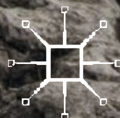
THE POLITICS OF AUSTERITY

A Recent History

MICHAEL BURTON



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To Ann Burton (1926–2015).

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Finally, on a personal note I want to mention my mother, Ann Burton, who passed away at the age of 89 as I was completing this book. She always had a huge interest in politics and public services and read my last book *The Politics of Public Sector Reform from Thatcher to the Coalition* in 2013 with great dedication and much commentary. I shall miss not hearing her opinion of this one.

Terminology

This is a book aimed at readers with an interest in politics and economics rather than at professional economists so I try and avoid too much jargon. However certain words crop up regularly, in particular deficit, gross domestic product, public sector net debt and occasionally automatic stabilisers. These are explained as follow:

Automatic stabilisers: government fiscal policies which moderate the cyclical rises and falls of the economy such as through welfare payments to offset unemployment during a downturn.
Balanced budgets: an annual budget in which government spending matches government revenues. If spending is more than revenue this creates a deficit and if the opposite, a surplus.
Balance of payments: the record of trade between the UK and the rest of the world.
Counter-cyclical: fiscal policy which runs counter to the cycle of the economy e.g. stimulating the economy during a downturn by increasing public spending/cutting taxes or cooling the economy during a boom by increasing taxes/cutting spending. A pro-cyclical policy does the opposite e.g. cutting spending/increasing taxes during a recession or increasing spending/cutting taxes during an upturn.
Deficit: the gap between a government's annual spending and its income. The deficit, usually presented as a percentage of GDP, has to be financed by borrowing. Public sector net borrowing (PSNB) is the measure of this deficit or surplus. The deficit was also known as the Public Sector Borrowing Requirement (PSBR)

Fiscal consolidation: a technical term for austerity, namely an improvement in the public finances through a combination of cuts in public spending and tax rises.
Gross domestic product: the value of all goods and services produced for money in an economy.
Monetarism: an economic theory prevalent in the 1970s and 1980s that inflation could be controlled by limiting the supply of money in the economy.
Public sector net debt: the total outstanding amount the government has borrowed.
Total managed expenditure: (UK) the total amount that the government spends.

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CHAPTER 1

The Politics of Austerity: A Recent History

Introduction

After 15 years of recession-free economic growth, enjoyed by both Europeans and North Americans from the mid-1990s, the financial crisis of 2008 was a brutal end to the dream that the days of boom and bust were over. The crash also blew a hole in the public finances of scores of advanced economies, as the apparently endless flow of tax revenues to fund public spending dried up. Governments struggled to respond to the tide of red ink that was engulfing budgets. After initially maintaining or even expanding public spending to offset the sharp drop in private sector activity, governments tried to reduce their debt through fiscal consolidation, cutting spending and increasing taxes, a process dubbed by opponents as 'austerity', with widely varying results. For the public, especially the poor, austerity meant hardship brought on by cuts in pay, benefits and public services, higher taxes and declining living standards. How governments manage the politics of austerity, balancing harsh economic realities with voter expectations, form the subject of this book.

The Great Recession that followed the fiscal crash of 2008 was the most severe since the Great Depression of the 1930s. It also lasted longer than its predecessor, with some European countries still struggling to balance their budgets nearly a decade later. Because the Great Recession occurred after 15 years of prosperity built on cheap credit, its impact was particularly felt by a population that had known only plenty and grown used to a generous level of public spending. In some countries, especially

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those dependent on the taxes generated by financial services or property, the downturn in public finances was catastrophic, causing sudden hikes in budget deficits. Politicians, who had presided over years of spending rises as tax revenues flowed into their coffers, now had to apply the brakes with little understanding of the consequences. In the case of Europe, two ways of boosting recovery, namely exports and exchange rate depreciation, were absent. Because most European countries went into recession simultaneously, it was impossible for them to export their way back to growth by selling to each other, as had occurred in previous downturns while furthermore the eurozone states were locked into a fixed exchange rate through their single currency.

Although this book is ostensibly about an economic subject, namely managing public finances during recessions among developed, democratic countries, my approach is through politics. This has been done because decisions about deficit-reduction are of course taken by politicians. Economists set out theories, but the difficult process of implementing them, including persuading sceptical voters these are in their best long-term interests, is down to governments. In this book, I set out to explore how, why and when politicians make such decisions and drawing on recent examples, try to ascertain a pattern in their response to downturns.

Politicians in Europe and the USA took lessons from the failures of governments in the Great Depression of the 1930s in order to guide them through managing the Great Recession of the late 2000s. Initially, they took the view espoused by the great British economist, John Maynard Keynes, that it was a mistake to cut spending during a downturn. Indeed, governments like those of the UK and the USA poured public money into the financial system to boost liquidity and prevent it from seizing up. Their model from the Depression was not President Hoover, the exponent of cuts, but President Roosevelt, the believer in public works. Once the initial fiscal crisis was over, however, and the crash became a recession, governments in 2009 were left with huge deficits in their public finances that at some stage had to be reduced; the challenge was when. As one prominent UK economist put it: 'At the height of the crisis spending went up and tax was cut. It was a Keynesian response. The question is at what point you bring the deficit back down and at what speed. That was the balance of risk.'[1]

The consequent fiscal consolidation programmes, often at different levels of severity and speed in different countries, were conducted amidst fierce debate among politicians and economists as to whether they

were either ending or prolonging the recession, whether they were too early in the cycle or whether austerity was necessary at all. Governments that failed to persuade their voters that there was no alternative or could offer no light at the end of the tunnel were punished at the ballot box. The long-dead Keynes, whose theories of full employment supported by public spending had gone out of fashion in the 1970s, was suddenly a household name once again in the corridors of power.

Politicians and economists, who had thought in 2006 that recessions were history, now had to revisit the past for guidance. The Great Depression was not the only example of deficit-reduction. The recessions of the 1970s, 1980s and 1990s all involved periods of fiscal consolidation, some of which were successful in both reducing deficits and boosting economic growth. Indeed, the UK Coalition government in 2010 drew on the lessons of austerity gained from 1990s Canada and Sweden when it embarked on its own programme. The supporters of vigorous deficit-reduction—termed by economists the 'austerians'—cited the successful examples of Canada, the USA and Sweden in the 1990s, while the 'anti-austerians' pointed to the soaring unemployment figures under Margaret Thatcher in early 1980s Britain, using them as a warning of what could happen. In practice, as austerity took effect from 2010, both parties were correct and could produce examples to support their own arguments.

The controversy over austerity economics has often been described as a political battle between left and right, Keynesians and non-Keynesians. Yet Keynes believed in running budget surpluses when economies were expanding. His biographer noted that Keynes's fiscal policy 'required current spending to be balanced by tax revenues', adding: 'It may surprise readers to learn that Keynes thought that government budgets should normally be in surplus … nor was Keynes a tax and spend fanatic. At the end of his life he wondered whether a government take of more than 25 % of the national income was a good thing.'[2] Some of the most successful deficit-reduction programmes have taken place under left-of centre governments such as the UK in the 1970s, Canada and Sweden in the mid-1990s and the USA under Democrat President Bill Clinton. These programmes occurred in democratic countries whose politicians had to not only apply unpopular measures to balance their budgets, but do so while maintaining the support of voters which, in most cases, they managed successfully.

In the next chapters, I shall examine how governments in the developed, democratic countries initiated previous programmes of fiscal con-

solidation, or austerity, as well as focus on cases from the recent Great Recession. I have divided the book into two parts. The first looks at the UK which, after a long period of economic growth from 1945, went into sharp decline from the 1960s. The 1970s, whose oil price shock devastated many western economies, tipped the UK into recession and a Labour government found itself initiating the toughest programme of spending cuts since the 1930s. The decade also marked the end of the Keynesian consensus over maintaining high employment and high public spending and led to monetarism and Thatcherism. The recession of 1980/1981, made worse by spending cuts, turned into the boom of the late 1980s and the bust of the early 1990s, when another round of austerity created a budget surplus. There followed the longest period of public spending increases since 1945, until the fiscal crash. The Labour government of Gordon Brown briefly pursued a Keynesian policy of maintaining spending, but the new Conservative-led Coalition in 2010 set out an ambitious five-year programme of fiscal consolidation to reduce the deficit with mixed results; debt remained high, the deficit was still 5 % in 2015, but the UK's GDP growth was among the fastest among developed nations.

In the second part of the book, I look at case studies from other developed, democratic countries. This is complicated by the fact that some have federal systems, but rather than unpick the fiscal balance between central and provincial, I work on the budgets, including deficits and more rarely surpluses, set by federal governments.

The first country I analyse in this second part is the USA, in particular the successful austerity programme of President Bill Clinton which led to a budget surplus for four years, until it was whittled away by tax cuts under his Republican successor, George W. Bush. Next, I look at how Europe dealt with the Great Recession, with a focus on the eurozone, whose single currency made recovery especially difficult for the southern states of Greece, Portugal and Spain. I also spend some time on Ireland, which initiated one of the toughest fiscal consolidations in Europe and emerged with an expanding economy. The Baltic states of Latvia, Lithuania and Estonia also provide some unusual case studies; their own harsh austerity was followed by strong economic growth and they are often cited as examples of 'expansionary fiscal consolidation'. Canada and Sweden both provide models of successful deficit-reduction programmes under left-of centre governments in the 1990s, though these did not occur without controversy. I also briefly look at Asia Pacific, where the downturn

in China in 2015/2016 had repercussions for the Australian economy, which had been enjoying a quarter century of growth and had avoided the Great Recession. Japan, in contrast, endured 25 years of stagnation with the world's highest debt. I end with a chapter examining the arguments by 'austerians' and 'anti-austerians' for and against deficit-reduction policies.

While some of the above examples of austerity are historic, they still have much relevance for the future. Gloomier economists already spoke in 2016 of the next recession, even though many countries had yet to emerge from the last one. In addition, the ageing populations of the advanced economies mean a greater proportion of their public spending will be devoted to pensions and health care and less to universal services. No government wants to repeat the mistakes of the mid 2000s by relying on cheap credit and tax revenues from bubbles in property and financial services to fund otherwise unaffordable levels of public spending. Austerity, in its various guises, may be with us for many years to come. For politicians managing expectations, this is a challenge they will have to surmount if they are to win and maintain power. I hope this book will provide some guidance.

Notes

1. Author interview with Paul Johnson, director, the Institute for Fiscal Studies, London (January 2016).
2. Robert Skidelsky (2010). *Keynes*. (Penguin p.113 and p.xviii).

PART I

Austerity in the UK

CHAPTER 2

The Rise of Public Spending

On a wet afternoon in the English seaside resort of Blackpool on September 28, 1976, British Prime Minister Jim Callaghan stood up before delegates at the annual Labour Party conference, and in one of the most celebrated speeches of modern British politics, brought to an end 30 years of economic consensus. He told his party members:

> The cosy world we were told would go on for ever, where full employment would be guaranteed by a stroke of the Chancellor's pen, cutting taxes, deficit spending, that cosy world is gone …. We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step … Like everyone in the Labour movement, I believe in a high level of public expenditure. But I part company with those who believe we can rely indefinitely on foreign borrowing to provide for greater social expenditure.[1]

Callaghan's speech marked the point at which the post-war consensus on economic policy, namely that the state had a leading role in ensuring full employment and preventing recessions if necessary through deficit financing, usually dubbed Keynesianism as a shorthand, drew to a close.

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As one historian wrote later: 'It was a landmark in British political history. For the first time a Labour Prime Minister had publicly abandoned the consensus built on deficit spending and full employment.'[2]

But the decades of post-war consensus and the growth of consumerism in the three decades from 1945 had masked underlying structural weaknesses in the UK economy, which became apparent in the 1960s but then disastrous in the 1970s, triggered by external global shocks, a dramatic downturn and a soaring public sector deficit. The management of troubled public finances in the 1970s would turn out, in hindsight, to be a pivotal period between the end of post-war consensus and the start of a new anti-statist, anti-Keynesian ideology whose consequences would last well into the next century.

The Background to Public Spending

Until as late as the nineteenth century in the UK, there were no state pensions, no state schools, no welfare other than the limited handouts under Poor Relief, no state police and no health service other than that provided by volunteers. There were also few taxes and what little revenue was collected went to cover the costs of foreign wars. Classical economists believed the role of the state was to provide defence, police and basic administration. In 1853, the government spent at 2015 prices the equivalent of £2.8 billion, compared to the actual £730 billion in 2015.[3]

The pattern was similar in other industrialised countries like Germany and the USA. In the USA in the 1870s, public spending was around 7 % of GDP and did not exceed 10 % in Germany. In France, it was higher at 12–18 %, leading one prominent French economist to warn in 1888 that a share of 5–6 % was moderate but above 12 % was 'exorbitant' and would damage the economy. Overall, average spending in European countries in the 1870s was around 10 % of GDP.[4] However, social changes in the UK brought about by industrialisation and the decline of agriculture from the late eighteenth century onwards led to a huge increase in the urban population and demands by the working and middle classes for representation in Parliament. The Reform Acts of 1832, 1867, and 1884 had expanded the voting base to almost six million people by the 1890s. In 1918, another Act increased the number of voters to 21 million by including some women; in 1928, this was extended to all women.

The extension of the franchise had a major impact on public attitudes to the role of the state. The consequences of this great extension of democracy were demands by the newly enfranchised voters for improvements in

their living conditions, better housing, environmental services, education, and financial support during periods of unemployment and in old age. Lord Salisbury, the aristocratic Conservative and three times Prime Minister (1885–January 1886, July 1886–1892 and 1895–1902), who had previously opposed electoral reform in 1867, feared that the newly enfranchised people would never, as a result, vote Conservative. His biographer commented: 'The central lesson of 1867 was that he and the Conservative Party, rather than retreat hermit-like into black reaction, would have to improvise new techniques and "cries" to win the allegiance of the enlarged electorate.'[5]

The lesson therefore was that the Conservatives, along with their opponents, the Liberals, must learn to cater to their new voters or disappear into oblivion. Public spending was no longer just a priority for the left. This message was accompanied by fierce ideological debate between those who believed the state's role should be as minimalist as possible, and those who saw the state as delivering a fairer, more equal society. History, however, was on the side of the statists, with an emerging trade union movement and the Labour Party putting pressure on the Conservatives and in particular the Liberals to move further in the direction of more state provision of services.

As pressure grew for improved public services, so spending began to rise, albeit modestly. From 1870 until the mid-1890s, central government spending averaged 5–6 % of gross domestic product (the measure of the country's economic output), rose to 10 % during the Boer War in the early 1900s, then stabilised at 8–10 % for the decade to 1914. To put this into context, peacetime UK public spending as a percentage of GDP was 40 % in the 1970s and at the depth of the recession in 2009, it was almost 46 %.[6] Spending rose in other industrialised countries, with Germany introducing a social security system in the 1880s.

The question though was who would pay for this increased spending. Until the twentieth century, what little income was raised by the state came from indirect taxes, mainly customs and excise duties. Income tax was first introduced in 1799 as a temporary measure to pay for the wars against Napoleon, and was set at 10 % of all annual income above £60. Although briefly repealed, it was re-introduced in 1803 and then abolished in 1816, a year after the defeat of Napoleon. In 1842, with a growing government deficit, income tax was re-introduced by the Conservative Prime Minister Sir Robert Peel on higher annual incomes. By the early 1900s, political and social changes were shifting the debate away from the idea that income tax was a limited measure to finance wars, to viewing it as a means of funding welfare for the working classes, the unemployed and the old. Some 80 %

of the population now lived in towns, mainly in crowded and unsanitary conditions, and the Labour Party, founded in 1906, was emerging as the new parliamentary voice of the urban working class. The 1906 Liberal government, supported by new Labour MPs, was the first to bring in early forms of welfare support such as non-contributory old age pensions to those over 70, national insurance and unemployment assistance, funded by increased income tax. Its 1909 so-called 'People's Budget' increased the rate of tax on unearned income from 12d to 14d in the pound, death duties to 15 % on estates worth more than £1 m and a 'super-tax' of 6d in pound on incomes above £5000. The Budget provoked a constitutional crisis; after the House of Lords blocked it, the government brought in the 1911 Parliament Act which removed their power of veto.[7]

By 1914, the standard rate of income tax was 6 %, bringing in revenues of £44 million and a further £3 million in 'super-tax' with government spending at 15 % of GDP. The 1909 Budget had introduced the concept that tax must be redistributive, transferring income from the wealthy to the poor, and that income tax was now the prime source of government revenue.

From Great War to Great Depression

The First World War was not only calamitous in human cost but for its duration wrecked the public finances. Public spending as a proportion of GDP peaked at 60 % as the government borrowed heavily to fund the war. In 1914, the national debt had stood at £706 million. In 1920, it was £7.85 billion. Other countries involved in the war, Germany, France and Italy, also saw huge increases in spending above 25 % of GDP. By 1918 the standard rate of income tax had risen to 30 %, bringing in revenue of £257 million and a further £36 million in super-tax on the very rich. In all, taxes brought in government revenues of over £580 million, seventeen times the 1905 figure.[8]

The Liberal coalition government, elected on a landslide in 1918, set about to create 'a land fit for heroes' for returning soldiers with increased spending on education, health—the Ministry of Health was created in 1919—higher pensions and housing. But while income tax and spending were here to stay and spending as a proportion of GDP in the 1920s averaged 25–30 %, considerably above pre-war levels, these expansionist goals proved to be illusory under the pressure to reduce wartime debt and successive governments' fiscal conservatism. Orthodox thinking dominated the

Treasury while Cabinet ministers of all parties, including Labour—briefly in power in 1924—ensured that 'balancing the books' and adhering to the gold standard which limited governments' ability to expand the money supply to stimulate the economy, remained policy throughout the 1920s. It was, after all, only a few decades previously that spending had averaged just 5 % of GDP and income tax scarcely existed. Many economists and politicians believed that spending was already dangerously out of control and that it was the duty of government to reduce both the deficit and taxes.

So long as the economy was buoyant, as it was in the USA and Europe during much of the so-called 'roaring twenties,' delivering employment, higher wages and prosperity to the middle and working classes, fiscal conservatism remained untested by the ravages of recession.

But in 1929, an event occurred whose consequences were to reverberate through economic policy for the rest of the century and into the next. The Wall Street Crash and the collapse of the banking system following an over-extended stock market rapidly led to the Great Depression, bankruptcies, soaring unemployment, rising public sector debt, deflation and the vicious cycle of less consumer spending, leading to more joblessness and business closures. In the USA, where the Great Depression began, first as a banking crisis, unemployment hit 25 %; in the UK the figure was 2.5 million and in Germany six million. The question now was whether it was the task of the government to intervene or let the markets take their course.

Supporters of spending argued that pumping government money into the economy would fill the gap left by the recession-hit private sector, and maintain employment and consumer demand until the economy improved. Running a public sector deficit—or deficit financing—that is to say, a government spending more than its income (as usually measured by public sector net borrowing) was acceptable in such circumstances as it sustained jobs and businesses. It could be reduced once an expanding economy generated more taxes and the government could repay the debt. Proponents of deficit financing maintained that trying to balance the books during a recession was self-defeating because deflationary spending cuts only further weakened the economy, leading to a spiral of decline. The most famous advocate was renowned economist John Maynard Keynes who 'was against a self-defeating attempt to balance the budget in a recession by cuts that would inadvertently prolong it rather than achieve their professed objective.'[9]

Keynes has been so associated with deficit financing that he has even given his name to it, as in Keynesian economics. Keynesianism was vindicated by

the devastating impact of the 1930s Great Depression, which scarred a generation of young politicians, and would dominate government economic policy for three and a half decades from 1945 to 1980, and again from 2001 to 2009. It would still be fiercely debated in 2015. However, in 1930, Keynes was a prophet without honour. The Labour government, elected in 1929 under Ramsay MacDonald and his fiscally conservative Chancellor Philip Snowden, initially pursued an enlightened social agenda and expanded unemployment assistance. But its policies proved inadequate in responding to the devastation wrought by the Great Depression. By December, unemployment had hit 2.5 million and as the deficit widened, the government reverted to spending cuts to balance the books. Keynes and his supporters called for greater spending to stimulate the economy but 'the Treasury would not of course entertain such radical ideas and stuck to its traditional refrain that such policies could not possibly work although the post-war growth of the economy was to demonstrate that they could indeed do so.'[10]

In the summer of 1931, the May Committee, set up by the government to find ways to reduce public spending, suggested that the Treasury faced a deficit of £120 million. It proposed fiscal consolidation of £96.5 million to be achieved by cutting public sector pay, making a 20 % cut in unemployment benefits and raising taxes. The opposition Conservatives were in dilemma. They could only oppose the Labour government's response by demanding even greater spending cuts, which would be unpopular. The Cabinet met on 19 August to discuss this but set a target of finding £78.5 million and could only find £56.25 million. The projected deficit had now increased to £170 million but there was no agreement with ten of the 21 ministers refusing to accept more cuts. That month the government resigned. MacDonald then led a National Government with the Conservatives and a breakaway group of Liberal MPs, and was expelled from the Labour Party which was reduced to a rump in the election of October 1931.

His perceived treachery and insistence on adopting what were seen by Labour activists as right-wing economic policies was to haunt the party for the rest of the century. Each time a crisis in the public finances erupted under a Labour government, in the 1960s, 1970s and 2009, the memory of MacDonald would be resurrected by opponents of spending cuts. In his own account of that period, a future Prime Minister Gordon Brown wrote: 'In the 1930s when markets failed, governments had to step in, and so the modern relationships between governments and markets resulted from the New Deal in the 1930s.'[11] Brown's Chancellor Alistair Darling

wrote in his own memoirs in 2011: 'After the Wall Street crash of 1929, as a result of falling government revenues, conventional wisdom meant that the US government cut its spending. Money dried up, unemployment soared, businesses crashed and recession turned into the misery of the Great Depression. Exactly the same wisdom, or lack of it, led the Labour Chancellor, Philip Snowden, in 1931 to propose cutting benefits, which led to the fall of the government. It would take the advent of the Second World War and its associated spending on rearmament to bring about a full economic recovery.'[12] Keynes's biographer commented: 'For roughly a quarter of a century after the Second World War, Keynesian economics ruled triumphantly. No one wanted to go back to the 1930s.'[13]

Dismay at the impact of the depression and the government's inability to lower unemployment was not confined to the left. Many 'one nation' Conservatives also came to regard the state as holding an essential role in maintaining full employment and welfare support for the poor, and would form part of the post-war consensus on spending. One such Conservative politician was the later Prime Minister, Harold Macmillan, 'whose reputation as a maverick Keynesian pioneer was proudly guarded by the Prime Minister himself.'[14] In 1938, Macmillan published a book, *The Middle Way*, which espoused a social democratic approach to spending including a minimum wage and public works, the nationalisation of the coal mines and public control of the utilities. It was 'in many ways a revolutionary document' according to his biographer.[15] Tony Blair, who later developed his own version in the 1990s, the Third Way, with President Bill Clinton, said Macmillan's book 'accurately reflected where social democratic politics should have been. But such politics only got there in the 1960s.'[16]

For Keynes the National Government's efforts to balance the books at the bottom of the slump were his target believing that spending cuts were self-defeating as the budget would never be balanced by cutting national income. Unemployment peaked in 1932 at 25 % of the workforce, an all-time high, before declining. By 1934, as the Depression began to recede, the new Chancellor Neville Chamberlain was able to revoke the cut in unemployment benefits.

But by then, far more ambitious reflationary policies were capturing the public's imagination. In the USA, there was President Roosevelt's public works programme, in Germany rearmament was underway under the new Nazi regime, and in the Soviet Union, industrialisation. A more favourable account of the National Government's economic policy says that its refusal to indulge in unbalanced budgets meant that 'the shadow

created by the dole queues shortened more quickly per head of population in timid, prudent Britain than in countries like Sweden and the United States which attempted to finance growth through budget deficits.'[17] Nonetheless, even the UK, once it dropped out of the straitjacket of the gold standard in 1931, developed a more relaxed fiscal policy so that towards the end of the decade, the worst of the depression was over, even though there was no complete global recovery. Perceived wisdom says that the Great Depression was ultimately only cured by public spending through rearmament in Germany and infrastructure investment in the USA. In fact, spending rose during the 1930s as a proportion of GDP, and was most prevalent in Canada, Germany, Japan, Spain, the Netherlands, Sweden and the USA. Nonetheless, 'by 1937 the minimal state committed to laissez-faire policies was on the way out. The ground had become fertile for the future growth of the welfare state, and in this growth redistribution would play a large role.' The onset of the Second World War, with its huge increase on military spending, effectively ended the Depression.[18]

The New Welfare State and Post-War Consensus

The Great Depression dissipated with the advent of the Second World War and the huge investment of public spending on arms. When the most destructive conflict in history drew to a close, economists and politicians contemplated the fact that the massive increase in public spending on arms had ended the Depression by creating full employment. Surely it was possible for the state to direct public spending to better uses, such as infrastructure rebuilding or education and welfare, and achieve the same ends? In addition, the wartime UK government, a coalition of all parties with Labour leader Clement Attlee as deputy Prime Minister, created through its mobilisation of the nation's economic resources a centralised, planned economy with a quasi-socialist redirection of welfare to the poor. It improved infant, child and maternity services, gave grants of milk and fuel to young mothers, introduced free milk in schools and diphtheria vaccinations, increased pensions and brought in rationing to ensure that diminished food supplies were equitably spread, with the result that the diet of the poor actually improved. The evacuation of young families from city slums to the countryside to avoid the Blitz revealed, for the first time, the shocking scale of urban poverty to the middle classes who sheltered them.

In 1942, the government asked economist and social reformer Sir William Beveridge to look into ways Britain should be rebuilt after the

war. In his ground-breaking 300-page study, *Social Insurance and Allied Services*, otherwise known as the Beveridge Report, he said the five 'giant evils' of want, disease, ignorance, squalor and idleness had to be overcome. He proposed benefits for those who were sick, unemployed, retired or widowed, to be paid for out of a weekly contribution by all those in work, and a national health service. It was effectively a blueprint for the welfare state.

In 1945, voters went to the polls. Fearing that backing Conservative leader Sir Winston Churchill was a vote for a return to the pre-war depression years, the electorate swept Labour into power with 393 seats to the Conservatives' 210.

It was a sensational and unexpected victory for Labour, whose leader Clement Attlee announced that he would implement the Beveridge Report. It was the green light for a greatly increased state, in which the nation's income would cascade down to the poor. What was extraordinary about the UK post-war Labour government led by Clement Attlee and why it has provoked admiration of an almost religious intensity across successive generations of Labour activists is that it managed both to rebuild the economy and create the welfare state while being virtually bankrupt. Attlee's government managed to expand welfare, create the NHS, invest in education and still run a tight fiscal policy. However, the flipside was that the late 1940s, for most people, truly were a time of austerity with continued rationing and few luxuries even though the war was over. The difference was that austerity was shared by everyone and not just the poor who, because of welfare and the free NHS, were actually better off than they had been in the 1930s.

In 1945, after six years of war, the national debt was 240 % of GDP. But this time there were to be no unmet promises of 'a land fit for heroes,' adherence to conservative Treasury fiscal policy or spending cuts that hit the poor and the unemployed, such as had been pursued by the previous Labour government of the now-reviled Ramsay MacDonald. The new Labour government was determined to embark on a major programme of economic and social reform, creating a welfare state funded by taxes from an expanding economy, just as Keynes had proposed. As Keynes's biographer wrote in 2009: 'Postwar chancellors, no longer slaves to the debt in an era of alleged Keynesian profligacy, had different priorities, namely economic growth. The results are sobering, one way or another. By 1965 the national debt was only 96 % of GDP; by 1980 it had been halved again, down to 48 % and was at much the same level at the end of the century.

The reason was not the decline in the debt but the growth in GDP, more than 100 times greater at current prices over the same period. By looking after output and employment it was indeed true, as Keynes had put it in 1934, that the budget could look after itself.'[19]

One reason, other than economic growth, for why Attlee was able to both run a budget surplus and create a welfare state was the ending of war, the 'peace dividend,' with military spending sharply reduced. Defence expenditure declined from 52 % of GDP in 1945 to 5.6 % in 1950, and the government was able to channel the money into education, health and pensions. There were other causes for the budget surplus too. As the economy recovered, unemployment fell to as low as 2 %—compared to the predicted 8.5 %—which also reduced unemployment and sickness benefits while tax revenues increased. Furthermore, in its drive to boost exports and investment, the government ran a tight fiscal policy to counter excess demand. The government proceeded quickly to nationalise the coal mines, gas and electricity, railways, London underground and buses, iron and steel and telecommunications. By 1951, 20 % of the economy was controlled by the state employing two million people. Most of these sectors were inefficient and loss-making and were to become a major financial drain on the public purse during the 1970s. A National Insurance Act guaranteed sickness and unemployment benefits to those who had paid the minimum contributions. Food subsidies were retained, progressive taxation continued and a million new homes built, of which 80 % were council houses. Social security spending by 1949 reached 14.5 % of government spending (and 33 % in 1997).[20] The government's crowning achievement was the 1948 National Health Service, available to everyone and free at the point of delivery. The Conservatives originally opposed it, although opposition declined as the NHS proved widely popular, especially among working class women. Of all the post-war welfare programmes that would be reformed or dismantled from the 1980s onwards, the NHS would prove to be the most enduring and was the centrepiece of the opening ceremony of the London Olympics in July 2012. In 1950, it made up 9.3 % of government spending (compared to 18.3 % in 2008).[21]

Economic problems soon engulfed the radical new government. The country was broke after the war and the affluent Americans were in no mood to bail it out with grants. A loan of £3.75 billion was eventually negotiated by an exhausted John Maynard Keynes in 1946 for a low 2 % interest, on the understanding it would support the UK's overseas military spending and not welfare reforms. Keynes died soon after. The loan was

finally repaid in 2006. The Americans more generously funded European reconstruction through the $13 billion Marshall Plan in 1948, in which the UK received the lion's share of 26 %, followed by France at 18 % and West Germany at 11 %.

The Bretton Woods agreement in 1944 created a new global financial world order and led to the creation of the International Monetary Fund. Keynes realised the cost of the war, the relative decline of the British economy and the post-war welfare state envisaged by Labour made it likely Britain would have to borrow heavily in future decades. In fact, between 1947 and 1971, Britain borrowed more from the IMF than any other country. It took out loans from the IMF in 1947, 1948, 1965, 1967, 1969 under Labour governments and in 1956, 1957, 1958, 1961, 1962, 1963, 1964 under Tory governments.[22]

The later years of the Attlee government were marked by increased austerity as economic problems worsened, and it won a second election in 1950 with a reduced overall majority of just five seats. To many Treasury mandarins, spending was now out of control. Sir Norman Brook, Cabinet secretary from 1947 to 1962, wrote to Treasury permanent secretary Sir Edward Bridges in 1950, two months after Labour was returned, that 'it is remarkable that the present government have never reflected upon the great increase in public expenditure and the subsequent change in its pattern which has come about during the past five years in consequence of their polices in the field of the social services.'[23] A Cabinet committee was set up to 'monitor soaring expenditure on the NHS' but initially, no charges were imposed.[24]

Sir Norman recommended twice yearly forecasts on future spending to be prepared for the Cabinet and the designing of a review procedure to examine the distribution of spending between various services. But the outbreak of the Korean War in 1950, which involved the UK, wrecked all these plans as defence costs soared. In his March 1951 Budget, the new Chancellor Hugh Gaitskell imposed charges on false teeth and glasses to raise £23 million, as defence spending rose from £3.7 billion to £4.7 billion. The controversial decision to breach the principle of a free health service caused a Cabinet split and the resignation of Minister Aneurin Bevan, the architect of the NHS. It was the first example of an ongoing division within Labour ranks over how to fund the ever-increasing costs of the NHS.

Labour's post-war government ended in the 1951 general election with a Conservative victory as the country tired of austerity and rationing. Labour's achievements, the creation of the 'cradle to grave' welfare

state, the implementation of the Beveridge Report, the return to full employment, the winding down of expensive overseas commitments, all carried out despite the debt legacy of war, were immense. To all succeeding Labour activists, Attlee's government was to be a golden age of what could be achieved in socio-economic policy despite financial handicaps. Once created, the welfare state and the mixed economy could not easily be rolled back and nor were the moderate 'one nation' Conservative governments which ruled the UK for the next 13 years inclined to do so, for both practical and ideological reasons. Such consensus was satirically dubbed 'Butskellism,' a combination of the surnames of Chancellor Rab Butler and Shadow Chancellor Hugh Gaitskell, and it would continue to dominate post-war politics until the mid-1970s and the election of Margaret Thatcher in 1979.

Never Had It So Good

During the 1950s, the UK economy experienced a consumer boom, full employment, and an ever-increasing standard of living for the public. Harold Macmillan was the dominant Conservative politician from the mid-1950s, first as Chancellor and then from 1957 to 1963 as Prime Minister. In his 1930s book *The Middle Way,* he had shown he was a one-nation Conservative, appalled by the ravages of the Great Depression on employment and what he saw in his pre-war Stockton-on-Tees constituency, and believing that the state had a responsibility towards alleviating unemployment, ill-health and poverty.

With the consumer boom well underway by the mid-1950s, Macmillan said in a speech in July 1957 that Britons had 'never had it so good.' It was a phrase that would sum up the increasing consumerism of that decade as GDP steadily grew, but in the hindsight of economic crises that followed would also sound complacent. Fiscal conservatives believed he was too lax on public spending and he would later be criticised by Thatcherite ministers in the 1980s, and in turn roundly condemn them for over-zealous spending cuts. Economists later maintained that the seeds of industrial decline in the 1970s germinated in the 1950s, with the boom in consumption masking underlying weaknesses such as lack of investment in industry, poor management and out-of-date working practices at a time when potential competitors like Germany and Japan were reforging their economies. Later, Prime Minister Margaret Thatcher commented that 'towards the end of that second half of the 1950s, people got the idea that things

were to go on steadily improving, and they were [but] people somehow got the idea this steady increase would go on forever.'[25] Even the optimistic Macmillan remarked that 'the country simply did not realise that we were living beyond our income and would have to pay for it sooner or later.'[26] Yet the steady increase in GDP continued to outpace the growth in public spending.

However, a portent of what would a quarter of a century later become a fault line within the Conservative Party over spending policy occurred soon after Macmillan became Prime Minister in 1957. His Chancellor, Peter Thorneycroft, told him in December 1957 that Treasury forecasts showed a rise in public spending for 1958/9 and, according to Macmillan in his diary, the Chancellor 'wanted some swingeing cuts in the Welfare State expenditure.'[27] Thorneycroft wanted cuts of £153 m, about £2.8 billion at 2015 prices. Ministers managed to find all but £50 m, equal to about £1 billion at 2015 prices and at 1 % of total public spending 'not a great sum even in 1958 terms.'[28] Nonetheless Thorneycroft dug in his heels and resigned, saying in his letter to Macmillan that he was not prepared to accept spending levels that were higher than the current one in the following year, 1957/8. His two ministers, Nigel Birch, Treasury economic secretary and Enoch Powell, first secretary, resigned with him.

Macmillan dismissed their puzzling resignations as 'a little local difficulty' but in hindsight, we can see the developing split within the Conservatives over how to treat public spending, which was to erupt under Thatcher from 1979 and continues to this day. Enoch Powell later claimed that 1957 'marked the end of seven years of decline in government expenditure as a proportion of national income. Through the subsequent six years of Conservative and six years of Socialist administration it rose steadily and rapidly.'[29] Thorneycroft, who was to become Conservative Party chairman under Thatcher, said that in those days 'the prevailing idea was to spend your way out of a crisis' but that he had made his stand too early.[30]

The Treasury decided to sharpen its monitoring of spending. The Plowden committee of 1959–1961, set up to examine the control of public spending, reported in 1961 and criticised the piecemeal approach to spending planning. It recommended regular reviews of spending, a modernising of the government's accounting system and collective responsibility of ministers for public spending rather than just the Chancellor. A Treasury ministerial post responsible for enforcing spending policy was created with the title of chief secretary in 1961. A later Chancellor, Nigel Lawson, would write: 'The job of Chief Secretary, invented by Harold

Macmillan in the early 'sixties to relieve the Chancellor of what had become an unbearable load, is to ensure that public expenditure is kept under control. It requires unceasing vigilance to that end and an ability and appetite to master detail.'[31] As a result 'the most significant development of the 1950s was a gradual transformation of the mechanics of long-term public expenditure planning and control.'[32]

The 1959 Budget was deliberately reflationary given the looming election and Thatcher later said that 'part of our post-1959 problems arose from an extremely over-generous Budget in 1959.'[33] The electorate, however, liked it and Labour's campaign was not helped by its leader Hugh Gaitskell's unrealistic pledge to increase pensions and benefits without raising taxes. The Conservatives increased their majority.

Macmillan's gloom about the state of the economy was realised as the new decade began with worsening balance of payments trade figures—which were to be a feature of the next decade—runs on sterling, and poor industrial relations. The 1961 Budget increased taxes, squeezed spending, and put up the bank rate. But the world was changing and the patrician Macmillan appeared increasingly out of touch in an era of the Beatles, Mods and Rockers, and TV satire. After the damaging Profumo spy scandal, he resigned on health grounds in October 1963, ceding to the even more patrician Sir Alec Douglas Home. The next year, Labour, under its new leader Harold Wilson, won the general election with an overall majority of five.

Spending Under Labour 1964–1970

After 13 years of Conservative government, Labour and its leader Harold Wilson heralded a more technocratic age in which technology would deliver an ever-increasing standard of living while the taxes mass consumption generated would fund more public spending. In reality, the six years of Labour government were dominated by increasing economic problems and balance of payments crises, though Wilson himself argued that it managed 'through taxation and greater public expenditure' to create a fairer order of society. He later wrote: 'We carried through an expansion in the social services, health, welfare and housing, education and social security, unparalleled in our history.'[34]

This did not stop Wilson from blaming the Conservatives for bequeathing the new Labour government a huge balance of payments crisis and a budget deficit. The outgoing Conservative Chancellor, Reginald Maudling, reputedly left a note to his successor saying 'Good luck old

cock, sorry to leave it in such a mess,' a gesture to be repeated in May 2010 by another outgoing Treasury Labour chief secretary to his successor. One historian wrote later: 'From the first weekend in October 1964 when Wilson, his Chancellor Jim Callaghan and the other senior ministers picked up their briefing papers appalling dilemmas stared them in the face … Britain under the Tories had been wildly overspending. It was living on borrowed money.'[35]

The Wilson Cabinet's first statement on the economic position, delivered ten days after taking office in October 1964, said:

> The large public expenditure programmes which the government found on taking office would if left unchanged fully absorb for the years ahead the future growth of revenue at present levels of taxation, even on the assumption of a regular 4 per cent per year rate of growth of gross national product; and without a growing increase in the rate of personal saving, higher rates of taxation would be needed.[36]

Devaluing the pound would have helped reduce the balance of payments deficit, but Wilson was adamantly opposed to this. Wilson was especially sensitive about these speculative runs on the pound, which he blamed on international capitalism trying to derail an elected Labour government implementing socialist policies. He clashed repeatedly with the then governor of the Bank of England, Lord Cromer. In his memoirs Wilson wrote: 'We had to listen night after night to demands that there should be immediate cuts in government expenditure and particularly in those parts of government expenditure which related to the social services. It was not long before we were being asked, almost at pistol-point, to cut back on expenditure even to the point of stopping the road-building programme or schools which were only half constructed—for every Government learns pretty quickly that it is easier to talk about restraining public expenditure, easier to cut Government expenditure in the long term, than to make cuts which can have an immediate impact. For so many spending programmes are committed for years ahead.'[37]

By November 1965, Wilson claimed the government 'had weathered the storm resulting from the £800m deficit; we were getting close to balancing our accounts.'[38] His biographer later agreed. Despite its small majority and the fact it 'had no earth-shaking legislation to its credit, no National Health Service or major extension of public works,' the first Wilson government before it went to the polls again in spring 1965 'had done well' and weathered economic crises.[39]

But economic problems deepened. Soon after re-election in spring 1966 on a larger overall majority there was another balance of payments crisis and, in November 1967, a step Wilson had always until then refused to consider, the devaluation of the pound. Half a century later it seems puzzling that devaluation should have been seen as such a defeat; the pound was devalued by almost a third after the 2007 financial crash and the public barely noticed. Indeed, devaluation was to become a feature of fiscal consolidation to promote export-led recovery.

But devaluation did not rescue Britain from its mounting economic problems. The first Budget of new Chancellor Roy Jenkins in March 1968 announced a record increase in tax. But by 1969, the impact was feeding through 'because we had taken a firm grip on expenditure for 1969–70 as well as 1968–9.' Chancellor Roy Jenkins also announced that from now on, a much fuller Expenditure White Paper would detail plans for the next two years. Wilson said this meant then there could be 'no suggestion of a last-minute pre-election spending spree such as had characterised British political history under our predecessors in 1959 and in 1964.' It also meant the government could challenge the Opposition—'which was attacking the total level of public expenditure while demanding increases in most of the separate items'—to say what they would cut 'to achieve their promised total and which items they would expand to win their hoped-for votes.'[40] In fact, Jenkins's Budget in spring 1970 was light on pre-election sweeteners.

But by now the opposition Conservatives had decided the post-war 'Butskellite' consensus on the economy and public spending needed refining, arguing for a more monetarist and free market policy with tougher controls on public expenditure. Meeting at the Selsdon Hotel in Croydon, south London in January 1970, the Shadow Cabinet laid out its policy, which Wilson derided as reactionary and a product of 'Selsdon Man,' a satirical reference to the prehistoric hoax discovery Piltdown Man. In a speech in February 1970, Wilson said Selsdon Man meant the Conservatives 'reject even the Butlerian acceptance of the partnership philosophy in British community life. They even reject the benevolent, father-figure image of Harold Macmillan.'[41]

Instead, the voters surprisingly rejected Wilson himself in the 1970 general election, though it was not fought simply over whether one party favoured spending and tax cuts and the other tax and spend. Wilson had managed to increase spending through difficult economic times. During the 1960s, tax as a proportion of GDP rose, although this was not unique

to Britain. Later, Labour Chancellor Denis Healey would comment in his own memoirs, 'In 1970 … public spending was under firm control and the PSBR was in surplus.'[42]

Conservative leader Edward Heath was more in the mould of the Butskellites than Selsdon Man. The question now was whether Selsdon Man was a political gimmick or a genuine line in the sand that would bring the post-war consensus on the role of the state to an end. The answer, just as the decade turned into the 1970s, would come swiftly and brutally as Britain's chronic industrial and economic weaknesses burst into the open.

