

# The Macroeconomics of Austerity

March 2023

Rob Calvert Jump, Jo Michell,  
James Meadway & Natassia Nascimento



## **The Macroeconomics of Austerity**

Rob Calvert Jump, Jo Michell,  
James Meadway, Natassia Nascimento

March 2023

**Acknowledgements:** This study received funding from the Alex Ferry Foundation.

# Table of Contents

<b>Executive summary</b>	<b>1</b>
<b>Introduction</b>	<b>2</b>
Crisis and coalition	2
Public finance, 2010-2019	3
Austerity accounting	5
<b>The macroeconomics of austerity</b>	<b>7</b>
Rhetoric and rationale	7
Expansionary austerity	9
Exploitative austerity	16
<b>Counterfactuals</b>	<b>19</b>
Multipliers	19
Public sector spending	22
Fiscal space	23
<b>Breaking the doom loop</b>	<b>25</b>
Policy recommendations	27
<b>Appendices</b>	<b>29</b>
<b>References</b>	<b>36</b>

## Executive summary

---

- With the rhetoric of fiscal prudence now returning on both sides of the political divide, there is a need to assess the macroeconomics of austerity.
- The social consequences of austerity are now understood. But austerity was originally, and explicitly, sold to the public as a strategy for rebuilding the British economy.
- A number of strategies are available to governments to manage the public sector finances. Spending cuts do not have to be the primary tool for bringing the path of government debt and deficits under control.
- Yet, spending cuts made up the bulk of the austerity programme. Current public sector spending per person fell in real terms in every fiscal year between 2010-11 and 2018-19.
- George Osborne and David Cameron justified spending cuts using the idea of “expansionary austerity”: the claim that a reduction in the size of the state would raise confidence in the ability of the government to service its debt, leading to lower interest rates, greater macroeconomic stability, and thereby higher growth.
- There is, however, another mechanism of “expansionary austerity” which works via the labour market. Cuts to government spending, particularly on benefits and public sector employees, increase the cost of being unemployed and worsen the public sector employment alternatives available to private sector workers. This reduces the bargaining power of private sector workers so they become willing to work for lower wages. The result is higher employment and economic activity.
- There is no evidence of the improved confidence mechanism of “expansionary austerity” during the post-2010 austerity period. Instead, the effects of austerity operated through the labour market in the form of lower wages and worse conditions. The indirect effects of this were severe and highly unequal: the costs fell overwhelmingly on women and the lower paid. This is *exploitative austerity*.
- Economic policy after 2010 did not need to be this way. If public spending had increased by 3% a year as part of a balanced budget expansion (meaning that spending increases were matched by increased tax revenues), it would have been over £91bn higher by the end of 2019 - equivalent to the entire education budget in that year. Moreover, under such a scenario, the debt-to-GDP ratio could have been 3 percentage points lower by the end of 2019.
- We do not need a return to austerity in 2023. Balanced budget increases in spending, reinforced by root-and-branch changes to our policy institutions, are necessary to break the doom loop of austerity.

# Introduction

---

## Crisis and coalition

---

Austerity was not an inevitability. The financial crisis of 2008 sent the global economy into a tailspin, with capital flows collapsing and world trade grinding to a halt. Economic output across rich economies slumped dramatically. In immediate response, the G20 conference in April 2009 produced a hard-won international consensus on the need for coordinated fiscal and monetary expansion.

Hosted by Prime Minister Gordon Brown in London, the G20 meeting was widely hailed at the time as a critical victory for international coordination. It stood in marked contrast to the beggar-thy-neighbour policy failures that came in the wake of the 1929 crash and Great Depression – the last comparable occasion of genuinely international, systemic financial failure. “Stopping the drop in the global economy” looked to be secured by the “most successful summit in history”, the Brookings Institute reported shortly after.

Domestically, Brown’s Labour government had been first among the major economies to launch a stimulus package in response to the crisis, launching a programme of deficit spending in late 2008.<sup>1</sup> This was shortly followed by a massive Chinese stimulus programme, and others across the world. But following the general election of May 2010, the incoming Coalition government performed an abrupt volte face in British policy, leading the charge against efforts at international reflation. Instead, the new Conservative and Liberal Democrat government committed, in its founding document, to “significantly accelerate the reduction of the structural deficit over the course of a Parliament, with the main burden of deficit reduction borne by reduced spending rather than increased taxes.”<sup>2</sup>

The 2010 election failed to hand a clear majority to any single party. But despite the electorate’s hesitancy, the United Kingdom was pulled into a radical programme of austerity of a depth and intensity unknown for generations. The general election of 2015 handed a slender majority to the Conservative Party, which used the opportunity to attempt further, substantial cuts to public spending. This programme of cuts continued, despite promises of its termination, until the decisive return to real-terms departmental spending increases after the arrival of Boris Johnson in Downing Street in the last half of 2019, immediately prior to the Covid-19 pandemic.

Despite its deep public unpopularity among the public, and, until recently, a consensus between the major parties against a return to spending cuts, austerity has returned as an apparently

---

<sup>1</sup> Stratton and Seagar (2008).

<sup>2</sup> HM Government (2010, pp. 15).

serious policy prospect.<sup>3</sup> Spending plans presented by Chancellor Jeremy Hunt in November 2022 included spending cuts from 2024-25 onwards.<sup>4</sup>

Austerity's social consequences are, by now, well understood.<sup>5</sup> But austerity was originally, and explicitly, sold to the public as a strategy for rebuilding the British economy. We offer an assessment of this strategy. After laying out some basic statistics and definitions, we present an account of austerity that judges its successes and failures against the macroeconomic targets laid out by George Osborne in 2010. We then present a set of counterfactual economic outcomes to determine whether – and in what way – things could have been different.

## Public finance, 2010-2019

---

At the eve of the 2008 financial crisis, the UK public sector net debt stood just shy of 40% of GDP. As illustrated in figure 1, emergency spending and reduced tax revenues alongside a sharp drop in GDP resulted in debt increasing to over 70% of GDP by 2010.

Excluding bank bailouts, public sector net debt peaked at just over 80% of GDP in 2015, and began to fall thereafter. This coincided with a steady reduction in the public sector deficit to a low of around 2% of GDP in 2019, as illustrated in figure 2.

The prolonged reduction in borrowing between 2010 and 2019 was primarily the result of cuts to government spending. It is this period of government policy – largely engineered by the Conservative Party, but supported in government between 2010 and 2015 by the Liberal Democrats – that is commonly referred to as austerity.

It is notable that the public sector's overall financial balance was never in surplus in this period, and in fact has only been in surplus in nine years out of the last 70. The public sector's current balance, however, did briefly record a small surplus on a fiscal year basis between 2018 and 2019. This measure of the deficit excludes investment, and implies that tax receipts were marginally greater than day-to-day spending during this period.

This brief return to a current surplus was hailed by George Osborne as a “remarkable national effort”.<sup>6</sup> But this “national effort” was the result of the longest continuous period of spending cuts, relative to GDP, since at least the Second World War. As illustrated in figure 3, after taking into account increases in prices, current public sector spending per person fell every year between 2010-11 and 2018-19.

---

<sup>3</sup> Walker (2022).

<sup>4</sup> HM Treasury (2022).

<sup>5</sup> United Nations (2019).

<sup>6</sup> Calvert Jump and Michell (2018).

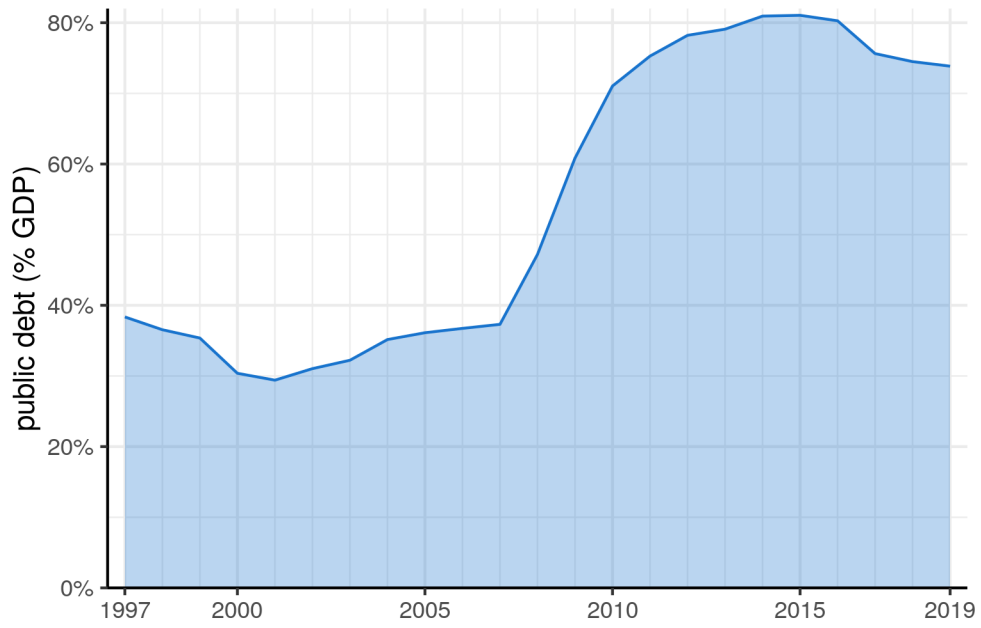


Figure 1: Public sector net debt (excluding Bank of England), % of GDP

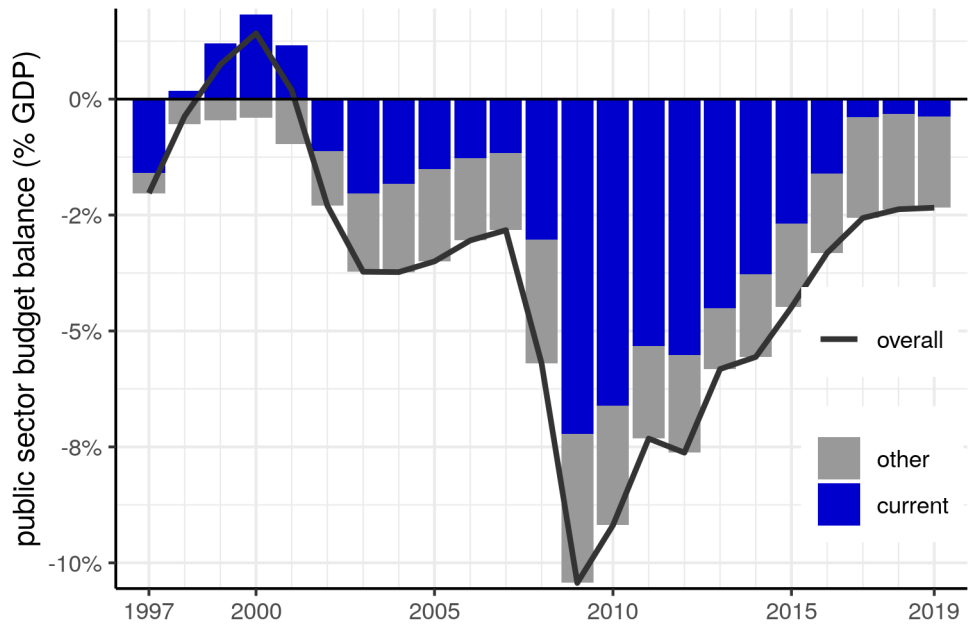


Figure 2: Public sector budget balance, % of GDP.

Moreover, these magnitudes disguise dramatic differences between ‘protected’ areas, like the NHS, and the worst-hit areas, like justice and local government.

Before we consider the macroeconomic effects of austerity, and consider the likely effects of greater public spending on the wider economy, it is important to emphasise that there are several ways to bring down deficits and the public debt as a percentage of GDP. We consider these in the next section.

## Austerity accounting

---

As noted above, there are many ways to reduce public debt relative to GDP. One way to visualise the factors that drive changes in debt is provided in figure 4.<sup>7</sup> This splits the amount of new borrowing, commonly referred to as the ‘deficit’, into two components. The first is the amount spent on interest payments during the period. This is determined by two things: the interest rate on the public debt, and the size of the debt. The second component is called the ‘primary deficit’. This is the difference between public sector spending (excluding interest payments) and tax revenues (plus any other public sector receipts). The increase in the public sector debt each year is then the sum of the primary deficit and interest payments, plus certain accounting adjustments.

So the dynamics of the public debt in cash terms are affected by changes in government spending, changes in tax revenues, or changes in interest rates. However, the size of the debt in cash terms is not particularly meaningful. A more meaningful measure is given by comparing the size of the debt to the size of the economy, and thus the available tax base. The most commonly used measure is public debt as a percentage of GDP. This measure is affected both by the size of the debt in cash terms and the size of the economy: if GDP growth is high enough, public sector debt will decrease relative to GDP even if the government runs a deficit. This is how the debt to GDP ratio has usually been reduced historically. Britain’s World War Two debt was reduced by this method, for example.

