Austerity in the UK: Why it is not common sense but politically driven nonsense

Andrew Baker
School of Politics, International Studies and Philosophy
Queen’s University of Belfast

Austerity is the new commonsense on how to reduce the huge increase in public debt caused by the financial crisis through stringent spending cuts. The UK coalition government have convinced a significant part of the electorate and the media that the cuts are the ‘necessary’ solution to current economic problems and the route to prosperity. Today, I am going to argue that the austerity agenda is a politically driven nonsense. To understand why this is so, we have to engage more fully with the case for the cuts and identify how austerity emerged as the new common sense agenda in the current circumstances. First, five claims made by the coalition government will each be scrutinized. Second, some observations about the politically expedient and opportunistic nature of the strategy of the coalition government will be made. Third, an alternative prescription will be forwarded.

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1 This title is inspired by a short video put together by Professor Mark Blyth of the Watson Institute, Brown University, simply entitled ‘Austerity’ see here http://vimeo.com/15061570. This paper is direct reflection on the ideas and argument used by the UK government to justify ‘austerity’. Also see Blyth’s forthcoming book Austerity: The History of a Dangerous Idea, Oxford University Press.
1. *The country was on the verge of bankruptcy and risked becoming like Greece*

George Osborne first made this claim in an op ed piece in the Daily Telegraph on 21 December 2009. This claim has become instrumental in explaining the necessity of the cuts to the electorate. Osborne repeated the claim in his speech to Parliament announcing the Comprehensive Spending Review on October 20 2010. According to both HM Treasury and the National Statistics Office, total UK public debt is 64.5% of GDP (57.2% of GDP without bank bail outs.)


That is only 4.5% above the Maastricht convergence criteria on public debt for entry into the Euro, that was considered ‘punitive’ after a decade of fiscal consolidation in Europe in the 1990s. It is not the debt-GDP ratio, of a country on the verge of bankruptcy. Most historical data sets suggest that financing problems for governments do not arise until debt/ GDP ratios go well over 90% and get close to 100%.

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2So punitive indeed that the condition was eventually waived in the case of countries like Italy and Belgium.
Moreover, the Bank for International Settlements (BIS), ranks the UK joint second, with Germany, out of G7 countries for the lowest government debt as a percentage of GDP. 

http://www.bis.org/publ/work300.pdf. Taken across all OECD countries, total public debt as a percentage of aggregate GDP is 96%. At 64.5% the UK is well below average. Between the 1920s and the 1960s, UK public debt was almost permanently above 100% of GDP. Neither, historically nor comparatively, is UK public debt anywhere near record levels.

All of this would be immaterial however, as the Irish government is discovering, if those current arbiters, agenda setters and veto players of contemporary public policy, - the bond markets lacked ‘confidence’ in UK public debt. However, the rate of interest the government was paying on UK government bonds peaked in 2009 at just over 3% on 10 year bonds. Now those rates are down to 2.5%. The financing of UK government debt is almost all long term, - and at affordable rates. Unlike Greece and the Republic of Ireland, the UK has its own currency, can turn to quantitative easing or devalue the currency (to lower rates) and the debt itself is denominated in sterling and is almost entirely British owned. The chances of the UK government defaulting on debt repayments are as close to zero as is possible. Consequently, Osborne’s
claims have left many good judges of the intricacies of public finance, speechless and incredulous. Rachel Lomax, who headed the public finance section at HM Treasury under both Thatcher and Major governments and is by no means a ‘deficit dove’ has claimed that Osborne’s comparisons with Greece are absurd – ‘it is just not true, we weren’t on the brink of bankruptcy.’ Market voices such as Trevor Greetham, asset allocation director at Fidelity Investment, have been equally clear, ‘the UK is under much less pressure from the markets to cut government spending than is commonly believed. The UK is not Greece’. Ultimately, the evidence running contrary to Osborne’s assertion is substantial and speaks for itself.

2. Government debt is like household debt, or credit card debt. Like a household we have to balance the books and not live beyond our means as a nation.