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CHAPTER 3

The Party's Over

For historians of post-war Britain, the 1970s was when the structural weaknesses concealed behind the nation's 'never had it so good' consumer economy, the lack of investment, outdated working practices, over-mighty unions, weak management, high inflation and soaring government debt finally burst into the open. The 1970s was when the lights literally went out, when the government had to go cap in hand to the International Monetary Fund for a loan to prevent it from bankruptcy and when a Labour Cabinet minister told public sector workers that the 'party is over'. Joel Barnett, Chief Secretary to the Treasury from 1974 to 1979, later recalled: 'In retrospect it will surely be seen that what baffled and dominated the life of the 1974-79 Labour Government was what I called "four damned letters"—the PSBR [public sector borrowing requirement, the old name for the deficit] … Indeed finding ways of cutting the PSBR without having any real effect, especially on employment, occupied our most fertile minds.'[1]

Barnett later wrote that too much of public spending went on non-selective subsidies such as housing, supporting the—by now—ailing nationalised industries of steel, railways and mines, and transport, food and school meals rather than improving the fabric of public services or industrial regeneration.[2] In the mid-1970s, with spending at about £50 billion or 42 % of GDP, 80 % went on five programmes, namely defence, social security, housing, health and education.[3]

In fact, historians have perhaps been unfair in their grim portrayals of the seventies which, in the summer of 1976, broke records with one of

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the hottest summers in Britain's history. The Labour government, despite a small parliamentary majority, managed to hold onto power for five years from 1974, during which it agreed upon an accord with the unions until its last few months. Labour also imposed major spending cuts, paid off a loan from the IMF, introduced monetarism long before it became fashionable under the Thatcher government, and could have won a general election in 1978 or 1979 but for a series of catastrophic political misjudgements. Had Labour won the election, it is unlikely Margaret Thatcher would have survived as Conservative leader. A more centrist politician would have replaced her. Furthermore, while Labour could not have prevented the recession of the early 1980s, it is unlikely to have imposed such swingeing spending cuts which drove up unemployment to three million. We may instead have seen a more drawn-out fiscal consolidation such as Labour proposed for a later recession in 2009.

The Rise and Fall of Selsdon Man

But all these events lay in the future when the new Conservative Prime Minister Edward Heath arrived in Downing Street in June 1970, confounding the opinion polls which had been predicting a third Labour victory. The publication of poor balance of trade figures—then an important measure of a government's economic competence—helped tip voters against Wilson at the last minute.

Heath had indicated at his Selsdon Park conference that he intended to plough a different economic furrow not just from Labour, but the previous consensus Conservative governments by insisting on a tough approach to public spending. He also maintained it was time for the public to face up to the reality of decline, recalling that 'despite the difficulties of the 1960s there were still those whose memories of Britain's past greatness prompted them to imagine that our former status somehow guaranteed a bright future. It was my duty to dispel this illusion.'[4] In a speech in October 1970, he pledged that he would 'put our own house in order by looking at the whole of government expenditure and cutting costs wherever we identified waste.'[5]

The new Chancellor Anthony Barber in his first real Budget in April 1971 reduced council house subsidies, raised NHS prescription charges and withdrew free school milk from children aged between eight and 11 years (Labour had already withdrawn it from secondary school pupils). Ministers, albeit Conservative, tried to defend their departments, Heath

recalling that 'even though we were committed collectively to reducing public spending each individual minister could fight like a cornered cat to protect his or her own fiefdom.'[6] Ironically, in the light of her later conversion to monetarism and spending austerity, education secretary Margaret Thatcher 'was the only minister to clash seriously with [Treasury chief secretary Maurice Macmillan, the son of Harold] when he suggested ways of trimming her departmental budget and later found herself the target of unfair abuse for the cut in school milk' [she was later to be dubbed 'Thatcher, milk snatcher.']'[7] Heath optimistically hoped that once restored to shape, the public finances would not require more drastic pruning. In his memoirs he said that 'this first package from Tony Barber deliberately concentrated help upon those in the greatest need, minimising the pain for the poorest in society at a time when a national crisis demanded sacrifices. Naturally we hoped that these cuts would be the last.'[8]

Thatcherite ministers would later castigate the Heath government for its alleged timidity over public finances. One of Thatcher's Chancellors, Nigel Lawson, was scathing about Heath's first year, saying in his own memoirs that Heath 'announced an inadequate public expenditure package for the following financial year' and no Budget until April 1971.[9] The trouble was that despite his rhetoric, Heath was still a one-nation Conservative. One historian of the decade later wrote: 'As had been demonstrated repeatedly since he had become Conservative leader the confrontational right-wing side to [Heath's] politics was essentially an illusion: Heath was a One-Nation Tory, much more interested in keeping the country together than dividing it.'[10] Heath's speechwriter told a national newspaper in December 1973 that Heath was worried about a Tory landslide as it would 'sweep away the moderation which post-war Tories went into politics to defend.'[11] But Heath in this sense was also in tune with the mood of the country and its institutions, which were still wedded to the post-war consensus. 'Heath was governing at a time when the old Keynesian consensus, however battered and bruised, was still embedded in the body politic.'[12] In fact, throughout the 1950s, the Conservative government had studiously avoided confrontation with the powerful union movement which meant 'thirteen peaceful years' for industrial relations. Harold Macmillan had once even joked that the three institutions the Conservatives would never take on were the Catholic Church, the Brigade of Guards and the National Union of Mineworkers.[13] But from the late 1960s, a new militancy among union leaders coupled with spending constraints caused by economic problems meant that 'for

the next fifteen or more years the question of trade union power was to be central to British public life' with union membership peaking at 13 million in 1979, over half of the entire workforce.[14]

The Heath government was soon tested by the powerful National Union of Miners, whose strike over a pay rise demand of 25 % in February 1972 led to the temporary imposition of power cuts for householders—with the lights going off. The government conceded to the union. But as the economy deteriorated and unemployment suddenly rose, the government abandoned Selsdon Man and reverted to Butskellite policies to stoke demand by increasing public spending and cutting taxes, an economic strategy dubbed 'the dash for growth'. The economy boomed, with GDP rising by 3.5 % in 1972 and 5.4 % in 1973, 'the kind of rate usually achieved by Britain's economic superiors such as Germany and Japan.'[15] But it also stoked inflation and another balance of payments crisis as imports soared through excess demand.

The UK economy, along with other western economies dependent on oil, was then devastated in October 1973 by war in the Middle East between Israel and its Arab enemies on the Jewish holiday Yom Kippur. Although a ceasefire was arranged within weeks, the Arabs responded by quadrupling the cost of oil, causing petrol to soar in price. A later Cabinet minister commented that 'the whole post-war world, in a sense, came to an end on that day.'[16]

In December, Barber delivered a mini-budget with spending cuts of £1.2 million equal to 2015 prices of some £14 billion, which were 'the death knell for an era of economic optimism, the end of a consensus based on ever-growing public spending and ambitious Whitehall-driven empire-building.'[17] Barber's brief boom had proved a last-ditch attempt by the government to spearhead a growth-led recovery which was now put sharply into reverse. 'For the welfare state, for the post-war consensus and for Heath himself, it would never be glad, confident morning again.'[18]

The miners, recognising their new found power after the oil price hike, demanded at the end of the year a rise of 31 %, causing the government to impose a three-day week across industry during the winter to conserve power; the miners then went on strike. Heath decided the only solution was to go to the country in February 1974 and ask voters to back him against the miners. The gamble failed; the voters decided it was preferable to give the miners what they wanted for the sake of industrial peace than ensure more confrontation, three-day weeks and power cuts and duly returned Labour and its leader Harold Wilson to power, but without

an overall majority. A second election in October gave Labour an overall majority of three.

Five years later, it would be a different story but for now, as Heath later ruefully admitted, the public was not yet ready to take on the powerful nationalised industry unions or face up to the task of tackling a sclerotic economy, ageing infrastructure and industry, and a level of spending that was increasingly difficult to sustain. Nor had Heath himself attempted to change the post-war consensus on spending. 'Between 1970 and 1974 public expenditure continued on an expansionary trend … expenditure continued to grow because the Heath Government had continued to work within the political agenda of the post-war period'.[19]

The Party's Over

The new Labour government immediately gave the miners what they wanted. A 'social contract' between the government and unions to restrain inflationary wage rises underpinned Labour's economic policy, but the government was still saddled with the same economic problems that had confounded the Conservatives while the Labour party faithful were opposed to spending cuts. Joel Barnett, Chief Secretary to the Treasury in charge of public spending throughout the entire Labour government 1974–1979, recalled: 'All my years of responsibility for public expenditure were dominated by economic crises …. After five years at the Treasury I finished as an undoubted pessimist at least as far as Britain's general economic and industrial performance is concerned.'[20] Many of the most powerful trade unions were based in the nationalised industries like coal, steel, the railways as well as the NHS and local government and were not inclined to welcome public sector cuts. 'The jobs of public sector workers were protected by the continuing increases in public spending.'[21]

The outgoing Tory Chancellor Anthony Barber had warned that because of the oil crisis, public spending as a proportion of GDP would rise to 51.7 % 'if nothing was done.'[22] As one Whitehall-watcher noted: 'Economic crisis overshadowed Wilson's (1974) administration as it had Heath's. The Treasury, as well as Wilson's ministerial team, seemed paralysed in the face of it for the first year at least.'[23]

Critics later argued the new government wasted its first year while spending continued to rise. Barnett later recalled: 'The first year was "a phoney phase,"' adding: 'It was a period when public expenditure was allowed to increase at a pace we could not afford leading inexorably to the

enormous political and practical problems of having to make large cuts later, particularly difficult for a Labour Government.'[24] In fact, quite the opposite was happening, Barnett recalling that 'in my early days as Chief Secretary I was not involved in major expenditure-cutting exercises. The first months of the new government were characterized by our spending money which in the event we did not have.'[25]

It was clear that by 1975, as the Treasury began its fiscal plans for the following year 1976–7, major spending cuts would be on the agenda, no easy task for a Labour government which had been elected to maintain the state. The new Chancellor Denis Healey called it 'a Herculean task' and later wrote: 'Politically by far the most difficult part of my ordeal was the continual reduction of public spending; almost all of the spending cuts ran against the Labour Party's principles and many also ran against our campaign promises.'[26] Yet in his first year, he had allowed spending to continue its upward path.

Part of the initial failure to tackle spending was the assumption that GDP would continue to rise. Healey would later castigate the Treasury for the quality of its forecasting, though he admitted that 'none of the independent forecasting bodies had a better record.'[27] In his memoirs, he recalled that for his first budget in spring 1974 the Treasury's estimate of the PSBR (the deficit) for 1974/5 turned out to be £4bn too low, equal to 5.4 % of that year's GDP. As a result, the Budget 'I intended to be roughly neutral turned out to be reflationary.'[28] His efforts to curb spending were complicated by 'the Treasury's inability to either to know exactly what was happening or to control it.'[29]

He was not alone in his complaints. His Chief Secretary Joel Barnett also recalled that ministers planned for too high a level of public expenditure in the expectation of growth that never occurred. Barnett said later that 'we did not know at that time how often the forecasts would prove to be inaccurate.'[30] and added that because of the under-estimates of the real level of PSBR, 'the whole course of the next five years might have been changed had we decided we could not plan for such a high PSBR and therefore not increased public expenditure to the extent we did.'[31]

He recalled that the expenditure White Paper in January 1975, looking ahead for the years 1974/5 to 1978/9, assumed GDP growth of about 3 %, but it was never this high, while spending was forecast to increase by 2.8 % a year. 'As we did not achieve the growth of resources, we could not afford the growth of public expenditure at what was not an excessive rate, given the growing demand for public services. In fact we were compelled

to cut back public expenditure but as we were not prepared to cut it back too drastically we were also obliged to increase income tax … overall we failed to achieve the right balance between public and private expenditure because we stuck with levels of public expenditure decided on assumptions of growth in resources that was never achieved.'[32]

Figures showed public spending in 1974/5 was £5 billion higher in real terms than planned by Anthony Barber in 1971. Whitehall watcher Lord Hennessy later wrote: 'The Treasury in the mid 1970s was the scapegoat department as the economic setbacks crowded in. Public expenditure control, or the apparent lack of it, was the motor which drove public and political abuse.'[33] The Commons Expenditure Committee '"discovered" in November 1975 the legendary "lost five billion"—the difference between the real out-turn of public expenditure in 1974–5 and the figure that had been allowed for in the 1971 Spending White Paper. This led to huge, adverse publicity for the Treasury and put the select committee firmly on the journalistic map.'[34]

In May 1975, environment secretary Anthony Crosland, who was in charge of local government funding, signalled that the era of rising spending was at an end. Crosland told a local government conference at Manchester Town Hall that 'for the time being at least the party is over' and added, 'The crisis that faces us is infinitely more serious than any of the crises we have faced over the past 20 years.'[35]

Joel Barnett recalled that 'it was not until 1976/77 (planned in 1975) when there was an actual fall in expenditure of 3.8 % that the reality hit us and the real heartache began.'[36] The first big spending cuts of £1 billion for the Cabinet to consider were presented in March 1975. 'For some colleagues it was the worst crisis since 1931,' Barnett recalled. In the previous three years, public spending had grown by nearly 20 % and the ratio of spending to GDP had risen from 50 % to nearly 60 % 'having been only 42 % fifteen years earlier.'[37] The Cabinet finally agreed on cuts of £3 billion, announced in the April 1975 Budget mainly in defence, food subsidies, nationalised industries and capital spending on roads and transport as well as in housing and environmental services. Not for the first time—as was to occur in 2010—the major cuts were in capital spending as ministers preferred these to cuts in revenue spending.

To some observers, the Budget marked the end of post-war Keynesian economics. The oil crisis and the deteriorating UK economy coincided with increasing doubt in Whitehall about whether it was feasible to sustain the current levels of public spending. Healey later told an interviewer:

'I'd been very pro-Keynesian before I knew anything about economics. But the world changes … Keynesianism had really had its day by the seventies.'[38] Treasury mandarins were becoming 'sceptical about the ability of other government departments sensibly to consume the revenues the Treasury helped gather.' They 'had found the barely controlled surge in public spending during the first half of the seventies simply too alarming.'[39]

For the first time, Healey deployed the argument that public spending had to be cut to free up resources for private sector investment and exports. He also, for the first time in August 1975, introduced cash limits for Whitehall departments to prevent them from using inflation as an excuse to increase spending, an initiative he regarded a success.[40] Initially seen as 'a technical measure with little political significance', they were soon to 'assume a political dimension as the government attempted to find a way of reducing expenditure.'[41] However, Chief Secretary Joel Barnett was more circumspect. 'Cash limits could only squeeze,' he later wrote. 'They could not amputate. For amputation you needed real cuts.'[42]

The IMF Crisis of 1976

The spending cuts proved only a temporary respite as the economy continued to deteriorate. By the financial year 1975/76, spending was almost 50 % of GDP, almost 10 % more than just three years before. The Public Expenditure White Paper published in Feb 1976 itemised cuts of £1.6 billion in 1977/8 and £3 billion in 1978/9. In July, Healey announced a further £1 billion cuts out of a total budget of £54 billion as the pound began to slide.

Following Harold Wilson's resignation, the new Prime Minister James Callaghan decided it was time his own party faced reality. At the annual Labour Party conference in September 1976, he made his historic speech when he told delegates: 'The cosy world we were told would go on for ever, where full employment would be guaranteed by a stroke of the Chancellor's pen, cutting taxes, deficit spending, that cosy world is gone …. We used to think that you could spend your way out of a recession, and increase employment by cutting taxes and boosting Government spending. I tell you in all candour that that option no longer exists, and that in so far as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment as the next step. Higher inflation followed by higher unemployment. We have just escaped from the highest

rate of inflation this country has known; we have not yet escaped from the consequences: high unemployment …. You know we have not been creating wealth as fast as we have been distributing it. Over the last three years you know that our domestic product has risen by 2 per cent and the increase in our public expenditure, including central and local government, has increased by 18 per cent … it would be folly to continue to borrow at the present rate of £10 billion a year, even if we could find the lenders … Like everyone in the Labour Movement, I believe in a high level of public expenditure. But I part company with those who believe we can rely indefinitely on foreign borrowing to provide for greater social expenditure, a better welfare service, better hospitals, better education, the renewal of our inner cities and so on …'[43]

Callaghan knew when he made that speech that the country was facing its most serious economic crisis since the oil price rise of 1973. In an early portent of what would later occur in the indebted eurozone states three and a half decades later, the UK was fast running out of money and the pound was plummeting. Healey was forced at the last minute to cancel a trip to meet Commonwealth finance ministers in Hong Kong to deal with the sterling crisis at home. The government decided to ask the International Monetary Fund for a loan of £2.3 billion.

In itself, there was nothing unusual about applying for IMF loans. In fact 'between 1947 and 1971 Britain borrowed more from the IMF than any other country. It took out loans from the IMF in 1947, 1948, 1965, 1967, 1969 under Labour governments and in 1956, 1957, 1958, 1961, 1962, 1963, 1964 under Conservative governments.'[44] But by the 1970s, the IMF had concluded that to defeat inflation, public spending had to be controlled. Furthermore, the loan request by Healey was the largest the UK government had ever demanded. The IMF agreed to provide the £2.3 billion loan on condition that the government made cuts of £3 billion in 1977/8 and £4 billion in 1978/9.

Published minutes show the anguished discussions that took place in Cabinet, including suggestions that import controls be brought in as an alternative if the IMF refused to reduce its terms, though this was swiftly rejected on the grounds that a siege economy was not in the UK's interest. Healey told one Cabinet meeting on 1 December 1976 that 'the PSBR had to be cut because it was impossible to finance it at the prospective high level by printing money or maintaining excessive interest rates. Without the IMF loan the external deficit could not be financed, there would be no safety net for the sterling balances, no acquiescence by other countries in

a scheme of import deposits and no bilateral lending.'[45] Eventually, after tough negotiations with the IMF, Callaghan and Healey persuaded both the IMF and the Cabinet to compromise on cuts of £1 billion and £1.5 billion respectively. Joel Barnett later described 1976, which in the UK saw the hottest summer since records began (temperatures hit 96.6F), as 'depressing' and a 'dreadful year.'[46]

Labour politicians would later argue that the cuts were unnecessary because once again, the Treasury forecasts were wrong. In 1977/78, the PSBR turned out to be £8.5 billion rather than the £10 billion predicted by the Treasury.[47] In his memoirs, Healey wrote: 'I handed an estimate to the IMF which turned out to be twice as high as it should have been. Moreover long before any of the measures imposed by the IMF had any chance to take affect, our balance of payments in 1977 was in equilibrium, compared with the heavy deficit originally forecast. If I had been given accurate forecasts in 1976 I would never have needed to go to the IMF at all.'[48] In an interview 30 years later, Healey said: 'The big problem they always have in the Treasury is getting governments to control spending. So any excuse they can find for getting spending cut they will take. We didn't really need the [IMF] money at all.'[49] No 10 adviser Bernard Donoughue also claimed the Treasury exaggerated the crisis on the basis of, as a Treasury official once told him, 'you only get a chance once every decade to get the economy under control. What you need is a crisis that frightens ministers.'[50]

In the end, the government used less than half the loan and paid it back early. Healey boasted in his memoirs that 'by 1978/9 my successive cuts had brought down [the ratio of public spending to GDP] to 42 %, about the same as West Germany but far below Scandinavia and the Netherlands.'[51] The irony was that far from marking the beginning of a wave of cuts, the IMF loan crisis had only confirmed what Healey had already been implementing, albeit at a more gentle pace. But the humiliation of the IMF loan would cast a shadow for decades, not least across the 2010–2015 coalition government dealing with another deficit crisis for whom the loan was a warning of what might re-occur if public spending were not curtailed. As one historian wrote over three decades later: 'What the IMF crisis really marked was not so much the advent of monetarism as the death knell for Keynesianism … But this was not just a British phenomenon; across the western world Keynesianism seemed in headlong retreat.'[52] Furthermore, it was Labour which introduced monetary targets and tough spending controls, even though it was Margaret Thatcher who would later make

monetarism a centrepiece of her fiscal strategy. In 1976, Healey brought in money supply targets to set a monetary framework to reduce inflation, which had hit 25 % the year before and reducing the money supply meant cutting spending. As one historian of public spending wrote: 'It was the Labour government that in 1976 eventually abandoned the commitment to the post-war settlement. The decision to reduce public expenditure and the acceptance that such a decision was likely to result in increased unemployment confirmed the beginnings of the departure within the Treasury from the principles of Keynesian demand management.'[53] Nonetheless, Healey's medicine worked; spending as a proportion of GDP declined from a peak of 48.9 % in 1975/76 to 43.7 % in 1979/80 while the deficit, which had reached a peak of 6.7 % in 1975/76, fell steadily to 4.8 % in 1978/79 and 3.9 % in 1979/80.

But Thatcher, elected leader in 1975, had undergone a Damascene Conversion, now believing that the post-war 'Butskellite' and Keynesian consensus had allowed the state to crowd out the private sector and was in need of dramatic downsizing. Thatcher and her mentors believed it was no longer sufficient to merely trim public spending in response to economic crises as had happened for the previous two decades. They argued that the size of the state was actually responsible for the UK's decline and needed to be drastically reduced. The Butskellites saw the state as a benevolent entity, protecting the weak; the Thatcherites, as they would become known, saw the state as a producer-dominated burden, depressing private sector entrepreneurship and wealth creation and creating welfare dependency.

Thatcher was still not entirely in sync with the electorate, but public opinion was changing. Opinion had also shifted within Whitehall. Healey described the Treasury as 'the slave' of Keynes when he arrived as Chancellor in 1974.[54] Five years later, according to Joel Barnett, his Chief Secretary, Treasury officials were 'producing more and more pessimistic forecasts of the PSBR' and he was 'daily becoming more suspicious of their motives.' He reckoned it was because they knew 'we were almost certainly on the way out' and that potential Conservative ministers 'had made it patently clear that they intended to make substantial cuts in public expenditure and I knew that such views coincided with what officials thought to be necessary. I am not suggesting that officials were party political but there was a combination of "natural conservatism" and a genuine belief in the need for public expenditure cuts.'[55] A later Conservative Chancellor Nigel Lawson saw the Treasury's role differently, writing that 'it welcomed our

Table 3.1 UK public spending as a percentage of GDP 1972/3 to 1978/9

Financial year	*% of GDP*
1972/73	40.1
1973/74	42.1
1974/75	47.0
1975/76	48.9
1976/77	47.8
1977/78	44.8
1978/79	44.1

HM Treasury (July 2015) Statistical bulletin. Public spending statistics

Table 3.2 UK budget deficits as a percentage of GDP 1970/71 to 1978/79

1970/71	–0.6 (surplus)
1971/72	1.0
1972/73	2.7
1973/74	4.3
1974/75	6.0
1975/76	6.7
1976/77	5.2
1977/78	4.1
1978/79	4.8

Source: Institute for Fiscal Studies. http://www.ifs.org.uk/uploads/publications/ff/debt_borrowing.xls

See also Office for Budget Responsibility figures at http://budgetresponsibility.org.uk/data/

determination to curb public expenditure; economic fashions come and go but the one constant belief at the heart of the Treasury … is its mission to stand firm against the desire of politicians of all parties and the whole of the rest of Whitehall to devise new ways of increasing Government spending.'[56]

Although Joel Barnett would remain in politics after his traumatic term as Chief Secretary, first as chairman of the Commons Public Accounts Committee and later as a peer, his main claim to posterity was to give his name to an obscure public spending funding formula which would become especially controversial in 2014. He devised the formula, which

determined a higher level of funding to Wales, Scotland and Northern Ireland, in 1978 as a temporary measure to placate Cabinet colleagues battling over spending cuts, but also to reflect Scotland's urban challenges, lower incomes and extra demands on health and housing. The formula became increasingly controversial as the wealth gap between England and Scotland narrowed, and yet public spending remained fixed in Scotland at a higher level per head. In 2014, after the Scottish referendum, Prime Minister David Cameron insisted it would remain.

Barnett, who died in November 2014, ended his memoirs of his five years at the heart of the Treasury with advice for all political parties. He concluded: 'The 1974–79 Labour Government had a difficult economic and financial task rendered impossible by pledges foolishly made without any serious thought as to where the money would come from. You name it, we were pledged to increase it. The crucial lesson for all political parties must be that we cannot take growth for granted and above all, we should not plan in advance how to spend it.'[57]

For his own party he added: 'If the health service, housing, education and say pensions are to have a high priority, some other programmes will simply have to be cut. Areas of public expenditure that have become almost sacrosanct for dedicated Labour Party workers will in consequence have to be sacrificed. If we do see lower growth rates, without a proper debate inside and outside the major political parties, then many great public services will deteriorate.'[58]

But in May 1979, the time for debate ran out; that month, the post-war political consensus that had governed spending policy for three and a half decades came to an abrupt end.

Notes

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CHAPTER 4

The End of Consensus

Few commentators in 1979 believed that they were at a pivotal moment in the UK's political and economic history. That appreciation would come later with the wisdom of hindsight. As one historian later noted in 1991: 'In retrospect, the 1979 election has been analysed as one the Conservatives were certain to win. And so perhaps it was, after the catastrophic winter and the draining away of Labour's claims to be uniquely fitted to rule. But only much later did it become clear quite how completely a socialist epoch was drawing to a close.'[1]

Chancellor Denis Healey's new-found fiscal conservatism and firm control of spending helped deliver an improving economy in 1978 and 1979 and Labour was certainly by no means guaranteed to lose the election in 1979. What brought down the government was a series of political misjudgements, firstly Healey's insistence on 5 % pay rise limits, even tighter than those previously agreed on with difficulty with the unions, and then Callaghan's decision to postpone the election in October 1978. During the next few months, the so-called Winter of Discontent, a series of damaging strikes against Healey's policy by public sector unions alienated the electorate and destroyed Labour's trump card—the belief that it could control the unions. In March 1979, a no-confidence vote in Parliament against the government was won by one vote, triggering an election in May.

Thatcher won a clear victory in the election with a majority of 43 and 43.9 % of the votes, although it was nothing like the landslide victory of 1997 when Tony Blair won a majority of 179. There was also little

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indication that her arrival would mark a fundamental shift in UK politics, though she herself was certainly convinced of it. In her memoirs she wrote: 'I sensed, as apparently Jim Callaghan sensed during the course of the campaign, that a sea change had occurred in the political sensibility of the British people. They had given up on socialism—the thirty year experiment had plainly failed—and were ready to try something else. That sea change was our mandate.'[2]

In fact, both Denis Healey and Jim Callaghan had initiated the sea change with their tough fiscal and monetary policy and recognition that the UK was now part of a global economy and had to compete on a global scale. Sound fiscal policy and balanced budgets were replacing full employment as the totem of a successfully managed economy. Indeed, as one commentator later wrote: 'What Callaghan and Healey realised … was that Britain was now inextricably locked into a vast global system. And so it is a myth that if Callaghan had called the election a year earlier, Britain would have avoided the hardship and suffering of the early to mid-1980s. A Labour government re-elected in 1978 would have pursued a similar economic course to that charted by the first Thatcher administration, albeit with more hesitation, more compassion for the victims of deindustrialisation, and a longer, more agonising divorce from the unions.'[3]

Thatcher herself was by no means mistress of her own house either. The post-war consensus supporters of the ex-leader Edward Heath, the heirs of Butskellism, were contemptuous of her and many were in her Shadow Cabinet. The public knew little of her. 'When Margaret Thatcher walked into Downing Street in May 1979 … she was still an unknown quantity. Her manifesto had been surprisingly moderate, and power had changed hands so many times in the 1970s that nobody expected her to last for more than a decade.'[4] Her election campaign had talked of controlling public spending 'but there wasn't a word about cutting public services.'[5]

However, she wasted little time stamping her authority on government, especially in the public finances, for dark clouds were again gathering over the economies of the industrialised world. In summer 1979, she decided to reopen Labour's public spending plans 'against the background of an international economy slipping faster and faster into recession.'[6] Determined not to repeat what she regarded as Heath's error in delaying his first Budget until the year after his election, she and her Chancellor Sir Geoffrey Howe opted for a June 1979 emergency Budget. Her first task was to make reductions for the current year (1979/80) and announce them with the budget although 'the scope for cuts was limited.' The Conservatives, despite their

later reputation for being tough on public spending, had made expensive promises in opposition such as increases on defence and law and order, inflation-linked pensions and a ring-fenced NHS. Thatcher recalled: 'We might have taken cash from the contingency reserve but if there was to be any cash to take we would have to resist extra claims from government departments—no easy matter.'[7] Another alternative was to hold to existing cash limits even though inflation had risen since they had been set by the previous government. 'But that in turn would mean holding the line on public sector pay—again, no easy matter … much of the work on public expenditure cuts which we had done in Opposition had been overtaken by events. In short we seemed to be boxed in.'[8]

Thatcher felt that the Treasury's first plans for cuts in 1979/80 did not go far enough, so she asked for more. In the end, the government announced £3.5 billion of 'economies' in Chancellor Geoffrey Howe's first Budget in June 1979, including raising prescription charges. He also cut the top rate of tax from 83 % to 60 % and the basic rate from 33 % to 30 % paid for by a single rate of VAT at 15 %, up from 8 % and 12.5 %. Joel Barnett later commented that the first list of cuts of the new Conservative government 'contained most of the items on the list given to me' by the Treasury in February 1979. Barnett had thrown out the lot, apart from deferment of regional development grants.[9]

Next, the Cabinet had to plan for 1980/81 and beyond. In July 1979, Thatcher recalled that 'we had a series of particularly testing (and testy) discussions on the issue.'[10] Her goal was to bring public spending back to 1977/78 in real terms. She aimed to achieve this by 1982/3 'but in spite of reductions we had already made public expenditure was already threatening to run out of control' which in turn would have 'serious consequences for the PSBR and thus for interest rates, in the longer term for taxation, and ultimately for our entire programme.'[11]

The Heathites in her Cabinet, who would later be dubbed 'the wets', objected to spending cuts. She recalled: 'For those who had not heard that Keynes was dead, the prospect of reducing expenditure and curbing borrowing as we and the world sank into recession was undoubtedly alarming.'[12] Howe wanted cuts of £6.5 billion. 'Ministers had to recognise we were not cutting to the bone but merely reining in the increases planned by Labour and compensating for other increases that the recession had made inevitable.'[13]

Thatcher claimed that Labour's plans envisaged an increase in spending of 2–3 % in 1979/80, compared to 1978/9 and 5 % in 1980/81, on

the assumption the economy would grow by 2–3 % a year. She said the Treasury had a chart dubbed 'the porcupine' in which the forecasts of economic growth in successive public spending White Papers 'shot ever upwards looking like porcupine quills' while 'the actual course of economic growth stubbornly remained on an only gently rising gradient. This was a literally graphic illustration of the overoptimistic assumptions on which past public expenditure plans had been based year after year.'[14]

The 1980/1 Public Expenditure White Paper was published in November 1979, with pledges to increase defence, law and order and pensions and hold the total to the same as 1979/80, which meant a cut of £3.5 billion from Labour's plans. The cut was denounced as 'draconian' but 'was not large enough' in Thatcher's view.[15] Thatcher argued that high public spending was causing high interest rates which were hitting the private sector. 'I knew that we had to break this vicious spiral. We had to make further attempts to curb public spending and borrowing because otherwise private enterprise would have to bear a crushing burden of public sector profligacy.'[16]

Thatcher and her Chancellor believed the state was too big, public spending too high, taxes too onerous and full employment should no longer be the goal of economic policy. In their view, jobs would be created naturally in a market-driven economy by a private sector released from the shackles of high tax and employment regulation and public spending curtailed. The problem was that another global recession was underway, exacerbated by the second oil price rise, this time due to a cut in oil production in Iran following the fall of the Shah. The economy peaked in 1979 and the total loss of output 'between the cyclical peak in the second quarter of 1979 and the recession low point in the first quarter of 1981 was 5.5 %.'[17] The Heathites argued in vain that public spending should be allowed to rise in a recession to offset the drop in private sector economic activity, just as Keynes had proposed. In the end, Chancellor Howe's second budget in March 1980 announced £900m extra savings in 1980/81, or £5 billion less than Labour had planned to spend.

The recession continued to upset Treasury forecasts, with the public finances battered by the combination of sharply declining GDP and rising unemployment costs. During 1980, when the new Medium Term Financial Strategy to control spending was created, it became clear that borrowing was running ahead of the £6 billion target set in March 1980, and that the deficit that year would be at £11.5 billion; in fact, it ended up at £12.5 billion or 5.25 % of GDP, of which half was attributed to the

recession due to unemployment and social security benefits. To put this into perspective, the deficit in 2009 was double that figure.

Most of Thatcher's first term (1979–83) was dominated on the one hand by the global recession, which was decimating manufacturing, and on the other by her determination to reduce public spending. The problem was that she was, in economists' jargon, being pro-cyclical. She was trying to cut public spending at a time when the private sector economy was also shrinking. She continued to press her divided Cabinet for more cuts even though the Heathites were convinced they were increasing unemployment and exacerbating the recession. Observers expected her to do what Heath had done and drop his 'Selsdon Man' policies as the economy worsened; she insisted she was 'not for turning' even as unemployment topped two million by autumn 1980 and hit three million in January 1982, the highest since the 1930s.[18] Spending as a proportion of GDP, which had been falling steadily from 1975/76 to 43.7 % in 1979/80 under Labour now rose again, to 46 % in 1980/81, then 46.4 % in 1981/82 and 46.9 % in 1982/83, the highest in six years. Far from reducing the burden of spending, Thatcher's policies were actually increasing it (see table below).

The spending battles continued with mounting pressure from public sector pay and the nationalised industries. If the government could hold public sector pay rises to 6 %, it could still expect a deficit of £12.5 billion in 1981/2 compared to the £7.5 billion implied in the government's medium term financial strategy. Further spending cuts would be needed and this time defence and social security would have to see their costs pruned. 'We were entering perilous waters,' Thatcher later recalled.[19] The Autumn Statement announced rises in employees' National Insurance, a slower rate of increase for pensions, an extra tax on North Sea oil profits and cuts in defence and local government spending. Treasury financial secretary Nigel Lawson said the pension changes alone were 'a critical part of regaining control of public expenditure.'[20]

By the end of February 1981, the deficit was predicted at £14 billion. The deflationary Budget of March 1981, which both raised taxes and cut spending, aroused huge controversy, its opponents arguing that it was precisely the wrong policy in the middle of a recession. A total of 361 economists even signed a letter criticising it. The Budget in March 1981 aimed for a deficit of under £11 billion or 4.5 % of GDP through a combination of spending cuts and freezes in the tax free thresholds, although Thatcher baulked at any increases in income tax rates.

She later summed up her policy on the public finances: 'If you believed … that increased government borrowing was the way to get out of recession then our approach was inexplicable. If on the other hand you thought, as we did, that the way to get industry moving again was above all to get down interest rates, then you had to reduce government borrowing … [21]' But she recognised the political difficulties of such an approach, writing: 'Because it [the Budget] departed so radically from post-war economic orthodoxy, even some of our supporters would not wholly believe in the strategy until it started to yield results. That might not be for some time.'[22] Nigel Lawson later claimed that in fact 'the Budget was a prelude to eight years of uninterrupted growth' and 'it brought public borrowing back on track.'[23] But still, government spending rose from 44 % of GDP in 1979 to a peak of 46.9 % in 1982/83, meaning that further 'corrective action' was needed in the next spending round.[24]

Sir Geoffrey, later Lord, Howe died in October 2015. In his newspaper obituary for his former boss, Nigel (by then also Lord) Lawson said that Howe's 1981 budget was 'the great turning point in the Thatcher government's economic and political fortunes' even though it was 'controversial' and 'raised taxes substantially and cut the deficit at a time when the economy was in deep recession.'[25]

The Budget also made a major change to Treasury accounting methods. Although Labour had begun to introduce cash limits, Treasury spending forecasts did not build in inflation, which was high in the 1970s and early 1980s, and gave departments little incentive to cut spending to compensate because programmes were planned in the prices of the starting year, known as 'constant' or 'survey' prices, dubbed 'funny money' which led to 'a complete loss of control over public expenditure.' Spending was linked to the services required rather than the amount available to fund them.[26] Thatcher said the result was that 'the Treasury never knew until far too late in the day the cash consequences of decisions on spending.'[27] Instead, the government switched to 'cash planning' which according to Lawson 'proved successful … because it required spending ministers to justify demands for additional cash rather than receiving the money automatically.'[28]

Nonetheless, in July 1981 a further Cabinet row erupted, this time over spending plans for 1982/3, which Thatcher called 'one of the bitterest arguments on the economy or any subject that I can ever recall taking place during my premiership'.[29] The Heathites wanted to increase spending to stimulate the anaemic economy. Spending ministers had submitted bids

for an extra £6.5 billion, including £2.5 billion for the ailing nationalised industries. But in view of past overspending and the recent tax increases, the Treasury wanted to cut spending for 1982/3. After the row, Thatcher reshuffled the Cabinet in September 1981, ditching 'the Heathites.' She recalled: 'This did not mean that we would always agree, or that there would not be the regular arguments about public spending. But it would be a number of years before there arose an issue which fundamentally divided me from the majority of my Cabinet.'[30]

With a more pliant Cabinet, the end of the recession in 1982 and a second general election win in 1983 thanks to a divided opposition, Thatcher now dominated her government. Her new Chancellor, Nigel Lawson, who had been financial secretary at the Treasury 1979/81 before being promoted to energy secretary and then Chancellor in June 1983 and would remain in post for the next six and a half years, was in her mould. Looking back on the first year in government when he was financial secretary and the recession had been raging, he argued that deficit-financing was acceptable so long as the deficit was at the right level at the start. He recalled: 'Unreconstructed Keynesians might have argued that on the contrary the situation called for a stimulus and an even higher PSBR [deficit]; but right from the beginning we had set our face against this sort of fine-tuning. Simply allowing the PSBR to rise as a result of the lower tax revenues and higher spending (on unemployment benefit and the like) caused by the recession, without any deliberate stimulus, would have been perfectly acceptable had the PSBR not been too high to start with.'[31]

Thatcher and her Chancellor now faced yet another spending challenge as the Treasury's summer 1983 forecast showed a PSBR overspend of £3 billion. After four years, most of which included a recession, spending as a proportion of GDP had actually increased. Lawson recalled: 'Public expenditure, partly as a result of inherited commitments, had risen by 3.5 % points as a proportion of GDP during the first three years of a supposedly ferocious Thatcher Government.'[32] Furthermore, the overall burden of tax had climbed from 34.75 % of GDP in 1978/9 to 38.25 % in 1982/3. The new Chancellor admitted ruefully: 'It is noteworthy that during the period between 1978–9 to 1983–4 when the Thatcher Government was supposedly trying to cut public spending the ratio of public spending to GDP rose embarrassingly.'[33]

Thatcher met Lawson in summer 1983 to discuss further spending cuts. She later recalled: 'It is never an easy matter to rein back public spending part way through a fiscal year but the argument for early action

was overwhelming. The earlier you make a cut the less drastic it has to be and the more chance you have of sustaining your credibility with the markets which is a useful bonus. The obverse of this however was that to announce further public expenditure cuts just weeks into a new Parliament would be extremely unpopular and politically embarrassing. The public would think that we had deceived them at the election and the spending ministers would feel bounced.'[34]

They decided to include pay in the squeeze and settled on a 1 % reduction in the pay bill and 2 % reduction in other cash limits. One change was to introduce 'end-year flexibility' to stop the end of year surge when underspending departments get rid of their spend since they could not take it into the next year. The new flexibility allowed departments to carry over some of their underspending into the next year. In total, Lawson and Thatcher estimated the savings would be £1 billion in-year.

In his memoirs published in 1992, Lawson devoted considerable space to public expenditure planning under Thatcher. One of the government's first decisions was to review each year the spending plans for the next three years, adopting the 'envelope' approach in which the Cabinet agreed total public spending and departmental programmes had to fit within it. The spending round for the next financial year started in July when the Chief Secretary set out total public spending guidelines for the year followed by bilateral discussions between himself and spending ministers. Often, there would be three such bilateral meetings before agreement could be made. If there was still no agreement then the spending minister might meet the Chancellor or even the Prime Minister if large sums were involved.

John Major, Chief Secretary from 1987–89, called the process 'ritual foreplay', but it was also important that a minister did not concede too much as had happened with one secretary of state who 'bid for too little money in the public expenditure settlement, rather than too much. This concern for prudent economics would cause him much difficulty.'[35]

The so-called 'Star Chamber' would solve unresolved issues in the autumn. This was the name given to an ad hoc Cabinet committee which started work after conference season in October to resolve any disputed issues and consisted of four Cabinet ministers ('three spending hawks and one dove'), the Chief Secretary and the Chief Whip. The final stage was the November public spending Cabinet meeting after which decisions were outlined in the Autumn Statement, a document initiated in 1982, which brought together various disparate announcements as well as gave an economic forecast.

Thatcher was not always so belligerent about spending, especially when it alerted her acute political antennae and particularly when it concerned the NHS, which even she could see had a special place in voters' hearts. In September 1982, a study by the Conservative Central Policy Review Staff on tax and spending scenarios up to the 1990s was leaked to the media. The Cabinet had asked the CPRS to spell out what would happen to the big spending programmes in a nil or low growth economy if public spending were not to absorb an increased proportion of GDP. The CPRS said there would be an end to state funding of higher education with fees set at market rates and 300,000 state scholarships a year backed up by a system of student loans, a de-indexing of all social security payments and the replacement of the NHS with a system of private insurance. The most damaging part was the reference to the NHS. The leak meant the Cabinet had to deny it had plans to dismantle the free health service. A Whitehall watcher late wrote: 'Thanks to the leak the [CPRS] paper effectively killed all Whitehall debate about long-term spending and taxation until after the 1983 general election by which time its authors had been scattered.'[36] Thatcher scrapped the CPRS in 1983.

In 1984, a Green Paper *The Next Ten Years: Public Expenditure and Taxation into the 1990s* published alongside that year's Budget maintained that in the previous 20 years, national income had increased by 50 % but public spending by 90 % while taxes to pay for it took up 40 % of GDP. The Green Paper said that demand for public services was 'literally limitless' as it was not constrained by price mechanism 'which forces those making demands to balance them against costs.' It added that 'the only means of controlling costs is for the government to limit the supply.' But from the mid-1980s the anaemic economy moved into rapid recovery. Contrary to the Green Paper's predictions, spending as a ratio of GDP actually fell as the economy expanded. And by 1988, the deficit turned into surplus. Lawson boasted that during the next five years, the ratio of public spending to GDP fell to its lowest level in three decades.

By the 1988 budget, when Lawson sensationally cut the basic rate of income tax to 25 % and the top rate to 40 %, he was able to claim both a budget surplus plus tax cuts and higher public spending 'a hat trick.' Lawson recalled: 'Normal UK experience since the mid-1950s was for public expenditure to rise faster than GDP with control being effected only by periodic sterling crises such as those accompanying the 1967 devaluation or the 1976 borrowing from the IMF. The unusual element

in the 1980s was the maintenance of very firm public expenditure control in absence of any crisis imperative. This, rather than the boom alone, was what made the hat trick possible.'[37] Lawson's target now was a balanced budget in which the deficit would be at a low or zero percentage of GDP.

