The message we are often sold by politicians and in the media is that the UK is ‘broke’, and that we can’t afford to borrow any more in order to invest in productive assets like infrastructure and renewable energy. But in the first Mythbuster of this series, Howard Reed from Landman Economics and Tom Clark from The Guardian expose the ‘maxed-out credit card’ metaphor as both false and damaging.

The myth
It is easy to forget now that a keystone of David Cameron’s modernisation of the Conservative party was supposed to be matching Labour’s public spending totals. During the dying months of long boom, the new-look Tories pronounced a decisive break with the old Thatcherite mix of private affluence and public squalor by insisting that they would spend just as much as Labour on state services, and indeed that they would make these services even better by allocating and investing this same money more wisely. Almost the moment the economy hit the rocks, however, a deep conservative instinct reasserted itself – the instinct that says industrial contraction must be matched by retrenchment in the public realm.

Precisely two weeks after Lehman Brothers went bust in 2008, as Gordon Brown, the world’s central bankers and even the Bush administration were scrambling around for emergency expansionary measures, George Osborne took to the rostrum of the Tory conference and sternly announced that “the cupboard is bare”. There was, he said “no more money […] Borrowing is out of control […] Our first priority will have to be bringing stability to the public finances.”

To vanquish any residual doubt about his commitment to ancient orthodoxies, Osborne borrowed a favourite establishment phrase from the Great Depression, and said “we will put sound money first”. His argument, exactly as in those pre-Keynesian years, relied on a commonsensical appeal to an analogy with household budgeting. Every shrewd household knows that the road to ruin lies in spending more than the family is bringing in, and – the old argument goes – accordingly every sensible government faced with hard times must cut its coat to fit its restricted cloth.

Liberal Democrats such as Vince Cable would once have mocked such thinking as superstition whipped up by an inappropriate metaphor; inappropriate because a household, unlike a
government, cannot print money, raise taxes or hope to affect the overall size of the economy through its actions. But by the time the Coalition was created, the early stirrings of a debt crisis in southern Europe added a superficially more credible sheen to fears that Britain was teetering on the edge of bankruptcy. Treasury and Bank of England officials, who always regard the immediate aftermath of an election as the moment to pressure politicians into grappling with tough decisions, sternly warned that if cuts were not soon set in train then Britain, too, could soon face a financial crisis of its own.

And so the cutting began. Amid such a big squeeze, nothing was immune. Short term ‘current’ spending on things like public sector wages certainly took a hit. But the investment budget (defined by accountants as spending on anything which will yield benefits over a period of more than one year, e.g. infrastructure building projects) took a much greater hammering.

Despite George Osborne’s claim that the Coalition was protecting investment spending, the Treasury’s own figures reveal the reality. In just two years, net public investment\(^1\) plunged from £48.5bn in 2009–10 to £28.0bn in 2011–12. It is now projected to fall even further to £22.6bn by 2015–16. Assuming, as the Treasury does, a return to growth over the medium term, net investment dives from 3.5 per cent in 2009/10 to 1.3 per cent in 2015/16, a decline of more than a half during a single parliament.

Every patient in a crumbling hospital ward, every commuter on an overcrowded train and every pupil in a temporary classroom knows the cost of Britain’s historic underinvestment. The only question therefore is whether cut-backs on the sort of scale are inevitable because Britain really cannot afford to invest?

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**The reality**

**Britain’s national debt is smaller now than for most of the last 300 years**

In legal terms, an organisation is bankrupt if it cannot afford to pay back its creditors. There are two obvious ways of assessing whether Britain is in this position:

1. How large are Britain’s debts relative to its national income? If they are so large as to make it unlikely that the debt will ever be paid back, then it seems reasonable to define the nation as ‘broke’.

2. Is anyone still prepared to lend to Britain at interest rates which are not prohibitive? If not, then again it would seem that Britain is in a bankrupt position.

