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Austerity: The wrong story

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Introduction

Over their 5 years in power, the Conservative Party has claimed that their austerity policy saved the country from disaster. This purported economic competence sat at the heart of their 2015 election campaign. It needs critical scrutiny.

The Coalition government has given two main reasons why austerity – cutting the budget deficit – was necessary. The first is that its predecessor Labour government, living 'beyond its means', left the nation with a rising mountain of public debt. The only way to restore fiscal probity was to start austerity as soon as possible. The second reason was that commitment to austerity was the only way to reassure the bond markets that the British government would not 'go the way of Greece', that is, default on its debts. Both arguments were false, but they have never been properly exposed in the media, and for various reasons, Labour has not attacked them with the vigour they deserve.

In economic logic, the two reasons are independent of each other. How much a government needs to borrow should be determined by the state of the economy, not by how much debt its predecessor has left it. In a slump, a government should aim to increase its deficit, not reduce it, to compensate for the fall in private sector spending. This will normally cause the economy to grow faster than the deficit and in turn reduce the deficit, and eventually the national debt, as a share of national income. But to understand this, you need to understand that a slump is defined by the existence of spare capacity: spare because the private sector is unwilling to create the jobs to use it. Instead of borrowing to keep people in idleness, the government should borrow to create jobs. But this common sense was seemingly no longer the common understanding.

Linking Labour overspending with the risk of 'going the way of Greece' offered the Conservatives an alternative narrative of undoubted persuasive power. Had the Labour government not left so much debt, the Conservatives said, there would have been less need for austerity to reassure bondholders. George Osborne had to be so austere because Gordon Brown had been so profligate.

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This message resonated politically. The collapse of the economy in 2008 took place on Labour's watch. So it was easy to blame Labour for it. Labour felt unable to defend its record, so the Conservative narrative became the accepted one among the punditry. However, it is far from clear that voters bought this story at the time. Labour only narrowly lost the 2010 election; most political analysts believe that Brown's lacklustre leadership cost the party 20 to 30 seats. So defending Labour's record was not a hopeless task politically. But the Labour opposition soon gave up the attempt to do so, leaving the telling of Labour's story to the Conservatives.

In the interests of truth, we need to ask two questions. How profligate or extravagant had the Labour government been? And how real was the threat of a bondholder strike?

The myth of labour profligacy

The answer to the first question can be divided into two parts: Labour's economic record before 2008 and its record in the Post-Crash years 2008–2010.

The Labour government had committed itself to Gordon Brown's famous fiscal rules. In its draft election manifesto of 1996, it promised to 'enforce the "golden rule" of public spending – over the economic cycle, we will only borrow to invest and not to fund current expenditure'. This pledge was buttressed by the 'sustainable investment rule': over the cycle, the government would hold net public debt to below 40% of GDP. Significantly, Brown's tight spending plans of 1997–1998 were set against 'Conservative mismanagement of the public finances' – which only goes to show that, following a change of government, the incoming government always blames its predecessor for the fiscal mess it inherits.

A detailed, and far from uncritical, analysis of Labour's fiscal record by Malcolm Sawyer, of Leeds University, dating from 2007, found that between 1997–1998 and 2005–2006 Brown, as chancellor, 'nearly met' his fiscal targets. The current account deficit was close to zero over the period and the national debt stayed under 40% of GDP. Sawyer put this 'close to achievement of the golden rule' partly down to good luck – surpluses generated by the dot.com boom of the late 1990s, reduction in world nominal interest rates – but partly to tricky ('creative' in the jargon) accounting. The use of the private finance initiative (PFI) to fund the building of schools and hospitals 'off budget' lowered the deficit in 'real time' at the cost of raising it in the future. Had this investment programme been financed by conventional borrowing, the net debt to GDP ratio would have been closer to 50%, rather than the recorded 33.6%. Second, the Brown Treasury kept re-dating the 'economic cycle' (a fuzzy concept at best) to make its fiscal rules easier to meet. The main effect of this re-dating was to postpone the achievement of the zero balance on public investment needed to meet the sustainable investment rule. It was for these reasons that the OECD in 2005 noted that fiscal policy 'required attention'.

