macroeconomic solution to Britain’s problems. Almost every possible macroeconomic permutation has already been tried, to no avail. Specifically:

• Interest rates have been maintained at near-zero levels for 28 months, yet no recovery has ensued.

Fig. 37: Unravelling: How low growth could undermine the government plan

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<td>104%</td>
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Source: * Tullett Prebon calculations. ** Debt to GDP ratio on the Maastricht Treaty definition.
5. Politically, government needs to offer the public some offset to the generally depressing economic outlook. The best way to do this, we believe, would be to promote a ‘liberty agenda’ which strips away much of Britain’s excessive surveillance, reduces the powers of national and local government to interfere in the lives of individuals, removes many of the coercive aspects of government, and promotes a greater degree of consumer protection.

6. Finally, it needs to be realised that the government’s glib-sounding “we’re all in this together” is, in these circumstances, literally true. The financial crisis and its economic aftermath have revealed a culture of self-interest and blame-shifting that may only be overcome by a complete explanation of what a debt crisis would mean at ground level. Those who believe that significant cuts in public spending (let alone in public services, or in public sector terms and conditions) are unacceptable need to ask themselves exactly what might happen to services, and to public sector pay and pensions, if the British economy followed the path already trodden by Greece and Ireland.

4. The problem with this, and the fourth critical point which needs to be grasped by policymakers and the public alike, is that the necessary reforms will cut across many vested interests and entrenched prejudices. To a very significant extent, the ideology of ‘fairness’ and ‘entitlement’ which has been absorbed into the public psyche over the last fourteen years constitutes the single greatest obstacle on any road to reform-driven recovery.

Government (both Labour and the Coalition) has borrowed £390bn, or 27% of current GDP over a three-year period; yet, again, there has been no recovery in economic activity.

A further £200bn has been pumped in through QE, again to no apparent effect (though it may have contributed to the surge in inflation).

Sterling has remained at depressed levels, clearly at an inflationary cost, but there has been no ‘export-led recovery’.

If the macroeconomic policy cupboard is demonstrably bare, then it follows that any solutions which may be found must lie on the supply-side. The most positive finding of this report is that there exists major scope for supply-side reform.

5. Politically, government needs to offer the public some offset to the generally depressing economic outlook. The best way to do this, we believe, would be to promote a ‘liberty agenda’ which strips away much of Britain’s excessive surveillance, reduces the powers of national and local government to interfere in the lives of individuals, removes many of the coercive aspects of government, and promotes a greater degree of consumer protection.

6. Finally, it needs to be realised that the government’s glib-sounding “we’re all in this together” is, in these circumstances, literally true. The financial crisis and its economic aftermath have revealed a culture of self-interest and blame-shifting that may only be overcome by a complete explanation of what a debt crisis would mean at ground level. Those who believe that significant cuts in public spending (let alone in public services, or in public sector terms and conditions) are unacceptable need to ask themselves exactly what might happen to services, and to public sector pay and pensions, if the British economy followed the path already trodden by Greece and Ireland.

Led by the then Labour government (which, risibly, denied any culpability at all for the financial crisis), different interest groups have sought to pin the blame on international markets, bankers, the public sector, and virtually any interest-group they can think of, other, of course, than themselves. Continued self-interest and blame-shifting can serve only to impoverish the UK as a whole if it acts as a block to effective reform.

The scope for supply-side reform is clearly visible in the 2010 Global Competitiveness Report (GCR) issued by the independent, objective and highly respected Davos-based World Economic Forum (WEF). Though still the world’s eighth-largest economy in terms of GDP, Britain’s overall competitive position has declined from 7th to 12th since 1997. The UK’s overall ranking is far less significant, however, than the detailed findings of the report.

For a start, the effectiveness of government and its agencies is even lower than might generally be assumed. Out of the 139 countries covered by the report, Britain ranks 72nd – behind such models of efficiency as Ghana, Pakistan, Malawi and Egypt – in terms of the “wastefulness of government spending”. Perhaps reflecting this, the quality of the overall infrastructure, where the UK ranks 33rd, is worse than that of Barbados, Namibia or Slovenia, and the quality of the UK’s roads (35th) is worse than those of Portugal, Namibia or Croatia. Despite the massive (60%) real-terms increase in education spending which occurred between 1999-2000 and 2009-10, Britain ranks 28th for the overall quality of its education system (behind Costa Rica, Lebanon and Malta), and fares even worse (55th, behind Romania and Cyprus) in terms of the quality of maths and science education, a weakness which is extremely detrimental to competitiveness.