Supporters of the notion that ‘Britain is broke’ tend to use a graph like Figure 1 to back up their argument. The chart shows the UK debt–GDP ratio from 1997 up to 2011 (and for 2012 onwards, the OBR projections in the 2012 Autumn Statement). From 1998 onwards the debt–GDP ratio was below the 40 per cent level specified in Gordon Brown’s ‘sustainable investment rule’. But then, rather suddenly, debt–GDP appears to have exploded – surging, in the wake of the Great Recession to reach almost 80 per cent by 2012.

Presenting the data in this way certainly makes the 2012 debt burden look very large by historical standards. If a much longer time period is used, however – say, from 1700 rather than 1997 – we see that UK debt–GDP was above 80 per cent for the majority of the last three hundred years (as shown in Figure 2 below). On two occasions – the Napoleonic Wars and the Second World War – UK debt–GDP rose to well over 200 per cent. And in both cases it remained well over today’s 80 per cent for a very long time: for half a century in the former case, and until the 1960s in the latter.

So if Britain is broke at the moment, it was also broke for a whole century between 1750 and 1850, and for 20 years after the Second World War. Given that both these periods were times of large-scale investments and national renewal in the UK, the label hardly seems fitting.

In the first case, there was the Industrial Revolution, and along with it huge, largely private, investments in infrastructure projects including the canals, and early railways. Soon after this period, other essential amenities such as the sewers under London were built with public funds. The post-war period, by contrast, witnessed not only the creation of the National Health Service (NHS) and other elements of the welfare state, but also huge school-, road- and house-building projects, very often publicly financed.

Furthermore, the UK’s long track record over this three-century stretch suggests the country is more than capable to managing debts of this scale. At no point during the last 250 years has the UK ever defaulted on its debt. In these circumstances it is preposterous to base the claim that ‘Britain is broke’ solely on the size of our national debt.

The cost of servicing Britain’s debt remains at historic lows
So what about the second plank of the bankruptcy argument, the idea that the cost of servicing the debt is bankrupting the UK?

Figure 3 shows UK debt interest payments as a percentage of GDP since 1945 and reveals that the debt burden now is actually lower than at any point up to the year 2000. If debt payments are the yardstick for being ‘broke’, Britain would again appear to have been broke over the whole second half of the 20th Century!

Nonetheless, it is always as well not to be complacent. The modest current cost level of current debt servicing will be of no comfort, if this cost could soon rocket skyward. And Figure 3 does suggest that the swelling of the debt burden since the great crash thus far has indeed coincided with the start of a modest upward spike in debt interest payments over the last few years. Any prudent chancellor should of course be very concerned if there were a serious possibility of things spinning out of control.
We have already established the absolute size of the debt burden is not in itself any reason to panic. But could nervousness on the part of investors push up borrowing costs to the extent that this burden is difficult or impossible to manage? After all, the reluctance of the market to lend to countries like Spain, which had entered the great recession with modest levels of public indebtedness, soon enough gave rise to a financial crisis. If it looked as if Britain could go the same way, then the claim that we could not afford to invest would be hard to dismiss.

The reality, however, is that there is as yet no sign at all of the increased public debt pushing up public borrowing costs. The recessionary increase in public borrowing began during the financial year 2008–9 (in 2007–8 net debt remained at the historic low of 36.4 per cent of GDP), and Figure 4 records what has been happening to rates since then.

The chart also shows the difference in the borrowing costs that face London and those that are available to Berlin. Germany is of course the economic powerhouse of the euro. It has a reputation for being tough on inflation that has been built up over 70 years, and at the present time it is benefiting from capital flight as investors from the continent’s south search out a secure home. For all these reasons, it is an attractive place for investors to lend to. And yet the UK’s borrowing costs are not that much higher. The gap is rarely more than 50 basis points (or in everyday language, half a per cent) and there has been no upward trend in this gap.

Comparison with other non-euro countries, not shown on the chart, further dispels the idea that the Coalition’s austerity package is essential to stop the interest rates on UK Government debt spiralling out of control. British borrowing costs have not, for example, departed significantly from those of the U.S., which has chosen a more expansionary path. There has been some reduction in average interest rates across Germany, Britain and the US since 2010, and surely no one can claim that this cross-national trend is down to choices in the UK alone. Box 1 offers the outline of a more convincing explanation.
There are important differences between Britain and the PIIGS

All evidence, then, contradicts the claim that Britain simply cannot invest because it is bust. But what about those, such as the Liberal Democrats, who were won over to austerity by their horror at the undoubted mess they saw playing out in southern Europe? Isn’t it naïve to rely too much on the lessons of long-gone financial history when there are fellow European countries – the so-called PIIGS – who are facing ruin in the here and now?