Cameron has likened government debt to credit card debt, while Clegg, much against the wishes of his own party’s advisers, has repeatedly used the household analogy. This is a common sense empathetic appeal to the electorate’s instinct for thrift and belt tightening, and the hardships they will be experiencing in difficult times. Both this and claim 1 are
rhetorical devices designed to create a sense of moral panic about levels of public debt. Unfortunately, there are some rather obvious differences between households and governments when it comes to debt. Household income is not dependent on tax revenues from a complex range of economic activities that follow a variety of cycles and trends within an entire sovereign jurisdiction. Neither do households have a moral and political responsibility for managing an entire national economy, in accordance with a wider ‘public interest’. Households do not have the capacity to determine the supply of a currency they preside over, which enables governments to issue their own IOUs. It is next to impossible for a country with its own central bank to go bankrupt. In short, governments are not ordinary debtors. They have more capacity to create and manage more debt, for many varied purposes and demands, which in turn have to be juggled. In certain circumstances, as democratically elected sovereign authorities, governments have a moral obligation to actively increase debt to protect their citizens from the vagaries of the economic cycle. A government’s calculations, impulses, responsibilities, strategies and possibilities are therefore infinitely more varied and complex than those of a household. Their capacity to take on debt, to pay it off, or to put it on the back burner, by negotiating very
long term options is immense, but also can change quickly in accordance with the rhythms of wider economic cycles. In short, the household and credit card analogy is entirely fatuous and it is not something serious politicians should be reaching for unless they wish to: insult the intelligence of their populations; are sufficiently arrogant to think they can get away with it; or are genuinely economically illiterate?

3. *Spiralling public debt is the result of 13 years of ruinous Labour spending and economic mismanagement.*

When Labour came to power in 1997 they inherited a public debt of 42.5% of GDP, by 2001-02 this was down to 29.7% of GDP. By 2007 as the financial crisis was beginning to unfold, total public debt had risen to 36.5% of GDP, second lowest out of G7 countries at the time. There is nevertheless a plausible argument for saying that fiscal policy was insufficiently counter cyclical during the 2001-2007 boom. While the argument that Labour should have cut spending during the boom period has some merit, it should be accompanied by two health warnings. Firstly, building greater fiscal resources during this period would not have done much to dampen the huge asset bubble that was inflating in Anglo-Saxon financialized economies, and it is difficult to believe that the greater public resources
accumulated would have been sufficient to have offset the huge increases in private debt that caused the crash and later translated into exponential increases in public debt. Second, the increase in public debt during the period 2001-2007 was due to extensive capital investments in education and health, following two decades in which infrastructure in both areas had been neglected. During the 2001-07 period, public debt increased by about 1 per cent of GDP a year. However, the real explosion in UK public debt comes in 2008, following the financial crisis. We have seen a 28% of GDP increase in public debt from FY2007 in the space of 2-3 years. The contribution and size of the bank bail out is difficult to calculate, because of accounting complexities and because the full cost of resolving opaque bank balance sheets through intricate bail out packages are still emerging. Using the ONS data referred to earlier, the bail outs appear to have added 7.3% of GDP to the national debt, but this is undoubtedly a very conservative measure. Taking this measure, 26% of the increase in national debt since the financial crisis would appear to be accounted for by financial bail outs. In 2009-10, tax revenues were £100 billion less, some 17% lower, than the Treasury had predicted at the start of 2008. When we consider that the CSR documents £80.5 billion in spending cuts up to 2014-15, which is pledged by the coalition to bring the deficit down to 2.5% of GDP and the debt to
42% of GDP, the huge scale of falls in tax receipts brought about by the financial crisis induced economic downturn becomes clear. The explosion in public debt is therefore primarily down to a combination of the cost of bailouts, the collapse in tax revenues and the increase in social security outlays resulting from unemployment rising to 2.4 million. Despite references to the structural deficit it is primarily a cyclical debt and deficit that requires economic recovery for it to fall.

The alarm for the UK is the rate at which the annual deficit (annual government borrowing requirement) has been rising. This is currently 11% of GDP. This is the highest annual deficit out of G7 countries. The reasons for this lie in the structure of the UK economy and how badly it was hit by the financial crisis, resulting in the biggest downturn since WWII. 25% of UK tax receipts, prior to the crisis came from financial services. Between 2002 and 2007 British bank balance sheets tripled, and it is widely accepted that the UK financial system was even more heavily leveraged than the US. A global financial crisis was always going to have severe ramifications for the UK, in terms of an overstretched banking sector putting public finances under strain, resulting in big bail outs and a severe contraction in growth. If new Labour stands accused of anything therefore, it is not profligate rampant public spending, despite claims to the contrary, but failing to
address the structural weaknesses of the British economy, notably the over reliance on financial services and the failure to adopt a stricter financial regulatory line. The relationship with the City of London, manufactured for political reasons (and some questionable economic ones) looks in retrospect to have been New Labour’s Achilles heel. New Labour inherited a growth model which they failed to challenge. Instead they took it to the next stage. Serious questions need to be raised about the sustainability of a financialized debt ridden growth model. Austerity offers no prospect, or strategy for overhauling that growth model. Indeed, it potentially makes the UK ever more dependent on rising asset prices as a route to growth. This is evident in the coalition leadership’s claims that cuts were required to keep UK interest rates low.

