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What Is Austerity?

Anthony J. Evans

When David Cameron spoke about an 'age of austerity' he was describing the economic policy that would come to define his government. But 'austerity' is a misunderstood term. One way to think of it is in relation to the concept of a fiscal stimulus. In the standard Keynesian model, when consumption or investment are subdued, government spending or reduced taxation can 'kick start' the economy and boost output. In theory, governments can run a debt-financed budget deficit. Most stimulus plans will be a mixture of increases in government spending and reductions in taxes. But traditionally, stimulus advocates tend to focus on timely, temporary and targeted spending plans in line with the Keynesian belief that part of any tax cut will be saved.

Fiscal austerity is thought of as the opposite of a stimulus – that is, as the process of significantly reducing the budget deficit, predominantly through spending cuts rather than tax rises. We can immediately see two problems. The first is what we mean by 'significant'. If the budget deficit falls from 9.1% of GDP to 8.9% of GDP, few would treat this as an austerity measure. The second problem is the definition of the term 'predominant'. Few economists advise governments to increase taxes during a recession. This is also true of non-Keynesian economists who would cite supply-side reasons for not increasing taxes in a recession. But what proportion of the austerity package should be spending cuts? George Osborne's original plan was to reduce the deficit with around 75% coming from spending cuts and 25% from tax rises. This was an adaptation of the previous government's plans of 67% spending cuts and 33% tax rises. So the only difference between this government and the last government is the speed and composition of the austerity package, not whether there should be one.

But should we be using the word 'austerity' to describe this reduction in government borrowing at all? The term 'austerity' (which stems from the Greek for 'harsh' or 'severe') became popular after World War II, when government policy led to a reduction in the amount of luxury goods that people could consume. But the 'luxuries' that were being enjoyed prior to the financial crisis were bought with borrowed money and we could not afford them in the long term. Current government policy is an attempt to live within our means: it is a confrontation with reality and a correction of the previous largesse.

So, perhaps the word 'austerity' is inappropriate. But it is also important to look in more detail at the government's plans to understand their true characteristics. Firstly, not all government departments are being treated the same. The budgets for each department (known as 'Department Expenditure Limits') show that total spending is set to *rise* (from £322.5bn in 2011–12 to £330.2 in 2013–14), with more departments seeing an increase in budget than receiving a cut.

Secondly, 'Total Managed Expenditure' (TME) is also set to rise, from £696bn in 2011–12 to £756bn in 2016–17. Although it is the nominal levels that are supposed to matter in Keynesian theory, even in real terms there is little evidence of significant cuts.

Thirdly, the reason the budget deficit is expected to fall is mainly due to increases in tax. Tax receipts are expected to rise from £570bn in 2011–12 to £735bn in 2016–17, and there has been a whole host of tax increases announced over the last few years. So, what we have in reality is private sector, but not public sector, austerity (if austerity is the right word).

Finally, when looking at these figures as a proportion of GDP we rely on notoriously unreliable economic forecasts.

In Figure 1, the blue line shows the ratio of government spending to GDP which is set to peak in 2012 before falling until 2015. However any ratio is simply the product of the numerator (in this case government spending) and denominator (GDP). The ratio is falling, but only because GDP is expected by the government to rise more rapidly than government spending. If we replace the official GDP growth forecast with one at half the level we end up with a rising government spending to GDP ratio as shown by the red line.

There have been some instances where governments have significantly cut government spending and seen growth prospects improve – Canada in the 1990s and Estonia right now are good examples. But in the UK the picture is more nuanced and we can sum it up as follows:

- We are not following an 'austerity' path: if anything we are following a 'fiscal stabilisation' path.
- The government is not cutting its spending but cutting spending projections.
- So far, the main adjustment has fallen on the private sector as a result of increased taxes. There are adverse supply-side consequences of such tax hikes.
- Spending may fall as a proportion of national income, but only if national income grows rapidly.

