TUC

# The price of austerity

How spending cuts damaged the economy, and how they could do so again

## Summary and recommendations

Austerity has suppressed UK economic activity for the last five years and kept resources under-utilised. This is why the UK has experienced the slowest recovery on record.

While the quantity of jobs has increased, they have often been low quality. Working conditions have been seriously undermined, there has been a significant increase in underemployment, and the fall in living standards has been longer and deeper than in any previous slowdown.

Of course growth has picked up in the last two years (as we approach the election). This is because (despite slashing public services) the Chancellor slowed the overall cuts programme after 2012 and there has been additional monetary stimulus from the Bank of England. But the growth we have seen is on the back of a big increase in household debt as well as a record balance of payments deficit. There are now signs that the recovery is slowing, just as it becomes clear that it has been too weak to have had much impact on the government's central economic commitment of reducing the deficit. Depressed wages have reduced the tax take and mean that deficit reduction has stalled. The threat of deflation from a permanently depressed level of activity is growing.

Yet the Chancellor – if re-elected – plans another round of deep spending cuts early in the new government, in a repeat of what he did after 2010. Such cuts would inevitably slow the economy, and there is a real risk - on the basis of Office of Budget Responsibility (OBR) projections of spending – that we could go back into recession.

A shallow pre-election recovery may suit the political needs of the government, but does not make a long-term plan or sustained economic recovery. Austerity has failed in the UK, just as it has across Europe and much of the world. A real recovery, that includes the many, needs an end to austerity through large-scale spending on infrastructure, an end to the public sector wage freeze and pay rises across the economy. Almost forgotten is the government's commitment to rebalance the economy. Investment has underperformed, trade has disappointed and consumer debt (rather than equitable wage growth) is powering the growth we have. Instead the government have adopted an ideologically driven, rather than economically sensible, target for a surplus in the public finances, and otherwise seem happy to return to an economy that looks much the same as it did before the crash. This ignores the real problems exposed by the near collapse of the global economy in 2008. Yet the system is potentially still vulnerable to the excessive indebtedness that built up before that crisis and the banking and financial system in the UK and across the world is still fragile. A far sighted government would act now to strengthen industrial policy and reform corporate governance, protecting us from the imbalances that caused such damage in the past.

## 1. Introduction

The government's failure to reduce the deficit is now obvious. A five-year programme has become ten years, with the scale of cuts proposed roughly doubling and more than half still to come. Less attention has been paid to *why* the public finances have gone so far off the rails.

This report shows that the cuts have been self-defeating. The failure to reduce the deficit is a result of deteriorating economic conditions that are a direct result of the cuts themselves. In other words a vicious circle:

- austerity has reduced government demand
- reduced government demand held back economic growth
- the labour market and wages weakened to accommodate reduced growth
- reduced labour income growth means reduced government revenues as the tax take falls, so at best deficit reduction has stalled with a cumulative failure over this parliament amounting to around £150bn in extra borrowing.

Cuts in government spending therefore result in falling government income. Spending cuts, rather than reducing the deficit, end up having little impact on it. But lower levels of government spending not only hit vital services but depress the whole econony leading to falling living standards and an economy that is working well below its potential.

International evidence re-inforces this argument. We have seen the same story in all advanced economies. Reductions in growth across developed nations correspond closely to the extent of austerity programmes.

In addition:

- Monetary stimulus in the UK has led partly to asset and debt inflation rather than increased production and higher living standards.
- Policymakers continue to misread low productivity as a result of capacity constraints; but while there are supply-side polices that can boost capacity and help rebalance the economy, there is no productivity puzzle – low productivity is just one of the ways that that the economy has adjusted to weak demand.
- Weak demand and the resulting failure to efficiently use the economy's resources has caused seven years of falling real wages.
- Low wages and low demand mean many economies – including the UK – now face deflationary pressures; this is a particular threat to economies with high levels of private debt.
- The extraordinary severity of the cuts the OBR say are necessary to meet the current Chancellor's election programme would lock the economy into a cycle of further decline and even threaten recession.

The alternative is to end austerity, and reverse the policy-levers with large-scale infrastructure spending and policies to boost wages, including an end to the public sector wage freeze, coupled with supply-side reforms to banking, industrial policy, corporate governance and skills.

This report starts from an empirical analysis of recent outcomes. It is based on official statistics which extend to 2013 as a whole (as at the September 2014 Quarterly National Accounts), and the December 2014 OBR forecast (their last *major* forecast before the general election).

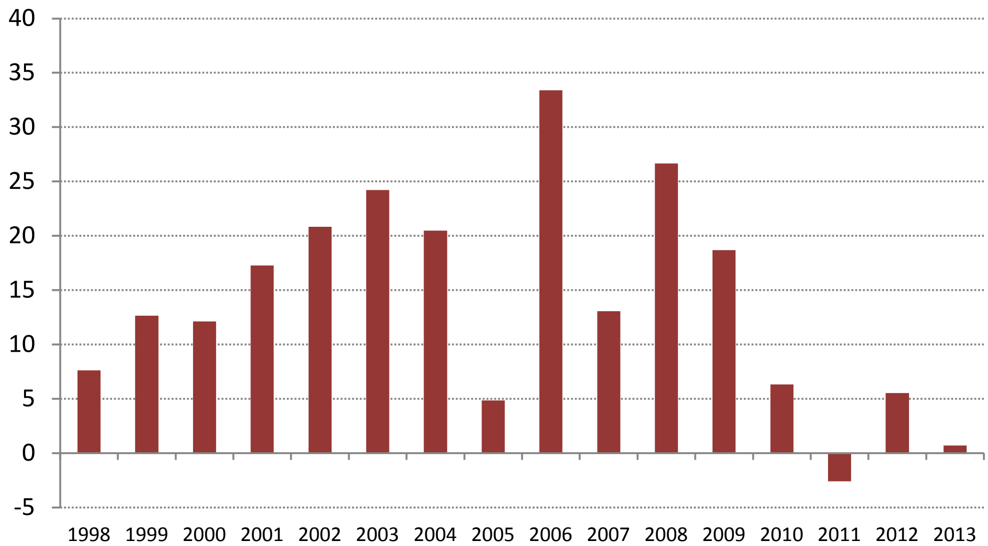
The analysis is based on nominal / cash figures, as cash outcomes are the most relevant for considering public sector finances.[1]

## 2. Austerity and government demand

Austerity has defined the government's policy over the course of this parliament. It is difficult to measure the scale of cuts precisely as figures tend to be based on a comparison with previous plans (often 2009). Any estimate will additionally depend on assumptions about growth and inflation.

From the point of view of macroeconomic outcomes, the most relevant measure is government final demand, which includes government consumption and investment expenditures.[2] Chart 1 shows that cash increases in government final demand have been very subdued relative to increases in previous years.

Chart 1: General government final demand, annual change £ billion




[1] Real figures abstract from developments in price that are integral to overall outcomes; in particular the labour market expansion is underpinned by increases in quantity (employment) at the expense of price (wages). In addition, analysis of cash figures is not distorted by the way that official tatisticians derive real terms measures of government output, and any analysis of multipliers should also be based on cash figures. While such analyses of government spending have been based on levels of spending, here the intensity of demand pressures are judged mainly through contributions to aggregate growth, with comparisons between activity before (2004 - 2008) and after (2010 - 13) the crisis; as the most severe year of crisis, 2009 is omitted.

