PAPER **EA020**

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A series of background briefings on the policy issues in the May 2015 UK General Election

Austerity: Growth Costs and Post-Election Plans

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#ElectionEconomics

CENTRE for ECONOMIC PERFORMANCE

CEP ELECTION ANALYSIS
Austerity: growth costs and post-election plans

- At the end of 2014, UK GDP per person was about the same as it was at the end of 2006. The UK was about 16% poorer than would be expected on pre-crisis trends (from 1970).
- The coalition government's establishment of the Office for Budget Responsibility (OBR), which gives independent economic and fiscal forecasts and assesses government tax and spending plans, is welcome.
- Fiscal consolidation ('austerity') reduced GDP growth by 1% in both 2010-11 and 2011-12, according to the OBR. Recent research on the impact of government spending in recessions suggests that this is likely to be an underestimate of the negative impact.
- Some of the UK's poor performance has been due to the eurozone crisis, where countries also pursued tough austerity policies. Financial dislocation and high commodity prices were also drags on growth.
- The arguments for accelerated austerity after May 2010 were to boost consumer confidence, to avert a Greek-style debt crisis and/or to allow looser monetary policy. None of these justifications are convincing.
- Based on plans in the 2014 Autumn Statement, public service spending (DEL) will be reduced by 22% in real terms between 2010-11 and 2019-20. The result would be that public spending as a share of national income would fall to its lowest level since 1948.
- The Autumn Statement plans cuts in spending on public services of 14% between 2015-16 and 2019-20 to generate a total budget surplus. Unprotected departments (those outside the NHS, schools and overseas aid) face cuts of over a quarter, on top of cuts of a fifth in the previous five years.
- The public services cuts set out in the 2014 Autumn Statement are tougher than those implied by the fiscal rules of Labour at 1.4% and the Liberal Democrats at 2.1%. Moreover, they are even tougher than the official position of the Conservative party, at 6.7%.
- All the main parties plan to balance the cyclically adjusted current budget by 2017-18 and reduce debt over the next Parliament. Only the Conservatives plan to have a surplus on the *overall* budget by 2019-20, so their plans imply both lower spending on public services and less room to borrow for additional public investment. Given longstanding problems of low UK public investment, which acts as a break on productivity, this is a cause for concern.
- The fiscal plans of Labour and the Liberal Democrats would result in slightly higher growth and lower unemployment, but also slightly higher debt than those of the Conservatives.
- Net taxes have risen by around £5 billion following each election since 1992. Given the magnitude of the spending cuts required, it is highly likely that there will be some unexpected tax hikes regardless of who wins power.

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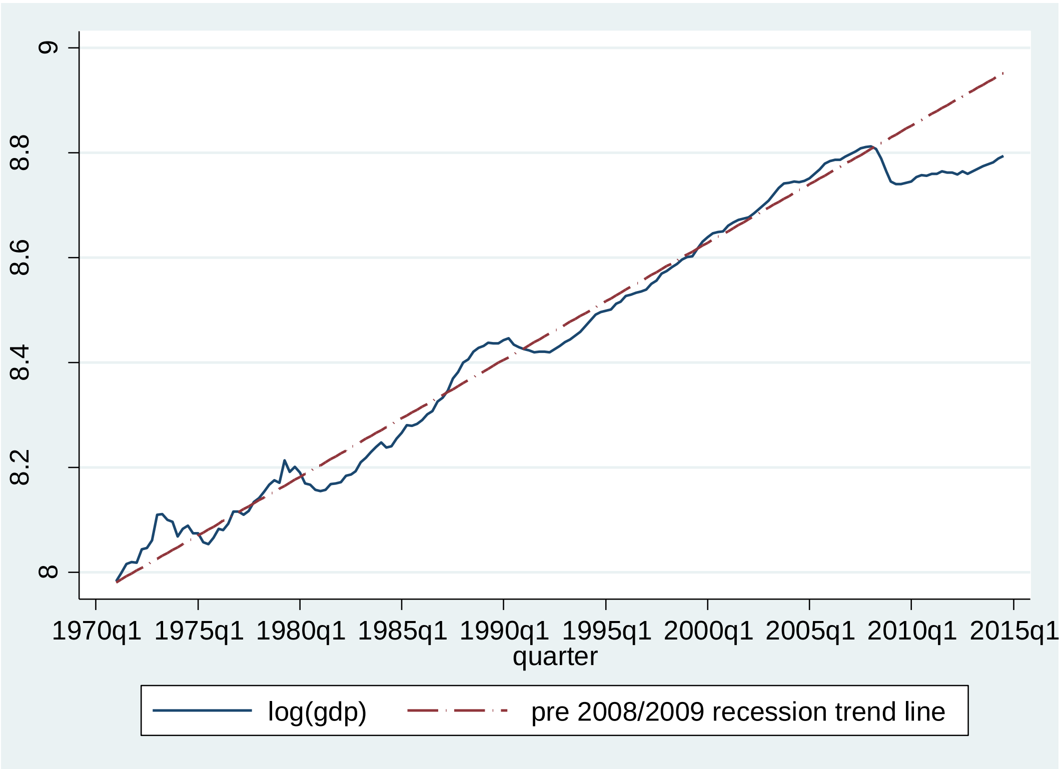
Recent UK economic performance