While there are, therefore, many ways to reduce public debt as a percentage of GDP, reductions in public sector spending made an unusually large contribution after 2010. Changes in taxes were a relatively unimportant part of post-2010 austerity, and some taxes (e.g., corporation taxes) were actually decreased during austerity.

While public debt and deficits can be reduced in several ways, including increased taxation and, if it can be achieved, strong economic growth, the Coalition government’s austerity programme was characterised by spending cuts above all else.

---

<sup>7</sup> This figure, and some of the discussion in this section, is taken from the authors’ previous paper, Calvert Jump and Michell (2022).



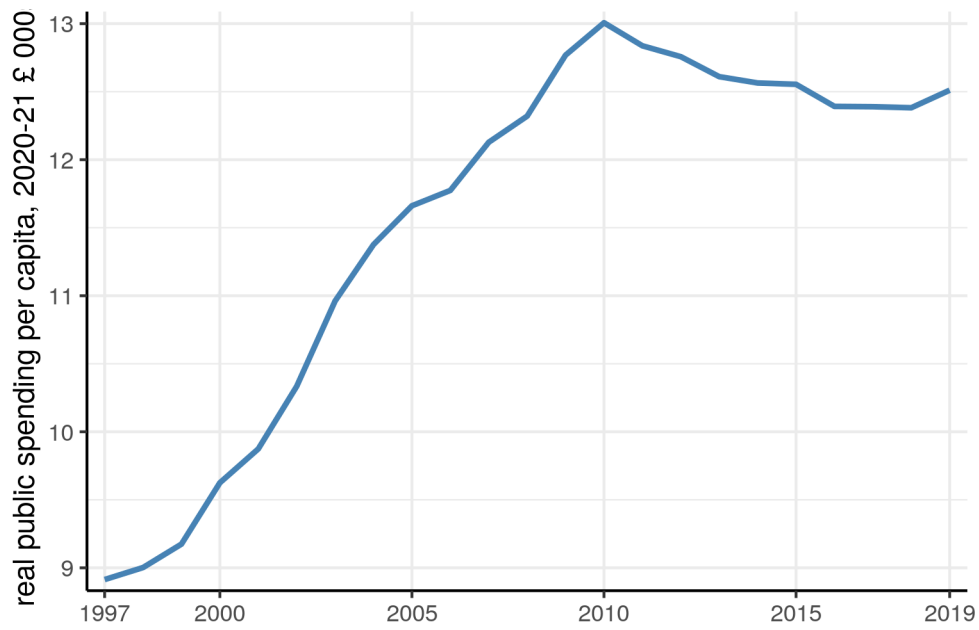


Figure 3. Government current spending per person, £000s in 2020-21 prices.

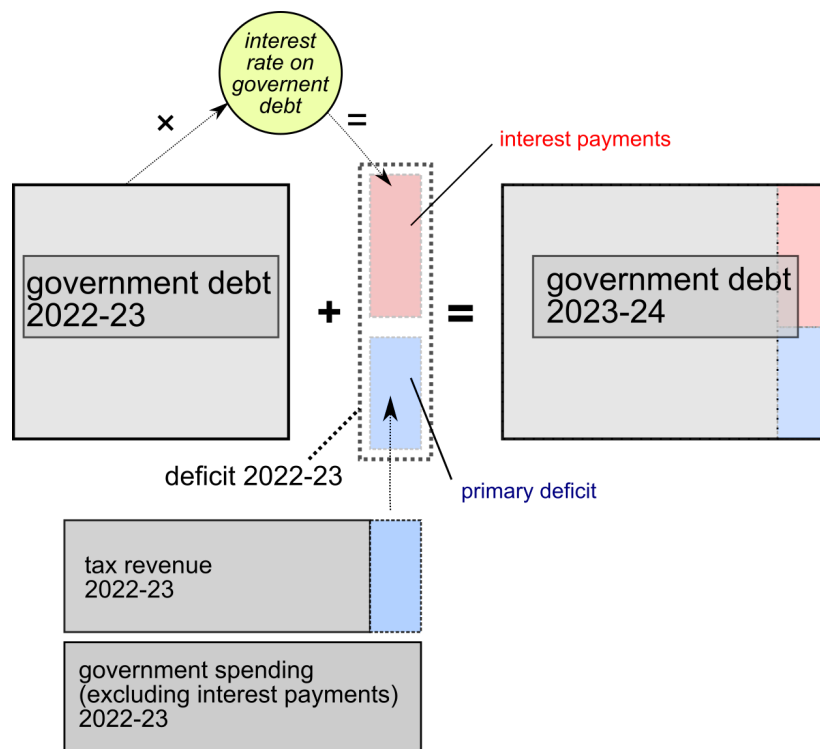


Figure 4: Graphical illustration of the change in public debt between two periods.

# The macroeconomics of austerity

---

## Rhetoric and rationale

---

From late 2008 onwards, the Conservative Party had been arguing that spending cuts were necessary for Britain's economic recovery. In the months leading up to the general election of May 2010, one widely anticipated to result in an outright Conservative victory, the Shadow Chancellor George Osborne began to spell out his party's argument in more detail, delivering two high-profile public speeches, the prestigious Mais Lecture and a follow-up speech at the London School of Economics. Osborne argued that Britain's economic woes were largely – if not completely – caused by the Labour government's "overspending" in the decade before the financial crisis.<sup>8</sup> Having previously affirmed the Conservatives' support for Labour's spending plans, right up to the bankruptcy of Lehman Brothers in September 2008, this represented a 180-degree turn in Conservative policy.

Developing a platform around the essential need for spending cuts was Osborne's central aim in these lectures. He criticised the economic growth model used by Britain in the previous decade, claiming that it was one that depended on a "public spending boom we couldn't afford, [an] overblown banking sector, and unsustainable consumer borrowing".<sup>9</sup> In comparison, he claimed that a Conservative government would usher in a strong recovery based on long-term saving and investment. While Conservative claims about Labour overspending are incorrect, the diagnosis of the problems of the pre-2008 economic model have substance. Osborne claimed that the government would create a new economic model based on a "competitive tax system, modern infrastructure, education and welfare reform". He proposed eight "benchmarks for Britain" to provide a yardstick by which the coalition's success, or failure, would be judged. These "benchmarks" are summarised in table 1.

In practice, the first "benchmark" became the overwhelming focus for government policy over the five years of the coalition government, and for some time beyond this. Looking back on the first five years of his project, Osborne argued that a lot of focus had been placed in the early years of the coalition on whether or not fiscal consolidation would be compatible with recovery. Yet, he went on, "it is now clear that credible fiscal policy is a precondition for recovery, underpinning confidence and an activist monetary policy." So austerity underpinned macroeconomic stability, which in turn underpinned confidence and permitted monetary policy to remain expansionary. These two factors, according to Osborne, underpinned economic growth during the coalition government through expansionary austerity.<sup>10</sup>

---

<sup>8</sup> This argument has no merit; the debt to GDP was lower when the 2008 financial crisis struck than when Labour took power in 1997.

<sup>9</sup> <https://www.ukpol.co.uk/george-osborne-2010-speech-on-a-new-economic-model/>.

<sup>10</sup> <https://www.gov.uk/government/speeches/extracts-from-the-chancellors-lecture-on-economic-policy>.

Benchmark for Britain	Policy problem	Policy solution
To “cut the deficit . . . to safeguard Britain’s credit rating”.	A credit downgrade “would mean higher interest rates”, which “could tip us back into recession”.	“[We] will set out a plan in our first budget to eliminate the bulk of the structural deficit over a Parliament”.
To “create a more balanced economy”.	“Investment as a share of GDP is the lowest of any G7 country”; “Global export market share is falling”; “Growth is driven by public and private debt”.	Increase investment and exports, by “more support for exports, lower corporation tax rates, an attack on regulation and measures to restore our savings culture”.
To “get Britain working”.	“We have the highest youth unemployment ever”; “Child poverty rising”.	Not discussed in Mais lecture, but “our plans” will “help more people into work”.
To “make sure that Britain is open for Business”.	Britain is “struggling to compete”; the “UK ranking on government regulation has fallen from 4th to 86th.”	To “simplify taxation and combat excessive regulation”.
To “ensure that the whole country shares in rising prosperity”.	“Growth in the rest of the UK has lagged behind the South East”; “The private sector’s share of the economy has fallen in every region”.	To raise the private sector share in all regions with “a high speed rail network, with super-fast broadband, and with really effective local support for businesses”.
To “reform public services to deliver better value for money”.	“We have seen public sector productivity falling since 1997.”	“Increasing diversity of provision, extending payment by results, giving more power to consumers and improving financial controls”.
To “create a safer banking system that serves the needs of the economy”.	A “massive failure of regulation” put the whole economy at risk; “And still small businesses are struggling to get credit”.	“Lower leverage”; “More credit to small businesses”; and “abolish the failed tripartite system of regulation”.
To turn around “higher emissions than 1997 – and . . . just 5% of the global market for green goods and services”.	Greening the economy can be a “huge opportunity” and a “win-win solution”.	The Green Investment Bank and “new incentives for energy efficiency investments”.

Table 1: Osborne’s “benchmarks for Britain”. Source: Mais lecture.

## Expansionary austerity

---

Osborne's justification for austerity was based on the expectations view of "expansionary fiscal contractions", as explained here by one of its proponents, the economist Silvia Ardagna:

"... fiscal stabilizations may be expansionary if agents believe that the fiscal tightening generates a change in regime that 'eliminates the need for larger, maybe much more disruptive adjustments in the future' ... If agents believe that the stabilization is credible and avoids a default on government debt, they can ask for a lower premium on government bonds. Private demand components sensitive to the real interest rate can increase if the reduction in the interest rate paid on government bonds leads to a reduction in the real interest rate charged to consumers and firms."<sup>11</sup>

In simpler language, the argument is that confidence in the public finances lowers interest rates and increases asset prices. Lower interest rates reduce the cost of borrowing for investment and consumption. A weaker exchange rate, which usually accompanies lower interest rates, makes exports more competitive. Higher asset prices make people feel richer, raising consumption spending. Taken together, spending on consumption and investment should increase alongside increased demand for exports. These increases in aggregate demand, the theory suggests, should outweigh reductions in demand due to spending cuts.

This is the mechanism that Osborne relied on in his 2015 lecture, cited above. Five years earlier, his "Emergency Budget" speech of June 2010 spelled out the same idea:

"A sustainable private sector recovery built on a new model of economic growth, instead of pumping the debt bubble back up. Part of the reason, as we have always argued, is that tighter fiscal policy can enable interest rates to stay lower for longer."

Osborne's proposed expectations mechanism for expansionary austerity was as follows:

- Lower government borrowing increases the confidence of bond market investors that the government will service its debts, ensuring that investors are willing to hold government bonds.
- This prevents unsustainable increases in the interest rate on government debt and in the costs of servicing that debt.
- This lowers the likelihood of a debt spiral which would require even more severe future cuts or tax hikes, and thus increases consumer and business confidence.
- Lower interest rates on government debt feed through to lower interest rates for businesses and consumers.

---

<sup>11</sup> Ardagna (2004).

- Lower borrowing costs and increased consumer and business confidence lead to increased spending. Increased spending leads to higher economic activity and growth.

Other senior government figures repeated this line of argument at the outset of the austerity programme. David Cameron, on his return from the G8 and G20 summits in 2010, endorsed the version of expansionary austerity discussed by global leaders at those meetings:

“The argument proposed by some that deficit reduction and growth are mutually exclusive is, in my view, completely wrong. The whole approach underlined by the International Monetary Fund for this G20 and the subsequent meeting in Seoul is about how the world should maximise growth through the right combination of three things: deficit reduction; tackling imbalances . . . and structural reform in the advanced economies.”<sup>12</sup>

This mechanism was widely understood amongst the government’s supporters. On the government backbenches at the time, Matt Hancock spelled out the expectations mechanism of expansionary fiscal contractions in detail in the Commons in 2010. After citing Alberto Alesina, one of the doctrine’s foremost proponents, he first argued that lower interest rates are one of the key reasons explaining why “a fiscal consolidation can lead to growth”. And of the remaining reasons,

“The first, of course, concerns expectations of future tax rates. If people around the country can see that spending is out of control, they will anticipate that taxes might have to rise in future, whereas setting out a clear path for taxes makes it clear that there will not have to be sharp and immediate tax rises in future.”<sup>13</sup>

Finally, it is worth highlighting that this justification still persists. David Gauke, Treasury minister from 2010 to 2017, for example, used a variant of this logic in a recent defence of austerity, arguing that, “the risk of a loss of market confidence was real, with the currency weakening and interest rates rising. Regaining lost confidence would be much more painful than taking pre-emptive action to retain it.”<sup>14</sup>

This relatively benign expectations mechanism is not, however, the only one proposed by the expansionary austerity theorists. They also outline a labour market mechanism, in which cuts to government spending have “positive benefits” by weakening the bargaining power of workers relative to employers. In particular, lower public employment decreases private sector outside options, and cuts to the generosity of social security increase the cost of being unemployed:

“Consider . . . a fiscal stabilization that relies on cuts to public spending. A decrease in government employment, in government wages, and in unemployment benefits can have positive effects on the economy because it makes the labor market less tight . . . Any decrease in these public spending items lowers pressure on the equilibrium wage with positive consequences for the economy.”<sup>15</sup>

---

<sup>12</sup>

<https://hansard.parliament.uk/Commons/2010-06-28/debates/1006288000001/G8AndG20Summits?highlight=david%20cameron#contribution-1006288000225>.