[2] Transfers such as debt interest and benefit and pension payments tend to be excluded as they are (broadly) non-volitional, and any associated flows of spending are captured elsewhere in GDP (e.g. in household spending).

The post-crisis annual increase in spending averaged £2½ billion a year, compared to the four pre-crisis years of around £19½ billion. Even under the coalition there has still been a net injection of demand, but only just, although figures suggest spending in the crucial pre-election year of 2014 has been much stronger (see below).

This means there has been a net reduction of around £17 billion a year in demand across the five years of parliament, or around £85bn in total.

## 3. Aggregate demand and economic growth

The previous government's economic stimulus was cut off soon after the election, even though the economy was still relatively fragile (the last negative quarter of GDP growth was 2009 Q2). Office of National Statistics (ONS) data suggest that the stimulus was working. All areas of private demand were coming out of recession at a fairly quick pace. But the new government's austerity economics led to slower growth.

Chart 2 shows GDP growth against growth in government spending in cash terms. Annual economic growth rates of between 4 and 6 per cent slowed to figures of between 2-4 per cent since the crisis. Looking at averages, growth slowed from 5.0 per cent before the crisis (2004-08) to 3.7 per cent after the crisis (2010-13).[3]

[3] The figures would be worse, if 2008 and 2010 are omitted as well as 2009. The change in real terms is a little lower, because some of the shortfall is accounted for by lower inflation, but this is irrelevant to the arithmetic here.

Chart 2: GDP and government final demand growth, per cent

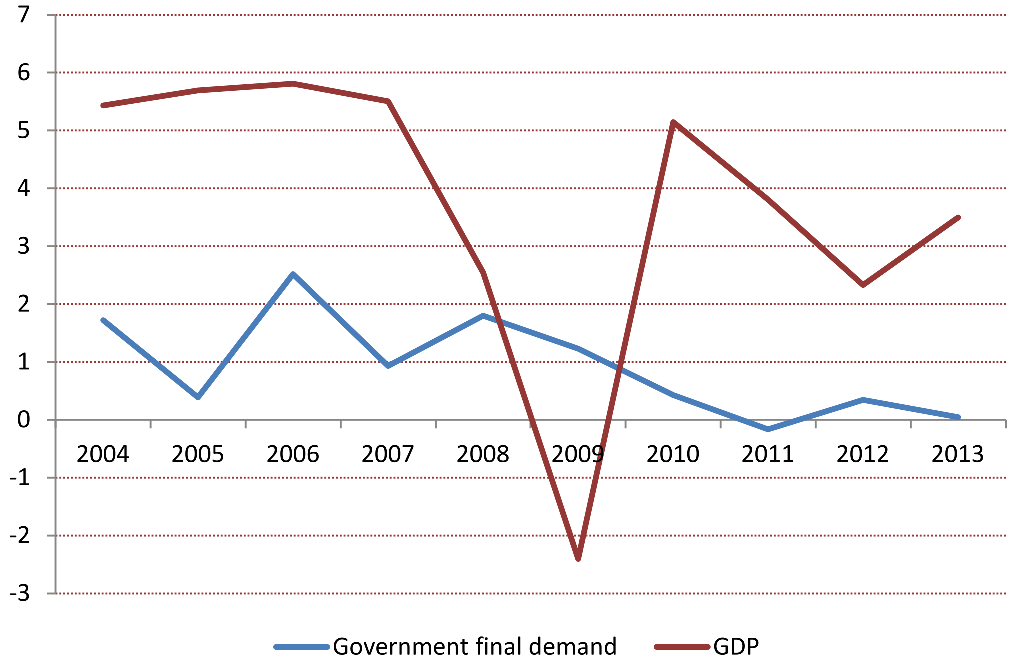
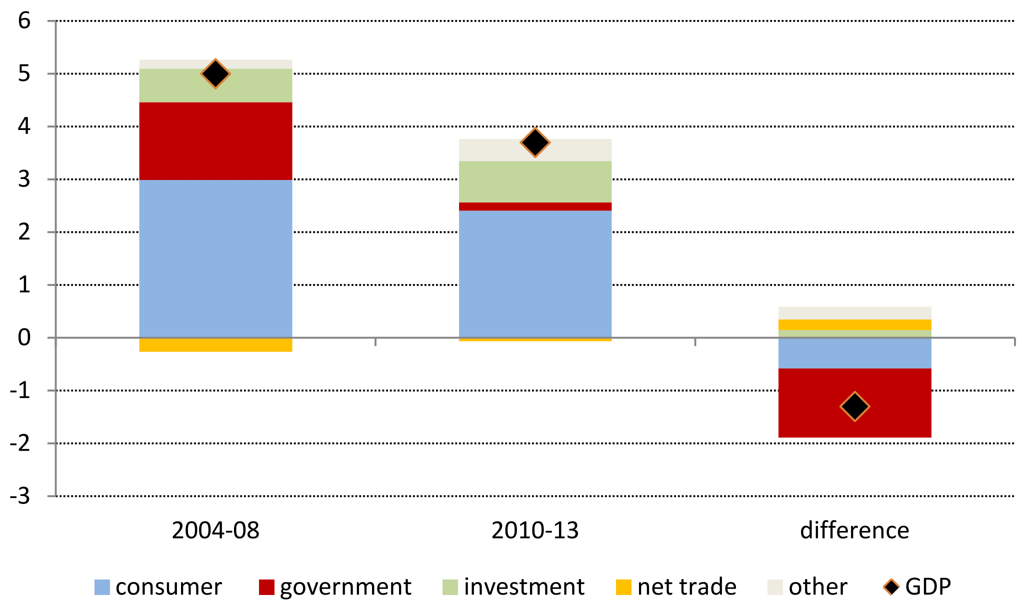



Chart 3 shows the expenditure contributions to GDP growth, first before the crisis, then under the coalition, and then the differences. It is clear that the whole of the shortfall in growth of 1.3 percentage points is accounted for by the reduced contribution of government (in fact -1.31 of -1.30 ppts).

Chart 3: Contributions to GDP growth, percentage points



This is exactly the opposite to what austerity advocates expected. The government said that reduced spending and 'hence' improved public sector finances would boost confidence in the private sector and lead to a revival in activity.

But, as the chart shows, investment spending hardly changed and consumer demand fell.

The OBR has argued that the slowdown in the economy followed from weakening overseas demand after the Eurozone crises. But in both the pre- and post-crisis periods net trade has made a negligible contribution. While the wider international economic outlook will no doubt have impacted on the UK, given the limited contribution trade has historically made to our growth prospects it is hard to see how it can have been substantial.

This government inherited an economy which had started to recover, driven by stimulus in the UK and overseas. But it was fragile, and the removal of the stimulus set matters in reverse.

## 4. The false analogy of the household budget

The Chancellor has compared the nation's budget to that of a household.

It certainly looks as if this is how he thinks about the economy as it is the basis of the government's calculations. They expected that a deficit of between £100 and 150 bn (depending on the actual definition used) would be brought into balance by annual spending cuts of around £20bn a year over five years (and some tax changes).

Plainly a household can repair its finances by cutting back on spending. This will not have any measurable impact on the wider economy. But government spending accounts for around a quarter of overall spending (final demand) in the economy. When the government cuts it does affect the wider economy. The government is not like a single household. It is not a helpful metaphor for understanding how a national economy works. But it is perhaps worth noting that a quarter of UK households is in excess of six million; if six million households all cut their spending – or for that matter increased it – it would have a wider impact on the economy.