Spending as a proportion of GDP fell from a peak of 46.9 % in 1982/83 and declined from then on each year, reaching a low of 37.3 % in 1988/89 as the economy recovered during the mid 1980s, driven by financial services. In October 1986, the deregulation of the London Stock Exchange, the so-called 'Big Bang', led to a boom in the City and the beginning of London's pre-eminence as a global centre of financial services. It was the era of high-sending 'yuppies' and conspicuous consumption parodied as the 'loadsamoney' generation of City whizkids, but the overall economy also improved and unemployment fell to its lowest level in a decade by 1989. The tight control of the money supply which marked the first five years of Thatcher's premiership now gave way to fiscal laxity. Edward Heath later maintained that 'in 1985 the old monetarism was truly dead.'[38] Lawson's tax cuts and low interest rates further stoked the economy but also led to rising inflation (11 % by 1990), soaring house prices, a consumer credit boom and a widening balance of payments deficit as consumers sucked up imports. By 1989, GDP was growing at an annual 5 %. Looking back on that period, Institute for Fiscal Studies director Paul Johnson wrote: 'Nigel Lawson thought he had permanently improved the UK's economic performance to the extent that he could afford massive tax cuts. He hadn't. A huge fiscal deficit resulted in the early 1990s.'[39]

Conclusion: Did Spending Really Fall Under Thatcher?

Thatcher's three terms fall into two distinct phases, the first, 1979–84, which coincided with the recession, and 1984–90, which saw a sharp upturn in the economy leading to a boom (and eventually another recession). Most of the controversy about Thatcher's spending policies concerns the first phase, when GDP was falling and unemployment was sharply rising and economic policy dominated by a focus on the money supply.

Opponents of her spending cuts took the Keynesian view that with the economy in recession and the private sector shrinking, the public sector

had to take up the slack and therefore cuts only made the recession worse. Any savings from spending cuts were immediately swallowed by the soaring cost of unemployment benefits. Edward Heath, a bitter opponent of Thatcher's policy, later summed it up: 'Far from succeeding with its stated course of controlling the money supply and public expenditure, the new government comfortably missed all of its targets. The main reason for the government's failure was that monetarism is self-defeating. The unemployment created by the crude application of tight monetary policy after 1979 meant that public spending could not be brought down. Benefits had to be paid for, and many people who could have been paying taxes were forced instead to look to the state for help.'[40]

Heath added: 'In the four years following the setting out of the Medium Term Financial Strategy in 1980, increases in the (PSBR) exceeded the government's target in every single year.'[41] An historian of public spending concluded: 'The Thatcher revolution "is much more associated with the administering of the public sector rather than the financing of public services."'[42]

Even Thatcher's supporters had to admit that it was the expanding economy that eventually reduced the impact of public spending. In his memoirs, Lawson concluded that spending as a proportion of GDP grew under Wilson and Heath, slowed under Wilson and Callaghan in the 1970s, then under Thatcher 'rose only slightly more slowly than under the previous Labour Government but economic growth was a good deal faster and the spending ratio fell by two percentage points.'[43] He added: 'It is noteworthy that during the period between 1978–9 to 1983–4 when the Thatcher Government was supposedly trying to cut public spending the ratio of public spending to GDP rose embarrassingly.'[44]

In fact, the ratio was only 1.6 % less in 1982/83, after almost four years of spending cuts, than it was in 1975/76 at the depths of Labour's recession without spending cuts. According to Treasury figures, spending as a proportion of GDP declined from a post-war high of 48.9 % in 1975/76 to 43.7 % in 1979/80 before rising again to 46.9 % in 1982/83. It was only after that, by which time the recession had blown out and GDP was on an upward curve, that the spending ratio declined, reaching a low of 37.3 % in 1988/89. It is also true that the ratio never reached the peak of 48.9 % in 1975/76.[45]

Automatic stabilisers, which kick in as the private sector declines, usually mean an increase in the spending ratio and the deficit but the brutality of

the early 1980s recession and the spending cuts that accompanied it exacerbated the downturn. Whitehall historian Lord Hennessy estimated the recession caused spending to increase by 90 % on unemployment benefit and 39.5 % on social security.[46]

As GDP improved, the ratio of spending fell to the point at which the deficit actually turned into surplus, a genuine achievement though how much was down to cuts has been the subject of much debate among economists and politicians since. Certainly the size of the state reduced as loss-making nationalised industries such as the ailing car giant British Leyland were privatised, as well as gas, electricity, water, British Telecom, British Airways, British Steel, British Aerospace and British Petroleum. Edward Heath later commented that 'in many cases utilities were privatised purely because they required massive capital investment and the Treasury had decided that this must not be allowed to take place within the public sector, again for fear of adding to the PSBR.'[47] The Thatcher government was also blessed with the advantage of tax revenues pouring in from North Sea oil which by the mid-1980s made up 10 % of tax income, a goldmine which critics argued was squandered on tax cuts and unemployment support instead of being diverted into a sovereign wealth fund for the future.

Heath remained the most implacable critic of Thatcherism. In his memoirs he wrote: 'I regard the 1980s as an aberration when a combination of economic and political circumstances, a divided centre-left, vast regional disparities in unemployment and changing working patterns seriously but temporarily unbalanced the political equation. The 1990s marked a return to more traditional attitudes.'[48]

Lawson claimed to have solved the chronic indebtedness of previous decades and indeed, it seemed for a couple of years in the late 1980s that the UK economy was indeed heading for years of balanced budgets. But the boom turned out to be yet another bubble built on property speculation and credit. Years later, another Chancellor, Gordon Brown, would comment on the Thatcher years: 'Previous Governments have made the mistake, most recently in the late eighties, of claiming that they had solved our deficit problem when all they had was a short term surplus. Surpluses in 1988 and 1989 collapsed into a deficit approaching £50 billion in just four years, the biggest deficit in our history. What was claimed to be the end of one crisis turned out to be only the beginning of the next.'[49]

Brown was right. The slump of the early 1980s, followed by the boom of the late 1980s, turned swiftly into the recession of the early 1990s.

Recession and Recovery 1990–1997

The consumer boom rapidly turned to bust as the overheated housing market collapsed and the decline in consumer confidence spread across the economy. Following Thatcher's departure in November 1990, John Major, now Prime Minister, had his first meeting with his new Chancellor Norman Lamont. In a repeat of the early 1980s, spending as a proportion of GDP was now increasing as tax revenues fell while social security costs were rising due to the recession. Major recalled: 'The government's income was falling as the economy slowed but spending was rising sharply as unavoidable social costs piled up … In 1991/92 public sector borrowing to fill the gap between income and expenditure was forecast to be under £8 billion but turned out to be nearly £14 billion. In 1992–93 the forecast of £28 billion became £36 billion.'[50] This was due to a combination of falling tax revenues due to recession, rise in benefit costs, plus discretionary spending 'to protect people from the worst effects of the recession.'

John Major, who had been both Chief Secretary in 1987–89 and briefly Chancellor in 1989–1990, was in a unique position to understand the political challenges of managing the public finances. He was also less ideological than other Thatcherite ministers about curbing the state's role, believing that while spending had to be controlled, public services performed a valuable role. Nonetheless, his new government faced the unenviable task, for the second time in a decade, of managing rising public spending during a recession. In April 1991, ministers submitted bids that would increase spending by a further £15 billion in the next year, though these were later reduced to £5.5 billion of which £4 billion was increased social security costs. Spending as a proportion of GDP rose from 37.7 % in 1990/91 to 41.5 % in 1992/93.[51]

As ever, ministers continued to promote their own departmental budgets, especially after Major won the April 1992 general election. He and his Chancellor Norman Lamont were 'affronted' by 'totally unrealistic bids' from ministers for 'a further £14 billion.' He recalled: 'It was evident that the system of bidding for public spending was breaking down. Moreover even if we did not concede a penny of new money the Treasury forecast that borrowing would rise since government income was below that expected.'[52] This was 'politically embarrassing' as the Conservatives had forecast in the election campaign that their spending plans were sustainable.

Major recalled in frustration: 'Now, only weeks into the new Parliament, we faced the age-old dilemma; cut spending, raise taxes or borrow more.'[53]

Major, with his inside knowledge of spending rounds as Chief Secretary, decided the system needed to change. In June 1992, he and Lamont 'concluded that the rules of the public spending game had become too well known; every year each department took its existing level of spending as if it were an irreducible minimum and put in a bid for additional money to accommodate inflation and new expenditure … The end result was invariably a further increase.'[54] So they agreed from now on that they should stick to the total agreed the previous year. A new Cabinet committee, EDX, was set up to replace bilateral bargaining. This did not necessarily end rows about spending cuts. In October 1992, there were divisions over whether capital spending should be reduced along with current spending. Ultimately, the new Private Finance Initiative which took capital spending off the government balance sheet provided one answer, though it would come back to bite governments after the next recession.

But the Conservatives' reputation for sound financial management took a devastating and electorally fatal hit when the UK's membership of the European Exchange Rate Mechanism ended in a humiliating withdrawal on so-called Black Wednesday, 16 September 1992. Sterling had joined the ERM in October 1990 when Major, an enthusiastic supporter, was Chancellor, with the aim of reducing volatile exchange rate swings between the pound and other currencies to no more than 6 % and curbing inflation. Under the rules, the government was obliged to intervene if the pound reached the bottom of its permitted range. It was not the most auspicious time with the Lawson boom about to burst, the UK saddled with inflation and the level at which the pound entered the ERM, at 2.95 Deutschmarks, too high. Opponents of the ERM argued that it locked the UK into high interest rates linked to the German DM and therefore exacerbated the UK's recession.

By autumn 1992 speculators, realising sterling was over-valued and that the ERM itself was unstable, began a run on the pound and other weaker currencies, piling instead into the strong German Deutschmark. The government responded by raising interest rates and the Bank of England by selling foreign currency to buy pounds in a desperate bid to shore up sterling. After hundreds of millions had been spent to little avail, the government abandoned its efforts on the evening of 16 September and suspended membership of the ERM. Politically, it was devastating for Major who had supported the ERM. 'Barely five months after Major's unexpected election victory the Tories' reputation for economic competence (and with it any

realistic expectations of electoral survival) was destroyed in a single day.'[55] Major himself argued that a combination of the UK's weak economy, political problems in Europe over acceptance of the Maastricht Treaty on European union and Germany's adherence to high interest rates all combined to create an unexpected 'witches' brew' that could not have been foreseen when sterling joined the ERM.[56]

It was an early and graphic example of the defects of monetary union. The ERM was the forerunner of the single European currency. Two of Lamont's close associates at the time, his private secretary Jeremy Heywood later Cabinet Secretary, and David Cameron, his political adviser, later Prime Minister, would two decades later find themselves dealing with the eurozone crisis in another recession.

Economically, Black Wednesday was a blessing in disguise. Withdrawal enabled sterling to devalue, interest rates to fall and the economy to improve. And while Black Wednesday shredded the government's economic reputation, it did not prevent Major and his Chancellor from pressing ahead with unpopular measures on taxation and spending. Major regarded the March 1993 Budget as 'the sternest for a decade.'[57] The Budget statement laid out the difficulty that the government—and indeed all governments, not least that of 2010–2015—faced in constraining spending during recessions when it said: 'Fiscal policy will be set to maintain sound public finances which are essential for a sustainable economic recovery. The Government's objective is to bring the PSBR back towards balance over the medium term … A run of large budget deficits, even if largely cyclical in origin, would lead to a weakening in the underlying fiscal position … the speed with which the PSBR declines will depend on the rate of growth of the economy over the medium term.' In 1992–93, the deficit was 5.75 % of GDP and the Budget expected it to rise to 8 % the following year, then decline to 3.75 % in 1997–98.[58]

Staged tax rises, including 8 % VAT on energy, brought in £10 billion but were hugely unpopular. A pledge to increase the new 8 % VAT rate on energy to 17.5 % by 1995, thereby bringing in a further £1 billion, was never enforced after the government lost the vote in Parliament in 1994. There was a political price to pay as 'four years later [in the 1997 general election] the tax increases announced in the 1993 budget would still damage us at the polls.'[59] It was a lesson the 2010 Coalition would heed when it too had to plug a huge deficit in the public finances.

The 1993 Budget was not the end of austerity, even though the recession was lifting, aided by the UK's abrupt exit from the European

Exchange Rate Mechanism in autumn 1992 which effectively devalued the pound, aiding exports and allowing interest rates to fall to a level that encouraged borrowing and stimulated the stagnant economy. The new Chancellor Ken Clarke, who took over in June 1993, was a veteran minister who, despite a successful career under Thatcher, was in the moderate wing of the party. In his first November Budget, he set the ambitious goal of eliminating government borrowing by the end of the decade, froze personal tax allowances, reduced mortgage tax relief, cut budgets for house building, roads and defence and increased taxes on cigarettes and petrol. Critics, not least from his own party, claimed the Budget represented the biggest increases in tax and the largest cuts in spending since the war and that the tax changes from that and the 1993 Budget were equal to putting an extra 7p on income tax.

Major argued that the tax rises over the term of his government had far less impact, arguing that 'the tax burden' was 36.3 % when he became PM and 36.6 % on 1 May 1997 which 'over the span puts our tax record in a proper perspective.'[60] But he admitted it was 'a vote-free recovery' which ultimately benefited the next Labour government.[61]

However, the spending/GDP ratio began to fall from 1993 and continued to fall for the rest of the decade as the economy once again moved out of recession, this time into the longest run of uninterrupted growth since the 1950s. By 1997/98, the ratio was almost as low as it had been in the heady days of the Lawson boom.

Chancellor Ken Clarke, looking back 20 years later on his time in office, stuck by his record. Insisting that governments should 'run a surplus in good times and a deficit in bad' he added: 'It's essential to have fiscal discipline and to balance a budget and to run a surplus when the economy is running above trend growth. If you don't run a surplus you can't control debt so that in the next economic crisis you find you have no weapons.' His target, he said, was for public spending never to exceed 40 % of GDP and total debt not to be more than 60 %.[62]

Despite its political weaknesses, the Major government's record in managing public finances through the recession has to be regarded as a success. It managed to cut spending while diverting resources to priority departments like the NHS and was prepared to risk public opprobrium by increasing indirect taxes. It also avoided the temptation of a pre-election spending spree and tax cuts that had stoked the Lawson boom of the late 1980s. But the humiliating ejection of the pound from the European ERM in 1992 fatally damaged the Conservatives' reputation for fiscal

competence and would be an albatross for the party for a decade. Indeed, many critics regarded the subsequent recovery from 1992 not as a result of sound fiscal management but because the pound was no longer trapped in the ERM straitjacket.

As Major himself commented in his memoirs, the recovery was voteless and Labour won a landslide victory in 1997. He wrote ruefully that the new government 'accepted the buoyant economy as if it were their own creation … they stuck to the public-spending figures they had previously announced as "cuts" and to the tax changes they had attacked.'[63]

The stage was now set for the return of a Labour government for the first time in 18 years. But this time, there was to be no repeat of the fiscal crises of the 1970s. Instead, Labour would benefit politically from the longest period of economic growth in half a century. 'You've never had it so good' was making a comeback.

Table 4.1 UK public spending as a percentage of GDP 1979/80 to 1997/98

Financial year	*% of GDP*
1979/80	43.7
1980/81	46.0
1981/82	46.4
1982/83	46.9
1983/84	46.6
1984/85	46.3
1985/86	44.0
1986/87	42.7
1987/88	40.3
1988/89	37.3
1989/90	37.5
1990/91	37.7
1991/92	39.7
1992/93	41.5
1993/94	40.9
1994/95	40.5
1995/96	40.2
1996/97	38.2
1997/98	37.1

HM Treasury (July 2015) Statistical bulletin. Public spending statistics

Table 4.2 UK budget deficits as a percentage of GDP 1979/80 to 1997/98

1979/80	3.9
1980/81	4.6
1981/82	2.2
1982/83	2.8
1983/84	3.6
1984/85	3.5
1985/86	2.3
1986/87	2.0
1987/88	1.0
1988/89	–1.1 (surplus)
1989/90	–0.1 (surplus)
1990/91	1.0
1991/92	3.5
1992/93	7.0
1993/94	7.2
1994/95	5.8
1995/96	4.4
1996/97	3.3
1997/98	0.6

Source: Institute for Fiscal Studies. http://www.ifs.org.uk/uploads/publications/ff/debt_borrowing.xls

See also Office for Budget Responsibility data at http://budgetresponsibility.org.uk/data/

Notes

1. Hugo Young (1991). *One of Us*. (Macmillan p.139).
2. Margaret Thatcher (1993). *The Downing Street Years*. (London, Harper Collins p.10).
3. Dominic Sandbrook (October 2 2008). *New Statesman*.
4. ibid.
5. Hugo Young (1991). *One of Us*. (Macmillan p.139).
6. Margaret Thatcher (1993). *The Downing Street Years*. (London, Harper Collins p.49).
7. ibid. p.49.
8. ibid. p.50.

9. Joel Barnett (1982) *Inside The Treasury.* (London, Andre Deutsch p.183).
10. Margaret Thatcher (1993). *The Downing Street Years.* (London, Harper Collins p.50).
11. ibid. p.50.
12. ibid. p.51.
13. ibid. p.51.
14. ibid. p.51.
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CHAPTER 5

From Boom to Bust

Labour's inheritance in 1997 was enviable. Not only did the new government under Prime Minister Tony Blair have a Commons majority so large at 179 that it virtually guaranteed a second and even a third term, but the economy was strong and unlike the two previous governments of Thatcher and Major, it was not about to head into recession. Indeed, for the first time in decades, Tony Blair would be a Prime Minister who presided over a recession-free economy for his entire ten years in office.

Blair himself argued that one reason for the Conservative Party losing the election was because it underinvested in public services, but the new Labour government, in power for the first time in 18 years, also wanted to prove it could be trusted with the economy and was not about to embark on rash spending programmes. The new Chancellor Gordon Brown made two immediate big decisions. The first was to hand over responsibility to the Bank of England for setting interest rates, thereby removing politics from the monetary decision-making process. The second, citing 'stability and prudence' as his watchwords, was to announce that for its first two years until April 1999, he would adhere to the previous government's spending targets.

In his summer Budget 1997 speech Brown outlined his 'golden rule', namely that over the economic cycle, he would borrow only to invest and that he would fund current spending from tax revenues to ensure debt falling as a percentage of GDP. He further tightened fiscal policy 'for long-term stability in the public finances.' He added: 'Tough and prudent

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management is our watchword in what will continue to be a thoroughly disciplined approach to public finances.'[1]

One commentator later noted that the spending targets 'were so tight that even the former Chancellor Ken Clarke said he would not actually have kept to them had he been re-elected. But Brown brought down the state's share of public spending [to]the lowest percentage since 1960 and far below anything achieved by Thatcher. He was doing the opposite of what earlier Labour Chancellors had done. They had arrived in office, immediately started spending and then had to stop and raise taxes later on.'[2] In fact, the ratio of spending to GDP reached a low of 36 % in 1999/2000, still 1.3 % lower than the best achieved under Thatcher in 1988/89.

In his Budget 1998 speech, the Chancellor blamed the Conservatives for presiding over a cycle of slump, boom and slump again, adding: 'We are determined to avoid such mistakes. To balance the Budget for one or two years and then let it run out of control in the years that follow is simply to fail those who depend on public services being sustained year in, year out.'[3]

But 'Prudence', as the Chancellor's policy was dubbed, could not continue indefinitely. Labour was committed to investing in public services after years of spending constraints and ministers were becoming restless. A subsequent Labour Chancellor Alistair Darling commented in 2011: 'There are many who have said subsequently that we spent too much in the previous decade. Back in 1997, however, there was near consensus that investment in neglected public services such as an underfunded NHS and decrepit school buildings, was of paramount importance.'[4]

But the new Labour leadership was pragmatic, believing that this investment was not simply a case of pouring money into the public sector; the deal was that cash must be accompanied by reform and 'modernisation.' Blair summed it up: 'In short our mantra was "investment and reform together"—emphasising rhetorically the big difference in the public services between New Labour and Old Labour (investment without reform) and New Labour and the Thatcherite Tories (reform without investment).'[5] Alistair Darling commented that 'New Labour's economic policy was built on discounting the old left's "tax and spend" approach whereby the country borrows beyond what it can afford in order to finance spending on public services.'[6]

In July 1998, the Comprehensive Spending Review setting out spending for the next three years proposed big increases in health and education

from 1999. Brown 'began as Scrooge and quietly fattened up for Santa. Then there was an abrupt and dramatic shift and public spending soared, particularly on health, back up to 43 % [of GDP]. So there were the lean years followed by the fat years, famine, then feast, squeeze then relax.'[7] But in his introduction to the Comprehensive Spending Review, Blair said that investment would not be possible 'if the economy lurched from boom one year to bust the next. That is why we have taken a prudent approach to public finances. We have stuck rigidly to tough spending plans since the Election … This Government will spend only what it can afford.'[8]

With the brakes off, the UK entered the longest sustained period of above-inflation spending on public services since the Second World War, funded by taxes from a buoyant economy, particularly the financial sector. Between 1997 and 2010, spending on the NHS more than doubled in real terms. The Institute for Fiscal Studies noted in 2009 that the health spending increases 'since the late 1990s are not only much larger than in past decades, but have also been more sustained than any spending increases in the past.'[9]

The average real rate of total spending increases during the Conservative years of 1979 to 1997 was 1.5 %, and under the Labour government from April 1997 to March 2009 it was 3.2 %. In 2008, UK total government outlays as measured by the OECD were 48.1 % of GDP, the tenth highest level of public sector spending as a proportion of national income out of the 28 countries for which the OECD had consistent data, and the third highest out of the then G7 countries. The NHS had average annualised real increases of 3.2 % under the Conservative governments from 1979 to 1997, and 6.3 % under Labour from 1997 to 2008.[10] Treasury figures show that after the record low ratio of spending to GDP of 36 % achieved in 1999/2000, the ratio began to increase each year, reaching 39.9 % in 2006/07 just before the fiscal crisis.

The spending increases were accompanied by public sector reform and efficiency savings with mixed results, but were well received by voters and put the Conservatives on the spot.[11] In the 2005 election, after five years of spending increases, they were still a vote-winner for Labour. The Conservatives ended up fighting a campaign in which while promising tax cuts, they also matched Labour's spending plans, bridging the divide by claiming there were £35 billion of efficiency savings, a figure derided as 'back of a fag packet stuff.'[12]

In fact such was the popular consensus on the need to invest in public services that the division between Labour and Conservatives was not

about cutting spending but the rate of its increase. Tony Blair later claimed that by then he was beginning to wonder whether there should be some restraint on the rate of increases. In his memoirs, he reflected that during the 2005 election campaign 'we had an interesting debate, not quite a contretemps, about tax and spending. My view was that we had reached the limit of spending. We had increased National Insurance to pay for the NHS, yet even with the economy still growing I could sense that enough was enough … the third term had to be about making the money work.'[13]

He said that some Labour politicians believed 'the public wanted even more spending and were prepared for the extra tax, by reference to polls that the Treasury had—which I said was nonsense. On these issues the public fib. They say they want increased spending and in theory they do—but in practice they think someone else should pay for it … the public aren't always logical but that's their prerogative. They do expect their government to be, nonetheless … During the campaign I slowly but surely started to posture, to be in a position of saying: there are no big increases in tax to pay for more spending coming this time.'[14]

By 2006 he was concluding that 'I had no precise percentage of public spending in my mind that corresponded to the right figure for the economy's equilibrium between public and private sector but I knew there was a limit. So I thought, post-2005, this was the time to shift focus and to drop the notion that it was all about who would spend most.'[15]

Blair maintained he was thinking then about the composition of the state at a time when, while spending was rising, so was demand. In his memoirs he reflected that rising demand, especially from an ageing population, meant 'there was inevitably going to be a crunch at some stage. Better to confront it now and set in place a framework that over time would make costs manageable and tilt the responsibility for provision from state to individual. The state would still be there as an enabler and in case of hardship, guarantor; but it made sense for people to provide more for themselves.'[16]

His chief of staff, Jonathan Powell, also later claimed to be concerned about the continuing rise in spending, writing: 'I was worried about the spend, spend, spend nature of some of our Budgets and noted in my diary that without reforms to save money in the public sector we would have no cushion if the economy turned south.'[17]

But the economy continued to head north. In his March 2007 Budget, Gordon Brown referred to 'the longest period of economic stability and sustained growth in our country's history.' The British economy was growing faster than all the other G7 economies and he predicted it would

continue growing at 2.5–3 % in 2008 and 2009. Furthermore, his fiscal 'golden rule' that current government spending was paid by tax revenue had been comfortably met while debt as a percentage of GDP would be 38.2 % in 2007/8 compared to 44 % in 1997 and net borrowing at 2.7 % would fall to 1.4 % by 2011/12.[18]

A decade previously, Brown had promised an end to the boom and bust that had bedevilled UK economic policy since the 1960s. For ten years he fulfilled that promise. Now, just months after his last Budget as Chancellor, his confidence was about to be spectacularly punctured.

The Return of Recession

The new Chancellor, Alistair Darling, who succeeded Brown in June 2007 when the latter became Prime Minister, arrived at the Treasury to find senior officials relaxed about the economy. He recalled later: 'The landscape seemed extraordinarily tranquil. Britain had seen more than ten years of continuous economic growth, something that had not been experienced for more than two centuries. Our debt levels had fallen from being the second highest of the world's seven largest economies to the second lowest, behind Canada.'[19]

No one at the Treasury appeared especially concerned about how dependent the public finances were on taxes from the financial sector, which represented some 12 % of total tax receipts (which were about £553 billion in 2007/8). Reading through the briefing paper, Darling noted 'We seemed very dependent on taxes coming in from the financial services industry. About 25 % of our corporate taxes came from that sector. And the much criticised bankers' bonuses and sometimes inflated salaries made a big contribution to income tax receipts [but] Treasury officials expressed no concern about the banking system in the course of the early briefings I was given as a new minister.'[20]

But then, as Darling later wrote, the economic forecasts looked promising. He rejected later Conservative claims that Labour had squandered the boom years, failing 'to fix the roof when the sun shines' and that the public finances should have been much more robust and able to withstand the shock of the fiscal downturn after so many years of a buoyant economy. Consequently, on the eve of recession, despite a decade of growth, the UK still had a budget deficit.

Yet as Gordon Brown's biographer also noted, 'Britain entered the recession with the deficit at 3 % of its GDP which was not high by

international standards.'[21] The economy grew by 3 % in 2007, borrowing averaged 1.2 % of GDP between 1997 and 2007, almost a third of the level between 1979 and 1997, while debt was at 36.6 % of GDP compared to 43.3 % in 1997. The problem, as Darling recognised, 'was that it had been assumed that tax receipts would continue to flow in from the financial sector.'[22]

The Treasury was not alone in believing boom and bust was in the past. Few politicians, journalists or business leaders expressed concern about the dependency of ever-rising public expenditure on buoyant tax revenues fuelled by big City bonuses. As one financial journalist later wrote: 'It is almost impossible to overstate the breadth of relaxed consent, if not evangelical support, for the City and its doings at the zenith of the boom. The ruling left had few complaints about a sector that sent tax revenues cascading into the Treasury.'[23]

The Conservatives did not envisage any downturn either. Knowing that any suggestion they might want to cut public expenditure was electoral suicide, they continued to back Labour's spending plans. In autumn 2007, in the middle of the furore caused by Brown's decision not to hold an election that year, Osborne announced the Conservatives would match Labour's spending plans announced in Brown's March 2007 Budget, raising total spending to £674 billion by 2010/11.

But there were already indications that the overheated economy was coming off the boil. In the USA, investors were growing nervous about their exposure to the sub-prime mortgage market. In the UK, rising inter-bank interest rates forced one mortgage lender, Northern Rock, to ask for emergency finance from the Bank of England, provoking panic-stricken queues of customers wanting to withdraw their money. In February 2008, the government decided to nationalise Northern Rock as the least worst option.

By coincidence, Chancellor Alistair Darling had to set, in November 2007, the next three year Spending Review for 2008/11, the fifth since Labour had introduced them in 1998. As he admitted later 'the timing of the Spending Review could not have been worse.' In 2007 it was 'by no means certain' in his view that an economic downturn was looming, but by 2008 'it was obvious that the assumption that the economy would continue to grow uninterrupted could no longer hold. Had we known what was about to happen I would almost certainly have fixed spending for the following year making plans for a further review the year after.'[24]

As it was, Darling decided to cut the rate of growth in spending by half on the basis that 'after ten years of almost uninterrupted increase in

public spending we could afford to do so. … I thought that it was time to apply the brakes on the amount we were spending … That would be easily manageable on the back of a much higher level of spending than we had inherited ten years earlier and would still allow us to continue to improve public services.'[25]

As 2008 progressed, the global financial scene worsened and the March 2008 Budget predictions proved wildly optimistic even though at the time 'very few were predicting a recession.'[26] The trouble was that 'no one realised just how far economic conditions would decline during the course of that year … It was only following the collapse of the American bank Bear Stearns immediately after the Budget that the economic outlook darkened significantly.'[27] More worrying was the impact of the rapidly slowing economy on the public finances since a quarter of corporate taxes came from the financial sector, while a collapse in the housing market meant a sharp drop in stamp duty receipts, a consumer slowdown smaller VAT revenues and rising unemployment less income tax. 'The problem was that it had been assumed that taxes coming in from the financial sector would go on and on. After all they had done so since the beginning of the decade … the real problem was that the economy had become too dependent on one sector. When the crisis hit, the UK was hit very hard.'[28]

Keynes was now making a comeback. The government's aim was to avoid drastic cuts in spending but 'plan how to cut borrowing and reduce debt once we moved out of recession in 2009 or 2010.'[29] Economist Robert Skidelsky wrote in 2009 that 'Keynes is back in fashion.'[30] The UK government took the Keynesian view that a recession was not the time to cut public spending, or it would turn into depression, a view by no means confined to left-of centre politicians. Chancellor Alistair Darling later wrote: 'When households and companies spend less, and governments cut public spending, recession risks turning into depression. The argument for maintaining public spending is therefore quite straightforward. It takes the strain as business activity reduces and people spend less … Certainly, to start cutting public spending midway through 2008 would have jeopardised millions of jobs.'[31] He admitted that 'in late 2008 I was hugely influenced by Keynes's thinking—as indeed were most other governments dealing with the fallout from the crisis. I could see that if we did not maintain our spending levels we ran the severe risk of an inevitable recession turning into a deep depression which might last for years … At the end of 2008 there were very few people in the world who thought that it was a good time to cut back public spending.'[32]

But the firestorm of bank failures in the USA and the UK caused by toxic loans reached its zenith in the catastrophic collapse of Lehman Brothers in September, an event which for most people marks the real beginning of the fiscal downturn. The global fallout threatened an exodus of confidence in the entire banking system until the UK government bought failing banks and the US government injected almost a trillion dollars to keep the system liquid.

As government revenues fell across the world, so deficits widened, yet few were as wide as the UK's. In October 2008 the IMF's World Economic Outlook report warned that the UK could face the worst downturn of any of the leading industrialised economies because of its dependency for tax revenues on financial services and stamp duty from the housing boom. A McKinsey study of ten mature economies stated that 'the United Kingdom experienced the largest increase in total debt relative to GDP from 2000 to 2008 … and has the second highest ratio of debt to GDP among major economies after Japan.'[33]

The problem was that while the downturn had an immediate negative impact on tax revenues, public spending continued on its trajectory, as planned two or three years previously, so that the gap between the government's income and its outgoings began to widen immediately. Darling tried to argue that a debt level of 40 % of GDP was sustainable as 'no British government has ever defaulted on its obligations; indeed, unlike most governments, which borrow over a short period of about seven years, most of our debt is borrowed over a longer period, on average over thirteen years. That is one of the reasons why we were never at any time at risk of being unable to raise the money we needed.'[34] In the March 2008 Budget, Darling had planned for annual spending growth of 1.8 %. In the Pre-Budget report in November he cut it to 1.2 %. He also cut the rate of VAT from 17.5 % to 15 % for a year to stimulate the economy and forecast as a result that borrowing would soar to £118bn in 2009 and debt to 57 % of GDP by 2013/14.

But by the end of 2008, the deficit was 8 % of GDP, the highest since records began in 1970. Britain was now officially in recession for the first time since 1991 after two consecutive falls in GDP. In total, during the recession the British economy would lose 6 % of its GDP with a catastrophic impact on its public finances. The British economy contracted from minus 0.3 % in the second quarter of 2008 to minus 0.9 % in the third quarter and then to minus 2.0 % in the final quarter of 2008. Later figures would show that UK output dropped 5.4 % between the first

quarter of 2008 and the second quarter of 2009, ‘a decline not seen since the 1930s depression.’[35]

At the time the government was still bound by its fiscal ‘golden rule’ not to borrow to fund day-to-day spending but ‘from 2008 our strategy was essentially to support the economy through the recession and then to cut the deficit once growth was established.’[36] In the Pre-Budget Report in November 2008, Darling abandoned the ‘golden rule’ of balancing the Budget over the economic cycle, maintaining it would be reinstated in 2015. This did little to reassure Treasury officials and he ‘was to come under mounting pressure from them to cut the deficit.’[37]

The same month, the Conservatives abandoned their policy of sticking to Labour spending plans which they now said were plunging the country into huge debt. The biographer of Shadow Chancellor George Osborne said that to Osborne ‘restoring Britain to fiscal health was to be his mission. Austerity, though he would almost never use the word, would be his strategy.’[38] As a result, battlegrounds were drawn up among the political parties over how to tackle the catastrophic downturn in public finances. Darling’s view was that ‘although we had entered the recession with a deficit of 3 % of our national income, which was not high by international standards, it had now risen to 8 %, the highest since records began in 1970. Even so it was manageable. But it looked to some as though we were spending more money that we did not have. This gave the Tories the space they needed finally to abandon support for our spending plans which they had maintained up until that point.’[39]

By the 2009 Budget—delayed by a month due to the London G20 summit—Darling decided that it was no longer sufficient to maintain a Keynesian approach to spending and that the government needed to lay out a plan to reduce the soaring level of borrowing, now £178 billion or 12 % of GDP. It was also the first Budget since Britain had gone into recession in the last quarter of 2008. In the first quarter of 2009 the economy contracted by 1.9 %, the worst performance for 30 years. He later wrote in 2011: ‘For most of the New Labour years, the story of Labour investing in public services, and the belief that the public sector and the private sector should complement each other, dominated the British political scene. The banking crisis changed all that. We could, and did, still argue that government spending was making the difference between recession and depression. Indeed three years later, it was public spending in the shape of a still substantial deficit that was supporting the economy in the absence of a return of private sector confidence. What had changed though was

that the old battle lines were now hopelessly out of date. We had to show that while we would do whatever was necessary to support the country, we would have to tackle the deficit in order to get borrowing down. It was one of many preconditions for a return to growth. The argument therefore had to be more subtle. It had to strike a chord with voters … once the recovery was underway we would cut our borrowing but do it in a way that allowed us to prevent essential services.'[40]

His approach, however, was at odds with that of his Prime Minister, who feared even using the word 'cuts' and preferred to call public spending 'investment'. Brown's mantra was that the battleground was between Labour's 'investment' and the Conservatives' 'cuts' just as it had been in the 2001 and 2005 elections. The Treasury, he believed, were being too pessimistic about the state of the public finances. Brown 'had become engrossed by how the world had responded to the Great Depression in the 1930s.' On a flight back to London from Afghanistan in December 2008, he read a book on Roosevelt's first 100 days. 'The mistake Roosevelt made, Brown came to believe, had been to cut spending too quickly following his initial stimulus … Keynes's insight that governments could play an active role in stimulating demand during recessions was sweet music to Brown's ear. He had long believed in the efficacy of public spending.'[41] He was also haunted by the example of the Labour government in 1929, which had resorted to spending cuts when faced by the Great Depression.

Darling believed that to be credible the government had to show it was prepared to tackle the deficit. The 'cuts versus investment' argument had worked for Labour in 2001 and 2005, but the economy then was booming. The electorate in 2009 knew that public spending was out of kilter with tax revenues and that at some stage there would be a reckoning. Opinion polls showed that voters were 'angry about the recession and the threat to their jobs and they couldn't readily comprehend how increased borrowing or spending would make things better.'[42] Darling's supporters argued that only Labour could manage the inevitable spending downturn sensitively. Darling later wrote: 'By accepting the need for cuts in spending, we were only doing what everyone knew we would have to do … We knew the Tory position would be to use the cover of high borrowing to make significant and rapid cuts in public spending for ideological reasons.'[43]

There were now three approaches to managing the deficit. There was the Darling way, avoiding spending cuts in the short-term so as not to make the recession even worse but with a commitment to reducing debt

once the recession appeared to be over. There was the Gordon Brown way, which was to maintain spending levels and avoid suggestions of cuts, based on a passionately-held view that at all costs the unemployment of the 1930s and the early 1980s must be avoided. Then there was the George Osborne way, which was to warn of major spending cuts in order to balance the books while accusing the government of being reckless. '[Conservative leader David]Cameron had believed the Conservatives had been punished by the electorate because they were not trusted with public services. But he now changed tack … The spending pledge had never been popular with the right of the Conservative Party and the decision to abandon it was relatively easy. The return of the Tories to fiscal conservatism and "sound money" played very well with the right wing press though they feared it would allow Labour to claim the party was turning its back on vulnerable people who needed help at this time. The stage was set for a major clash of ideologies.'[44] In fact, Osborne decided that, far from fudging the issue about cuts, he needed to make it plain to the electorate that he intended to do whatever necessary to reduce the deficit even if it lost them votes.

From the start of 2009, the big media story was the size of the deficit. 'The public narrative of debt had become the defining issue … concerns grew about how long market confidence would tolerate these levels of borrowing.'[45] Tensions between the Darling and the Brown ways erupted as the Budget 2009 was prepared. Treasury officials feared No 10 failed to recognise the gravity of the debt crisis while No 10 was convinced that only fiscal stimulus through public spending would guide the economy out of the recession. The resulting compromise was a tax-raising Budget, with 50p on the top rate, taxes on fuel, alcohol and tobacco alongside spending cuts that critics said were insufficient. The Institute for Fiscal Studies warned it would take two Parliaments, or another eight to ten years, to rebalance the public finances. Darling recalled that the media headlines in response 'were as bad as they could be' because of 'the combination of massive borrowing, growth forecasts that were not believed and a lack of a clear plan to get borrowing down.'[46]

Darling assumed a permanent 5 % drop in economic capacity which would mean a larger structural deficit. He therefore planned to halve the deficit over a four year period while protecting health, schools and policing with inflation-only increases. Protecting these services, which covered 60 % of spending, would mean cuts of 15 % on other government departments. He later recalled that 'I could see, though, that there was no

appetite for this in No. 10' even though that 'by accepting the need for cuts in spending we were only doing what everyone else knew we would have to do.'[47]

Throughout the year, Brown continued to be under pressure from the Treasury, some of his own Cabinet ministers and the Conservatives to specify the cuts needed to meet the target of halving the deficit in four years. In September, however, in a speech to the TUC conference, Brown finally used the word 'cuts' and 'there was relief around the Cabinet table.'[48] At the same time, Osborne at his party conference spelled out the cuts he intended to make if in government. It was a calculated gamble but his speech 'was his matriculation as a truly serious and substantial figure. Perhaps no other prominent Western politician was being so explicit so early about the inescapability of austerity.'[49]

In the Pre-Budget Report in December 2009, Darling announced an increase in VAT and National Insurance and spending cuts in unprotected departments. In September a poll for *The Times* newspaper showed that 60 % of the public preferred spending cuts to higher taxes. 'The great danger was that the public would feel that at a time of cuts they should hire the experts—and that would not be Brown.'[50]

By 2010, growth was returning, albeit 0.1 % in the last quarter of 2009, and suggested that the government's handling of the downturn was working. Darling believed that cutting public spending faster would have derailed the recovery and led to an increase in borrowing. He saw the dividing line between his approach and that of the Tories as about how to bring down borrowing 'in a way that did not damage it or the services on which people depended' which was why he set a four year target to halve the deficit. He later wrote in 2011: 'That was the essential difference—the dividing line, if you like, between us and the Conservatives and it still is in 2011.'[51]

The March 2010 Budget, weeks before the general election and with the optimistic strapline *Securing the recovery*, therefore still envisaged overall public spending rising the next year 'to help support the economy through the recovery' though current spending would increase by just 0.8 % each year on average to 2014/15. Some £11 billion savings were announced from 'operational efficiencies', plus a 1 % cap on public sector pay rises and it predicted that public sector net debt would peak at 74.9 % of GDP in 2014/15. As GDP growth was expected to be 3–3.5 % in 2011, the Budget envisaged that would be the year when deficit reduction would really take effect.

Darling did admit that deficit reduction 'gained considerable traction' among the public.[52] As he had predicted, voters no longer believed that spending could or should continue to increase when GDP was unable to sustain such a rate of growth and that it was up to the next government to lay out a feasible debt reduction plan. As one journalist wrote: 'One of the great achievements of the Conservative campaign was to force the idea of the deficit across voters' doorsteps, explain that it was a bad thing, and persuade them that Brown and his gang would never deal with it.'[53]

In fact, support for Labour's strategy of fiscal stimulus in 2010 followed by deficit reduction in 2011 when GDP was expected to recover came from no less an august body than the International Monetary Fund. In its *World Economic Outlook: Rebalancing Growth* report in April 2010 the IMF stated: 'Most advanced economies should embark on fiscal consolidation in 2011. Meanwhile, given the still fragile recovery, the fiscal stimulus planned for 2010 should be fully implemented.'[54] However, the IMF also emphasised that without debt reduction, there could be higher interest rates and low growth and that increasing tax was likely to be a prime means of achieving it. By 2009/10, spending as a proportion of GDP was 45.7 %, the highest it had been since the dark days of recession in 1982/83 when it hit 46.9 % and approaching the record 48.9% in 1975/76.

Was Public Spending Too High?

The issue of how much responsibility the Labour government should bear for the deficit and whether it had spent recklessly would haunt the party in opposition for the next five years.

Undoubtedly the governments of Tony Blair and his Chancellor, then successor, Gordon Brown presided over the biggest increase in public spending since the Second World War. The increase was funded by taxes from a booming economy which for fifteen years was free of recession, a dramatic change from the three decades to 1992 which experienced three sharp downturns. Chancellor Gordon Brown predicted the end of the boom and bust cycles of previous governments and until 2008 he appeared to be proved right. Complacency set in among those in positions of power. They should have been more cautious, more questioning and more sceptical about the idea that recessions were history. In particular, they should have more closely examined the nature of the economic boom

and realised that at its heart lay dependency on just two highly volatile sectors: financial services and property, the first of which had become dangerously light-touch regulated. The so-called Big Bang deregulation of the City in October 1986 marked the start of London's climb to the top as the pre-eminent global financial services centre; the credit crunch 20 years later was its consequence, an under-regulated sector which made reckless gambles.

