Kaleidic Economics

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Austerity and the passage of time

At present there is a fervent debate about the extent to which the UK is engaged in fiscal "austerity". It may quite possibly define the economic reputation of the present government. We use the term loosely, referring to a reasonably large fiscal contraction that is weighted more towards spending cuts than tax rises. And therein lies the rub – the rhetoric and reality are somewhat in conflict. Fraser Nelson has referred to it as "thesp-austerity: minimal cuts imposed with maximum dramatics"[1], whilst Tullet Prebon's Tim Morgan has called it "phoney austerity"[2].

If the government's primary audience is the bond markets, then their strategy is working. They have made a credible commitment to alter the growth rate of government spending, and convinced the markets that Britain is unlikely to default. In the present environment, this can't be taken for granted.

But very few economists endorse the detail of the government's austerity plan. Austerity advocates point to cases such as Canada in the 1980s, or Estonia, Ireland, and Iceland today, to show that dramatic reductions in spending don't necessarily lead to a downward spiral. Clearly more academic work needs to be done on "expansionary fiscal contractions", but the British "experiment" is flawed. It is too focused on tax rises, and completely ignores supply side problems.

The anti-austerians also have a point. They would argue that too much of current government spending is welfare based (i.e. that it is not "targeted"), or that the deficit – whilst still large in an absolute sense – should not be falling when in a recession. The debate will not be settled soon, but we intend to contribute to it with three main claims: that temporary changes in the tax code are inconsistent with *both* sides of the debate; that we cannot ignore the historic state of the UK economy when discussing fiscal policy; and that alternative forecasts for GDP can make a dramatic difference to austerity measures.

Temporary reforms don't help

Shadow Chancellor Ed Balls has called for tax *cuts* as a way to generate growth, but relies on a confidence mechanism to do so, "Such a tax cut now would boost confidence, help families feeling the squeeze and help get our economy moving again"[3]. Indeed his criticism of plans to cut government

[1] "Turn off your iPad, David Cameron, and start dealing with Britain's debt" Fraser Nelson, Daily Telegraph, May 17th 2012
[2] "Blowing the whistle on UK 'austerity'", Tullet Prebon, May 14th 2012
[3] "Ed Balls suggest Budget tax cut options" BBC News, February 12th 2012

spending in the future rests on an assumption that it is the anticipation of spending cuts that reduces present output. But if people are so far sighted why should temporary changes to the tax code have any impact? It isn't the first time politicians have underestimated the ability of taxpayers to react to policy changes. According to the Office for Budget Responsibility (emphasis added):

> "HMRC have now undertaken the first ex post analysis of the 50 per cent yield, based on 2010-11 self-assessment tax returns. One striking finding is that high-income individuals appear to have shifted at least £16 billion of income that would have been taxed in future years into 2009-10 so that it would be taxed at 40 per cent rather than 50 per cent. This has a one-off cost to the Exchequer of around £1 billion. The scale of forestalling, **which was not factored into the March 2010 Budget costing at all**, illustrates how willing and able high-income individuals are to adjust their behaviour in response to changes in tax rates."[4]

In short, the greater the extent to which you rely on a confidence channel of individuals anticipating future policy, the weaker the argument for temporary, rather than permanent changes.

We can't choose our starting point

Although the UK debt to GDP ratio is not historically high, public spending constitutes a larger proportion of GDP than at any time outside of war. The size of the deficit is colossal, and Britain entered the recession with a debt problem. In basic Keynesian theory there is a role for government to "smooth the cycle" and temporally boost output during a recession via borrowing funded deficits. But these are supposed to be paid back by running surpluses during the boom. Regardless of whether or not Britain can borrow more without pushing up borrowing costs, it is dangerous to base policy on how a fiscal stimulus (or indeed austerity) is supposed to operate "in theory". The debate is often about whether more government spending will crowd out the private sector. But the public sector *already has* crowded out the private sector. Investec point out that the public sector constitutes more than 60% of regional GVA in Northern Ireland, Wales and the North East. Only in London is it less than 30%, and there is a striking inverse correlation between the size of the public sector and GVA per region.[5] This suggests that much of the slow "recovery" is down to structural, as well as purely cyclical factors.

[4] "Economic and Fiscal Outlook March 2012" Office for Budget Responsibility
[5] "Has the UK gone ex Growth?" Investec, May 2012

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Forecasting is foolish

Figure 1 shows a simplistic treatment of government spending as a proportion of GDP. It uses "Total Managed Expenditure" from the OBR[6] and GDP figures from the IMF.[7] All calculations are in the Appendix. It clearly shows how it is forecast to fall from 2012 onwards. Hence "austerity".