4. *Bond markets were demanding cuts in public spending and without them interest repayments on government debt would have spiralled out of control, choking off any prospect of UK economic growth.*

Bond markets will be reassured by cuts, as a symbolic act – or a confidence trick, but the trick needs to work, and total public debt and annual budget deficits actually need to reduce, as a consequence of the cuts. If cuts actually result in the debt and the deficit getting bigger (as in
Ireland), because of falling growth, reduced tax revenues and increased expenditures, governments will have a credibility problem. Confidence is subjectivity. Simply offering up spending cuts might buy a government short-term credibility gains, but the cuts alone cannot guarantee even medium term confidence in either bond markets, business more generally or the public at large, because ultimately no government is in a position to determine its own deficit. This depends on the actions of the economic system as a whole and its reaction to government policies. For deficit reduction to become a reality, cuts need to be accompanied by growth. Debt and deficits (see 3 above) are largely cyclical. They fall when the economy rises, and they rise when the economy falls. They act as a stabilizer, protecting the population from severe downturns and offering the prospect of a return to growth, but they also start to reduce once growth and recovery returns. If cuts damage UK growth, as the Office of Budget Responsibility accepts, the debt will actually get bigger, (see the recent Irish experience, and numerous other examples throughout history of large scale fiscal contractions as a response to recession, which actually made public debt worse). Once this occurs a downward spiral of contraction can occur. Cutting spending before recovery is secured, could mean growth fails to materialise. Tax
revenues then remain stagnant and erode further. Unemployment rises and social security outlays increase. This squeezes consumer demand and so business confidence suffers, as do order books, damaging corporate profitability, leading to further unemployment, more social security outlays, and further reductions in tax revenues and so on. In such circumstances, it is far harder to resort to increased public spending to stimulate the economy, because the interest rates the bond markets demand to hold government debt have now risen as confidence and credibility have evaporated, because of the failure of the government’s initial policy. In short, it is far easier to use public spending to support the economy, or at least to keep it neutral until recovery is secured, than to try it the other way round and reverse course once the cuts are underway. If cuts do not produce the required growth to bring down the deficit, bond markets and the voices arguing for cuts now, will demand further cuts, and the government’s fiscal room for manoeuvre will be far less then it is today because market rates on government bonds will have risen. Short term credibility gains by macho posturing (what the government is effectively doing) would therefore be largely illusory and a lengthy period of stagnation and recession would surely follow. Following a 6.8% of GDP fall in output in the UK, reaching a low
point in mid 2009, a positive increase in output only re-emerged in the first quarter of 2010, and with the banking/credit problem still far from resolved, as evident in the Bank of England’s return to quantitative easing, the timing of spending cuts embarked upon by the coalition government, are a high risk strategy. In this sense, the cuts are an attempt at a symbolic confidence gesture, but in a situation that has been far from critical in terms of the ‘confidence’ of bond markets. It is the economic equivalent of putting the cart before the horse – the horse being the restoration of the growth, which in turn leads and moves the cart of bond market confidence in the desired direction. The Republic of Ireland is now discovering the reality of this much to its cost.

5. *Fiscal austerity is expansionary and will lead to private sector growth*

All economic theory is contingent. There is no such thing as a universal economic truth that applies everywhere at all times, irrespective of particular, social, political, economic and historical contexts. Bearing this in mind, as my good colleague at Brown University, Mark Blyth, has recently observed, believing in growth friendly fiscal consolidation in the current conjuncture, is rather like ‘believing in a magic unicorn with a bag of magic dust.’ Blyth is not alone in taking this sceptical view on growth friendly fiscal
consolidation. Similar sentiments have been expressed by Joseph Stiglitz (Columbia University), Paul Krugman (MIT), Dean Baker (CEPR), Robert Skidelsky (LSE/ Warwick), Brad De Long (University of California), Nouriel Roubini (Stern Business School), Avinash Persaud (Intelligence Capital), with all warning of the dangers of premature austerity. You will notice that the other thing that ties this list together is that they were the very voices who called the financial crisis and were right about the dangers and problems brewing. On the other side are those who dismissed these concerns and are now advocating austerity. It is this theoretical school of thought, broad church though it is, that is now being listened to in the drive to austerity. Theories of growth friendly fiscal consolidation are as close we get to an intellectual underpinning for the coalition’s policies, so they deserve further scrutiny.