The UK's overall economic performance, as measured by average national income (GDP per capita), has been dismal in recent years. Figure 1 shows that unlike in the aftermath of other post-war recessions, there is no sign of recovering the output lost following the global financial crisis of 2008-09. This reflects an exceptionally poor productivity performance: GDP per hour is about 15% lower than it would have been on pre-crisis trends (CEP's Election Analysis on Productivity and Business Policies, 2015).

By contrast, the labour market has done relatively well, with about 74% of the working age population in jobs – a return to pre-crisis levels. Employment has been supported by lower labour costs, with real wages having fallen by over 8% since 2008 (CEP's Election Analysis on Real Wages and Living Standards; Pessoa and Van Reenen, 2014).

This Election Analysis addresses the question of whether any of the poor economic performance was due to the coalition government's deficit reduction policy: would things have been even worse without austerity? The Analysis goes on to compare the fiscal plans of the three main parties.

Figure 1: UK GDP per capita (log series) 1970Q1- 2014Q3



Notes: Trend line at 0.558% per quarter (linear trend from 1970Q1 to 2008Q1 when recession began). Growth 2010Q2 to 2014Q3 was 0.195% per quarter. Quarterly Gross domestic product (average) per head (series IHXW), market prices (downloaded February 23rd) http://www.ons.gov.uk/ons/datasets-and-tables/data-selector.html?cdid=IHXW&dataset=ukea&table-id=X11.

Government fiscal policies since 2010

The coalition government established the Office of Budget Responsibility (OBR) in 2010 to provide independent fiscal forecasts. Setting up the OBR echoed Labour's 1997 introduction of independence for the Bank of England in setting interest rates. It shields important decisions from political manipulation and is now an accepted part of the policy-making landscape. As argued by the LSE Growth Commission (Besley and Van Reenen, 2013), such independent bodies are to be warmly welcomed.

A particular role assigned to the OBR is to judge whether the government's fiscal plans are consistent with its two fiscal mandates: first, to balance the cyclically adjusted current budget deficit over the next five years; and second, for government debt to be falling in 2015-16. There is little clear rationale for the second target, which has, in any case, been missed. The first fiscal target makes sense during 'normal' times, as fiscal policy is a much blunter weapon for demand management than interest rate setting (Portes and Wren Lewis, 2014).

Unfortunately, we have not been living in normal times. The UK – alongside most of the developed world – has been caught in a 'liquidity trap' where interest rates have reached the 'zero lower bound' (they have been 0.5% since March 2009). The standard macroeconomic medicine for the situation where monetary policy has lost its bite is to turn to fiscal stimulus. This is exactly what initially happened in the depths of the 2008-09 recession.

