

Progressive Economics Group (PEG)
Policy Brief

When is austerity an *appropriate* economic policy?

Sue Konzelmann
July 2018

Policy Issue

The results of the consistent application of austerity policies – cuts in public expenditure and/or increased taxation – since the Conservative-led coalition government came to power in 2010, do not make for encouraging reading. Although politicians have claimed that austerity means “living within our means”, the reality for the vast majority of British citizens is very different. Not only have critical public services been either withdrawn or severely limited by the progressive removal of social protections, both GDP and wage growth have been constrained. Austerity has also failed to deliver its stated objectives – of rapidly cutting then eliminating the government’s deficit (the difference between its annual expenditures and revenues) and reducing national debt (the accumulation of any previous deficits and interest charges plus the current year’s deficit).

But the fundamental question isn’t whether austerity is a “good” or “bad” policy. Rather, it is whether austerity is an *appropriate* policy, given a particular economic situation.

When is austerity an *appropriate* economic policy?

Policy Analysis

Eight years after the turn to austerity in 2010, the United Kingdom’s recovery from the recession, precipitated by the 2008 financial crisis, is its slowest in recorded history. The government’s initial response was to rescue financial institutions deemed “too big to fail” and engage in emergency fiscal and monetary stimulus; and by 2010, a weak recovery was underway, with GDP returning to growth of 1.7 percent. But concerns about rising government deficits (which increased from 2.6 percent of GDP in 2007 to 10.1 percent in 2009) and high levels of public debt (which during the same period had risen from 41.9 to 64.1 percent of GDP) caused an *apparent* sharp reversal in policy. “Apparent” because – although the word hadn’t yet been popularised – austerity has been the policy of all Tory governments since 1979.¹

The Greek sovereign debt crisis served as the catalyst for austerity in the EU. In the UK, although the government’s deficits and public debt were a direct result of the bank-bailouts and emergency stimulus measures, the crisis was re-defined as a “crisis of debt”; and it was (falsely) alleged that high levels of public deficits and debt were the result of excessive government spending. From this perspective, investors – that is, speculators – in government bonds were assumed to be worried about the increased risk of sovereign debt default. So unless government deficits and public debt were reduced, bond yields – the cost of government debt – would rise sharply, adding to the cost of borrowing, and hence to the public deficit and accumulated national debt.

The idea that public deficits and debt have a negative effect on investor confidence is rooted in the belief that a state’s creditworthiness rests upon a balanced budget: Fiscal deficits and public debt are

¹ Weeks, John (2018) “Same old same old ... Tory austerity”. *Prime Blog*. 15 May [Online]
Available at: <http://www.primeeconomics.org/articles/same-old-same-oldtory-austerity>

held to erode confidence in the government's ability to repay those debts; by contrast, austerity is seen to have a positive effect on confidence – not only of government bond holders but also of consumers and businesses – and hence on private sector spending.

However, unlike Greece, for which (as a member of the Eurozone) the risk of sovereign debt default is a credible one, the UK is in no risk of default. This is because it both borrows in its own currency and has a floating exchange rate. So, if necessary, it has the ability to print money and devalue its currency to manage its debt. In addition, the Bank of England can prevent a rise in interest rates by purchasing public bonds at a fixed rate.

To persuade voters that austerity was indeed required, a number of other arguments have been made. Perhaps the most common one has been the likening of the government's budget to that of a household or business, which requires balancing. This analogy dates back centuries, to the time when government budgets were mainly spent on wars and national emergencies – and there was no such thing as either permanent spending on social welfare or revenues from income tax. However, once the government came to rely heavily upon income taxes for its revenue, and with the expansion of social welfare commitments during the first part of the twentieth century – both of which have a dampening effect on growth during recessions – the logic supporting this argument disappeared.

A less common argument is that first made by John Maynard Keynes during the 1920s and 1930s. Keynes also saw an essential role for austerity – but as a necessary counterpart to stimulus, to be applied during the boom, when the economy's resources are fully employed, as a means of cooling an over-heating economy and thereby averting inflation or financial collapse. This makes the use of stimulus sustainable, by liquidating the cyclical deficit – the part of the deficit caused by fluctuations in government spending and revenues resulting from the economic cycle – and providing the funds to deal with future recessions.