There are two elements to the growth friendly theory of fiscal consolidation. Two elements that are themselves historically contingent. The first of these elements is based on something called Say’s law and the notion of Ricardian equivalence. Say’s law holds that supply creates its own demand. All money earned is therefore bound to be spent and factors of production will always be fully employed. The notion of capacity being underutilized because of a short fall in demand is not possible under Say’s
law. Say’s law has a specific implication for public spending. New classical Chicago School macroeconomists such as John Cochrane are of the view that if the government borrows a dollar from you, that is a dollar that you don’t spend, or lend to a company to spend on new investment. In other words, government spending acts to ‘crowd out’ private investment. This is linked to the notion of Ricardian equivalence, which holds that firms, households and individuals calculate that increased government spending and borrowing is simply deferred taxation. Households will respond to increased government spending and debt by cutting back on their consumption in anticipation of future tax increases. When spending is cut this creates an expectation of lower taxation in the future, encouraging economic agents to spend and invest more now. Consequently cutting government spending will boost demand, with the increased spending offsetting the money taken out of the economy by spending cuts, leading to the creation of new private sector jobs.

The second element to ‘growth friendly fiscal consolidation’ also relates to the notion of ‘crowding out’. Government borrowing it asserts drives up interest rates. Government demand for money makes credit scarce and increases the price private actors have to pay to borrow. Government spending thus once again crowds out private spending. Cutting government
spending will reduce the cost of borrowing for the private sector through lower interest rates, thereby stimulating a private sector expansion. One recent study by Broadbent and Daly looked at 44 cases of fiscal consolidation in OECD countries over 35 years. In 11 of those cases, spending cuts resulted in sharply lower interest rates, rising asset prices, increased confidence and growth. However, in almost all of these 11 cases, countries were operating close to full output and full employment. Today the UK economy is operating at much lower capacity than in any of the successful adjustment cases considered in the above study. HM Treasury currently puts the UK output gap between potential and actual GDP at 6%. When such evidence is considered, the experimental nature of the British government’s policy becomes clear. We are in unchartered waters. Never before has a government successfully attempted such large cuts when output has been so much below potential. In other words, Britain is a test case.

According to the theory of ‘expansionary fiscal consolidation’ cuts in government spending can therefore provide the policy space for taxation cuts and lower interest rates. Taxation cuts and interest rate cuts are the two transmission mechanisms through which so called ‘growth friendly fiscal consolidation’ works. Observant readers will already have worked out
there is problem with both of these possibilities as a route to growth in the current historical conjuncture. First, given the objective of deficit reduction as the immediate priority for the coalition government, taxes (VAT in January) are set to rise not to come down. Because of the political climate, context and mood created by the coalition, few actors will have ‘rational expectations’ of future tax cuts, at least in the medium term, and therefore are unlikely to be willing to spend more today in anticipation of lower taxes in the future. The political and policy discourse used by the government about the deficit has made it very difficult, if not impossible for it to introduce tax cuts, given that this would potentially undermine the tax base. Second, central lending rates set by the Bank of England’s Monetary Policy Committee are currently at 0.5%. They have nowhere to go. Moreover, rates on government bonds are hardly punitive (see point 1). The problem of course is that banks have not been lending. Banks are not lending, not because government is mopping up all the available cash, as the New Classical model proposes, but because we have just experienced the biggest global financial crash since the great depression, which blew somewhere between a 2 -13 trillion dollar hole in the global financial system. Consequently, banks have been attempting to clean up very messy balance sheets, or ‘deleverage’ – clearing up bad debts and ‘hoarding’
money to cover the costs of toxic assets. Rather than the state ‘crowding out’ the private sector as the new classical model would have it, I would contend that what is actually happening in the UK, is that a bloated, oversized and debt ridden financial sector is actually being allowed to devour parts of the state. The uncertainty associated with bad debts in the banking system and the need to fill holes in corporate balance sheets are the principal reason, why banks have only been willing to lend only at punitive rates. To facilitate this balance sheet cleansing, or ‘deleveraging’ the Bank of England have been practising quantitative easing round 2 (QEII), or pumping money into the system. Consequently, because neither of the two mechanisms that generate growth in notions of growth friendly fiscal consolidation appear to be open to the coalition in the current conjuncture, the coalition’s entire macroeconomic strategy seem to rest on the possible success of QEII. Namely, that QEII will result in banks increasing their lending on more generous terms, thus stimulating private sector activity, creating the growth needed for government debt and the deficit to reduce. Given that the losses associated with the global financial contagion of 2008 are still unravelling this is an extremely high risk gamble. Surely nobody