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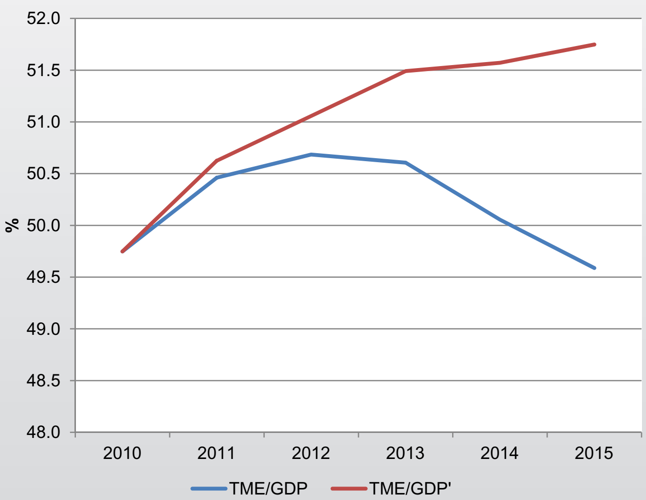
Figure 1: Spending to GDP ratio



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Unicef Conclusions on Inequality Ignore Unicef Evidence on Inequality

Kristian Niemietz

UNICEF's past research on child poverty in developed countries (UNICEF, 2005; 2007) has often attracted a lot of attention in the UK, because it showed British child poverty rates to be remarkably high by international standards. In 2011, the organisation seemed to perform something of a U-turn, now diagnosing that British children and their parents were suffering from far too much consumption rather than too little:

> 'UK parents almost seemed to be locked into a system of consumption which they knew was pointless but they found hard to resist, and found themselves "sucked in"[. . .] Parents and children alike knew that this sort of vicious cycle of consumption would not bring the happiness they intend but somehow they were compelled to continue' (UNICEF, 2011, pp. 45–46).

The recent report, UNICEF (2012), returns to the familiar narrative of widespread child poverty, linked to 'austerity' policies. For critics of fiscal consolidation, the report was just what they had been waiting for. The Independent newspaper (2012) labelled it a 'shock report', and summarised it in the following way: 'Government's spending cuts will have a "catastrophic" effect on British children, a UN agency has warned, endangering their future health, education and employment.'

UNICEF showing some improvement ...

The recent UNICEF report is in many ways an improvement over previous ones. It addresses the weaknesses of relative poverty measures much more explicitly than previous studies have done (UNICEF, 2012, pp. 9–11). In prior reports, UNICEF had claimed, without much hesitation, that the UK had higher rates of child poverty than, for example, Hungary. The current report still uses such figures, but explains what they really mean. There are more British children living in households with incomes below 60% of the British median than there are Hungarian children living in households with incomes below 60% of the Hungarian median. But, since median incomes in Britain are about three times higher than in Hungary, the British relative poverty line itself is higher than median incomes in Hungary. UNICEF still defends relative poverty figures, but urges those who use them to make clear how these figures ought to be interpreted. This is a huge step forward. Currently, one of the most frequent sources of confusion in the poverty debate is that poverty campaigners routinely conflate relative poverty with absolute poverty and/or material deprivation. Relative poverty measures produce high poverty figures and absolute poverty measures often produce alarming descriptions, so poverty campaigners combine the figures of the former with the descriptions of the latter.

This UNICEF report also complements its analysis with a consumption-based child poverty measure, 'Child Deprivation'. It measures the proportion of children lacking goods and services deemed, in a broad sense, 'essential'. There are a number of problems with deprivation measures of this kind, but in the current arsenal of poverty indices, they are by far the best we have.

... But must try harder

On the whole, though, UNICEF remains faithful to the spirit of its earlier studies as far as its policy conclusions are concerned. In previous studies, based on relative measures, UNICEF used to conclude that poverty was largely a function of low public social spending levels (e.g. UNICEF, 2005, pp. 4–5). A similar claim is repeated in this report (UNICEF, 2012, pp. 26–27), this time specifically linked to austerity measures. For the UK, the following narrative is provided: under the previous government, child-related benefits were increased and, as a consequence, child poverty fell. Under this government, child-related benefits are being cut and, as a consequence, child poverty will revert to its former level (ibid. pp. 4–5). This is not an accurate characterisation of the UK experience, and it is not even backed by the UNICEF report's own figures.

It is true that social spending, especially on family-related benefits, has increased hugely over the past 15 years. By the mid-2000s, the British welfare state had reached Scandinavian proportions. In terms of total net social spending, the UK is in the same league as the Nordic (broadly defined) countries. In terms of expenditure on family-related benefits, the UK has even overtaken the Nordics (Table 1). These spending levels are currently being consolidated, but they are not being 'cut', on balance.