<sup>13</sup> <https://hansard.parliament.uk/Commons/2010-07-20/debates/10072029000003/FinanceBill?highlight=matthew%20hancock#contribution-10072035000026>.

<sup>14</sup> Gauke (2023).

<sup>15</sup> Ardagna (2004) and the references therein.

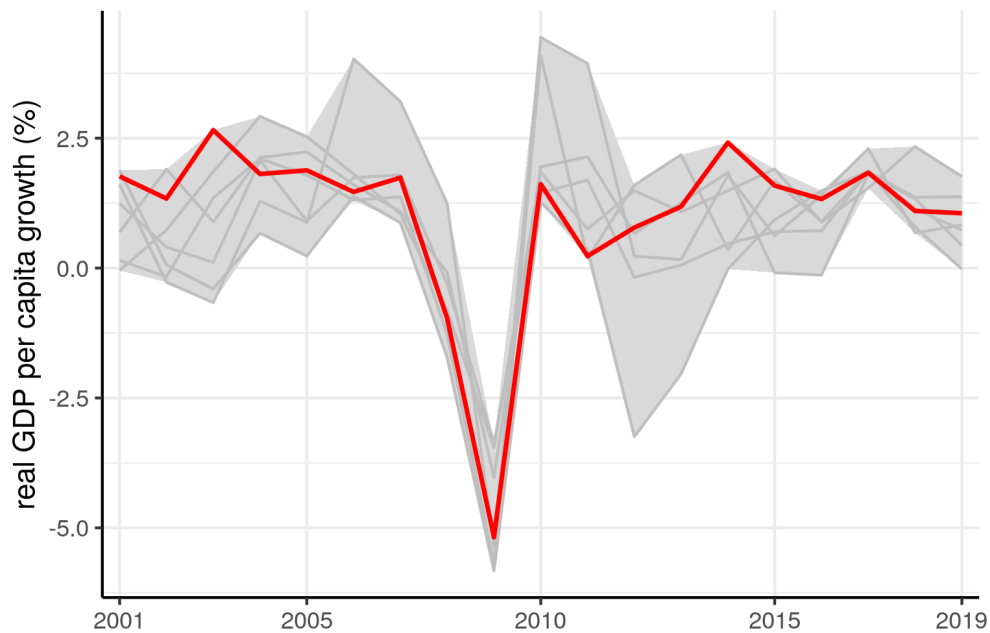


Figure 5: Real GDP per capita growth rates, UK in red; G7 countries in grey.

This labour market mechanism was not emphasised by Osborne, Cameron, or other Conservative MPs in 2010. Moreover, Osborne did not spell out the details of his plan to “get Britain working” in the Mais lecture, and the Conservatives’ 2010 manifesto merely promised a “fair but firm” welfare system that would “give unemployed people a hand up, not a hand out”.<sup>16</sup> Yet to the extent that the coalition’s economic programme did increase growth, it appears to have worked entirely through this labour market mechanism.

Figures 5 and 6 provide the initial evidence for this hypothesis. First, as illustrated in figure 5, the UK did not suffer a collapse in growth after 2010, although the recovery from the 2008 crisis was weak in historical context. In fact, the 2007 pre-crisis level of GDP was not attained again until 2012. And while growth per capita was low compared to the other G7 countries in the first few years of the austerity period, it improved as austerity slowed somewhat, with growth after 2013 reasonably strong in comparison to the rest of the G7.<sup>17</sup>

Alongside this growth record, the UK saw a dramatic fall in average real wages alongside a dramatic increase in employment rates, as shown in Figure 6. Despite a partial recovery between 2015 and 2019, real wages were to remain below their previous peak for the longest period since the Napoleonic Wars, 200 years ago.<sup>18</sup> At the time of writing, after the twin shocks of Covid-19 and the cost of living crisis, average earnings are not expected to return to their 2008 level until the end of the 2020s.<sup>19</sup>

<sup>16</sup> Conservative Party (2010).

<sup>17</sup> See Wren-Lewis (2014).

<sup>18</sup> Tily (2018).

<sup>19</sup> Office of Budget Responsibility (2022).

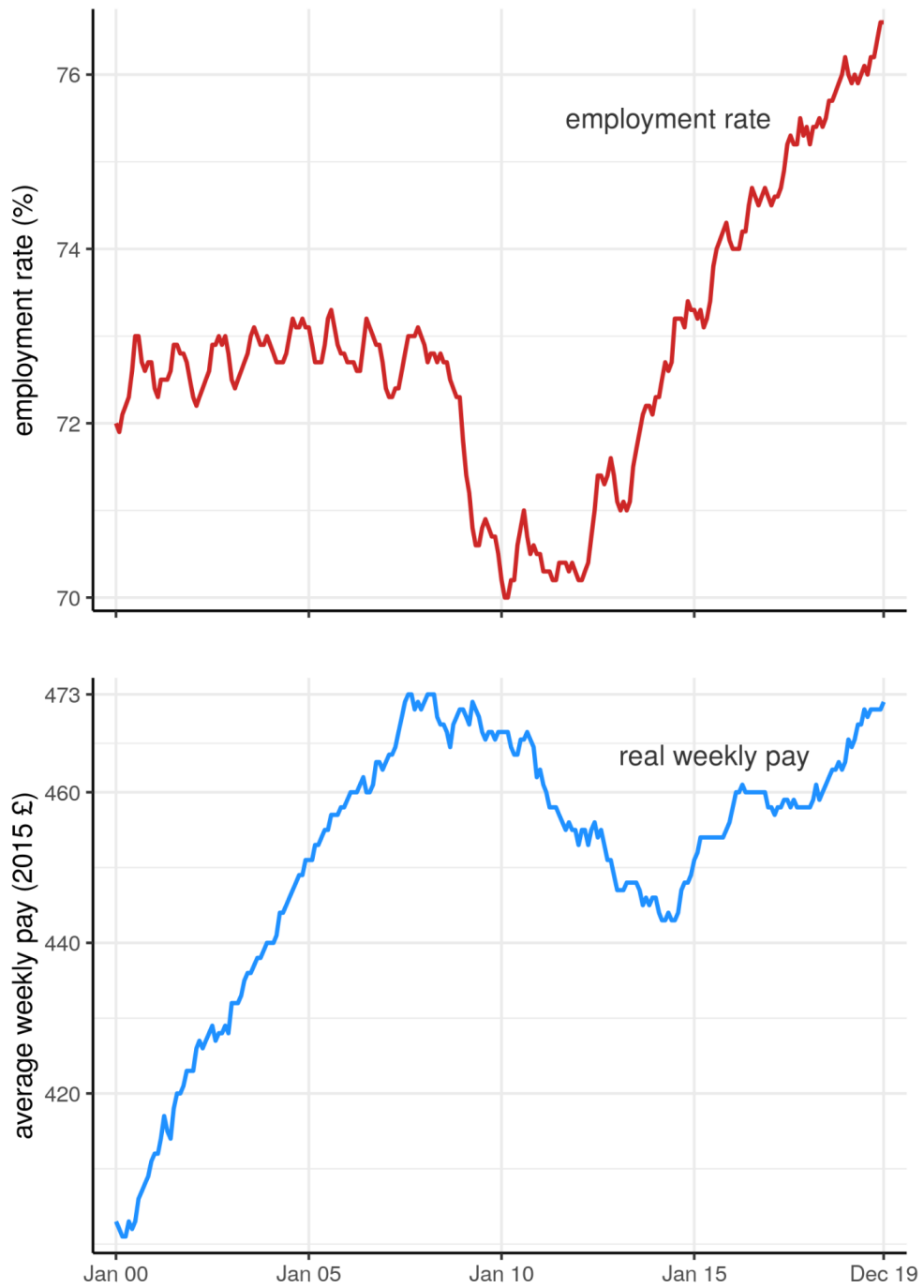


Figure 6: UK employment rate, % and UK real average weekly pay (in 2015£)

Alongside this decline in real earnings, the employment rate for those aged between 16 and 64 increased rapidly (and to record levels) – a straightforward prediction of models in which the “equilibrium wage” is reduced by a shock to bargaining power.

Relatively steady growth alongside dramatic increases in employment suggest that productivity growth must have declined after 2010. As illustrated in figures 7 and 8, this was indeed the case. There has been substantial discussion of this ‘productivity puzzle’ since 2010: the observation that output per person employed, or output per hour of work, has flatlined. The long-run trend of steady productivity growth gave way to stagnation, meaning that GDP growth was driven almost entirely by increased employment.

This puzzle, however, provides the second piece of evidence that austerity works through the labour market mechanism, rather than the expectations mechanism. This is because the two mechanisms push in opposite directions on productivity. The expectations mechanism would be expected to have a *positive* effect on labour productivity, as interest rates fall and investment increases. In contrast, the labour market mechanism would be expected to generate a *negative* effect on labour productivity, as low-wage, insecure employment increases. An important part of the so-called productivity puzzle is, therefore, that while the expectations mechanism did not emerge after 2010, the labour market mechanism did.<sup>20</sup>

Indeed, as illustrated in figures 9 and 10, there is no evidence of a positive effect of austerity on aggregate demand via the expectations or interest rate mechanisms, which we would expect to appear in increased investment and rising exports. Investment did not contribute any more to GDP after austerity than under New Labour. The problem identified by Osborne, that investment as a share of GDP was lowest in the G7, worsened during austerity: the average level was lower in the UK in the decade from 2010 than in the previous decade in the UK, and lower than in any G7 country in either decade. Net exports only returned to the share of GDP they had achieved between 2005 and the financial crisis. In other words, Osborne’s second “benchmark” was not met.

Meanwhile, inflation fell almost continuously between 2011 and 2015, undershooting the Bank’s target between 2014 and 2016, despite interest rates staying close to their effective lower bound for the entirety of the 2010 parliament. This is not suggestive of an expansion driven by increases in demand.

After a decade of accrued evidence, the hypothesis that austerity might increase demand has been widely discredited, and it is now understood that unconventional monetary policies have limited effects on aggregate demand. If anything, aggregate demand was subdued after 2010, as the coalition’s deficit reduction programme sucked demand out of the economy. Contrary to the expectations mechanism of “expansionary austerity”, austerity did not increase consumer or business confidence, and falls in interest rates did not stimulate investment or net exports.<sup>21</sup>

---

<sup>20</sup> The obvious counter-argument to this explanation is that the financial crisis led to a persistent negative effect on productivity, which in turn reduced wages and increased employment, without austerity playing an important role. We discuss this possibility in appendix B.

<sup>21</sup> We provide references for further reading on this, and other, aspects of austerity in appendix C.



