IN SEARCH OF AUSTERITY:
AN ANALYSIS OF THE BRITISH SITUATION

Anthony J. Evans
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ABSTRACT

**This paper intends** to provide a basic overview of the fiscal position of the United Kingdom. The UK government’s response to the recession has been to eliminate the structural budget deficit over the medium term. However, this paper argues that the reason spending as a proportion of GDP is expected to fall is due to implausible growth forecasts rather than an absolute reduction in spending.

*JEL code: E62*
This paper intends to provide a basic overview of the fiscal position of the United Kingdom. The 2008–2009 recession has been deeper and more sustained than the two previous recessions (in 1990–91 and 1979–81). When the present coalition government formed in 2010, it made deficit-reduction measures a key part of its economic strategy. Indeed, then-opposition leader David Cameron used the phrase “age of austerity” in a speech in April 2009 while attempting to portray the incumbent government as having caused the financial crisis through excessive spending. With gross domestic product (GDP) slipping back into negative growth in Q4 of 2011 and Q1 of 2012, the economic debate about the impact of fiscal policy on economic activity reached fever pitch. Whether the austerity measures the government has introduced have been the cause of this lethargic recovery or whether the lack of growth suggests that austerity measures are in fact a myth is a subject of heated debate.¹

Section 1 presents official forecasts of government spending and looks into the composition of changes within different departments. Section 2 focuses on the importance of GDP forecasts when assessing the scale of spending changes, and provides some rudimentary scenario analysis. Section 3 analyzes government plans for the balance between spending cuts and tax rises. Section 4 defines and critiques the focus on fiscal adjustment as a means to define the stance of fiscal policy. Section 5 looks at some of the political economy of austerity measures. Section 6 briefly concludes.

1. GOVERNMENT SPENDING IS INCREASING

The term austerity often is used to refer to a reduction in a government’s budget deficit, and logic dictates that there are two means to achieve this: reductions in government spending or increases in tax. In the same way that a traditional fiscal stimulus tends to refer to a fiscal expansion focused mainly on the spending side, an austerity program is a fiscal contraction also focused on spending. For example, Paul Krugman refers to fiscal austerity as “slashing spending in an effort to balance their budgets,”2 and indeed most economists who advocate austerity are focused on cutting spending. This makes sense given the origins of the word. “Austerity” came into wide usage during World War II, as government policy caused a reduction in the availability of luxury goods and induced “simpler” living.3

The most obvious place to look for signs of austerity is in government spending. Figure 1 shows the nominal amount of total managed expenditure (TME) in the United Kingdom from 2010–11 through 2016–17.4 One might think this would be enough to stop the debate: Spending increases.5

That government spending continues to grow does not mean actual cuts do not cause genuine hardships. The problem is that commentators use evidence of specific cuts to make an inference about the global picture. It is important also to look at the breakdown of spending. Simply looking at the expenditure limits of the departments of the government (see table 2 in the appendix) reveals that the nominal total is increasing, from £322.5 billion in 2011–12 to £327 billion in 2014–15. Indeed, most departments are seeing increases. In the two years following 2012, the budgets for all departments rise by an average of 7.7 percent: 13 departments receive an increase in budget, 10 see a decrease, and 4 do not change. Over three years, the increase is 4.5 percent: 11 see budgets rise, 14 see a cut, and 2 see no change. The main reason for this is that one of the biggest departments, the National Health Service, is also the most politicized and its budget was protected.6 The inevitable result of increasing debt repayments and excluding large departments is that the remaining ones are

3. “Austerity” derives from the Greek for “severe,” “stern,” or “harsh,” which also explains why it often operates as a value judgement as opposed to a descriptive term.
4. In 2012–13, expenditure is temporarily reduced by £28 billion due to the transfer of assets from the Royal Mail pension plan to the public sector. Total managed expenditure adjusts for this (See HM Treasury, Budget 2012, 54).
5. Some may argue that these figures have not been adjusted for inflation and that real spending is projected to decline. But in theory, it is supposed that nominal variables matter in the short run. See Tyler Cowen, “Economic Growth Is Not Contractionary, and Other Confusions about Stimulus and Spending,” Marginal Revolution, May 9, 2012, http://marginalrevolutions.com/marginalrevolution/2012/05/economic-growth-is-not-contractionary-and-other-confusions-about-stimulus-and-spending.html. Moreover, when realistic forecasts are used, spending is going up relative to nominal GDP, and any inflation factor in nominal spending is cancelled out when divided by a GDP figure that also is not adjusted for inflation. See figure 4.
6. Indeed, increases in spending on health and defense meant that in Q1 of 2012 public spending grew by the largest amount in the previous four years.
FIGURE 1. TOTAL MANAGED EXPENDITURE IN THE UNITED KINGDOM

Source: HM Treasury, Budget 2012.

