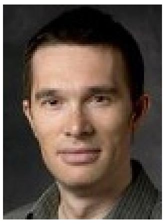
The UK should have waited to enforce austerity

Jonathan Portes and John van Reenen pick apart the arguments used to intially justify austerity policies and argue that delayed fiscal consolidation would have been a far better policy than immediate cuts.



When Britain's coalition government announced its plan for aggressive fiscal consolidation on taking office in May 2010, three key arguments were advanced by its supporters.

The first was that there was no alternative: if borrowing continued on its current track, the gilts market would panic. In its extreme form, this was always scaremongering. But it has been disproved by events even more thoroughly than most of us expected. We are now on course to borrow even more than was planned before the austerity programme was announced. Yet long-term interest rates in Britain are at historic lows just as they are in virtually every industrialised country with monetary independence. This is the result of low growth, not fiscal consolidation.

The second argument was that fiscal consolidation would help, or at least not derail, recovery. Again, this relied more on faith than economics. While we shouldn't read too much into last week's output figures, the UK economy is hardly thriving. Its weakness is in large part the result of fiscal policy – the International Monetary Fund estimates that this has reduced gross domestic product by about 2.5 per cent so far.

The third, much more compelling, argument was that since, over the long run, the books have to balance, fiscal consolidation was inevitable. So why delay the pain? This sounds logical. But it contravenes the textbook prescription – followed successfully by the 1992-97 government – that deficit cutting should follow, not precede, sustained recovery. The economic case for delaying deficit reduction has been powerfully made by Brad Delong and Larry Summers, who argue that – given plausible assumptions about the impact of fiscal policy when economies are depressed, as opposed to "normal" times – this would yield big medium to long-term benefits.

On August 3rd the National Institute of Economic and Social Research (NIESR) publishes research that attempts to put hard numbers on the economic impact of immediate versus delayed fiscal consolidation in the UK. We look at the impact of implementing the same tax rises and spending cuts, only starting in 2014, when we assume the economy would have returned to "normal". We also look at what would have happened without any consolidation at all.

This affects the projections, first, because both short and long-term interest rates are currently very low, so the response of monetary policy to fiscal policy differs a lot. Second, many UK households and firms are financially constrained right now because borrowing is difficult. Again, this makes fiscal policy more potent. Finally, protracted high unemployment affects the supply side of the economy in the medium term. The long-term unemployed are less likely to look for, or find, jobs, and may suffer permanent damage to skills and motivation. All these effects are well known, but hard to incorporate in standard models.

The results are striking. The modelling confirms that doing nothing was not an option; our "no fiscal consolidation" scenario leads to unsustainable debt ratios. So some pain was inevitable; under both our "immediate consolidation" scenario and that of "delayed consolidation", deficit cutting worsens growth and unemployment, just as it has done.

But our estimates indicate that the impact would have been much less, and less long-lasting, if consolidation had been delayed until more normal times. The cumulative loss of output over the period

2011-21 totals about £239bn in 2010 prices, or 16 per cent of 2010 GDP. And unemployment is higher for some two to four years longer if tightening comes when the economy is depressed. So early tightening has real, large costs.

These are scenarios, not forecasts. The choice of 2014 as a time when the economy would have returned to normal is arbitrary and, in reality, global developments could well have changed that in any case. But the research shows why, and how much, macroeconomic judgments matter.

The good news is that, in our model at least, the UK economy eventually returns to equilibrium whatever the path of consolidation. But in the long run we are all dead. This analysis shows that the economic pain resulting from fiscal consolidation, while unavoidable, could have been substantially reduced by a sensible application of basic macroeconomic principles.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

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