A 2010 election briefing by the respected Institute for Fiscal Studies stated that total public spending was forecast to be 48.1 % of national income in 2010/11, up from the 39.9 % Labour inherited in 1997 and the highest percentage since 1982/3 when the country was mired in recession. Over the period 1997–2007, just before the fiscal crisis, the UK had the second largest increase in public spending as a percentage of national income out of the 28 industrialised countries for which the IFS had comparable data. Over the period 1997 to 2010, including the crisis, the UK had the largest increase. Spending on public services increased annually by 4.4 % a year under Labour, compared to 0.7 % under the Conservatives (1979–1997) mainly due to increases in health, education and transport. Spending on welfare actually grew less under Labour than under the Conservatives due to the strong economy. But spending also improved public services, with investment in new schools and hospitals and help for working-age poor through tax credits. The Office for National Statistics estimated a one third increase in the quantity and quality of public services under Labour.[55]

However, for international comparisons of debt, the UK was around halfway. In 2007, the UK had the 11th highest level of general government net debt among 21 advanced economies surveyed by the IMF.[56] IFS director Paul Johnson, writing later in 2015, said: 'Gordon Brown appeared quite convinced he had abolished boom and bust. He kept telling us. He hadn't. We all know what happened next. There were many other symptoms of his hubris. One was the belief that running a significant deficit after more than a decade of continuous growth was safe.'[57]

So should debt have been lower in 2007, on the eve of the crisis, as critics suggested, so that the economy was better prepared to weather the downturn in tax revenues? The IFS study said the first four years of Labour saw the public sector move from deficit to surplus whereas the next seven years—with spending sharply increasing from 2001—saw it move to deficit. Labour arrived in power in May 1997 with the deficit

falling that financial year 1997/98 to 0.6 %. In 2006/7 on the eve of the fiscal crash, the deficit was up to 2.6 %. However, in 2007, Labour still managed to reduce public sector borrowing to below the level it inherited in 1997, although other industrialised countries had reduced their debt by more. The IFS report stated that 'while the UK public finances were in better shape when the financial crisis began than they were when Labour came to power, the UK was in a worse position relative to most comparable countries.'

The OECD concluded that 'strong growth and macroeconomic stability in the run–up to the crisis had hidden a build–up of significant imbalances, influenced by over-reliance on debt–finance and the financial sector, and booming asset prices … The fiscal position was weak coming into the recession and worsened rapidly as output dropped and the deficit reached almost 11 % of GDP in 2009.'[58]

The fiscal crash and the consequent recession saw levels of public sector net borrowing 'balloon to levels not seen since the Second World War,' certainly higher than in the 1990–1992 recession.[59] Critics argued that the public sector deficit should have been eliminated by 2007, considering a decade of strong economic growth such as happened in New Zealand and that if so, the public finances might have weathered the storm and austerity been avoided. It is unlikely that any surplus could have soaked up such a catastrophic drop in GDP in such a short time. The problem was that day-to-day public spending was based on too narrow a tax base which once sharply reduced left a huge hole in revenues. A later Budget report, admittedly under a different government concluded: 'In the UK, a property boom and unsustainable profits and remuneration in the financial sector in the pre-crisis years drove rapid growth in tax receipts. The spending plans set out in the 2007 Comprehensive Spending Review were based on these unsustainable revenue streams. As tax receipts fell away during the crisis, the public sector was revealed to be living beyond its means. Public spending increased from 41 per cent of GDP in 2006/07 [later revised down 39.9 %] to 48 per cent of GDP in 2009/10 [later revised down to 45.7 %], while tax receipts fell by 2 per cent of GDP over the same period.'[60]

The IFS in a later commentary (2015) said that before the fiscal crash in 2008, Labour was planning to reduce borrowing to 1.3 % of national income by 2012/13 (it was actually still 5 % in 2015) by increasing spending less than the increase in GDP. The Treasury's estimates of structural borrowing—the difference between spending and revenues after

adjusting to the ups and downs of economic growth—was 'only slightly more optimistic than that of the IMF or the OECD' but 'the UK's public finances could have been better prepared for a potential downturn.'[61] Furthermore, while in 2008 the Treasury estimated that structural borrowing was 2.7 % of national income in 2007/8, later estimates from the Office Budget Responsibility in March 2014 suggested it was actually 3.9 %. At its peak, the UK's level of borrowing of 11 % was behind only Greece, Iceland and Ireland.

Alistair Darling was later frank about his own government's reliance on financial services tax revenues to fund its spending programmes. He admitted: 'We mistakenly assumed that the revenue that rolled in from the financial services sector and from stamp duty would keep on coming. Our spending was based on that assumption and when it came to an end borrowing rose. There had been no reason to assume that revenues would fall—after all, very few foresaw the banking crisis … [but] to assume that revenues would continue to flow uninterrupted from the sometimes volatile financial services industry was a mistake. When the crash came there was no margin to fall back on.'[62]

The government's immediate response to a financial crisis that could have destroyed confidence in the entire banking system was swift and decisive. To many commentators, it was Gordon Brown's finest hour as he dragooned the leaders of the world's largest economies to bail out their collapsing banks. The government harnessed the wealth of the state to sustain liquidity, nationalising failing banks, printing money in the form of quantitative easing and avoiding a repeat in the UK of the catastrophic Lehman Brothers collapse. But managing the public finances once the tax tap from the City dried up was a long-term challenge. As its debt piled up, the government had to outline a strategy to reduce it, if not in the short-term at least when the recession ended, for as well as economists warning about the impact of debt on interest rates, the mood of the British public also changed. For three general elections in 1997, 2001 and 2005, voters had confidently backed the 'investment, not cuts' strategy of New Labour and rejected Conservative austerity knowing that a strong economy could sustain rising spending. The global fiscal crisis and consequent ballooning of debt punctured that confidence. The public knew that debt would have to be reduced before it smothered the economy or interest rates soared,

that taxes therefore might rise but spending must be curbed. The issue from 2008 onwards was not whether there should be spending cuts but when, with what severity, for how long, and which political party was best placed to deliver them with minimal pain.

All three main political parties planned for a reduction in debt, the difference being the timescale with the Conservatives wanting to start and achieve their targets earlier with a greater emphasis on spending cuts and less on tax increases. The IFS estimated that Labour and the Liberal Democrat plans would bring spending as a proportion of national income down to 2004/5 levels and tax revenues to their highest since the late 1980s boom, while the Conservatives would reduce spending to 2003/4 levels and tax revenues to the level in 2006/7.[63]

Their consistent double digit lead in the polls during 2008 and 2009, George Osborne's bold decision to cease backing Labour spending plans and campaign for deficit reduction from 2008 plus an unpopular Prime Minister persuaded the Conservatives that in May 2010, they would win over Labour by a landslide. They were in for a surprise.

Table 5.1 UK public spending as a percentage of GDP 1997/98 to 2009/10

Financial year	*% of GDP*
1997/98	37.1
1998/99	36.4
1999/2000	36.0
2000/1	36.2
2001/2	37.2
2002/3	38.0
2003/4	38.6
2004/5	40.1
2005/6	40.1
2006/7	39.9
2007/8	40.2
2008/9	43.5
2009/10	45.7

HM Treasury (July 2015) Statistical bulletin. Public spending statistics

Table 5.2 UK budget deficits as a percentage of GDP 1997/98 to 2009/10

1997/98	0.6
1998/99	–0.5 (surplus)
1999/2000	–1.5 (surplus)
2000/01	–1.7 (surplus)
2001/02	0.1
2002/03	2.3
2003/04	2.6
2004/05	3.4
2005/06	3.0
2006/07	2.6
2007/08	27
2008/09	6.7
2009/10	10.2

Source: Source: Institute for Fiscal Studies. http://www.ifs.org.uk/uploads/publications/ff/debt_borrowing.xls

See also Office for Budget Responsibility data at http://budgetresponsibility.org.uk/data/

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CHAPTER 6

Austerity Britain

Towards the end of 2009, the Conservatives' huge lead in the opinion polls began to slide. Some commentators argued this was due to improving economic figures and a growing sense among the public that the government was perhaps right to make only modest cuts, thus avoiding a depression on the scale of the 1930s or the 1980s. However, the Conservatives' diminishing poll lead failed to shift George Osborne from his austerity rhetoric.

The May 2010 elections gave the Conservatives 307 out of 650 seats but without an overall majority, and talks began with the Liberal Democrats about forming a Coalition, the Tory leadership preferring that to limping along as a minority government. Conservative election policy was to eliminate most of the structural deficit by 2015 starting immediately, whereas the Liberal Democrats favoured delaying any cuts until the economy looked more solid, probably in 2011 just as Darling's Budget and the IMF had proposed. After the election, the Lib Dems decided that to avoid instability, deficit-reduction should be initiated immediately. As one of the Lib Dem negotiators later revealed: 'We assumed George [Osborne] would want to do something tough on the deficit and we were open to in-year cuts.'[1] Lib Dem Chief Secretary Danny Alexander later recalled: 'In 2010 there was no choice but to take action to sort out the public finances. When you've got a 10 % deficit you have to do something. When we started we were borrowing £150 billion just to service our debt.'[2] Ministers were careful at the time not to use the word 'austerity', which became a euphemism for spending cuts used by opponents

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of Coalition economic policy—and then later to describe fiscal reduction generally across Europe, especially at its harshest in Greece and Ireland.

Following days of tortuous negotiations, the Conservatives and Liberal Democrats created a formal Coalition and formed a government with David Cameron as Prime Minister, Lib Dem leader Nick Clegg as Deputy Prime Minister and George Osborne as Chancellor with the Lib Dems' David Laws as Chief Secretary to the Treasury, in charge of public spending (Laws was replaced by Danny Alexander later in May). Debt reduction was the centrepiece of the parties' new written agreement, *The Programme for Government,* which called it the 'most urgent issue facing Britain' and one which 'takes precedence over any of the other measures in this agreement.' The parties said they would 'accelerate the reduction of the structural deficit over the course of a Parliament' to be achieved primarily be cutting spending rather than increasing taxes, including £6 billion of in-year cuts on 'non-front-line services'.[3]

The question was how tough the fiscal consolidation should be set. The Coalition, according to the Treasury, inherited the largest deficit in Britain's peacetime history at 12 % of GDP in 2009, while debt interest payments were costing £43 billion a year[4] The Institute for Fiscal Studies estimated that the fiscal and economic crisis had expanded the deficit by £86 billion a year at current prices which 'would be impervious to economic recovery and would put public sector debt on an unsustainable path if left unaddressed.' The new government inherited plans from Labour that would have brought this deficit down by 70 % by 2016/17.[5]

The Treasury now offered three options to the new team, ranging from a radical extra £60 billion of tightening over the next five years at one extreme 'which the Treasury did not expect the new government to entertain' and a softer plan, more like the one proposed by Alistair Darling, at the other. 'In the middle was a fiscal consolidation only slightly more aggressive than the one Osborne ended up embarking on … in other words far from imposing an extreme and ideological will, the Chancellor went with the grain of mainstream Treasury thinking.'[6]

The next step was an Emergency Budget in June, which outlined its targets for the next five years. One of Osborne's first moves was to create an Office for Budget Responsibility (OBR) to deliver 'independent and authoritative analysis of the UK's public finances' with a brief to scrutinise Budgets and Autumn Statements in advance for comment. 'By draining the politics from the key statistics, the Office would prevent desperate men from doing desperate things. The markets could be certain that the

books had not been cooked.'[7] The OECD also approved, commenting: 'By setting up the OBR with a remit to produce the official macroeconomic and fiscal forecasts, the government has addressed one element behind previous fiscal indiscipline in both the United Kingdom and other OECD countries. The OBR's responsibility for forecasts and evaluating whether current policies are consistent with the fiscal targets makes it highly involved in the budget process.'[8]

The Emergency Budget in June set a fiscal mandate

- To achieve a cyclically-adjusted current balance by the end of the rolling five year forecast period or 2015/16 (the fiscal mandate)
- and for public sector net debt (PSND) to be falling as a percentage of GDP by 2015/16 (the supplementary target)

Both these targets had a greater than 50 % chance of success according to the OBR. The Budget, quoting IMF figures, maintained that the target of reducing public sector net debt by 8.4 % of GDP between 2010/11 and 2015/16 was similar to that achieved in the UK between 1993/4 to 1999/2000, when structural debt was reduced by 6.5 %, in Sweden in 1993 to 1998 when it was cut by 9.4 % of GDP, and in Canada between 1992 and 1999 when it was cut by 7.5 %. The deficit-reduction records in both countries were much admired by Coalition ministers who often referred to them (see later chapters).

The tax and savings changes announced in the Budget—including an increase in VAT to 20 %—alongside the deficit-reduction proposals in Labour's last Budget in March 2010 three months previously amounted to a total 'consolidation' (that is, improvement in the public finances) of £113 billion a year by 2014/15 and £128 billion a year by 2015/16, of which £99 billion a year would come from spending cuts and the rest from tax increases. The OBR now forecast that were these to be achieved, public sector net borrowing—the deficit—would decline to 1.1 % of GDP in 2015/16 (as compared to 4 % without any action), the structural current deficit would be eliminated by 2014/15—in other words, meeting the fiscal mandate a year earlier than planned—and public sector net debt would peak at 70.3 % of GDP in 2013/14 before declining to 67.4 % of GDP in 2015/16—meeting the supplementary target.[9]

Total managed spending for 2010/11 was now forecast at £697 billion (down from the March Budget forecast of £708 billion, which included a £11 billion rise) A total £30 billion of savings were earmarked to take

effect by 2014/15, with £11 billion from welfare, £3.3 billion from a two-year freeze in public sector pay, £6 billion of 'efficiency savings' and £10 billion from lower debt interest repayments as a result of consolidation. But health and education were protected, implying cuts of 25 % across unprotected departments.[10] Institute for Fiscal Studies director Robert Chote—soon to chair the OBR—commented: 'In total, the cut in central government public services spending as a share of national income now planned by the Coalition will more than reverse the entire increase we saw under Labour. We are looking at the longest, deepest sustained period of cuts to public services spending at least since World War II.'[11]

The IFS, which examines each Budget in detail afterwards as well as producing its own 'green' Budgets beforehand, pointed out that the burden of fiscal consolidation would fall on spending cuts rather than tax increases. Labour's plans envisaged a ratio of 70 % spending cuts to 30 % tax rises. As these were incorporated into the new Coalition's plans and topped up by Osborne's more stringent targets, the overall ratio was now expected to be 74:26 in 2014/15 and 77.23 in 2015/16. This was less than Osborne's favoured 80:20 ratio, but more than the Budgets of Chancellors Lamont and Clarke in the previous recession in 1993, which aimed for a 50: 50 split.

Comparison between this forecast and that made in Labour's March 2007 Budget before the fiscal crash shows the impact of the downturn; the 2007 Budget had forecast that spending in 2010/11 would be £674 billion, or £23 billion *less* than the OBR was now predicting as part of a major cuts programme. The March 2007 Budget had estimated public sector net debt would be 38.6 % of GDP by 2011/12, compared to the 70.3 % forecast by the OBR for 2013/14.

The planned cuts were followed by negotiations between the Treasury and Whitehall departments to detail where the reductions would fall, mostly on welfare, local government and defence, while health and education were protected. An autumn announcement by Osborne limiting child benefits to standard rate taxpayers rather than all taxpayers was a signal that the middle classes must also bear their share of austerity.

The targets were tougher than Labour's but the difference was the severity of the recession since 2008. The IFS later said: 'At the time of the March 2010 Budget, the Labour government had thought its consolidation plan was sufficient to return the cyclically-adjusted current budget to surplus by 2016–17 (i.e. one year later than required by the coalition government's new fiscal mandate).' However, this was no longer the case.[12]

In October, the Spending Review confirmed the pattern for the next four years to 2014/15, with the aim of returning public spending as a percentage of GDP to 2006/7 levels and in real terms to 'around' 2008/9. But the Review was less draconian than the June Emergency Budget had suggested, with cuts of 19 % over the next four years rather than 25 % and a greater focus on welfare reductions. Because the Conservatives were acutely sensitive to accusations that they intended to privatise the NHS it was protected from the level of cuts falling on other parts of the public sector. The NHS was ring-fenced with a pledge to increase its funding in real terms each year and to ensure that it was 'free at the point of use and available to everyone based on need, not the ability to pay.' In addition, increases in the basic state pension were guaranteed to increase each year from 2011, linked to a 'triple lock' of earnings, prices or 2.5 %, whichever was highest. The Spending Review also promised to increase the schools budget every year in real terms for 5 to 16 year olds by 0.1 % a year in real terms and added a 'pupil premium' for poorer early years pupils worth £2.5 billion a year. Finally, the overseas development budget, a small proportion of total spending, was also ring-fenced.

The major savings were anticipated from welfare with a new Universal Credit system merging the complex assortment of working age benefits and net cuts of £7 billion a year, including capping child and housing benefit. There were also big cuts in local government, justice, police and defence. The Review now said that £81 billion of savings were required by 2014/15, with the result that annual total managed expenditure would rise from £697 billion in 2010/11 to £740 billion in 2014/15. The IFS however said the Review still meant that public spending was the tightest since the austerity years of April 1975–March 1980.[13] The impact of consolidation in the devolved countries of Wales, Scotland and Northern Ireland was marginally different from England's as they were able to prioritise within their overall budgets. In Scotland, the choices were similar to England, with the NHS being protected from deep spending cuts and major cuts to spending on housing, justice, and further and higher education. In Wales, the NHS was unprotected, meaning that the cuts elsewhere were on average lower than they would otherwise have been and certainly lower than in England's unprotected departments. Northern Ireland—like England and Scotland—also decided not to cut the NHS budget but chose to cut spending on schools more than cuts on further and higher education.

So how did the UK compare with other countries? According to the IFS, among 29 advanced economies, the UK had the (equal) third highest level of headline borrowing in 2007, before the fiscal crisis, along with France and the USA. Between 2007 and 2010, the UK had the eighth largest increase in headline borrowing, which left the UK still being the third highest borrower in 2010. The figures were similar to cyclically-adjusted borrowing, with the UK being the fifth highest in 2007 before the fiscal crisis, rising in 2010 to second joint highest with the USA after Ireland.[14]

In its first six months, the Coalition displayed its intention to ruthlessly reduce the deficit and more importantly, conveyed this message to the financial markets. Tory right-wingers wanted tax cuts and even more spending reductions, chafing at the protection of the NHS and education, while Labour's left said spending cuts would only delay the recovery. But 'with the most aggressive austerity programme of any G7 country, even critics of the government acknowledged its daring.' The IMF and the OECD joined the Bank of England 'in furnishing [Osborne's] approach with their *ex cathedra* endorsement.'[15] The OECD approvingly said that 'while fiscal risks remain, the announcement and initial implementation of the consolidation programme strikes the right balance between addressing fiscal sustainability and thereby reducing tail–risks on the one hand, and preserving short–term growth on the other.'[16] Financial markets responded positively, the interest rate difference between UK and German government bonds declining for the first time since the general election, as opposed to that between Spanish and German government bonds, while the UK government's prized Triple A credit rating appeared solid. However, the Institute for Fiscal Studies commented: 'The government's spending cuts and tax rises are forecast to be sufficient to return the UK's public finances to a sustainable position, but the same would have been true under the fiscal consolidation plan set out by Labour in its March 2010 Budget.'[17]

One commentator later recalled that the 'air of confidant professionalism defined the first phase of Osborne's Chancellorship. It ran through the Spending Review of 2010 and the Budget of the following year. And it sustained itself on the OBR's sunny forecasts, which suggested that both the deficit and debt targets would be hit a year early.'[18]

Unfortunately, the government's weakness was its optimistic assumptions that growth, now the worst of the recession appeared to be over,

would soon move upwards, allowing spending to fall as a proportion of GDP and tax revenues began to flow into Treasury coffers.

Dark Clouds from Abroad

The government's spending plans were predicated on GDP returning to growth as it had proved since the last quarter of 2009. The OBR in June 2010, as part of its Emergency Budget commentary, had predicted GDP rising by 1.2 % for the whole of that year, followed by 2.3 % in 2011 and then higher growth from 2013 onwards. In its November 2010 forecast, the OBR said the economy was improving faster than it appeared to have been back in June, but that recovery would take longer than the recessions of the 1970s, 1980s and 1990s. It now expected GDP to rise by 1.8 % in 2010 instead of the 1.2 % forecast in June, partly because of an increase in construction output which Labour maintained was due to its housing investment stimulus in 2009. The OBR agreed with Labour that 'the strength in GDP relative to the June forecast looks to have come from government expenditure.' GDP was predicted then to dip to 2.1 % in 2011 under the impact of spending cuts and the rise in VAT, then rise by 2.6 % in 2012 and 2.9 % in 2013.[19]

The same month, the IMF and the EU stepped in with an €85 billion bail-out for the indebted Irish economy, which had been heavily dependent on the banking and property sectors, both of which had been decimated by the recession. As Ireland was the UK's fifth largest export market, this was bound to impact the UK economy. 'Osborne, backed by third parties such as the IMF and OECD, insisted that it was fanciful to expect an open, medium-sized economy such as Britain to grow at a healthy clip while the continent on its doorstep was undergoing such convulsions.'[20]

The forecasts were then knocked by the revelation that in the last quarter of 2010, GDP contracted by 0.5 %. (GDP for the whole year ended up as 1.5 % according to the ONS) In addition, soaring oil costs were forcing up prices and reducing household income, in turn depressing economic growth. By Budget 2011, the GDP forecast for 2011 was now 1.7 % due to 'global commodity price shocks.' Nonetheless, the Treasury optimistically stuck to its spending plans. The Budget predicted that 73 % of the consolidation would be delivered by lower spending by 2014/15, rising to 76 % in 2015/16. The OBR estimated that public spending would fall from 47.5 % of GDP in 2009/10 to around 40 % by 2015/16, while tax

receipts would rise from 36.5 % to 38.5 % of GDP over the same period. Public sector net debt would peak at 70.9 % in 2013/14 before declining to 69.1 % in 2015/16, slightly more than predicted in June 2010. Nonetheless, the OBR optimistically predicted that the outlook for the public finances was still 'broadly unchanged' since then.[21]

The Budget quoted OECD and IMF research 'which suggests that fiscal consolidation efforts that largely rely on spending restraint promote growth.'[22] In fact, the OECD in its survey of the UK in March 2011 said that the recovery, which had started at the end of 2009, had slowed during the second half of 2010 and predicted 'significant headwinds' in 2011 caused partly by the global downturn and partly by the UK's 'necessary fiscal tightening.' Because of spending cuts, the recovery would have to be led by the private sector.[23]

The IFS, however, worried 'that the official view of future prospects, as contained in the OBR's analysis, is overly complacent about both future inflation risks and the scale of the required fiscal consolidation.' It added: 'The government's six-year plan to reduce borrowing will see public spending brought down from its peak of 47.4 % of national income in 2009–10 to 39.3 % by 2015–16. The period from April 2011 is set to be the tightest five-year period for public spending since at least the Second World War. Out of 29 leading industrial countries, the IMF forecasts that only Iceland and Ireland will deliver sharper falls in spending as a share of national income than the UK between 2010 and 2015.'[24]

As if these tough spending targets were not bound enough to depress the UK economy, as the year progressed the clouds over the global economy darkened. In Europe, the heavily indebted eurozone countries of Ireland, Spain, Italy, Greece and Portugal struggled to service their debt as the recession exposed the fragility of their economies and interest rates rose. Greece was the worst hit; it borrowed 110 billion euros from the IMF in 2010 in return for implementing austerity measures which provoked riots, then came back for a further 130 billion euro loan at the end of 2011, which led to a political crisis. The austerity measures deepened the Greek recession. In 2011 its GDP declined by 6.9 %. Ireland borrowed 67.5 billion euros in return for reducing its deficit to 3 % by 2015, and also implemented stringent public sector cuts. As the UK's export trade to the EU was worth some £450 billion in 2010 and generated 3.5 million jobs the latter's weakening economy was bound to drag down the UK.[25]

Critics of austerity argued that Greece was held up as a warning to those who dared oppose the Coalition's strategy. As one economist later put it,

Greece was 'a metaphor for the perils of Keynesianism' for 'austerity's moment in the sun had arrived courtesy of the Greeks. The offensive against Keynesianism at the global level was married to the discovery of the Greek debt crisis and amplified via the threat of contagion to establish fiscal austerity as the new policy *du jour*. But in doing so, cause and correlation were confused, quite deliberately, on a massive scale.'[26]

There was also a sharp rise in commodity prices causing a hike in inflation which the OBR said was the main reason for the UK economy growing more slowly than forecasts in March 2010. Oil prices rose to a peak of $117 a barrel in the second quarter of 2011, against an assumption based on futures prices of just over $80. The IMF commodity food price index rose by around 30 % between the first quarter of 2010 and the second quarter of 2011.[27] Higher utility prices reduced household income and spending, thus further depressing the economy. Real household disposable income fell by 2.3 % in 2011, a post-war record. The result was a major revision to the deficit-reduction forecasts. The OBR in November 2011 now forecast that potential output would be 3.5 % less than predicted the previous March. It said that public sector net debt (PSND) would peak at 78 % of GDP in 2014/15—7.5 % higher than expected in March 2011—before falling to 77.7 % in 2015–16—compared to the 69.1 % it had optimistically predicted in March—and 75.8 % in 2016/17. The OBR predicted that the eurozone crisis was more likely to get worse than get better. It expected the economy to grow by just 0.7 % in 2012, 2.1 % in 2013, 2.7 % in 2014, and 3 % in 2015 and 2016.[28]

The OBR was clear on the reasons for the decline in the state of the public finances, namely the stagnation in economic activity. 'The deterioration in the public finances in this forecast reflects lower government receipts and higher spending as a share of national income. The main factors are: lower forecast growth in the key economic drivers of tax receipts—labour income, household consumption and company profits—which feed through to lower forecasts for income tax, VAT and corporation tax; falls in oil prices, equity prices and interest rates compared to March, leading to lower North Sea taxes, stamp duties, and interest receipts; and the sharp fall in financial sector corporation tax receipts seen so far this year.'[29]

By the time of the Autumn Statement in November 2011, stalled growth was impacting Treasury forecasts for reducing the deficit. GDP growth for 2011 was now forecast at almost half the rate assumed just seven months previously in the March Budget at 0.9 % instead of 1.7 %, while for the next year, it was predicted at even lower, 0.7 % from 2.5 %.

The slowing economy meant less tax revenue so that the government now had to borrow an extra £111 billion over the next five years. Public sector net borrowing and the structural deficit were revised upwards in every year of the forecast as a result of the weaker economy, while public sector net debt as a proportion of GDP was forecast to peak at 78 % in 2014/15, 7.5 % higher than in the previous Budget (it had been 52.9 % in 2009). Spending cuts were now extended a further two years, making a total of six years of spending reductions. Far from eliminating the bulk of the structural deficit by 2014/1, cuts would stretch into the next parliament. Public sector pay curbs and an extension of the retirement age to 67 from 2026 were also announced. Osborne reportedly told colleagues that although there was light at the end of the tunnel 'the tunnel is getting longer and the light is getting dimmer.'[30] However, the government stuck to its predictions that public spending as a proportion of GDP would fall from 48 % in 2009/10 to 39 % in 2016/17.

Institute for Fiscal Studies director Paul Johnson commented that the Chancellor 'has ended up on course to be in exactly the place he wanted to avoid—promising further spending cuts in the period after the next election. This is also where the last Labour Government's fiscal plans—as set out in Alistair Darling's March 2010 Budget—would have left them under previous growth forecasts.'[31]

Johnson however said that Labour's plans by now would have meant even higher debt, adding: 'With the worse economic outlook, [Labour's] slower fiscal squeeze—with smaller tax rises and less deep spending cuts—would, if it had been implemented, now of course have implied even higher debt levels over this parliament than those we will in fact see. That would have left an even bigger job to do in the next parliament.'[32]

The economic gloom continued throughout the next year. GDP contracted by 0.1 % in the last quarter of 2011 and was 1.1 % for the whole year, 0.4 % less than in 2010 but slightly better than the Autumn Statement had predicted. Provisional figures for the first quarter of 2012 showed a GDP drop of 0.2 %, meaning that as the last quarter of 2011 also showed a contraction, the economy was technically back in recession, hardly a triumph for the government after two years of austerity. 'The double dip forecast by Keynesian critics of austerity had transpired.'[33] In fact, the ONS figures were later revised upwards, the first quarter of 2012 showing 0 % change on GDP, meaning that the UK did not in fact re-enter recession. For the whole of 2012, GDP ended up at precisely nil growth.

The damage, however, was done; the economy, if not in recession, was stagnant. The opposition claimed spending cuts were shrinking the economy just as the Keynesians had predicted back in 2009, while a badly handled Budget in March 2012, which included a cut on the top rate of tax further dented the government's reputation for sensible and fair economic management. The reduction in the 50 % tax rate to 45 % and increase in the tax-free allowance at a cost of £3.5 billion a year (as part of the agreement with the Liberal Democrats) muddled the government's message that cutting the deficit was its overriding mission. The public accepted the principle of spending cuts to reduce debt but not cuts in order to reduce tax for the wealthy. The Budget, dubbed an 'omnishambles' by critics, marked the government's mid-term low point which even the triumph of the London Olympics was unable to dispel. Osborne himself was booed by spectators when presenting medals. The government's previously substantial lead over Labour on perceived economic competence narrowed and when the socialist Francois Hollande in France was elected president in May it seemed to signify a European-wide reaction against austerity.

Liberal Democrat Treasury Chief Secretary Danny Alexander later admitted that 2012 had been a potential turning point in the Coalition government's austerity programme when it could either turn the screw tighter, water down its fiscal consolidation or stick to its programme. 'In autumn 2012 we had a debate as to whether we should slow down or increase austerity. We had plenty of advice and we took the view that we had set out our programme of savings and we shouldn't adjust that. People's trust in us came because we had set out our programme. We decided we would let the automatic stabilisers operate otherwise we would end up chasing our tail adding more cuts every time circumstances changed.'[34]

In December 2012, the OBR admitted to being 'more pessimistic about the economy's growth prospects' than the previous March with growth lower than expected due to weaker exports and the eurozone crisis which it still said would drag down UK growth 'for several years to come.' It added: 'The outlook for the world economy and UK exports has deteriorated and we expect the difficulties of the euro area to depress confidence and put upward pressure on bank funding costs for longer.'[35]

In the Autumn Statement in December 2012, public sector net debt was now forecast to be 79.9 % of GDP in 2015/16, even though a year previously it had been forecast at 78 %, a figure already 7.5 % higher than predicted in March 2011, while the Budget 2012 just seven months earlier had forecast it at 76 % in 2015/16, almost 4 % lower. The supplementary

target, part of the fiscal mandate outlined in 2010, for PSND to be falling by 2015/16 and was now pushed into the following year. This was a significant decision bearing in mind that the five-year target of balancing the cyclically-adjusted current Budget had already been shunted to 2017/18. Institute for Fiscal Studies director Paul Johnson said it was 'probably wise', but to meet his main fiscal mandate the Chancellor 'has had to extend the period of spending cuts into 2017–18—an eighth year of cuts. That is even more unprecedented than the unprecedented seven years of cuts announced last year, itself superseding the unprecedented five years originally announced.'[36]

Osborne could have stuck to the supplementary target and imposed immediate further spending cuts. He did not do so because further cuts would have tipped the stagnant economy back into another recession, as even the OECD warned—while backing his fiscal consolidation strategy—when it said that the fiscal mandate needed to be flexible with a focus on infrastructure investment if necessary to lift growth.[37] Far from being the ruthless slasher of public spending portrayed by the Opposition, the Chancellor stretched deficit-reduction and therefore spending cuts further into the future and opened himself to criticisms that not only was he failing to reinvigorate the economy, he was also failing to reduce debt, the central plank of the Coalition's mission statement in 2010. Meanwhile, quantitative easing—the printing of money to generate liquidity and increase growth—now reached £375 billion.

The Chancellor's caution was justified when a modest growth in GDP in the third quarter of 2012, attributed to the Olympics, was followed by a 0.3 % contraction in the last quarter. The Treasury admitted that 'the global shocks that have hit the UK economy in recent years have been unusually large and the resulting challenges of restoring productivity and rebalancing the economy are significant.' It estimated that the financial sector had contracted by 12.5 % since the economy's pre-crisis peak and 2 % in the past year alone, while the North Sea oil and gas sector had shrunk by 38.5 % since the peak. Both sectors were a major source of tax revenues; but then tax for middle income earners was making up some of the difference.[38] The IFS estimated that by 2015, the number of employees paying tax at the higher 40 % rate would be a million more than in 2012, taking the number to five million, double the number at the end of the 1990s.[39]

To compound the UK economy's woes in the last quarter of 2012, eurozone growth declined by 0.6 %—the largest quarterly fall since early

2009—meaning the zone was still in recession while the US economy was also flat. Worse news came in February 2013 when credit rating agency Moody's downgraded the UK's triple-A rating to AA1 for the first time since 1970, reflecting concerns that the sluggish economy would make it less likely the UK could bring down debt. The prospect, although unthinkable, of the UK government's interest repayments rising as a result of its downgrade was more a political than a fiscal humiliation. The government had always argued that austerity would help keep interest rates on its debt low; the large rises in borrowing rates for indebted eurozone countries like Spain, Portugal, Greece and Italy was an extreme example of what occurred if financial markets concluded that a country was a lending risk. In reality there was never any chance of this happening in a stable, albeit indebted, economy like that of the UK which was always regarded as a safe haven by investors while critics of austerity pointed out that Japan had survived with the highest debt in the developed world for years thanks to its low interest rates.

Assailed from one side for not reducing debt sufficiently, the Chancellor was also attacked unexpectedly by the IMF for the opposite reason when its chief economist told the BBC that the flat economy meant there should be 'a reassessment' of the government's austerity plans and that fiscal consolidation should be 'slow and steady.'[40] By the time of the March 2013 Budget, the OBR was predicting a paltry annual UK GDP growth for 2013 of 0.6 %. Thanks to spending cuts and tax increases 'announced by this and the previous government' public sector borrowing, the gap between what the government spends and its revenue, fell by a quarter between 2009/10 (when it hit its post-war peak of £159 billion) and 2011/12. But public sector net debt (PSND) was now set to be 85.6 % of GDP by 2016/17 rather than 79.9 % in 2015/16 as the OBR had predicted three months previously meaning the government continued to be way off course to meet its supplementary target as part of its fiscal mandate. In fact, PSND was now expected to be 7.5 % higher in 2017/18 than the OBR had expected three months previously.[41]

The figures were grim. Almost three years had passed since the Chancellor had launched his ambitious deficit-reduction plan, centrepiece of the Coalition's programme, and net debt continued to rise against the backdrop of a stagnant economy. As IFS director Paul Johnson commented while reviewing the March Budget: 'The truth is that borrowing is the same this year as it was last year. And it will be the same next year as this year. Because of that, this year's precedent suggests that there must

be a risk that effort will be expended again next year to shift spending into 2014–15. All this is desperately disappointing for a Chancellor focussed on reducing the deficit. Some sense of how disappointing is illustrated by two sets of numbers. 121, 120, 108. 89, 60, 37. The first three numbers are borrowing in pounds billion expected this year, next year and in 2014–15. The second three numbers were the forecasts for the same years made at the time of the June 2010 Budget. The Chancellor now looks like he will be borrowing £70 billion more in 2014–15 than he had originally hoped.'[42]

A combination of the eurozone crisis stifling the UK's export market and flat domestic consumption due to stagnant wages, a real drop in household income, spending cuts and tax rises and a lack of business investment was dragging down growth when the economy had been predicted in 2010 to be improving. Keynesian critics argued that the recession was being extended because of spending cuts and this was just the time when public spending needed to fill the gap to sustain GDP rather than be reduced. The anaemic growth figures boxed in Osborne's options; even tougher spending cuts in order to meet the fiscal mandate outlined over-optimistically in 2010 would tip the economy into a triple-dip recession (at the time the ONS figures showing a GDP drop in the first quarter of 2012 and a technical second recession had not been revised upwards). In April, the IMF also called for a loosening of austerity when it said that 'greater near-term flexibility in the path of fiscal adjustment should be considered in the light of lackluster private demand'.[43]

Osborne made it clear he was not about to abandon his strategy, though in fact the 'austerity Chancellor' was nowhere near as inflexible as the Opposition claimed. As Paul Johnson of the IFS remarked at the time: 'Mr Osborne has actually decided to loosen the purse strings a little in 2014–15 and 2015–16. A £3 billion net tax cut in 2015–16 has not been offset at all … [while] year on year real cuts in departmental spending have effectively come to an end for the period of this parliament.'[44]

But just when it seemed the Coalition government's entire economic strategy was doomed to failure along with the prospects of it ever forming the next government—always a consideration at the back of every UK Chancellor's mind—fate took a different course.

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CHAPTER 7

Light at the End of the Tunnel

The UK Coalition government's debt-reduction strategy had been blown off course by the eurozone crisis, which showed little sign of improvement with near-bankrupt Greece teetering on the edge of quitting the euro altogether. The Bank of England even drew up contingency plans for a disorderly Greek exit (dubbed 'Grexit') which was 'war-gaming to chill the soul' and for which making provisions 'was like looking into the abyss.'[1]

However 'Osborne did not know it at the time but his recovery was already in train thanks to an Italian technocrat running a German-based central bank on behalf of a seventeen-nation currency of which Britain was not even a member.'[2] The European Central Bank (ECB) had long adopted a conservative approach to lending. believing it was up to the indebted eurozone nations to fix their public finances rather than rely on the ECB to shore up the euro. But in the summer of 2012, the German chancellor Angela Merkel had a change of heart, terrified that a Greek exit would be another Lehman Brothers and cause mass panic in the EU. Her certainty emboldened those in the ECB who were pushing for a more interventionist approach to saving the euro. Its president, the Italian Mario Draghi, now hinted that the ECB would do 'whatever it takes' to shore up the euro and even buy the sovereign debt of troubled eurozone countries like Spain and Italy to force down their borrowing costs in return for economic reforms and spending cuts.

It would take months for the impact to feed through into the moribund UK economy, but little did its politicians and economists know at

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the time that the worst had passed. The 2013 Budget had been delivered without any knowledge of the GDP figures for the first quarter of 2013; a fall after the dip in the last quarter of 2012 would mean the third recession since 2008, itself only the first since 1991. In fact, GDP showed a modest growth of 0.3 % in the first three months of 2013 which 'opened the window to a summer of radiant economic data' with falling unemployment and a 'rampant' FTSE.[3] Furthermore, GDP for the first quarter of 2012 was revised upwards, meaning that the UK had technically not even entered a second recession after all. In July 2013, the ONS reported a second quarter of GDP growth at 0.6 %.

The OBR, having been over-optimistic about the economy, now admitted it had become too pessimistic when in its December 2013 Economic and Fiscal Outlook it said that 'the UK economy has picked up more strongly in 2013 than we expected in our March forecast.' It predicted lower public sector net borrowing, a result of higher tax receipts fuelled by North Sea oil and stamp duty from a buoyant property market. It now estimated that the deficit would fall from 11 % in 2009/10 to –0.1 % in 2018/19, of which 80 % was down to lower public spending, and 20 % to higher tax revenues, mainly from increasing VAT to 20 % in 2011. The OBR however predicted that PSND would peak at 80 % of GDP in 2015/16, more than twice its pre-fiscal crash level. In addition, it also warned that if potential GDP turned out to be lower than expected, then the deficit would be structural and remain even after the economy had recovered, meaning austerity could potentially be a long-term, even permanent, feature of UK fiscal policy.[4] The economy, however, was on the mend. Total GDP growth for 2013 was 1.9 %, the strongest annual rate since 2007. In the last quarter a milestone was passed when real GDP regained its pre-recession peak. It seemed that the Chancellor's adherence—with some adjustments—to his deficit reduction programme was at last bearing fruit and he had no intention of diluting it. The Autumn Statement in December 2013 warned that economic growth alone would not eliminate the deficit and that in effect there must be no let-up in controlling spending. The Treasury's one-year spending review for 2015/16 announced in July envisaged further cuts of £11.5 billion, especially in welfare which would be capped for the next four years because, said the Autumn Statement, in 2013/14 welfare amounted to 29 % of public spending and had increased by 58 % between 2000/1 and 2010/11. It said this was 'in line with international best practice' and cited the Netherlands, Sweden and Finland as examples where similar spending ceilings covered 75 % of public spending. Any change to the cap would require a vote in Parliament.[5]

Far from rejecting the 2015/16 review, the Labour Opposition pledged to honour it should the party win the 2015 general election. This in itself was not unusual as the new Labour government in 1997 had stuck to the tough spending plans of the Major government until 2000 as well, but Labour's decision was symbolic; it meant that austerity had won the argument over Keynesianism. In a speech to activists, Labour leader Ed Miliband said: 'Our starting point for 2015–16 is that we won't be able to reverse the cuts in day to day, current spending unless it is fully funded from savings elsewhere or extra revenue, not from more borrowing.' He even cited Attlee's post-war government as an example of how Labour could be both prudent on public finances and still launch a radical programme.[6] As an historian of the Coalition noted: 'Osborne, of course, had missed his own targets and been mocked for doing so. But he had defined the rules of the game, the terms of the debate.'[7]

The economic indicators were moving in the government's favour; borrowing was falling faster than forecast thanks to buoyant stamp duty revenue from house price rises while lower inflation meant lower interest rate payments. The deficit was expected to halve from 11 % of GDP in 2009/10 to 5.5 % by 2014/15. Public sector net debt was set to peak at 78.7 % of GDP in 2015/16 and start falling.[8]

But how much of this improvement was down to the government's fiscal consolidation programme? The Autumn Statement 2013 insisted consolidation was central to debt reduction with £64 billion of the planned £80 billion reduction already implemented and £10 billion annually saved in lower interest payments. Consumer spending was the main driver of growth in 2013 while unemployment continued to fall and a new property boom was underway with house prices rising by 5.5 % in the last quarter of the year alone, stimulated by continuing low interest rates caused by the historically low Bank of England base rate of 0.5 % set in March 2009. Inflation was declining and GDP was picking up in the eurozone and the USA. The IFS's Paul Johnson noted: 'The return of growth has not in any sense obviated the need for continued austerity. We are still looking at borrowing of £108 billion this year—nearly £50 billion more than planned back in 2010.'[9] The biographer of George Osborne commented: 'The recovery was tardy and uneven and per capita GDP was still below the crest it reached in the boom years. Neither was the deficit gone or, nor the debt falling. Still, it took some obtuseness to not see a Chancellor in the ascendant.'[10] Belated praise finally came from the IMF, whose managing director Christine Lagarde, after a week-long visit to London in June 2014 by IMF officials, said 'the news coming out of the UK recently is all good'.[11]

In the year before the 2015 general election, the economic indicators continued to improve, primarily due to global events. Perhaps the biggest impact was the plummeting price of oil, which in turn dragged down inflation to the point at which deflation became a concern. Low oil costs brought down the price of household energy and food and meant that even paltry wage rises were above inflation, thereby increasing consumer spending. But there was concerning news behind the optimistic headlines. The growth in employment was in low-wage jobs yielding little tax revenue, with the result that the budget deficit in 2014 was down at half the decline the OBR had anticipated back in March, the second smallest year-on-year reduction since its peak in 2009/10 despite 2014 being the strongest for GDP growth.[12]

Nonetheless, the feel-good factor that low inflation and high growth engendered, months before a general election, could not have been better timed. There was further good news in the eurozone when belatedly, the European Central Bank launched quantitative easing in spring 2015, boosting the eurozone economies.