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3 One of the more nonsensical claims that we will hear made is that this hoarding is the result of future onerous regulatory requirements for banks to hold more capital. But capital requirements, or capital buffers are being made counter cyclical, that is that reserves have to grow in tandem with lending, investment activity and balance sheets.
with a basic grasp of probability would stake their entire political career on such gamble, unless of course there was something else driving the strategy, - a less risky, but more overtly political gamble. Before I turn my attention to that in the final section of this paper, there are two other problems with theories of growth friendly fiscal consolidation that need to be discussed.

The first is that despite being a macroeconomic theory, growth friendly fiscal consolidation is actually based on a view of the world and a methodology (individual rational expectations – see Say’s Law and Ricardian equivalence) that is too micro, and insufficiently macro. That is that this approach is so busy looking at the incentives and ‘rational’ behaviours of individual firms, households and consumers, that it loses sight of the implications of these incentives and rational behaviours for the system as a whole. In other words, it is guilty of a fallacy of composition – what makes sense and is good for an individual actor, can be a disaster for the system as a whole, if all of these actors try the same thing, at the same time. In an era of global economic integration, this oversight is a fatal mistake. Currently, banks are cleaning their balance sheets, households (confidence shaken by events) are tightening their belts – spending less, companies are seeking to reduce their debts, and now since early/ mid 2010 virtually all G20
governments too have decided to clean up their balance sheets – more or less simultaneously, as they repeatedly and somewhat mindlessly, chant the mantra of growth friendly fiscal consolidation. In other words, we currently have something called ‘synchronized austerity.’ Global demand is shrinking, and rising unemployment, as an uncharacteristic recent IMF report indicated, is becoming a problem. In this context of shrinking global demand, the Chinese are devaluing their currency to make their exports competitive, which is already drawing a protectionist response from the US Congress. This also removes exchange rate depreciation as a viable policy tool for most ailing western economies, as a strategy by which to grow their own exports. Not everybody can rely on currency devaluation at the same time. Consequently, both currency wars and trade protectionism are lurking in the shadows of the current global political economy. Today’s situation is therefore much closer to the 1930s collapse of demand, when austerity policies proved disastrous and led to a resort to protectionism, than to the inflationary troubles of the 1970s. Unfortunately, current UK politicians seem to know only the lessons of the 1970s and have turned their back on the insights of the man who called the 1930s right, every step of the way – John Maynard Keynes.

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4 The United States remains the exception, but given the current political complexion of Congress and Republican and Tea Party demands for cuts for how much longer?
The second problem relates to this last observation. It is that growth-friendly fiscal consolidation emerges from the same stable of ideas that came to prominence in the 1970s and which got us into this sorry financial mess in the first place and should have been discredited as a consequence of this crisis. The fact that these ideas are back in the driving seat in the domain of fiscal policy is the first of two poisonous ironies of this crisis. More about the second one shortly. The rational expectations new classical model of the economy, using Say’s Law that supply creates its own demand, contends that stimulus cannot tackle unemployment, since workers have as much employment as they want. Unemployment is therefore a rational voluntary preference for leisure over work. The implicit assumption underlying this theory is perfect information. Actuarial computation allows for the accurate calculation of probability, reducing uncertainty and risk, creating a natural equilibrium between supply and demand. Efficient market theory pioneered by Eugene Fama, consequently claimed that on the basis of perfect knowledge, markets would accurately price risk. It is these theoretical premises that feed the belief that financial markets could be left to regulate themselves, because a mis-pricing of risk was if not impossible, extremely improbable. Moreover, markets self correcting nature would also create as much employment as is desired, making
government intervention and stimulus redundant and disruptive. Unfortunately, as we have just seen, risks can be mispriced by the market, because peaks and troughs in confidence can and do drive asset values to extremes. New classical economic theories based on rational expectations under conditions of perfect information, provided the intellectual justification, rationale and underpinning for both efficient market theories and growth friendly fiscal consolidation. Given that they also gave rise to the modern risk management paradigm of self regulation that has underpinned international and UK financial governance and regulation for the last 20-30 years, the financial crisis should really have killed these theories off once and for all.

