WHO IS WINNING THE BATTLE OVER ECONOMIC AUSTERITY?

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Austerity policies are intended to reduce fiscal deficits as a percentage of GDP by cutting government spending or increasing taxes, or both, *and, at the same time,* maintaining GDP growth. Emphasis is placed on "at the same time" since the rigours of policy design require adherence to the implied causality from an induced reduction in the fiscal deficit to the maintenance of, or an improvement in, the rate of GDP growth that is consistent with the recent trend. The economic principles involved relate to the capacity to fill the gap in aggregate demand following the drop in government contributions to aggregate demand by one or more of the following: (1) increased investment by the private sector, (2) increased spending by households, or (3) an improvement in the trade balance (exports minus imports).

The first could follow from an avoidance of the crowding-out effect, which is said to occur when government expenditures continue at the existing rate (or increase) and thereby drive up the market rate of interest and increasing the cost of private sector borrowing.[1] In reference to household spending, since a reduction in government spending will result in a reduction in aggregate income (an increase in tax will similarly lower aggregate income), the gap resulting from austerity is likely to increase for at least the first few periods after the beginning of the austerity program. But if consumers form an expectation that increased income will occur in subsequent periods as a result of the austerity program, then later periods are expected to show progress in both fiscal deficit reduction and GDP growth. Improvements in the trade balance could occur with an increase in competitiveness as a result of the austerity program.

David Cameron became the UK prime minister in March 2010 and, with Chancellor George Osborne, began a mixed austerity program of reduced spending and increased taxes.[2] Some of the proposed cuts in government spending were substantial, but as we have all experienced since the global financial crisis, intentions as reflected in government budgets do not always conform to reality. The wisdom of the austerity program has been discussed widely (see attached references); the focus here is more on the nature of the program and the conclusions that could be drawn from it.

Chart 1 on the next page shows that government spending in the UK remained relatively flat from January 2010 to January 2012 when it rose rapidly and continued an upward trend from the third quarter of 2012.[3] This is not a pattern of changes that is normally expected for a government that is seriously undertaking an austerity program. The line in the chart should be slanted down, not up. It should, for example, more closely resemble changes in spending by

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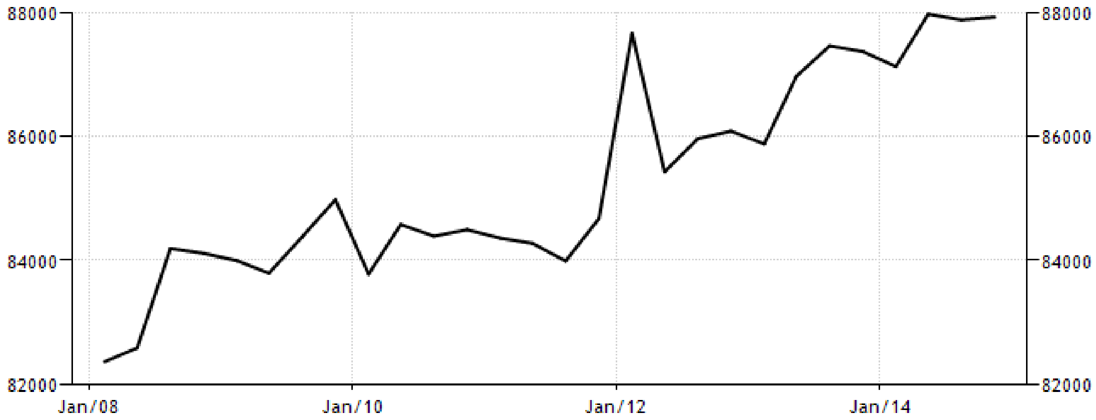
[1] A relatively easy-to-follow discussion of the economic effects of a fiscal stimulus was written by Robert A Hall, "Fiscal Stimulus," *Daedalus*, Vol. 139, No. 4 (Fall 2010), pp. 83-94. Available for purchase at: http://www.mitpressjournals.org/doi/pdf/10.1162/DAED_a_00045.

[2] Details are provided by Larry Liu, "The Austerity Trap: Economic and Social Consequences of Fiscal Consolidation in Europe" Academia.edu, June 2013 at: https://www.academia.edu/4083342/The_Austerity_Trap_Economic_and_Social_Consequences_of_Fiscal_Consolidation_in_Europe.

[3] The chart does not provide sufficient detail to discern numerical values, but they can be stated as £84, 578 million in Q2 2009, £83,988 million in Q3 2011 and £87,671 in Q3 2012.