The government's assumption that they can reduce spending with little economic impact has been shown not to be true. To put this in technical economic terms, their belief that the multiplier was very low is wrong. In fact a reduction in government demand growth has led almost 1:1 to a reduction in the growth of GDP. The UK government and the OBR need to catch up with the International Monetary Fund (IMF) who have changed their own estimates. The Treasury and OBR multipliers seemingly are still based on the old IMF view. This misjudgment is common among UK commentators, particularly those who share the small-state preferences of the Chancellor. An updated view of multipliers is set out in section 6 below.

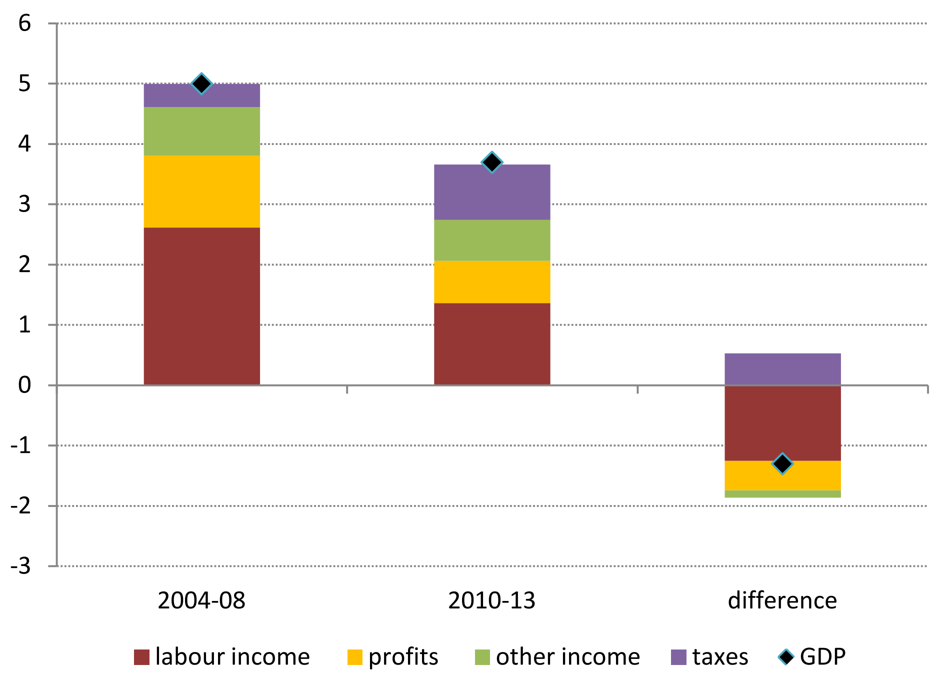
## 5. How weak growth has fractured the labour market

Employment has certainly done better during the recession and its aftermath than many expected. Instead, the impact has been on pay and through a deterioration in the types, security and quality of work.

In macroeconomic terms, as with aggregate GDP growth, the sum of the parts still adds up to a shortfall in overall performance. It has just manifested itself differently during this economic slow-down. The gains in employment are more than offset in terms of aggregate impact by the shortfall in earnings. While it may have been preferable to share out the misery, it would have been better to avoid it in the first place.

The impact of austerity on the labour market comes in two broad stages. First, reduced GDP growth is shared between profits and labour. Second, labour market income is shared between earnings and employment. Chart 4 shows contributions to the income measure of GDP, across the same periods as the preceding chart.

Chart 4: Contributions to GDP(I) growth, percentage points




Reduced GDP growth causes both reduced labour income (strictly, compensation of employees, which includes wages and salaries and employers' contributions to pensions) *and* reduced profits (more properly, gross operating surplus).

Other income – which includes that going to the self-employed, a group that has expanded rapidly – is little changed, indicating that the expansion has been more than offset by lower wages.

The only component of GDP to rise (on this cash basis) is tax, as a result of the increase in VAT. (With both labour and profit income falling, the respective labour/capital shares have remained fairly stable over this period – it has not been the case that profits have gone up at the expense of wages as both have been squeezed, though the share has tipped away from labour over 2014.)

The main adjustment of the labour market is within the 'wages and salaries' component of compensation of employees. In theory, 'wages and salaries' is the sum of the earnings of all employees. In practice, its growth is roughly the sum of employment and earnings growth. As with GDP, these can be shown before and after the crisis (Chart 5).

Chart 5: Decomposition of wages and salaries growth


Despite recent jobs growth, labour income growth in aggregate terms has reduced, just as with GDP. Within the labour market the reduction in economic growth has led (almost) entirely to lower earnings growth rather than unemployment.

This is nothing to celebrate. Workers have had to accommodate themselves to the reduced growth in aggregate incomes. Any gains in employment have been at the expense of wages. New jobs have been concentrated in low-paying occupations. Underemployment, part-time work, temporary work, poor quality and bogus self-employment have increased. Insecurity has grown with with zero-hours contracts and agency working is on the increase. The government has reduced protection against unfair dismissal making it straightforward for employers to sack people in their first two years of a job.

This adds up to a structural change in the labour market towards low-cost and insecure work. None of this rules out ongoing expansion of full-time jobs (given aggregate demand is still expanding), it just makes low pay and underemployment much more likely than in the past.

Incomes have now fallen continuously for seven years as consumer price inflation has continuously outstripped earnings growth. The government's preferred measure of real household disposable income per head is not expected to return to the level it was in 2009 and 2010 until later in 2015. This is the largest and most prolonged fall in living standards since records for the UK began.

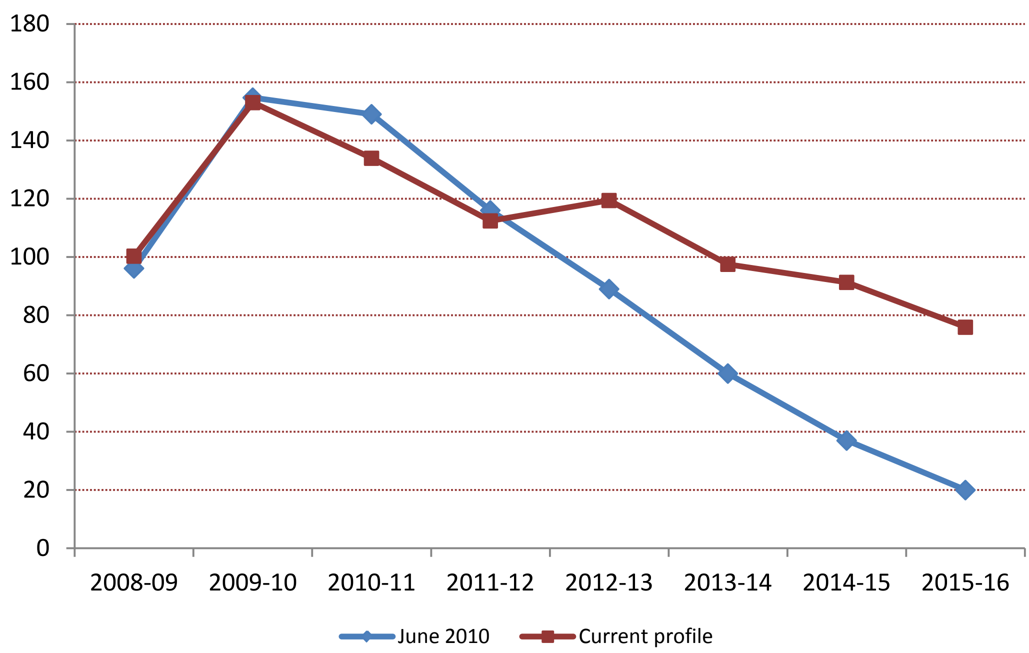
This is how the workforce has paid the cost of austerity. Yet it is not only socially unjust but also unnecessary. And as we have seen in section 3, shrinking the state shrinks the private sector too. Aggregate activity has suffered as government demand has been withdrawn.

