

Pain, No Gain: The Austerity Scam

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Prime

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By John Weeks

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An occupier in Zuccotti Park in 2012 had the solution to the UK recession (Photograph by author)

1 The Austerity Election

The election of May 2010 produced a coalition of the Conservative Party and the Liberal Democrats that embarked on cuts in public expenditure unprecedented since the end of World War II. Few voters could have anticipated the coming five years of "austerity".

In the debates just preceding the election of May 2010, Gordon Brown the Labour Prime Minister explicitly rejected cuts in the public budget because they would in his view make the recession worse. Nick Clegg, the leader of the Liberal Democrats, had in March 2010 attacked budget cutting as "economic masochism". He maintained this position in the debates.

Of the three party leaders engaged in the pre-election debates only David Cameron of the Conservatives pledged [his party to cut expenditure](#), though ambiguous as to the severity. The lack of a Conservative majority in the subsequent voting led to a coalition with the Liberal Democrats. Given Clegg's pre-election opposition to any but minor cuts, the Coalition seemed unlikely to embark on radical reductions in spending. However, [the leader of the Liberal Democrats reversed himself](#), asserting that before the election he had favoured cuts but neglected to state this opinion publicly.

Suddenly, and to its considerable surprise, the British public discovered that its votes had produced a government fervently dedicated to radical reduction in public expenditure. The Coalition government, and especially its Tory Chancellor George Osborne, presented the need for expenditure reduction as self-evident. The public budget manifested a deficit, expenditure over revenue, of 10% of gross national product, allegedly unprecedented during peacetime. In fact the deficit excluding investment -- current expenditure balance -- was higher under the John Major government in 1994 (minus 9.1 percent of GDP compared to 8% in 2010).

Clegg's U-turn on budget cutting might be explained as political opportunism dictated by the hunger of a junior Coalition partner to achieve a share of power (Clegg was awarded the dubious prize of deputy prime minister). No less of a U-turn by the leadership of the Labour Party proves more difficult to explain. Though at times ambiguous, by 2013 the Labour Party leadership endorsed deficit reduction as the central component of its fiscal policy.

As the 2015 election approaches the Coalition and the Labour party differences on fiscal policy appear to be ones of emphasis, not principle -- how quickly and what to cut. In his speech to the Fabian Society on 25 January 2014, shadow chancellor Ed Balls [committed Labour to surplus on current expenditures](#). While asserting that Labour policies would be more growth generating than those of the Coalition, he set the record straight on Labour and cuts,

Without fiscal discipline and a credible commitment to eliminate the deficit, we cannot achieve the stability we need...Labour will combine iron discipline on spending control and action on growth with a fairer approach to deficit reduction. That means facing up to the tough choices that are necessary if we are to take a fairer approach to deficit reduction.

Ten months [later Ed Balls repeated this position](#) in a shadow cabinet meeting, "the shadow chancellor bluntly warned colleagues that even under a Labour government there would have to be serious cuts", perhaps referring to [the Coalition's £30 billion "hit list"](#) being drawn up in the Treasury.

Where would a Labour government make these "serious cuts"? A few numbers make the answer obvious. Excluding interest on the public debt, social support ("benefits"), health, education and pensions account for [over 75% of government expenditure](#). The "tough choices" Mr Balls has in mind are by necessity about reducing social support programmes, the National Health Service, schools and/or pensions.

In 2010 British voters faced an election in which one of the three major parties supported fiscal cuts -- austerity -- and two did not. The austerity party, the Conservatives, received 36% of the votes cast, while Labour and the Liberal Democrats combined for 52%. Nonetheless, a few weeks after the election austerity became the economic policy of the new British government.

Unless a major change occurs in party positions in 2015, voters will find on their ballots no major party opposed to continuing economic austerity for the foreseeable future. This pamphlet is dedicated to promoting that major change. The economic policy that the Coalition has implemented since 2010 and will continue if returned to power, and what the Labour Party promises if it wins, are socially and economically dysfunctional.