Despite the questionable nature of the arguments in support of austerity when the economy is in recession, the *politics* of austerity trumped the economics; and in 2009, the term “age of austerity” – which had earlier been used to describe the years immediately following the First World War – was popularized by the Conservative party leader, David Cameron, who declared that “the age of irresponsibility is giving way to the age of austerity”,² pledging to put an end to excessive government spending, if elected in the following year's general election.

The 2010 election produced a Conservative-led coalition government; and in his first budget speech, the new Chancellor, George Osborne, told the House of Commons that “unless we deal with our debts, there will be no growth”.³ He then announced a £40 billion “emergency” austerity budget that included significant tax increases (including VAT) and cuts in social welfare and other areas of public expenditure, with the objective of eliminating the full employment deficit – the part of the deficit that remains even after growth has returned to normal – and reducing public debt by the end of parliament in 2015.

But rather than hastening the recovery, austerity slowed it; and the promised private sector-led expansion failed to materialize. Between 2010 and 2012, GDP growth stagnated, at rates well below

² Cameron, David (2009) “The Age of Austerity”, Cheltenham, 26 April. [Online] Available at: <https://conservative-speeches.sayit.mysociety.org/speech/601367>

³ Osborne, George (2010) “Budget 2010: Full Text of George Osborne's Statement”. *The Telegraph*, 22 June. [Online] Available at: <https://www.telegraph.co.uk/finance/budget/7846849/Budget-2010-Full-text-of-George-Osbornes-statement.html>

2 percent; unemployment remained stubbornly high, at around 8 percent, compared with pre-crisis rates of about 5 percent; and due to continued public deficits, government debt continued to rise, reaching 84.5 percent of GDP in 2012.

Later that year, the government's austerity program – which had in practice involved a sharp reduction in the *rate of increase* in public expenditure (as opposed to an absolute reduction) and large absolute cuts to local government grants (which do not appear in the central government budget) – was quietly relaxed. However, the political rhetoric continued; and by 2013, all three main parties endorsed deficit reductions as the central component of the government's fiscal policy.

But by the end of parliament, the coalition government's record on the economy had not lived up to its promises. Economic growth had been significantly reduced, averaging 2 percent per year, compared with 2.6 percent for the period 1948 to 2007. Slower growth meant lower tax revenues and increased social welfare costs, despite tax increases and public spending cuts.

Thus, although the government's deficit as a percent of GDP had been reduced to 4.3 percent, less than half of its level in 2010, it was still higher than the coalition had predicted; and although the sale of government assets (mostly shares of stock in the nationalized banks) had slowed the rate of increase in public debt, which stood at 88.2 percent of GDP in 2015, it was 17 percent higher than it had been when the coalition came to power – and it was continuing to rise as a consequence of the failure to turn the government's deficit into surplus.

By 2018, despite austerity's failure to achieve its stated objectives in relation to the government's deficits and debt (which at the end of 2017 stood at 1.9 and 87.7 percent of GDP, respectively) – let alone its damaging impact on the vast majority of UK citizens, particularly those most reliant on public services – the government persists with its programme of austerity.

Policy Framework

Booms and recessions have been a fact of life for at least the past two centuries; and during much of that time, urgent calls for reducing public debt have accompanied recessions – when government deficits and public debt naturally increase – rather than booms, when this dynamic is reversed. However, counter-intuitive though it might seem, this is exactly the wrong way round.

From an *economic* perspective, the choice between austerity and stimulus depends entirely upon the state of the economy, rather than the state of public finances. The following guidelines for austerity policy would serve the interests of the majority of the population:

- **Austerity is an *appropriate* policy during a boom, when the economic risk is over-heating, inflation and financial crisis.** In this context, discretionary increases in taxes and/or reductions in public expenditure will have the effect of cooling the economy and averting inflation and the risk of financial crisis. They will also eliminate the cyclical deficit – and if turned to surplus, help to reduce the national debt – as well as providing the budgetary resources to deal with future recessions.
- **Austerity is an *inappropriate* policy during a recession.** In this context, increasing taxes and/or reducing public expenditure, when the economy is already weak, will only serve to deepen and lengthen the slump. It will also worsen rather than improve the government's deficit and add to public debt.

Sue Konzelmann is a Reader in Management at Birkbeck, University of London, a Research Associate of the Cambridge Centre for Business Research and Co-Executive Editor of the Cambridge Journal of Economics. She is also author of "The Economics of Austerity" (Edward Elgar 2014).