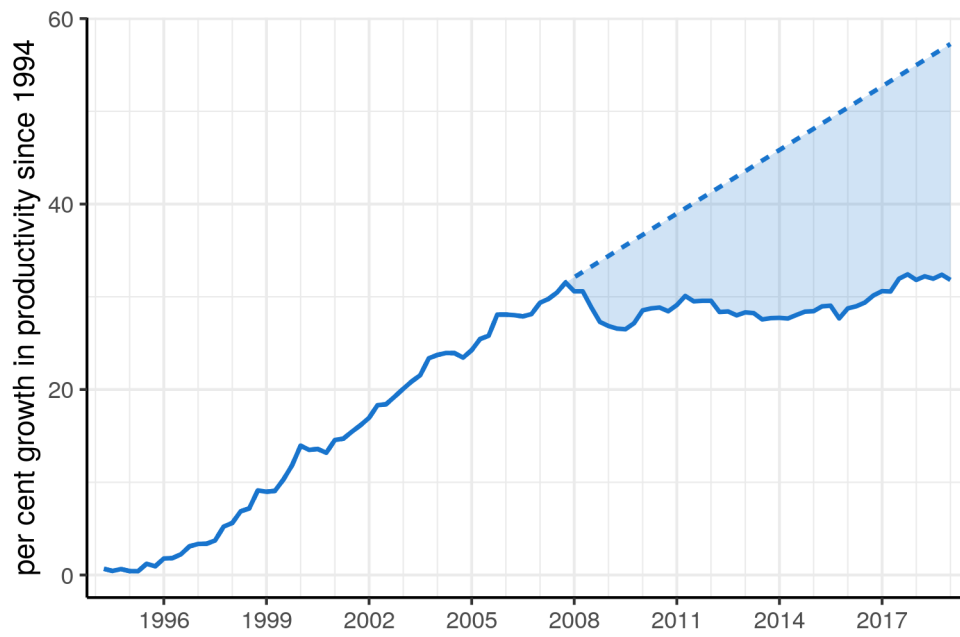


Figure 7: Productivity growth (solid) versus trend (dotted)

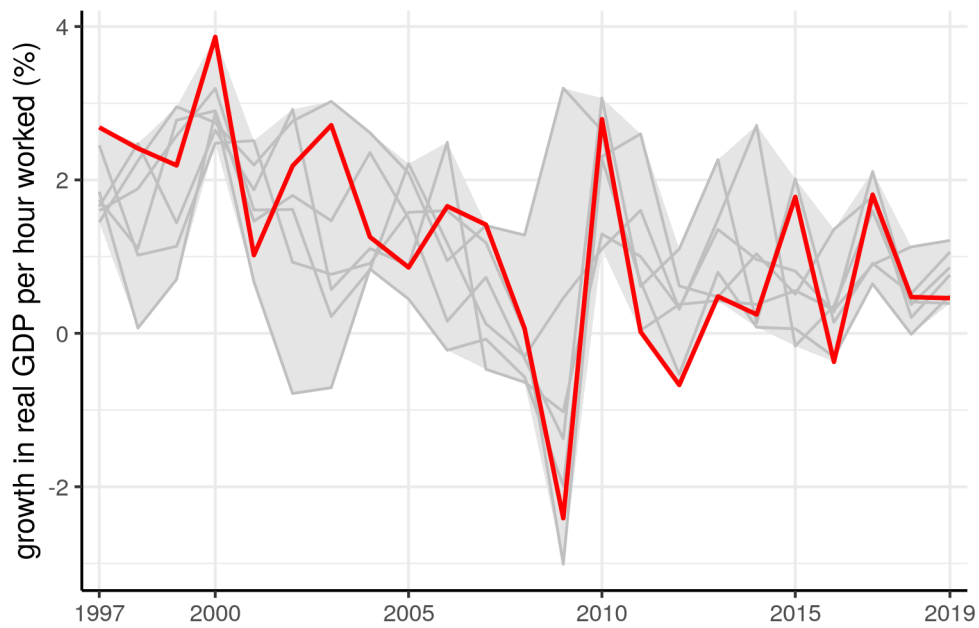


Figure 8: Labour productivity growth, 1997 to 2019, with G7 productivity growth rates for comparison (UK in red; other G7 in grey).

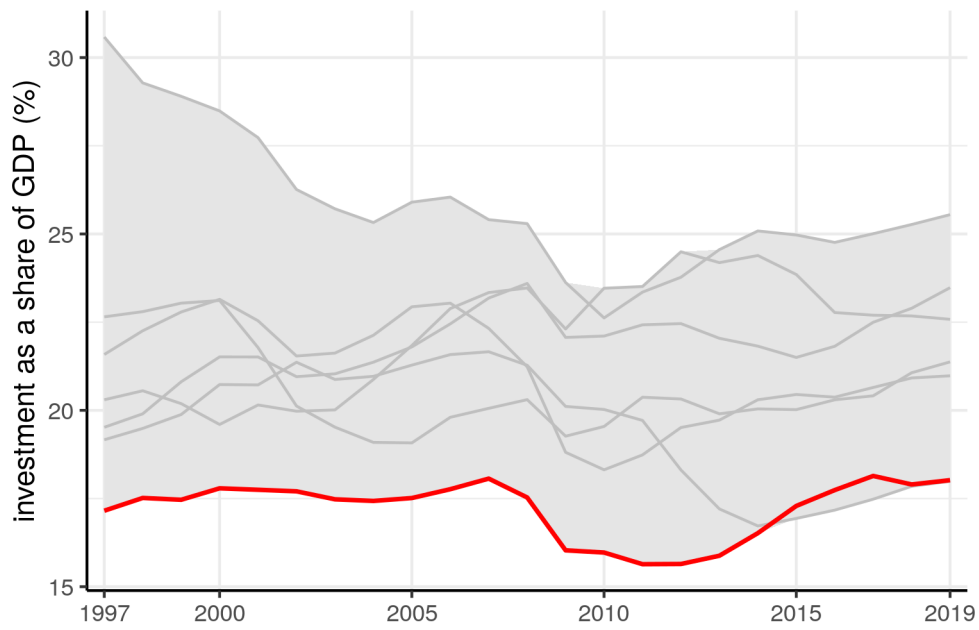


Figure 9: Gross capital formation, % of GDP. UK in red, other G7 countries in grey.



Figure 10: Net exports, % of GDP.

## Exploitative austerity

---

There is, therefore, no convincing evidence in favour of Osborne's preferred argument for austerity. Instead, increases in output alongside stagnant productivity, caused by significant increases in employment in combination with falling real wages, all point towards the labour market mechanism of austerity. In short, a large negative shock to bargaining power led to workers having no other choice than to work for lower wages. This led to increases in employment, which in turn maintained GDP growth.

Note that this is a *macroeconomic* mechanism based on a *supply-side* shock. Specifically, this shock took the form of a series of coalition policies that significantly reduced the bargaining power of labour relative to capital after 2010.

Collective bargaining in the public sector was abrogated by a series of policies, imposed across the sector by the Treasury. Pay was frozen in nominal terms from 2010-12, and then a 1% average pay cap was implemented, allowing wages to rise as long as departmental total wage bills rose by no more than 1%. This 1% cap, like the freeze, represented a real-terms pay cut for as long as inflation remained above 1%, which for most of the austerity period it did. The 1% cap ended in 2017.<sup>22</sup>

In addition to these direct controls, which severely weakened the position of public sector workers, the Coalition and Conservative governments introduced broader legislation and policy changes that affected workers across the public and private sectors. On entering the austerity period, the UK was already an outlier for labour market 'flexibility' relative to the European norm, but the Coalition government oversaw further erosion in rights at work, including an increase in the minimum period of service required for unfair dismissal cases, and the introduction of a new fees regime for employment tribunals.<sup>23</sup>

Sanctions and restrictions on benefits claimants were made more onerous, including enforced community service for the long-term unemployed. Overall, the strong bias towards means-testing of existing UK welfare provision was reinforced, tying labour market law and policy changes directly back into the overall programme of spending cuts.<sup>24</sup>

The approach taken by both the Coalition and Conservative governments in the austerity period was piecemeal, and did not see significant confrontations with the trade unions of the kind that had marked an earlier period of spending cuts in the 1980s. Trade union membership and union recognition, two key determinants of worker power in workplace bargaining, declined through the period of austerity, from 7.3m members in 2009-10 to 6.6m in 2018-19. This continued a trend of declining participation and membership that was apparent under the New Labour government. The approach under austerity, reflecting the pre-existing weakness of

---

<sup>22</sup> Brione and Francis-Devine (2022).

<sup>23</sup> Hastings, and Heyes (2016).

<sup>24</sup> *ibid.*

potential opponents, represented more of a consolidation of existing trends towards ‘flexibility’ in labour markets than a change in direction.

Shifts in the balance of bargaining power can be hard to register, although recent research by the Resolution Foundation summarises the broad shift against labour since the 1980s that the austerity period reinforced.<sup>25</sup> Firm power, by comparison to worker bargaining power, appears to have risen since the early 2010s, with a pronounced break in the responsiveness of employee job changes to changes in relative pay after 2010. This indicates that firms enjoyed an increased degree of leverage over labour, since falling relative wages provoke fewer employment changes than would be expected in a market where both sides were more evenly matched.<sup>26</sup>

Moreover, as illustrated in figures 11 and 12, the majority of the employment increases in the UK in the immediate years after 2010 were increases in non-standard employment. The number of employee jobs did not recover to pre-crisis levels until 2014. The largest contributing groups to these employment increases were single parents and coupled mothers – those most likely to respond to falls in household income with increases in labour supply.<sup>27</sup>

Employment growth was strongest among those at the bottom of the wage distribution – those most affected by spending cuts.<sup>28</sup> Migration also played a role in this process, with the percentage of non-UK born workers in total employment continuing its steady increase from around 10% in the early 2000s to around 18% on the eve of the Covid-19 pandemic.

Crucially, increasing employment and profits via a massive state-engineered reduction in the bargaining power of labour was not the policy programme that Osborne described to the UK electorate.

Those in favour of austerity argued for an “expansionary fiscal contraction” on the basis of increasing confidence and falling interest rates sustaining higher economic growth, but there is no evidence for this relatively benign macroeconomic mechanism of austerity.

In reality, the labour market was the primary route through which austerity affected the wider economy. Calling this “expansionary austerity” in the context of weakening labour power is a misnomer. This is *exploitative austerity*, designed to force more and more workers into employment.

---

<sup>25</sup> Altunbeken, Bukowski, Machin and Slaughter (2022).

<sup>26</sup> Langella and Manning (2021).

<sup>27</sup> This ignores women in their early 60s, who also saw large increases in employment following increases to the state pension age starting in April 2010. See Bell and Gardiner (2019).

<sup>28</sup> Bell and Gardiner (2019).

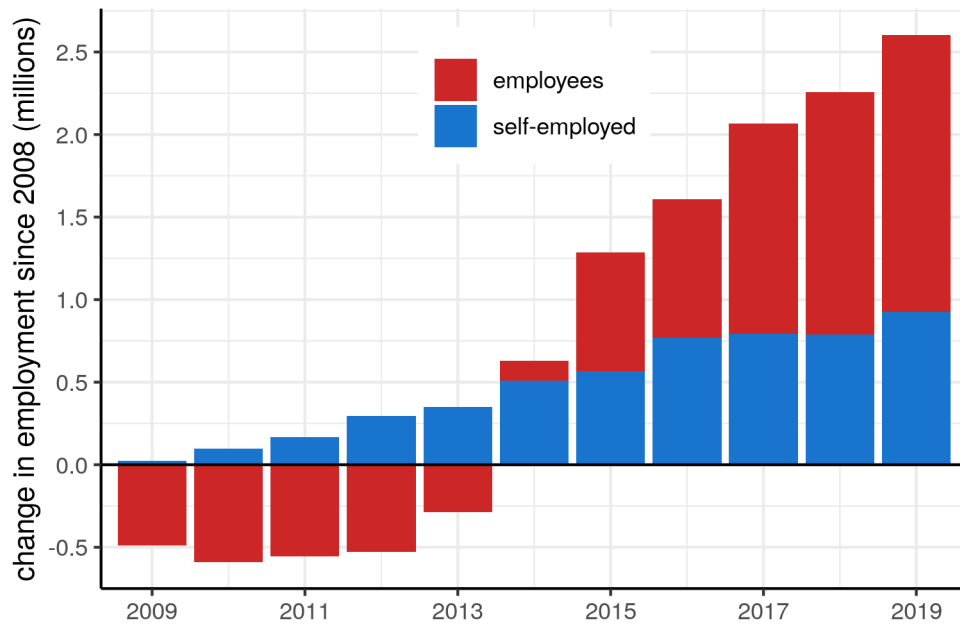


Figure 11: Employment changes since 2008, employees vs self-employed.

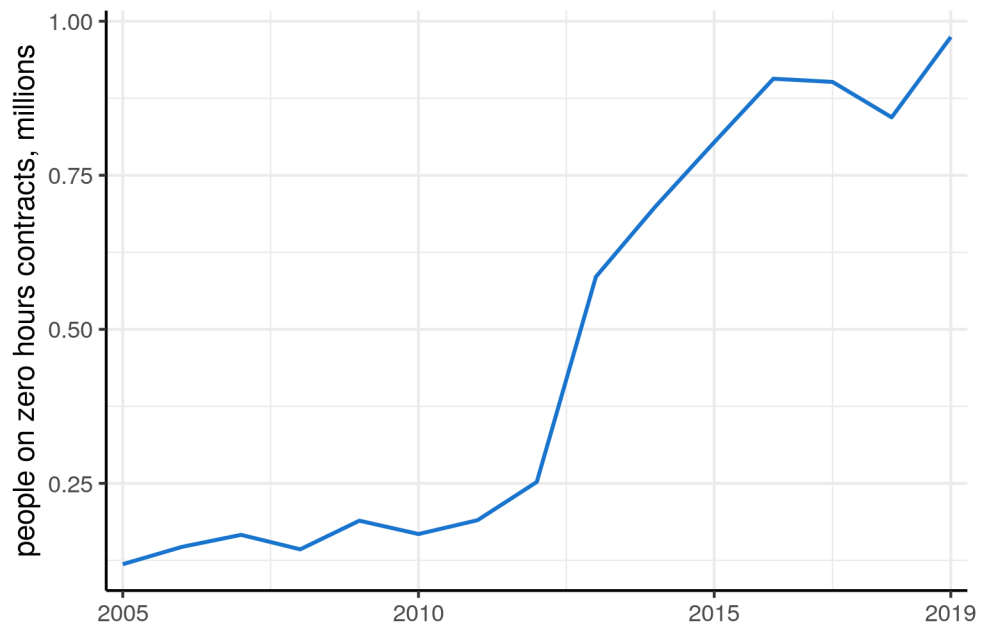


Figure 12: Number of people on zero hours contracts, millions.