To put the issue simply, austerity policies, by Tories, Liberal Democrats or Labour, are unnecessary and bad economics. Their social impact is divisive. The "hard choices" are unnecessary, and destructive for the vast majority of people in Britain to no purpose.

2 Deficits and Austerity

The first step towards a rational approach to economic policy is to do what is never done in the media, clarify what is meant by a "deficit" and how it should be calculated. The details may prove tedious, but no more difficult than balancing a cheque book -- they can easily be understood by the general public.

The most used and least informative measure is total revenue minus total budgeted expenditure, the **overall fiscal balance**. In fiscal year 2013/14 this balance was minus £101 billion (-5.5% of GDP). Almost without exception the media and most politicians use this measure when they refer to "the deficit". It suffers from the basic failing that it is not an accurate measure of the balance between revenue inflow and expenditure outflow.

Public expenditure falls into three categories, current spending, investment spending and interest payments to holders of the public debt. The UK fiscal accounts separate out investment because it, unlike the other two categories, creates assets (roads and school buildings for example).

Perhaps the most important reason for listing interest payments separately is that part of it is not expenditure. In the 2013/14 fiscal year the Bank of England held 27% of the public debt and other publicly owned banks held an additional 9% (see Office of National Statistics, *Public Sector Finances September 2014*, tables PSA1 and PSA4, web address given in sources for chart 1, below). These interest payments are merely transfers from one government institution to another, with no net spending. In the 2013/14 fiscal year this interest transfer was £18 billion, which tells us that the actual expenditure deficit was not £101 billion but 83 billion, what might be called the **outflow balance or deficit** (minus 4.5% of GDP).

A further important distinction in the public expenditure accounts is between programmed and transitory items. Most expenditure is of the first type, allocations to fund the operations of specific ministries and activities, such as the National Health Service. Transitory items are those that change as the health of the economy changes. These are called "countercyclical" expenditures because they increase when the economy contracts and vice-versa. The most obvious of these are the payments to the unemployed.

In 2007 just before the great recession hit, the UK unemployment rate was about 2.5 percentage points lower than during the 2013/14 fiscal year. As a result, expenditures on support to the unemployed in 2013/14 were almost £21 billion higher than in 2007/08. This expenditure will disappear as unemployment declines. It is now substantially lower than in 2010 when the jobless rate was near 10%.

We know that this spending requires no parliamentary action in order for it to decline. If we subtract this from the deficit on actual outlays (£83 billion, see above), the balance between revenue and spending falls to £62 billion (minus 3.4% of GDP). This third measure can be interpreted as the **basic overall deficit**, "basic" because it

eliminates what the government pays to itself and what will disappear as the economy recovers.¹

Like companies and households, governments invest to create assets that generate a flow of benefits in the future. Companies directly charge for these benefits, such as rent on commercial and residential buildings. Households make investments, the most important being mortgages for homes to replace expenditure flow on rent.

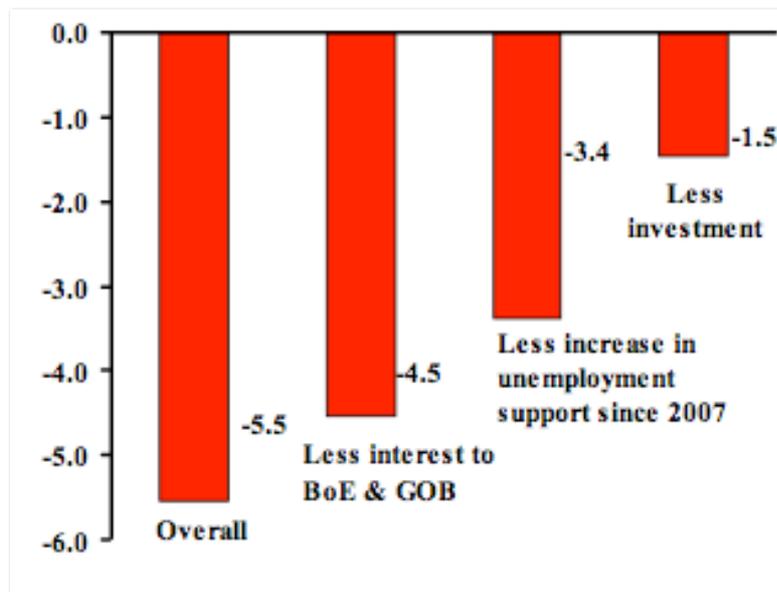
Both households and companies borrow to fund these investments, which is sound economics. If the household or business chooses its investment wisely, it produces a flow of benefits in money or kind to pay for the investment. This is more obvious for a business. It is unnecessary for a company to hoard profits to pay up-front to build a software factory (for example), because the sales generated by the factory will more than cover the cost of the investment.