But did the preceding spending splurge make a difference? It did – initially. For a while, various measures of living standards at the lower end of the income distribution, especially among families with children, recorded improvements. Yet as soon as the rate of increase in spending slowed down, progress abruptly came to a halt. The poverty reduction strategy had failed to gather any momentum of its own; it was wholly reliant on ever-increasing injections of public spending. As soon as the increase in the funding stream slowed down, progress stagnated and threatened to go into reverse. Poverty reduction

Table 1: Net social spending, total and family-related, % of GDP

	Net social spending in % of GDP (public & publicly mandated)	Family Benefits in % of GDP
Austria	24.8	2.6
Denmark	23.9	3.3
Finland	22.6	2.8
Germany	27.2	2.7
Netherlands	20.4	2.8
Norway	20.0	2.9
Sweden	26.0	3.4
UK	22.7	3.6

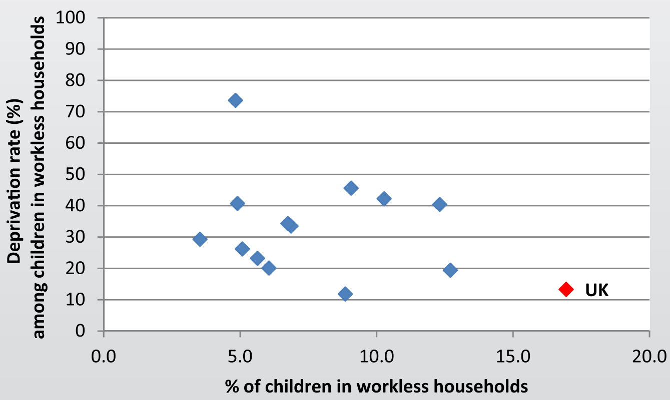
was not about social inclusion and a virtuous circle of increased participation in society and increases in incomes – it was simply about income transfers. Supporters of this state-centric approach realised this, but merely argued that the government should have maintained the initial pace of spending increases.

UNICEF must work harder

One of the main reasons why the redistribution strategy did not, and could not, have developed a dynamic of its own is that it failed to address the underlying socio-economic risk profile. Broadly speaking, there are two developments which can lead to a fall in poverty: the poverty rate within a given risk group can fall, or the size of that risk group can diminish, as more individuals leave it by switching to a low-risk group. For example, the single biggest risk factor for child poverty is parental worklessness. In every single country, children with no parent in employment experience significantly higher rates of deprivation than children with at least one working parent. It is in this context that the UK occupies an extreme position. On the one hand, its deprivation rate among children in workless households is the second lowest in Europe. No other country except Sweden has reduced the poverty risk associated with parental worklessness to such a low level (and even Sweden only leads by 1.5 percentage points). But at the same time, no other country in Europe has such a huge proportion of children in workless households to begin with.

Thus, moving the position of the UK 'leftwards' in Figure 1 ought to be a more obvious policy focus than moving it further 'downwards'. This, however, has very little to do with public spending levels, and a lot to do with labour market institutions and work incentives in the welfare system (see Niemietz, 2011). And yet UNICEF seems to regard rates of parental worklessness as a given, and focuses only on those policy variables that are related to social spending. This is strange because even its preferred relative measure shows that the UK has reached the limits of what income redistribution can achieve. The reason why the UK ends up with a rather high rate of relative child poverty is not a lack of redistribution. When looking at incomes before taxes and transfers (i.e. market incomes), the UK starts off with a relative child poverty rate above 30% – more than twice as high as in the Scandinavian countries, and higher than anywhere else in Europe except Ireland. Through redistribution, the UK then reduces this rate by about twenty percentage points. Thus, the British welfare state redistributes a lot more resources to low-income families than its Scandinavian counterparts. It does not attain a Scandinavian-style income distribution because its starting point is a vastly higher level of market income inequality, due to the extent of worklessness.

Figure 1: Percentage of children in workless households (average 2000–2010) vs. deprivation rate among them, Western Europe



Based on data from Eurostat (2012) and UNICEF (2012)

The key difference between the UK and the Nordic countries is parental employment, not social spending. Even now in the present recession, the share of Swedish and Danish children in workless households has remained below 10% (Eurostat, 2012). Even among single parents, a group which faces particular time pressure, Sweden and Denmark reach employment rates above 80% (DWP, 2010, p. 23), compared with a mere 55% in the UK (Eurostat, 2009). The gap widens further when comparing workloads among those single parents who are in employment. In Sweden and Denmark, three out of four employed single parents work full-time (NOSOSCO, 2004, pp. 14–15). In the UK, the vast majority of employed single parents work between two and three days per week (ONS & HMRC, 2012). Hence, if the UK attained Scandinavian levels of parental employment, it could achieve much greater reductions in child poverty with much lower levels of public spending.