The problem with the UK government’s current strategy is that there is no theory of growth underpinning it. This is evident in the scrapping of the government’s white paper on growth last weekend (Nov 20, 2010). It is not even a green paper. Currently it is little more than a briefing note and Cabinet Office insiders have suggested this is the case because there is nothing substantial to go into it. In other words, there is a complete lack of ideas about growth. If the cuts don’t work and the fall in output means that the debt doesn’t come down, there is a duel problem – big debt, no growth. This will mean the markets will want double reassurance in the form of more return to
hold government debt, so that the costs of servicing government debts will go up and the whole exercise of cutting will have been completely and utterly pointless in terms of achieving the stated initial objectives (deficit reduction) – but at considerable human and social cost. In this respect, the government’s policy is simultaneously a political and economic gamble as well as an economic and social experiment, and worryingly there is currently no plan B.

*The political opportunism and expediency of the coalition*

In the circumstances, it is worth probing whether or not the government *genuinely* believe that fiscal consolidation can actually be expansionary in the current conditions. One hope they appear to be clinging to, as discussed above, is that QEII will pull things round for them. This is combined with another belief. Namely, that the cost of servicing the debt through interest rate payments is likely to exceed the underlying trend growth rate of the economy for a prolonged period. That would raise the possibility of insolvency for the UK government at some point in the future. It is possible that it is this calculation that is informing government strategy. What should be clear from this is that the notion that the government has been forced into the cuts and had no other option is a myth. Rather the policy is premised not on what is happening right now, but what might be
happening in the future – an effort to convey future intentions. In other words, the entire enterprise is based on a series of forecasts, models and predictions that are highly uncertain given the nature of the circumstances we find ourselves in. Some of the calls this involves include: whether global long term interest rates are likely to rise and stay higher – this in turn will depend on whether China, other BRIC and GCC states boost domestic demand, reducing global levels of public and private saving; whether real GDP growth will shrink relative to the rates typical of the last two decades and with them tax revenues. In other words, to intellectually justify and rationalise the policy, some highly uncertain judgement calls have had to be made. Such as there is reasoning and logic behind the fiscal policy proposed by the government it is a highly speculative, and some might say, even tenuous one.

The other uncertainty at work here is the confidence the bond market has in UK government bonds and the rate demanded as a risk compensation to hold UK government debt. The cases of Greece and Ireland indicate that market sentiment can change quickly, but crucially those states are trapped in a monetary union and much of their debt was held by foreign banks. In the UK it is held by British citizens in pension funds that have an interest in avoiding destabilizing the whole show. Yet when we look at the evolution of
Conservative party policy, bond market confidence and the prospect of falling confidence leading to rising interest rates on government debt appear to have been the crucial catalyst in the step by step chrystallization of the stringent austerity agenda.