Anyone who is inclined to question the need for reductions in public spending should consider such findings in conjunction with the analysis of declining productivity outlined earlier. In short, massive public spending has failed to deliver either the infrastructure or the educational outcomes that might be expected in what remains one of the world’s largest economies.

After the spectacles of bodged IT programmes, and critical data left on trains and in cars, it should come as no surprise to anyone that the GCR finds that the process of government has been conducted in a less than efficient way. Of even greater significance are the findings of the GCR where they concern the interaction between government and business.

According to the report, Britain ranks 89th (behind Egypt, Paraguay, Zambia and Saudi Arabia) in terms of the regulatory burden imposed on businesses. The extent and effect of the taxation system sees the UK ranked 95th, worse even than Zimbabwe, let alone Guatemala or Angola. The overall tax burden on business is worse than in Pakistan or Nigeria or, for that matter, in 51 other countries. Very little of Britain’s huge public spending seems to go into the purchase of advanced technology products, where Britain ranks 53rd, behind such tech-driven economies as Rwanda, Angola and Azerbaijan.

The GCR survey’s ranking of the obstacles to business growth is a telling one. First on the list is the overall rate of tax, followed by difficult access to finance, the complexity of the tax system, the inefficiency of the government bureaucracy, policy instability, restrictive labour regulations, an inadequately educated workforce, poor infrastructure, and a weak work ethic in the labour force.

This independently-established assessment surely acts as an agenda for reform. Whilst none of the GCR findings is particularly surprising, the overall impression which emerges from the survey is of an economy which is slipping down the international competitiveness table because of a government system which is costly, wasteful, inefficient and chronically prone to meddling.

Whilst it will be equally obvious that correcting these faults could only help to improve economic performance, it may be less obvious that supply-side reform is the only remaining route to economic viability now that all macroeconomic policy options have been exhausted.

This poses the question which ultimately could determine the fate of the British economy – do policymakers and the public actually want a viable economy, if this can be achieved only at the price of overcoming self-interest and abandoning many cherished assumptions and prejudices?

fixing the obvious

Fortunately, many of the reforms which are required if Britain is to restore competitiveness at the microeconomic level are either low-cost or could actually make a positive contribution to the Treasury. Some aspects of the required programme, however, would require the commitment of resources, meaning that savings need to be made elsewhere. We believe that the government’s deficit reduction targets are the minimum that are compatible with continued market confidence, and that there is no economic scope for further increases in taxation. Moreover, our analysis suggests that a more realistic appraisal of the economic outlook means that the government’s
deficit targets will not be met unless spending cuts are taken a great deal further than is currently intended.

Perhaps the biggest single problem with spending cuts is the way in which leverage effects amplify comparatively modest reductions in overall spending into much bigger inroads at certain levels.

Based on the government’s plans, the maths work like this. The Coalition plans to reduce real-terms public spending from £688bn in 2009-10 to £668bn by 2014-15, a reduction of 3%. However, and resulting from past increases in public debt, interest expense is expected to rise by £24bn. This means that ex-interest spending is set to decline from £657bn to £612bn, a fall of 6.7%. Spending on health and on international development has been protected and, with these also omitted from the equation, all other spending is set to fall by 9.4%, from £527bn to £478bn.

But the really big leveraging effect comes neither from interest nor from departmental ring-fencing, but from transfer payments. Essentially, government outlays can be divided between money which the government spends itself (in 2009-10, £339bn) and money which it hands on to others (£349bn). This latter figure comprises interest expense (£32bn), state pensions (£121bn) and other transfers (£198bn). If, in addition to ring-fencing health and overseas aid, the transfer pot is left unchanged in real terms, a pretty small cut in overall spending is leveraged into very painful reductions where unprotected services are concerned.

Within the context that overall public spending has become excessive, this leads to the inescapable conclusion that transfer spending has to be cut. Within total transfers, interest expense is outside the government’s control, whilst the aim is to keep aggregate pension outlays broadly flat by raising the age of retirement. Within the overall transfer pot, then, attention has to be focussed on other payments, which comprise in-work benefits (such as tax credits and universal benefits), and out-of-work payments (such as unemployment, lone parent and incapacity benefits). This category of expenditure increased by a massive 87% in real terms between 1999-2000 (£105bn at current values) and 2009-10 (£196bn). The case for looking at out-of-work benefits is strengthened by the widespread (if also widely mistaken) public perception that people who work can often seem to be worse off than those who do not.