By 2007, the Treasury admitted that it was time to slow down the public sector growth engine. Its Comprehensive Spending Review of February 2007 cut projected public spending from 4% a year to 2.1% a year over the following 3 years, less than the expected growth of the economy, which was itself expected to be lower than in the previous boom years. This would yield a current account surplus of 0.3% and cap the national debt at 39.8%, by 2010–2011. However, Brown's luck finally ran out: instead of slipping gently into a new economic cycle, the economy fell into a deep hole. Economic growth did not slow down, it collapsed.

To summarise, in its first 10 years, Labour may have fiddled the books a bit, as do all governments, but it had certainly not created a mess. And it had built lots of hospitals and schools. The more honest charge is that New Labour overestimated the revenue flows it would go on receiving from a flaky financial services sector, whose largely unregulated expansion it had encouraged and whose inherent instability it had ignored. But this is a judgement after the event. Most academic economists ignored the possibility of a financial crash. Nor did the Conservative opposition think the government's finances were messed up in 2007. In September of that year, George Osborne confirmed that he would match Gordon Brown's spending plans and that 'under a Conservative government, there will be real increases in spending on public services, year after year'.

The mess, if that is what it was, came in the two big slump years, 2008 and 2009. Owing to the collapse of its revenues and the additional spending on social security, public sector net borrowing shot up from 2.7% to 10.2% of GDP. The cost of bailing out insolvent banks added to a national debt that ballooned from under 43.6% of GDP pre-crash to 76.4% by 2010.

In short, the big holes in the public finances inherited by the Coalition when it took office were not the result of misguided splurging, but the sudden emergence of deep craters in the British and world economy. This is confirmed by a 2011 IMF Report which calculated that of a 37% increase in UK public debt from 2007 to 2011, 25% was due to loss of revenues, 7% to support of the financial sector support and only around 2% to fiscal stimulus. Furthermore, it is true that the rise in the deficit was somewhat higher than the OECD average, but this was because British governments were more dependent on revenues from the financial services sector.

The Conservative charge of Labour profligacy boils down to the claim that the Labour government did not start cutting spending immediately it saw its revenues falling. But Conservative spokesmen have never honestly faced up to the question: what would have happened had the government started cutting its spending with the economy in a tailspin? The Labour government did what any sane and civilised government would have done in the circumstances (and which all other governments did): continue to support the economy as best it could to limit the damage caused by the collapse in private spending.

The Greek excuse

Enter the coalition and George Osborne. The British economic collapse bottomed out at the end of 2009, and the economy started growing modestly. Then came the Greek sovereign debt crisis and the switch to austerity. Osborne made the link explicit when he declared in his emergency budget of June 2010, 'you can see in Greece an example of a country that didn't face up to its problems, and that is the fate I want to avoid'. That austerity was the only way to avoid a British sovereign debt crisis remains the official defence of austerity to this day. As Treasury Minister Lord Deighton told the House of Lords last March, 'the markets would not have allowed us to continue with the scale of deficit we had'.

But Britain was not like Greece or any other country in the Eurozone. Locked into a system of nation state debt issuers without currency creating powers, Greece and other Eurozone debtors faced a dire choice between austerity and default. But with its own currency and its own 'lender of last resort' central bank to backstop its bond issues, Britain had an extra margin of freedom (secured ironically by the Labour government when it decided not to join the single currency) to conduct a macroeconomic policy suited to the condition of its economy. Fiscal policy was not disabled by the bond markets as in the eurozone; there was no need for 'an accelerated plan' to reduce the deficit. What did happen was that Osborne's alarmist anti-Labour rhetoric talked influential commentators who should have known better into believing that Britain was on the road to deficit-fuelled ruin.