If we accept the argument made by many that governments should operate more like households and businesses then governments should borrow to invest. At the present moment this option is especially relevant because the UK government holds ownership in two major banks, RBS and Lloyds. This principle, that borrowing should fund investments, means that the deficit to concern us is the **current fiscal balance**; i.e., the basic fiscal balance on non-investment outlays.

Chart 1 shows these measures of the fiscal balance. In 2013/14 the one that obsessed the Chancellor and the media, the **overall balance**, registered minus 5.5% of GDP. Focusing on this measure serves no rational purpose because it includes government payments to itself. Relevant to the balance of our government's spending and revenue is the **outflow balance**, which at most was minus 4.5% of GDP ("at most" because I may be underestimating transfers between public institutions). And for policy purposes of "balancing the books" of the public sector the relevant measures are what I name the **basic overall balance** minus 3.4%) and the **basic current balance** (minus 1.5%, including all the previous corrections and adjustments).

¹ The £21 billion is an under-counting. The increase in unemployment payments represents only a part of countercyclical expenditures, though the largest part. All means-tested social support tends to decline as the economy recovers. Detailed statistics can be found on a government website, <https://www.gov.uk/government/collections/benefit-expenditure-tables>.

Chart 1: Measures of the UK Public Sector Fiscal Balance, 2013/14



- 1st column is total revenue minus total budgeted expenditure, overall balance
- 2nd subtracts interest paid to Bank of England & publicly owned banks, outflow balance.
- 3rd subtracts increase in payments to the unemployed since Jan 2007, basic overall balance
- 4th subtracts public investment, basic current balance.

Sources: Department of Debt Management, <http://www.dmo.gov.uk/>, and Office of National Statistics, <http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-354787>

Clarity on what deficits are and what they are not makes the issue of the public sector balance much more manageable, considerably less than the headline 5.5% of GDP. We can now move to the analytical issues: why do we have a deficit, is it a problem, and how do we eliminate it?

3 The Deficit & how we got it

History offers many examples of false assertions that become accepted as fact as a result of repetition. Chancellor George Osborne provides a clear example in his repeated claims that 1) the UK deficit he so fervently seeks to reduce is the fault of the Labour government that preceded him, and that 2) he has made substantial progress in reversing that deficit.

We find these allegations, "Labour broke it and Osborne is fixing it", endlessly repeated in the media, not least in "news" stories and opinion columns in *The Guardian*. So pervasive is the belief in the Labour-to-blame and Osborne-to-the-rescue thesis that even many progressives accept it. Both are 100% wrong. The Labour government was not the cause of the deficit, and Chancellor Osborne has made reducing the deficit harder not easier.

The Osborne assertion of Labour culpability can be stated as follows -- excessive spending by Labour governments before May 2010 (when the Coalition took government) created the deficit, and in contrast the current chancellor has practiced "sound finance".