# Counterfactuals

---

## Multipliers

---

As we have seen, there is no evidence that austerity had an expansionary effect on aggregate demand, or rebalanced the economy. In other words, the government spending multiplier was positive, as suggested by the large theoretical and empirical literature on this topic. The effect of this positive multiplier on government spending was to amplify spending cuts, making their overall impact on the economy worse. For expansionary austerity to work a negative multiplier is required, such that cuts to government spending provoke increased activity elsewhere in the economy sufficient to offset the direct effects of decreased government spending.<sup>29</sup>

Given a positive multiplier on government spending, the effects of higher government spending relative to the post-2010 trajectory would be amplified, boosting demand. Was, then, a recovery from the 2008 crash based on higher aggregate demand possible? And, even if a more expansionary fiscal stance was possible, would this not have reduced the government's fiscal space before the Covid-19 pandemic?

In this section, we answer the first question in the affirmative, and the second question in the negative. It would have been possible to expand output after 2010 in a just, non-exploitative manner, and to reduce the debt-to-GDP ratio simultaneously. Specifically, the government could have undertaken a balanced budget expansion relative to the trajectory of public sector borrowing that actually existed after 2010. A 'balanced budget expansion' means that the government would have increased both spending and taxation relative to their post-2010 trajectories such that borrowing remained the same in cash terms.

As illustrated in figure 13, increasing public sector spending by 3% per year from 2011 onwards would have resulted in around £91 billion pounds a year of extra expenditure by 2019. In order to keep borrowing constant over this period, tax receipts would have had to increase by around the same amount. Is this plausible? To answer this, it is important at this point to consider what happened to nominal and real interest rates in the UK after 2010, as these have implications for the size of the multiplier – i.e., the increase in GDP (and therefore tax receipts) caused by an increase in government spending.

Figure 14 plots the time path of the nominal and real Bank of England base rates between 2006 and 2019. Importantly, the nominal rate fell rapidly to its lower bound, and the real rate was negative for the majority of the post-crisis period.

---

<sup>29</sup> See, e.g., Ramey (2019) for a recent survey of multiplier estimates.

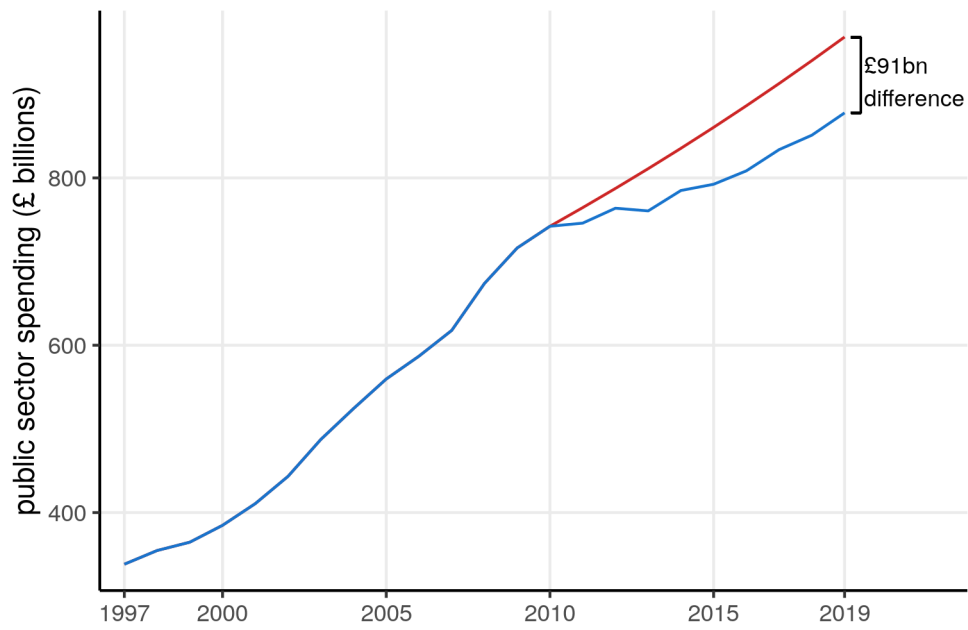


Figure 13: Public sector spending counterfactual (actual in blue; 3% growth balanced budget scenario in red).

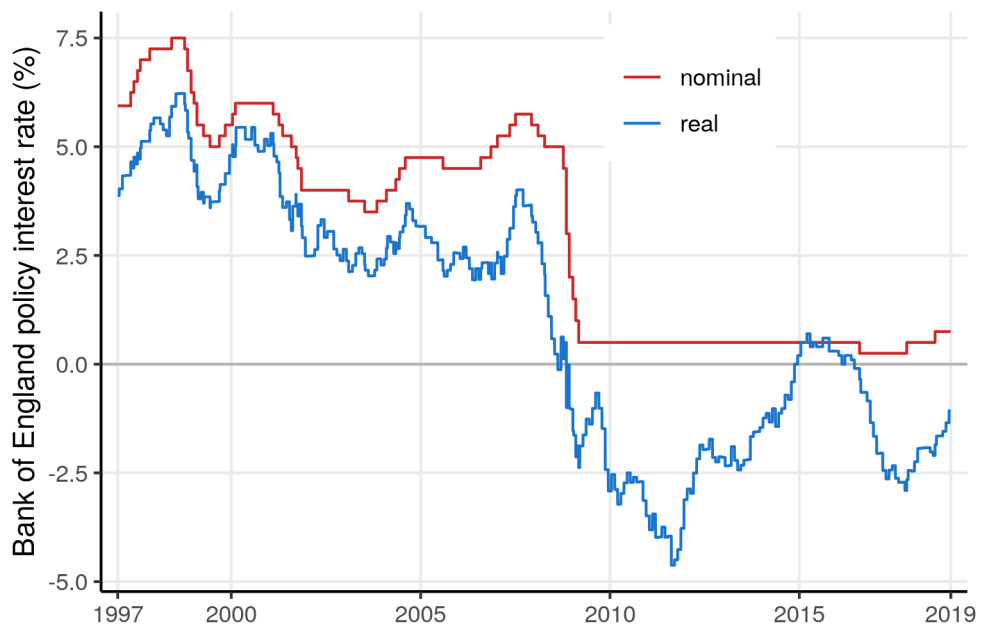


Figure 14: Bank of England bank rate, nominal and real (using CPI inflation).

Quite clearly, the Bank of England would have liked a lower real interest rate than the rate that actually transpired after 2008; this is a direct implication of remaining at the effective lower bound on the nominal rate for so long. The lower bound is the point at which nominal interest rates cannot plausibly go any lower, but this means that the real interest rate (which is the nominal rate minus inflation) also cannot be made to go any lower unless inflation increases. The Bank of England's response to this situation, like other central banks, was, from early 2009 onwards, to use "unconventional monetary policies" such as Quantitative Easing as an imperfect substitute for further nominal interest rate reductions.

All else equal, increasing aggregate demand ought to lead to the Bank of England raising interest rates. But we have already seen that the Bank would have liked a lower interest rate than it could achieve after 2010, and thus we can reasonably assume that the Bank would not have raised interest rates – or at least, not by more than any increase in inflation – in the event of a balanced budget expansion after 2010. Given this point, consider a textbook characterisation of households and firms, in which private expenditure depends on the time path of real interest rates. If the time path of real interest rates is constant, then the aggregate demand identity implies that,

$$Y_t = \bar{E} + G_t$$

in each year, in which  $\bar{E}$  denotes a constant trajectory of private expenditure, and  $Y$  and  $G$  are national income (GDP) and government spending, respectively.<sup>30</sup> It follows directly from this observation that the multiplier is equal to one, conditional on a fixed trajectory for real rates. If nominal interest rates were to rise *faster* than any increase in inflation associated with a fiscal expansion, then the multiplier might be reduced somewhat; if private expenditure is itself stimulated by current income (i.e., traditional Keynesian effects are present), then the multiplier might be increased somewhat.<sup>31</sup>

With a balanced budget multiplier of around 1, we would expect an increase of around £1 in GDP for every £1 of increased public expenditure. In turn, we would expect this increase in GDP to increase tax revenues by approximately £1 multiplied by the tax-to-GDP ratio, in the absence of any changes to tax rates. If anything, this multiplier is likely to be a conservative estimate – it is quite likely that the multiplier is larger, meaning that growth could have been higher still, alongside lower debt/GDP ratios. We choose, however, to work with relatively conservative assumptions for the sake of illustrating the choices available to policy-makers.

On the revenue side, the direct effects of some of the Coalition and Conservative government tax cuts were very expensive. According to the Office of Budget Responsibility's policy measures database, for example, the 2019 cost of Osborne's successive cuts to the headline

---

<sup>30</sup> See, for example, Woodford (2011).

<sup>31</sup> Woodford (2011) suggests that the balanced budget multiplier might be greater than one in some circumstances. The result above assumes that the long-run level of output is not reduced by a sustained balanced budget increase in public spending.



rates of onshore Corporation Tax was about £10 billion, while the 2019 cost of increased personal allowances was around £23 billion.<sup>32</sup>

Thus, it seems reasonable to suppose that a balanced budget expansion, relative to the actual trajectories of public spending and receipts after 2010, could have been engineered by a motivated government. Multiplier effects would have implied somewhere between £34 billion and £50 billion of increased revenue by 2019, depending on the multiplier, while reversing some of the coalition tax cuts would have raised over £30 billion in the same year. In 2019 prices, the Warwick CAGE/LSE “Wealth Tax Revenue Simulator” suggests CGT equalisation would be worth around £13 billion, while Avinash Persaud’s 2017 proposals for reforms to the taxation of financial transactions in the UK would have raised around £5 billion in that year.<sup>33</sup> In each of these cases, the increases in taxation would fall overwhelmingly on the richest.

Austerity was never necessary. Worse, to the extent that it worked at all, it imposed a terrible cost on the whole country, resulting in worse public services, lower growth, and lower wages and salaries than if the choice had not been made. Other choices were open to governments in the last decade. The counterfactual presented here demonstrates that a government making different choices could not only have matched the outcomes for debt reduction, relative to GDP, but supported higher household incomes and dramatically improved funding for public services.

## Public sector spending

---

Between 2011 and 2019 the increased public spending implied by our counterfactual would have amounted to over £540bn. What would an extra half a trillion pounds of government spending between 2011 and 2019 have meant in practical terms?

This is, clearly, a huge amount of money. A large hospital costs around £1 billion to construct, while the total NHS budget in 2018-19 was around £114 billion. In 2023, every 1% pay increase for NHS workers on the Agenda for Change pay scale, which includes nurses and midwives, would cost around £700m – a drop in the ocean compared to the amounts of annual spending implied by our counterfactual. An extra £91bn in 2019, as implied by our counterfactual scenario, would be enough to fund the entire education budget. It is easily enough to “end austerity”, on the terms Resolution Foundation offered, which costs a relatively smaller £30bn.<sup>34</sup>

Alternatively, one could consider the potential impact on levelling up. A number of observers have concluded that the amounts of money pledged by the Johnson administration are

---

<sup>32</sup> See the Policy Measures Database at <https://obr.uk/data/>.

<sup>33</sup> In 2019 prices, the Warwick CAGE/LSE “Wealth Tax Revenue Simulator” suggests CGT equalisation would be worth £13bn. From the OBR Policy Measures Database, the cost of the Personal Allowance increases in 2019 was £23.1bn and the Corporation Tax cuts was £7.39bn. See Persaud (2017). Note that increases in personal allowances significantly affect the richest:

<https://equalitytrust.org.uk/blog/personal-tax-allowance-how-increase-widens-inequality>

<sup>34</sup> Resolution Foundation (2018).

completely inadequate to reverse a decade of cuts to local authority funding – let alone correct the regional inequalities that existed before austerity. Many point to the experience of Germany, in which €2 trillion was spent on the reunification of East and West Germany between 1990 and 2014, or around £71 billion a year.<sup>35</sup> This is comparable to the extra spending implied by our counterfactual increase in UK public sector spending between 2011 and 2019.

## Fiscal space

---

One of the major defences of post-2010 austerity is that it increased fiscal space in advance of the emergency spending required during the Covid-19 pandemic.<sup>36</sup> In other words, if the public debt to GDP ratio had been higher in 2019, it would have been more difficult for the government to support the economy with deficit spending in 2020.

