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It’s Official: Austerity Economics Doesn’t Work

Posted by *John Cassidy*

With all the theatrics going on in Washington, you might well have missed the most important political and economic news of the week: an official confirmation from the United Kingdom that austerity policies don’t work.

In making his annual Autumn Statement to the House of Commons on Wednesday, George Osborne, the Chancellor of the Exchequer, was forced to admit that his government has failed to meet a series of targets it set for itself back in June of 2010, when it slashed the budgets of various government departments by up to thirty per cent. Back then, Osborne said that his austerity policies would cut his country’s budget deficit to zero within four years, enable Britain to begin relieving itself of its public debt, and generate healthy economic growth. None of these things have happened. Britain’s deficit remains stubbornly high, its people have been suffering through a double-dip recession, and many observers now expect the country to lose its “AAA” credit rating.

One of the frustrations of economics is that it is hard to carry out scientific experiments and prove things beyond reasonable doubt. But not in this case. Thanks to Osborne’s stubborn refusal to change course—“Turning back would be a disaster,” he told Parliament—what has been happening in Britain amounts to a “natural experiment” to test the efficacy of austerity economics. For the sixty-odd million inhabitants of the U.K., living through it hasn’t been a pleasant experience—no university institutional-review board would have allowed this kind of brutal human experimentation. But from a historical and scientific perspective, it is an invaluable case study.

At every stage of the experiment, critics (myself included) have warned that Osborne’s austerity policies would prove self-defeating. Any decent economics textbook will tell you that, other things being equal, cutting government spending causes the economy’s overall output to fall, tax revenues to decrease, and spending on benefits to increase. Almost invariably, the end result is slower growth (or a recession) and high budget deficits. Osborne, relying on arguments about restoring the confidence of investors and businessmen that his forebears at the U.K. Treasury used during the early nineteen-thirties against Keynes, insisted (and continues to insist) otherwise, but he has been proven wrong.

With Republicans in Congress still intent on pursuing a strategy similar to the failed one adopted by the Brits, this is a story that needs trumpeting. Austerity policies are self-defeating: they cripple growth and reduce tax revenues. The only way to bring down the U.S. government’s deficit in a sustainable manner, and put the nation’s finances on a firmer footing, is to keep the economy growing. Spending cuts and tax increases can also play a role, but they need to be introduced gradually.

Before the last election there, which took place in May, 2010, the U.K.’s economy appeared to be slowly recovering from the deep slump of 2008-09 that followed the housing bust and global financial crisis. Just like the Bush Administration (2008) and the Obama Administration (2009), Gordon Brown’s Labour government had introduced a fiscal stimulus to help turn the economy around. G.D.P. was growing at an annual rate of about 2.5 per cent. Once Osborne’s cuts in spending started to be felt, however, things changed dramatically. In the fourth quarter of 2010, growth turned negative and a double-dip recession began. So far, it has lasted two years. While G.D.P. did expand in the third quarter of this year, the Office of Budget Responsibility, an independent economic agency that Osborne set up, has said that it expects another decline in the current quarter. For 2013, the O.B.R. is forecasting G.D.P. growth of just 1.3 per cent. With the economy so weak, the O.B.R. says that the unemployment rate will tick up from eight per cent to 8.2 per cent next year.

That austerity has led to recession is undeniable. Despite the Bank of England slashing interest rates and adopting a policy of quantitative easing, consumer and investment spending have remained depressed. Osborne places much of the blame on continental Europe, Britain’s biggest trading partner, but that’s a lame excuse. It was perfectly clear back in 2010 that Europe was headed for trouble. The proper reaction to a negative external shock is to loosen fiscal policy, not tighten it, much less tighten it violently. But Osborne was determined to go ahead with his grisly exercise in pre-Keynesian economics.

If all the pain he has inflicted had transformed Britain’s fiscal position, his policies could perhaps be defended. But that hasn’t happened. Back in 2009, the O.B.R. predicted that by the end of 2013-2014, the deficit would have fallen to 3.5 per cent of G.D.P. Now, the O.B.R. says that the actual figure will be 6.1 per cent. And since most of its forecasts have proved too optimistic, this might well be another underestimate. Even by Osborne’s preferred measure, which adjusts the headline figure for the state of the economy and doesn’t count capital spending, the deficit won’t be eliminated before 2016-17 at the earliest. The debt-to-G.D.P. ratio, which Osborne originally said would peak at about seventy per cent, has now hit seventy-five per cent, and it is forecast to come close to eighty per cent in 2015-2016. It was supposed to start falling next year. Now, it is set to keep climbing until at least 2017-2018.

A comparison with what has happened on this side of the Atlantic is illuminating. For the purposes of the natural experiment, the U.S. can be thought of as the control. In adopting a fiscal stimulus of gradually declining magnitude over the past four years, the Obama Administration has administered what was, until recently, the standard medicine for a sick economy.

As one would have expected on the basis of the textbooks, the American economy, while hardly racing ahead, has fared considerably better than its British counterpart. Between 2010 and 2012, G.D.P. growth here has averaged about 2.1 per cent. For the U.K., the figure is 0.9 per cent. What may be more surprising—at least to those of you who have been listening to the deficit hawks—is that the United States, while sticking with Keynesian stimulus policies, has also managed to bring down the size of its deficit, relative to G.D.P., almost as rapidly as hairshirt Britain has. Back in 2009, at the depths of the recession, both countries had double-digit deficits. Today, the U.S. deficit stands at about seven per cent of G.D.P., and the British deficit is about five per cent of G.D.P. But with the U.S. growing faster than the U.K,. the gap is set to close. Next year, according to the latest forecasts from the Congressional Budget Office and the O.B.R., the U.S. deficit will be considerably smaller than the U.K. deficit: four per cent of G.D.P. compared to six per cent.

Let’s go over that one more time. Having adopted the policies of Keynes in response to a calamitous recession, the United States has grown more than twice as fast during the past three years as Britain, which adopted the economics of Hoover (and Paul Ryan). Meanwhile, the gaping hole in the two countries’ budgets has declined at roughly the same rate, and next year the U.S. will be in better fiscal shape than its old ally.

Q.E.D.

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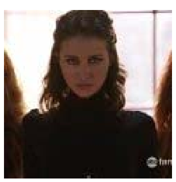
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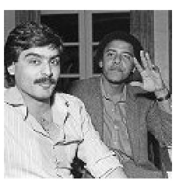
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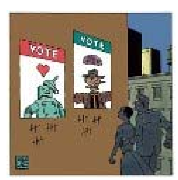

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