An inspection of these allegations of feckless financial management by the last Labour governments requires comparison of like with like. Through the end of September of this year, the Coalition has held government and passed budgets covering 17 quarters (it did not hold government in the first month of the 2nd quarter of 2010). Seventeen quarters of Labour governments takes us back to the 2nd quarter of 2006.

Chart 2 tells the story of Labour and the Coalition over identical time periods, measured with prices of the last quarter of the 8½ years 2006-2014. Total expenditure and revenue by the UK central government are measured in billions on the left axis, and the fiscal balance in billions on the right axis. Labour outcomes are shown in red and those of the Coalition in blue. Because both revenue and expenditure fluctuate seasonally they are measured as the annualized average (average of the current and three previous quarters).

From 2006.2 through 2010.3 Labour governments spent a cumulative total £3137 billion while the economy generated public revenue of £2698 billion, for a fiscal balance over the 17 quarters of minus £439 billion (one-third of which came in the last nine months of 2009). During the 17 quarters of the Coalition cumulative expenditure weighs in at £3164 billion and revenue at £2639 billion, for a fiscal balance of minus £525 billion.

Contrary to his boasts of fiscal rectitude, Chancellor Osborne has overseen a deficit larger than Labour's over the same time period. This is all the more extraordinary because the UK economy has not suffered from a global collapse under the current Chancellor's watch as it did during 2008-2010.

Chart 2 also clearly tells the basic cause of the deficit -- drastic falls in revenue as a result of the economic collapse of 2008-2009. In the first quarter of 2008 total central government revenue adjusted for inflation reached a peak of 193 billion. Nine quarters later in 2010.2 it had fallen to 141 billion. Over the same nine quarters expenditure rose by a mere 2 billion. Almost the entire increase in the deficit, over ninety percent of it, resulted from the fall in revenue.

Especially scurrilous are allegations that the huge increase in the fiscal deficit resulted from the policies of Gordon Brown. From mid-2007 until the end of the Brown government three years later, quarterly increases in expenditure measured in constant prices were *lower* than they had been over the previous three years. Far from being spendthrift, the Brown government reduced the rate of increase of real spending during the great recession. This was an unwise policy for a contracting economy. The Labour government's fiscal sin was to spend too little not too much.

Chancellor Osborne cannot blame Labour for his woes. They are self-inflicted. The public sector balance remains deep in the red because of the stagnation of public

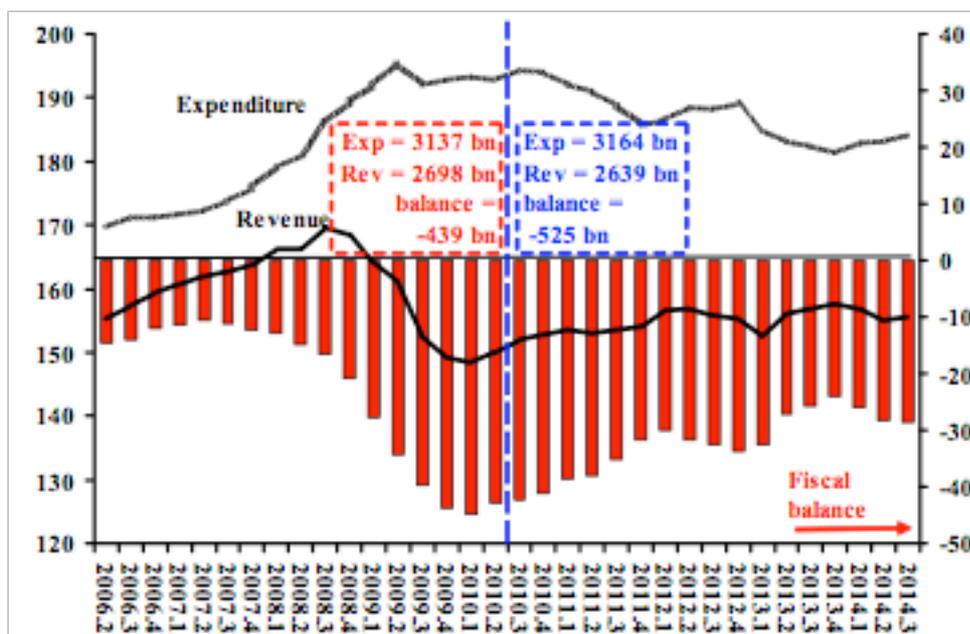
revenue over the four years of Coalition government. The chart shows that the Brown government left Mr Osborne an *improving* budget balance, because the UK economy was in the early stage of recovery.