Leaving the merits of this argument to one side, our proposed counterfactual increase in public sector spending between 2011 and 2019 would have resulted in a lower debt to GDP ratio than the ratio that actually occurred. This is a trivial implication of a balanced budget expansion – which leaves the time path of borrowing unchanged – and a positive multiplier. Debt would have been the same, but GDP would have been higher, and thus the debt to GDP ratio would have been lower. An illustrative scenario for the debt-to-GDP ratio (excluding public sector banks and the Bank of England) for a multiplier equal to 1 is displayed in figure 15. The counterfactual value of the public debt in 2019 is just over 70% of GDP – or 3 percentage points lower than the actual debt-to-GDP ratio in 2019.

So a fiscal policy mix involving both higher spending and taxation after 2010 would have resulted in greater fiscal space for the government in the run-up to the pandemic. It would have prevented the collapse in public services that the country has experienced over the last decade, and it would have avoided the exploitative destruction of bargaining power suffered by workers – particularly women and the lower paid – over the same period.

Why, then, was such a policy not followed? It was, in part, a distributive choice. Figure 16 plots average household wealth by decile (measured between April 2018 and March 2020). There is, clearly, a direct trade-off between the private consumption of those households with significant asset holdings, and the public consumption of those households without. More simply, there is a direct tradeoff between private and public consumption. Lower taxes mean higher private consumption, at the expense of fewer (and more badly paid) nurses, teachers, and other public servants. After more than a decade of austerity, the UK lives with private affluence – if only for the privileged few – amid public squalor. This did not have to be the case, and does not need to be the case in the future.

---

<sup>35</sup> Enenkel (2021).

<sup>36</sup> See, for example, the comments by Rupert Harrison, chair of the Council of Economic Advisors and Osborne's lead economic advisor, 2010-15: "that hard work [of austerity] made policies like furlough and the energy cap possible", Twitter, 17 October 2022: <https://twitter.com/rbharrison/status/1581935959704481793>

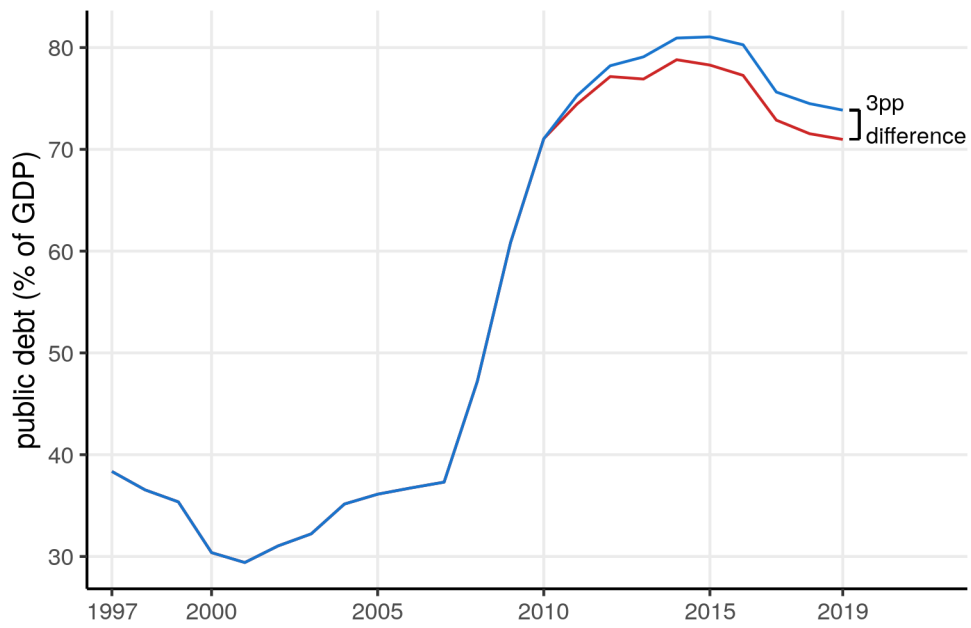


Figure 15: Public debt ratio counterfactual (actual in blue, 3% growth balanced budget expansion scenario in red).

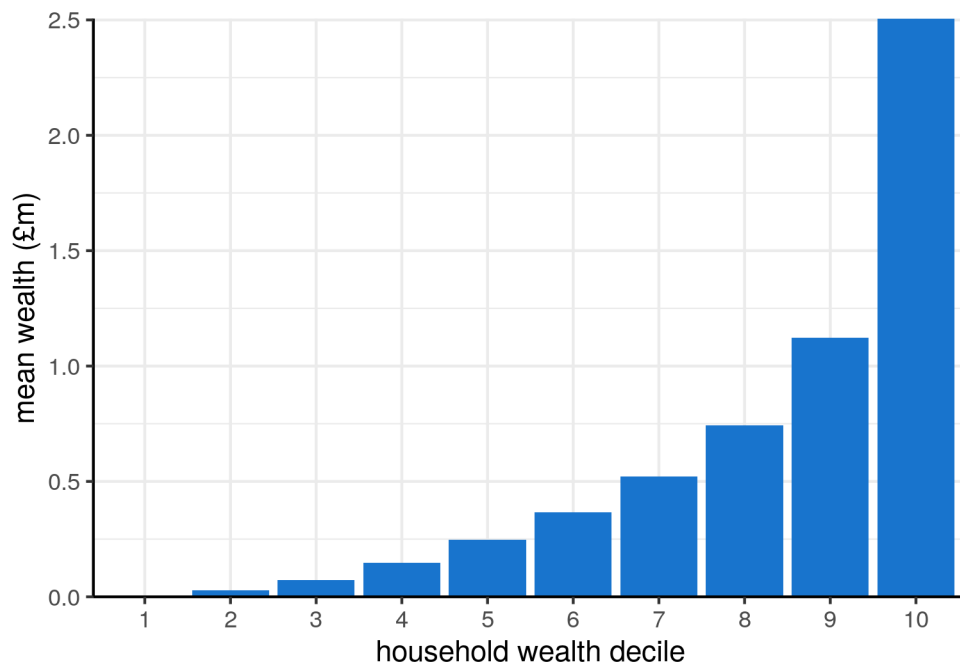


Figure 16: Mean household wealth in Great Britain by decile between 2018 and 2020.

## Breaking the doom loop

---

We have shown how austerity in Britain was justified, by government ministers and supporters alike, by reference to its supposedly positive effects on confidence and therefore its expansionary effects on aggregate demand.

In reality, however, austerity worked by a brutally exploitative mechanism, reducing earnings while increasing employment. Productivity flatlined while public services collapsed.

The latest round of austerity, this time proposed by Chancellor Jeremy Hunt in the government's November 2022 Autumn Statement,<sup>37</sup> comes after 12 years of cuts from Osborne onwards. This is a key difference, and has led to Tony Danker of the CBI describing an austerity "doom loop": spending cuts weaken the economy, leading to reduced tax revenues and higher debt, to which the response is yet more austerity.<sup>38</sup> Elsewhere, the Trades Union Congress has made the same point.<sup>39</sup>

Exploitative austerity generated a lose-lose-lose for the UK economy after 2010, leading to stagnant productivity, falling living standards, and worse public services. For as long as some part of the population was insulated from its worst effects, this programme could be sustained. And for much of the decade, the political balance held. Gradually, however, the impacts of austerity became unavoidable, and it was only after the political shocks of the Brexit referendum and the 2017 general election that the Conservative Party began to talk about ending austerity, before actually reversing some of the cuts under Prime Minister Boris Johnson in 2019.

In fact, some academics have argued that austerity was an important cause of the voting patterns that delivered the Brexit referendum result in 2016.<sup>40</sup> This casts doubt on the relevance of the argument – made by some – that the UK's economic woes are exclusively the result of Brexit, and have nothing to do with austerity.<sup>41</sup> As we have shown in this paper, a number of obvious structural breaks occurred after the financial crisis and austerity, and well before any impacts of Brexit were felt. Nonetheless, Brexit – Osborne and Cameron's other major legacy – compounds the effects of the exploitative austerity in the years which preceded it.

It took substantial political shocks to dislodge austerity. It will take many more years, with significant amounts of spending and political commitment, to undo the damage that has been already done. And yet, confronted by the financial shock of market reactions to the "mini-Budget" of September 2022, the current government is committing to further rounds of

---

<sup>37</sup> HM Treasury (2022). Further spending cuts are scheduled, in this programme, to return from the financial year 2024-25 onwards.

<sup>38</sup> Partington (2022).

<sup>39</sup> Tily (2023).

<sup>40</sup> Fetzer (2019).

<sup>41</sup> See, for example, Gauke (2023).

spending cuts from 2024 onwards. This is the “doom loop” in action: failure and crisis provoking actions that helped produce failure and crisis in the first place.

This stubborn attachment to austerity, despite its political unpopularity and obvious economic downsides, suggests more than only a political failure, or a poor choice of policy. It suggests a broader institutional failing, locking our political and economic systems into underperformance and failure. We suffer from permanent austerity as a result of *systemic failure*. Economic policy is generated, implemented and sustained across multiple institutions in Britain. Although the Treasury takes a lead on fiscal policy, since 2010 its decision making has been conditioned by the forecasts of the Office for Budget Responsibility.

Meanwhile, the Bank of England has been setting operationally independent monetary policy since 1997, subject to a mandate set by the Treasury. Other government departments also set their own policies on specific subject areas, from corporate law to research spending, and Number Ten has maintained its own economic policymaking function – occasionally clashing with the Treasury and others.

Beyond government, the Institute of Fiscal Studies occupies a prominent place as the presumed authority on economic policy, habitually deferred to by the media and political parties. The failure that produces austerity is a failure produced by this system in total, with the bias reinforced by multiple, different actors. The Treasury is the dominant force in this policymaking system, setting the pace and direction for the rest, but it is not the only factor at work.

One institutional element of this systemic failure has been assessed recently by the BBC’s “thematic review” of its coverage of fiscal and macroeconomic topics. The review did not find evidence of political bias, skewing coverage towards the government, so much as broader institutional failings ranging from political journalists’ lack of knowledge of economics, to the reliance on a limited number of trusted “experts” to the exclusion of broader debates.<sup>42</sup> These findings closely align with those of other, academic assessments of the media’s reporting of economics.<sup>43</sup>

Another aspect of this failure has been the continued making (and breaking) of fiscal rules. It is possible to argue that ever-changing economic circumstances require ever-changing fiscal rules, but this cannot explain the regularity with which the government’s borrowing targets were revised from 2010 onwards.<sup>44</sup> Yet another aspect of institutional failure has been the reliance on a very small number of institutions to pass judgement on fiscal strategy, most notably the IFS and OBR, and the overwhelming dominance of ex-Treasury officials in those institutions.

---

<sup>42</sup> Blastland and Dilnot (2022).

<sup>43</sup> Berry (2019); Wren-Lewis (2018).

<sup>44</sup> We discuss this point further in appendix D.

## Policy recommendations

---

So how can the doom loop be broken? As we have shown, increasing public expenditure by 3% a year as part of a balanced budget expansion would have resulted in over £90bn of extra public spending by 2019. The United Kingdom's governing class needs to recognise that public squalor, alongside private affluence for the few, is deeply unjust and highly inefficient. Rebuilding public services, funded by progressive taxation, is the only way to break the doom loop of austerity.

The starting point for any change is a recognition of austerity's failure and a commitment to avoid it in future. For a new government, this would ideally take the form of **a clear manifesto statement against spending cuts**, setting the direction for the party and the civil service, and expectations for wider society. But such a commitment will plainly not be enough: the 2019 Conservative government was elected on such commitments, but, confronted by a crisis, is looking to return to spending cuts. The institutional failures also need addressing.

Some of these will be outside the reach of the government, and the remit of this paper. The BBC Board's pledges to act on the findings of the "thematic review", for example, are positive,<sup>45</sup> but not something a government should immediately involve themselves in, for obvious reasons. Similarly, the over-reliance on the IFS as a single source of presumed authoritative fiscal analysis is not something that the government can plausibly change, but the emergence of new organisations able to credibly commentate on fiscal and economic policy has helped ease the systemic failing at this critical point.

This government can, however, still do much to reshape the wider system and set its direction. Control of the Treasury is critical to this.

### - **The requirement for credible, functioning fiscal rules**

The repeated failures of the government's fiscal rules, with seven different iterations of supposedly cast-iron rules between 2011 and 2022, were an integral part of the systemic failure. One response to this is to discard fiscal rules entirely, since (in theory) there are few reasons to place restrictions on the tax and spending decisions of the government. But in practice this means both allowing the Treasury to write its own rules, and failing to signal to the wider system the direction that is intended. It will not end the systemic bias towards austerity.