## 6. From weak incomes to failing government finances

When incomes and economic activity fall, tax revenues fall too. A collapse in income tax and other government revenue streams such as national insurance contributions, VAT and corporation tax is now clearly visible.

This has meant that any improvements in the public finances have stalled. Chart 6 compares the latest out-turn information and the most recent forecast with the original projection made in June 2010.

Chart 6: Public sector net borrowing, £ billion




By 2012-13 borrowing was £30 billion more than planned in 2010 by the new government. The gap has grown by about £10 billion each year.[4]

The cumulative shortfall against the original profile (i.e. to 2015-16) is £153 billion. The government now expects the deficit to be half its peak by 2015-16. Their original intention was that it should be 10 per cent of the peak by next year.

[4] Note that this is likely to flatter the actual outcome given the current figures include transactions that were not anticipated in the original profile such as the Bank of England returning to the government interest payments on government debt that has been purchased as part of QE.

This shortfall is explained by the relation between cuts in government spending and reduced growth in the economy.

It is not controvertial to claim that spending cuts reduce growth – the debate is about how much. The OBR view is that the multiplier – the impact that cuts have on growth – is 0.7. But many economists have suggested that multipliers are higher, particularly when economies are depressed. For example in 2009 the US Council of Economic Advisers in 2009 considered the multiplier effect to be 1.5, and recent indicative figures from the IMF suggested multipliers in advanced economies had ranged from 0.9 as 1.7.

As set out above, cuts of around £17bn a year reduced GDP growth by around 1.3 percentage points a year. With GDP at around £1,700bn, this was equivalent to a cash reduction of £25bn a year. If we project forward, at the end of five years of cuts of £85 billion, GDP will have been reduced by £125 billion. (These figures suggest that the 1.3 percentage point contribution of reduced government spend to reduced GDP growth reads across directly to a multiplier of 1.3.[5])

The overall impact on the public finances compared to expectations in June 2010 is *cumulative*. So if in the first year aggregate GDP is £25 billion short of expectations, it will be £50 billion in the second year, through to £125bn in the fifth year.

This means that by the end of the parliament the total shortfall in GDP against plans will be £375bn. This arithmetic model may be somewhat simplistic, as it ignores potential lags in impact as well as other factors influencing economic growth over this period. However, the estimated total shortfall corresponds very closely to the cash shortfall in GDP between the OBR's June 2010 projections and the latest outcomes.[6] Our assessment is that the majority of this shortfall is a

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[5] This figure is not out of line with the multiplier of 1.5 proposed by the US Council of Economic Advisers in 2009, as well as recent indicative figures from the IMF. It is way above the OBR estimates on government final consumption of 0.6 and investment of 1.0. That said, there is little literature on how to estimate multipliers in the context of growth of expenditures rather than levels of expenditures.

[6] The table below includes the June 2010 OBR projections for the level and growth of nominal GDP. These are compared with a projection for levels based on the latest ONS growth figures to 2013 and latest OBR forecasts, to give a total cumulative difference of £374bn. This is a helpful and reassuring cross-check.

Projections for the level of nominal GDP, £ bn

| | 09-10 | 10-11 | 11-12 | 12-13 | 13-14 | 14-15 | 15-16 |
|---|---|---|---|---|---|---|---|
| **June 2010** | | | | | | | |
| level | 1408 | 1474 | 1539 | 1620 | 1710 | 1803 | 1902 |
| growth | | 4.7 | 4.4 | 5.3 | 5.5 | 5.4 | 5.5 |
| **Dec 2014** | | | | | | | |
| growth | | 5.1 | 3.2 | 2.3 | 4.1 | 5.1 | 3.7 |
| projected level | 1408 | 1480 | 1526 | 1561 | 1626 | 1709 | 1772 |
| *Difference* | | 6 | -13 | -59 | -84 | -94 | -130 |
| *Cumulative difference* | | 6 | -7 | -66 | -150 | -244 | -374 |

direct result of austerity slowing growth prospects, and that the actual UK multiplier effect has been larger than the OBR anticipated.

The actual shortfall in exchequer revenues depends on how this shortfall affects different parts of the economy: profits, employment, self-employment, and salaries for example. Others have made estimates of this. The OBR estimated that for 2013-14 around £30bn of an overall shortfall in receipts of £52bn was accounted for by weaker income tax and national insurance receipts. The hit to income tax is particularly heavy because low-paid work is increasingly untaxed. Income tax revenues are boosted by high wage growth rather than just by high employment growth.

Low wages also mean that the government has had to meet a higher than expected bill for tax credits and housing benefit. The government has also had to meet the costs of raising the income tax personal allowance, which means that many low paid workers no longer pay income tax, although the main cost of the change comes from the benefits to those on higher household incomes.

The government has also reduced corporation tax beyond the OBR's expectation, resulting in a loss of £9bn. Any picture of the public finances is complicated by these give-aways to certain sections of the electorate, and others – such as changes to tax credits and other in-work benefits - that take money away from those on low incomes.

But in very broad terms the projected total GDP shortfall of £375bn is well in line with the cumulative shortfall in the public finances of £150bn, corresponding to a ratio of 40 per cent, and broadly in line with the share of the economy accounted for by the public sector.

The vast scale of these shortfalls shows just how wrong the household budget analogy is. The tax shortfall shows that multipliers are much higher than the Chancellor or the OBR thought. Instead of the OBR estimate of around 0.7, this analysis of the cumulative impact on the economy and public finances suggests a multiplier of around 1.3 (though any such estimate appears to depend on the specific conditions when cuts are imposed, as discussed further below). In non-economic terms, spending cuts are self-defeating as they slow the economy so much that the tax take falls substantially and the deficit is barely reduced at all.