While deficit reduction during the 2015 election was not the main concern that it had been in 2010, all the main parties remained committed to tight control on spending and implied austerity over the next parliament. While borrowing had been halved the deficit was still just under 5 % of GDP in 2014/15. The parties' differences were their respective timescales over debt reduction, the Conservatives being the most ambitious about spending cuts to aim for a budget surplus in 2018/19, although light on detail as to how this might be achieved.

The Conservative Government from 2015

Opinion polls suggested a minority Labour government supported by the Scottish National Party (SNP) winning the May 2015 election, a prospect which the Conservatives played on to scare middle England. The final result saw the Liberal Democrats reduced to a rump of eight seats, Labour wiped out in Scotland by the SNP and the Conservatives gaining 24 seats to win an overall majority of 12. It was difficult to see the result as a rejection of austerity even though the SNP campaigned on a platform of rejecting 'Westminster cuts.'

Following the Conservatives' surprise victory, their first since 1992, the public sector braced itself for the implementation of the party's tough spending plans. In fact, Chancellor Osborne's summer Budget in July proved more relaxed about the deficit-reduction timetable than the party's manifesto had suggested. It even postponed the return to a budget surplus

by a year to 2019/20. The OBR agreed that the next Spending Review now appeared 'a lot less challenging than it appeared in March' and added: 'The new Government has used its first Budget to loosen significantly the impending squeeze on public services spending that had been pencilled in by the Coalition in March. This is being financed by welfare cuts, net tax increases and three years of higher government borrowing.'[13] Tax increases amounted to £47.2 billion and welfare cuts to £34.9 billion over the next five years.

Bizarrely, the Conservatives had won an election on a programme of more pain, then diluted it a few weeks later. Some commentators believed they had deliberately over-egged their austerity pledges in order to have something to give to their partners, the Liberal Democrats, as part of negotiations when they formed another Coalition government. In the end, the opinion polls were wrong: the Lib Dems were wiped out and the Conservatives were able to form their first government in 18 years.

There were more surprises in the Spending Review announcement in November 2015—the first since 2007 to be combined with the Autumn Statement and the first since 2010—which outlined fiscal plans for the next four to five years. Whereas the summer Budget had assumed cuts of 27 % in non-protected departments (health, education, international development being protected), the Review for the next four years now implied cuts of 17 % along with tax rises. The OBR commented that the spending plans 'in aggregate further reduce the squeeze on public services spending planned for this Parliament, implying real cuts more than a third smaller on average than those delivered over the last Parliament and around two thirds smaller than those pencilled in by the Coalition back in March.' Osborne reversed a controversial plan to cut tax credits but still forecast a budget surplus by 2019/20, the first since 2001/2. The OBR reckoned that the plans would add an extra £18.7 billion to borrowing by 2020/21, though it still expected debt as a percentage of GDP to have peaked in 2014/15.

The OBR added that the planned cuts for the next Spending Review period as a percentage of GDP were 20 % smaller than during the previous five years. Lower welfare spending was a big contributory factor while tax receipts were up due to improved GDP. Over the new SR period, spending was set to reduce by 1.1 % a year compared to 1.6 % a year in the previous five years. The OBR said that 'fiscal consolidation continues to depress the level of GDP, while acting as less of a drag on growth than over the past four years.'[14]

Media coverage trumpeted the 'end of austerity' though for many government departments and especially local government, it was clearly

not. There were still spending cuts and demand for services in health and care especially was growing faster than the money to pay for them. Danny Alexander, Chief Secretary from 2010–2015 until he lost his seat in the election, summed up the new era as ‘not austerity but scarcity.’[15] The government’s fiscal strategy was dealt a self-inflicted blow in June 2016 when Prime Minister David Cameron’s gamble on placating the anti-EU MPs in his party by holding a referendum to either leave or remain backfired. The voters supported leaving the EU, Cameron resigned and Chancellor George Osborne, who had backed remaining in the EU, tore up his plans to deliver a fiscal surplus by 2020. Rather than marking the end of austerity, this move reflected Treasury concern that the UK economy was entering a turbulent period with lower GDP putting pressure on the public finances. Following the election of a new Prime Minister, Theresa May, in July George Osborne was unceremoniously sacked in the Cabinet reshuffle. The first cut in interest rates by the Bank of England since 2009 to a record low of 0.25% and a new round of quantitative easing signalled that monetary policy was now taking an active role in fending off recession.

Did the Coalition’s Austerity Programme Work?

Apart from the far left which claimed that austerity was a conspiracy against the poor, or the far right which believed that all public spending was a drain on income and should be abolished, the consensus among the main political parties in 2009 was that the deficit was too high and public spending should be reined in without destroying public services. Criticism concerned the extent of the cuts, either for being too stringent or too modest, the former because they failed to take into account the global downturn and delayed recovery and the latter because debt-reduction targets were missed. As Osborne’s biographer commented: ‘Keynesians recall a promising recovery snuffed out by hasty cuts followed by two years of avoidable stagnation. Their opponents remember the external shock of a sovereign debt crisis, one that menaced Britain in 2010 and poisoned its economic sentiment thereafter.’[16]

Certain facts were indisputable. UK public sector debt was at a record high in 2009 because of the catastrophic fall in tax revenues from the financial crash and an above-inflation real terms increase in the rate of spending. The Coalition’s fiscal consolidation plan in 2010 was highly ambitious and its estimates for GDP growth—with the private sector supposedly filling the gap left by reduced public spending as the economy improved—wildly optimistic. Oil price rises led to higher than expected

inflation and a hike in energy bills which constrained household consumption, already curbed by stagnant wage growth, and dampened GDP. The fiscal crisis in the eurozone, which took half of the UK's exports, further depressed growth. A change of strategy by the European Central Bank to support eurozone currencies then averted a sovereign debt crisis. The UK GDP increased. The oil price dropped as fracking in the USA flooded the markets with oil and inflation fell, boosting consumer confidence and household spending as wages edged ahead. Quantitative easing in the eurozone further increased liquidity and confidence, offsetting concerns about Greece.

When it was clear that his debt targets would be missed, the Chancellor could have cut spending further; instead, he shifted the targets into the next Parliament. When it was clear the recovery was delayed and it seemed the UK was back into recession in 2012, he could have loosened his spending constraints; in fact, he stuck to his plans. He managed both to convey the impression that the government was furiously driving down spending while being flexible over targets. The IMF recognized his flexibility when its Managing Director, Christine Lagarde, said in 2014: 'Fiscal consolidation has been a key policy anchor for the UK economy. The deficit has been halved to 5¾ percent of GDP over the last four years. While adhering to the medium-term framework, the government has shown welcome flexibility in implementation, allowing the automatic stabilizers to operate while continuing with the underlying adjustment effort.'[17]

Another commentator noted later: 'The economy was stunted, tax receipts were just as bad, the Tory backbenches were in a state of quivering disgruntlement, and yet the Chancellor didn't really alter his plan—even if it meant missing one of his targets. The calculation was, I'm sure, that the public wouldn't tolerate more pain in pursuit of something as abstract as a declining debt-to-GDP ratio. But the Tory leadership may also have also have reckoned that, with [Labour leader] Ed Miliband and [Shadow Chancellor Ed] Balls struggling for economic credibility, they just didn't have to try so hard.'[18] Treasury Chief Secretary Danny Alexander even maintained that a 5 % deficit—the figure reached in 2015, half what it had been in 2009/2010 at 10.2 %—was itself still pretty Keynesian. 'When you've got a 10 % deficit you have to do something. A true Keynesian perspective would recognise that even a 5 % deficit is a massive stimulus.'[19]

The statistics however show how far off course Osborne was in achieving deficit reduction and why as a result it stretched on another five years. They also show how difficult it is to make predictions based on so many indicators that can easily change, as the OBR found, and as a swift analysis

of Budget projections reveals. The cautious Budget of April 2009, when Labour's Alistair Darling was Chancellor, envisaged as a result of its spending cuts that the deficit would fall to 5.5 % of GDP by 2013/4. According to the OBR, quoted in the Coalition's Emergency Budget in June 2010, 'without further action' to tackle the deficit, borrowing would be 4 % of GDP by 2015. The Emergency Budget planned for it to fall to 1.1 % by 2015/16. In fact it ended up at 5.6 % in 2013/14 and 4.9 % in 2014/15, almost as predicted in 2009 but above what the OBR forecast 'without further action' and way off course from the Coalition's optimistic projections, even though borrowing was still impressively cut by half since its peak in 2009/10 when it was 10.2 %.[20] The Coalition government ended up borrowing £100 billion more over its five year term than it had forecast in its November 2010 Autumn Statement. The IMF estimated that out of 31 advanced economies, only Japan had higher structural borrowing than the UK in 2015 despite the UK having implemented the seventh largest fiscal consolidation since the financial crisis began.[21]

The forecasts for public sector net debt (PSND) showed a similar pattern. The 2009 Budget forecast it rising steadily to peak at 79 % of GDP in 2013/14, then declining. The Emergency Budget of 2010 said that its spending cuts would mean PSND would peak at 70.3 % of GDP in 2013/14 before declining to 67.4 % in 2015/16. In fact, PSND ended up at 79.1 % in 2013/14, again remarkably similar to the 2009 projection, except that the OBR in its March 2015 forecast said it would actually rise to 80.4 %, before declining only from 2015/16. In October 2015, public sector net debt stood at 80.5 % of GDP. In July 2015, the OBR predicted PSND would drop to 68.5 % of GDP by 2020/21.[22]

One respected Conservative commentator concluded in 2015 that while Osborne's Chancellorship was a success because Britain that year was the fastest-growing economy in the G7, 'at the centre of it lies a failure' because 'the Conservative Manifesto of 2010 aimed to eliminate "the bulk of the structural current budget deficit over a Parliament". Five years on, it remains the best part of £90 billion—a figure that the Treasury itself concedes is, as a proportion of GDP, one of the highest in the developed world.'[23]

One aspect of the UK's recession in 2009 was the stability in unemployment figures in contrast to previous recessions, when jobless figures had sharply increased, especially during the early 1980s. It helps explain why the Coalition's austerity programme never provoked the same reactions as spending cuts under Thatcher. Static wages made it easier for employers to hold onto staff while many of the new jobs were low-paid and part-time.

The converse side of this low-pay, low unemployment trend was that as the economy improved, tax revenues remained subdued, further adding to the difficulties of forecasting deficit reduction targets. In his 2015 summer Budget following the Conservative election win, Chancellor George Osborne made a surprise announcement by increasing the minimum wage. The increase was largely to offset cuts in working tax credits but it was also a signal to employers that they were expected to pass on the benefits of recovery to their employees and thereby generate income tax revenues.

So the question is, bearing in mind that the Coalition targets were never met as planned, what would have happened if its fiscal consolidation programme of austerity had never been implemented? What if it simply carried through Labour's own more modest debt-reduction programme? Would there have been any difference? Was the real influence on the public finances not the level of cuts or tax rises but global forces forcing down growth? To those who argue that cuts delayed recovery, the biographer of George Osborne asked: 'If tight fiscal policy caused the economy's inertia from 2010 to 2012, why did it not prevent the subsequent bounce-back? All that had changed were the external conditions. Namely the eurozone calmed down.' There again if that were the case 'we might conclude that Osborne was the principal author of neither the stagnation nor the recovery. Both emanated from Europe.'

Indeed, was the Chancellor, as his biographer postulated, really 'just the finance minister of a medium-sized and vulnerably open economy on the edge of a continent-sized currency union that spent two years toying with oblivion'? The decisive moment took place, not with the Emergency Budget, but when the head of the European Central Bank finally agreed to support the euro 'whatever it takes' and which 'was also enough to turn Britain around.'[24] The Institute for Fiscal Studies maintained that had Labour's last Budget strategy for debt reduction in March 2010 been retained instead of the Coalition's, then taxes would have been lower and spending higher but it 'would have resulted in significantly more borrowing and would only have deferred, rather than avoided, the need for greater fiscal consolidation.'[25] In other words, without the Coalition's harsher programme of consolidation, even though it missed its targets, debt would have been even higher and subsequent cuts post-2015 even deeper.

One analysis by McKinsey in 2010 based on past recessions accurately predicted what would prove to take place in the UK, namely that austerity or 'belt-tightening' takes place two years after the start of a financial crisis and recession, is then followed by a decline in GDP for two to three years, then a rebound in growth even while austerity continues.[26]

We can speculate endlessly about what might have been. Alistair Darling's 2009 Budget could not predict the impact of the eurozone crisis. Without the Coalition's highly visible commitment to its ambitious fiscal consolidation programme, Britain might have been engulfed by the crisis in the eurozone as the markets concluded the UK was not prepared to take action to reduce its historically high debt. Christine Lagarde told a media conference in London in 2012 that 'when I look back to 2010 and what could have happened without fiscal consolidation I shiver.'[27] The targets laid out in Osborne's Emergency Budget, according to one sympathetic commentator, were 'not as meaningful as we were encouraged to believe. But they did express some sort of meaning. They said to the credit rating agencies and the voting public alike: don't worry, the professionals are here.'[28]

The Liberal Democrat Danny Alexander, who as Treasury Chief Secretary from 2010–2015 was the second-longest holder of that post after Labour's Joel Barnett in the 1970s, in an interview with this author in 2015, maintained there was no alternative. 'If nothing had been done we would have seen interest rates rise and markets would have lost faith. You can't live with a large deficit for any sustained period. It's true that some countries have a higher debt to GDP ratio but the issue is resilience. The Labour government was irresponsible in running a structural deficit [the part of the deficit that will not disappear when the economy returns]. It meant the underlying position of public finances was therefore weak which means we were not in the strongest position to weather the storm.' However, in hindsight he admitted that his government might have cut capital spending less and revenue spending more to invest in infrastructure. 'I think the system could have taken more cuts in current spending rather than capital spend. In retrospect I'd have preferred more cuts in current spending.'[29]

The ultimate verdict came from the electorate in May 2015, when it elected the Conservatives with an overall majority. If there had been five years of austerity it had made insufficient negative impact to make middle England vote for Labour, though in Scotland it certainly contributed to the Scottish National Party landslide. Local government, which bore the burden of spending cuts of some 30 % over the five-year Parliament, managed to implement them without apparently damaging frontline services or at least cutting those services which were least visible. The high profile services of education and health were protected. Cuts in welfare were generally well-received by those in work. The highly political Chancellor knew how to convey the language of austerity to the financial markets while ensuring the reality was muted. 'Osborne knew that many in his own party considered the cuts much too timid and wimpish. This he

could live with. What mattered was that the public not equate cuts with declining service; austerity had to be a prompt for public service reform, not an excuse for shoddiness.'[30]

At its peak, the UK's structural borrowing among 32 advanced economies judged by the IMF was below only that of Greece, Iceland and Ireland. Yet, although by 2015 the UK was estimated to have seen the seventh largest reduction in structural borrowing, it was still behind only Japan due to lower than expected economic growth depressing tax revenues. This led to higher than expected borrowing and higher than planned public sector net debt, but the Coalition stuck to its original fiscal consolidation plans laid out in 2010. The rest of consolidation was shunted into the next parliament.

The head of the Institute for Fiscal Studies, Paul Johnson, said that although in 2010 'the government's programme looked austere' because the revenues were below target, 'the deficit was higher than intended. In 2010 it looked like austerity. From the perspective of 2015 it didn't do nearly enough to get the deficit down to the level originally intended.' Would Labour have done any better? Johnson maintained in an interview with the author that Labour would have probably not made in-year cuts in 2010, although its 2010 election manifesto pledged to cut the deficit faster than actually happened. However, after the 2015 election the paths converged with Osborne's new austerity-lite spending plans to 2020 looking much more like Labour's own election manifesto pledges than those of his own party.[31]

While austerity certainly had its opponents, it was nonetheless accepted in principle by the majority of the general public who knew that debt was on an unsustainable path and had to be brought down. Indeed, the only difference between the main parties was over the speed and timing of debt reduction rather than whether it was right. As Danny Alexander recalled: 'Throughout our five years there was a good level of support in the UK that the deficit had to be dealt with.'[32]

The Changing Pattern of Tax and Spending

Despite periods of austerity, UK public spending has maintained an upward trajectory, as much as fivefold since the 1930s according to some estimates, slightly more than the rise in GDP although there have been peaks and troughs.[33]

In the twentieth century, it was war that created spikes in spending, notably the Boer War and the First and Second World Wars, but though

spending reduced after hostilities ended, on each occasion it never quite fell back to pre-war levels. After 1945, with the creation of the welfare state and the NHS and the steady reduction in the UK's overseas military commitments (as the British Empire drew to its end), public spending—which continued to rise throughout the 1950s and 1960s—was increasingly dedicated to welfare, pensions, health, education, housing and support for the burgeoning nationalised industries. Full employment became the priority of all political parties as UK politicians of both left and right determined to avoid a repeat of the 1930s Great Depression. From the 1970s and 1980s, as economic crises necessitated an end to the inexorable rise in spending, this shifted away from housing and support for industry and towards health, welfare and pensions, a trend which has become noticeably more marked since the 2000s. Although the big increases in spending from 2001–2009 were balanced by rising GDP, recessions, especially those of the early 1980s, 1990s and late 2000s, saw an increase in spending as a proportion of GDP as the economy dipped.

Treasury figures show how public spending has increased consistently since the 1950s and particularly since the 1970s. Fixed at 2013/14 prices, total managed expenditure in 1972/3 was £270 billion. In 2015/16 it was £716 billion, almost three times as much. For most of that period it increased every year, except during recessions and spending cuts. After rising to £333.6 billion in 1976/77, the year of the IMF crisis, it dipped to £320.5 billion the next year as Labour Chancellor Healey's cuts took effect before rising again. Total spending was £707 billion in 2010/11 and £735 billion in 2014/15. When adjusted to 2014/15 price levels, taking into account inflation, the figures become £756 billion and £735 billion respectively. Since 1972/73, real term spending decreases have only taken place in 1977/78, 1985/86, 1988/89, 1996/97, 2011/12 and 2013/14. As a percentage of GDP, public spending was 40.7 % in 2014/15, the lowest since 2007/08.

The pattern is similar for spending as a proportion of GDP. It peaked at just under 50 % in 1975/6 before the IMF had to be called in by Labour's Chancellor Healey, then again at 47 % in 1982/83 at the depth of the recession under Thatcher, at 43 % in 1992/83 after the early 1990s recession under Major and at 46 % in 2009/10 after the fiscal crash.[34] Spending growth masked fluctuations within spending departments, with an increasing percentage of the total flowing to health, pensions, education and welfare and less to housing, defence and nationalised industries. In the past 30 years, increased life expectancy has led to an ever-upward rise in

health, social care and pension costs which now make up two-thirds of the total to the extent that other parts of the public sector are being squeezed out. The question is whether this exponential rise can be contained or if it means either even greater spending cuts elsewhere, or tax rises, even aside from the more short-term need for debt reduction.

The biggest changes over this 35-year period were increases in pensions, welfare and health and decreases in spending on social housing (some of which transferred to housing benefit). Health has been the biggest beneficiary of spending increases. From 1948 until the late 1990s real spending increased gradually at about 3.7 % a year. It slowed under Thatcher and Major, then under New Labour real health spending grew at an annual rate of 5.6 % until 2009/10 and as a share of GDP increased from 5 % in 1996/97 to 6.7 % in 2007/8 (and then to 7.8 % in 2009/10 as GDP fell during the recession). From 2010/11 to 2013/14 average real growth has been 0.8 % a year, the tightest period since 1951/2 to 1954/55 when dental fees and prescription charges were introduced. Just after the NHS was founded in 1948 health spending was 10 % of all public spending but by 2013/14 it was 18 %. Health spending as a share of national income has more than doubled from 3.5 % in 1949/50 to 7.5 % in 2013/14.[35]

In 2013/14, 51.5 % of households (13.7 million) received more in benefits (including in-kind benefits such as education) than they paid in taxes in 2013/14. This continued a downward trend seen since 2010/11 (when it was 53.5 %) but remained above the proportions seen before the economic downturn.[36]

In comparison to other EU and G7 countries' total expenditure on health, both public and private, as a percentage of GDP, the UK ranks twelfth out of 17, behind the USA, France, Germany, Canada, and even Spain and Portugal. But because of the NHS, the UK has a much smaller private sector health spend at 1.5 % of GDP, the second lowest after Luxembourg and below that of supposedly statist France and Belgium.[37]

The changing demographics of the UK, and indeed of all developed economies, with an increasingly ageing population, have also pushed up spending in pensions. The state pension (introduced in 1908) and the free NHS (created in 1948) came at a time when average mortality was only a few years after retirement. Nowadays, older people may be fitter but because they increasingly live beyond the age of 80, long-term chronic health conditions, particularly dementia, develop. During the 2010–2015 spending cuts only health, international development and climate were spared. Spending

on pensions and pensioner benefits is projected to increase from 15.6 % of non-interest spending in 2010–11 to 21.8 % by 2060/61.

As one historian of spending commented: 'In spite of the reluctance of the Conservatives to make substantial outlays of expenditure on welfare, spending in real terms on the elderly increased from £13.7bn in 1973/4 to £23.1bn in 1987/88, the basic state pension increased by 10 % and the number of recipients increased from 7.7m to 9.9m people.' From the mid 1980s, the value in real terms of the basic state pension continued to increase with periodic updates so that by April 2005, it was £91.64p a week in 2008 prices whereas it had been £85.45p in 1985.[38]

The Coalition and then the Conservative governments locked in pensioner benefits from 2010 through the so-called 'triple lock' in which they rose at the higher of inflation, the increase in average earnings or 2.5 %. From April 2014, pensions were £440 higher than they would have been if increased only in line with average earnings.

The other big spending growth area has been in welfare and benefits. Spending on welfare was 15 % of total spend in the 1940s, rising to 20 % in the mid-1970s as a strong economy soaked up rising welfare costs. But as recession hit and unemployment soared, welfare spending rose to 30 % in the mid-1980s. Between 1996/97 and 2010, welfare spending rose by 40 % in real terms despite a strong economy throughout most of this period. In contrast, education spend has been consistent and education largely maintained its share of total spend rising from 18.7 % to 19.1 % in 2013/14, reflecting the government's decision to protect education budgets from austerity cuts. In 2013/14, spending on health as a percentage of GDP was 7.5 % compared to 5.1 % in 1993/94, while education over the same period went up from 4.8 % to 5.3 %. Interest payments as a percentage of GDP were 2.1 % in 2013/14, below the peak of 3.4 % in 1995/96.[39]

The shift towards spending on pensions and the elderly means less money available for other parts of the public sector. The Coalition's spending axe fell mainly on local government and defence while health and education were protected, although health inflation still outstripped even a static budget. The extra demands from an older population means less room for governments to reduce spending during recessions. Local government lost a quarter of its government grant under the Coalition, but cuts were increasingly falling on its social care budgets (which together with education make up two-thirds of all local government spending) with

a knock-on effect on health costs. Old people with no home care support end up in hospital, the most expensive part of the NHS.

While spending patterns have changed so has tax policy. Since the 1980s, there has been a shift away from direct tax to indirect tax. Tax absorbed 23.4 % of GDP in 1939, while by 1945 it had reached 37.6 %, compared with the 9.0 % of 1900. It is now around 35 %.[40] One pre-2015 election study looked at options for tax increases to meet the next round of fiscal consolidation. A 1 % rise in the income tax rate would yield £5.5 billion a year, while a similar rise in VAT would yield slightly less at £5.2 billion and £4.9 billion if National Insurance were increased by 1 %.[41]

Among OECD countries in 2012, tax revenues as a proportion of national income were highest in Denmark at 47.2 %, followed by France and Belgium (both at 44 %), Finland at 42.8 %, Italy at 42.7 % and Sweden at 42.3 %. Germany's share was 36.5 % while the OECD average was 33.7 %, just above the UK's 33 % which itself was the same as New Zealand's. The lowest were Chile at 21.4 % and Mexico at 19.6 %.[42]

Table 7.1 UK public spending as a percentage of GDP 2009/10 to 2014/15

Financial year	*% of GDP*
2009/10	45.7
2010/11	44.9
2011/12	43.4
2012/13	43.3
2013/14	41.7
2014/15	40.7

HM Treasury (July 2015) Statistical bulletin. Public spending statistics

Table 7.2 UK public sector deficits as a percentage of GDP 2009/10 to 2014/15

2009/10	10.2
2010/11	8.5
2011/12	6.9
2012/13	7.2
2013/14	5.7
2014/15	4.9

Source: Institute for Fiscal Studies. http://www.ifs.org.uk/uploads/publications/ff/debt_borrowing.xls

See also Office for Budget Responsibility data at http://budgetresponsibility.org.uk/data/

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PART II

Global Experiences of Austerity

CHAPTER 8

Deficit-Reduction in the USA

The second part of this book looks at other global case studies of fiscal consolidation, in particular the USA, the eurozone, Asia Pacific and Canada and Sweden, the last two being much admired by the UK Coalition government planning its own deficit-reduction from 2010.

As the richest country in the world, the USA might be assumed to have been a model of fiscal rectitude. Yet even aside from the property bubble that led to the fiscal crash in 2007/8, the country's public finances have been in deficit for most of the period since the Great Depression. In the forty-year period between 1929 and 1969 the US economy was in surplus for a total of only nine years and never more than three years in a row.[1] Thereafter it was in surplus only for four years from 1998. Seven times in US history the federal budget deficit has exceeded 10 % of GDP, including during the Civil War, WW1 and WW2.[2] In the 50 years since 1961, federal government has run annual deficits in all but six years (1960, 1969, 1998, 1999, 2000, 2001).[3]

The British political economist Lord Skidelsky commented that 'budget deficits—sometimes relying on the automatic stabilisers, sometimes promoted by vigorous tax-cutting—remained the basis of "pragmatic" macro policy American style from Kennedy and Johnson in the 1960s to Reagan in the 1980s and Bush in the 2000s … It is hard to avoid the conclusion that the quasi-permanent deficit has been, for a long time, the mainstay of the American consensus.' He referred to the brief surplus under Bill Clinton as 'an intermission of virtue.'[4] He also pointed out that 'the greatest splurgers in US history have been Republican presidents preaching

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free-market, anti-Keynesian doctrines; the one fiscal conservative in the last thirty years [he was writing in 2009] has been Democratic president Bill Clinton'.[5]

Federal spending in the USA is divided between mandatory spend (social security such as pensions and benefits and health, mainly Medicare and Medicaid), discretionary spend (defence, law and order) which is set each year by Congress, and interest on debt while American states are required to balance their budgets. The US fiscal year is October to September. In 1983, the US federal deficit as a proportion of GDP was the highest since 1946, when US debt was still swollen by the cost of the war. During the 1990s, the deficit was steadily reduced until from 1999, it went into surplus for four years, only to slip back into deficit in 2002 where it has remained ever since, exacerbated by the fiscal crash of 2008. However, it is important to note that the size of the US government sector is smaller than that of most major OECD states.

Managing deficit-reduction is complicated by the political structure of the USA. By law, Congress sets an annual debt ceiling which limits the amount the Treasury can borrow but which can be increased if both houses in Congress agree. Failure to agree on a debt ceiling which meets the administration's spending requirements technically means the government could default. Republicans traditionally back tax and spending cuts and Democrats vice versa though in practice 'pork barrel' politics where individual Congressmen/women and Senators back spending in their constituencies is cross-party. The president's party does not always command a majority in Congress and there have been legendary battles between the White House on the one hand and the House of Representatives and the Senate on the other over the former's efforts to cut the deficit. Both Bill Clinton and George W. Bush used the casting votes of their vice presidents to get their fiscal programmes through the Senate, while Obama had up-to-the-wire battles with Congress over his budget spending plans. US presidents do not necessarily divide into Keynesians and non-Keynesians depending on their political allegiance; the Democrat Bill Clinton took office in 1993 with deficit-reduction as his primary target while it was the Republican George W. Bush who, faced with the recession in 2008, announced he would be 'a Roosevelt' over public spending.[6] Alan Greenspan, the head of the Federal Reserve Board from 1989 to 2006, grumbled that in Congress the comment '"deficits don't matter" became part of Republicans' rhetoric.'[7] Average debt to GDP according to George W. Bush's own memoirs was 4.2 % under Reagan, 4 % under

the first Bush and 0.8 % under Clinton. The spending to GDP ratio under Reagan was 22.4 %, under Bush senior 21.9 %, under Clinton 19.8 % and under Bush 19.6 %. Total debt to GDP was 34.9 % under Reagan, 44 % under Bush senior, 44.9 % under Clinton and 36 % under Bush.[8]

US economists continued—and still continue—to argue the merits of deficit-financing. George W. Bush once joked to Bernard Bernanke, the chairman of the Federal Reserve Bank: 'You're an economist, so every sentence starts with "On one hand … on the other hand." Thank goodness you don't have a third hand.'[9] As one study noted: 'Deficits can serve as powerful instruments of fiscal policy and are not necessarily problematic. Governments use deficit spending to smooth outlays and taxes so that taxpayers and program beneficiaries are shielded from abrupt economic shocks and to mitigate the size of those shocks. However persistent deficits lead to growing accumulation of federal debt that may lead to higher interest payments, tax increases or spending cuts.'[10]

One study backed deficit finance during recessions only if consequent surpluses in the good times could reduce the deficit that had accumulated.[11] 'Running surpluses during normal economic conditions may strengthen a government's capacity to manage its economy not only by reducing public debt levels but also by enhancing its reputation for fiscal prudence which may widen its policy options in the event of a subsequent downturn.'[12]

However, few economists believe that running deficits permanently is sound economic policy. 'Using deficit finance to expand government spending and federal aid during economic downturns is only sustainable if governments run surpluses during economic expansions to repay debt or accumulate reserves or stabilise the debt to GDP ratio.'[13] But 'government debt that nears unsustainable levels, however, can inject turmoil into an economy and governments may go bankrupt if they fail to repay what they borrow.'[14] Alan Greenspan argued that 'big deficits have an insidious effect. When the government overspends it must borrow to balance its books. It borrows by selling treasury securities which siphons away capital that could otherwise be invested in the private economy.'[15]

The dispute over deficit-financing was described by one commentator as between macro-economists from so-called 'freshwater' universities (those by lakes such as Chicago, Minnesota and Rochester) and 'salt water' universities by the coast (Berkeley, Harvard, Yale, UCLA, MIT). The former argued that market forces, not government pump-priming, led an economy out of recession. The latter, citing the Great Depression,

said it was up to governments to mitigate the impact of downturns and that deficits expanded weakened economies.[16]

As in Europe, the failure of economic policy in the Great Depression dominated US economic policy in the three decades after 1945. Alan Greenspan noted: 'Keynes offered a mathematically elegant solution to why the world economy had stagnated [in the 1930s] and how government deficit spending could bring prompt recovery.'[17] An historian of the US economy commented: 'After the Great depression began late in 1930 new policies of political economy were required to sustain the consumer culture. What were the new policies? The short answer is massive fiscal intervention by the national government in the peacetime economy.'[18] The Second World War was funded by huge budget deficits so that by 1948, the national debt was two and a half times larger than in 1932. But as the economy moved into the post-war boom, rising GDP ate into the debt even though public spending also increased from 12 % of gross national product in 1946–8 to 21.4 % by the 1960s.[19] Between 1929 and 1969 the federal budget was in surplus for a total of nine years and never more than three years in a row. But GDP was strong and so total debt reduced until 1974 after which it rose. Tax receipts fell from 19 % of GDP in 1980 to 17.4 % in 1986.[20] By the late 1960s and 1970s, rising unemployment, competition from the Far East and the tripling of the oil price in 1973 contributed to a downturn in the economy and rethink in economic policy. 'Keynesian intervention was still the overwhelmingly dominant paradigm in the mid-1970s though it was already on the cusp of decline.'[21]

The recession which ravaged the USA and other industrialised countries in Europe in 1980/81 was the deepest and longest since the 1930s and also led to a 6 % deficit in 1983, the highest as a percentage of GDP since 1946. So-called 'Reaganomics', the economic policy of the Reagan administration, 1981–88, involved lower taxes and cuts to public spending (other than defence) which exacerbated unemployment and raised welfare costs. Although the economy improved enough for Reagan to be re-elected on a landslide in 1984 and his administration did indeed reduce tax, he was never able to achieve his goal of a substantial long-term reduction in public spending partly due to resistance from Congress. Federal spending was 22.9 % of GDP in 1981 and after increasing fell back to 22.1 % in 1989. Federal Reserve chairman Alan Greenspan, who was appointed by Reagan in 1987, estimated that the administration ran

a deficit of over $150 billion for five years and that this was 'undermining the economy.'[22]

Greenspan later commented that 'Everyone knew that whoever came in after Reagan would face big economic challenges … whopping deficits and the rapidly mounting national debt.'[23] Indeed, Greenspan was keen to tackle the deficit while the economy was still buoyant, recalling in his memoirs: 'My main concern was that the new administration attack the deficit right away while the economy was still strong enough to absorb the shock of cuts in federal spending. Big deficits have an insidious effect. When the government overspends it must borrow to balance its books. It borrows by selling treasury securities which siphons away capital that could otherwise be invested in the private economy.'[24]

But the new President, George Bush, had been elected in 1988 on a promise not to increase taxes. Soon afterwards the economy tipped into recession and although he had to amend that tax pledge in his 1990 Budget and recovery was underway by 1991, it was too late to save his presidency. Greenspan recalled: 'The deficit probably hurt Bush worse than anything else. Although the belated Budget cuts and the tax hikes of 1990 had put the country on a somewhat better fiscal footing the recession cut so deeply into federal revenues that the deficit temporarily mushroomed.'[25] Bush's son, George W., reckoned that the recession 'cost Dad the election' [in 1992].[26]

Fiscal Consolidation in the Early 1990s

The task of restoring the nation's public finances now fell to Bill Clinton, the first Democrat president in a dozen years. Ideologically, Democrats were committed to a bigger state, to higher taxes and to more spending than the Republicans, even though in practice the record of Republican presidents in the 1980s on balancing the books was poor. But Clinton and his advisers concluded that reducing the deficit as the economy gradually moved out of recession was their biggest challenge. In his memoirs, Clinton said that Reagan and Bush had built in a large structural deficit that 'persisted in good times and bad', that national debt under Reagan tripled and continued to rise under Bush and that annual interest payments were the third largest item in the federal budget after defense and social security.[27] Clinton dismissed the idea that lower tax cuts caused the economy to grow, thereby generating more tax revenue. 'Of course it didn't work and the deficits exploded throughout the recovery of the

1980s.' But the Republicans had an 'ideological aversion to taxes.'[28] Alan Greenspan tended to agree, later commenting: "The hard truth was that Reagan had borrowed from Clinton and Clinton was having to pay it back."[29]

Clinton recalled that he and his advisors held a pre-election summit at Little Rock where 'there was an overwhelming consensus that my number one priority should be to reduce the deficit.'[30] On assuming the presidency in January 1993, he discovered that the figures were even worse than expected. In a debate which would be repeated in the downturn of 2008, there was now argument between the Keynesians, who believed any fiscal consolidation would slow growth and those who argued it would do the opposite. Greenspan recalled that some of the White House staff 'ridiculed the deficit-cutting approach as a sell-out to Wall Street.'[31] But Clinton wanted both to cut the deficit and give a tax boost to the lower-paid. He said he wanted to 'cut the deficit in half [in four years] without weakening the fragile economic recovery in the short run; to find the right combination of spending cuts and tax increases necessary to reduce the deficit and increase spending in areas vital to our long-term economic prosperity; and to ensure more tax fairness for middle and lower income working people.'[32]

Greenspan also took the view that 'the deficit was by far the most pressing concern. I'd made that argument at the start of Bush's term and now the problem was four years worse.'[33] Interest rate payments were the third largest federal expense after social security and defence. The government was heading for a $360 billion deficit in 1997, $50 billion higher than the previous estimate. Greenspan told the president that a combination of rising social security costs and then rising interest on the deficit threatened 'a spiral of rising deficits.' He added: 'Unless it's aborted that could lead to a financial crisis.'[34]

Clinton decided 'the deficit hawks were right' and that if the deficit were not brought down the government would be stuck with high interest rates. Without his plan the annual deficit, he estimated, would increase to $635 billion from 1993's $290 billion within a decade. Middle class tax cuts were abandoned and the top rate of tax increased from 31 % to 36 %. The proposal for $255 billion in cuts and $241 in tax rises over four years was fiercely fought, with even some Republicans opposing it in Congress. The Senate eventually passed the Budget in summer 1993 only with vice-president Al Gore's vote. Legislation signed in August, according to Clinton, 'reversed twelve years in which the national debt

had quadrupled with deficits built on overly optimistic revenue numbers and an almost theological belief that low taxes and high spending would somehow bring enough growth to balance the budget.'[35] Alan Greenspan said Clinton's 'decision to go ahead and fight for the deficit cuts was an act of political courage.'[36]

The combination of a tough anti-deficit programme, a reduction in defence spending from a peak of 6.2 % of GDP in 1986 to 3 % in 1999 following the collapse of the Soviet Union, an improving economy and also the dotcom boom led to the elimination of the deficit altogether by 1998. By 1997, Greenspan later wrote, the deficit had shrunk to a tiny $22 billion which was 'statistically insignificant' when GDP was $10 trillion and budget $1.6 trillion. For the next four years the federal budget was actually in surplus. Clinton later stated that 'we had brought arithmetic back to the budget and broken America of a bad habit.'[37]

However, the scale of the recovery in the public finances was unexpected. As one analysis noted: 'The budget surpluses that occurred during this decade surprised many budget analysts with deficits forecast beyond 1998. The President's budget proposal for the financial year 1998 also predicted a deficit but strong economic growth led to a rise in tax revenues alongside impact of spending cuts.'[38] Alan Greenspan, the Federal Reserve chairman, maintained the turnaround was due to 'fiscal conservatism and economic growth' even though no one at the Fed predicted that in 2000 the surplus would be the largest percentage of GDP since 1948.[39]

The political consequences of austerity however proved a longer-term problem for the Democrats, who lost control of Congress and in 2000, the presidency itself. Clinton later ruefully remarked that he and his party 'bore the brunt of the public's withdrawal pains. I couldn't expect gratitude. Even with an abscessed tooth, nobody likes to go to the dentist.'[40] When the figures showed the budget was in surplus he held a party at the White House but pointedly declined to invite Republicans because none had voted for his austerity package in 1993.

From Boom to Bust

For four years in succession from 1998, the federal budget was in surplus. It seemed that deficits were now a thing of the past and the question was how to manage the flood of money pouring into the nation's coffers, helped by the technological revolution. As Alan Greenspan noted: 'Nearly a decade of rising productivity growth and budget discipline had

put the US government in a position to generate surpluses "as far as the eye could see."'[41] The Congressional Budget Office predicted that by 2006 the surplus would be $500 billion and continue annually thereafter. The Republicans wanted tax cuts, the Democrats more public spending. Greenspan preferred to continue paying off debt which was still $3.7 trillion because he was concerned that with the post-war baby boomer generation ageing, there would be big medical and health costs looming down the line. He saw that the 'greatest challenge on the economic front was the aging of thirty million baby boomers … the financial demands on the system would become extremely heavy in the decades beginning in 2010. Social security and Medicare would need major revision.'[42]

The focus of the new president George W. Bush, who won the 2000 election, was on tax cuts, claiming that tax as a percentage of GDP was at its highest in 1999 since the Second World War.[43] Greenspan was not averse to tax cuts but 'could not shake off a conviction of many decades that the biases in our political system favour deficits.' His ultimate goals remained 'debt reduction and zero deficits.'[44] In June 1991, Bush signed off a $1.35 trillion tax cut, the largest since the Reagan years, reducing marginal tax rates, doubling child tax credit and eliminating the lowest tax bracket.

But a permanent budget surplus proved to be a mirage and the timing of the tax cuts could not have been worse. The dotcom bubble collapse and the impact of 9/11 pulled down growth and tax revenues and in 2002, the surplus vanished. In January 2002 the Congressional Budget Office had optimistically predicted tax receipts of $2.236 trillion for the fiscal year 2002, but by August that figure had shrunk to $1.860 trillion, of which $75 billion was down to tax cuts and $125 billion down to the slowing economy.[45] As Greenspan recalled: 'Suddenly and inexplicably, federal revenues plunged … The vaunted surplus, still going strong when Bush signed the tax cut in June and forecast to continue for many years, was effectively wiped out overnight. Starting that July red ink was back to stay.'[46] In 2002, the deficit was $158 billion compared to a $127 billion surplus in 2001.

Bush later defended his fiscal record, rejecting claims that he had 'squandered the massive surplus I inherited' on the grounds that 'much of the surplus was an illusion, based on the mistaken assumption that the 1990s boom would continue. Once the recession and 9/11 hit there was little surplus left.'[47]

Bush faced fierce opposition in 2003 when he came back to Congress to ask for more tax cuts, with critics saying it would only increase the deficit. Bush wanted $670 billion more tax cuts to add to the initial $1.35 trillion. The tax cuts issue, according to Greenspan, 'became a media circus.' When 450 economists including ten Nobel laureates published a letter saying tax cuts would worsen the deficit without helping the economy, the White House countered with a letter from 250 economists supporting its plan. Greenspan noted: 'The 450 were mainly Keynesians and the 250 were mainly supply-siders.'[48]

Bush himself defended his record saying: 'It was true that tax cuts increase the deficit in the short term. But I believed the tax cuts … would stimulate economic growth.'[49] His plans scraped through Congress in 2003 by 231 votes to 200 in the House of Representatives, while in the Senate Vice President Dick Cheney had to use his casting vote in his constitutional role as president of the Senate.