Despite widespread mythology to the contrary, it would be difficult to describe out-of-work benefit payments as “generous”, and anyone who believes otherwise should try living on incomes at these levels. But the number of recipients does seem excessive. Government plans to tighten the criteria for incapacity benefit, a move which clearly is highly desirable, but we believe that technology may make another solution attractive where out-of-work benefits are concerned.

We believe that government should move towards paying benefits in kind rather than in cash. Obviously, rent can and should be paid directly to the landlord, not to the benefit claimant, but the principle could be extended by the use of smart cards which the claimant could use to purchase approved goods at participating shops. The cash/kind proportion could be varied over time, increasing the incentive to find work. A card-based system could also work in favour of children by ensuring that a specified proportion of lone parent benefit would have to be spent on clothing and other items for children.

Universal benefits are a thorny issue. On the one hand, paying benefits to people on comfortable incomes seems wasteful, but, on the other, these benefits give the broader community a stake in the system. Historically, working people were happy to contribute to, for example, unemployment benefits, because they could be in need of such benefits themselves at some point in the future. But this relationship has long since broken down, since asset tests alone mean that a high proportion of working people could not in practice access these benefits if they became unemployed.

To a significant extent, demographic and economic change has divided the population into those who receive benefits and those who, whilst paying for them, have little real likelihood of ever being able to claim them. We recognise that the elimination of universal benefits would strain this relationship even further, and we would not, in ideal circumstances, favour such a course. But, with circumstances being very far from ideal, we believe that universal benefits need to be reduced and, in some instances, eliminated altogether.

Within a general need to find further economies, the issue of public sector funding needs to be addressed in a strictly pragmatic and non-ideological manner. Though we believe that the British state has become far too large as a proportion of the economy, we do not advocate further marketisation or privatisation of the public services, since the evidence of the past two decades suggests that this process does not boost productivity, tending instead to create top-heavy administrative structures and a duplication of functions. Competition within the public services is, in any case, intrinsically artificial. Rather,
management of the public services should rely instead on a rebuilt social ethic, something which marketisation has tended to undermine. We also believe that the PFI programme has proved excessively expensive, and should be scrapped.

Marketisation has resulted in the inappropriate aping of private sector practices in the public sector. Senior public sector salaries are often set using private sector comparators when the reality is that there is almost no overlap between the skill sets required in the public and private sectors. The payment of bonuses in the public sector is inappropriate, as is the provision of the hefty expense accounts identified in Sir Philip Green’s report. One of the key findings of the Green report was the need for greater centralisation in procurement so that government can leverage its size and creditworthiness to extract greater value from its contracts with private sector suppliers.

Government needs to bear down on management excess both at national and at local level. With the exception of certain highly technical scientific and financial posts, there is in general little need for government to pay salaries in excess of £100,000, and there is most certainly no need to do so at local authority level. In addition to the savings to be made from reducing both the numbers and the pay and perks of public sector managers, government needs to further the public service ethic by narrowing the excessive gap between senior and rank-and-file remuneration.

**the high value of low-cost reforms**

Were circumstances more propitious, we would have no hesitation in advocating reductions in the tax burden on small and medium enterprises (SMEs), by raising the VAT threshold, exempting SMEs from corporation tax, and creating enterprise zones in which SMEs are exempted from business rates as well. We would advocate focusing any scope for tax reductions on SMEs because smaller firms are far more job-creative (and, at least arguably, far more innovative as well) than larger businesses.

In practice, however, the UK’s fiscal situation is so bad that little or no scope exists for reducing taxation. Fortunately, a great deal can be done to improve the environment for SMEs without spending much government money. As the GCR shows, businesses in the UK are hampered by a hefty regulatory burden and an excessively complex tax system.

Let’s take fiscal complexity first. It should surely be possible to design an integrated small business tax system which strips away complexities by combining all payments to the state into a single system. Software could be developed (presumably by HMRC) to aggregate VAT, PAVE, business rates and corporation tax into a single-point system, a process which could add value both to businesses and, conceivably, to the Exchequer as well, by cutting out unnecessary complexities. Under Gordon Brown, Labour seemed to revel in adding even greater complexity to the tax system, more than doubling the size of the tax code and often tripping themselves up in the process (as witness the 10p tax-rate fiasco). The Coalition should give very high priority to unravelling this inherited mess.