Keynes recommended public investment (for example, spending on road repairs and building). By contrast, the first column of Table 1 shows that the coalition government cut investment significantly in their first two years from 3.3% to 1.9% of national income - about 40%. In June 2010, the Chancellor announced £32 billion of new spending cuts by 2015, and the VAT rate was increased from 17.5% to 20% at the beginning of 2011. Table 1 also shows the overall fiscal forecasts and what actually happened subsequently (the 'out-turn').

Table 1: Fiscal aggregates, forecasts and outputs

	Public sector net investment (PNI)	**Current budget deficit**		**Cyclically adjusted current budget deficit**	
		June 2010 forecast	**Out-turn**	**June 2010 forecast**	**Out-turn**
2008-09	3.2%	3.5%	3.4%	3.1%	3.4%
2009-10	3.3%	7.5%	6.9%	5.3%	4.8%
2010-11	2.6%	7.5%	5.9%	4.8%	3.9%
2011-12	1.9%	5.7%	5.0%	3.2%	3.2%
2012-13	2.1%	4.0%	5.0%	1.9%	3.0%
2013-14	1.5%	2.3%	4.1%	0.7%	2.6%
2014-15	1.5%	0.9%	3.5%	-0.3%	2.7%
2015-16	1.4%	-0.0%	2.6%	-0.8%	2.2%

Notes: All numbers expressed as a proportion of GDP.
Sources: OBR Public finances databank (accessed 26th January 2015). PNI, Current budget deficit and cyclically adjusted current budget deficit from OBR Public Finances Databank; http://budgetresponsibility.org.uk/data/ Aggregates (percentage of GDP) Table. June 2010 forecasts from OBR Budget Forecast, June 2010, Table C1: Fiscal Forecast Overview, p.77; http://budgetresponsibility.org.uk/wordpress/docs/junebudget_annexc.pdf, available from http://data.gov.uk/dataset/uk-budget-june2010-data-tables.

In 2010-11 and 2011-12, the out-turn was more severely austere (more of a deficit reduction) than forecast (the deficit was 5.9% of GDP in 2010-11 instead of the planned 7.5% – and 5% versus 5.7% in the following year). This means that the reduction in the deficit was faster than planned. By contrast, from 2012-13, the budget deficit has not been cut as quickly as planned, and this remains true after adjusting the budget deficit for the state of the business cycle (last two columns). Indeed, in the current financial year, the cyclically adjusted deficit is essentially flat, which means that deficit reduction was put on hold (http://niesr.ac.uk/blog/fiscal-policy-plan-and-recovery-explaining-economics).

One interpretation of Table 1 is that the government abandoned their 'Plan A' in 2012-13 in favour of slower austerity as the nascent recovery of 2009-10 shown in Figure 1 petered out. The slowest recovery of output following a recession for a century seemed consistent with conventional macroeconomic analysis of the impact of contractionary fiscal austerity in a severe downturn (Bagaria et al, 2012; IMF, 2012; Wren-Lewis, 2015). Consequently, the government pushed more of the planned fiscal consolidation into the next Parliament.

An alternative interpretation is that nothing essentially changed because the absolute levels of planned expenditure cuts from the November 2010 Autumn Statement were broadly the same. In response to economic under-performance and low tax receipts, repairing the fiscal position would always have been pushed forward rather than adjusted to meet the initial target for budget balance. But the previous Labour government was criticised for not responding when revenues were below forecast, and it is standard to look at out-turns when judging policy stances.

Whatever interpretation is made of the policy stance, it is clear that the coalition government's austerity programme was front-loaded between 2010-11 and 2011-12, involved significant public investment cuts and was less than initially planned.

By how much did austerity reduce economic growth?

The failure to recover lost output shown in Figure 1 cannot be attributed to UK austerity only. The eurozone crisis, the lingering effects of the banking crisis, higher commodity prices, and the decline of high productivity sectors like oil and gas should also be apportioned some part of the blame (Corry et al, 2012, offer an assessment).