The $300 billion deficit projected for 2003 and 2004 was still only 2.7 % of GDP and along with more tax cuts, there were increases in defence spending (the consequences of 9/11) and in particular, funding of prescription drug benefits under Medicare at a cost of $500 billion over ten years. Bush argued that spending on Medicare, established in 1965, had become a '$13 trillion unfunded liability' due to the ageing population and needed reform. To bring market forces into the system, he offered free prescriptions to the elderly in return for their taking out private health insurance policies. Greenspan thought that the health changes 'had not been unrealistic in the light of large and projected surpluses … [but] in the revised world of growing deficits the goals were no longer entirely appropriate.'[50]

In addition, Greenspan was critical of what he saw as the lack of fiscal responsibility by politicians, in particular 'pork barrel spending' adding: 'Most troubling to me was the readiness of both Congress and the administration to abandon fiscal discipline.'[51] This was cross-party as to his chagrin '"deficits don't matter" became part of Republicans' rhetoric.'[52]

He said that 'budget discipline in Washington gave up the ghost on September 30 2002.' That was the day the Budget Enforcement Act 1990, which set deficit targets and spending limits, was allowed to expire. During the 1980s, legislation had been introduced to control deficit levels through the Balanced Budget and Emergency Deficit Control Act of 1985, which aimed to eliminate the deficit by the early 1990s by imposing

automatic spending cuts (or sequestration) if Congress and the president failed to enact legislation to ensure deficit was not above what was allowed in the Act. However, it was unsuccessful and debt continued to rise until the early 1990s. It was later replaced by the Budget Enforcement Act which had 'played an important role in bringing the federal deficit under control thereby helping to set the stage for the 1990s boom.'[53] Greenspan begged the House Budget Committee in vain not to abandon the Act, arguing that 'without clear direction and constructive goals the inbuilt political bias in favour of budget deficits likely will again become entrenched … If we do not preserve the budget rules and reaffirm our commitment to fiscal responsibility, years of hard effort will be squandered.' And he told the committee that 'history suggests' that abandoning fiscal discipline would eventually push up interest rates, crowd out capital spending, lower productivity and 'force harder choices upon us in the future.'[54]

While not denying that he turned a surplus into a deficit during his two administrations, Bush maintained the deficit fell from 3.5 % of GDP in 2004 to 2.6 % in 2005, 1.9 % in 2006 and 1.2 % in 2007. He claimed the average deficit-to-GDP ratio during his two terms was 2 % 'below the fifty-year average of 3 %.'[55]

Recovery After 2011

When the property crash followed by the fiscal crisis occurred in 2007/8 and threatened the entire financial system, Bush recalled the failure of policy during the Great Depression by Republican president Herbert Hoover and the consequent neo-Keynesian interventionism of the Democrat Franklin Roosevelt that helped restore the economy. Bush told his White House advisers: 'If we're really looking at another Great Depression you can be damn sure I'm going to be Roosevelt, not Hoover.'[56] He was supported by Greenspan's successor as Federal Reserve Board chairman, Ben Bernanke, who, in Bush's words, also had a 'fierce determination to avoid the mistakes of the 1930s.'[57] Interest rates were slashed and the subsequent bail-out of the banks dwarfed Roosevelt's spending programmes. When TARP, the $700 billion Troubled Asset Relief Programme, was eventually passed in October 2008, Bush said it 'helped spare the American people from an economic disaster of historic proportions … the second Great Depression … did not happen.'[58]

The downturn however also left the economy with a huge deficit caused by higher welfare costs and a plunge in tax revenues. In the financial year

2008, the US budget deficit was $455 billion or 3.2 % of GDP, up from $161 billion or 1.2 % of GDP in 2007. In 2009 the Congressional Budget Office (CBO) projected that the deficit that year would be 8.3 % of GDP, compared to 3.2 % in 2008. In fact, it was 1.4 trillion in 2009, equal to 9.9 % of GDP. TARP added $180 billion to the deficit in 2009. In 2008, as a share of GDP federal revenues fell to their lowest level since 2005 while spending reached its highest level since 1994 though total debt at some 85 % of GDP was still lower than many European countries.[59] But with the economy weak, this was still not the time for fiscal consolidation. GDP fell by 8.3 % in the final quarter of 2008 and 5.4 % in the first quarter of 2009. Bush's successor, Barack Obama, who became president in January 2009, wanted to deliver a fiscal stimulus of up to $1.2 trillion in the short term as a mix of infrastructure spend and tax cuts with a longer-term plan to tackle the deficit. Republicans wanted tax and spending cuts. The battles with Congress over his early budgets are detailed in a book *The Price of Politics* by the famous Watergate journalist Bob Woodward, who wrote that Obama was 'torn between competing priorities. Wanting to tame the federal deficit, he nonetheless believed that, with unemployment on the rise the economy needed aggressive government support.'[60] The head of the Senate budget committee 'believed the country was heading off a fiscal cliff' but 'he didn't want to impose fiscal austerity in the midst of a downturn. That would only lead to a bigger downturn, more deficit, more debt.'[61] In the end, the administration was able to push through $700 billion of stimulus between 2009 and 2012, which helped the USA avoid the much longer and deeper recession that ravaged the eurozone while increasing tax for higher-rate taxpayers. Simultaneously, the Budget Control Act of 2011 imposed caps and spending reductions that would reduce the deficit in theory by $2.1 trillion between 2012 and 2021. Failure to agree to these targets would lead to automatic cuts being imposed, which did in fact occur in 2013.

The Republicans won control of the House of Representatives in 2011 on a platform of spending cuts which Democrats opposed, calling for an increase in the debt ceiling. The impasse almost brought the government to the edge of defaulting but subsequent compromises meant that by 2013, the deficit was down to 4 % from its peak of 10 % in 2009. In the 2014 fiscal year the deficit fell by a third to 2.8 % of GDP, the lowest since 2007 and driven by buoyant tax revenues.

However, the Congressional Budget Office warned that spending would rise and the deficit would worsen again longer-term, due to the

costs of an ageing population, health (Medicare and especially Medicaid which rose by 13 % in 2013/14 due to changes to eligibility criteria) and welfare costs. It said that federal spending in 2015 was $3.7 trillion, an increase of 4.7 % on 2014, and likely to rise by an average 5 % a year to 2025. Its forecast for 2015–2025 estimated that the deficit would be stable at around 2.5 % until 2018, after which it would rise to 4 % by 2025 with federal debt at 79 % of GDP. It predicted an increase in welfare bills from 4.9 % of GDP in 2016 to 5.7 % by 2025 in health (Medicare, Medicaid, Children's Health Insurance Program and other subsidies) from 5.3 % to 6.2 % of GDP by 2025 and for interest rate costs from servicing the debt to double by 2025 from 1.5 % of GDP in 2016. Between them, these three components would account for 85 % of the increase in costs over the next decade, whereas other spending would reduce as a proportion of GDP, partly because of limits on discretionary spending—determined by annual appropriation acts—imposed by the Budget Control Act of 2011.[62]

The picture was forecast to worsen still further after 2025, with debt as a proportion of GDP reaching 100 %, the percentage recorded just after World War Two, because of soaring health costs. The CBO added: 'Such high and rising debt relative to the size of the economy would dampen economic growth and thus reduce people's income compared with what it would be otherwise. It would also increasingly restrict policymakers' ability to use tax and spending policies to respond to unexpected challenges and would boost the risk of a fiscal crisis, in which the government would lose its ability to borrow at affordable rates.'[63]

The dilemma, as ever, is choosing the best time to implement such fiscal consolidation. Economists continue to argue over whether fiscal policy in the USA from 2009 to 2014 was contractionary or expansionary, whether spending increases were too much or too little and whether Republic control of the House meant tougher spending cuts than the economy could sustain. One study, for example, argues from both sides, maintaining that fiscal policy was indeed 'unusually expansionary' from 2009 but that from 2010, it became contractionary. The combination of expansion and contraction when averaged out meant that fiscal policy overall during the recovery was 'only slightly more contractionary than the historical norm.'[64] Other commentators maintained that compromises over budget cuts between the White House and Republicans led to 'fiscal drag' which slowed the recovery.

The Congressional Budget Office estimated in 2013 that automatic stabilisers, the natural consequence of recession when public spending

like welfare increases and offsets the drop in economic activity and tax revenues, added the equivalent of 2.3 % of GDP to the deficit in 2012. This was the fourth year in succession that the stabilisers added the same or more than 2 % of GDP to the deficit, the largest percentage in 50 years apart from during the recession of 1982 and 1983.[65] But it also estimated that tax rises and spending cuts reduced GDP by 1.5 % in 2013 and 0.25 % in 2014.[66]

In a separate report, the CBO summed up the choices facing politicians in a downturn of the future when it stated: 'Lawmakers face difficult trade-offs in deciding how quickly to carry out policy changes that will make the path of federal debt more sustainable. On the one hand, waiting to cut federal spending or to raise taxes would lead to a greater accumulation of debt and would increase the magnitude of the policy adjustments needed. On the other hand, implementing spending cuts or tax increases quickly would weaken the economy's current expansion and would give people little time to plan for and adjust to the policy changes.'[67]

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CHAPTER 9

Austerity in Europe

The political and economic case for austerity began to fall apart when it came to the experience of European countries, in particular the southern states in the 17-member eurozone, whose economies were mired in recession long after the fiscal crash. The financial crisis that struck Europe in 2008 triggered a sovereign debt crisis whose causes included 'weak banking supervision, poor fiscal policies and the difficulties experienced by large financial institutions (the bailout costs of which were borne by the general public).'[1] Ultimately, eight EU members states were forced to seek financial help from the European Commission.

Despite stringent rules on debt, many of the EU countries consistently ignored them. As one account put it: 'By end of 2010 21 of the 27 EU countries and 13 eurozone countries had failed to meet the Maastricht stability and growth pact limit of 3 % deficit max. The average deficit of EU countries in 2010 was 6.5 % of GDP. 14 of the EU group exceeded the limits for three or more years. In 2010 average EU debt as percentage of GDP was 80 % and in the eurozone 86 %. As of 2010 France's budget deficit failed to meet the criteria 6 years out of 9 since 2002 while in Italy it was 9 out of 10 years since 2001.'[2] A later European auditor's report said 'the Commission was unprepared for the magnitude of the crisis that broke out' and concluded: 'An important weakness of the Commission's assessments prior to 2009 was the lack of reporting on the build-up of contingent public sector liabilities, which often became real liabilities during the crisis. Nor did the Commission pay sufficient attention to the link

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between large foreign financial flows, the health status of the banks and, ultimately, government finances.'[3]

Following initial Keynesian spending to stave off a full-blown depression, the turn to fiscal consolidation after 2010 was, in the words of one economist critical of austerity policies, 'so drastic, particularly in European debtor nations, that the usual cautions lose most of their force. Greece imposed spending cuts and tax increases amounting to 15 percent of GDP; Ireland and Portugal rang in with around 6 percent; and unlike the half-hearted efforts at stimulus, these cuts were sustained and indeed intensified year after year. So how did austerity actually work? The answer is that the results were disastrous—just about as one would have predicted from textbook macroeconomics … the countries forced into severe austerity experienced very severe downturns, and the downturns were more or less proportional to the degree of austerity.'[4]

One reason why southern eurozone countries took so long to recover from the fiscal crash was the straitjacket of the euro, set up in 1999, which removed the freedom for a national currency to find its own level. The euro was designed to remove the temptation by members to over-borrow by setting through its Stability and Growth Pact a maximum of 3 % of GDP for deficits and 60 % debt to GDP ratio as well as a pledge not to allow bail-outs. The trouble was that banks remained a national responsibility along with the risk to their governments should they fail and as the eurozone countries were not in a fiscal union, each country continued to run its own tax and spending policies. The relationship between the euro's flawed design and the sovereign debt crisis therefore fell into three phases, according to one analysis. The first was the build-up of risk during the pre-crisis period, the second when these risks then multiplied the fiscal impact of the crisis and third when monetary union coupled with political impotence impeded recovery.[5] In addition, the southern eurozone countries, especially Greece, had inefficient tax systems and costly social security provision, in particular on pensions.

However, by the mid-2000s there was no evidence that debt was a major problem, other than in Greece. Among the so-called PIIGs eurozone members (Portugal, Italy, Ireland, Greece, Spain), only Italy and Greece had a debt to GDP ratio of over 90 % and neither had ever met the 60 % limit in the eurozone fiscal rules. One critic of austerity later commented: 'Italian public sector debt in 2002 was 105.7 % of GDP and no one cared. In 2009 it was almost exactly the same figure and everyone cared.'[6] Ireland, Portugal and Spain actually saw debt decline during the

1990s while France and Germany met the 60 % ceiling. In 2007, Greece's debt to GDP ratio was 107 %, that of Portugal 68 %, Spain 36 %, Italy 103 % and Ireland 24.9 %. 'Moreover, the low spreads on sovereign debt also indicated that markets did not expect substantial default risk and certainly not a fiscal crisis of the scale that could engulf the euro system as a whole.'[7] Both Ireland and Spain, which were to be so badly hit by the fiscal crash, had stable public finances in 2007. In Ireland, the deficit was almost nil while Spain actually had a budget surplus with a debt-to-GDP ratio of just 35.5 % compared to a eurozone average of 65 %.[8] In effect 'of the PIIGS only Greece was in any meaningful sense profligate'.[9]

However, these countries had their own individual weaknesses that were masked when economic growth was strong. Greece was a particular problem with high public sector debt, generous public sector benefits especially pensions, weak competitiveness and an inefficient tax system with persistent tax avoidance and a flourishing black economy which successive governments did little to address. Even in 2009, 75 % of non-interest public spending went on public sector wages and social benefits while cheap credit from being in the euro was funnelled into spending and to offset low tax revenue. Greece was highly dependent on cheap credit and therefore sensitive to any upward movement in interest rates if investors feared it could no longer service its debts. In fact, these weaknesses had been endemic for years. For more than half of its time since independence from the Ottoman Empire in 1832, Greece had been in default. Even by 1990 the state controlled 75 % of all business assets, reduced only to 50 % in 2008.[10] Greece's entry into the euro opened it up to cheap credit which was used to pay for public spending and to offset low tax revenues; despite constantly breaking the EU's 3 % debt ceiling, the EU never punished Greece, which never received financial sanctions.

Ireland and Spain had property bubbles funded by over-extended banks while Portugal had low growth and low competitiveness. These were all risks if the economies were to reverse and by the mid-2000s, all the signs of dangerous over-heating were apparent even though no government made any effort to prepare for a potential bust which so often follows a boom. A credit surge as eurozone banks took advantage of the ability to borrow in one currency and as interest rates fell fuelled a major rise in household debt and a property bubble, especially in Ireland, which was dubbed 'the Celtic Tiger' while Greece was able to borrow far more cheaply than it had been able to previously with its own currency. In theory, the extra tax revenue generated by this activity should have been

an opportunity for governments to tighten fiscal policy, but 'these large-scale revenue windfalls were only partially used to improve fiscal positions with the balance paid out in extra public spending or tax cuts.'[11] Some economists believe organisations like the OECD, IMF and the European Commission should have been more aggressive in insisting on the accumulation of 'buffers that might help if or when the boom ended in a sudden and disruptive fashion.'[12] Indeed, in 2006, the year before the crash, the IMF predicted world growth at 5.1 % that year and 4.9 % in 2007, which 'would be the strongest four-year period of global expansion since the early 1970s.'[13] Even the following year, as the fiscal crash developed, the IMF predicted: 'Events of the past few months have been a major test of global financial stability, and some unexpected weaknesses have emerged. As long as those remain contained within a few industrial countries and are addressed in a timely fashion, the impact on world growth should be small.'[14]

When the financial crash came, all the eurozone countries were sucked into the downturn as GDP fell but each had different experiences depending on their economic circumstances. Germany, with its budget balanced on the eve of the crash, was least affected even though debt shot up to 80 % of GDP in 2011 before falling back. Ireland's nominal deficit rocketed to 7 % in 2008 and almost 15 % in 2009 while in one year, 2008, Spain's budget surplus of 2 % became a deficit of 4.4 %. Initially, the eurozone countries, especially France, Italy and Spain, responded with fiscal expansion to offset the drop in tax revenues, but after 2010 as GDP apparently began to rise again and with the public finances now immersed in red ink, expansion became fiscal contraction through spending cuts and tax rises. The problem was that this assumed GDP growth would be strong enough to offset spending cuts and tax rises while Italy and Spain in addition were tipped into a double-dip recession from a sovereign debt crisis.[15]

The eurozone came under huge pressure from 2008 as cross-border financial deals dried up, hitting countries, like Ireland, most reliant on external funding. As the property market collapsed, banks were exposed to huge losses from bad loans while by late 2009 debt levels climbed to alarming levels as countries reliant on tax revenues from property and financial services saw their income plummet.

The biggest problem was Greece, whose interest rates escalated as investor confidence weakened. The Greek government announced a revised budget deficit of 12.7 % of GDP in October 2009, double its previous estimate, which rattled investors. It then further revised its earlier

estimates to show it had consistently failed to meet the eurozone fiscal rules. Its 2009 budget deficit later became 15.4 %. These revelations tarred the other southern European countries whose deficits were in no way comparable and their bond yields rose as markets became concerned about their credit risk. Fearful of contagion from the Greek crisis and of the country defaulting altogether, the EU and IMF jointly agreed a three-year loan of 110 billion euros in May 2010 in return for austerity measures and economic reforms, which would reduce Greece's deficit to 3 % by 2014. This involved public spending cuts especially to its civil service and its generous pension scheme and tax rises. As economic conditions continued to worsen, another loan, this time of 109 billion euros, was agreed in July 2011 in return for a further bout of austerity with more spending cuts and a privatisation programme. Austerity rapidly proved to be both difficult to implement and unpopular. One opinion poll in June 2011 said that 50 % of Greeks wanted their parliament to reject new austerity measures while unemployment doubled between 2008 and 2011. An analysis in 2011 bluntly concluded that 'growth is proving difficult because austerity measures have depressed domestic sources of growth. Moreover, Greece cannot easily rely on exports for expanding its economy. As a member of the Eurozone, it cannot depreciate its currency against its major trading partners to help spur exports.'[16]

Bail-outs from the EU and IMF were also made to Ireland in 2010 of 80 billion euros and Portugal in 2011 of 78 billion euros with the stipulation that over the next three years, debt through fiscal austerity programmes must be reduced and structural changes made to boost economic growth and stabilise their banking systems. Both countries then plunged into recession. A 100 billion euro loan was also made to shore up Spain's banking system in July 2012 and to Cyprus in 2013.

Although eurozone debt peaked in 2009, it continued to rise over the next two years because of low growth and interest rate payment costs. By 2011, the debt to GDP ratio was almost 163 % in Greece, 108 % in Ireland, 101.5 % in Portugal, 120.5 % in Italy and 85.4 % in France.[17] The problem was the time scale of the three-year loans was too narrow to give time for such changes to take effect while the three countries, because they were in the euro, were unable to use currency devaluations to help make exports more competitive, as the UK could. As Professor Paul Klugman noted: 'A funny thing happened to other countries with high debt levels, including Japan, the United States, and Britain: despite large deficits and rapidly rising debt, their borrowing costs remained very

low. The crucial difference … seemed to be whether countries had their own currencies, and borrowed in those currencies. Such countries can't run out of money because they can print it if needed, and absent the risk of a cash squeeze, advanced nations are evidently able to carry quite high levels of debt without crisis.'[18] In addition, austerity squeezed household income and impeded growth, thereby proving the Keynesian rule that fiscal consolidation should not take place during a recession. The weakness of the economies across Europe also made it even more difficult for the eurozone countries to export their way to growth.

The result of austerity in the PIIGs was high unemployment and social and political unrest, while in 2015, Greece almost defaulted on its loans and looked for a few months as if it might exit the euro altogether. Its anti-austerity government, led by the party Syriza, however, took the medicine from the IMF/EU/ECB's third bailout of £63 billion and then went to the polls in September 2015 to be re-elected, beating a anti-austerity breakaway faction. The Greek public, having initially rejected the onerous terms of the bailout and having stared into the abyss of default and 'Grexit' thus drew back from further confrontation. The Syriza Mark 2 government instituted tax rises, bank sales and further cuts. One former Syriza MP and economist later complained that his party's turnaround 'strengthened the perception across Europe that austerity is the only way' but that it 'failed not because austerity is invincible, nor because radical change is impossible, but because disastrously it was unwilling to put up a direct challenge to the euro.' Radical change on the left, he argued, meant smaller countries prepared to exit the euro.[19]

However, the picture was better for the other PIIGS. In December 2013, three years after its bailout, Ireland completed its bailout programme and in 2014 became the fastest growing economy in the eurozone with a growth rate of 5 % while Spain and Portugal completed in 2014.

Unlike in Greece, where voters opted for a left-wing government in protest at austerity, the Portugese were more measured. In October 2015 they reluctantly re-elected the centre-right coalition that had steered the country through four years of cuts including higher taxes, asset sales, and reduced public sector salaries even though the coalition lost its majority. In Spain it was also a conservative government under Mariano Rajoy which led the country through austerity, provoking fierce opposition at a time of recession. After an initial fiscal expansion, Spain had undergone spending cuts, public sector wage freezes, pension reform and high unemployment. As one commentator noted in 2015, by which time the Spanish

economy was rapidly improving, Spain was ‘one of the main battlefields in an ideological clash that pits anti-austerity movements such as Syriza in Greece and Podemos in Spain against the Berlin-led advocates of fiscal discipline and economic orthodoxy. The Rajoy government belongs squarely in the second camp.’[20] In 2015, Spain’s jobless figures fell below five million for the first time in four years, while its GDP growth rate was 3 %, one of the highest rates in the eurozone. The budget deficit also fell from 8.9 % in 2011 to 4.4 % in 2015, lower than that of the UK. Advocates of austerity argued that Spain’s recovery was due to its adherence to a strict programme of public spending cuts and reforms to its labour market. Opponents maintained that its GDP was still lower than before the recession, while the oil price drop and depreciation in the euro helped the recovery. The IMF appeared to back both arguments when it said Spain had experienced ‘a remarkable rebound in economic activity as a result of strong policy implementation and favourable external conditions.’ It attributed the recovery to a combination of financial sector reform, fiscal consolidation and structural reforms especially in the labour market which ‘supported the return of confidence’ along with external changes such as the oil price drop and euro depreciation. It also recommended the continuation of ‘growth-friendly fiscal consolidation’ to ensure that the debt-to-GDP ratio was ‘firmly on a downward path.’[21]

The eurozone’s stagnation was in marked contrast to the UK, whose debt in 2009 had been among the highest among developed nations but which by 2015 had halved to 5 % while the economy was back to growth, not least because it controlled its own currency and was able to ‘print’ money through quantitative easing. Indeed, in 2012 the European Stability Mechanism was created to provide a lifeline to eurozone members in financial difficulty and in 2015 the European Central Bank belatedly introduced quantitative easing six years after the UK to lower borrowing costs across the eurozone and fend off deflation.

As one study of the eurozone crisis concluded: ‘The origin and propagation of the sovereign debt crisis can be attributed to the flawed original design of the euro … there was an incomplete understanding of the fragility of a monetary union under crisis conditions.’[22] When the euro was created there was no mechanism to deal with debt crises ‘and as a result emergency rescue plans had to be drawn up and agreed on the hoof.’[23] Another view is that the debt crisis in all the PIIGS countries ‘was the consequence of the financial crisis washing up on their shores, not its cause.’[24]

Case Study: The Baltic States

However, not all 17 members of the eurozone faced the same hardships as the PIIGS and not all of them were sympathetic to their weaker members. Some states, especially those in central and eastern Europe with a lower standard of living than Greece, believed the country had brought the crisis upon itself by failing to tackle high public spending and reorganise its inefficient tax system. All three Baltic states joined the euro after adopting their own austerity packages and cutting spending. Their stance was summed up by the Latvian Finance Minister Janis Reirs, who suggested the Greeks might copy his country's austerity package, saying at the height of the Greek default crisis in 2015, a year after Latvia adopted the euro: 'We made some austerity measures and we put our fiscal matters in order in a speedy manner. We reduced the public sector by 30 % and this was expressed in wages and reduction of staff. These structural reforms helped [Latvia] to become one of fastest growing economies in 2012–13.'[25] The Slovakian Finance Minister Peter Kazimir similarly argued that his country, by reorganising its tax administration, had improved its revenues by 3 % of GDP in three years, writing in 2015: 'The Baltics, the Iberians, Ireland and Slovakia show that even small countries on the eurozone's geographical periphery can reform their economies and streamline their budgets. Like us, the leaders of Greece must be bold and honest with their public as well.'[26]

Estonia (which joined the euro in 2011), Latvia (in 2014) and Lithuania (January 2015), having expanded their public sectors substantially after liberation from the Soviet Union, had to slash budgets after 2008 only to bounce back to recovery although with a price paid in high unemployment and lower earnings. Their robust austerity provoked fierce debate among economists and politicians with the 'austerians' claiming it was an example of what could be achieved through determined fiscal consolidation and opponents arguing the Baltic states were unique and could not provide any blueprint for others to follow. 'The three countries, and in particular Estonia and Latvia, have been hailed by some as successful austerity policy cases. Others have questioned this assertion and argue that a more expansionary policy mix would have benefited the countries.'[27]

All three states adjusted painfully to a market economy during the 1990s, the decade after independence from the Soviet Union, and their citizens became to some extent resilient to the vicissitudes of the economy, recession and privatisation and more tolerant of hardship than western

Europeans. Once the states joined the EU in 2004 their economies boomed, fuelled by cheap credit from bank lending along with fixed exchange rates and the prospect of soon joining the euro and their average annual GDP growth rates of 8 % between 2000 and 2007 earned them the epithet 'the Baltic Tigers.'[28] However, this also led to inflation, declining productivity as wages increased and big increases in public spending. Although their over-heated economies were slowing by 2008, 'the incipient end of the boom was recognized sooner in Estonia than in Latvia and Lithuania, where large pension and public sector wage increases were granted as late as mid-2008. In the late summer the Baltic economies seemed to be headed for a drawn-out post bubble slowdown.'[29]

Already exposed to inflation, a property bubble and a credit boom, the economies were devastated by the fall-out from the bankruptcy of Lehman Brothers in September 2008 and the drying-up of credit as plummeting confidence in banks spread through the financial system. The Latvian government, worst hit among the Baltic states by the banking crisis, was forced to take an 85 % stake in its second largest bank following a run on deposits and turned to the EU and IMF for a loan in early 2009. Although the loan prevented a complete liquidity crisis, it could not stop the collapse in output as credit, which had driven the Baltic economies, dried up, domestic demand fell, exports shrank, unemployment rose and the economy plunged into recession. Exports were double hit due to trading partners like the Nordic countries and Russia being devastated by the fiscal crisis. The decline in output in the Baltic states over 2008/09 ranged from 14 % in Lithuania to 25 % in Latvia, among the world's highest. The decline in GDP from the third quarter of 2008 to the first quarter of 2009 was 13.1 % in Estonia, 13.9 % in Lithuania and 11.9 % in Latvia.

The crash exposed underlying weaknesses in all three states, notably lack of competitiveness and debt, both private and public. The rise in public spending during the previous decade and the drop in tax revenues from the recession led to high deficits. During the previous decade, public spending had risen substantially on the back of rising tax revenues from the booming economy with the growth of public sector salaries and welfare benefits far outpacing inflation. In Lithuania, welfare benefits rose by 44 % in 2006/8 driven by a 40 % increase in pensions and a doubling of maternity benefits. When the crisis brought tax revenues down to 2006 levels, spending continued at its 2008 peak, triggering a sharp rise in the deficit, to 18 % of GDP in Latvia and Lithuania and over 10 % in Estonia in 2009. As one study noted: 'The fiscal deficit risked to balloon, threatening

financing and confidence … Financing such large fiscal gaps would have been extremely challenging given the extreme stress in international financial markets and the limited capacity of domestic debt markets. Even more importantly, deficits of such magnitude would have undermined confidence and called into question the longer-term compatibility of fiscal policies with the exchange rate pegs and eventual euro adoption. The Baltics therefore had little alternative but to implement sizeable fiscal consolidation that was unprecedented by historical and international standards.'[30]

Despite external advice from policymakers and economists, the Baltic governments insisted on sticking to fixed exchange rates to the euro, refusing to devalue or let their currencies float and depreciate such as had occurred in other countries with success. Instead they imposed 'internal devaluation,' a harsh regime of fiscal consolidation in 2009 of which the largest of the three states was in Latvia where the debt to GDP ratio fell by 11 % in one year to 7 %, while Estonia managed to reduce its deficit to 3 %, thus enabling it to meet its cherished ambition of entering the euro in 2011. Most of the consolidation was done through spending cuts, about half in Estonia and Latvia and 75 % in Lithuania. Estonia increased VAT, social security contributions and excise taxes while education and health bore the brunt of cuts in Latvia, the hardest hit of the three states, and its public sector wages were cut by 26 %. Across all three Baltic states, public sector jobs were cut and remaining staff had wages reduced or frozen. The welfare system was also restructured with reductions in pensions and benefits, though with support from the IMF and World Bank some assistance was given to the poorest recipients of welfare while the states still received EU funding. Despite average wages falling at the end of 2009 by 11 % in Latvia, 9 % in Lithuania and over 6 % in Estonia, unemployment soared, to as much as 20 % in Latvia by 2010, and outward migration increased. Growth finally returned to Latvia in the third quarter of 2010 after nine consecutive quarterly falls in GDP, its deficit fell to below 8 % and exports jumped, aided by increased competitiveness in part due to the fall in wage costs caused by 'internal devaluation.' In Latvia the overall fiscal contraction between 2009 and 2011 was 16.3 % of GDP.[31]

An early study of the Baltic consolidation found that 'despite an unprecedented economic downturn, both devaluation and a banking crisis have been avoided [and[very large fiscal adjustments were undertaken without encountering large-scale social resistance.'[32] Indeed their governments' rapid and ruthless response was 'critical to sustain confidence in sovereign solvency.'[33]

A separate, more subjective, study supporting Baltic austerity was co-authored by former Latvian Prime Minister Valdis Dombrovskis, who was PM from 2009 to 2014 and took office in the depths of the recession. He and his fellow author maintained that 'internal devaluation' as opposed to currency devaluation was the key to success and that fixing the currency to the euro received broad popular support. Indeed, they argued that 'Latvians no longer opposed cuts but called for more radical austerity measures … One "sacred cow" after the other was slaughtered with great speed, and after every slaughter the public cried for more.' They also argued that consolidation was best achieved by radical measures early on through frontloading of cuts and that internal devaluation as opposed to currency devaluation was too often overlooked as a remedy, especially for those eurozone countries like Greece, Spain and Italy unable to devalue.[34]

The lack of popular protest against austerity is one of the features of the Baltic experience. One study argued that in the case of Estonia the impact of fiscal consolidation 'had little impact on everyday life' and indeed the government implementing austerity was re-elected in March 2011.[35]

Unsurprisingly the Baltic experience has attracted major controversy among economists and between the austerians and the anti-austerians. The unique make-up of the Baltic states makes it difficult to argue that their response to soaring deficits should be a global template for other countries facing debt crises. The Baltic economies were already flexible after decades of post-independence upheaval, their citizens were more adaptable to economic change and readily prepared to accept the need for a period of austerity in order to enter the security of the eurozone, and their financial markets were small and dominated by a small number of local banks. EU funding throughout the austerity programme also helped as the Baltic states were net recipients of EU structure and cohesion funding, an option not available to Greece, Spain or Italy. Latvia also had a low deficit before the crisis, at 9 % of GDP in 2008 while total debt was never above 60 % compared to Greece's 114 % that year. Emigration helped to bring down unemployment as many Baltic citizens left for jobs elsewhere in Europe.

Both pro- and anti-austerity economists agree that the Baltic states' refusal to devalue their currencies helped recovery, though the austerians maintain the alternative of 'internal devaluation' was essential and that such an option should have been adopted by the southern European eurozone countries. The anti-austerians in contrast argued that the latter did not have either the open economies and flexible jobs market or public

support available in the Baltic states. Some economists maintain that there are indeed lessons to be gained from the Baltic experience, namely that countries with high debt and a dependency on exports were worst affected by the fiscal crash. As one study maintained: 'Empirical studies have found that countries that had a large foreign debt stock, large current account deficits and a high share of exports before the crisis suffered the largest output declines after the outbreak of the global financial crisis. This seems to hold both for emerging market economies and for the EU.[36]

Economists continue to argue over whether the Baltic experience is relevant to other countries dealing with major deficits. As a study of fiscal consolidation in the Baltic states concluded, offering support for both austerians and anti-austerians: 'Most of the downturn after the outbreak of the global financial crisis was a consequence of pre-crisis overheating and financial exposure in the Baltic states. In this respect, the austerity measures came too late. This suggests that the Baltic states, in line with most other European countries, should not shy away from austerity measures, including contractionary fiscal policy, but such policies should preferably be applied during booms.'[37]

Ireland

Ireland entered the fiscal downturn in a worse state than most other European states, was forced to ask for loans from the IMF and the EU, experienced one of the most severe fiscal consolidations of all the economies hit by the collapse in tax revenues and yet emerged in 2014 with a booming economy. In November 2015 the *Financial Times* of London concluded: 'Of all the countries afflicted by the global financial crisis, few have rebounded more remarkably than Ireland. After being bailed out by its single-currency partners in 2010, the Irish drastically tightened their belts and began restoring order to the public finances …. Ireland is to be congratulated on its impressive recovery from the crisis.'[38]

Yet a decade previously in the mid-2000s, Ireland's economy was one of the world's most dynamic. After a recession in the late 1980s, at which point public sector debt was 107 % of GDP, the economy moved into boom for seven years from 1994, with many US multinationals using the country as their European base, attracted by low tax. In 2006, public sector debt was just 25 % of GDP.

However, the boom, which earned the country the epithet 'the Celtic Tiger', was based on unstable foundations, namely a property bubble

encouraged by the government which needed its tax revenues and funded by bank loans, cheap money as a result of Ireland joining the euro in 1999, lax regulation of financial services and a lack of exports. As part of its bid to become a low tax economy and attract investors, tax income declined. The contribution of personal income tax fell in the six years ending in 2006. Average income tax rate for a single-earning married couple on average wage with two children was 6.7 % compared with an EU average of 23.7 % and an OECD average of 21.1 %. The share of property-related revenue (stamp duty, VAT, capital gains tax) of government income declined to 3.4 % in 2009/10 and 1.9 % in 2011 compared to 18 % in 2006 (and 8.4 % in 2002). In addition, property tax was only introduced in 2012.[39] Although tax overall was falling the revenues from the property boom encouraged governments to step up public spending, albeit from a low base. As in the UK there were big increases in education, up by 58 % between 2000 and 2007, and health, up by 77 % over the same period. The public sector payroll also increased as did the cost of their pensions.

There were however few outward signs on the eve of the fiscal crash; in 2007, growth was 5 % of GDP and debt just 25 %. Even international monitors failed to spot the looming disaster. The OECD in 2007 said of Ireland 'the fiscal situation is healthy'[40] while the IMF 'commended Ireland's continued impressive economic performance, characterized by one of the highest growth rates of GNP per capita among advanced countries and one of the lowest unemployment rates. This performance has been underpinned by outward-oriented policies, prudent fiscal policy, low taxes, and labor market flexibility.'[41] Public spending in 2007 was just 27 % of GDP, the deficit was almost nil, and debt about 20 %. As one study noted: 'Official projections at the time of the 2008 Budget estimated a "soft landing" in stark contrast to the actual outcome.' It later concluded: 'The failure to anticipate the crisis was contributed to by the fact that the government tended to run budget surpluses while complying with the requirements of the Stability and Growth Pact (budget deficits less than 3 per cent of GDP, public debt less than 60 per cent of GDP) … With regards to the banking sector, the IMF and the European Commission acknowledged high exposure to the property market but, as capital adequacy ratios were strong (assuming no decline in property values), this was not seen as a major issue.'[42]

Yet when in 2007/8 the fiscal crisis erupted, the consequent property market collapse revealed that 'Ireland Inc and the vast majority of the Irish people had been living well beyond their means for most of the decade.'[43]

The property crash overwhelmed the over-leveraged banks which had rashly fuelled the bubble with loans to developers and now faced the prospect of never seeing their money again. To prevent a banking crisis the government guaranteed the financial liabilities of all six domestic banks in September 2008. 'This decision, despite receiving broad domestic support at the time, later come to represent for many, the source of much of the enormous financial difficulties the state has faced … since that fateful night.'[44] In effect, the taxpayer became liable for the banks' losses, therefore swelling the public sector deficit, already soaring because of the collapse in tax revenues. By 2012 the amount needed to prop up the banks was equal to 40 % of GDP.

With spending still rising and revenues plummeting, Ireland's public finances were engulfed in red ink. Even aside from the costs of supporting the banks, the deficit reached 11.5 % in 2009, an increase of 3 % over 2008 when public spending reached almost 43 % of GDP. By 2011, public debt was 110 % of GDP. 'The dramatic deterioration in Ireland's budgetary position from 2008 onwards was virtually unprecedented in the history of post-war industrial countries.'[45]

The Irish government responded with spending cuts, slashing public sector salaries in 2009 by between 3 % and 10 % and increasing income tax. But by 2010, yields on government debt had risen to 9 %, effectively locking Ireland out of the international bonds market and preventing it from borrowing to fund the deficit. In December 2010 the government was compelled to apply for an €85 billion loan from the troika of the European Central Bank, IMF and EU which at least enabled it to maintain public services.

Fiscal consolidation—austerity—was a key but controversial part of the Irish government's economic strategy, as well as a prerequisite by the troika for the loan. This strategy also included reducing the size of the banking sector and implementing structural reform to make the country more competitive and boost growth. The government's first plan in 2008/10 had been a fiscal consolidation of 6–10 % of GDP, followed by a similar reduction over the next four years which became 'the blueprint for the plan imposed by the troika.'[46]

The government's target was threefold, to restore the viability of the banking system, restore the health of the public finances so it could again access overseas markets for funds and restart the economy. A major bank recapitalisation in 2011 helped stabilise deposits while access to international markets returned in 2012 while that year the economy began to recover.

The government persisted with its ambitious fiscal consolidation, aiming to reduce the deficit to 3 % of GDP by 2015 and laying out its strategy in its National Recovery Plan 2011–2014. In 2012, unemployment hit 15 %, yet in the 2011 elections over 80 % of the electorate favoured parties committed to the broad elements of the bailout programme.

The harsh medicine appeared to work. By 2013, the economy was officially out of recession, growing by 0.4 % in the third quarter and in December that year it exited the troika programme. One analysis at the time commented: 'Both the Irish Government and the IMF appear to be broadly happy with the progress that has been made in administering this stern medicine. Ireland has certainly done more to put its house in order than a number of other eurozone countries.'[47] In 2014, GDP grew by 5 % and by 2015, income per capita was back to pre-financial crisis levels with growth boosted by external trade and household spending as well as falling oil prices and a weaker euro. However, debt in 2015 was still over 100 % of GDP though the deficit was 3.9 % of GDP in 2014.

Writing in 2013, the historians of the fiscal crisis commented: 'Ireland's capacity so far [in 2013] to implement a very severe adjustment programme has been in many ways remarkable. Six successive budgets since 2008 have contained cumulative tax hikes and expenditure cuts totalling around 20 % of GDP.'[48] One economic study in 2015 concluded that 'from a budgetary perspective, the Irish authorities had little option but to pursue a contractionary (and intensely pro-cyclical) budgetary policy from 2008 onwards …. The contractionary fiscal policy undertaken by the Irish authorities was, over the period 2010–2015, second only to Greece in improving its structural balance.'[49] In 2015, the OECD reported: 'Ireland has emerged from the crisis with a much reduced and still declining fiscal deficit, public debt on a downward path, a stronger fiscal framework, a more sustainable fiscal revenue base, a restructured and recapitalised banking sector, a strengthened and more efficient public administration, and a much improved labour market activation regime.'[50] Fiscal consolidation between 2008 and 2015 was 20 % of GDP with roughly one third made up of increased taxes and the rest spending cuts. Unemployment went down to 10 % from 15 % in 2011, but in 2015 was still above its pre-crisis level of 4 %.[51]

So what was behind Ireland's success in implementing one of the harshest fiscal consolidation programmes in Europe and yet meeting its deficit reduction targets? Firstly, there was an acceptance by voters that there was no alternative to stabilising the public finances, along with determination

by the government to implement its policies whatever the short-term pain. The OECD said that although Ireland had to borrow from the troika it had already taken 'significant consolidation action in 2009/10' and indeed the troika's own programme was largely based on the Irish government's National Recovery Plan 2011–2014.[52]

Secondly, as confidence returned, bond rates dropped, investors renewed their interest in Ireland's infrastructure and households began spending again. Thirdly, exports recovered despite stagnation in the EU thanks to the improving economy in its major trading partners, the UK and the USA—and the decline in the euro also helped Irish exporters-and fourthly, the drop in the oil price acted as a stimulus to growth. At a conference in Dublin in January 2015 to learn the lessons from Ireland's success, IMF managing director Christine Lagarde named 'clarity of purpose, financial and fiscal focus, ownership by the Irish government and resilience to stay the course' as reasons for Ireland's recovery.[53] A study of the Great Recession concluded that 'at moments of financial stress, a strong policy response is a must for reversing adverse public finance trends and regaining normal market access even under unfavourable macroeconomic conditions.'[54]

However, critics of austerity pointed out the harsh impact of unemployment, pay cuts and reductions in public services on the population and maintained that while the recovery was impressive, it would have happened earlier but for spending cuts. One economist, also at the above Dublin conference, argued that the fiscal consolidation was too fast, saying: 'Despite its success, the Irish experience, as well as that of other countries in the Euro periphery, is marked by a deep crisis that was made worse by the fiscal contraction.'[55]

A critical analysis of the recovery agreed that 'given the unfavorable circumstances that the Irish government faced during the crisis, a succession of fiscal plans managed to stabilize the debt to GDP ratio and as of 2014 put it in a downward trajectory. It has done so by requiring large sacrifices in terms of budgetary adjustments and the commitments of the government have all been fulfilled with minor delays. And this is remarkable given the constant downward revisions to the Euro and global macroeconomic outlook. The fact that the Irish government is now able to access international financial markets stands in stark contrast with what we witnessed a few years ago in the middle of the Euro sovereign debt crisis.'

However, the same analysis added: 'Despite its success, the Irish experience, as well as that of other countries in the Euro periphery, is

marked by a deep crisis that was made worse by the fiscal contraction' though it also admitted that there was no alternative model to prove what might have occurred had consolidation been slower.[56]

Economists will continue to argue as to whether Ireland's fiscal consolidation was too deep and too fast but they do agree that the country made a remarkable recovery. However, the longer-term challenge for Ireland and Europe remains; welfare costs will rise as the population ages while it cannot be assumed that the high levels of GDP growth in the 2000s will be repeated. As one economist put it: 'Despite all the success, the road ahead is not an easy one. The high levels of government debt will require a sustained fiscal effort over the years and decades ahead. While growth in 2014 has surpassed expectations the medium term outlook for public finances remains challenging given the demographic pressures on government budgets. Ireland is not alone in this path, most Euro countries face the same or even bigger challenges and they will have to navigate this together using the EU as well as the national fiscal frameworks.'[57]

Were All Income Groups Hit by Austerity?