The Conservative party pledged to keep to Labour spending plans during much of their time in opposition and only began to advocate a much tougher line on public spending in June 2009. This coincided with the ratings agency Standard & Poor’s hinting that the UK government’s triple A credit rating could come under scrutiny. Note that ratings agencies judgements had been found desperately wanting in rating structured financial products and credit derivatives that had collapsed during 2007-08, yet here they were setting the public policy agenda. In late November 2009, Morgan Stanley published a speculative research note that pondered the prospects of whether fall in bond market confidence could lead to a UK fiscal crisis. These were merely instances of market actors raising some questions and considering a range of possibilities. It did not suggest that a collapse in UK government debt was imminent. If this was market pressure it was very mild. It was the sovereign debt crisis in December 2009 and January 2010 in Greece and other peripheral euro zone states, that coincided with and provided the catalyst for Osborne to become even more
strident in advocating fiscal austerity, as seen in his Telegraph piece of December 21st, expressing the fear that the UK would become like Greece, and so needed to take action to prevent rising interest rate payments on UK government debt. By responding to supposed market pressure in this way, the Conservative Party was once again casting the same institutions that had caused the financial boom and collapse, and that had dominated financial policy making for the previous two decades, in the role of judge and jury - as the ultimate arbiters of public policy. This is the second poisonous irony of this crisis. The same banks who were shorting government bonds in the Euro zone and exacerbating the debt crisis, by exercising their verdict that government debt was too now big, were in many cases either direct beneficiaries of earlier government bail outs, or had their exposure to toxic, contagious, bad debts reduced as a consequence of those bail outs. The most direct beneficiaries of the world wide increase in public debt (collectively worldwide governments spent between 30 and 50% of GDP guaranteeing various financial sector liabilities,) were now reaching judgement calls that public debt was excessive and therefore dictating public policy, and moreover politicians and policy elites were allowing them to. In Britain, this happened rather too easily. Standard & Poor’s and Morgan Stanley did not need to lean on policy
makers, so much as nod gently in their direction. These market actors were essentially pushing at open door when it came to the British Conservative Party. The signs of this were clear less than month after the collapse of Lehmans, when Osborne claimed, ‘even a modest dose of Keynesian spending, increasing it by say 1% of GDP is a cruise missile aimed at the heart of the recovery.’ This was at a time when governments around the world adopted a Keynesian response, which in the circumstances, produced a relatively short period of negative growth. Osborne’s claim drew an interesting and withering response from his current cabinet colleague colleague Vince Cable who remarked “George Osborne is clearly way out of his depth.” Osborne’s reflex’s and instincts were to move to austerity all along, but openly devising an austerity programme was not electorally advisable, or politically possible, in the immediate post crisis environment. Changing market narratives allowed Osborne the political space to devise an austerity programme. He was aided in this enterprise by some hawkish voices in the Treasury and the Bank of England, that became concerned that market demand for auctions of government bonds was falling. A combination of these circumstances allowed what Keynes referred to as the Treasury view of the 1930s, to capture the British economic policy agenda.
The other interesting element about Conservative Party Strategy has marked a new and worrying direction in post war British politics. Osborne in early 2009 began to predict a sterling crisis. This broke long standing conventions that aspiring Chancellor’s of the Exchequor should not openly talk down the pound and wish a crisis into existence, lest it become a self fulfilling prophecy. He dropped these claims abruptly presumably on advice from his own party officials, but by December that year he was openly comparing the UK to Greece and again predicting a financial market led collapse in confidence in the UK, - this time emanating from the bond market. In volatile financial times this willingness to invoke the spectre of crisis, is either extremely foolhardy, reckless and dangerous, or more likely driven by a desire to discredit Labour, safe in the knowledge that such a crisis was extremely unlikely to materialise. Such a strategy of course has diminishing returns. Chancellor’s do need credibility with the markets and do need to be able to offer re-assurance. Credibility in the financial world accrues from a track record of making the right calls, advancing analyses that turn out to be correct or accurate, not by injudiciously shouting one’s mouth off. This was not just Osborne’s individual recklessness. It was a more far reaching element of Conservative Party strategy. In May 2010, the ‘avuncular’ Kenneth Clarke appeared in the BBC Newsnight studio, two
weeks prior to the election, cheerfully warning the British electorate that a sterling crisis was likely if the election failed to deliver an outright Conservative majority, producing a hung parliament and a coalition government. Consequently, current Conservative Party leadership have a consistent track record, of falsely warning of eminent financial disaster, (although not when it really mattered,) to essentially serve political and electoral purposes.

Austerity then in its current manifestation appears to have been driven largely by political opportunism, rather than either financial necessity, or a compelling economic rationale. The picture becomes more worrying when it becomes clear that the plan is for a fiscal tightening of £110.3bn by 2014-15, composed of 73% in spending cuts and 27% in tax rises. The plan as laid out by the Office of Budget Responsibility is for 1.3 million jobs to be created between 2010 and 2015, which are required to allow the deficit and debt to come down. We know that 490,000 public sector jobs are to go and the coalition’s own estimates say that a further 700,000 private sector jobs will be lost. Consequently, over the next five years the plan depends on the private sector generating 2.5 million jobs. The coalition hopes exports will expand but in the last quarter the trade in goods and services deficit in the UK was the worst since 1955. Begbies Traynor, the business recovery
specialist currently estimates that 123,361 UK companies are in significant financial distress owing a total of over £575 billion, to creditors and suppliers. Post crisis, with consumer demand low, large parts of the private sector in the UK are not in any sort of financial or competitive shape to make the quantity or quality of investment to fill the gap left by the government’s spending plans. Widespread unemployment and hardship therefore look likely, and Cameron’s we are all in this together appeals suggest the coalition government know that this will be the case. Notably, however the entire narrative and discourse of the government, evident in their exaggerated claims about bankruptcy and sterling crises, is that they are clearing up a ruinous mess left by the previous government. Their political gamble is that they can sell to sufficient numbers of the electorate the message that the coming hardship is all Labour’s fault. This is why it has been imperative, from a political perspective, that the cuts agenda proceed immediately, – not out of immediate economic necessity, but for the political reason of striking out while the previous government still loomed large in the electorate’s collective consciousness. Delaying public spending cuts would not only have constituted an implicit admission that there was an alternative route or strategy available, it would also have distanced Labour from the problem and made the current government more readily
associable with cuts, meaning the message of cleaning up Labour’s mess would have been diluted and even lost. The political imperative was to start announcing cuts straight away.