This nascent recovery that Labour bequeathed the Coalition demonstrates the old saying, "no good deed goes unpunished". Far from building on hesitant improvement, the Coalition government embarked on recession generating budget cuts. These failed miserably in their aim of deficit reduction, and Mr Osborne attributes his failure in great part to what Labour bequeathed to him in May 2010. The truth is the reverse.

The Coalition government made bad economic conditions worse. Why, then, does every major media outlet repeat the false tale of a chancellor struggling to repair the damage left to him by a spendthrift Labour government? If we could answer that question we would be well on the way to a strategy to rid ourselves of this government.

Chart 2: Labour Government not the Cause of the Deficit

Central government revenue, Public expenditure and the overall fiscal balance, billions of pounds, 2006.2 - 2013.3 (constant prices of 2014.3)



Note: Expenditure, revenue and therefore the fiscal balance vary considerably by quarter. To adjust for this seasonal variation the chart uses "annualized" quarterly statistics. The number for each quarter is the average for that quarter and the three previous.

Source: [Office of National Statistics](#)

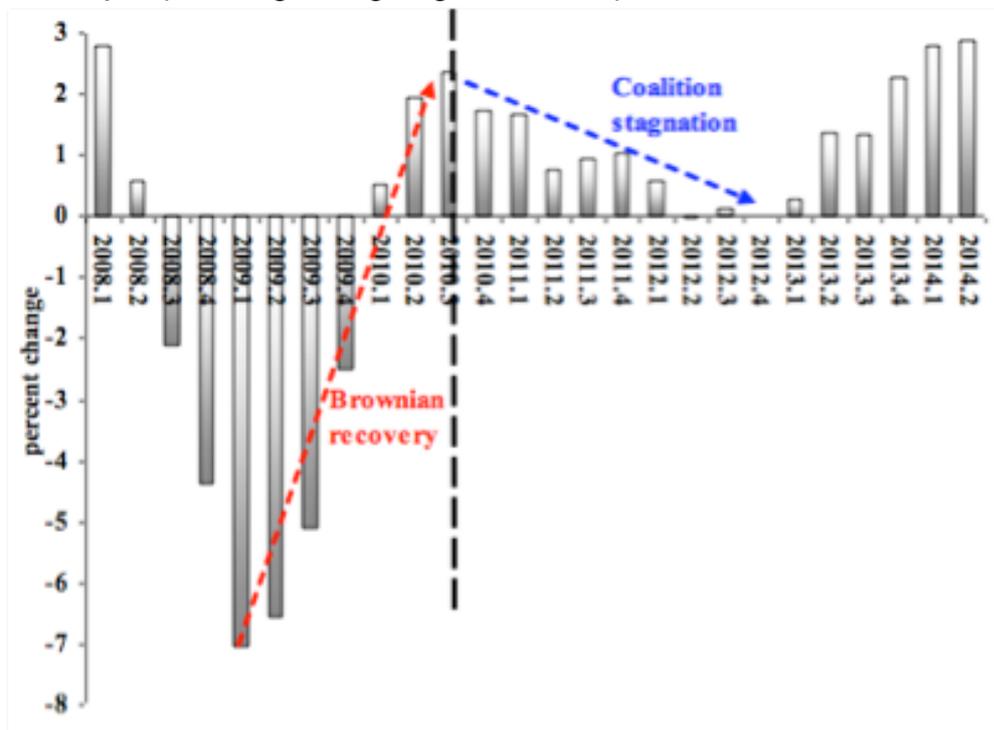
4 Mr Osborne's Record

A further lesson from Chart 2 is that the Chancellor has made no substantial progress towards deficit reduction despite his cuts in public expenditure. On an annual basis, inflation adjusted borrowing in the first quarter of 2012 was £30 billion. Two and one-half years later in the third quarter of 2014 borrowing remained almost the same, £29 billion, having increased for three consecutive quarters.