FIGURE 2. TOTAL RECEIPTS AND NATIONAL ACCOUNT TAXES

Source: HM Treasury, Budget 2012.

Note: The figure uses “National Accounts Taxes” as a better indication of the tax burden on individuals because “Current Receipts” are the total government revenue that also includes things like contribution to the EU budget interest and dividends. See Office for Budget Responsibility, Economic and Fiscal Outlook, tables 4.6 and 4.7, March 2012.
more likely to be cut. Local governments have to cope with significant reductions in resources, and some public services will undoubtedly suffer. But these are changes in the composition of government expenditure, not a fall in the absolute level. They should not cause a recession.

2. GDP FORECASTS

One of the most widely used figures in public finance is the comparison of government spending and tax receipts used in the budget. As figure 2 shows, the government plans to drastically reduce the amount of government spending to narrow the gap between spending and receipts.

Note that the numbers in figure 2 are given as a proportion of GDP. Figure 3 reproduces the supposed smoking gun of the critics of austerity—the declining rate of TME to GDP (right-hand side y-axis). It also shows the growth rates of the level of TME and the level of GDP, where 2010–11 is set to 100. Two things affect the ratio of TME to GDP: changes in TME and changes in GDP. Figure 3 shows that the fall in the TME-to-GDP ratio is driven by the fact that the denominator (GDP) is growing faster than the numerator (TME). It is more smoke and mirrors than smoking gun.

The Treasury uses GDP forecasts from the Office for Budget Responsibility (OBR), but that is just one of a number of forecasting organizations. For example, the OBR forecast for 2012 GDP growth is +0.8 percent. However, as of May 2012 the median forecast of the Treasury’s survey of independent organizations was only +0.4 percent (with the lowest forecast at −0.5 percent). If one were to substitute the official GDP forecast with the median forecast of independent economists, the ratio of government spending to GDP will rise (see figure 4).

Based on the official figures, there are savage spending cuts, but you could just as easily explain the same as overly optimistic growth projections. Note that both the government and the opposition are incentivized to stress the former. The government does not want to argue that the OBR is overestimating the health of the economy, and the opposition wants to stress the severity of the spending cuts. Thus, political incentives ensure that the myth continues.

3. THE BALANCED APPROACH

Government budgets contain a combination of tax and spending decisions, and we should not focus solely on changes to TME. In reality, a balanced approach relies (to varying degrees) on tax increases and spending cuts. The chancellor George

8. For illustrative purposes, I compare the OBR forecasts for GDP with a GDP,* which grows at half the rate.
FIGURE 3. GOVERNMENT SPENDING VS. GDP

Source: HM Treasury, Budget 2012.

FIGURE 4. OFFICIAL VS. ALTERNATIVE FORECAST OF SPENDING-TO-GDP RATIO

Source: HM Treasury, Budget 2012.

Note: GDP* represents an alternative GDP forecast to grow at half the rate of the official OBR forecast for illustrative purposes.
Osborne presented plans in 2010 to engage in £83 billion of spending cuts and £29 billion of tax increases (that is, a split of 75:25) by 2014–15, which is in line with academic literature suggesting more emphasis should be on spending cuts. Osborne inherited £73 billion of this total austerity package from the previous Labour government, to which he added £40 billion. According to a BBC report, the Labour Party proposed a split of 67 percent cuts and 33 percent tax increases, and the party’s leader Ed Miliband personally favors a 50-50 split.

The main problem, however, is reality rarely reflects intentions. We can see this in two ways. The next section argues that official forecasts overestimate the ability to deliver spending cuts. But in this section we see the implications of this: fiscal tightening will be financed more by tax increases than expected. For example, of the £38 billion actually reduced from the deficit since 2009–2010, only one-quarter came from spending cuts. The rest resulted from tax increases.

In 2011, the United Kingdom had higher rates of personal income tax than any other G20 country, and current receipts from major taxes are rising from 37.3 percent of GDP in 2010–11 to 37.9 percent in 2016–17 (see figure 6 in the appendix). A number of new taxes adopted during the recession mean current receipts are expected to rise from £550 billion in 2010–11 to £735 billion in 2016–17 and national accounts taxes should rise from £529 billion to £704 billion (for a sample list see appendix). This is in direct contrast to what austerity advocates propose.