The assumption that fiscal consolidation always hits the poor hardest because they are most dependent on public services, especially welfare, is not necessarily always accurate. A series of analyses of European austerity for the UK's Institute for Fiscal Studies found different income groups were affected.[58] France, Italy and Spain all put up their higher rate taxes (as did the UK). In France, Ireland and the UK, the largest losses from the post-crisis fiscal consolidation were among the highest paid tenth of the population. In Italy, the richest 10 % and the poorest 10 % bore the burden. France, Italy, Ireland and Spain reduced spending on public services and froze public sector wages. France, Ireland and the UK protected health and education from major cuts while Italy and Spain cut them deeply. In Italy, pensioners and public sector workers were particularly hit. In France, where minimal changes were made to benefits, tax increases between 2011 and 2014 of 3 % of GDP hit most income groups expect for the poorest while the richest 10 % saw income falls of 5 %.[59] Analysis for the IFS found that in Ireland tax, benefit changes and cuts to public sector wages hit the richest and the poorest 10 % hardest although all families endured a drop in income.[60] One study of five European countries for the IFS concluded: 'One common theme across the five countries that have implemented significant fiscal consolidation (Spain, France, Italy, the

UK and Ireland) is that those in the richest tenth of the population have, on average, seen their incomes reduced by a larger percentage than those further down in the income distribution. The pattern of losses across the rest of the income distribution varies across the five countries: in France, poorer households have tended to lose less than richer ones; the pattern of losses is flatter (or at least more complicated) in Ireland and Italy, while poorer households have tended to lose more than richer ones (with the exception of the richest) in the UK.'[61]

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CHAPTER 10

Two Case Studies: Canada and Sweden

When the Coalition government was formed in the UK in 2010 and began its fiscal consolidation programme to reduce its record debt, its ministers cited two previous case studies as examples of how advanced economies could successfully cut spending. One was Canada, whose federal government, run by the Liberals from 1993 to 2006, delivered a successful debt reduction programme in the mid-1990s following a deep recession which has often been quoted by adherents of deficit-reduction as a textbook example of how to manage public finances during a downturn. The other was Sweden, which also went through a sharp fiscal consolidation in the mid 1990s. In both cases, the austerity programmes were run by left-of centre governments, just as successful debt reduction was taking place at the same time in the USA under the Democrat president Bill Clinton.

A Case Study: Canada

Even though Canada's fiscal consolidation programme had taken place some 15 years previously, the UK's Conservative-led Coalition which won the 2010 election regarded it as a role model. A prominent UK peer and expert on government, Lord (Michael) Bichard, wrote: 'The effective management of a country's public finances is a cornerstone of good Government … Canada in the mid-1990s provides an outstanding example of the sustainable elimination of a budget deficit through expenditure control.'[1] One UK journalistic account floridly put it in 2010: 'Canada may be better known for its brightly-attired policemen and love

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M. Burton, *The Politics of Austerity*,
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of ice hockey, but its example of successful budget-cutting is suddenly all the rage with the UK government. As Prime Minister David Cameron warns of the need for extensive spending cuts to bring down the UK's substantial public deficit, the Conservative-Liberal Democrat coalition is aiming to follow the achievement of the Canadian government between 1993 and 1996.'[2] UK Treasury Chief Secretary from 2010–2015 Danny Alexander later recalled: 'One of their [Canada's] lessons was if you want reductions they have to be sustainable and long term and they have to be based on savings with public sector reform not tax rises. They also took the public with them by making and remaking the argument about why it was necessary.'[3]

In those three years from 1993 to 1996, Canada's Liberal government managed to convert a 9 % deficit into a small surplus. It was then the largest such fiscal consolidation in the G7 and among the largest in OECD states and was largely achieved through spending cuts rather than tax rises. The UK Coalition, for example, never came close to replicating such a cut between 2010 and 2015 despite five years of austerity when its deficit halved from 10.2 % to 5 %. 'In 1994/95 federal spending was CAN $123.2 billion with a deficit of $36.6 billion. In 1995/96 spending was $120.9 billion with a deficit of $30 billion. In 1996/97 the figures respectively were $111.3 billion and $8.7 billion. In 1997/98 they were $114.8 billion with a surplus of $3 billion.[4] Canada's resulting remarkable fiscal transformation (federally and provincially) contributed significantly to [its] outstanding economic performance from 1997 to 2007.'[5]

So how did Canada manage such a reduction in its debt, are there lessons for other countries or was its experience unique to Canada and a confluence of fortunate events, as some critics maintain?

Canada's recession in the 1990s, its worst since the 1930s, began in 1990, lasted for three years and saw a 6 % drop in GDP as well as a soaring increase in public sector debt. But budgetary problems had been looming for many years. Like the UK and the USA, Canada began the post-war period with high debt, then enjoyed 25 years of prosperity. Unlike the UK, Canadian governments at federal and provincial level managed to balance the books while the federal debt to GDP ratio was just 18.4 % in 1974/5. But that year also happened to be the last for 12 years in which the government saw an operating surplus. For by the mid 1970s, the economy was hit by the 1973 oil price hike, high inflation and low growth and a consequent increase in spending on welfare along with tax cuts to stimulate growth. The result of more spending and less tax

income led to expanding deficits, reaching 5.3 % of GDP in 1978/9 with debt to GDP at 26.7 %. Consequent governments attempted to reduce spending with mixed results and in 1980, an IMF report flagged up that Canada's deficit was 'disastrously high' compared to other industrialised countries.'[6] By 1982, Canada was in recession again and the federal government was persuaded to increase infrastructure spending and scrap earlier tax increases. In its annual review of the economy in 1982, 'the federally funded Economic Council of Canada urged the [federal government] to introduce a moderate dose of stimulus in its upcoming budget, postulating that efforts to reduce the deficit could wait until an economic upswing. In December of that year, the Governor of the Bank of Canada stated that high government deficits were not hurting the economy and would only drive up inflation if governments competed with the private sector on borrowing markets during an upswing … Gradually, the view emerged that the [federal government] could manage a $30 billion deficit with no detrimental effect on the economy, and that such a deficit would provide necessary support to those the recession had most affected.'[7] By 1983, the deficit was 7.9 % of GDP and debt was at 38.2 %. At the time there was a consensus 'in favour of a stimulus policy direction in spite of the mounting evidence indicating the adverse consequences of this course of action.'[8] Indeed, there was little debate about the impact of deficit funding such that one Canadian reporter commented presciently: 'If ever the federal Government makes the hard decision to get its finances under control, Canadians may be shocked and angered by the measures that will need to be taken; taxes almost certainly would be raised, some popular spending programs will be slashed, and some programs may need to be abandoned.'[9]

The study for the Institute for Government by a former Canadian head of its civil service made some key conclusions from this period. The first was that 'no public policy agenda is valid for all time' as 'the stimulus policies that served Canada well in the 1950s and 1960s eroded Canada's fiscal health in the late 1970s and early 1980s.' The challenge for governments 'is to anticipate emerging trends and adjust public policies to respond to changing circumstances, address emerging needs and seize opportunities.' In addition, consensus among the establishment does not mean this is the right route. Finally, governments need to learn from others as the IoG study found no indication that the federal government 'took account of the actions of other countries. As a result, Canada did not change its policy course for ten years.'[10]

By 1984, when the Progressive Conservatives won the federal elections, Canada's deficit was 8.3 % of GDP and its debt was 43.2 % of GDP, the second worst among G7 countries after Italy. Canada's provinces were also facing debt crises. Prime Minister Brian Mulroney signaled a change of attitude when he said that Canada could no longer spend its way out the crisis but must grow its economy instead. 'This marked a significant departure from the [Canadian government's] previous position and the beginning of efforts to build public awareness of the impact of growing deficits and debt for future generations of Canadians.'[11] An 18-month spending review task force, led by the deputy PM, Erik Nielsen, modeled on the USA's Grace Review and the UK's Rayner review into Whitehall efficiency, recommended some CAN$8 billion worth of cuts. By 1988, although the deficit was down to 5.2 % of GDP and by 1988/89 had reached an eight-year low of 4.4 %, debt was still historically high and a new recession was brewing.

Further spending cuts were introduced, including a public sector pay freeze which provoked the largest public sector strike in Canada's history in 1991. Between 1984 and 1993, the federal government made a total of 22 budget cuts 'each more difficult than the previous and each more demoralising for the Public Service' and yet the deficit rose again, reaching 5.6 % in 1992/93.

By then, public opinion had shifted sharply towards concern about debt and the need to reduce it through spending cuts; 'a broad-based societal consensus for action had emerged.'[12] Unfortunately for the Progressive Conservatives, their own record in deficit-reduction was forgotten even though the deficit in 1993 was lower than in 1984 when they took office. In November 1993 they lost the federal election to the Liberals. Among the key lessons drawn from the Conservatives' defeat was the need for a government to set out a clear and ambitious fiscal target from the outset but not to keep returning to a series of smaller but demoralising spending cuts or muddle along with 'doing more for less.' In addition, public awareness of the deficit crisis was essential. Thirdly, deficit-reduction is all-consuming across all government departments and needs complete focus; the Mulroney government became sidetracked by other hugely ambitious trade and constitutional legislative reforms.

These lessons were not lost on the Liberals. For years the Progressive Conservatives successfully branded the Liberals as 'fiscally irresponsible.' One Liberal politician later recalled: 'Tax-and-spend Liberals is what the majority of Canadians thought we were. Indeed, in opposition, we never

met an expenditure reduction brought in by the government to which we did not object, and we decried the introduction of a 7 percent value-added tax, the GST, in 1991'.[13]

But by 1993, the recession had wreaked havoc on the public finances and the Conservatives appeared unable to address the deficit running at 6.7 % of GDP with total accumulated debt at 67 % of GDP. A third of every tax dollar was paying debt interest compared to 11 % in 1974/5.[14] So in their 112-page campaign 'Red Book', the Liberals promised to 'reduce the deficit. We will implement new programs only if they can be funded within existing expenditures. We will exercise unwavering discipline in controlling federal spending and will reorder current spending priorities to make sure that maximum return is obtained on each investment … The immediate goal of a Liberal government will be to reduce the deficit as a percentage of GDP from its present level of 5.2 percent [as they believed it then was] to 3 percent.'[15]

The Liberals had campaigned during the election run-up on the need to reduce the deficit by half in three years, arguing that economic growth alone could not reduce the debt burden which would also have to be managed down through fiscal policy. Any cuts at federal level would inevitably impact on budgets for the nation's ten provinces, which have their own governments. The new Liberal federal government's first task therefore was to persuade the public that this target was essential for their wellbeing. As its finance minister Paul Martin, who held office until 2002 (and was Prime Minister 2003–2006), later recalled: 'Cuts in government expenditures hurt people. They will never be accepted if the only goal is to make bankers happy or if they are undertaken because of arcane economic theory. If deficit-reduction is to be successful, it must be seen as being essential to people's wellbeing—essential in the things that are important to them every day. Thus, our message was not that servicing the public debt was putting the brakes on private sector investment, but that the servicing of excessive public debt was leading to the gutting of needed social programs that people relied on … We made the deficit the government's and the nation's number one priority.'[16] His ministerial colleague John Manley agreed: 'Program review meant that choices were being made, rather than cuts being administered arbitrarily and across the board. The notion that all Canadians were being asked to make a sacrifice made the end product much easier to sell.'[17]

The government focused its deficit programme not on its first Budget in February 1994, but on its second, February 1995. That year the *Wall*

Street Journal described Canada as an honorary member of the Third World. 'The view was permeating political and economic commentaries that Canada was an economic basket case.'[18]

Delaying the tough decisions a year was a controversial decision considering the timescale. It was in contrast to the later UK Coalition which introduced an Emergency Budget just weeks after the May 2010 election, cutting in-year spending (and the Conservatives did the same in July 2015, two months after the election that year). It was also in contrast to the UK government of John Major which, in 1993, was embarking on major tax increases and spending cuts.

Liberal ministers argued such a delay enabled them to embark on extensive public consultation and 'in a lengthy series of very noisy meetings across the country, in town halls, in universities, in local and national televised roundtables where everyone let fly, we had the interest groups publicly debate the tradeoffs among themselves and with us.'[19] Paul Martin regarded this year-long consultation as 'critical to the Budget's acceptance.' But as Cabinet minister John Manley later recalled: 'How could a Liberal government turn the fiscal mess around when successive Conservative governments had failed? After all, if there was a party that would seem ideologically suited to cutting expenditures and shrinking the reach of the state, one would have expected it to be the Conservative Party. But then, it took a strong anti-communist, Richard Nixon, to go to China. And so it took a Liberal Party to reform Canada's finances.'[20]

Consultation was accompanied by the launch of a Program Review in May 1994, which drew lessons from the Nielsen Task Force exercise of 1984 and from other countries that meeting fiscal targets did not mean merely cuts in increases. Complaining that the political class on all sides had 'over the previous half century, been addicted to the fiscal growth of government, not its shrinkage' according to Paul Martin, the new government commissioned an independent series of projections 'in order to realistically estimate the size of the fiscal gap we had to deal with' because 'too often an excess of optimism about future revenue streams can become a cover for inertia.'[21] The government then took the 'absolute lower end' of the range of independent projections, added in a further reduction 'for prudence' and a contingency reserve and used this as its base projection. Its target was to halve the deficit in three years while Martin's own unannounced target was to eliminate the deficit altogether in five. The targets were deliberately tough so that the markets could not accuse the government of 'looking at the world through rose-colored glasses.' In addition,

Martin, not unusually for a finance minister, was sceptical about previous projections which he said had been 'consistently wrong, the wrong way' and led to the ballooning deficit. At least if his projections were wrong they would be 'wrong, the right way' by being over-cautious and so could not be knocked off course by bad news.[22]

The Program Review moved away from simply rolling out cuts across all departments to prioritising which public services needed preserving. 'Program Review was a broad-based exercise involving all departments and organisations reporting to a minister, and through a minister to Parliament, including agencies, Crown corporations or quasi-judicial bodies. It took a portfolio-based approach and nothing was off the table.'[23] John Manley later recalled: 'Across all departments, we had to answer six fundamental questions about every single one of our programs, while meeting very ambitious expenditure reduction targets: Is the program still in the public interest? Is its delivery a legitimate and necessary role for government? Is the current federal role appropriate or should the program be realigned with the provinces? Should it be delivered in partnership with the private or voluntary sector? How can it be redesigned for efficiency? Is it affordable, given fiscal constraints?'[24]

As the Institute for Government study noted: 'One of the most important characteristics of the Program Review process was the reliance on ministers and deputy ministers, equivalent to the UK's Permanent Secretaries, as the architects of departmental reforms. Minister and deputy ministers as a team were given the responsibility of coming forward with a common proposal for the future role of the department in serving Canadians, taking into account the GoC's three-year fiscal plan. This approach ensured a strong link between policy choice and policy implementation, and reduced the risk of tactical behaviour (ministers arguing that they could do more if it was not for the resistance of the Public Service, and public servants arguing that they could do more if there was the political will to take action).'[25]

Ministers and mandarins were given six key questions to apply to their departmental programmes. What public interest were these programmes serving? Was it right for government to be providing them? Could they become a provincial responsibility? (In the UK this might apply to transferring services to local government). Could these programmes be provided by the voluntary or private sectors? How could they be run more efficiently? Were they affordable and if not, what could be cut?

A total of 38 government departments were only then given the percentage cuts they were expected to make. Their proposals were examined

at three levels, a committee of deputy ministers (top civil servants), a special Cabinet of ministers and then full Cabinet. Departments' first meeting with Department of Finance officials were not about what to cut but what to preserve 'if Canada's economy was to grow and social equity was to be protected.' Paul Martin recalled that 'we were not interested in presenting a budget that would only skate us through for a couple of years. This meant we had to concentrate as never before on setting priorities and what that meant for the role of government.'[26]

Dealing with civil servants used to decades of higher spending is one challenge for an incoming austerity government, but dealing with unhappy ministers is politically more difficult. Ministerial careers have foundered because ministers too readily accepted cuts which later proved so unpopular they damaged the government. Canadian ministers, when presented with the cuts they were expected to implement in their departments, greeted them 'with total disbelief', but the government 'had a bottom line to meet and we were going to meet it come hell or high water.'[27] As John Manley recalled: 'Political calculations were being spun in every direction. Is it honourable or humiliating to take the biggest cuts? Does my department think I'm defending its turf? As that great source of guidance in parliamentary democracy *Yes, Minister* points out, unless the minister succeeds in defending the department's appropriation level, it could shrink to a size that could be managed by a mere … minister! And what about the stakeholders in my ministry? And in my case, what about my constituency and all of the public servants that live and vote there?'[28] As industry minister, Manley had to impose big cuts on his own department as he later recalled: 'In my own Department of Industry, we cut the budget literally by 50 percent, from 54 programs down to 11. Almost 3000 employees would be gone from my department, 16,000 from the federal government overall in the National Capital Region [his Ontario constituency] and over 48,000 across the country.'[29]

However, ministers were able to appeal to a cabinet committee which could, if necessary, reduce the cuts so long as they were then made up by other departments so that the government's overall target was unaffected. The Prime Minister's role was also crucial. 'The Prime Minister played a key role in ensuring the discipline of the governing party and the participation of all. No department was exempt, no minister was allowed to step aside leaving the burden to others, no exceptions or "special cases" were allowed until after the following election.'[30] Indeed, 'one minister tried early on to appeal directly and openly to the PM. It was in a cabinet

meeting. My colleague never had a chance to complete his sentence. "No" meant "no."'[31]

Canada's deteriorating economy, which caused one credit rating agency to issue a credit warning, piled further pressure on ministers to ensure that the next Budget, unlike the previous one, laid out a comprehensive plan to reduce the deficit. In fact, the Budget in February 1995 introduced in Paul Martin's own words 'massive cuts, far greater than anything Canada had ever seen. Nor were the cuts simply reductions in the growth of future spending as is so often the case. These were absolute cuts in existing spending, such that by the end of the process the federal government's expenditures as a percentage of GDP were lower than they had been at anytime in the previous fifty years.'[32] No government department was unaffected and there were cuts in health, education, transport, agriculture and industry while public sector employees were reduced by 20 %. Decisions taken in the Program Review were also enshrined in the Budget to prevent their being unpicked in the future.

It was also important that the government's programme of deficit-reduction was actually delivered as 'if the steps taken are insufficient, the public begins to sense the futility of the sacrifice they are being asked to make.' It was therefore vital that the government meet its targets at its first attempt because 'returning to the well' for a second or third time would lead to public anger 'and riots in the streets.'[33] The government introduced two-year deficit targets measured annually so the public could witness progress. 'When we beat our first-year target, the country took notice even though to be honest it had not been that difficult. But when we beat the second year target which was much tougher and we beat it by a significant margin, support for what we had done grew by leaps and bounds. At that point Canadians could see that the sacrifice being asked of them would not be in vain. They could see the end of the deficit on the horizon, and they realized that they were not merely spectators, they were active participants in a great national effort, the beneficiaries of whom would be their children, and they wanted that effort to succeed.'[34]

As a result of the Program Review, spending other than interest debt repayments fell in real terms by more than 10 % between 1994/95 and 1996/97. In 1998, the government announced the deficit had been eliminated leading to its first surplus budget in 28 years in 1997/98 and 11 consecutive years of surpluses. By 2007/08 the federal debt to GDP ratio was 29.8 %, down from a high of 70 % in 1995/96, the best performance among G7 countries.[35] Federal public sector employment fell

by 19 % in the five years to 1999, with many transferred to the private or voluntary sector and others taking generous severance packages.

Former minister John Manley emphasises the fact that the fiscal consolidation was achieved not by Conservatives but by Liberals, saying: ‘It was big news because it was dramatically uncharacteristic for a Liberal government to be presiding over the largest downsizing of government since demobilization after the Second World War. But I also think that because Liberals were implementing it further validated the necessity of the government succeeding in turning around its finances. The simple fact is, Liberals were not expected to impose fiscal discipline. This was important, because the cuts were not seen to be ideologically driven, but were a pragmatic necessity.’[36]

Indeed, he argued that the process itself led to a step change within government in which running large deficits became unacceptable both at federal and provincial level. Writing in 2005, he said: ‘I think that the most significant success was the transformation of attitudes. By 1997, when the deficit dragon was slain, there had been a complete and fundamental change in how government saw itself and what public opinion expected from it. I really do believe that the political culture in Canada had changed and balanced budgets became the expectation rather than the exception. A deficit is now simply an unacceptable outcome for political parties managing public finances in most jurisdictions in the country.’ He called for a debt to GDP ratio of 25 % and said governments should ‘annually show the debt reduction amount as a separate item above the bottom line. The budget should then be balanced over a three-year period, after debt reduction payments. This could restore confidence that the government is not fudging the numbers to achieve debt reduction by stealth.’[37]

Just as the federal government had to address its deficit, so Canada’s provincial governments in the early 1990s also grappled with their own debt. In 1991 the left-of centre New Democratic Party won power in the province of Saskatchewan and in its 1992 budget said it would balance its budget by 1996/97. They achieved their goal two years earlier. In three years from 1992/93 to 1994/95, the NDP government went from an $843 million deficit to a $128 million surplus. According to one study ‘the fact that these fiscal reforms were enacted by an NDP government, which historically had promoted expansive government spending, was critical in establishing the non-ideological importance of balanced budgets. Indeed, the changes enacted by Saskatchewan’s NDP government provided the ultimate stamp of credibility for federal Finance Minister Paul Martin a few years later.’[38]

In the province of Ontario, which contains 40 % of Canada's population, the debt burden increased between 1989/90 and 1994/95 by $49 billion. The provincial net debt, which stood at 13.5 % of GDP in 1989/90, had more than doubled by 1994/95. As a result of the rapidly escalating debt, interest costs had steadily increased from 9.3 % of government revenues in 1989/90 to 17.0 % by 1994/95.[39] In 1995, a new Progressive Conservative government announced its *Fiscal Overview* and in its 1996 Budget launched a three-year austerity programme. In the first year, spending was reduced by 4.1 %. In the next two years, spending growth averaged 1.1 % and spending in 1998/99 was lower than three years earlier. 'By 1999/00, one year earlier than anticipated, the [Progressive Conservative] government achieved the goal it set out in its original Balanced Budget Plan. For the first time in over a decade, Ontario's provincial government ran a small surplus. In just four years, Ontario went from running a substantial $8.8 billion deficit to a surplus of $668 million.'[40]

In Alberta, Ralph Klein was elected leader of the Progressive Conservatives in 1992 and Premier of the province on a mandate to reduce the province's deficit of 4.4 % of GDP which 'was caught in a fiscal spiral of persistent and substantial annual deficits, ever increasing government debt, and a growing interest burden.'[41] In the government's first four years in office, spending decreased from $16.2 billion in 1992/93 to $12.7 billion 1996/97, a reduction of over 20 %. While revenues as a percentage of GDP also decreased, spending fell even faster, resulting in a budget surplus of just under $1 billion or 1.1 % of GDP in 1994/95. The fiscal consolidation was dubbed 'the Klein Revolution' after its Premier or 'the Alberta Advantage' as he himself dubbed it.

After the government balanced its budget in 1994/95, it ran consecutive budget surpluses for the next 14 years. These surpluses helped pay down the provincial debt. In fact, by 2004/05 Alberta had eliminated its provincial debt altogether.[41]

Is Canada's Experience a Model to Follow?

Canada underwent austerity and currency depreciation at a time when its immediate trading partner, the USA, was buoyant, in contrast in 2011 to the eurozone whose members were contracting all at the same time. One of the lessons of austerity experiences is how difficult it is for a nation to use exporting to expand its economy out of recession if all its neighbours are also in recession. As the UK's civil service chief later

commented: 'Canada cut its budget at a point when the US economy was extraordinarily buoyant as opposed to Europe in 2011.'[42] Canada's Liberal government was therefore fortunate in being able to deliver an export-led recovery.

Critics of Canada's austerity, with its focus on spending cuts, said it hit the poor, through cuts in welfare and reduced social housing causing rising inequality. The real reason for the reduced deficit, they say, was an improving economy caused by exchange rate depreciation. Others argued that Canada escaped the worst of the 2008 fiscal crisis largely because its financial sector was more regulated than that of the USA and UK and that austerity, thanks to its success in the 1990s, has been less of an issue of public concern when applied on occasions since then. This 'austerity consensus' even gave room for the Conservative federal government, which gained overall control in 2011 after running a minority government from 2006, to briefly increase spending to offset the fiscal crisis.

Nevertheless, one austerity critic, from a trade union perspective, agreed that while the Liberals presided over a huge reduction in Canada's gross, much of it was achieved by spending cuts that hit the poor. He said: 'What makes the Canadian experience really stand out is the very heavy reliance on spending cuts to eliminate the deficit and then run budget surpluses. In 1996, when Canadian debt peaked, spending was 46.6 % of GDP, down a bit from a peak of over 50 % of GDP in the recession of the early 1990s. By 2007, spending was just 39.1 % of GDP, or more than 7 percentage points down from the peak debt year.' He argued that as a result, the Canadian cuts fell on the poorest. 'With elderly benefits virtually untouched, most of the burden fell upon federally administered unemployment insurance. Access to benefits was restricted, and the maximum benefit was frozen in nominal terms for a decade.'[43]

The IMF in contrast thought reducing the deficit through spending cuts rather than tax rises was sensible. Its directors thought the Liberals' deficit-reduction plans 'a considerable success' with GDP rising from 0.7 % in 1995 to 3.3 % by the end of 1996, adding that they 'were encouraged by the plans to eliminate fiscal imbalances at the federal and provincial levels during the next few years' and 'noted the quality of the fiscal adjustment, which relied mainly on expenditure cuts rather than revenue increases.'[44]

Even aside from the impact on the poor from welfare cuts, the challenge is to maintain a long-term policy of balancing the budget, especially with rising demographic pressures. As John Manley warned in 2005 before the fiscal crisis: 'All political parties will face a voting public whose increasing

preoccupation will be the needs that they have in their retirement years: the security of pensions, access to health care, medical innovation, and pharmaceutical therapy to assist in the quality of their lives, as well as safe communities with modern infrastructure. Strategies to improve productivity and economic growth over time may not carry the same relevance to a population that is increasingly out of touch with the workplace.'[45]

A Case Study: Sweden

Along with Canada, there was another developed nation whose deficit-reduction strategy impressed the world's finance ministers, especially the UK's, for its breadth and success. That country was Sweden, an established welfare state like Canada but on a much more generous scale. Indeed, Sweden until the late 1990s was synonymous with high taxes and high public spending. And just as the left-of centre Liberals presided over Canada's successful deficit-reduction, so it was a Social Democratic government in Sweden that led the austerity programme.

In the early 1990s, following a period of high borrowing, low interest rates and a property boom, Sweden experienced a severe financial crisis with bank failures, currency depreciation and rising interest rates. In 1993, its budget deficit hit over 11.4 % of GDP, and three years later its gross debt was 73 % of GDP and unemployment soared from 1.7 % in 1990 to 8.3 % in 1993. In four years, Sweden went from having the largest budget surplus in the OECD to the largest deficit. A later Swedish finance minister recalled: 'The public deficit was staggering. I was working at the Prime Minister's office in [1991] when we came in and we thought we were going in [1992 to] have a deficit of 10 billion Swedish kroner, in the first reports that we got in November and December. When we came back after Christmas [we]were saying 50 billion. In May, it was up to 100. When we came back after the summer, it was 250 billion in the Minister of Finance forecast. We had gone from almost balanced to 13 % in deficit in six-seven months.'[46]

After the Social Democrats won the 1994 election, Goran Persson was appointed finance minister and then Prime Minister two years later. The Swedish government set about restoring the public finances on a long-term sustainable basis. Central to this was Parliament approving a ceiling for total spending for 27 expenditure areas on a rolling three-year basis which 'has provided a key tool in constraining the growth of total central government spending' and encouraged Parliament to keep within limits rather than increasing the total.[47]

As the UK's Treasury later stated approvingly: 'A key element of [the fiscal consolidation] strategy was the reform of the fiscal framework, including the incremental introduction of a surplus target and rolling expenditure ceilings. These reforms supported a reduction of over a third in the Swedish debt-to-ratio in the following decade.'[48] A later Swedish finance minister, Anders Borg, recalled in 2012 how before the reforms, 'all the spending departments were preparing their proposals and they were constantly putting the Minister of Finance under siege and coming many times per year with new proposals. Today, we have one budget negotiation. It is in August. It is based on a full-fledged proposal from my side. It is based on the fact that we have already set nominal spending ceilings for four years. That creates a situation where the Minister of Finance is proposing the budget. You do a top down approach based on the macro-economic assessment, based on what kind of structural issues we want to deal with, what kind of welfare reforms that we want to do, and we do not add up from the bottom all the proposals from the standing ministers.'[49] In addition, local government, which in Sweden runs health, education and elderly care, was expected to balance its books and has ceased to run deficits ever since 2001. There are also health charges for GP visits, although the health system is still 95 % public.

It would be four years before the budget was balanced while in 2006, when the Social Democrats finally lost power after 12 years in office, debt had been almost halved to 40 % of GDP. By 2002, public spending was down to 52 % of GDP from its peak of 67 % in 1993, a combination, according to an OECD study, of 'dramatically improved economic circumstances and a major consolidation effort to eliminate the general government deficit, *inter alia* by reducing the generosity of social benefits, cutting back public subsidies, reducing net capital outlays and trimming public consumption.'[50] Writing in 2002, the OECD study concluded: 'Sweden has gone a considerable way towards improving both the quality and efficiency of public expenditure, achieving a reduction of the overall level of expenditures as a proportion of GDP and the corresponding burden on the economy.'[51]

Fiscal consolidation during Sweden's austerity years, from 1994 to 2004, consisted of one-third tax increases and two-thirds spending cuts. Goran Persson later stated in an interview: 'We cut pensions, sick-leave compensation, and unemployment benefits, which hurt people who already had only small margins in their household finances. That shouldn't have been necessary in an ideal world, because lower welfare

transfers reduced domestic demand and tax revenues and thus had a negative impact on growth and employment and a small net effect on the budget. But we had no choice. High interest rates made it necessary to regain the confidence of investors all over the world whose perception was that Sweden's generous welfare model was to blame for the crisis. In fact, it wasn't until we cut unemployment benefits and got into open conflict with the trade unions that market interest rates started coming down.'[52] Surprisingly for a Social Democrat government, Cabinet ministers were fully on board because, as Persson later recalled, 'we all understood that the budget deficit, if left unchecked, could destroy the public sector as we knew it.'[53]

Generally, fiscal consolidation needs to be a balance of cuts and tax rises. A later finance minister who was involved in the fiscal consolidation said: 'One of the main conclusions from our experience is that any consolidation that will be equal to 5 %, 10 %, 15 % of GDP must be broad-based. You cannot perform such a broad-based fiscal restructuring without using both taxes and revenues. You must deal with the fundamental structure of your expenditures, but you must also be ready to deal with the revenues.'[54] However, if the country, as was Sweden, already highly taxed there is less scope than a low tax nation. 'Ours [consolidation] was balanced between revenues and expenditure cuts. Obviously you must remember that we are coming from a very, very high tax rate to begin with. So you cannot say that there is a one size fits all. One has to go through the details of the specific country and obviously try to balance the reform program. But in general terms, a European situation where public expenditures are in the neighborhood of 45–50 % of GDP, it is quite clear that most of the consolidation should be taken on the expenditure side, and obviously if you're in a situation where the tax rates are substantially lower, the balance could be in a different manner.'[55] As later occurred with the southern eurozone states, lower spending levels means less public support for spending cuts; add in an inefficient tax-collecting system or a society where tax avoidance is normal, and fiscal consolidation becomes a real challenge.

As with the Canadian experience, each ministry had its own target and if there was no agreement, the finance minister and Prime Minister would arbitrate, though as Goran Persson said 'we would never tell [ministers] what to do' as 'giving direct and detailed orders would have broken the internal ethics of the budget-consolidation process—which we had agreed to achieve as a team. It would also have given the finance minister or prime minister ownership of somebody else's task.'[56]

Just as Canada's finance minister (and later Prime Minister) Paul Martin drew certain key lessons on how a government successfully reduces debt, so Goran Persson came to similar key conclusions. The first is ensuring fiscal consolidation has public support. Interviewed in 2009, he said: 'The electorate must understand that drastic measures are required. A crisis program will hurt, and you will need a mandate from the voters if you are to succeed. This makes it difficult for an administration that is in power without such a mandate to take the lead. But it is a fantastic chance for the opposition, provided that there is broad awareness of the gravity of the situation. My party was elected in 1994 because we promised to carry out the harshest program with the deepest budget cuts and the sharpest tax increases.'[57]

Another lesson is the need for the ruling party to be totally behind an austerity programme. As Persson recalled: 'You have to make it absolutely clear that you are putting your office at stake; that you are prepared to call new elections or, if your parliamentary group is not behind you, to resign. The forces working against a harsh crisis program are very strong—almost every area of the public sector has its own vested interests—so any sign that you might waver in your commitment will doom the program to fail.'[58]

A third lesson is the importance of ensuring budget cuts are fair, which is not easy if they are falling mainly on welfare recipients so 'so those who are better off need to contribute—for example, by paying higher taxes. Public support for tough policies would quickly deteriorate if they were not perceived as fair, and parliament would lose the political will to make hard decisions.'[59]

Just as Canada's Paul Martin argued that fiscal consolidation needs to be delivered in a 'big bang' rather than constantly revisited, so Persson also backed the big hit approach, saying in his interview: 'The consolidation program has to be designed as a comprehensive package; if you are in as deep trouble as we were, an ad-hoc hodgepodge of measures will only have a limited chance of success. Moreover, by presenting the measures together, it becomes clear to all interest groups that they are not the only ones being asked to make sacrifices. It also has to be a front-loaded program. By starting with the most difficult measures, you demonstrate your resolve and increase the chances of achieving the early results, which will be important for getting the continued support that is critical for sustaining the effort.'[60] Similarly, it is always better to under-promise rather than

make budget forecasts that are then missed, damaging credibility in the markets.

A later finance minister, commenting in 2012, concluded: 'Since then, there has been a period of two decades of consistent reforms, and broad-based reforms. While keeping a very well-functioning welfare state, we have been able to transform the labor market, so it is much more flexible. We have increased production, productivity in the industry substantially, particularly in the domestic sector. We have cut taxes. We have restored our public finances. We have repaid basically—last year we repaid the last of our current account debt that we built up over the last two decades.'[61]

A researcher for the UK thinktank Reform later commented approvingly: 'In the last two decades, Sweden has reformed its welfare state to deliver efficiency as well as equity. Policymakers have opened up services to competition, using new, for-profit providers to drive down costs and improve quality within Sweden's universal health and education systems … Sweden's reforms have brought the country's finances under control. Sweden has consistently run a budget surplus of 1 to 3 per cent of GDP. The UK has run a surplus in just 6 of the last 34 years.'[62]

Recent official figures show that in Sweden, the proportion of outsourced government contracts grew from 11.8 % to 13.1 % of GDP between 2000 and 2009. Public expenditure made up a declining proportion of GDP in the period 2001–07, then rose in the years 2008 and 2009, partly owing to a slowdown in GDP growth. In 2009, the level of public spending was 55.2 %, the same as in 2001.

Sweden was one of the OECD members with the lowest budget deficits in 2010. By European standards, the country also had a low level of gross general government debt as a proportion of GDP.[63]

Despite spending cuts, Sweden continues to be a high spender by OECD standards with a generous welfare system. The proportion of the population who consider that they have access to the hospital care they need rose from 69 % in 2004 to 82 % in 2010. The proportion of young people aged 20–24 who have completed upper secondary school in Sweden rose from 86 % in 2000 to 88 % in 2008. The corresponding EU averages were 77 % and 78 %. The proportion of Swedish pupils leaving upper secondary school with basic eligibility for higher education rose from 85 % to 91 % during the same period. The number of students attaining first and higher degrees and diplomas in higher education, as well as PhDs, in the period 2000–09, increased.[64] In addition, marginal tax rates,

according to one Swedish finance minister, were down 25 % between the late 1980s and 2012.

One academic study asked whether the spending cuts had turned Sweden into a 'liberal welfare state', that is, one with minimal welfare provision as opposed to the more generous 'social democrat welfare state'. It argued that it had not and that despite austerity in the mid 1990s, the basic principles of Sweden's welfare state were intact. It concluded: 'The changes of the Swedish welfare state during the 1990s were incremental, rather than fundamental. Cuts have been made, but they do not sum up to a radical restructuring of the welfare state. Moreover, there is still room for public policy divergence. Even for a small open economy with the highest budget deficit in the OECD in the early 1990s it has been possible to regain control over the national budget without dismantling the welfare state … Once and again the Swedish model of the welfare state is declared dead. Our analysis however suggests that there are no strong indications that the Swedish version of the social democratic welfare state regime has been completely transformed. We have found that it would be too far-fetched to argue that the Swedish welfare state has lost its traditional characteristics. On the contrary we show that some features, as for instance universalism, have in fact been strengthened in some of the core programs of social insurance and in the childcare sector.'[65] As finance minister Anders Borg concluded in 2012: 'Sweden is a society that believes in social cohesion and welfare states. But because the traumatic experience were so deep, the support today for responsible fiscal policy is very, very strong … That's why I believe in very stringent, conservative budget rules. I never want to be in this again. I would never in my life have another 20 years of tough social reforms.'[66]

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CHAPTER 11

Some Asia-Pacific Case Studies

Australia, the so-called 'lucky country', has certainly been fortunate with its economy in recent years, but it was not always the case. At the end of World War Two, public sector debt (both federal and states) was 100 % of GDP which declined to 10 % by 1980, only to rise again in the aftermath of a recession in the early 1980s. Fiscal consolidation led to a budget surplus by 1990, at which point Australia experienced the worst downturn since the 1930s. Some commentators believed the recession was necessary to stimulate long-overdue reforms to its inflexible business and labour market structures. The Labor federal government responded with a programme of modest infrastructure spending, then fiscal consolidation as the economy improved. The new Liberal/National Coalition government elected on a landslide in 1996 announced that much more ambitious fiscal consolidation was essential to reduce the deficit. Its Budget report that year stated: 'The Commonwealth budget position has been generally unsatisfactory for the past twenty years or so. On average over this period the Commonwealth has run a significant underlying deficit drawing on private saving to fund its activities. This record of inadequate fiscal resolve has persisted in recent years, with insufficient action taken to strengthen the budget position as economic recovery progressed. As a result, substantial fiscal consolidation has become a matter of urgency. It is essential that the structural integrity of the budget be restored while economic conditions are favourable.'

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The Budget also explained the classic austerian rationale for fiscal consolidation, adding: 'If the Government is to have the capacity to use fiscal policy to support economic growth during periods of weakness it must be achieving fiscal surpluses when the economy is growing strongly and is at a more advanced stage of the cycle. The surpluses achieved at such stages of the cycle reduce Government debt and provide the capacity for the Government to responsibly run deficits when economic growth is weak … Unless the budget is in a sound structural position the Government will not have the flexibility either to allow the automatic stabilisers to work in times of low economic growth, or to loosen fiscal policy. If the budget is in significant structural deficit then the passage of each economic cycle will see Government debt increase. Eventually such a position becomes unsustainable.'[1]

From then on, the economy enjoyed a meteoric rise with the longest expansion since the 1960s, while its debt remained low. In the quarter century to 2014, Australia's GDP grew twice as fast as its peers, averaging 3.25 % since 1998 while its net debt stood at only 15 % of GDP compared to 79 % on average for G20 countries. In a table of net debt among OECD countries in 1980, Australia was in the middle; by 1999 only Finland and Norway had lower debt than Australia. One official study of Australia's economy concluded in 2000: 'The two extended periods of fiscal consolidation [1980 and 1990] in the latter halves of the past two decades have meant that Australia has not experienced the significant fiscal deterioration suffered by many other industrial countries over this time … public finances were, by any normal standards, in exceptionally strong shape.'[2] The federal government deficit moved from 4 % of GDP in the early 1990s to a surplus by 1999. In 2000 the IMF approvingly commented: 'Fiscal consolidation over this period has involved structural expenditure cuts, while cyclical factors and tax-bracket creep have boosted revenues. Commonwealth [i.e. federal] net debt has declined to 12 percent of GDP from a peak of 19 percent in 1996, facilitating a fall in Australian interest rates toward international levels.'[3] But Australia's growth was in particular due to far-sighted fiscal and monetary policies, the careful regulation of financial institutions, the conservative management of the non-financial corporate sector, labour market reforms, low inflation and low interest rates. An OECD report in 2012 said 'With 21 years of uninterrupted growth Australia stands out among OECD countries.'[4]

While most of the industrialised world grappled with deficits after the fiscal crash of 2007/8, Australia continued to enjoy a strong economy driven by mineral resource exports to fast-growing countries like China.

For a few months in 2009 it looked like the contagion from the fiscal crash might spread to Australia's economy, but unlike many of the worst-hit industrialised economies like the USA, UK and Ireland, Australia had avoided the build-up of a property and financial services bubble and thus, recession. Speaking in 2009, the governor of Australia's central bank commented: 'Public finances remain in good shape, with a medium-term path for the budget back towards balance, and without the large debt burdens that will inevitably narrow the options available to governments in other countries.'[5] The country's weakness however was its dependence on China's growth through its unique position as a provider of huge mineral resources. These bankrolled the Australian economy but exposed it to any downturn in its biggest trading partner. For almost the next six years the Australian economy soared on the back of China's huge consumption of Australian mineral resources to fuel its own double digit growth. This protected the Australian economy from the ravages of recession that afflicted other industrialised economies as well as avoiding the need for tough austerity budgets. In 2012 the OECD approvingly reported that Australia's public sector debt was 'low' and that the federal budget, although modestly in deficit, was being returned to surplus 'to restore fiscal space.' Australia's public finances were 'in much better shape than those of many OECD countries' and although its deficit was 4 % of GDP, this was still half that of the USA, UK and Japan. It predicted that public sector net debt, just 5 % in 2011, would rise to 20 % of GDP only by 2050.

The OECD report added, however, that should there be a downturn, or what it called 'a sharper-than-expected cyclical weakening', then the government should let the fiscal automatic stabilisers kick in 'even if this postpones the return to budgetary surplus.' In a flavour of Keynesianism, the report said that 'if a new, full-scale global crisis of a similar magnitude as in 2008–09 breaks out, fiscal expansion to support activity would be warranted.' It suggested using mineral tax revenues from the booming mineral sector to set up a stabilisation fund which could act as a cushion during hard times to protect public spending from cuts that might slow recovery, or as the economists put it, counter the impact of pro-cyclical fiscal policy. It explained that 'such a fund would be a useful device to accumulate public revenues from mining taxes when they are unusually high. It would de-link public spending decisions from revenue changes caused by shifting terms of trade, which would be consistent with the rationale underlying the current budgetary strategy. The issue is not only to use the unusual revenue windfall to raise national savings, but also to mobilise these resources promptly in a downturn.'[6]

The downturn did indeed come when China's GDP fell back to 7 % in 2015 and its insatiable demand for mineral resources sharply declined, impacting on Australia's economy since the Chinese market had represented half of Australia's GDP growth for the previous three years.