This stagnation in reducing the fiscal -- by whatever measure one uses -- has an obvious and simple explanation. As pointed out above, the Labour government bequeathed the new chancellor a nascent recovery which his policies promptly terminated. The rate of change of GDP improved continuously from the first quarter of 2009 through the third quarter of 2010 when it reached an annual equivalent rate of 2.4%. A full three years passed until that rate would be achieved again, in the last quarter of 2013 when it rose to 2.7%.

Chart 3: Mr Osborne kills a recovery

Year-on-year percentage change in gross national product, 2008-2014



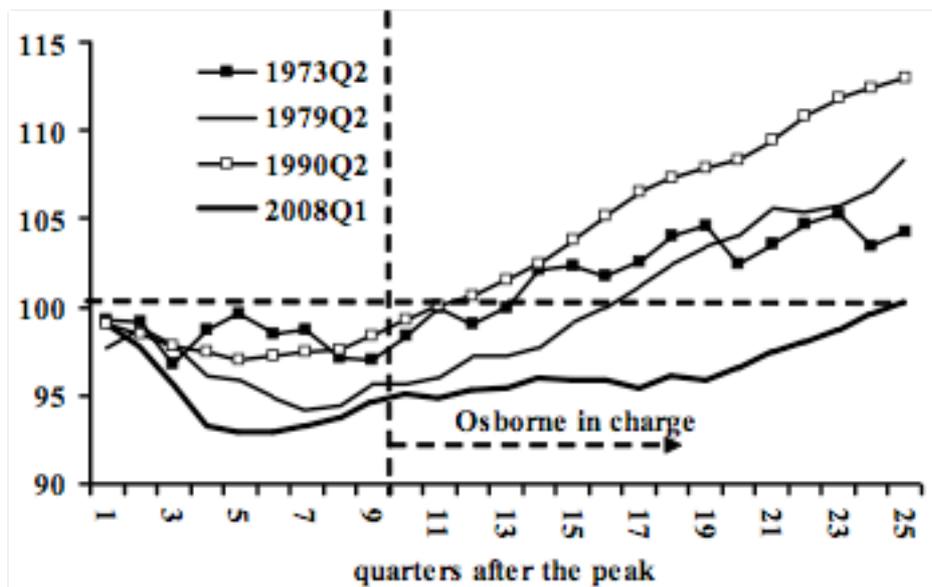
Office of National Statistics, Quarterly National Account Q2 2014 & www.oecd.org/statistics

This near stagnation of the economy for three years makes the current recovery the slowest since records are available, as demonstrated by comparisons made in the Office of National Statistics' Economic Review for July 2013. The comparisons are shown in Chart 4, with the original ONS chart extended through the third quarter of this year.

The recession that began in the second quarter of 1990 (Q2 1990) began to sustain output above the previous peak in the 12th quarter after the peak (number of quarters after the pre-recession peak measured on the horizontal axis). The 1973 recession regained pre-recession level after 14 quarters, and the 1979 recession after 17 quarters. The current recovery from recession required 24 quarters fifteen of which under Mr Osborne's economic management.

Chart 4: Recovery or stagnation?

Percentage point differences from peak GDP for the current and past recoveries from recession (pre-recession peak = 100)



Source: ONS, *Economic Review* (July 2013), where the same chart appears with statistics through 19 quarters in each case. For the current recession the 25th quarter is 2014Q3.