4. FISCAL ADJUSTMENT

Thus far this paper has focused only on the budget deficit, but we can break it down into different indicators. Table 1 presents forecasts from the Office for National Statistics for both the budget deficit and the public debt from 2010–11 through 2016–17 (see figures 7–10 and table 2 in the appendix).


12. See Heath, “It’s Austerity All Right.”

13. See HM Treasury, Budget 2012, chart 1.11.
### TABLE 1. BUDGET DEFICIT AND PUBLIC DEBT 2010–11 THROUGH 2016–17

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<td>£bn</td>
<td>% GDP</td>
<td>£bn</td>
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Source: HM Treasury, Budget 2012.

*Known as “public sector net borrowing.” See OBR, Economic and Fiscal Outlook, table 1.2, March 2012, or HM Treasury, Budget 2012, 24, table 1.4.

°HM Treasury, Budget 2012, 109–110. The data is published by the Office for National Statistics with series codes “Public sector net debt ex” (HF6W) and “Public sector net debt ex as a percentage of GDP” (HF6X).

Although the budget deficit forecast shows a decline, future deficits—even if smaller—will continue to increase the public debt burden. Even by 2015–16, the forecasted debt is only falling as a percentage of GDP, not in nominal terms. However, most critics of austerity do not focus on the budget deficit. We can split it up in two ways. The primary balance is the budget deficit excluding interest payments. The structural deficit is the underlying fiscal position once the effects of the business cycle have been stripped out (that is, once it has been “cyclically adjusted”), and Paul Krugman has argued that only increases in the structural deficit constitute a fiscal expansion (see appendix).14

Figure 5 shows official forecasts for the cumulative proportion of reductions in the structural deficit that are to come from spending cuts, and we compare figures from the 2010 and 2012 budget. Although they show only a limited data range, an interesting pattern emerges. One would expect that the 2012 budget would be on the safest ground when reporting the 2011–12 figures, and although the raw numbers are the same as in the 2010 forecast, the proportion of government spending fell by 1 percentage point (from 57 percent to 56 percent).15 In 2010, the intention was for 2012–13 spending cuts to constitute 64 percent of the consolidation, but by 2012 this has fallen to 64 percent. The 2010 budget forecast that 70 percent of the consolidation in 2013–14 would be spending cuts, but 2012 reduced this estimate to 69 percent. What we see is a tendency to overestimate the proportion of consolidation that can come through spending cuts. Interestingly, further into the future we see the 2012 budget forecast a higher ratio of spending cuts (79 percent) for 2015–16 than the 2010 budget (77 percent). There are multiple explanations for this, but one


15. Presumably this is due to a rounding error.
is that the government’s intention to finish up with an 80-20 split means they ignore a track record of missing their targets by simply assuming even greater strides will be made to compensate in the future (a future which, incidentally, will occur in the next parliament).

The International Monetary Fund defines a fiscal adjustment as “the change in the ratio of the cyclically-adjusted primary balance (CAPB) as a percentage of potential GDP”\(^\text{16}\) and attempts to strip policymakers’ actions from the surrounding noise of public finance. Bringing in the structural deficit helps mitigate the representative heuristic, and people often “underplay the extent to which policies other than fiscal policy affect borrowing.”\(^\text{17}\) Doing so opens up two major problems. First, it takes the government’s responsibility away from the deficit and places it on the part of the deficit economists believe is in the power for governments to really affect. Unfortunately, identifying which part of the public finances the government should be held responsible for is not a settled issue in macroeconomics. Second, this definition of fiscal adjustment rests on the concept of the output gap. Economists disagree significantly when it comes to forecasts of GDP. Establishing a meaningful estimate of potential GDP is even more controversial. It means the judgment of the government’s economic policy rests entirely with certain economists’ judgment about potential GDP. Criticisms of government policy decisions serve as implicit endorsements of output gap calculations.

\(^{16}\) IMF, “Staff Report for the 2012 Article IV Consultation,” 36.

5. PERMANENT BUDGET DEFICITS

The British government has only run a budget surplus in 5 of the last 40 years, and it entered the recession with a growing debt crisis. As Richard Wagner and James Buchanan forewarned, the Keynesian theory of “smoothing the cycle” is not compatible with political incentives. In November 2008, a £20 billion stimulus package was announced, and at the time of writing four years have passed. The main elements to the stimulus included a temporary reduction in value-added tax and the bringing forward of various infrastructure projects. For example, £3 billion of capital spending due to take place in 2010–11 was brought forward to 2008–09 and 2009–10. One reason growth was slow in 2010 was because planned spending had been shifted to an earlier time period. In addition, advocates of fiscal stimuli tend to neglect that such legislation must be paid for at some point, and this will dampen growth.