By 2015, Australia's commodity prices were down by 25 % over the previous year and its currency was heading towards six-year lows. Australia's central bank governor warned: 'The need for medium-term budget repair also remains. Here also progress has been made, and the budget deficit at present still compares favourably with what we see in many other countries. But my sense is that a fair bit of the necessary national conversation about how we pay for all the things we have voted for lies ahead.'[7]

Although the deficit stood at only 3 % in 2014/15 and the federal government's 2015/16 budget envisaged a return to surplus by 2019/20, some degree of fiscal consolidation was inevitable. In their survey of the Australian economy in September 2015, IMF staff agreed that 'a small surplus should remain a longer-term anchor of fiscal policy and a credible, though gradual medium-term consolidation path should be maintained' but urged caution, warning against 'frontloading'. They also called for more public investment funded by more borrowing, even though this would slow deficit-reduction. However, they concluded that 'Australia's low public debt is a critical buffer against potential external and domestic shocks and helps sustain the country's AAA rating, and the strong ratings of its banks.'[8] The OECD, in a report in December 2014, said that progress in deficit-reduction would be 'slow and somewhat bumpy' and that 'a conservative approach to public debt' was 'important'. By then the federal government was aiming for a surplus of 1 % of GDP by 2023 through its 'budget repair strategy' which envisaged any extra spending been offset by cuts elsewhere. Yet optimistically the OECD authors added that while automatic stabilisers should be used to cushion fiscal shocks, there was no advantage in 'accumulating a large war chest of net public assets' which could happen 'if budget surpluses are pursued at all costs.'[9]

In a newspaper article in January 2016, Peter Costello, the federal government Treasurer who had initiated the 1996 Budget which had preceded two decades of growth, defended his spending cuts and argued that a similar strategy might be needed again. In *The Australian,* he maintained that his government over the two years after his 2006/7 Budget cut public spending to 23.9 % of GDP which helped reduce interest rates and debt to zero by 2006. He added: 'A reduction in interest rates is not a major selling point today given that interest rates are already at record

lows. But the government can and should emphasise the strengthening of the government's financial position will give us additional protection against financial instability. We are in a period of high market volatility.'[10]

New Zealand

After decades of operating a regulated, state-dominated, protectionist economy with high budget deficits and high borrowing, New Zealand underwent dramatic financial and structural reform between 1984 and 1996 following the election of the Labour government in 1984. Two global shocks provided the incentive, the first being the oil price hike of the mid-1970s and the second the loss of its prime market for agricultural exports when the UK entered the Common Market, after which New Zealand's economy rapidly declined. Labour's aim was to liberalise the sclerotic economy and free up resources for investment in public services; when a Conservative national government took over in 1990, the reforms continued but with a greater emphasis on tackling the costs of the welfare state.

Financial markets were liberalised, controls on exchange rates transactions removed and in 1985, the exchange rate was left to float. Subsidies to farmers were phased out, state assets privatised and government departments restructured into commercially-orientated entities with modernised accounting procedures, tax was reformed and tariffs on imports cut. Government debt fell from 50 % of GDP in 1991 to 20 % five years later with the deficit down from 9 % of GDP in 1984 to 4 % in 1996.

The country became something of a test tube for global economists. One senior NZ Treasury official later recalled: 'We got two kinds of reactions. Some from the UK and US said it was very impressive but they couldn't do it in their countries because they were too big. Then we'd have a visit from Tonga saying NZ could make the changes because it was big whereas Tonga was very small. They were all looking for excuses or they'd take bits of it.'[11] New Zealand economists 'have for the most part been optimistic about the success of these reforms', especially in productivity and market flexibility, but less convinced about the economic benefits. Many small investors, attracted to financial markets after deregulation, lost money after the Wall Street crash of 1987. Some studies argue that New Zealand's economic performance lagged behind its neighbour Australia, which also went through deregulation and restructuring in the early 1990s but at less breakneck speed.[12] The pace of reform was later diluted under the later Labour government from 1999.

Years later, an OECD report in 2014 said that economic performance, already poor in the early 1980s because of the oil price shock 'worsened even more between the mid-1980s and early 1990s following a tightening of macroeconomic policies to reduce government budget deficits and debt and deep structural reforms designed to enhance long-term economic performance.' Since then, the country's economy has improved in relation to the OECD average and government debt is low 'by international comparison.'[13] Although the country's economy, like that of Australia, was spared the worst impact of the fiscal downturn in 2007/8, government debt rose from 5.5 % of GDP in 2008, went up to 9.2 % in 2009 as recession hit and peaked at 26.3 % in 2013. The government's target was to reduce the deficit by 6 %. In 2015, the IMF reported that 'a strong public sector balance sheet ultimately underpins confidence in [NZ's] economy.'[14]

The OECD reported in 2014 that New Zealand had one of the highest living standards among its peers and like its larger neighbour, weathered the fiscal downturn after 2008.

Japan

While Australia and New Zealand were grappling with high inflation in the 1990s, the opposite was happening in Japan. One of the most perplexing economies among the world's most developed states has been that of Japan which, in 2015, had the highest debt to GDP ratio in the OECD and was struggling to implement a fiscal consolidation programme. The fact that its debt burden did not put it into an Ireland scenario unnerving global money markets was down to Japan's unique situation; 90 % of the debt was held by Japanese savers while a large stock of external assets convinced lenders Japan would always repay its debt. As a result, Japan paid the lowest interest rate of all OECD countries. Anti-austerian economists cite this as a reason for indebted but stable countries not to worry about high levels of debt. Austerians maintain Japan is unique and that it is still exposed to any increase in interest rates.

In the five decades after World War Two, Japan was an economic powerhouse but from the mid-1990s following the asset bubble and a banking crisis, it went into long-term decline. In June 1998, Japan went into recession for the first time in 23 years. By 2015, after two decades of low growth and deflation, Japan's standard of living was below the OECD average. After 22 years of deficits, its net government debt at 129 % of GDP in 2014 (gross debt was 226 %) driven by high welfare costs associated with an ageing population and stagnant tax revenues was the highest

in the OECD. Its deficit in 2014 was 7 % of GDP, at a time when other advanced economies were emerging from recession and reducing debt to below 5 %, though low interest rates ensured that the level of debt was affordable. The catastrophic earthquake of 2011 put further pressure on public finances as the government invested in reconstruction.

High debt was down to the increasing cost of welfare at a time when economic growth to fund it was stagnant. Japan's social and welfare spending doubled from 12 % of GDP in 1990 to 24 % in 2013, making up half of all public spending, while its tax revenues as a percentage of GDP remained the same. With an ageing workforce and retirement at 60, low immigration—just 2 % of Japan's workforce were foreign compared to the 10 % average in Europe in 2014—and a low rate of women working, structural reforms to employment were long overdue.

Japan's high debt to GDP ratio was also down to deflation, which lowers nominal GDP and therefore increases the debt ratio. The OECD estimated that deflation drove down GDP by 8 % between 1997 and 2013. Even an annual 1 % inflation rate would have led to a gross debt ratio of 155 % instead of 220 % in 2013.

A programme to expand the economy and exit deflation, so-called Abenomics named after the Prime Minister of the time, Shinzo Abe, was launched in 2013. It had three 'arrows': monetary stimulus to curtail deflation, short-term fiscal stimulus along with long-term deficit-reduction and structural reform. But attempts to double consumption tax in two moves as part of fiscal consolidation, using the extra revenue to improve childcare, pensions and health and fund welfare, thereby cutting the deficit, foundered in 2015 when the second tranche of increases was withdrawn following public protest. The OECD expressed concern in 2015 that with its high level of public debt, any loss of confidence by international money markets would ratchet up Japan's interest rates and make any fiscal consolidation 'nearly impossible', destabilising both its economy and potentially others. If interest rates went up from the 0.9 % they were in 2013 to 3 %, the deficit would increase from the already high 8.5 % to 13 % of GDP. Alarmingly, failure to reduce the deficit would mean gross government debt would increase from 22 % to 400 % of GDP by 2040. The government was aiming for a deficit of 1 % by 2018.

The OECD in its 2015 survey called for more taxes, an increase in the retirement age and health reforms to reduce escalating health spend with more focus on home care rather in hospital. But in particular, it urged a credible fiscal consolidation strategy.[15]

The Asian Financial Crisis

The Asian financial crisis, often dubbed the 'Asian contagion' hit the booming economies of South East Asia in 1997. Although there were similarities with the fiscal crash of 2007/8, particularly as regards the property and credit bubble and banking crisis, one difference was the absence of a crisis in the public finances. In 2007/8 the UK, the USA and Europe entered the recession with public sector deficits. The Asian economies in contrast were fiscally conservative with low public sector debt when the crisis engulfed them and initially continued the same policies until it became clear that the automatic stabilisers needed to operate to offset the downturn in the private sector.

The stock market collapse in South East Asia followed years of unprecedented economic growth which had earned the countries of Malaysia, Singapore, Thailand, Indonesia and South Korea the epithet 'the tiger economies'. The growth was accompanied by a property boom, huge spending on infrastructure investment fuelled by borrowings and balance of payments deficits. The collapse of a Thai property developer in February 1997 began a chain reaction of other defaults, a run on the currency and a wave of speculation against other Asian currencies. The IMF agreed on a loan package with Indonesia which included spending cuts, bank closures and balanced budgets and then with South Korea and Thailand.

The Asian economies generally had balanced budgets and conservative fiscal policies, and in the case of Thailand, continuous public sector surpluses for the decade from 1987 to 1995, which meant that at first the downturn in their economies did not create a crisis in their public finances. Initially, fiscal policy remained tight but as the crisis worsened the Asian countries were encouraged to allow the automatic stabilisers, including more welfare spending, to kick in. At the time, the IMF was criticised for insisting on fiscal consolidation as part of its loan packages while some observers called for expansionary fiscal policies, though one IMF director argued that 'in fact, given the fiscal conservatism of these countries, in some cases the IMF found itself in the unusual position of trying to convince them to undertake fiscal expansion.'[16] Subsequently, deficits were gradually reduced with a focus on cutting inefficient infrastructure spending and reforming the tax system.

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CHAPTER 12

Is Austerity Necessary?

While austerity—fiscal consolidation—was not a response unique to the 2008 financial crash or indeed for those countries applying it, austerity was regarded as the principal panacea to the mismatch between government income and spending. After a brief spurt of Keynesianism in 2008/9, governments set about restoring their balance sheets, with, as we have seen, varying results, some successful, some still unfulfilled in 2016. But was there an alternative? Economists and politicians continue to argue the merits and the defects of austerity.

Just as the UK had undergone periods of spending cuts in the 1970s and 1980s, other nations had also controversially applied austerity to their public finances with apparent success, especially in Canada, Sweden and the USA. As former US Treasury secretary Lawrence Summers wrote: 'It is simply wrong to assert that austerity is never the right policy. Take, for example, the decisions of the US and Canada in the 1990s to sharply reduce budget deficits. The possibilities of offsetting reduced government demand with growing exports crowded in investment, and greater confidence made fiscal consolidation an appropriate strategy … issuing debt is not an alternative to cutting spending or raising taxes but only a way of deferring these painful steps.'[1]

But Keynesianism was by no means irrelevant or dead and buried. Summers also concluded that while financial crises were caused by 'too much confidence, too much lending and too much spending', the solution

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M. Burton, *The Politics of Austerity*,
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therefore was 'more confidence, more lending and more spending … exactly what is denied by austerity doctrines.'[2]

Indeed, advanced countries' initial reaction to the fiscal crash was to pump money into their economies to prevent a recession becoming a depression. As an IMF report noted in 2010: 'The increase in budget deficits played a key role in staving off an economic catastrophe' though it also added that 'the attention of policymakers should now turn to ensuring that doubts about fiscal solvency do not become the cause of a new loss of confidence.[3]

Economists continue to argue whether austerity is necessary, and if it is, to what extent before it becomes counter-productive, and at what time in the economic cycle. Critics of austerity argue that cutting spending simply worsens the recession and also hurts the poor, the people most dependent on public services. They cite the 1930s and the early 1980s as examples of where cuts damaged already weak economies. Far from too much debt being the problem, they maintain recessions are caused by other factors, such as property booms or in the case of the EU, the eurozone. In turn, economies emerge from debt, not because of spending cuts, but because of expanding exports, improved exchange rates and increased GDP. The 2008 fiscal crash was caused by irresponsible banks but the public sector had to pay the price. As one critic put it: 'The state plugged a gap and stopped a financial collapse. It did not dig a fiscal ditch through profligate spending … The banks promised growth, delivered losses, passed the cost onto the state, and then the state got the blame for generating the debt, and the crisis in the first place which of course must be paid for by expenditure cuts.'[4]

But the reality is that before the 2008 crisis, spending in many advanced countries was based on assumptions of tax revenues that were built on highly unstable foundations. The fiscal crash in 2008 reverberated around those countries which had become particularly indebted through high levels of public spending, exposed to speculative property bubbles, dependent on financial services for tax revenues or a combination of all three. When the revenues plunged, the countries' deficits soared. The IMF reported: 'The median debt-to-GDP ratio in advanced economies rose from around 45 percent at the start of the crisis to about 74 percent by the end of 2012—a level not seen since the years just after World War II.' Lost output from 2008 to 2011 averaged almost 8 % of GDP across the major economies and higher in Greece and Ireland. When the cost of initial spending to offset the downturn (the automatic stabilisers) is added

in then half of the 40 % increase in debt across OECD countries by 2015 was 'generated simply replacing lost revenues when tax receipts from the financial sector collapsed.' In 2010, two thirds of the debt increase in G20 countries was down to the fall in revenues and the loss of GDP in 2007/8.[5]

Over half the debt in the G20 countries was down to a reduction in output and 17 % as a result of fiscal stimulus. Fiscal consolidation in advanced countries after 2009, according to some studies, managed to reduce their deficits to an average 5 %, half the 2009 peak.[6]

Economists argue whether austerity causes GDP growth or the opposite. On the one hand, some believe that fiscal consolidation can be expansionary, that is, it stimulates economic growth by encouraging consumers and investors to believe that the economy will improve because action has been taken to reduce debt. A small tax rise now may suggest that further tax cuts will follow, boosting consumer confidence and encouraging them to spend. Indeed, there are many case studies where a period of austerity has been followed by a rapid increase in economic growth, not least in the UK after 2013. As the IMF's Oliver Blanchard commented on consolidation after the recession of the early 1980s: 'In a number of countries, most notably Denmark and Ireland, fiscal contraction on a scale that would make U.S. policymakers faint was associated with a strong output performance—an outcome that surprised even the governments that had implemented the consolidation.'[7] In contrast, other economists argue that austerity, or fiscal consolidation, is contractionary, reduces economic activity and therefore impedes debt-reduction. The case was supported by one study by IMF staff into the experiences of 17 OECD countries between 1978 and 2009. It concluded that 1 % of fiscal consolidation reduces private consumption by 0.75 % within two years, while GDP declines by 0.62 % and that its results 'provide little support for the expansionary austerity hypothesis' though the contraction is mitigated in some cases by a pick-up in exports due to the fall in the value of the currency.[8]

Analysis by IMF staff in 2012 concluded that austerity in certain areas is contractionary. The authors argued that 'withdrawing fiscal stimuli too quickly in economies where output is already contracting can prolong their recessions without generating the expected fiscal saving. This is particularly true if the consolidation is centred around cuts to public expenditure … frontloading consolidations during a recession seems to aggravate the costs of fiscal adjustment in terms of output loss, while it seems to greatly delay the reduction in the debt-to-GDP ratio—which, in turn, can

exacerbate market sentiment in a sovereign at times of low confidence, defying fiscal austerity efforts altogether.' The authors instead concluded that a 'gradual fiscal adjustment with a balanced composition of cuts to expenditure and tax increases boosts the chances that the consolidation will successfully (and rapidly) translate into lower debt-to-GDP ratios.'[9]

In 2011, global trade unions offered their own alternative to austerity in a submission to the IMF criticising its loan conditions because 'they increased unemployment and underemployment, imposed social costs through reduced government services, were pro-cyclical in their economic impact and represented unwarranted intrusion in countries' policy decision-making.' The Global Unions Group representing over 175 million members in 151 countries made seven recommendations and although they were specific to IMF loan conditions, they also provide a cogent summary of the alternative to austerity. Their first recommendation was that IMF loan conditions should not undermine a country's recovery plan 'to achieve full employment, universal social protection and reduced income inequality.' The second was that in recession-hit countries, the IMF should give priority to restoring the sustainable growth and reducing unemployment and underemployment. The third called for the adoption of employment targets and social protection measures while the fourth said deficit-reduction should 'should be designed so as to avoid accentuating economic downturns through austerity measures applied in the midst of recession.' The fifth recommendation was for recession-hit countries to focus on progressive tax measures to reduce the deficit while the sixth was for the IMF to focus on longer-term infrastructure programmes, especially in health and education. Finally, equal weight should be given to social protection and employment creation as well as to deficit-reduction.[10]

Is There a Template for Applying Austerity?

The IMF in turn argues it takes different approaches depending on a country's fiscal and economic status. One of its regular monitoring reports by staff gives an indication of its attitude: 'Use fiscal policy flexibly to support growth, while mitigating risks and ensuring medium-term debt sustainability. The degree and type of flexibility will depend on individual countries' fiscal positions, macroeconomic conditions, and relevant fiscal risks. Countries with fiscal space can use it to support growth, particularly where risks of low growth and low inflation have materialized. For

example, higher public investment in infrastructure could raise aggregate demand in the short term and increase potential output in the medium term. Countries that are more constrained should pursue more growth-friendly fiscal rebalancing and structural reforms to boost potential growth. Meanwhile, in countries where mounting fiscal risks may lead to market pressure, rebuilding fiscal buffers should be a priority.' Indeed, IMF staff in their summary of the report emphasized that boosting actual and potential growth was a priority.[11]

A separate 2010 study by IMF staff looking ahead to how advanced countries should tackle their high debt levels concluded: 'There should be fiscal adjustment, but it cannot be too abrupt. There should be a down-sizing of government, but without preventing it from playing a key role in the provision of basic services, and in particular in maintaining a level playing field by giving equal opportunities to all individuals regardless of their conditions at birth.'[12]

The emphasis on sensitive spending cuts allied with a priority on boosting growth is a regular theme in IMF papers. One of its regular studies says that fiscal consolidation in advanced economies should 'reflect each country's circumstances' and should generally 'stay clear of across-the-board cuts' which can hinder growth and hit low income groups, adding: 'Fiscal adjustments are more durable when attained through reforms that reflect well-thought-out strategic choices that protect programs with high marginal social benefit.' The study recommends reducing the public sector wage bill which represents 30 % and 60 % of government spending in health and education respectively in advanced economies, or about 10 % of GDP (and about 5–10 % in emerging countries) ideally with accompanying structural public sector reform. Since 2009, more than 20 countries undergoing fiscal consolidation have curbed public sector wage costs, many in Europe where public sector wages tended to be higher than private sector equivalents.

However, the key to debt-reduction is a return to economic growth for, as one IMF study showed: 'On average, debt reductions tend to be larger when growth rates are high and interest rates are low. While the average annual reduction in debt is 3.4 percent of GDP when growth is high and interest rates are low, it is only 1.7 and 2.4 percent of GDP, respectively, when growth is lower or interest rates are higher … Only 26 percent of all fiscal consolidation spells … are successful in reducing debt levels when growth is below median. When growth is above median, the success rate increases to 41 percent.'[13]

So does it matter for a country to sustain large deficits? After all, if interest rates are low then the cost of servicing debt can be bearable and reduced comfortably over the long term rather than a country having to experience the pain of spending cuts and tax rises to reduce the deficit in the short term.

Economists argue that debt generated as a result of government spending exceeding its revenue becomes a millstone around an economy, diverting funds such as tax revenues that could generate infrastructure investment or better public services into servicing debt interest payments. Debt makes an economy vulnerable to fiscal crises; the UK Labour governments in the 2000s were criticised for not creating a surplus when the economy was strong so that debt soared when the fiscal crash occurred in 2008. Most of the ensuing debt that built up in advanced economies after the fiscal crash had little to do with infrastructure investment costs and more to do with the mismatch between tax revenues and public spending caused by the slump in tax income. Debt was therefore a burden without tangible benefits such as enhanced public estate left for successive generations.

But some economists argue that if a country has 'fiscal space', then bearing debt is preferable to 'distorting' the economy in order to reduce it. One IMF staff discussion paper says 'when space is ample—which cannot be established through some mechanical rule but will generally require judgments based on stress testing fiscal balance sheets to withstand extreme shocks—the distortive cost of paying down the debt is likely to exceed the crisis-insurance benefit.' In plain English, the cure is worse than the disease with tax and spending cuts needed to reduce debt only slowing growth.[14]

However, while the fiscal crash of 2007/8 drove public sector debt to record levels, public debt 'had ratcheted up over many decades before, when it had been used, in most of the G7 countries, as the ultimate shock absorber—rising in bad times but not declining much in good times.' Furthermore, the ageing societies of the advanced industrialized countries, where debt was highest, meant they 'face the formidable challenge of reducing debt ratios at a time when ageing-related spending, in particular often underestimated pressures from health care systems, will put additional pressure on public finances.'[15] In the advanced economies, government spending outpaced GDP growth from the 1960s to the 1980s before levelling off while social spending, on health, welfare and pensions, increased to more than 50 % of GDP in a quarter of the advanced countries.[16]

Austerity, of course, is not new. In 15 OECD countries, Australia, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Portugal, Spain, Sweden, the UK, and the USA, there was a total of 173 years in which there were budgetary measures aimed at fiscal consolidation or about 40 % of the total years according to one study. The average size of fiscal consolidation was about 1 % of GDP per year.[17] Some countries between 1981 and 1989, notably Ireland, Denmark, Sweden, Belgium and the UK, managed to implement a major turnaround in their public finances while in Germany and France, the change was 'negligible'. The contribution from tax rises was more important in Ireland, Denmark, Sweden, Italy, Spain and Belgium while in Germany the focus was on spending cuts.[18]

One study for the IMF set out what it regarded as the reasons for introducing fiscal consolidation. It argued that to restore fiscal sustainability, economies have to reduce their deficits, which lowers growth in the short term. Within two years of cutting a budget deficit by 1 % of GDP, domestic demand is 1 % lower and unemployment 0.5 % higher just as Keynesian theory argues. However, the consequent fall in interest rates and drop in the value of the currency offsets some of the impact. Examples of large devaluations during fiscal consolidation are Finland (1992), Ireland (1987) and Italy (1992).

The IMF study also examined the effect of spending cuts versus tax rises. It concluded that cuts in public spending are less painful than tax rises as central banks tend to cut interest rates more after spending cuts seeing evidence of fiscal discipline. A fiscal consolidation based on tax rises of 1 % of GDP leads to a 1.3 % fall in GDP after two years, whereas a 1 % consolidation based on spending cuts leads to a 0.3 % drop in GDP. There is a similar impact on unemployment with the former causing a 0.6 % rise in joblessness and the latter just 0.2 %. In the long-term, fiscal consolidation raises output by bringing down interest rates and allowing taxes to be reduced. For every 10 % cut in the debt to GDP ratio, GDP rises by 1.4 %.

However, if interest rates are already low and many countries are undergoing fiscal consolidation at the same time—as occurred in the eurozone—and therefore unable to export their way to a recovery, then the impact of deficit-reduction on growth is much greater. The study added: 'Our simulations suggest that the contraction in output may be more than twice as large as our baseline estimate when central banks cannot cut interest rates, and when the adjustment is synchronized across all countries.' This of course is what occurred in Europe after 2009 when the base rate

in the UK was just 0.5 %, when eurozone countries were trapped in a rigid currency and exports were flat because all the countries were in recession at the same time. The report added: 'When countries cannot rely on the exchange rate channel to stimulate net exports, as in the case of the global consolidation, and cannot ease monetary policy to stimulate domestic demand, due to the zero interest rate floor, the output costs of fiscal consolidation are much larger.' Indeed, it adds that 'simultaneous fiscal consolidation by many countries is likely to be particularly costly.'[19]

However, a common theme between advanced and emerging countries is the need to balance the requirement for public services with that of long-term fiscal sustainability and a tax system that does not constrain growth. The IMF regards a debt to GDP ratio of 40 % as 'prudent'. One of its papers in 2010 outlined three key points for why debt needs to be managed, saying: 'Estimates based on a range of econometric techniques suggest that, on average, a 10 percentage point increase in the initial debt to-GDP ratio is associated with a slowdown in annual real per capita GDP growth of around 0.2 percentage points per year, with the impact being smaller (around 0.15) in advanced economies … If governments fail to signal a credible commitment to reduce debt ratios, the resulting increase in interest rates (and decline in growth rates) could increase the required effort markedly. The fiscal adjustment described above will be made more challenging by the spending pressures that will arise in the decades ahead, particularly in advanced economies. On average, spending increases in health and pensions are projected at 4 to 5 percentage points of GDP in advanced economies over the next 20 years.'[20]

The UK was not alone in pursuing a policy of high public spending growth from 2001. In France, while debt to GDP ratios was stabilised in the 1980s and 1990s during strong economic growth, debt continued to grow when GDP faltered, leading to record deficits in 1993/94 as a result of the crisis in the European Exchange Rate Mechanism (which led to the UK's ejection). Germany's debt ratio increased during oil price shocks and German reunification from 1989, while in Japan it rose over decades of stagnation and in the US debt increased sharply in the 2000s. Only Canada managed to buck the trend due to its dramatic fiscal consolidation programme in the 1990s, covered in an earlier chapter.

Yet another study by IMF staff of previous fiscal consolidations found that between 1980 and 2012, there were a total of 26 debt-reduction initiatives in 20 advanced economies which began when debt to GDP ratios were over 50 %. Most of them took place in the 1990s, in the Anglo-Saxon

economies, in Europe in the run-up to the introduction of the euro and in Scandinavia. The average reduction in debt was 26 % of GDP from an average starting point of 79 %, about the same level as experienced by indebted advanced countries after the 2008 fiscal crisis. Of the 26 initiatives, 22 resulted in reductions of at least 11 % of GDP. The average timespan was eight years with the shortest being New Zealand's in 1986/88 and the longest Ireland's in 1987–2007. Average annual debt-reduction was 3 % of GDP, driven by a combination of fiscal consolidation and growth.

Some of the biggest debt-reductions took place in countries where they appeared most difficult to achieve. According to the IMF authors' analysis during 1989–2007, seven advanced economies (Austria, Belgium, Denmark, Iceland, Israel, the Netherlands and New Zealand) achieved debt-reduction of 40 % of GDP 'in spite of *initially* high debt levels (averaging 90 % GDP), and zero or modest growth (averaging 0.3 %).' In the case of Italy during 1994–2003, debt was reduced by 18 % from 122 % of GDP, despite economic growth averaging 0.7 % in the three years before the debt-reduction and 1.5 % percent during it. The authors conclude that 'these episodes suggest that when countries try hard, large debt reversals can be achieved even in a low-growth environment.'[21]

So how did these countries manage to reduce debt in such adverse conditions? Firstly, exchange rate depreciation and rising exports prior to debt ratios actually reducing were contributing factors. Of the 26 countries studied, 24 had some depreciation 'at some point' during the four years before reduction took effect, caused in many cases by devaluation or in the case of the UK in 1992, ejection from the European Exchange Rate Mechanism. In 16 countries, depreciation was more than 10 %. Secondly, the start of debt-reduction coincided with a pick-up in GDP by as much as 2 % in the first year of falling debt, coinciding with falling interest rates and a rise in domestic demand. Thirdly, inflation did not contribute to debt-reduction and in fact fell and normally would have worsened debt ratios. The authors conclude: 'An improving growth environment was an important feature of successful debt-reduction experiences. The fact that growth did not decline in the year before the debt peak—a year of relatively strong fiscal consolidation—suggests that supportive monetary policy, falling long-term rates, and the healthy external environment likely played a part in reducing the size of the fiscal multiplier. Moreover, a reasonable argument can be made that the politics of the fiscal effort in that year will have been supported by the improving outlook for economic activity. Eventually, lower borrowing costs and the rapid pick-up in real

private consumption helped drive down debt ratios and also mitigated the impact of the fiscal adjustment.' Interestingly, cutting investment and welfare as part of fiscal consolidation adversely affects growth more than reducing non-targeted social spending while on the revenue side, the focus should be on fighting tax evasion, cutting employment taxes to generate jobs and increasing property taxes. Monetary policy should be flexible to maintain liquidity. Privatisation had considerable impact in some countries such as Portugal where it brought in revenue of 16 % of GDP from 1996 to 2000, and in Italy 7 % during 1997–2001, but overall has limited impact on the public finances.[22]

Focusing on main public spending costs, welfare and staff costs, is also a key part of fiscal consolidation. A separate IMF staff study concluded: 'Meaningful expenditure reform strategies essentially boil down to three main elements: ensuring the sustainability of social spending and the public wage bill—the main items in most governments' budgets—achieving efficiency gains while paying due regard to equity; and establishing institutions that promote spending control.'[23]

While economists generally agree that economic growth ultimately reduces debt, there is controversy over whether the conditions for growth in a high debt scenario can be best achieved by raising taxes or cutting spending. Critics of austerity maintain the focus should be on tax rises, especially for the better off. But one controversial study of fiscal consolidation across OECD countries from 1970 to 2007 concluded the opposite, that cuts help encourage growth as 'spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns.' Indeed, the authors presented their findings in April 2010 to the Economic and Financial Affairs Council of the European Council of Ministers.[24] The authors agreed with the anti-austerians when they argued that high debt need not be a problem if it can be reduced by high growth. They cited the debt levels after World War Two in the UK of 200 %, which nonetheless did not provoke a financial crisis due to the country's 'historically credible fiscal stance' and which was eventually reduced as the UK economy returned to growth. They also cited the USA in the 1990s where 'a large deficit turned in a large surplus' without any major tax increases or spending cuts though they maintained at the time (2009) that such high levels of growth were unlikely to return.

The authors asked: 'If growth alone cannot do it and inflation should not be used, we are left with the accumulation of budget surpluses to rein in the debt in the next several years in the post crisis era. But then the

same question returns: is it better to reduce deficits by raising taxes or by cutting spending?' They answered their own question with their conclusion that 'for fiscal adjustments we show that spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions.'[25]

Public support for austerity programmes is also an important factor in making them work. In 2010, the British public accepted in principle the need for spending cuts and voted in a Conservative-led government to implement them. Five years later and after five years of spending cuts, the Conservatives were returned with an overall majority although ironically the new government scaled back its austerity. The former Canadian finance minister Paul Martin, who led a successful deficit-reduction programme in the 1990s, later wrote that 'a government must bring its people onside if it wants its success to be more than short-lived.'[26] One critic of austerity agreed that without public support it could never work. 'In a democracy political sustainability trumps economic necessity every time.'[27]

A study for the IMF, posing the question as to whether austerity should be implemented quickly or more slowly, to mitigate its downward drag on GDP, concluded: 'Front-loaded profiles may be preferable to signal a resolute commitment towards fiscal consolidation when a country is facing an imminent debt crisis. Political economy considerations, such as reform fatigue or a reduced sense of urgency as the activity recovers may also make it difficult to sustain consolidation over time, calling for some front-loading of the adjustment.'[28]

A study by the McKinsey Global Institute looked at historic debt-reduction or deleveraging—private and public—in ten advanced economies, Canada, France, Germany, Italy, Japan, South Korea, Spain, Switzerland, the UK and the USA, and the four 'Bric' countries, Brazil, Russia, India and China. It also analysed conclusions from its database of 45 fiscal consolidation 'episodes' since 1930. The study, published in 2010 when advanced economies were grappling with their record levels of debt, found that a long period of fiscal consolidation always followed a financial crisis, that this lasted six to seven years reducing the ratio of debt to GDP by 25 % and that GDP typically contracted during the first years, then recovered. Of the 45 episodes of fiscal consolidation or deleveraging since the Great Depression in the 1930s, 32 of them followed a financial crisis and half involved austerity. From 2000 to 2008 there was little

change in advanced countries' deficit levels, which declined slightly in Italy, Spain and Switzerland but rose slightly in Canada, France, Germany and the UK.[29]

Five years later, returning to the same subject, McKinsey found that government debt in advanced countries had increased by $19 trillion between 2007 and 2014 and by $6 trillion in emerging countries and predicted it would continue to grow in Japan, the USA and most European countries, including the UK.[30]

However, the post-2008 recession was a greater challenge because of the record levels of debt. By 2014, the average public sector net debt/GDP ratio in advanced countries was 70.4 % and likely to decline only slowly in consequent years but this masked a range of levels from 79.7 % in the US to 69.8 % across the EU's bigger states. The average ratio for the G7 countries was 83.1 %. Countries with the largest net debt in 2014 were Greece at 174 %, Japan at 127 %, Italy at 110 % and Portugal at 120 %. In the UK, the ratio was 81 %, in Ireland 85.7 %, in France 87.4 %, in Germany 49.7 % and Australia 17 % while Sweden and Norway had surpluses.[31] Average net debt globally was 59.2 %, while in the so-called emerging market and middle economies it was 9.2 % and low income countries 25.8 %. In comparison, a measure of the devastating impact of the fiscal downturn on public finances was that in 2006, the debt to GDP ratio stood at 11.2 % in Ireland, 86.3 % in Italy, 81 % in Japan, 37.9 % in the UK and 56.7 % in Portugal.[32]

The role of automatic stabilisers in mitigating the impact of a downturn in tax revenue is well established but the opposite also applies, with governments tempted to spend surpluses when they arise when, according to the IMF, they should be kept as a cushion for future recessions. One IMF report commented: 'Automatic stabilizers have played an important role in fiscal stabilization, often accounting for more than half the stabilizing response of fiscal policy in advanced economies. However, they have generally not been allowed to play fully in good times, because spending a portion of revenue windfalls is tempting. The resulting asymmetry in the policy response to output shocks prevents the restoration of fiscal buffers when growth is strong and can contribute to significant accumulation of public debt over time.'[33]

Advanced countries also shared similar challenges in ageing populations and a drop in tax revenues during the recession. The bulk of recent spending increases were down to health and pensions. As one study noted:

'The bulk of the increase in public spending (over 80 percent) is due to two items: health care and pensions. In particular, health care spending has surged in many G7 countries. In the United States, it has accounted for more than two thirds of the increase in the primary spending ratio and more than half in Canada, Germany, and the United Kingdom. Other current spending items increased, partly using the space created by a decline in public investment (on average from 3 percent of potential GDP in 1960 to 2½ percent of potential GDP in 2007) and military spending, which dropped by some 3 percentage points of potential GDP between 1960–2007 on average for the G-7 countries. Nevertheless, it is clear that health and pension spending had the lion's share of the increase in primary public spending.'

Some countries, notably Canada, the Czech Republic, France, Ireland, Portugal, Spain and the UK, have mitigated the increase in age-related costs by increasing retirement ages. Indeed, one 2010 study said that the pension challenge was 'manageable' and that 'increasing the retirement age by a further two years over the next twenty years would be sufficient to stabilize pension spending.'[34]

However health spending is another matter. 'Drawing on recent U.S. Congressional Budget Office projections of federal spending on Medicaid and Medicare, IMF staff estimate that general government spending on health will rise by 4½ percentage points of GDP over the next twenty years. For Canada and Japan, IMF staff project health care to rise by about 3 percentage points, respectively.'[35]

But cuts in health spending have also slowed down the rate of increase in age-related costs, though few economies have undertaken fundamental reforms to their health services to make them more efficient and health spending overall will continue to rise.

A further complication is that unfunded government employee pension costs do not feature in national accounts and could add up to as much as 20 % of GDP. In 2013 the USA adopted defined pension benefit liabilities into its accounts as did Australia, Canada and the EU countries. 'In the countries that have adopted the new standard, the unfunded pension liabilities of the general government are substantial, at more than 20 percent of GDP. In addition, the two newly reported expenditure items (mainly the imputed interest) widened the reported overall deficit of the United States by an annual average of 1.2 percent of GDP during 2009–12.'[36]

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CHAPTER 13

Conclusion

As can be seen from the previous chapter, if you put two economists in a darkened room they will disagree with each other furiously. For every learned treatise on the merits of austerity, or fiscal consolidation, to use a less loaded term, there will be a contrary study arguing that austerity is the last policy governments should use in a downturn.

But this book is about the politics of austerity, or how politicians and governments make a reasoned judgement based not just on the advice of economists with their theories of contractionary or expansionary fiscal consolidation, but on what will have the greatest beneficial impact on the economy with the least pain for their voters—so that governments can win the next election as the economy improves. Ultimately, the buck stops with them. As this book shows, it is not an easy balance. But looking back over the experiences of the countries analysed in this study, there are consistent themes which emerge for any politician to consider when facing the next downturn and the ones afterwards.

Firstly, very high levels of public debt are not sustainable long-term. Japan, with the highest debt in the developed world, is unusual as most of its debt is held locally while it has also been in deflation for two decades. The austerians maintain that when downturns occur and the public finances as a result plunge into deficit as tax revenues fall, then tough spending decisions must immediately be taken. Actually deficits, so long as they are temporary and politicians have made it clear they must be

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reduced, can be tolerated. When GDP falls due to a downturn and deficits rise in the public finances, it is advisable to be initially counter-cyclical, injecting public money into the economy to offset the drop in private sector activity while signalling to markets that this is a short-term measure such as happened in most developed economies in 2008/9. The knack is at what point to then address the deficit, which is usually when there are signals that the downturn has bottomed out and GDP is set to rise again. At this stage, spending cuts and tax rises can be brought in; the politicians' art is to ensure the spending cuts do not fall disproportionately on the poor while the tax rises are felt only by the few or are barely noticed such as on insurance premiums, airline tickets and stamp duty (such as in the UK) rather than on VAT and income tax. Federal governments can also pass the buck to state or provincial governments and let them take the flak from the public. The UK government in 2010–2015 protected health and education but made sharp cuts in its funding to local government, letting local politicians make the difficult decisions.

Politicians also need to ensure the public understand the rationale for austerity. If it is seen as ideological, rather than pragmatic, then governments will lose the popular backing of those other than their own diehard supporters. It is unlikely Margaret Thatcher, after two years of spending cuts, soaring unemployment and deteriorating public finances as a result of the downturn, would have won the 1983 election but for a combination of external factors, namely the Falklands war, and the complete disarray of the Labour opposition. Some of the most successful examples of austerity were carried out by left-of centre governments, such as Labour in 1970s Britain and in the 1990s the USA, Canada and Sweden. Of course, governments undergoing fiscal consolidation rarely use the word 'austerity'.

Apart from Japan, most economies eventually emerge from a downturn and as GDP rises, the deficit reduces. How much of the increase in GDP is down to fiscal consolidation policy is open to endless discussion among economists, but a flat GDP makes it extremely difficult for deficits to decline. The battle therefore is how to get the economy moving again, even if it takes a short-term fiscal stimulus.

Some governments make a point of not just wanting to balance the books but also reach a surplus. The 'fixing the roof while the sun shines' is an attractive concept but it means using a buoyant economy to invest in infrastructure which will deliver long-term GDP rather than simply banking a surplus. Furthermore, surpluses have a habit of swiftly vanishing as governments cannot resist using them, such as they did after 2002 in

the USA with tax cuts and in the UK with big public spending increases, both of which brought back deficits. Future surpluses can also prove to be based on optimistic forecasts.

Alan Greenspan, chairman of the US Federal Reserve Board, found himself in the luxurious position of facing a predicted long-term surplus in early 2001. The administration wanted tax cuts but he had always believed in paying off government debt or putting it aside to pay for growing health costs. However, in this case the surplus was predicted to continue long after debt was paid off; he favoured paying down debt, then steadily reducing the surplus through tax cuts until the budget was in balance. He feared that a surplus would be too tempting for politicians to increase spending which would then be difficult to reduce. He was right, for unfortunately the predictions provided were far too rosy and although tax cuts were indeed brought in by the new Bush administration, the deficit was soon back.[1]

Optimistic predictions about surpluses which encourage higher spending and tax cuts that are later difficult to scale back are matched by equally over-egged forecasts on revenues. It was clear to the public by 2010 that the countries worst hit by the fiscal crash were those whose governments were heavily dependent on tax revenues from the over-heated property and financial services sectors. Politicians, economists, the media, all assumed that 'boom and bust' was history and that tax revenues would continue to flood into government coffers. The flipside of austerity therefore is for governments not to base their public finances on unstable tax revenue foundations. Hubris was not confined to just those governments convinced property and financial services could forever fund their public sectors. The eurozone's era of cheap credit during the early 2000s contributed to an expansion of borrowing that could no longer be sustained, especially by the southern European states, when the fiscal crash occurred.

One of the more obvious key messages from examining case studies of austerity is that each country's unique economic, tax and industrial base means its success or otherwise in implementing fiscal consolidation is not necessarily a template for others to follow. The Baltic states and Ireland, whose austerity was among the toughest in Europe, emerged with fast-growing economies and reduced debt: in contrast Greece, with a limited industrial infrastructure, an unreformed public sector and a weak tax-collection system found austerity merely added to its economic woes. Still trapped in the depths of recession, Greece theoretically needed a Keynesian boost of public spending to offset its enfeebled private sector

but this required the patience of its lenders, who feared the country did not have the infrastructure to recover GDP growth, reduce its deficit and repay the debt.

Currency devaluation has also been a key part of austerity to help exports and boost vitally-needed GDP, but it only works assuming the economies of neighbouring countries are buoyant and in itself is no panacea. Canada's austerity programme in the 1990s was helped by its powerful partner, the USA, next door. In contrast, the eurozone in the 2010 Great Recession was trapped within a single currency whose level worked for Germany but was a disaster for Greece and the southern European states. The UK was able to effectively devalue sterling by 25 % between 2008 and 2013 but as 50 % of its exports were with recession-hit Europe, the benefits were minimal. However the alternative, of being within the euro at a higher exchange rate, would have caused even greater damage to the UK's slow recovery after 2010.

Looking into the future as all politicians must do, the pressures on the public finances will increase, rather than diminish, although from different demands. Developed countries battle with the rising health and pension costs of an ageing population living longer with chronic diseases. Governments can no longer rely on bubbles to fund these costs; the public must take a decision on whether they will pay for them through higher taxes or expect reduced services in return. Emerging economies will eventually face the same challenges. Self-inflicted shocks to the world economy such as the referendum vote in the UK in June 2016 to leave the European Union add another challenge to financial stability. Austerity, far from being an aberration, an occasional response to downturns, may well become the new reality for governments running public finances for the coming decades.

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