But what is striking is how much worse the UK performed during the first half of this Parliament when austerity bit hardest. Between 2010 and 2013, GDP per capita growth was worse than in the United States and Japan, both of which had independent currencies like the UK. UK performance was similar to the countries in the eurozone hit by even more severe austerity and a currency crisis.

The OBR takes these external forces into account when it calculates the contribution of austerity to cutting GDP growth by 2% (one percentage point in both 2010-11 and 2011-12). After this, the pace of consolidation slowed, as Table 1 illustrates. The OBR's calculations are likely to underestimate the growth costs of austerity for two reasons:

- It uses historical multipliers, whereas recent research suggests that the effect of fiscal policy is greater when economies are depressed and interest rates are near zero (for example, Jorda and Taylor, 2014).

- There are hysteresis effects: underused resources lead to scrapping of capital and loss of skills (for example, DeLong and Summers, 2012).

There were several rationales offered for the acceleration in austerity after 2010, including monetary policy, debt crises and confidence.

First, would the Bank of England have increased base rates (or reduced 'quantitative easing') if there had been a slower rate of fiscal consolidation? Although inflation was often above its 2% target, the Bank's inflation forecasts were consistently below 2% after 2008 (Wren-Lewis, 2015), implying that it was unable to use monetary policy tools sufficiently to boost demand. This is the definition of the liquidity trap and justifies why fiscal policy is needed.

Second, was the level of austerity in 2010-12 needed to prevent a Greek-style debt crisis? Although this argument was often invoked, it was never credible. Unlike Greece, the UK has never had a formal default on its debt, which is at long levels of maturity (see Annex). Most importantly, unlike the eurozone, the UK has an independent currency, and a country with a floating exchange rate and a credible, inflation-targeting central bank simply does not face the risk of a liquidity crisis turning into a solvency crisis (De Grauwe, 2011). The irrelevance of this analogy has been demonstrated conclusively by market reaction both to persistently high UK deficits (much higher than forecast in 2010) and by ratings agency downgrades for both the UK and the United States; long-term interest rates have remained exceptionally low.

Finally, sharp fiscal consolidation was said to reassure consumers that government debt was under control and hence inspire confidence. The empirical basis for 'expansionary contractions' was always dubious and is now discredited (see Annex).

Fiscal policy after 2015

In the December 2014 Autumn Statement, the Chancellor laid out the fiscal plans in detail through to 2015-16 and (with less detail) through to 2019-20. The present government's aim is to balance the cyclically adjusted *current* budget in 2017-18, the overall budget (that is, including current and *capital* spending) in 2018-19 and then to have a £21.6 billion overall budget surplus in 2019-20 (1% of national income).

The consolidation through to 2019-20 will be achieved almost solely by cutting Total Managed Expenditure (TME) to 35.2% of national income (rather than raising taxes). To put this in context, TME in 2014-15 is £60 billion and 40.5% of GDP, whereas it was 45% in 2009-10.[1] If fully implemented, this would mean that government spending would be at a level of GDP not seen since 1948. Table 2 shows that this is a real terms cut of 2.3% (£51 billion in 2015-16 prices) from the levels expected in 2015-16 and cumulatively 5.4% lower than in 2010-11.

About half of total spending is public services (Departmental Expenditure Limits, DEL) and half is 'welfare' (Annual Managed Expenditure, AME). Welfare spending is projected to continue to rise from 2015-16 to 2019-20 by 9%, just as it rose from 2010-11. This is mainly because pensions are about half of welfare spending and have been protected from cuts. Hence public services are to be cut by 14.1%. Since the population is rising, this is even more dramatic when expressed per capita – about £1,800 less spent per person.

[1] OBR (2014) Chart 1.1, p.7; Table 4.17 p.134.

Some public services are 'protected' in real terms: health, schools and overseas aid. Hence the unprotected parts of DEL (for example, transport, justice, local government and business) will be bearing the cuts. These departments have already experienced cuts of 20% between 2010-11 and 2015-16, and they will now face cuts of 26% between 2015-16 and 2019-20.