Where regulatory excess is concerned, there are three main areas of difficulty. These are planning, health and safety, and employment legislation. Small firms are at a disadvantage here because, whilst larger companies can afford to employ specialists in these areas, smaller companies can not. SMEs often find themselves walking through a minefield of HSE and employment regulations, all of which absorbs scarce management resources whilst often skewing decisions and deterring investment. We should make it abundantly clear here that strong health and safety standards are essential in a civilised society, as are protections for workers. But the risks that firms face arise less from the Health and Safety Executive, or the Department for Work and Pensions, than from opportunistic claimants. An adverse HSE inspection is a pretty unusual event, but legal action seeking compensation is far more of an everyday risk. This risk is by no means confined to SMEs, but affects large businesses and government departments as well. For example, it has been reported that as many as 30,000 “road accidents” were staged in the UK in 2010 alone, the aim being to make fraudulent insurance claims for personal injury.

Our preferred solution to the problem of opportunistic claims would be to outlaw contingent litigation, colloquially known as “no win, no fee”. Deregulation of the legal system has allowed this practice – long known in the US as “ambulance-chasing” – to feed into the development of a compensation culture in Britain. The abolition of this practice would need to be offset by increases to the Legal Aid budget in order to ensure that the rights of those with genuine (rather than purely opportunistic) claims are protected.

At the same time, SMEs should be exempted from almost all labour legislation, a move which would be cost-free to government but would make job creation very much easier.

**do we want economic viability?**

Where creating an enterprise culture is concerned, the required reforms are pretty straightforward. Carrying them out, however, could be a much more difficult matter, because the required measures would cut across the spurious moral absolutism and culture of entitlement that Labour did so much to foster.

Industrial action over public sector pensions provides just one current example of the way in which the spurious values promoted over the last decade have created an economy divided by selfishness into warring interest groups. If their representatives are to be believed, these public sector workers ’will not accept plans which would result in working somewhat longer and contributing more towards their pensions. When this argument is put forward, there is no mention of the UK’s weak economy or overstretched public finances, no mention of the way in which private pension provision has been battered by taxation and by low annuity rates; no mention of the fact that public sector earnings have been battered by taxation and by low annuity rates; no mention of the fact that public pension provision has all but ceased to exist in the private sector.
To overcome the division of society into warring interest groups, and as a third, is an imperative need to offer the public some offset to the depressing economic conditions that are now beginning to unfold. We believe that each of these objectives can be furthered by the creation of a radical ‘liberty agenda’, getting government off the backs of the public and administrators off the backs of front-line public sector workers.

Where the general public is concerned, one of the most distressing features of Britain’s evolution over the last two decades has to have been the relentless spread of surveillance and coercion. Britain is plastered with warning notices, CCTV and speed cameras, and other aspects of the surveillance state. Government needs to start stripping away much of this panoply of surveillance and coercion, and to enshrine in law the primacy of individual liberties. The Coalition cannot leave them freer from government surveillance and coercion.

A notable feature of Britain’s public service sector is the extraordinary intransigence over pensions typifies a broader culture in which broader social values have broken down in the face of self-interest and greed. The Coalition needs to offer the public an offset to the economic hardship which has become unavoidable.

needed – a liberty agenda

As has been outlined in detail in this report, the economic outlook for the UK is grim, and individuals can longer be insulated from this by government borrowing. One requirement that has been established here is to free up SMEs to invest and create jobs, a requirement which means reversing much of the complication and bureaucratic meddling which was forced upon businesses by Labour’s moral absolutism. But a second requirement is to build a social cohesion which can start to overcome the division of society into warring interest groups, and a process which has been in part a logical extension of the national disease of bureaucracity and in part a result of the doctrines of moral absolutism and entitlement.

The public also needs to be freed from exploitative practices in the private sector, most notably in the form of “terms and conditions” (known to a previous generation as “the small print”), and also in the form of exploitation of the public’s lack of understanding of banking and other financial matters. In addition to strengthening existing consumer protection systems, government should create a Consumer Court, empowered to set aside onerous, unreasonable and one-sided contractual terms.

The scale of Britain’s underlying economic weaknesses is such that David Cameron and Nick Clegg cannot realistically expect to make Britain a richer country, but they can most certainly make it a freer one.