AUSTERITY:

A REALITY CHECK

The debate about "austerity" in the UK and Europe rages on. In this context, there has been much talk of how the IMF came close to calling for the UK to "slow down" the pace of its deficit reduction programme.

But the UK deficit has been £120bn since the first full year over which the Coalition had control of the Budget (2011/12), did not fall at all in 2012/13, and is not even planned to fall in 2013/14. How much "slower" a pace of fiscal consolidation could one have than "none whatsoever"?

There are widespread claims that "austerity" has slowed UK growth. Advocates of that view point to the fact that there has been very little growth since 2010 as if that proved the point. But it does no such thing! The economies of many other European states have shrunk markedly since 2010. It's perfectly plausible that the UK economy would, likewise, have shrunk since 2010 if the deficit had been higher. Chemotherapy makes you feel very ill. Does that mean the chemotherapy is bad for you?

No-one said cutting the UK's deficit was going to be any fun. But the reason the austerity was so necessary was because the growth outlook was so bad. Observing that growth was indeed as bad as advocates of austerity said it would be and then blaming the austerity for that is like blaming the treatment for the cancer.

The early phase of the government's deficit reduction programme mainly involved tax rises. Advocates of early spending cuts said at the time that raising taxes early could damage growth and retard deficit reduction. So even if there were evidence that tax rises had damaged growth (which there isn't), that in no way implies that advocates of spending cuts have been proven wrong.

The Reinhart and Rogoff paper from 2010 that has been recently attacked for its calculation errors was not a significant part of the intellectual foundations for the argument for spending cuts.

It was on June 10th 2009 that Cameron's famous Prime Minister's Question Time switch to advocating spending cuts occurred. The widely-discussed November 2009 Policy Exchange paper *Controlling Spending and Government Deficits - Lessons from History and International Experience* that the BBC described as providing the "essential theory" behind the Coalition's 2010 deficit reduction strategy (and which Reinhart has quoted as one of five key papers on fiscal consolidation) was published before Reinhart and Rogoff's paper.

In any case, the particular Reinhart and Rogoff result that unravelled was not one anyone took literally - the notion that growth fell off a cliff, going suddenly negative, at a specific debt to GDP ratio was not something even the authors themselves appealed to strongly.

OVERWHELMINGLY, THE MAIN REASON FOR THE RISE IN THE DEFICIT WAS THAT SPENDING ROSE

On the other hand, the Reinhart and Rogoff claim that higher government debts are, at some point, associated with lower growth is a very old result that has been confirmed in many other empirical studies - the most authoritative recent example of which is that by Cecchetti et al published in 2011 by the Bank for International Settlements.

And there have been many studies showing that deficit reduction programmes

are as often associated with higher as with lower growth, including many produced before the Great Recession - e.g. from the European Commission in 2003.

Planned spending rises and government borrowing after 2007

The rise in the deficit relative to GDP post 2007 did not occur because GDP fell or because the tax take fell during the recession. It was not an automatic consequence of recession; neither was it typical of what happens in recessions. Overwhelmingly, the main reason for the rise in the deficit was that spending rose, as is illustrated in Table 1.

The considerable majority of the spending rise that led to the deficit opening up was not increased capital spending or benefits spending caused by "automatic stabilisers". If certain economists believe that capital spending should be maintained or that we should allow benefits to rise in recessions, then, if we don't touch those items, there is still a useful £75bn of spending cuts that can be obtained by reversing the non-capital, non-benefits spending rises between 2007 and 2010.

IT SIMPLY IS NOT TRUE THAT MAINSTREAM OPINION HAS APPROVED OF RUNNING THE SCALE OF GOVERNMENT DEFICITS WE HAVE SEEN IN EUROPE IN RECENT YEARS

Krugman and Stiglitz are the eccentrics when it comes to fiscal policy

Some advocates of running even higher deficits like to pretend that all mainstream economic opinion is with them, whilst folk like me are, at best, interesting eccentrics. Exactly the opposite is true.

The folk like me are the mainstream economics profession, reflecting the mainstream orthodoxy in macroeconomics as it has been taught for the past 30 years.

The paleo-Keynesians like to quote economists such as Paul Krugman and Joseph Stiglitz, neither of whose central expertise lies in fiscal policy - Krugman is a trade economist who's dabbled in monetary theory, whilst Stiglitz is an expert on asymmetric information models in finance theory.

But if we really must get into an infantile "my economist has a bigger publication list than yours" argument, I would recommend the work of those great minds that produced modern orthodox macroeconomic and finance theory: Robert Lucas Jnr, Eugene Fama and Robert Barro.

And we should be aware that the models of proponents of the "New Keynesian synthesis" do not work the way imagined by those Keynesians who are so vocal in current debates. The "New Classical" and rational expectations revolutions in macroeconomics in the 1960s and 1970s destroyed the intellectual foundations of the sort of old fashioned Keynesianism that is presented by many as "mainstream opinion" today. And, indeed, even an old-fashioned Keynesian would have quailed at most of the proposals of today's paleo-Keynesians.

To put the point another way: if it were 2005 and you asked almost any mainstream economist: "Are there plausible conditions under which running a deficit of 15 per cent of GDP will (a) provide more stimulus than a 12 per cent of GDP deficit and (b) even if it did boost GDP, would it be a good idea?" he or she would have said "no".

It simply is not true that mainstream opinion has approved of running the scale of government deficits we have seen in Europe in recent years. Even Gordon Brown accepted the concept that active fiscal management did not boost output up until 2008.

We can see that it cannot make any sense to maintain that mainstream macroeconomic opinion was in favour of running huge deficits to boost growth when we note that the Maastricht Treaty constrained governments never to run deficits above 3 per cent of GDP.