Instead, a robust, credible fiscal rule could be provided by the government, to act as a framework for its own decisions, a "lock" for the Treasury, and a clear signal of intent for the wider system. In place of the pro-austerity biases of the succession of fiscal rules seen over the last decade and more, an ideal fiscal rule would operate in line with macroeconomic principles, including the capacity for substantial government borrowing as needed, and build in sufficient flexibility to respond appropriately to shocks. In outline, this is likely to mean operating a clear

---

<sup>45</sup> BBC Board (2023)

distinction between current and capital expenditure, and the use of a rolling target for any deficit target, as well as provision for exceptional economic shocks (like the financial crisis or covid).<sup>46</sup>

**- The Office for Budget Responsibility should become more independent**

Although the OBR has established a very good reputation for the quality and independence of its advice and analysis since being established in June 2010, its remit prevents the office from operating as a genuine source of impartial macroeconomic advice. Unlike the USA's Congressional Budget Office, its staff and its capacity is not made available to opposition parties, and still less to MPs and others, restricting its remit to commentaries only on the activities of the Treasury. This, inevitably, skews its analysis towards the priorities of the Treasury.

Expanding the OBR's research and forecasting capacity, and making it report directly to Parliament, would make the OBR more obviously an independent source of macroeconomic advice. Allowing the OBR to report more widely on not only government but also opposition party and other proposals would significantly improve the quality of macroeconomic discussion in general. Finally, the OBR itself could introduce more clarity about the necessarily uncertain nature of its own forecasting through the expanded use of alternative scenarios and fan charts in its output, as the Bank of England now does habitually. Recognition of this uncertainty could include recognition of a range of estimates for its multipliers.

---

<sup>46</sup> Portes and Wren-Lewis (2014) provide the theoretical case for such a rule.

# Appendices

---

## Appendix A: Detailed data sources for figures

- Figure 1: ONS series cpof and bktl. Downloaded from <https://www.ons.gov.uk/>. This (and all other data) downloaded February 2023.
- Figure 2: ONS series j5ii, jw2t and bktl. Downloaded from <https://www.ons.gov.uk/>.
- Figure 3: See the OBR' December 2019 databank at <https://obr.uk/public-finances-databank-2019-20/>, and <https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ebaq/bb>
- Figure 5: OECD Gross domestic product per capita, constant prices, growth rate; series T\_GDPPOP\_V. Downloaded from <https://stats.oecd.org/>.
- Figure 6: ONS series lf9d, downloaded from <https://www.ons.gov.uk/>; ONS average weekly earnings EARN01 <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01>
- Figure 7: ONS analysis, Figure 3 of <https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/labourproductivity/articles/ukproductivityintroduction/octobertodecember2018>
- Figure 8: OECD Growth in GDP per capita, productivity and ULC: Growth in GDP per capita and labour productivity (GDP per hour worked, constant prices). Downloaded from <https://stats.oecd.org/> February 2023.
- Figure 9: OECD gross fixed capital formation (P51) and gross domestic product (B1\_GE) at current prices, downloaded February 2023.
- Figure 10: Net exports (ONS series ktmy) and GDP (bktl), downloaded February 2023.
- Figure 11: Employee and self-employment counts from the “annual population survey - regional - labour market status by age” tables in NOMIS, for population aged 16-64, observations in the 12 months to December for each year. Downloaded February 2023.
- Figure 12: Persons on zero hour contracts from the ONS EMP17 dataset, downloaded from <https://www.ons.gov.uk/> February 2023.
- Figure 13: ONS series kx5q, downloaded from <https://www.ons.gov.uk/> February 2023.
- Figure 14: <https://www.bankofengland.co.uk/boeapps/database/Bank-Rate.asp> for Bank rate history. CPI series d7bt downloaded from <https://www.ons.gov.uk/>, February 2023.
- Figure 15: See sources for figure 1.
- Figure 16: “Distribution of household total wealth and its components by total wealth decile: Great Britain and London, April 2018 to March 2020” ONS user request, downloaded from <https://www.ons.gov.uk/>, February 2023.



## **Appendix B: Further reading on austerity, the financial crisis, and productivity**

In this paper we make a connection between austerity, increasing employment, and stagnating wages. This labour market mechanism of austerity is one of the ways in which cuts to government spending were predicted to increase output, made in various papers in the expansionary fiscal contraction literature in the late 1990s and early 2000s (Alesina and Perotti, 1997; Alesina et al., 2002; Ardagna, 2004). In fact, Ardagna (2004) suggests that the labour market mechanism is more important, empirically, than the stance of monetary policy or exchange rate devaluations, and more robust than the expectations channel emphasised by George Osborne.

All else equal, a decrease in bargaining power associated with a policy change like austerity will be associated with falling wages and increasing employment. If GDP continues to grow at roughly the same rate as before, then productivity will stagnate. The obvious counter-argument to the role of austerity in this chain of events is that the financial crisis led to the fall in UK productivity after 2009, and thus the fall in wages, which in turn led to households supplying more labour to maintain overall earnings. This is essentially the argument in Bell and Gardiner (2019), who argue that a “global financial crisis and the biggest recession in living memory” led to a fall in incomes, and to households increasing their supply of labour to make up for this. They reject the argument that “microeconomic causes” following the actions of policy makers played an important role in the employment boom after 2010.

There is a well-known lending channel by which financial crises can lead to lingering negative effects on productivity. However, the evidence for this lending channel is not clear-cut for the UK after 2009. Riley et al. (2014), for example, found that bank lending to businesses did decline after the crisis, but firms that were relatively dependent on bank lending did not grow more slowly than other firms, which would be expected if banking sector impairment was the key factor holding back productivity growth after 2009. The obvious alternative hypothesis for stagnant productivity, as they point out, emphasises labour market flexibility and the willingness of workers to accept pay cuts.

Moreover, using 2011 data from the Workplace Employment Relations Study, Bryson and Forth (2016) found that productivity did not become a more commonly reported consideration in firm-level wage setting as a result of the recession, which one would expect if falling wages after 2010 were driven by an exogenous (to the labour market) fall in productivity. They offer a complex picture of changes in labour relations pre- and post-crisis, but suggest that firms were more likely to take advantage of flexibility via shift-working, fixed-term and temporary contracts, freelancers, agency workers, and so on, in 2011 compared with 2004. Notably, this type of flexibility was associated with weaker productivity and lower workplace performance.

Ultimately, observational equivalence limits the extent to which macroeconomic shocks, let alone their underlying causes, can be identified. Nevertheless, as we have argued in this paper, there is significant evidence in support of the “expansionary fiscal contraction” theorists’ prediction of a labour market mechanism for austerity.

## **Appendix C: Further reading on austerity**

An enormous amount has been written on the economics and impacts of austerity in the UK, and we cannot do complete justice to the literature here. Nevertheless, a good place to start is the book-length treatment in Blyth (2013).

For a useful discussion of the political economy of austerity, see Konzelmann (2014).

The consequences of austerity on public health have been covered particularly widely; readers can refer to Loopstra et al. (2016), Stuckler et al. (2017) and Dorling (2019). Marmot et al. (2020) is particularly damning.

For an argument that austerity was a causal factor behind the Leave vote in the 2016 Brexit referendum, see Fetzer (2019). For readings on the intersection of gender and austerity, readers can consult Karamessini and Rubery (2013) and Bargawi et al. (2016).

The original literature on expansionary fiscal contractions tended to rely on a small number of case studies, in which certain countries managed to shrink their budget deficits alongside increasing their growth rates. Ireland's experience in the 1980s is commonly touted as a case study for the positive effects on growth of fiscal consolidations; Kinsella (2012) pushes back against this argument.

Aside from the straightforward implications for labour productivity of the type of exploitative austerity discussed above, there are various ways in which austerity might harm total factor productivity growth. Public capital expenditure, particularly on infrastructure, is usually understood to increase total factor productivity, and this tends to be cut relatively quickly in periods of austerity. Similarly, the types of 'structural reform' that often accompany austerity can drive resources into inefficient uses, further harming productivity. Bardaka et al. (2021) is the only existing paper that attempts to measure the longer term effects of austerity on total factor productivity, and finds these to be negative and persistent.

For overviews of the original arguments in favour of expansionary fiscal contractions, see Alesina and Perotti (1997), Alesina et al. (2002), and Ardagna (2004). Again, this is a large literature, and some of these authors became less willing to support post-2010 austerity policies after they had been implemented, and the consequences had become more obvious.

A large number of economists consistently opposed austerity from the start. Paul Krugman and Jonathan Portes were very vocal, as were Victoria Chick, Ann Pettifor, and Simon Wren-Lewis (Chick and Pettifor, 2010; Wren-Lewis, 2011). Lord Skidelsky organised a letter to the Financial Times in opposition to austerity in February 2010, co-signed by a significant number of economists, including the Nobel memorial prize winner Joseph Stiglitz (Skidelsky, 2010). One of the co-signatories, David Blanchflower, was also very vocal at the time. Later polls of academic economists consistently found a majority in opposition to the policy (Chu, 2015).

## Appendix D: The failure of fiscal rules

A good indicator of the strains that austerity placed on a weak economy was the cycling through successive fiscal rules over the period 2010-19. The stated intention of a fiscal rule is to provide a robust framework for a government's tax and spending decisions, and so provide a good guide to the likely future course of government borrowing, and therefore the government's debt. A desired outcome from this can be a reduction in any political risk premium against either government borrowing costs, or the value of a freely-floating currency, or both together.

Under Gordon Brown's Chancellorship, from 1997 to 2007, the fiscal rule had been the so-called Golden Rule, formulated very early in the Labour government's time in office, with the government committing to borrow only to invest and attempting to run a balanced current budget "over the economic cycle".<sup>47</sup> This was backed up with a "sustainable investment rule", which was that the government would keep the debt to GDP ratio below 40%. The requirement to balance "over the cycle" was attacked by Labour's opponents at the time, and then after the 2008 crash, as failing to look forward to the course of the deficit and the debt in the future, and (crucially) allowing the Treasury too much leeway to determine where the cycle began and ended. These criticisms may have been overplayed: the Office for Budget Responsibility's first director, Alan Budd, in his assessment of Labour's fiscal policy found that "the Government could claim that both its fiscal rules were met over the period from 1997–8 to 2006–7 with a comfortable margin".<sup>48</sup>

Osborne's creation of the Office for Budget Responsibility (OBR), which was intended to be an independent body scrutinising the government's plans against its new rules, and generating unbiased forecasts, was one part of his solution to this alleged deficiency. The creation of a new fiscal rule was the other.

But if the Treasury had altered its own assessment of the cycle on two occasions between 1997 and the crash of 2007, and on each occasion this had tended to expand the government's room to borrow, successive Conservative Chancellors had been pushed to revise not their forecasts and underlying assessments of the economy – these were now in the hands of the OBR – but the very framework of the rules on six separate occasions, updating their Charter for Budget Responsibility every time.

These rule shifts since the beginning of austerity are detailed in table D.1 below.

It can be argued that changing economic circumstances knocked the government off-course, requiring a flexible approach. The pandemic was certainly a dramatic, largely unforeseen global event with catastrophic economic consequences, and no-one would reasonably expect a fiscal rule designed for normal times to operate during it. But it is harder to make the case that major, unforeseen external events were otherwise responsible for persistent rule failures and changes.

---

<sup>47</sup> As detailed in the 1998 *Code for Fiscal Stability*.

<sup>48</sup> Budd (2010).

**Table D.1: Fiscal rules since 2010**

April 2011 Charter	Fiscal mandate	A forward-looking target to achieve cyclically-adjusted current balance by the end of the rolling, 5-year forecast period
	Supplementary debt target	A target for public sector net debt as a percentage of GDP to be falling at a fixed date of 2015-16
March 2014 Charter	Fiscal mandate	Same as 2011
	Supplementary debt target	Same as 2011
	Welfare cap	The cap on welfare spending, at a level set out by the Treasury in the most recently published Budget report, over the rolling 5-year forecast period, to ensure that expenditure on welfare is contained within a predetermined ceiling
December 2014 Charter	Fiscal mandate	A forward-looking aim to achieve cyclically-adjusted current balance by the end of the third year of the rolling, 5-year forecast period
	Supplementary debt target	An aim for public sector net debt as a percentage of GDP to be falling in 2016-17
	Welfare cap	Same as March 2014
October 2015 Charter	Fiscal mandate	In normal times, once a headline surplus has been achieved: a target for a surplus on public sector net borrowing in each subsequent year; for the period outside normal times: a target for a surplus on public sector net borrowing by the end of 2019-20
	Supplementary debt target	For the period until 2019/20 a target for public sector net debt as a percentage of GDP to be falling in each year
	Welfare cap	Same as March 2014

January Charter	2017	Fiscal objective	Return the public finances to balance at the earliest possible date in the next Parliament
		Fiscal mandate	To reduce cyclically-adjusted public sector net borrowing to below 2% of GDP by 2020-21
		Supplementary debt target	Public sector net debt as a percentage of GDP to be falling in 2020-21
		Welfare cap	A target to ensure that expenditure on welfare in 2021-22 is contained within a predetermined cap and margin set by the Treasury at Autumn Statement 2016
January Charter	2022	Fiscal mandate	To have public sector net debt (excluding the Bank of England) as a percentage of GDP falling by the third year of the rolling forecast period
		Supplementary debt target	A target to balance the current budget by the third year of the rolling forecast period
		Welfare cap	A target to ensure that expenditure on welfare is contained within a predetermined cap and margin set by the Treasury
		Investment limit	A target to ensure that public sector net investment does not exceed 3% of GDP on average over the rolling forecast period
November Autumn Statement	2022	Fiscal mandate	To have public debt (excluding the Bank of England) to be falling as a percentage of GDP by the fifth year of the rolling forecast period
		Supplementary debt target	Public sector borrowing must be below 3% of GDP
		Welfare cap	Same as January 2022

*Source: House of Commons Library (11 July 2022), "The UK's fiscal targets"; HM Treasury, Autumn Statement, November 2022.*

A similar, if smaller, case can be argued for Brexit - a largely unexpected economic shock to which the authorities were forced to respond. But the rules were changed regularly, without reference to obvious external factors. Far more important were domestic economic circumstances, particularly including the Office for Budget Responsibility's downgrade of its estimate for the UK's underlying (trend) rate of growth.

