



Fiscal conservatism is dead – on both sides of the Pond

Ryan Bourne

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The launches of the Conservative manifesto and Donald Trump's first budget could not have been more different in tone.

Theresa May's offering was cautious, with minor tweaks to policy to reflect concerns about intergenerational fairness.

The Donald, on the other hand, is promising a revolution, slashing a host of government programmes to protect old-age entitlements and expand the military, while also cutting taxes.

But one trend unites both the Republican President and the Tory leader: conservatives on both sides of the Atlantic seem much less concerned with budget deficits than they were seven years ago.

Yes, the Conservatives here have overseen a reduction in the budget deficit from 10 per cent of GDP in 2010 to 2.9 per cent today, and are notionally committed to eliminating it entirely.

But back in the early Cameron and Osborne days, they promised this would occur by 2015. With productivity growth lower than expected and some international events impairing growth early in that parliament, it was legitimate to argue for a slower consolidation path. Now though, the Tories are only committed to obtain fiscal balance by 2025, a full 17 years after the financial crisis first struck and with taxes already at their highest burden for three decades.

Nobody could argue this is "too far, too fast".

The US deficit is about the same size as the UK's today, but in many ways the country is in a worse fiscal position. Even on unchanged policies, the Congressional Budget Office projects the deficit will rise over the next decade to 5 per cent of GDP, meaning a continual uptick of the debt-GDP ratio. While Trump has railed against former President Barack Obama running up debt, he is now in fact pledging substantial tax cuts to "prime the pump" of the economy.

His budget only projects deficit elimination in the longer term through some fairytale accounting on tax revenues. If his policies were accepted by Congress, it would rise further.

The conservative relaxation about deficits perhaps represents a flaw in the theory that government spending can support the economy through counter-cyclical action: politics.

Far from fixing the roof while the sun shines, politicians get relaxed about deficits when times are good. Indeed, the UK deficit is now similar to levels pre-crash, when Gordon Brown believed he had abolished boom and bust, making borrowing modest amounts forever sustainable.

Some academic economists, who should know better, now again seemingly assume that growth will continue uninterrupted.

Despite both countries being at near full employment, the deficit as an issue is simply falling off the radar.

Of course deficits are not in and of themselves a problem. The absence of sharply rising government bond yields in both countries suggests that creditors are not particularly worried about our governments' inability to repay right now. Other priorities, such as raising the economic growth rate, may well mean that cutting taxes to improve incentives and borrowing more for a time makes sense.

The main issue with the large deficits in the UK and the US is that we are heading into major fiscal headwinds caused by an ageing population, with debt at historically high levels already.

To see the long-term scale of the challenge to come, consider these figures. On roughly unchanged policies, the OBR calculates that UK government debt would explode from 87 per cent of GDP today to 125 per cent within 30 years driven with the deficit rising again to 8.5 per cent of GDP; in the States, the CBO says debt would jump from 77 per cent to 150 per cent of GDP, over the same period, with the deficit rising to closer to 10 per cent of GDP.

Significant and permanent tax hikes or spending cuts are going to be needed to stabilise the path of debt, and even tougher restraint to get the debt-to-GDP ratio back down to around the 40 per cent of GDP level seen before the financial crisis.

This all presumes, of course, there are no other major recessions which impair our growth potential.

The most worrying consequence of the pivot from deficit concern then is not the threat of an immediate bond strike, but the cultivation of a complacency that no more restraint is needed.

Both countries have unsustainable fiscal outlooks, which require long-term action. The President and Prime Minister might feel more sanguine about deficits today, but we very soon will not.

Ryan Bourne occupies the R Evan Scharf Chair in the Public Understanding of Economics at the Cato Institute in Washington DC.