Table 2: Cumulative real change of planned departmental spending

	2015-16 to 2019-20	2010-11 to 2019-20
Total Managed Expenditure	-2.3%	-5.4%
of which:		
Annual Managed Expenditure (AME)	9.0%	13.0%
Departmental Spending Limits (DEL)	-14.1%	-22.2%

Sources: Public Expenditure Statistical Analysis (2014); Autumn Statement (2014); IFS Green Budget, Table 7.6 (2015).

Comparing the fiscal plans of the three main parties

There is some fiscal consensus across the three main parties. All have signed up to the coalition government's spending plans up to 2015-16, and all have voted for the Charter on Budget Responsibility, which commits the government to balancing the cyclically adjusted current budget over a rolling three-year window (so 2017-18 for the winner of the election). Each of them would also keep the OBR.

A complication with comparing the stances of the parties is that the targets in the 2014 Autumn Statement are tougher even than the official position of the Conservative party (Crawford et al, 2014). Table 3 shows that in contrast to the 14.1% cut in DEL in the Autumn Statement, the reduction implied by the Conservatives' fiscal rules could be as little as 8.3% or even 6.7% if we include policy announcements.[2] This compares with a 1.4% cut under Labour and a 2.1% cut under the Liberal Democrats.

There are at least three important differences between the parties over austerity: the treatment of public investment; the mix of taxes and spending in achieving fiscal consolidation; and the speed of the fiscal adjustment.

Public investment

By 2019-20, the Conservatives aim to have an overall budget surplus; Labour aims to have a surplus on the current budget; and the Liberal Democrats aim to balance the cyclically adjusted current budget.[3] By including public investment in plans for balance, this would prevent a future Conservative government from borrowing for additional public investment. The Autumn Statement pencils in public investment as just 1.2% of GDP from 2017-18 onwards. The fiscal

[2] This figure includes the tax and spending giveaways and takeaways announced as of December 2014. In particular, the Prime Minister's promised £12 billion of cuts to the welfare budget (only £3 billion of which has been specified).

[3] The Liberal Democrats have suggested that only 'productive' investment would be excluded from the calculation of the current budget. It is very unclear how this is different from the standard ONS definition and seems to create some unnecessary ambiguity in what the target actually is. In what follows we assume that they will use the standard ONS definition.

rules of Labour and the Liberal Democrats would allow them to bring down public borrowing more slowly *so long as it is used for investment*.

Table 3: Potential departmental spending under alternative party proposals

	2015-16 to 2019-20		2010-11 to 2019-20	
	Percentage	**£billion**	**Percentage**	**£billion**
2014 Autumn Statement	-14.1%	-51.4	-22.2%	-89.5
Given party fiscal rules				
Conservatives	-8.3%	-30.1	-16.9%	-68.3
Labour	-1.9%	-6.8	-11.2%	-44.9
Liberal Democrats	-1.7%	-6.2	-11.0%	-44.4
Given party fiscal rules and stated intentions				
Conservatives	-6.7%	-24.8	-15.5%	-53.1
Labour	-1.4%	-5.2	-10.8%	-43.3
Liberal Democrats	-2.1%	-7.5	-11.3%	-45.7

Notes: Potential departmental spending under the alternative parties' proposals assume that they all stick to the Autumn Statement 2014 plans for investment, that they borrow the maximum amount their fiscal rules allow, and that they implement their specific tax and benefit reforms and stated intentions as of December 2014 (see Annex).
Sources: 2014 Autumn Statement; Various editions of Public Expenditure Statistical Analysis; OBR's 2014 Economic and Fiscal Outlook and IFS Green Budget (2015, Table 7.7).

The argument for separating capital from current expenditure in fiscal targets is strong – public investment creates an asset so it should be treated differently from current spending on the salaries of government employees. As with a company, one should look at the balance sheet as well as the profit and loss account, which is what is being attempted with the 'Whole of Government Accounts'. It is true that capital and current spending is sometimes hard to separate accurately in the public accounts. But just because the division line can be blurred, does not mean it is impossible to draw and the Office for National Statistics (ONS) does just this.