## 7. International evidence

Both the Organisation for Economic Cooperation and Development (OECD) and IMF now say that inadequate demand explains current economic difficulties. This is not what they said in the early years of the crisis. Their view at that stage was that low productivity was the problem (rather than a symptom) and that

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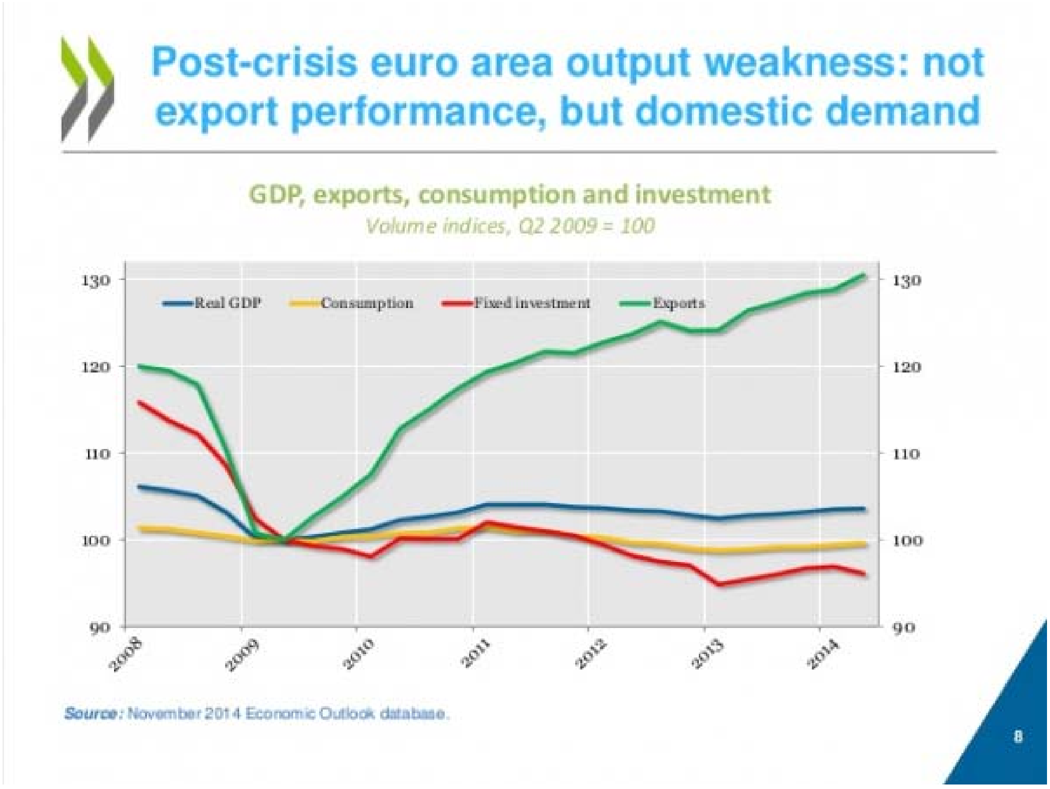
Note that a direct comparison cannot be made with the latest OBR profile for nominal GDP, because these are based on the revised ESA 2010 methodological standards that ONS implemented in autumn 2014. These added around £100bn to the level of GDP, disproportionately affecting incomes outside wages and salaries.

therefore supply-side policies to increase 'competitiveness' and allow countries to trade their way out of the crisis were the solution.

Periphery economies saw the largest gains in productivity (though it is difficult to establish whether these were entirely planned). While these led to gains in exports, the OECD have illustrated wider developments in the euro area as follows, in the commentary around their latest *Economic Outlook* (2014).




For the euro area as a whole (as well as for individual countries), high export growth did not compensate for weak growth in domestic demand. (These processes are examined in more detail in a separate discussion on productivity, TUC, 2015.)

But we can use the same analysis we applied to the UK in Chart 3 above to assess the effects of austerity across the OECD by breaking down growth before and after the crisis into its component parts.

Chart 7 shows in nearly all cases a negative effect on GDP from reduced growth in government demand, and it varies in severity according to the size of the reduction. In no case did another source of demand expand to compensate for reductions in government demand. In fact reductions in government demand have led to reductions in all other aspects of demand. (The only exception is Korea, where a minor reduction in government demand was accompanied by a moderate expansion elsewhere.)

Countries where government demand growth has expanded, Germany, Israel and Japan, are the only economies where economic growth has increased in the post-crisis relative to the pre-crisis period.

The analysis reinforces the contrast between the "tremendous amount of fiscal consolidation in periphery countries" and the more limited amounts in the core observed by the OECD.

It also puts the UK into perspective when we look at how much worse other countries have fared. But this does not vindicate the approach our government took, it just shows other countries have been even more misguided.

For a handful of these countries (Greece, Portugal, Spain and Slovenia), nominal GDP growth has not only been reduced but forced into the negative. Under these conditions 'productivity' gains are even more irrelevant, with likely associated falls in wages and salaries growth leading to the deflation threat that is discussed in section 10.

Chart 7: Contributions to change in GDP growth between 2004-2008 and 2010-2013, ppts

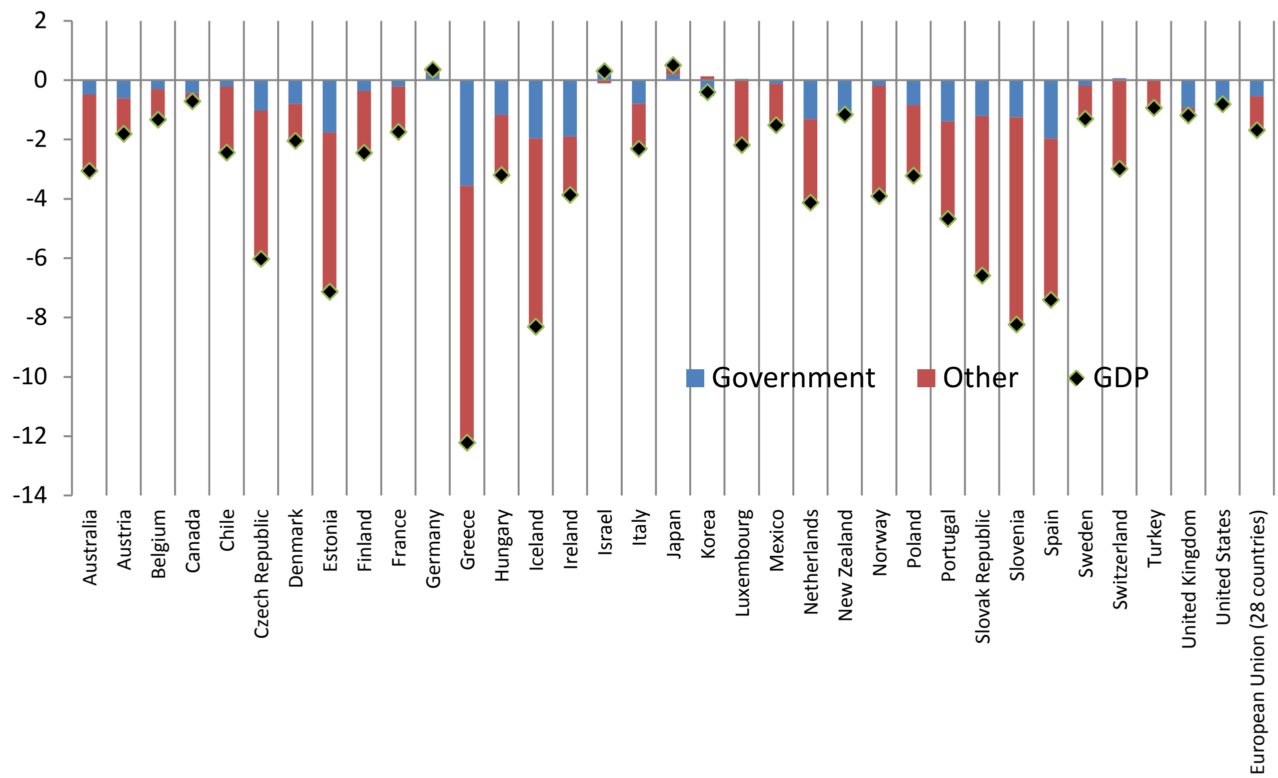
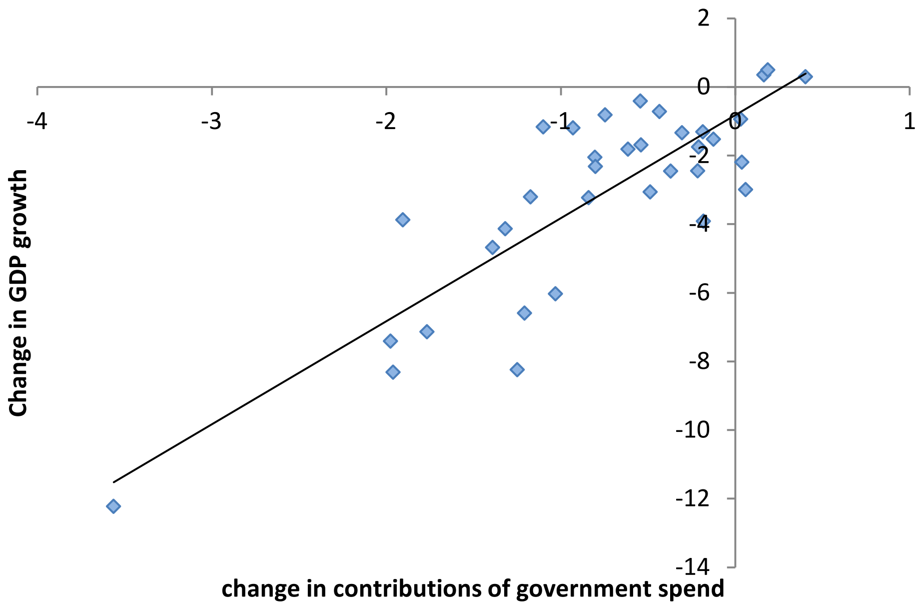