So why did Osborne do it? Historians will debate his motives, but I believe that this intensely political Chancellor saw in a manufactured crisis of confidence a once in a lifetime opportunity to cut the size of the state. The view, long held by the neoliberal right, that state spending stole resources from the productive economy was re-packed for the purposes of austerity as the doctrine that government spending was 'crowding out' more efficient private sector spending, and therefore damaging recovery: a re-statement of the Treasury View of the 1920s which Keynes had exploded with a common sense argument: in a slump increased government spending does not take resources from the private sector: it brings into use resources which are idle.

From his theoretical rag bag, Osborne constructed a consummate political narrative which linked folklore economics ('the government can't spend money it hasn't got') to the politics of blame ('cleaning up the mess left by Labour') to the politics of fear ('the Greek bogey') to grand economic strategy ('reducing the deficit is a necessary condition for sustained recovery').

There is no doubt that, aside from his basic instincts, George Osborne received some very bad economic advice. 'Unless we deal with debts there will be no growth', he declared in June 2010. This echoed the briefly fashionable views of two American economists, Reinhart and Rogoff, who claimed that if the ratio of public debt to GDP rose above 90%, growth would go into reverse. Their main finding was quickly discredited, but Osborne said they were the economists who most influenced him.

Another argument briefly called into use in 2010 was the theory of 'expansionary fiscal consolidation'. The theory was that the boost to business confidence given by cutting welfare benefits would more than offset their contractionary effects on demand. Indeed, its main inventor and advocate Professor Alberto Alesina of the Bocconi University, Milan, assured European finance ministers at a meeting in Madrid in April 2010 that not only would a 'credible policy of fiscal consolidation' boost growth but would do so quickly.

The failure of the 'Alesina effect' to materialise in those European countries which were unwise enough to try out his remedies should have discredited austerity as a recovery policy. Over nearly 3 years following Osborne's 2010 deficit cutting budget, the British economy stagnated. The Chancellor forecast an average GDP growth of 2.7% between 2011 and 2013. Actual growth in the period was 1.3%. Austerity's supporters blame the stagnation on 'headwinds' – the continuing Eurozone crisis, higher oil prices – but the Office of Budgetary Responsibility (OBR), the watchdog Osborne himself set up to monitor his performance, disagrees. Austerity, it says, reduced GDP growth by 1% in 2010–2011 and a further 1% in 2011–2012.

Extrapolating these OBR figures puts the cumulative cost of austerity since 2010 at 5% of GDP. Some leading economists, including Professor Simon Wren-Lewis of Oxford University, consider 10%–15% a more realistic figure. That means between 5% and 15% of British output has been permanently lost. The lowest estimate, 5%, indicates £100 billion or £1500 billion for every citizen. The truth is that austerity stopped the recovery in 2010 and caused the economy and society unnecessary damage.

The failure of growth to materialise dished the Chancellor's 5-year timetable for cutting borrowing. With government revenues failing to recover, George Osborne quietly slowed down the speed of his cuts, eventually declaring that a further £35 billion of consolidation would be needed in the next Parliament. The Bank of England injected another £175 billion into the economy between October 2011 and July 2012. In 2012, the government started subsidising bank lending for mortgages through its 'Help to Buy' scheme. The shaky recovery, which the easing of austerity brought about in 2013, made possible the Chancellor's rhetorical master-stroke: we are growing faster than any country in Europe. This shows austerity works!

Labour's weakness

Conservative rhetoric has left Labour floundering. The Conservatives have been able to take the narrative of the economic crisis away from Labour and turn their disastrous economic stewardship to political advantage. Their surprising weakness in the polls suggests that their story is not entirely believed. This may still enable Labour to form a minority government. Osborne does not deserve another go. He has done his best and worst.

Could Labour have done better? Its first, and probably decisive, failure was to mount a convincing defence of its own record. Yet, there was much to be proud of and particularly in the crisis years of 2008–2010 – the very years in which, according to the Conservatives, they messed up the public finances. In fact, the Labour government's decent and principled reluctance to cut public spending in the crisis years was what kept the economy going; to which must be added Gordon Brown's exceptional leadership in coordinating the global recovery effort in 2009. But the chance to establish this is as the story of the crisis was missed; and after the electorate had given its verdict in 2010, it could not be politically resurrected.