Those domestic circumstances were influenced first and foremost by the actions of the government. And it was the actions of the government that caused these rule failures. Worse, each rule change was an adaptation around the presumed need to continue supplying spending cuts, rather than representing a fundamental change of direction. The *failure* of each set of rules was, itself, taken as a reason to re-impose further rules which then would also fail in the future.

This has created the perverse situation in which critically important economic principles, like the idea that public investment can help sustain private investment, are abandoned due to "uncertainty", while highly uncertain estimates for constructs like the "output gap" and forecasts for economic performance in five years' time are presented as if they were rock-solid economic facts.<sup>49</sup>

As Liam Stanley has suggested, a form of economic governance in which failure against self-imposed rules is persistent should lead us to treat this as a *feature* of the system, rather than a bug.<sup>50</sup> There is a meta-rule in operation: that whatever the set of *formal* rules that the government presents, the *real* rule of Treasury control and the "Treasury View" will persist. The result is an in-built, systemic bias towards underinvestment and an excessive expansion of fiscal space for the government at the expense of wider economic goals.

These rolling failures of fiscal rules are a crucial link in the austerity doom loop. The rules are set, targets are set – and then repeatedly missed. Covid excepted, the targets are missed primarily because the very weakness of the economy occasioned by austerity makes them too hard to reach. It is as if Sisyphus, having rolled his boulder to the top of the hill, was choosing to roll it back down again himself – a frantic, self-defeating cycle of failure whose costs are typically borne not by those imposing it, but the poorest and most vulnerable.

---

<sup>49</sup> See, for example, Calvert Jump and Michell (2022).

<sup>50</sup> Stanley (2016).

## References

---

*Speeches, data sources, and media are included as direct links in footnotes. All other references are provided below.*

---

Alesina, A., Ardagna, S., Perotti, R., and Schiantarelli, F. 2002. Fiscal policy, profits, and investment. *American Economic Review*, 92(3), pp. 571-589.

Alesina, A. and Perotti, R. 1997. The Welfare State and Competitiveness. *American Economic Review*, 87(5), pp. 921-39.

Altunbuken, U., Bukowski, P., Machin, S., and Slaughter, H. 2022. Power Play: The shifting balance of employer and worker power in the UK labour market. Resolution Foundation: <https://economy2030.resolutionfoundation.org/reports/power-plays/>

Ardagna, S. 2004. Fiscal stabilizations: When do they work and why. *European Economic Review*, 48(5), pp. 1047-1074.

Bardaka, I., Bournakis, I., & Kaplanoglou, G. 2021. Total factor productivity (TFP) and fiscal consolidation: How harmful is austerity?. *Economic Modelling*, 94, pp. 908-922.

Bargawi, H., Cozzi, G. and Himmelweit S. (eds). 2016. *Economics and Austerity in Europe: Gendered impacts and sustainable alternatives*. London: Routledge.

BBC Board 2023. BBC Board response to BBC Thematic Review of Taxation, Public Expenditure, Government Borrowing and Government Debt, BBC, 29 January 2023.

Bell, T. and Gardiner, L. 2019. Feel poor, work more: Explaining the UK's record employment. Resolution Foundation: <https://www.resolutionfoundation.org/app/uploads/2019/11/Feel-poor-work-more.pdf>

Berry, M. 2019. *The Media, the Public, and the Great Financial Crisis*. London: Palgrave Macmillan.

Michael Blastland and Andrew Dilnot, November 2022, Review of the impartiality of BBC coverage of taxation, public spending, government borrowing and debt. London: BBC.

Blyth, M. 2013. *Austerity: The history of a dangerous idea*. Oxford University Press.

Brione, P. and Francis-Devine, B. 2022. Public sector pay. House of Commons Library Briefing 8037.

Bryson, A. and Forth, J. 2016. The UK's productivity puzzle. In: Askenazy, P., Bellmann, L., Bryson, A. and Moreno Galbis, E. (Eds.), Productivity Puzzles Across Europe. (pp. 129-173). Oxford, UK: Oxford University Press.

Budd, A. 2010. Fiscal policy under Labour, National Institute Economic Review, 212, p.R47.

Calvert Jump, R., and Michell, J. 2018. "A remarkable national effort": the dismal arithmetic of austerity. Critical Macrofinance blog post:  
<https://criticalfinance.org/2018/03/07/a-remarkable-national-effort-the-dismal-arithmetic-of-austerity/>

Calvert Jump, R., and Michell, J. 2022. The dangerous fiction of the fiscal black hole. Progressive Economy Forum working paper:  
<https://progressiveeconomyforum.com/wp-content/uploads/2022/11/PEF-Briefing-fiscal-black-hole.pdf>

Chick, V., Pettifor, A., (& Tily, G. in later editions). 2010. The economic consequences of Mr Osborne: <https://www.annpettifor.com/wp-content/uploads/2010/06/Fiscal-Consolidation1.pdf>

Chu, B. 2015. Two thirds of economists say Coalition austerity harmed the economy. The Independent:  
<https://www.independent.co.uk/news/business/news/two-thirds-of-economists-say-coalition-austerity-harmed-the-economy-10149410.html>

Conservative Party, 2010. The 2010 Conservative Party Manifesto:  
<https://general-election-2010.co.uk/2010-general-election-manifestos/Conservative-Party-Manifesto-2010.pdf>

Dorling, D. 2019. Austerity bites: falling life expectancy in the UK. BMJ:  
[https://www.dannydorling.org/wp-content/files/dannydorling\\_publication\\_id7188.pdf](https://www.dannydorling.org/wp-content/files/dannydorling_publication_id7188.pdf)

Enenkel, K. 2021. What can German reunification teach the UK about levelling up? Centre for Cities blog post:  
<https://www.centreforcities.org/blog/what-can-german-reunification-teach-the-uk-about-levelling-up/>

Fetzer, T. 2019. Did austerity cause Brexit? American Economic Review, 109(11), pp. 3849-3886.

Gauke, D. 2023. In defence of austerity. Conservative Home blog post:  
<https://conservativehome.com/2023/01/02/david-gauke-in-defence-of-austerity/>

Hastings, T. and Heyes, J. 2016. Farewell to flexicurity? Austerity and labour policies in the European Union. Economic and Industrial Democracy, 39(3), pp. 458-480.



HM Government. 2010. The coalition: Our programme for government.

HM Treasury. 2021. Economic Evidence to the Pay Review Bodies:

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1038869/Economic\\_evidence\\_.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1038869/Economic_evidence_.pdf)

HM Treasury. 2022. Autumn Statement 2022. London: HMSO.

Karamessini, M., & Rubery, J. 2013. Women and austerity. Taylor & Francis.

Kinsella, S. 2012. Is Ireland really the role model for austerity?. Cambridge Journal of Economics, 36(1), pp. 223-235.

Konzelmann, S. J. 2014. The political economics of austerity. Cambridge Journal of Economics, 38(4), pp. 701-741.

Langella, M, and Manning, A. 2021. Marshall Lecture 2020: the measure of monopsony. Journal of the European Economic Association, 19(6), pp. 2929-2957.

Loopstra, R., McKee, M., Katikireddi, S. V., Taylor-Robinson, D., Barr, B., & Stuckler, D. 2016. Austerity and old-age mortality in England: a longitudinal cross-local area analysis, 2007–2013. Journal of the Royal Society of Medicine, 109(3), pp. 109-116.

Marmot, M., Allen, J., Boyce, T., Goldblatt, P. and Morrison, J. 2020. Health equity in England: The Marmot Review 10 years on. Institute of Health Equity:

<https://www.instituteoftheequity.org/resources-reports/marmot-review-10-years-on>

Office of Budget Responsibility, 2022. November 2022 Economic and Fiscal Outlook:

<https://obr.uk/efo/economic-and-fiscal-outlook-november-2022/>

Partington, R. 2022. CBI warns Rishi Sunak against ‘doom loop’ of public spending cuts. The Guardian (25 October 2022).

Persaud, A. 2017. Improving Resilience, Increasing Revenue: The Case for Modernising the UK's Stamp Duty on Shares. Intelligence Capital, 2017.

Portes, J. and Wren-Lewis, S., 2014, Issues in the design of fiscal policy rules, National Institute of Economic and Social Research, discussion paper 429.

Ramey, V. 2019. Ten years after the financial crisis: What have we learned from the renaissance in fiscal research?. Journal of Economic Perspectives, 33(2), pp. 89-114.

Resolution Foundation 2018. ‘Ending austerity’ will cost the Chancellor over £30bn, press release, 24 October 2018.

Riley, R., Rosazza-Bondibene, C. and Young, G. 2014. The financial crisis, bank lending and UK productivity: sectoral and firm-level evidence. *National Institute Economic Review*, 228, pp. R17-R34.

Stratton, A. and Seagar, A. 2008. Darling invokes Keynes as he eases spending rules to fight recession, *Guardian*, 20 October 2008.

Skidelsky, R. 2010. Letter: First priority must be to restore robust growth. *Financial Times*: <https://www.ft.com/content/84b12d80-1cdd-11df-8d8e-00144feab49a>

Stanley, L. 2016. Governing austerity in the UK: anticipatory fiscal consolidation as a variety of austerity governance. *Economy and Society*, 45(3-4).

Stuckler, D., Reeves, A., Loopstra, R., Karanikolos, M., & McKee, M. 2017. Austerity and health: the impact in the UK and Europe. *European journal of public health*, 27(suppl\_4), pp. 18-21.

Tily, G. 2018. 17-year wage squeeze the worst in two hundred years. Trades Union Congress blog: <https://www.tuc.org.uk/blogs/17-year-wage-squeeze-worst-two-hundred-years>

Tily, G. 2023. From the doom loop to an economy of work, not wealth. London: Trades Union Congress.

United Nations 2019. Visit to the United Kingdom of Great Britain and Northern Ireland: report of the Special Rapporteur on extreme poverty and human Rights, 23 April 2019.

Walker, B. 2022. Voters won't tolerate austerity 2.0, *New Statesman*, 17 November 2022.

Woodford, M. 2011. Simple analytics of the government expenditure multiplier. *American Economic Journal: Macroeconomics*, 3(1), pp. 1-35.

Wren Lewis, S. 2011. The case against austerity today. London, Institute for Public Policy Research.

Wren Lewis, S. 2014. Repeating mistakes, *The Economist*, Dec. 5th 2014.

Wren-Lewis, S. 2018. *The Lies We Were Told: politics, austerity, and Brexit*. London: Policy Press

Zaranko, B. 2022. What is the objective of public sector pay policy? What is it, and what should it be, trying to achieve? IFS Comment: <https://ifs.org.uk/articles/what-should-public-sector-pay-policy-be-trying-achieve>

#### **About PEF**

The Progressive Economy Forum (PEF) was founded and launched in May 2018. It brings together a Council of distinguished economists and academics to develop a progressive and sustainable macroeconomic programme and to foster wider public engagement with economics. It opposes and seeks to replace the current dominant economic narrative based on austerity.

#### **Acknowledgements**

Report layout and design by Daniel Norman ([daniel@planetbproductions.co.uk](mailto:daniel@planetbproductions.co.uk))

#### **Contact details**

Progressive Economy Forum  
180 N Gower St  
London  
NW1 2NB

Email: [info@progressiveeconomyforum.com](mailto:info@progressiveeconomyforum.com)

Phone: 020 7874 8528

Website: [www.progressiveeconomyforum.com](http://www.progressiveeconomyforum.com)

Twitter: [@pef\\_online](https://twitter.com/pef_online)

The views, policy proposals and comments in this report do not represent the collective views of PEF, but the views of the author.

The document can be cited as Calvert Jump, R., Michell, J., Meadway, J. & Nascimento, N. (2023) The Macroeconomics of Austerity: PEF.

The Progressive Economy Forum Ltd is funded by Patrick Allen and is a company limited by guarantee, company no: 11378679.