Chart 8 is an alternative presentation of the same figures as a regression of government demand against GDP. The correlation is around 0.8 and the slope around 3 (and these are only marginally influenced by Greece).

The fact that a straight line is a good fit for Chart 8's data points, taken with the previous detailed analysis of GDP in the UK, is a strong indicator of an average multiplier. While there is variation by country (particularly for lower reductions in government spend), this is likely to be linked to the initial conditions when austerity was implemented, as well as issues such as different national policies on tax and benefits. Against the figures discussed earlier, a multiplier of 3 is very high, but plainly many economies have been devastated by these policies.[7] The figures are also unequivocal that the best way to prevent reduced growth is increased government spending. Germany and the two others are fortunate in having taken that approach.

Chart 8: Change in government contributions against change in GDP growth




## 8. Monetary expansion and private indebtedness

Austerity was implemented against a backdrop of not only public but also private sector indebtedness. The scale of these private debts over the 2000s is widely regarded as the underlying cause of the global recession, with the UK among the biggest debtors in the world.

There has therefore been a perceived need for 'deleveraging', reducing debt as a share of income. This sits uneasily with the wider policy stance where expansionary monetary policy takes up the slack for fiscal restraint. After its initial impact of calming financial markets, monetary expansion seems to have worked primarily by fostering asset and debt inflations.

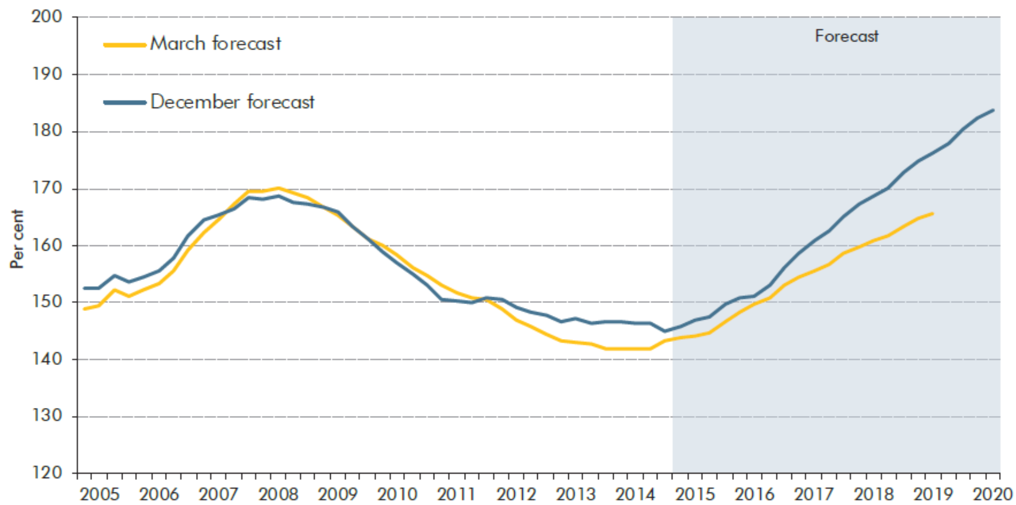
The major monetary initiatives of this parliament came around 2012 when it was already clear that growth and deficit reduction were already falling short. Forward guidance, funding for lending and help to buy caused a house-price boom (though the market may now be cooling). There have been major expansions in corporate asset markets, for example commercial property, equities

[7] In his *General Theory*, Keynes used the newly-constructed US National Accounts to derive an investment multiplier of "less than 3 and probably fairly stable in the neighbourhood of 2.5", though this was "both a lower figure and a more stable figure … than I should have expected" (127-8).

and bonds. In spite of deficits, government debt for major economies is trading at record prices.

There are then growing concerns over increasing household debt (see OBR figure below), the ongoing high levels of corporate debt and the deterioration of the current account to a record deficit of 6 per cent of GDP. All such increases show how expansionary monetary policies have also served mainly to increase domestic spending out of line with domestic production and income. Reports from debt relief charities such as StepChange suggest the pressures on households are severe.

Chart 3.31: Household gross debt to income




Source: ONS, OBR

Buttiglione et al (2014) argue that, “Contrary to widely held beliefs, the world has not yet begun to delever and the global debt-to-GDP is still growing, breaking new highs ...”. The UK remains among the highest debtors of all developed countries, second highest (behind Japan) if the financial sector is included. Debt is still significantly higher than before the crisis. This position not only means severe pressures on individuals and perhaps firms, but suggests an underlying fragility, leaving the economy vulnerable to panic in financial markets, but also to deflationary forces.

