BRIEFING 2

Austerity, deficits and the “fiscal balance”

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This is a briefing from Economists for Rational Economic Policies. These address major current issues affecting the UK economy, in particular those associated with counterproductive “austerity” policies.
Introduction

As we approach the General Election of 2015, there is a strong risk that any discussion of economic policies will be mired in a false and sterile debate around “eliminating the deficit”. This is the first of two linked briefings on the theme of austerity, deficits and debt.

A combination of government ministers, right-wing think-tanks and the media have for the last few years combined to persuade the British public that elimination of “the deficit” via austerity policies should be the single essential goal of economic policy – and that it is foolish and almost unpatriotic to deny this!

We disagree. Since at least the 1930s, both theory and practice have shown that deficits often play an essential and positive economic role, and that a fixation on eliminating deficits by contractionary fiscal measures is counter-productive. History shows that it is mainly by increasing investment and productive (and decently remunerated) work that we achieve more balanced budgets.

There are some excellent recent analyses of why the current political “fetish” for austerity and deficit-elimination (to the exclusion of other goals) is not only misconceived but is based on untruths.

Here are two easy-to-digest examples we recommend from prominent academic economists:


Professor John Weeks: “Pain, No Gain: the Austerity Scam”, PRIME economics, December 2014
Remembering how we got here!

When the financial crisis caused the global economy to implode over 2007-9, it was British and American taxpayers, via the public sector, that first took the strain. As the private sector contracted, as output collapsed and unemployment rose, both the UK and the US governments replaced the gaping hole left by the private sector with a cautious (and relatively modest) expansion of public sector spending. The Eurozone and other countries quickly followed down a similar path.

The 2008-09 crisis was not a UK phenomenon caused by the Labour government, but a crisis of the globally interconnected private financial system. It hit all developed economies, whether their government was of right or left. The Labour government made policy mistakes of under-regulation and excessive growth of the finance sector – but these were shared policy errors with the Conservative Party in the UK, and with international partners of different political hues.

If our governments had not reacted as they did, the crisis would have inflicted a double whammy: the failure and contraction of both private and public sectors. Instead, the public sector stepped in to support people affected and to bail out the private sector. A vast £350 billion was pumped into the City of London by a nationalized bank – the Bank of England. Taxpayer subsidies were provided to e.g. the motor industry (“cash for clunkers”), and more recently, by the Coalition government, to the banking system via the 2012 Funding for Lending scheme; and for banks and the private construction sector via “Help to Buy”.

In 2010, even Chancellor George Osborne had recognised that the global crisis was mainly a crisis of private sector debt – including the UK but also most other “developed” economies. In the 2010 June Budget, we find this chart showing the growth – under both Conservative and Labour governments – of private debt in the UK by sector since 1987 (note the rise in financial sector debt):
To put this in context, and show how relatively modest public debt was at the time of the crisis (less than 13% of total UK debt) here is a chart from the McKinsey Global Institute report on debt and deleveraging of 2010:
In a recent speech in Dublin, “Fortune favours the bold” (28th January 2015), Bank of England Governor Mark Carney acknowledged this role of the public sector in helping out the private sector after the “systemic shock”:

the UK’s fiscal policy framework helps insure against severe systemic shocks. The UK had the space to allow its automatic stabilisers to cushion the impact of the recession. With the deficit rising to a peak of more than 10% of GDP before steadily consolidating, fiscal policy effectively recycled elevated private savings and built a bridge to the period when private balance sheets were repaired and confidence returned.

Let us decode this. The “fiscal policy framework” means it is possible to borrow, when a severe “shock” occurs, to keep the economy going. “The UK has the space” means that it is not – like Euro zone countries in difficulties – forced into the harshest forms of austerity by perversely tight legal frameworks (especially the Maastricht Treaty criteria).

The “automatic stabilisers” means increases in public spending on unemployment and other benefits and support to those who lose out economically due to the crisis.

And when he says that “fiscal policy effectively recycled elevated private savings”, Mr Carney means that when, throughout the crisis, households and companies were cutting back furiously to reduce their own indebtedness, the public sector stepped in and kept the economy afloat – thanks to the virtues in adversity of a budget deficit!

For the greatest misconception (or untruth), and one peddled endlessly by the Coalition government and its supporters, is that running a government’s finances involves the same issues and principles as running one’s own private household. This is false. Once again, if everyone (households and companies) tightens their financial belt at the same time, the result is an economic catastrophe as spending power leeches out of the system in one go. If the government and public sector cut their spending at the same time, this makes the situation far worse.

And that is what almost happened in the UK. The Labour government had from 2008 to 2010 acted to minimise the impact of the crises by increasing public spending and reducing VAT, and by mid-2010 this was leading to improved GDP results. The basis for recovery had been launched. As a result, in 2010 GDP rose by 1.9%, the largest percentage rise till 2014.
The election of the newly formed Coalition government in 2010 began the reversal of this process. Instead the new Chancellor - supported by his colleagues in the Coalition – set in train his harsher austerity programme which has both failed in its own terms, and made the people of Britain endure falling wages, cuts in benefits and the most elusive economic ‘recovery’ on record.

![Chart from ONS data](chart.png)

He did this by piling public sector contraction on to private sector failure. Historic GDP data (which extends back to 1830) and analysed by the TUC, shows the current ‘recovery’ from deep recession as “twice as slow as the slowest recovery on record.”

GDP growth in 2011 slipped to 1.6% as the investment stimulus was withdrawn, and then fell back to a miserly 0.7% in 2012. Taking population growth into account, 2012 saw no increase in GDP per person at all. The economy was stagnating, and government revenue as well as real wages was declining.

It was at this point that – without saying so – the Chancellor decided to ease back to some degree on his austerity goals and postpone some of his own fiscal targets.

Allied to public subsidies to banks and house-builders, the higher-than-planned deficit in 2013 and 2014 actually helped revive economic activity, even if in an unbalanced way.
Our second linked briefing, “Public debt and deficits – back to basics!” looks in a little more detail at the definitions and misconceptions around public debt and deficits – and how for example interest charges on our debt are lower as a percentage of GDP than under the last Conservative Government! It concludes – as we do here:

All of this means that the current deficit obsession, or *fetish*, is absurd in economic terms. And attempts to bind future governments to balanced budgets, no matter what the circumstances, will prove to be malign or unworkable, once a severe crisis returns, as is inevitable. Governments need the capacity to respond to crises with a full range of potential fiscal and monetary measures.
This briefing is published by Economists for Rational Economic Policies (EREP)

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