How can the popular narrative that mainstream macroeconomic opinion maintains that deficit reduction damages growth and is a bad idea in a recession really be plausible when cutting deficits, despite recession, is the policy of virtually all European countries? Are the government economists of virtually all EU countries strange eccentrics?

As Wolfgang Schäuble, German finance minister, recently said: "No one in Europe sees this contradiction between financial policy consolidation and growth".

The US shows that stimulus works, doesn't it?

Some commentators try to find evidence for their case from US experience. They suggest that US

	Pre-recession level of net taxes and NICs as % of GDP	Recessionary trough (% of GDP)	Fall (% of GDP)	Rise in spending as % of GDP	Deterioration in deficit	% of deterioration attributeable to falling tax revenues	% of change in deficit attributes to spending changes
1971/2 to 1973/4	36.3	31.9	3.1	1.7	3.8	82%	45%
1989/90 to 1993/4*	35.4	31.8	3.6	3.8	7.9	46%	48%
2007/8 to 2009/10	36.4	33	3.4	6.8	10.2	33%	67%

Table 1 *Source: Public finances databank*

Notes: During the late 1970s, spending fell as a proportion of GDP, driven particularly by the IMF-required spending cuts. This meant that the deterioration in the deficit was much less than the fall in tax revenues. Tax revenues did not fall relative to GDP during the recession of the early 1980s Note that the last two columns should not be expected to sum to 100% as there is also the change to the operating surplus of nationalised industries

THE UK COULD HAVE GONE THE WAY OF IRELAND AND SPAIN, AND WE MAY DO SO YET

policy shows that a stimulus has created growth by comparing their relatively favourable record with that in Europe.

Quite apart from the fact that the experience of one country in one time period would prove very little, since special factors could be at work, in truth the deficit reduction in the US has been almost identical to that in the UK.

According to OECD figures, the structural deficit for the US fell by 2.60 per cent of GDP between 2009 and 2012, whilst the structural deficit for the UK fell by 2.68 per cent of GDP – surely no-one can seriously claim that a 0.08 per cent difference over three years, equivalent to around £400m per year, is macroeconomically significant?

The difference between the UK and US fiscal approaches lies in rhetoric, not reality (and furthermore the UK and US plans over the next two years are also almost identical).

Fiscal consolidation right then and right now

The reasoning used by proponents of deficit reduction in 2008 still stand:

- Fiscal policy does not provide big boosts to output, but not because of the "crowding out" problem discussed in the early 1980s (i.e. interest rates are driven up by government borrowing, and higher interest rates mean lower investment). In a well-functioning economy, things never reach the point of "crowding out" because "Ricardian" effects kick in first - i.e. households anticipate that higher deficits now mean higher taxes, to pay off debts, later, and so households save more now, thus offsetting the impact of any "injection" that would otherwise be provided by government borrowing. In the models of A-level economics, an increase in "G" (or a reduction in "T") leads to a reduction in "C".
- In a well-functioning economy governments can only increase growth by either spending on things that enhance longer-term growth or by cutting spending on things that damage growth even if they have other benefits (for example, healthcare for the poor).

- In an economy with a bust banking sector, some households may become liquidity constrained (they cannot borrow when they ought to be able to) and, under those conditions, government borrowing can serve as a second-best form of financial intermediation (households borrow today, via the government, paying back tomorrow in tax) thus increasing economic efficiency and hence output. However, if we accept this argument then the correct form of fiscal stimulus is a tax cut. Increasing government spending on inefficient things damages growth whilst cutting taxes may assist with financial intermediation. If governments really want growth, they should cut back on growth-damaging welfare spending and, to the extent that government balance sheets are not over-stretched, be willing to borrow to fund temporary tax rebates.

IT ILL-BEHOVES THE INTERESTING MINORITY THAT IS TODAY'S OLD-FASHIONED KEYNESIANS THAT THEY HAVE ATTEMPTED TO PAINT THEMSELVES AS THE ORTHODOX OPINION. THEY AREN'T. THEY JUST AREN'T

The UK is not like Greece. It is more like Ireland or Spain, with a banking sector vastly larger than the government could afford to bail out. Banking sector problems in Ireland and Spain ruined those governments.

In May 2010 Spanish government bond yields were lower than those in the UK; Ireland was AAA rated until 2009 and Spain AAA rated until 2010.

The UK could have gone the way of Ireland and Spain, and we may do so yet. It may well be true that QE and inflation have saved us from that fate so far. It is simply false to say that the fact that the UK prints its own money makes it impossible for us to go the way of Ireland and Spain in the future. Printing money in the early 1970s did not prevent the secondary banking crisis of 1973-75 – if anything, it caused it.

The UK needs growth and deficit reduction

The UK needs higher medium-term growth, to prevent its banks from going bust. Higher medium-term growth cannot be created by loose fiscal policy (nor indeed by loose monetary policy).

Advocates of ever-larger borrowing say they want growth, but all that fiscal policy can do (even to the extent it is effective at all - which is debatable) is to boost growth for a quarter or two at the expense of a little less growth later.

No serious economist has believed that running massive deficits could boost medium-term growth for forty years. It is simply absurd for some economists to imply there is any orthodox opinion that running larger deficits would increase the medium-term growth rate and that those of us that deny that are fringe eccentrics. Precisely the opposite is true.

The orthodox opinion is that there can be no positive impact on the medium-term growth rate from loose fiscal policy, but that overly-loose fiscal policy could damage the medium-term growth rate.

It is those who claim that more government borrowing could, via convoluted mechanisms, increase the medium-term growth rate who are the interesting eccentrics.

Of course, economists can be heterodox and right. But it ill-behoves the interesting minority that is today's old-fashioned Keynesians that they have attempted to paint themselves as the orthodox opinion – either in academic or in policy-making terms. They aren't. They just aren't.

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