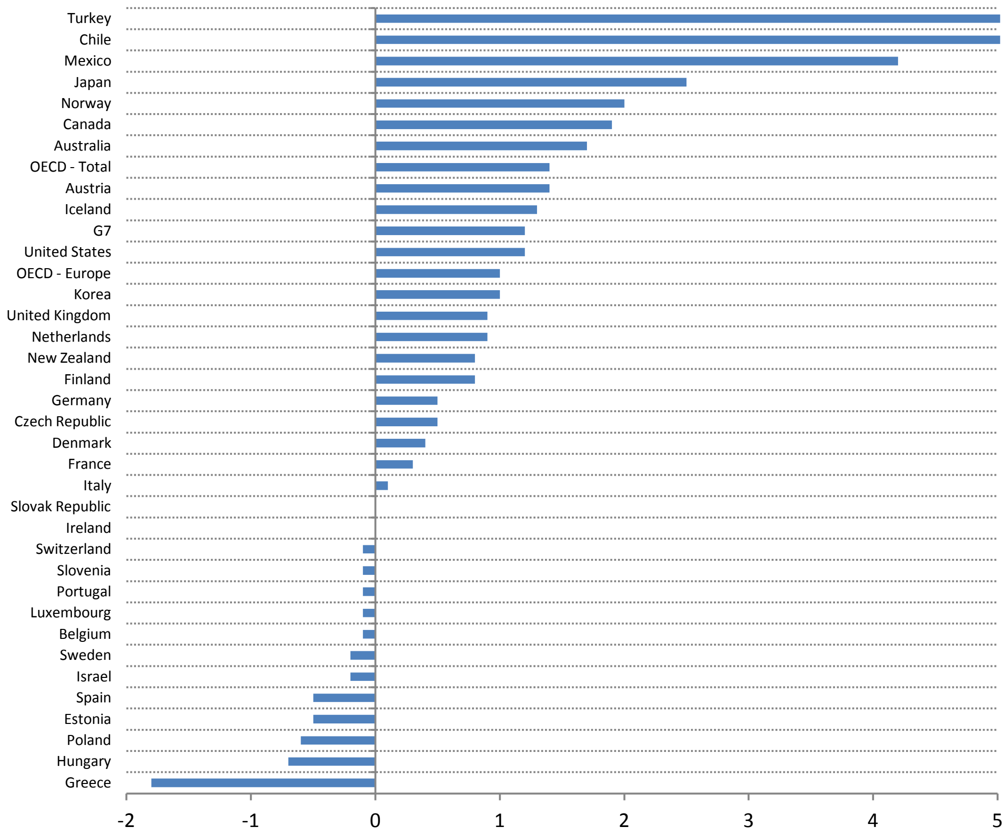
## 9. Capacity and deflation

Over 2010 and 2011 relatively high UK inflation was regarded as evidence that capacity was tight and the output gap relatively narrow, even though they were plainly affected by various factors related to the crisis (not least VAT changes and the weak exchange rate).

Since then the scale of the reduction in inflation has repeatedly surprised policymakers. Only a year ago the OBR were expecting CPI inflation of 2.3 per cent in the final quarter of 2014; the out-turn was 0.9 per cent. The Bank of England now expects inflation to fall to zero in the coming months, and quite possibly into negative territory. Yet these hugely significant changes have scarcely changed any judgements about capacity in the UK.

This is a global phenomenon. In 2014 Q4 there were 12 OECD countries with falling prices (Chart 9). The OECD are increasingly recognising that these outcomes reflect the disinflationary – if not at present outright deflationary – stance of fiscal policy.

Chart 9: CPI annual inflation, Q4 2014, percentage




But in the UK, even as recently as December, two MPC members were voting to raise interest rates. This misreading of economic conditions follows the excessively mechanical way in which productivity outcomes are interpreted, which has been discussed elsewhere (TUC, 2015).

To recap: weak productivity figures follow from the way that the labour market has adjusted to weaker GDP growth - mainly through *price* (wages growth) rather than *quantity* (employment growth). This adjustment and the associated productivity figures are a *consequence* of the weaker aggregate demand that is shown on Chart 2 to be caused by withdrawn government spending.

Yet both the OBR and Bank of England (BoE) believe that poor productivity is caused by deteriorating supply conditions. This mechanical approach leads unused capacity to be written off. Yet the evidence we present here suggests this is wrong. Capacity has not been used because of a lack of demand, and it remains available for future use.

This approach only allows us to understand the amount of spare capacity in broad terms. At the very least, any shortfall against the projection of GDP growth made in June 2010 ( before austerity began to bite) is likely to be spare capacity. In reality this is likely to be a significant under-estimate. As Martin and Rowthorn (2012) argued, there are good reasons to judge that the economy was operating with spare capacity ahead of the crisis. Most obviously, the failure of an economic model based on the interests of the wealthy and speculation should not be taken as an indication of the potential of an economy based on productive activity.

Spare capacity is most obvious in the labour market, where good job figures hide both unemployment and underemployment. The ILO unemployment count remains at 1.9 million and is still higher than before the crisis; temporary and part-time work are increasingly important; self-employment numbers and associated earnings estimates suggest people doing anything they can to try to stay afloat. Further evidence is provided by the repeated unprecedented lows in official earnings figures over the past three years, and equally by very low growth in unit labour costs, normally regarded as by far the most important determinant of inflation outcomes.

Yet despite our symmetric inflation target, policy makers seem resolved to disregard these price signals, although they would probably create hysteria if they were over the 2 per cent target. There is a determined political effort to present recent misses as good news.

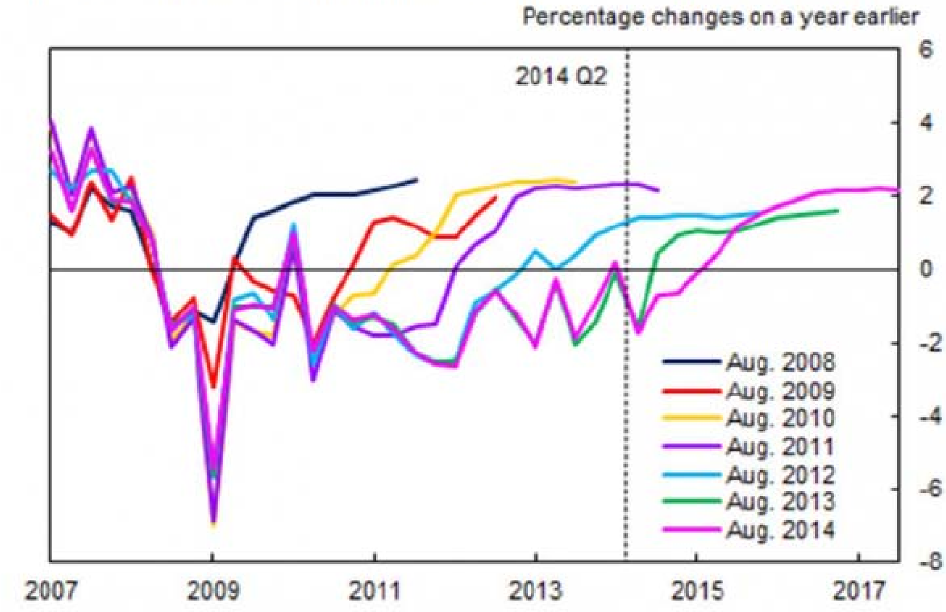
Yet because government policymakers cling to an entirely illusory notion of capacity, the economy has been condemned to operating with vast resources underutilised with seven years of falling real earnings. And it could well get worse. Given the scale of private indebtedness discussed above, the threat of debt deflation cannot be discounted. On top of this, most of the proposed spending cuts have yet to come.

## 10. Outlook

Just as productivity is central to the official assessment of spare capacity, it is equally important in official forecasts. The dominant, but mistaken, supply view believes that the economy will improve and wages grow by supply-side measures to improve productivity.