Once Osborne had put his strategy for recovery into place, it would have required not only exceptional rhetorical skill to have countered it but economic understanding of a high order. The Greek finance minister Yanis Varoufakis, a professional economist, has shown how important it is to have at least one political leader who combines rhetoric power with a solid knowledge of macroeconomics. For Mr Varoufakis has the knowledge and confidence to confront the platitudes and banalities that pass for economic wisdom in the temples of power and finance. Has anyone in these august places, one wonders, heard of the paradox of thrift, a key idea for understanding what happens when the private and public sectors simultaneously increase their desire to save? But no one in the post-2010 Labour leadership could have done that job except the Shadow Chancellor, Ed Balls, and his inability or unwillingness to make a decisive attack crippled Labour's intellectual firepower, and in effect let Osborne get away with it. It is pretty scandalous that it is left to the SNP to make the case Labour should have been making.

The opposition to austerity was also weakened by a factor outside Labour's control, namely, the rapid reassertion of macroeconomic orthodoxy in Treasuries, central banks, international organisations like the IMF and much economic journalism following their brief flirtation with Keynesianism in 2008–2009. Why, after the economies of the world had fallen into a hole, these people started turning their guns on the governments which had rescued their economies from another Great Depression is something historians and political analysts will have to puzzle out.

One baleful consequence of the return to orthodoxy was that the statistical basis for policy making was consistently slanted in the wrong direction. There was a systematic underestimate of spare capacity (and therefore fiscal multipliers) in the period 2010–2011 and a systematic over-optimism about growth prospects. Keynes said that 'When statistics do not make sense, I find it generally wiser to prefer sense to statistics'. Common sense should have told policy makers that the financial system and economy had been deeply damaged by the crash of 2008 and needed a very strong stimulus from government to avoid years of waste and stagnation. Prudence should tell policy makers that the promise to cut the welfare state to the bone will not only inflict further economic damage but also cause social resentment on a scale not seen since the 1980s. So far, little in the public discourse has enabled this common sense of the matter to emerge.

Post-script: Post-election

Labour lost the general election of 7 May 2015, ceding the Conservatives a majority for the first time since 1997. In the electoral debacle, Labour lost all but one of its Scottish seats; Ed Balls, the Shadow Chancellor, was unseated at Morley and Outwood; Ed Milliband resigned the leadership. Labour will require a swing of at least 100 seats to win a majority in 2020. The pro-austerity orthodoxy has been further entrenched.

Osborne has grasped his second chance with typical political precision in his budget of 8 July 2015 by declaring his intention for a 'new settlement' for the state. Over the last half a century, state spending has averaged about 43% of GDP, in line with the OECD average of 42% in 2013. Osborne intends to shrink this to 36% of GDP to achieve a permanently smaller state operating within a fundamentally different institutional environment – the '36% state' as Professor Colin Talbot calls it. This is to be achieved through hard-to-reverse reductions in taxation, £37 billion of cuts and a law enjoining a surplus (to enable debt repayment) in 'normal times', which is tantamount to the reinstatement of Victorian fiscal rules. Of the cuts, Osborne will reduce the welfare bill by £12 billion, with £9 billion coming from cutting tax subsidies for working families. To offset this cut, Osborne proposed to raise the minimum wage from £6.50 per hour to £9 per hour over the same period. As Paul Johnson, head of the IFS, put it, 'There is simply not enough money going into the new minimum wage to anywhere near compensate in cash terms people on tax credits'. Government departments, excluding health, international development and defence, have been asked to model 25%–40%

real-term savings by 2019/2020. This is to be bolstered by £5 billion raised from cutting tax evasion and a programme of land and other asset sales.

Labour's task in opposition remains as it was: to defend its record in government, to attack the consequences of austerity and to develop a policy for government capable of winning votes. It failed to do any of these in its last 5 years, and one cannot be confident that it will do better over the next 5 years. Social democracy is in retreat all over Europe, and as austerity continues to demolish society, more raucous voices are sure to be heard.

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