Extreme Austerity is the wrong medicine

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Increasing numbers of liberal economists are gravely worried that the UK has made a wrong turn in choosing an austerity budget. Here Professor John Van Reenen, Director of the LSE's Centre for Economic Performance, explains why the budget measures fulfil only a political logic, and risk creating a double-dip recession.

Last Tuesday the British Chancellor, made his emergency budget speech claiming that the draconian measures to slash public spending to an unprecedented degree was "unavoidable". Although there is consensus that budget deficits need to be reduced there is sharp disagreement over its pace. These disagreements were on clear show at the G20 Summit with Britain now on the extreme wing of demanding severe austerity, whereas President Obama sensibly argued against pushing the global economy back into recession.

George Osborne's budget has come under fire for putting the burden of adjustment firmly on the shoulders of the poor both through VAT rises and through spending cuts. It certainly is regressive and would be more so had the government not kept the high income tax rises introduced by Labour. But over and above any distributional issues, this was an economically irresponsible budget which runs unnecessary risks with the British economy.

Source: The Prime Minister's Office

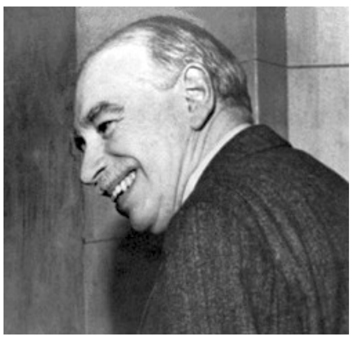
The current situation

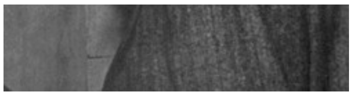
The UK currently has a structural deficit of around 8.8 per cent of GDP. But this has not been due to some unfunded spending splurge since 1997, but rather because Britain has just suffered the deepest recession since the 1930s. In 2007 on the eve of the recession the structural deficit was about 2.2 per cent of GDP, but rose because national output fell by 6.2 per cent from peak to trough. Rather than following Mr. Osborne's advice in Opposition and rapidly reduce spending in the midst of a downturn and allow more banks to fail, the Labour government (alongside most others) chose to simultaneously maintain a stimulus program and recapitalise the banks.

The Labour administration in the last budget planned severe consolidation to bring down the size of the budget by £73bn in 2014/15 and fill 70 per cent of the structural deficit by 2016/17. This implied very serious cuts in real spending of £52bn and increases in taxation of £21bn. By contrast, Mr. Osborne has pledged consolidation of *£113bn – an additional **£40 billion**, which includes an extra £8bn of tax increases and £32bn of spending cuts.*

Fiscal tightening on this scale sucks demand out of an economy barely making it out of a recovery with levels of unemployment not seen since last time the Conservatives were in power. Why on earth risk a double dip recession in these circumstances?

We have been here before of course. Historically, when weakened economies start pulling themselves out a recession the fiscal hair-shirters, temporarily silenced by the recession, often get back the policy reins and demand more consolidation. Keynes wrote the General Theory in response to the "Treasury view" which thought balanced budgets were the best way to pull the UK out of the Great Depression. In 1937 a combination of spending cuts and interest rates hikes plunged the US into a second Depression. In 1997 in Japan, a tentative recovery during the Japanese "lost decade" was snuffed out by an increase in VAT by two percentage points. This should sound hauntingly familiar to the current situation.





The budget risks pushing the UK back into recession. The existing plans under Labour were already risky enough, so I see no reason why we should massively increase such risks. The Office of Budget Responsibility thinks the budget will shave "only" 0.4 per cent off current growth so we are down to 1.2 per cent this year from the budget. The accuracy of all such macro forecasts is poor and the risks are on the downside. Canada's recovery after consolidation was through export-led growth as the US boomed. At the moment the developed world is still locked in slow growth, so the prospects of export led growth are meagre.

The economic basis for excessive austerity

There are at least three economic stories to justify the budget's slash and burn policies, none of which stand up to scrutiny.

- **King Mervyn to the Rescue.** "The Bank of England will use monetary policy to safeguard the expansion". If there is one thing I hoped we had (re)learned during the recession, it was that monetary policy is enfeebled in major downturns. Interest rates cannot fall below zero and quantitative easing is clearly no panacea.

- **The Markets Demand It.** "We don't want to become another Greece". These comparisons are platitudes which repeated enough seem like truisms. But they are false. First, at the end of last year UK gross debt to GDP was 68 per cent (less than Germany or France) and less than the average since 1855 (87 per cent). Second, we have very long-maturing debt, so unlike Greece we do not need to go to the markets frequently to roll over short term debt. Third, Britain has never defaulted on our national debt. Will the markets reward the government with a higher interest rate on gilts because of the promise to slash and burn? If the effect is to push the economy into recession, this will make it harder to reduce long-term debt and accomplish quite the opposite. There was certainly no post-budget market bonanza. Consequently, the argument that we should adopt policies that are objectively bad for the real economy because financial markets might reward us is wrong in both theory and practice.

- **Labour's plans relied too much on tax increases.** The Chancellor emphasised his plans lean more heavily on spending reductions than tax increases. Under Labour's plans 71 per cent of the savings came in the form of spending cuts by 2014/15 and under the Conservative plans this proportion is now 74 per cent. This is no big deal. The difference is in the overall magnitude – £113bn vs. £73bn by 2014/15, not the split between taxes and spending and which sections of society will pay for it. The additional consolidation over Labour's plans will fall on the poorest.

The political reasons for bad economic decisions

So if there are not strong economic arguments for the massive consolidation, why are they being done? The answer lies in raw politics.

Prematurely contracting government spending may harm the economy but it has many political advantages for the new government. First, they can blame any serious economic contraction not on their own actions but rather on the "irresponsible" actions of the previous government. Second, they appear to get all of the pain out of the way early on in their term, so they have no need for a second austerity programme. Third, there may be the simple ideology that having a state smaller than it was under Mrs. Thatcher is desirable. But if this is the case let us have an honest debate rather than dressing this up under the pretence that this is inevitable. It is not – it is a political choice.

The political benefits of excessive austerity are clear. But the potential economic costs make this budget both irresponsible and eminently avoidable. I hope for the sake of the British people that I am wrong, but I believe by succumbing to the politics of extreme austerity we are sleepwalking into a major historic blunder.