5 The Deficit is a problem?

The stagnation of the UK economy is the result of a collapse in private investment and a depressed world market, whose knock-on effects has been unemployment and lower household consumption. The solution is a substantial fiscal stimulus to restore aggregate demand.

The Coalition government has repeatedly stated that its rejection of this obvious route to recovery is not ideological. Their spokespeople claim that the size of the overall fiscal deficit precludes any further public expenditure. On the contrary, the urgent need is to reduce public expenditure to close that deficit. Let us suspend disbelief and momentarily accept the hypothesis that the government is not cutting out of ideological zeal.

If the cuts are not ideological, then the question immediately presents itself, what danger does a fiscal deficit pose? A search turns up four "deficit danger" arguments: 1) people will expect the government to raise taxes in the future to pay off the debt and

they reduce current expenditure in anticipation (so-called Ricardian Equivalence); 2) the interest on the deficit presents an unmanageable burden now and "for our children"; 3) deficits push up interest rates, crowding out private spending; or/and 4) unless the deficit is reduced, financial markets (aka speculators) will drive up the interest rates on UK bonds, as has happen to Greek, Italian and Spanish bonds.

The first argument is simply silly, literally silly in a simplistic way. It is flawed economic logic based on a series of assumptions so unrealistic that they are absurd (for example, continuous full employment). The second and third arguments require a specific outcome, rising interest rates, and the opposite has happened. In 2007 the overall fiscal deficit was less than three percent of GDP and the UK government short term bond rate was 5.5 percent.

In 2009-2011 the deficit averaged about ten percent, and Chart 5 shows the result, a continuous decline then a very slight rise in the interest rate ("bond yield") to level off at one-half of one. This very low interest rate on public debt implies a small public debt service, as well as being far too low to nudge much less crowd anyone.

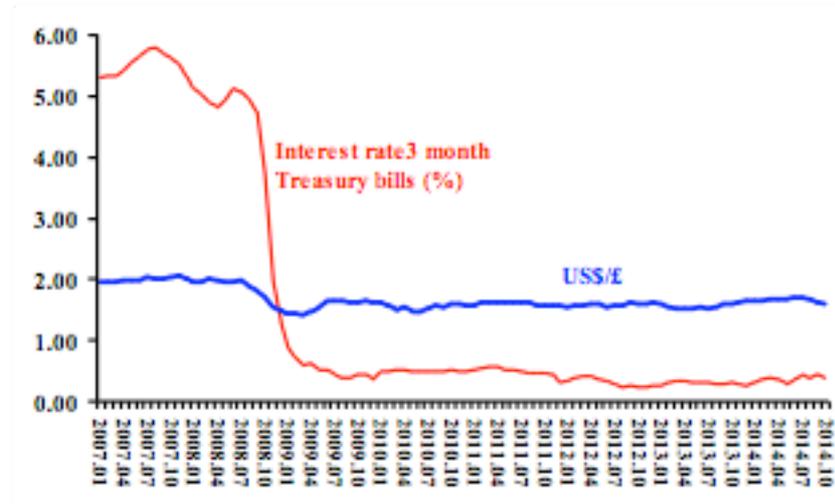
Even more important than the level of UK bond yields is the absence of any hint that they might rise. To the contrary, the Euro scares of 2010 and subsequently resulted in speculators shifting their ill-got gains *into* British public securities. Far from being in danger of becoming the next Greece, Spain, Italy, etc., the bonds issued by the UK government are viewed as a "safe haven" (aka, "rush to quality", among other clichés).

In summary, at the end of 2008 the Bank of England began to cut interest rates drastically. The three-month bond yield stood at about one-half of one percent when the Coalition government took power. Since then the bond rate has hardly changed. As for the pound and dollar question, if there is a problem, it lies in the pound being too strong for the government's hopes of an export-led recovery.