*Was there an alternative?*

For a government wishing to cultivate the confidence of bond markets, there was a far more, potentially growth friendly and socially just strategy than the ‘one stop’ game of chicken the government have essentially opted to pursue. As Robert Skidelsky has pointed out here was an opportunity to put in place a new independently monitored and genuinely counter cyclical fiscal constitution based on some simple rules. Yes, the deficit and UK debt needs to come down, but not at the expense of growth during a period of private sector distress. Fiscal policy needs to respond to the economy, not be mapped out for five years irrespective of patterns of growth and unemployment. A five year fiscal plan that is pledged to be implemented come what may, in a time of uncertainty, is not a route to credibility. If the plan has to change and be revised because of changing economic, market and political conditions – where is the credibility? Spending cuts are being introduced too soon and pledged too far in advance. A counter cyclical framework consisting of a system of automatic adjusters according to measurements of GDP growth, would enable
spending to be reduced when recovery is assured, increasing the possibility that fiscal policy could contribute to bringing down the debt and the deficit in a sustainable fashion, according to a clear set of criteria that be communicated to the markets. This would enable fiscal policy to remain mildly stimulatory, or at least neutral, until growth exceeds 2.5% of GDP for at least two quarters in a row. Exceptions could also be made should the government’s credit rating be seriously questioned, rather than simply being subjected to idle musings, as has recently been the case. This would provide more counter cyclical flexibility within clear parameters allowing the government to be able to respond to events, rather the current hostage to fortune ‘plan.’

Conclusions

1. The economic rationale for the CSR looks flimsy, there is no theory of growth underpinning it and the figures in relation to levels of private sector growth required to make it work do not add up. Moreover, never before has austerity worked when total economic output has been so much below potential. In this context, current UK government policy looks like a giant unprecedented economic experiment.
2. Government claims of ‘no alternative’ do not stand up to scrutiny. The more the government insists it was painted into a corner, the more likely this becomes if the initial plan fails to bring down the deficit. Current government strategy is a one off ‘golden shot’, all or nothing affair. If it does not work there genuinely will be no alternative, because rates demanded by bond markets will create a necessity for more spending cuts.

3. The principal driver of the strategy looks to be political opportunism and a concerted effort to pin the blame on the last government. This is the coherent thread running through the narrative the government are constructing and it explains the timing of the cuts and the sense of urgency. The hope is that such claims will make Labour unelectable for the foreseeable future. Government policy is a political gamble as well as an economic experiment.

4. It is too early to say how ideological all of this is. Clearly there are some ideological beliefs behind the agenda, but the process of arriving at this strategy looks to be driven more by political reflexes and instincts, rather than full blown ideology and any degree of intellectual coherence. Conservative positions look to be politically opportunistic first and ideological second, although the two obviously feed into one another.
Ideas and beliefs are being seized upon by the government, but there is little evidence of a systematic well thought out belief system and vision of society informing the austerity agenda.

5. As early Institute of Fiscal Studies’ analysis revealed, the cuts will hit low income groups hardest, thus targeting and penalising the weakest and most vulnerable members of our society for a massive increase in private sector debt that, in the main, they had relatively little to do with creating. Government strategy looks to be an effective way of fermenting class politics, social polarization and dislocation. Keynes verdict on the Conservative party in the 1930s as the diehard do nothing party, more interested in waging class war, looks as pertinent ever. The tragedy is that Keynes own party - the Liberals have been complicit by turning their backs on his legacy, at a time when it is sorely needed.