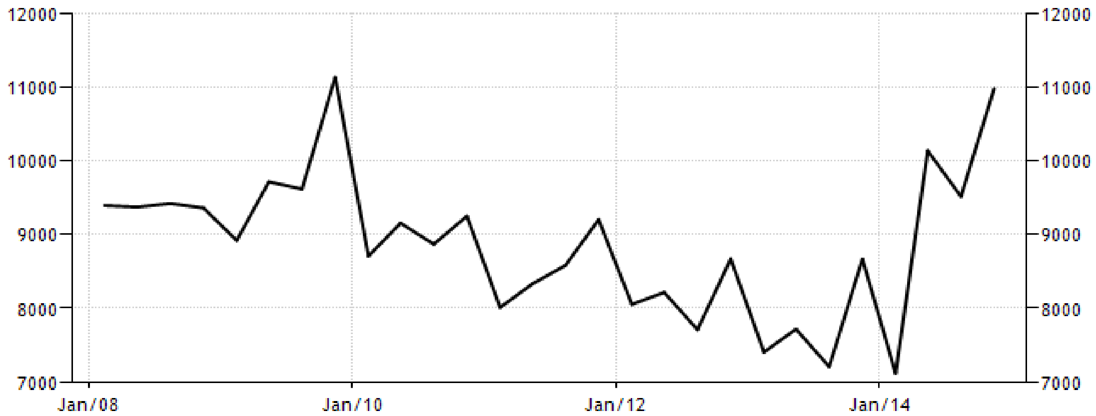
the Greek government (Chart 2). As a result of an apparent failure to sustain economic austerity, the British example should not be considered a fair test for the consequences, good or bad, of having austerity.

Chart 1: United Kingdom - Government Spending
(in millions GBP)



Source: www.tradingeconomics.com with data from UK Office for National Statistics

Chart 2: Greece - Government Spending
(in millions GBP)

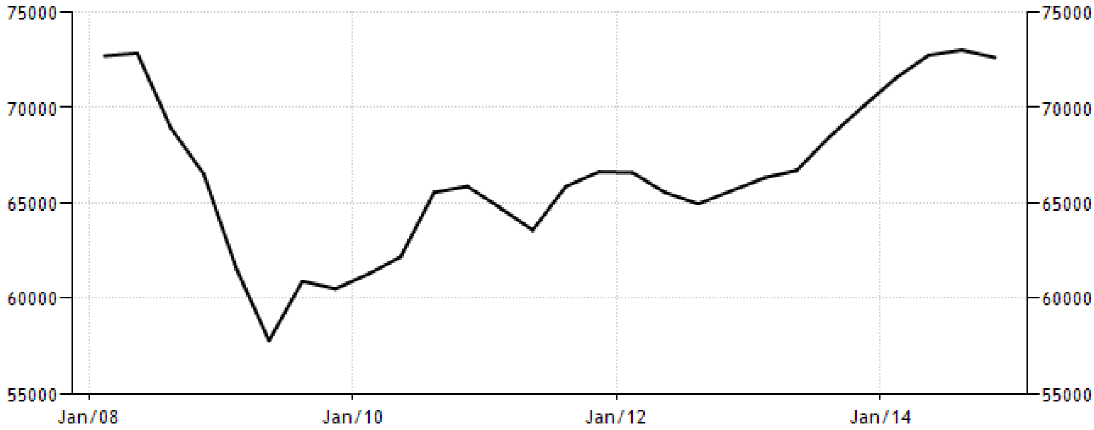


Source: www.tradingeconomics.com with data from National Statistical Service of Greece

The period from January 2010 to January 2012 nevertheless leaves a gap in the trend values of aggregate demand and it is useful to examine whether this was filled by increased investment by the private sector or by increases in household consumption. We can easily rule out increased exports since the current account balance was consistently negative for the UK throughout the entire period (the value of imports was consistently greater than the value of exports).

Chart 3 shows a generally upward trend in gross fixed capital formation in the UK from Q3 2008 to Q4 2014. Taking the period from January 2010 to January 2012 as the gap period, business investment contributed about £5,400 million to the gap, while consumption added slightly less with £4,500 (Chart 4). This occurred despite the greater annual contribution of consumer spending – £262,500 in Q1 2012 – compared to only £66,627 for gross fixed capital formation in the same quarter.

Chart 3: United Kingdom – Gross Fixed Capital Formation
(in millions GBP)



Source: www.tradingeconomics.com with data from UK Office of National Statistics

Chart 4: United Kingdom – Consumer Spending
(in millions GBP)