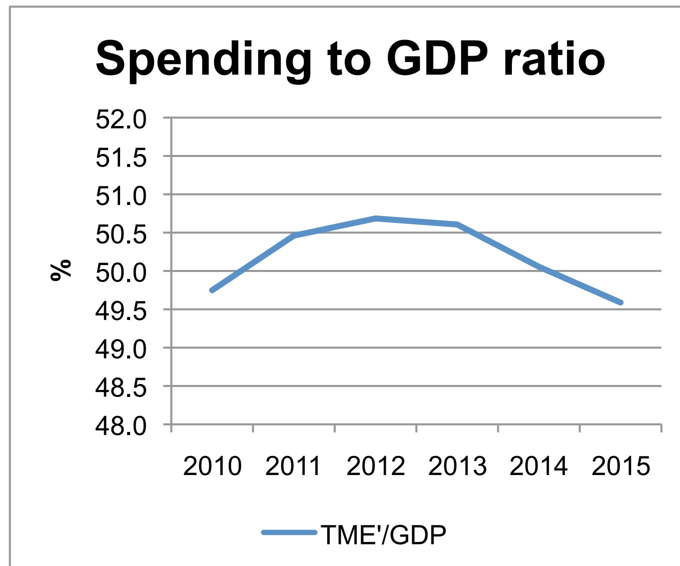

Figure 1

But these are forecasts. And indeed economists are hopeless at making forecasts. The UK Treasury regularly publishes a survey of different economic forecasters, and compares them to the official OBR figures.[8] In the May 2012 version the lowest GDP forecast made in the previous 3 months was -0.5% whilst the highest was 1.5%. The median of the independent forecasts was 0.4%, which is half as much as the official OBR one (0.8%). Figure 2 shows a very crude chart comparing GDP using the IMF data, and what GDP would be if it grows by half as much (which we label GDP').

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[6] In 2012-13 expenditure is temporarily reduced by £28bn due to the transfer of assets from the Royal Mail pension plan to the public sector. Therefore we use TME' which adjusts for this (See HM Treasury, 2012 Budget, p.54)

[7] This is at constant prices with forecasts from 2011 onwards, see http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/index.aspx

[8] "Forecasts for the UK Economy", HM Treasury, May 2012

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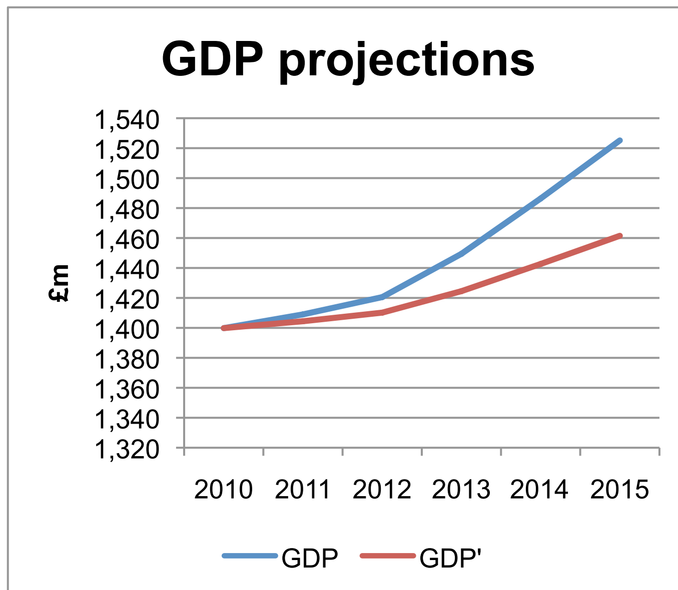

Figure 2

So far, so straightforward. But figure 3 then looks at the ratio of government spending to GDP', and reveals an interesting comparison to figure 1. In short, it goes *up*.

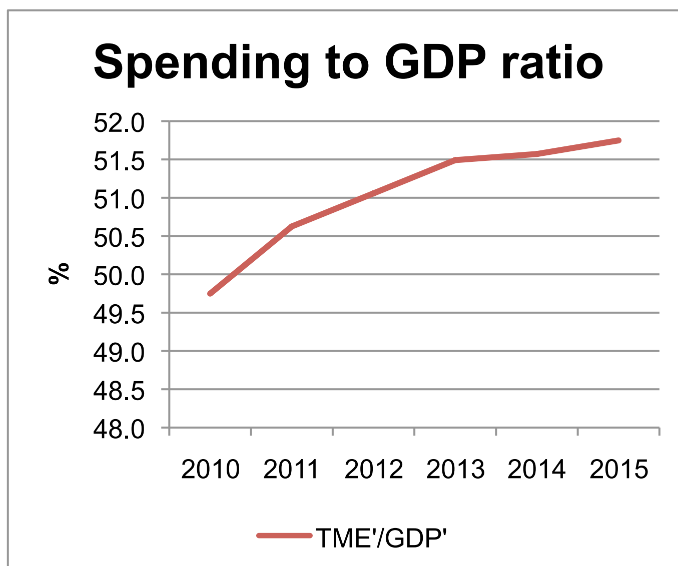

Figure 3

The fact that government spending is projected to fall as a proportion of GDP is partly due tot eh fact that GDP is expected to increase at a faster rate than government spending. In other words whether you interpret is as "harsh spending cuts" or "over optimistic growth forecasts" is a matter of taste. It seems odd that the anti-austerity brigade base their arguments on the strength of economist's forecasts.

Appendix

	2010	2011	2012	2013	2014	2015
GDP	1,400	1,409	1,421	1,449	1,486	1,525
GDP Δ		0.65%	0.82%	2.03%	2.55%	2.61%
GDP'	1,400	1,404	1,410	1,425	1,443	1,461
GDP' Δ		0.33%	0.41%	1.02%	1.27%	1.30%
TME'	696	711	720	734	744	756
TME'/GDP	49.7	50.5	50.7	50.6	50.1	49.6
TME'/GDP'	49.7	50.6	51.1	51.5	51.6	51.7

Kaleidic Economics is a business roundtable that meets each quarter in London. For more information: http://kaleidic.org

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