As Andy Haldane, chief economist at the Bank of England,  has recently observed: "the MPC [monetary policy committee], in common with every other mainstream forecaster, has been forecasting sunshine tomorrow in every year since 2008", showing the following chart of forecast real-wage recoveries:

**Chart 8:** Bank of England *Inflation Report* projections for real wages

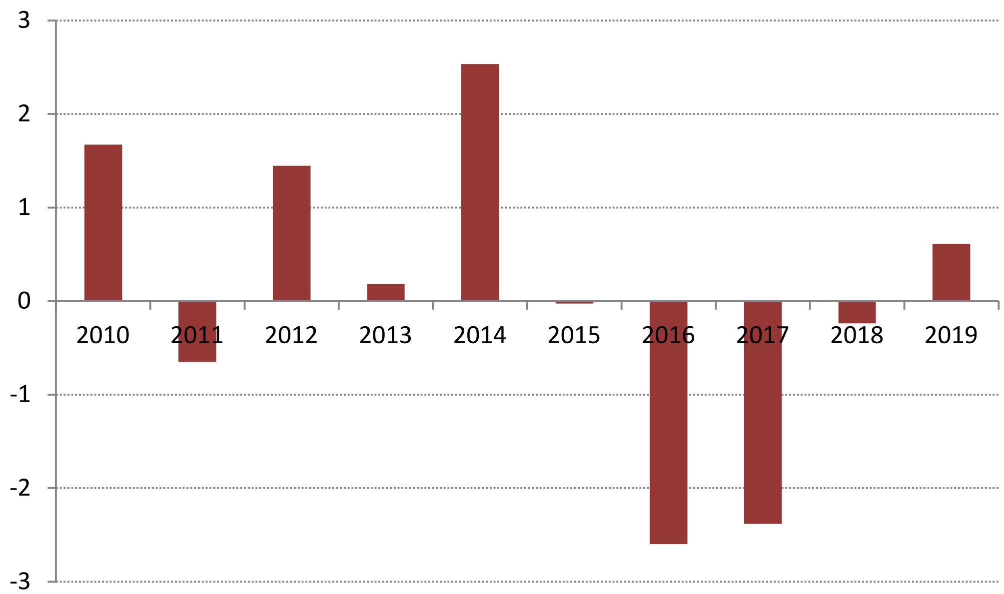



Most forecasters cover their backs by recognising that there may be no revival in productivity. But the recovery has failed to materialise because any revival of productivity depends on a revival in *demand*, not unpredictable quirks of the supply side. In turn, the *actual* outlook for the economy depends on the outlook for demand, which is bleak.

As seen, the bigger than expected impact of austerity on economic growth has led directly to a failure to meet the Chancellor's deficit reduction target. This in turn leads mechanically to further spending cuts, which this analysis shows will hit demand and incomes as they take effect.

The OBR projections, based on the government's future plans, now show actual *cuts* in nominal government final expenditure. These are huge as can be seen from Chart 10.

Chart 10: Growth in government consumption and investment expenditures




The only precedent for cuts on this scale (on records that extend back to 1830) is the disastrous Geddes Axe of the 1920s. In their December *Economic and Fiscal Outlook*, the OBR does not duck how painful this would be, seemingly thinking it very implausible.

But the analysis here suggests that the impacts will be even worse than the OBR anticipates. On the basis of the experience of the current parliament, the proposed scale of cuts will lead to greater reductions in GDP growth, even lower wages, and an ongoing failure to reduce the deficit.

In the context of an increasingly fragile global outlook and deflationary conditions compounding the drag from the underlying indebtedness of the private sector, resumed recession must be a real possibility.

At the very least an unchanged policy course will degrade services and social conditions as well as depress the economy and undermine living standards.

Confronted with the OBR's assessment, the government has tried to distance itself from the implied scale of future cuts. Spending growth in 2014 showed some flexibility. As ex-Chancellor Kenneth Clark recently conceded, when the economy seriously faltered in 2012, the government held back from the intensification of austerity that policy doctrine should have demanded (although the cuts that have been made to public services remain severe).

There has been a typical 'political business cycle' to austerity, with the most severe cuts early in the parliament. The stronger growth in government final demand as we approach the election made a cash contribution of [£3.3bn] to the aggregate GDP increase of [£20.4bn] into 2014.

This has certainly provided some relief, but is tiny when set against the scale of austerity across the current parliament as a whole and the pain and depth of the proposed cuts to come.

## 11. Policy

According to the argument above, the failure of austerity to restore public sector finances is because spending cuts have hit demand more than expected.

Nonetheless the impact of austerity is complex. On the one hand fears that cuts might put the economy back into recession proved too pessimistic. A number of factors may explain this:

- Economic conditions in 2010 were better than understood at the time, with the private sector recovering from the great recession at a fairly rapid pace.
- Despite cuts government demand still increased over the whole of the parliament.
- The impact of the various monetary interventions such as QE (on a domestic and global basis) throughout.

On the other hand, the analysis above shows there has been a very material impact on the rate of growth and conditions in the labour market.

Predictions that austerity policies will not restore the public sector finances to health therefore seem vindicated. Outcomes are a matter of degree. In the periphery of the euro area cuts were savage. Their disastrous impact wholly vindicates the opponents of austerity.

The only conclusion is that intensifying austerity will ‘simply’ intensify the negative outcomes that have we have already seen. Yet public discourse in the UK still takes austerity to come as a given, even though the IMF and OECD have been courageous in disowning failed policies, and looking instead to policies that increase demand, not least infrastructure spending.

Before the country is consigned to another parliament of misery, there must be a place for a serious and impartial examination of why austerity policies have entirely failed in their primary aim of bringing the public finances under control. There should be a review of the macroeconomic techniques, not least the output gap and multiplier and associated assumptions, against which spending plans are interpreted. In the meantime, in failing to recognise that failures of outcome are failures of austerity, mainstream economic debate sets up a dangerous narrative for the coming election that, if followed through, will perpetuate indefinitely the economic self-harm under the current coalition government.

The logical conclusion is the positive, macroeconomic one. Cuts have failed, but spending increases will succeed in restoring the public sector finances and prosperity. This is not to argue for permanent and across-the-board increases to spending, or tax giveaways. We need spending that will be effective in boosting the economy, such as infrastructure spending, and that will immediately reverse the greatest injustices. Conversely, competition for corporate taxes is counter-productive and inequitable. The extent and duration of any policies aimed at demand stimulus should be reviewed in the light of outcomes, given the revealed and plainly apparent failure of understanding of fiscal initiative.

But austerity is only one facet of the wider response to the global financial and economic crisis. The present government in their wider approach have shown no desire for reform, and are seemingly content to restore the pre-crash economy. For decades the economy has been servant to the interests of finance, and the casino activities of the city of London.

This is why we need progressive supply-side changes that can help rebalance the economy such as investment in skills, active industrial policy, corporate governance reform and support for R&D. These will bite much harder when the economy is growing, and no longer being suppressed by austerity.

The hardships endured over the past five years have been entirely unnecessary. As was understood long ago, the slump is avoided by expansion not contraction:

> "Worst of all has been the orthodox theory that bad trade calls for economy – economy in all new development, both public and private, economy in bankers' loans, economy in wages, economy in social services, economy in employment, economy in enterprise, "freedom from thought." This disastrous doctrine dominated British policy between the wars. The Geddes Report, the May Report, the Snowden folly in 1931, all illustrate it. … The Labour Party was right when it declared that all this was the exact reverse of the truth, and that the supposed cure only made the disease worse. The best cure for bad trade is to increase purchasing power and speed up development. The best preventative of bad trade is to maintain purchasing power and likewise to maintain a steady and well balanced programme of development."
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## 12. References

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