Greece, Portugal and Ireland have all been required to seek bailouts from the European Central Bank after their borrowing costs rose to unsustainable levels. None stands any chance of restored prosperity any time soon, and in the first two – where it is not merely prosperity, but stability that looks beyond reach – society could come unstuck. Italy and Spain are two bigger economies which are very different from each other, but both harbour dark fears of being pushed down the same road by sovereign insolvency. It would, of course, be wrong to argue that Britain should entertain running the same risks.

The idea that it would, however, ignores the fact that it is only Eurozone countries who have faced debt crises and spiralling funding costs during the Great Recession. This is mainly because nations in the Eurozone did not control their own currency and hence had no flexibility to respond to the recession with reduced interest rates or quantitative easing monetary loosening. It is because the PIIGS have no flexibility to set their
own monetary policy or vary their exchange rate, that would-be lenders rationally take flight.

Like the US, which has taken a more expansionary course, the UK just does not frighten investors in the same way. With our own central bank, we enjoy more freedom to grow our way out of recession with the help of expansionary monetary policy. Indeed there is not necessarily any reason why we cannot simply monetise the debt – i.e. print the funds required to avoid outright default. In other circumstances, this flexibility to print money might lead investors to fret about stoking inflation, as it undoubtedly could in a world of full employment. But amid a great recession where wages are stagnant, inflation is a remote concern and the first priority for any rational investor is to see that their debts are not simply reneged.

As well as contemporary institutional differences, differing historical records also divide the British from the PIIGS. In the case of Greece there is an established history of default: since becoming an independent state in 1830, Greece has been in default for almost half its history. This means that it has less of a reputation to lose. Given that the UK has never defaulted over this time, investors rightly reason that a rational UK Government would be prepared to do far more to avoid blotting its copy book now.

A downgrade from credit ratings agencies is unlikely to make any difference
The last gasp defence of the ‘Britain is bust’ thesis involves sternly warning of the grave dangers of getting on the wrong side of the credit rating agencies. Yet, when the US’ credit rating was downgraded in 2011, the world saw how the loss of top-notch status in the eyes of these self-appointed financial referees does not necessarily make any difference to the interest rates payable on government debt. This is hardly surprising given the dismal record of the rating agencies in terms of predicting default; right up until the 2008 crash happened, banks such as Lehmans and RBS were still rated at the safest ‘triple A’ investment grade.

Moreover, UK debt and deficits have turned out to be much higher than the OBR forecast in the 2010 Budget. Even the ratings agencies may soon start to notice that the road of austerity is self-defeating, and downgrade the UK anyway.

Britain cannot afford not to invest
As we have seen, Britain is not ‘broke’. In historical terms, it is ludicrous to claim it is anywhere near being so. As for Britain not being able to afford to invest, the truth is the exact opposite: with the cost of borrowing at historic lows, Britain cannot afford not to invest. Large-scale publicly financed investments in key aspects of infrastructure such as transport, housing (especially social housing) and renewable energy are a prerequisite for sustainable recovery.

Furthermore, failure to kick-start recovery through investment in the short-to-medium term is likely to lead to reduced productive capacity in the longer run due to ‘hysteresis’, as large parts of the UK’s productive capacity atrophy. For example, prolonged high unemployment will reduce skills and employability among a large section of Britain’s potential workforce. As in the 1930s, George Osborne’s ‘sound money’ philosophy is distinctly unsound economics.

Endnotes

1 The figures quoted are net of financial interventions, so as to avoid the picture being clouded by banking bailouts and acquisitions. Source: the January 2013 Public Sector Finances Databank, published by the Treasury. http://www.hm-treasury.gov.uk/psf_statistics.htm

