Buttonwood's notebook

Fiscal policy

What is austerity?

The public view and the economists' view are not always the same

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LOTS of people debate and campaign against austerity, but what exactly is it? Dictionary definitions vary. Merriam-Webster (http://www.merriam-webster.com/dictionary/austerity) defines it as:

"A situation in which there is not much money and it is spent only on things that are necessary"

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Or:

Enforced or extreme economy"

An austere individual would be someone who lives within their budget: that is, who spends less than their annual income. Anyone who has lived through a round of cost-cutting at a company knows it usually involves absolute reductions in spending, a clampdown on expenses (taxis, overseas trips) and staff redundancies.

But that is not what economists tend to mean when they talk about austerity. A government can impose an austerity programme and still spend far more than it receives in the form of taxes; indeed the British coalition government had a deficit of 9.3% of GDP in the first year of austerity, a very high figure by peacetime standards. But because this was less than the 11% of GDP in the year before, it counts as austerity.

What economists generally mean by austerity is a reduction in the "structural deficit" of the government, that is, ignoring the effects of the economic cycle. The automatic stabilisers of the economy mean that the deficit rises and falls as the economy contracts and expands. In a period of economic growth, tax revenues will rise and

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spending on unemployment benefits will fall; the
cyclical deficit will decline (or a surplus will rise) even if the government does nothing at all to change policy.

Keynesians argue that the automatic stabilisers are very useful in a recession since they support demand. A recession means that the private sector (individuals and companies) are trying to cut spending. This may make sense at the individual level but the aggregate level, the effect can be perverse. Overall demand falls, making the private sector even worse off. Government spending can cushion the blow.

Austerity usually involves a government trying to counteract the effect of the automatic stabilisers. Critics warn that this is counterproductive. The overall deficit could actually rise if a government tries to reduce the structural deficit at a time when the economy is weak; if the effect is to reduce GDP, tax revenues might fall even further while spending on benefits goes up.

Another issue is that certain parts of public spending have a tendency to rise because of the ageing population: pensions and health care, for example. Those elements were protected by the British government during the 2010-15 parliament, which thus necessitated (in the government's view) much tighter spending controls on other departmental budgets (welfare benefits for those of working age, for example). When it comes to controlling public spending, a government may have to run fast just to stand still. Again, the British coalition didn't even reduce total public spending by much in real terms (see graph on p11 of this IFS paper (http://www.ifs.org.uk/publications/1791)).

The dictionary definition of austerity that comes closest to the way the term is used by economists comes from Oxford (http://www.oxforddictionaries.com/definition/english/austerity) :

> *"Difficult economic conditions created by government measures to reduce public expenditure"*

But that is not quite right. In theory, a government could try to reduce its deficit purely by increasing taxes; the British government quickly put up VAT to 20%. Raising taxes is generally perceived to be a less effective way of cutting the deficit than reducing spending but there is plenty of room for debate. The governments

that tend to push though austerity tend to come from the right and thus have an ideological preference for lower taxes and a smaller state.

However, defining austerity as an attempt to reduce a structural deficit still creates a problem; how much of the deficit is structural and how much cyclical? That requires economists to have a view of the trend rate of growth of an economy and on the level of spare capacity, particularly in terms of employment. Unemployment has fallen faster in American and Britain than most people expected. Does this mean there is no spare capacity left or is there an army of economically inactive people who might take up work if jobs are plentiful? These are tricky questions to answer.

This uncertainty can create a vigorous debate. In Britain, this has focused on whether the coalition government overdid the austerity, or whether the recovery of the British economy in 2013 and 2104 showed that its policies worked. At the heart of this debate is the issue of whether the government changed course in 2012, and whether it was only this change of course that led to the recovery. David Smith of the *Sunday Times* argued in a recent post (the myth of abandoned austerity (http://www.economicsuk.com/blog/002094.html)) that (using figures from the IFS) far from abandoning austerity, there was fiscal tightening of more than 3% of GDP after 2012.

Simon Wren-Lewis of Oxford, one of austerity's fiercest critics, responded here (http://mainlymacro.blogspot.co.uk/2015/05/mediamacro-myth-makers-fight-back.html) , saying that:

> *"I have never said that austerity was abandoned in 2012. In fact I cannot think of anyone who did."*

And that he had argued instead that the *pace* of austerity had slowed.

As David Smith pointed out in a further blog (http://www.economicsuk.com/blog/002096.html) , this is a slightly surprising response, suggesting that Mr Wren-Lewis does not read the work of Paul Krugman, who wrote in the *Guardian* last month (http://www.theguardian.com/business/ng-interactive/2015/apr/29/the-austerity-delusion) that:

> *"Given the fact that the coalition essentially stopped imposing new austerity measures after its first two years, there's nothing at all surprising about seeing a revival of economic growth in 2013."*

And Michael Klein of Tufts in a *Wall Street Journal* blog (http://blogs.wsj.com/washwire/2015/05/16/eurozone-recovery-and-lessons-about-austerity/) wrote that:

> *"Only when its austerity policies were reversed did the UK economy start to grow again."*

One is tempted to recall GK Chesterton's joke about two housewives, berating each other over the garden fence, that

> *"They can never agree, because they are arguing from different premises"*

All this helps explain why non-economists despair; the profession is still arguing about the causes and cures for the 1930s Great Depression so they may still be debating the current crisis in 2100. At the heart of the problem is that it is impossible to isolate one part of economic policy and run a "control" as in a proper scientific experiment. Was fiscal policy the dominant factor in Britain's economic performance or was it the health of the euro-zone economy, changes in commodity prices that cut into consumer spending, the Fed's success in getting global rates down? We can't be sure.

There is also the problem of "Monday morning quarterbacking" about conditions in 2010. There was no crisis, critics claim, and thus no need to cut the deficit; they cite low government bond yields at the time as evidence. But bond yields are driven by the views of bond investors, which will include their views on fiscal policy. In the run-up to the 2010 election, both the Conservative and Labour parties were emphasising the need to cut the deficit (if not explaining the full details of how they would do it). Nobody was suggesting further stimulus; Labour was simply planning less austerity (as it happens, the deficit has ended up around the level that Labour was aiming for). What would bond yields have been if the government had been promising a 13% of GDP deficit, say? We can't know but it is a fair guess they might have been higher.

And while it is easy to say that no government that borrows in its own currency, and has a friendly central bank, need worry about a deficit, we can't be certain of that either. Mervyn King, then governor of the Bank of England, seemed to endorse austerity in 2010 (http://www.theguardian.com/business/2010/nov/25/mervyn-king-support-cuts-excessively-political) ; would he have authorised more QE if a Krugman-inspired politician had insisted on no changes to fiscal policy? We can't know. But the risk, when a deficit is as high as 11% of GDP, is that the markets lose confidence and push up bond yields, making the fiscal situation even more desperate. The costs of such an outcome are so great that a government can hardly be blamed for trying to avoid it. One can still argue that the way the government cut the deficit was wrong-headed, with far too much focus on cutting investment spending; arguably the bit of spending that has the greatest stimulatory impact.

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