The conclusion is obvious: so-called financial markets show no sign of anxiety about the UK deficit or debt. Therefore, a fiscal stimulus, i.e., more debt, is unlikely to unshackle them. On the contrary, the last several years have demonstrated beyond reasonable doubt that the demand for UK government bonds is strong despite their meager yield. "Markets" are greedy for UK debt. Therefore, a Labour government should feed that greed and use the proceeds from bond sales to "kick-start" the economy.

Chart 5: Nominal Interest Rate on 3 month UK Bonds,

January 2007-October 2014



Data source: Bank of England website.

6 Dispelling Misconceptions

Mr Osborne's record for economic management is appalling, delaying recovery and achieving only meager reductions in the fiscal deficit. But there is a more fundamental issue. The monumental mistake of the Chancellor, which the shadow Chancellor promises to duplicate, is treating the public sector deficit as a problem.

The fiscal deficit is not a problem. Quite the contrary, it is part of the solution to achieve a robust recovery. Except in rare circumstances, deficits and debt are responsible and safe. Deficits and debt are typically good things, contributing to social welfare. Public sector surpluses and the absence of debt are typically dysfunction, bad things for the well being of households and businesses.

To many if not most this characterization of deficits and debt is absurd. The first and fundamental step in understanding the functional role of public sector deficits is that rarely do they result from excessive spending. They result from recessions, as in the UK over the last six years.

In economically advanced countries such as Britain taxes on expenditures and incomes, of both households and businesses, increase to the point of overwhelming all other sources of revenue, such as tariffs and fees charged by governments. Income and sales taxes have two very useful characteristics. Governments find them easy to collect and they increase as the economy grows (and vice-versa). This may seem so obvious that it need not be explained, much less explained in tedious detail.

Explanation is necessary because it has major implications for assessment of public sector deficits. No important category of public expenditure increases automatically as the economy grows, quite the contrary. As briefly noted earlier, excluding interest obligations expenditures fall into two general categories, those determined by specific

legislation and those linked to unemployment and poverty. The first category is by far the larger, including expenditures on health, education, the military, and public sector pensions. Legislatures allocate the funds for each of these to a great extent independently of the state of the economy.

The expenditures linked to unemployment and poverty change opposite to the changes in the health of the economy. Unemployment declines as the economy grows, which reduce compensation payments. These are "countercyclical" expenditures in two senses. By definition they go up when the economy goes down, and vice-versa, moving against the economic cycle. More importantly, they make a contribution to reducing the economic cycle. When the economy declines, some people lose their jobs and all or part of their current income. As a result, household consumption declines, reinforcing the initial contraction of the economy.

Countercyclical expenditures reduce the strength of the "multiplier" process in which contraction leads to more contraction. By their nature the expenditures contribute to deficits, and we should be very glad that they do. They also work the other way, reducing deficits and helping to turn them into surpluses when the economy expands.

There is more to the countercyclical story. When a country has a progressive tax system it means that the percentage of income paid as tax increases as household income increases. This must mean that when the economy contracts, the tax share for households declines. As result household income after taxes ("disposable income") falls less than total income, and household consumption falls less than household income.

Two processes in particular link the health of the economy to public sector finances. First, government revenue comes from taxes on the economy's output. Second, in the aggregate income taxes are progressive, which means that the amount of tax households pay declines more than their income declines, and the reverse occurs during economic expansion.

These processes lead to a very important conclusion. The public sector goes into deficit just when we need it to. Deficits are a good thing and we should welcome them. When a government attempts to implement a balanced budget in a recession (or its fragile aftermath), as George Osborne seeks to do, the attempt makes the recession longer and deeper by reinforcing economic contractions. Public sector deficits are the automatic by-product of countercyclical processes that act to reduce the severity of boom and bust.

How should we assess the uncontrollable enthusiasm of the Coalition government for expenditure cuts to balance the national budget? It is the triumph of ideology over rational policy, the imposition of fantasy upon reality. It is troglodyte economics.

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*Cover Image: *Bowery men waiting for bread in bread line*, New York City, Bain Collection (LOC)



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