Low public investment is a particular concern in the UK context. As Table 1 shows, the austerity programme led to big cuts in public investment. There is much research suggesting that public investment has a larger effect on economic growth (the 'multiplier') in a downturn (for example, Blanchard and Leigh, 2013). And the LSE Growth Commission (Besley and Van Reenen, 2013) has highlighted that the major failing of the UK economy is inadequate long-run investments in infrastructure, human capital and innovation.

The Conservatives' argument for a surplus on the total budget is that the debt will be brought down more quickly. This reduces future interest payments and would leave the economy more resilient to another negative shock like the global financial crisis. The other parties' fiscal plans would also reduce debt as a proportion of GDP, but they would do this more slowly and could still spend significantly more on public investment.

In the aftermath of the financial crisis, the UK still has a high debt-to-GDP ratio compared with other OECD countries (the eighth highest out of 24 countries examined by the IMF, 2014) and the coalition government failed its second fiscal mandate to have a falling debt-to-GDP ratio by this election. Nevertheless, debt ratios are due to start falling in 2015-16 and at 81.1%, the net debt-to-GDP is not particularly high by historical standards. For example, the UK had debt levels above 80% throughout the period 1916-17 to 1967-68. Furthermore, there is no compelling evidence of a causal effect of high debt on growth and no 'magic number' of the debt-to-GDP ratio above which economic growth will plunge (see Annex).

One argument is that the government would be able to go on a wasteful investment spending spree, building 'bridges to nowhere' as happened in pre-crisis Spain. Such an argument seems fanciful in the UK context. Even before any fiscal rules, there has been systematic under-investment for many years. The key issue is what assets are created by the investment – not the level of debt *per se*.

The mix of taxes and spending in achieving fiscal consolidation

The Conservatives' fiscal plans amount to a more dramatic shrinking of the size of the state than the other parties. They intend a further £7 billion of tax cuts offset by a £12 billion cut in the welfare bill by 2019-20 (only £3 billion of which has been specified). Labour has announced new taxes on the better off (a 'mansion tax' on homes worth over £2 million, restoring the 50% top rate of income tax and a bank levy).

There is no compelling evidence that a smaller share of public spending in GDP is beneficial to growth or productivity in the range used by OECD countries. Some advanced countries appear to be successful with a small state (for example, the United States) and others with a larger state (for example, the Nordic countries). It is more to do with how the public money is spent than the amount of spending *per se*.

Speed of adjustment

The Autumn Statement implied cuts in DEL of over 14%. This would mean general government employment cuts of around 900,000 (on top of the 500,000 cuts between 2009-10 and 2015-16). The public has been surprisingly acquiescent about the spending cuts so far, but cuts on this scale would surely mean real reductions in the quantity and quality of public services.

Surveys of expert economic opinion are doubtful over the credibility of the plans (see Centre for Macroeconomics http://cfmsurvey.org/surveys/2014-autumn-statement). This contrasts with 2010 when similar economists' surveys thought the coalition government's plans were credible (although a plurality thought they were too fast).

Explicit macroeconomic modelling of the impact of alternative paths of fiscal consolidation suggests that by 2019-20 output, employment and debt would be a bit higher under Labour and Liberal Democrat plans compared with the Conservatives (Kirby, 2015).

Even if the reductions were somewhat slower as the parties' stated rules allow (see Table 3), the cuts will be hard to enforce, especially with a growing population. It is likely therefore that whoever wins the election will turn to tax increases to help meet deficit reduction targets. Indeed, every general election since 1992 has been followed by net tax rises of more than £5 billion in today's money.

All parties should be more honest about how exactly taxes are going to rise following the election. A quarter of all income tax revenue comes from just 0.5% of the adult population. A one percentage point rise in all rates of income tax would be progressive and raise £5.5 billion.