One reading of Keynes suggests that a fiscal stimulus of around 2 percent of GDP might be sufficient to offset an autonomous fall in aggregate demand and prevent an unnecessary recession. But if a country has a permanent budget deficit of around 3 percent of GDP, it is not clear why—in theory—a 5 percent stimulus would be sufficient. At some point the debt burden must make expansionary fiscal stimulus self-defeating and open the door to an expansionary fiscal contraction. That Britain entered the recession with such a large debt burden curtailed its ability to engage in a more substantial stimulus package. Net debt rose from 32.1 percent of GDP in 2003–2004 to 36.7 percent in 2007–08, but it then jumped above 40 percent in 2008–2009, above 50 percent in 2009–10, and above 60 percent in 2010–11.

The real problem is that the definition of the fiscal stance is a function of the theories a person believes. As Tyler Cowen has said, “I wonder if some Keynesians have in mind the baseline of ‘the expansionary policies which I think would be appropriate,’ in which case doing less than the Keynesian optimum is always a form of austerity.” Whether a 10 percent budget deficit is deemed fiscal stimulus or fiscal austerity ultimately depends on one’s beliefs about the potential growth rate of the economy and trust in economists’ ability to make accurate forecasts of future GDP.

6. CONCLUSION

This paper lends support to an odd claim: that the government is exaggerating an unpopular policy. Tim Morgan refers to the debate on public spending as “phony austerity,”22 while Fraser Nelson has called it “thesp-austerity: minimal cuts imposed with maximum dramatics.”23 Why would the government overstate the extent of austerity?

There are two main political reasons for this. The first is because the government has identified the problems in Greece and other European countries as a warning, and the priority of its economic policy is to avoid slipping into a sovereign debt crisis. The government has attempted to reassure the bond markets that the debt burden is under control and that sensible government finances are a priority. British households are overleveraged and high interest rates would cause significant pain. The government has staked its reputation on low interest rates, and having a credible deficit-reduction plan to calm the markets is a central platform.

Second, the government has inherited an expensive public sector. It helps wage negotiations to reinforce the message that public finances are in dire straits. The planned cuts are unpopular, but genuine cuts would be even more so. In March 2011 over 250,000 people protested cuts to public spending; this was the largest protest since the Iraq war.

This paper has argued:

- The UK government’s response to the recession has been to eliminate the structural budget deficit over the medium term.
- There are changes in the composition of government spending but not a fall in the absolute level.
- Forecasts of falling government spending as a proportion of GDP are due to implausible growth forecasts rather than an absolute reduction in spending.
- History indicates that the government overestimates its ability to fund austerity through spending cuts, and therefore above-expected tax rises are likely.

APPENDIX

A Selection of Tax Increases (2010–12)

- From December 2009 to April 2010: a temporary payroll tax of 50 percent on discretionary bonuses over £25,000.
- From April 2010: a new tax band of 50 percent on incomes over £150,000 (this was reduced to 45 percent in 2012).
- In the June 2010 budget: Capital Gains tax went up to 28 percent for top-rate taxpayers.
- In January 2011: value-added tax rose from 17.5 percent to 20 percent (after having been cut temporarily to 15 percent from December 2008 to December 2009).
- In an effort to raise £2.6 billion in January 2011: the government imposed a bank levy of 0.078 percent, increased to 0.088 percent one year later.
- In 2011: nondomiciled individuals living in the United Kingdom had to pay a £50,000 annual charge (up from £30,000).
- In March 2012: air passenger duty rose by 8 percent and stamp duty (a tax on the sale of houses) increased to 7 percent for properties sold for more than £2 million.

FIGURE 6. CURRENT RECEIPTS

Source: OBR, Economic and Fiscal Outlook, March 2012.
FIGURE 7. HISTORICAL DEFICIT AND DEBT LEVELS


FIGURE 8. BUDGET DEFICIT

Source: OBR, Economic and Fiscal Outlook, March 2012.
FIGURE 9. BUDGET VS. STRUCTURAL DEBT

Source: HM Treasury, Budget 2012.

FIGURE 10. PUBLIC DEBT

Source: HM Treasury, Budget 2012.
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<td>327.0</td>
<td>7.7</td>
<td>4.5</td>
</tr>
</tbody>
</table>

Source: HM Treasury, Budget 2012, table 2.4.