It is a shame that UNICEF ignores its own figures in order to revert to its familiar narrative, in which poverty is always caused by a lack of public spending and lack of redistribution.

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What Causes Recessions?

Richard Wellings

In his last budget as Chancellor, Gordon Brown said 'we will never return to the old boom and bust'. At the time it was hoped that better management would reduce economic volatility. But just three years later the UK had entered a prolonged slump.

Recessions have occurred throughout recorded history and it was perhaps naive to expect that policymakers could prevent them. They are defined as a period of falling output and are typically characterised by high unemployment, a rise in business failures and a drop in the standard of living.

This contrasts markedly with the normal progress of market economies. Driven by the profit motive, entrepreneurs discover better and cheaper ways of providing goods and services – for example, by deploying new technology or developing trade links with more efficient producers. This helps explain why market economies usually grow, but not why they contract in certain periods.

Economists disagree on the most important factors causing recessions, depending on their theoretical approach. There is to some extent a shared focus, however, on the causes of the mismatch between production and demand. During recessions, large numbers of producers struggle to sell their goods, at least at prices high enough to generate a profit. Some of them go out of business, while others shrink their activities to cut costs. This has a knock-on effect across the whole economy as people lose their jobs and make losses on their investments. In this way, problems in one sector, such as housing and construction, can spread to others such as retail.

Entrepreneurs often make mistakes, of course. Many products take several years to develop and by the time they are put on to the market, consumer preferences may have changed. Market prices constantly transmit information about the products consumers want, so at least in market economies there is a feedback mechanism to enable entrepreneurs to adapt to changing conditions and correct their errors. However, the boom periods that precede recessions are typically marked by entrepreneurial error on a grand scale.

Psychology may play a part here. There have been numerous 'manias' throughout history when over-optimistic investors piled into particular sectors, from the 'South Sea Bubble' of the early 1700s, to the 'Railway Mania' of the 1840s and the 'Dot Com boom' of the 1990s. Investors subsequently made huge losses, as projected returns failed to materialise, with negative effects on the wider economy.

Investments may fail as a result of unforeseen changes in circumstances. New technology or competition from abroad might render an industry obsolete, meaning that resources such as labour need to be redeployed. Such developments are beneficial in the longer term but lead to short-term disruption. The 'long depression' of the late 19th century, for example, was influenced by a decline in European agriculture as a result of competition from efficient new farms in the Americas.

Whilst shifts in trade patterns and the adoption of disruptive technologies inevitably have a significant impact on economic activity, generally their impact is too gradual or sector-specific to explain the very pronounced boom-bust cycles that are observed. The most plausible explanations for recessions therefore explain why large numbers of entrepreneurs in different sectors of the economy make bad investments at the same time.

One set of theories focuses on the role of money. When authorities such as central banks create money to stimulate the economy, this distorts investment decisions. An increase in the money supply initially tends to reduce interest rates. These lower interest rates encourage investment, particularly in long-term projects. Such projects would not be viable at higher interest rates because the repayments would be too high.

However, if increases in the money supply are too rapid, the prices of goods and services will eventually rise. Monetary authorities then seek to correct this by raising interest rates, which in turn undermines those investments that are only viable if interest rates remain low.

Theories based around the money supply and interest rates certainly seem to explain the current slump. In response to the mild recession of 2001 and the 9/11 attacks, the US Federal Reserve expanded the money supply to stimulate the economy. Interest rates dropped to very low levels, creating a boom in sectors such as housing and construction. The boom collapsed into bust as rising price inflation forced the Federal Reserve to raise interest rates. Banks reduced lending and investors realised their projects were unsustainable. The collapse of the US housing market helped trigger a wider slump in other sectors and other countries.

Such explanations for recessions suggest policymakers should be cautious in how they respond to economic contractions. By expanding the money supply to boost the economy, the authorities may be sowing the seeds of the next downturn. The causes of recessions are, however, complex and no single theory draws together all the different factors at work. So, the next time someone claims to have abolished boom and bust, the claim should be treated with scepticism.

Further reading

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