Conclusions

The austerity programme of the coalition government knocked at least 1% per year off growth in the first two years of this Parliament. In retrospect, this looks like a mistake and the slower pace of austerity in 2012-13 and thereafter was welcome (as was the setting up of the OBR).

The plans in the 2014 Autumn Statement are to accelerate the cuts in spending on public services over the next five years, until it reaches the lowest level since at least 1948. Other parties also plan big reductions although at a much slower pace and tempered by tax rises. In reality, it is likely that whoever wins the next election will increase taxes more than has been advertised – just as has happened after every election since 1992.

A major difference between the fiscal targets of the parties is over public investment. The Conservatives' targets to create an overall surplus by 2019-20 would also engender greater pressures to reduce public investment, which is worrying as UK public investment is lower than in many comparable countries.

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Further reading

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Annex

Significant tax and spending policies of the three main parties
The policy proposals discussed here are used in the calculations underlying Table 3 and taken from Crawford et al (2014), which has more details. The most significant policies announced by Labour are the decisions to reverse the under-occupancy penalty (the 'bedroom tax'), to increase the top rate of income tax from 45p to 50p, to cap child benefit increases at 1% in 2016/17 and to introduce a mansion tax on homes worth more than £2 million.

For the Liberal Democrats, the major policies are the mansion tax on homes worth more than £2 million, an increase in the personal allowance to £12,500 by 2020/21, an increase in capital gains tax, limits on pension tax relief, and an increase in the dividend tax rate for higher-rate taxpayers.

The Conservatives have stated intentions to raise the higher-rate threshold to £50,000 by 2020/21, to increase the personal allowance to £12,500 by the same year, and to implement £12 billion of welfare cuts (of which approximately £9 billion are as yet unspecified).

Debt and the deficit
Since there is frequent confusion between the two, it is worth recalling that the deficit is a flow and debt is a stock. If the government runs a deficit, it borrows to pay for this, which adds to the public debt. Having a high level of debt means higher interest payments and so it places a strain on the government to finance this over the long term.

The UK emerged from the financial crisis with a high deficit and debt. The IMF estimates that only Japan had higher levels of structural borrowing than the UK in its 2015 analysis of 31 advanced countries. The UK also had the seventh largest fiscal consolidation.

Although UK public debt-to-GDP ratios are high, they are far from historically alarming. The UK has never formally defaulted on its debt. Unlike the eurozone, it has an independent monetary policy. The debt is also relatively mature so there is little refinancing risk. Hence the alarmism over the UK facing a sovereign debt crisis like Greece was – and is – unfounded. The justification that the UK needed to accelerate austerity in 2010 because of this made no economic sense.

There has been a lively academic debate over the causal role of debt in slowing economic growth. Although there does appear to be a negative correlation between past debt-to-GDP ratios and future GDP growth, the interpretation of this correlation is very unclear. It is highly likely that countries experiencing a negative shock to GDP will see debt-to-GDP ratios rise. Hence the relationship could be from GDP growth to high debt, not vice versa. The empirical work on 'expansionary austerity' – the idea that austerity creates growth because it reduces expectations of future debt (Alesina and Ardagna, 2009) – has been largely discredited due to this reverse causality problem.

Reinhart and Rogoff's (2010) paper has been interpreted to mean that there were key thresholds for the debt-to-GDP ratio, above which growth would fall dramatically. The 'magic number' of 80%, 90%, or whatever, had no theoretical basis and empirical work underlying this threshold has also now been discredited (for example, Herndon et al, 2014). Despite these problems, the Reinhart and Rogoff work was extensively cited by pro-austerity policy-makers as a reason for rejecting the conventional macroeconomic policy to use fiscal policy to stimulate demand at the zero lower bound. For example, Olli Rehn, EU Commissioner for Economic Affairs in 2013 said 'public debt in Europe is expected to stabilise only by 2014 and to do so at above 90% of GDP. Serious empirical research has shown that at such high levels, public debt acts as a permanent drag on growth'.

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