Source: www.tradingeconomics.com with data from UK Office of National Statistics

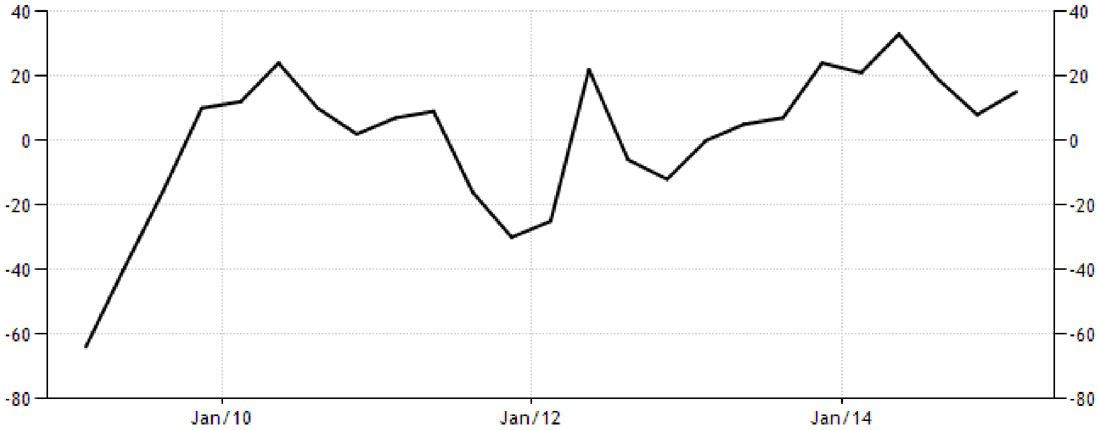
Additional information can be obtained from the charts of business confidence and consumer confidence, particularly in reference to the timing of upswings in confidence during or immediately after the gap period (see Charts 5 and 6 on the next page). Both businesses and consumers gained increased confidence in the UK economy during 2009, most probably as a result of the greater certainty, at that time, that the British banking crisis was over and bailouts would no longer be needed. Consumers, in particular, used that year to restore a portion of their wealth that was lost as a result of declining asset prices in the previous 12 to 18 months. Similarly, both businesses and consumers lost confidence in the UK economy early in 2010, most probably as a result of the uncertainty surrounding the austerity program, as well as a lack of clarity about the crowding-out effect.[4]

Business confidence recovered more quickly with a sharp rise early in 2012, whereas consumer confidence did not improve until the second half of 2013. Some analysts have used this longer period of uncertainty for consumers, relative to businesses, to suggest that it discouraged

[4] There was a need to clarify, for example, how crowding out could occur when interest rates remain the same for a sustained period of time.

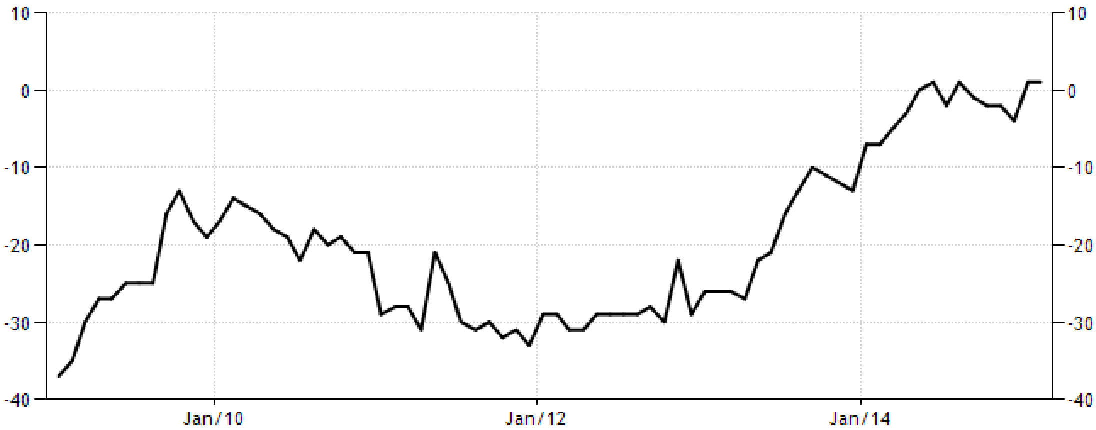
consumer spending that would have otherwise occurred during that period and therefore delayed the recovery in GDP growth rates.[5] Consumer confidence did not return to the pre-crisis level until the beginning of 2014 but then accelerated through 2014, whereas business confidence and business investment remained flat. This gives additional credibility to the argument that Great Britain's recovery is due more to consumer confidence and, subsequently consumer spending, with some assistance from business confidence and spending, than to the austerity program.

Chart 5: United Kingdom – Business Confidence
(in index units)



Source: www.tradingeconomics.com – with data from CBI (UK)

Chart 6: United Kingdom – Consumer Confidence
(in index units)



Source: www.tradingeconomics.com with data from GFK HOP (UK)

So, who is winning – the Austerity team or the Anti-Austerity team? No winner can be declared at this time. The battle is still raging, but on the basis of the information available here, the A-A team is ahead by a small but perhaps comfortable margin. The reason: it is difficult to be persuasive about austerity being the foundation for the return of private sector confidence in the UK when confidence began to rise before the "slash and burn" of government expenditure began, then fell when it picked up speed and finally returned after austerity was quietly phased out. Nevertheless, the final result will not be known until estimates are made of the economic

[5] These are mentioned in the annotated bibliography at the end of the analysis.

cost of the delay in recovery (following what might be called the confidence crisis) and comparing this with an estimate of the gain from the increase in gross fixed capital formation that occurred between January 2010 and January 2012. That is, the increase in private sector investment occurred in the absence of corresponding increases in consumer spending, so the latter can not be regarded as a causal influence. Cameron and Osborne could therefore claim credit for most of it.

This analysis of relevant data from January 2008 to 2014 is useful in pointing out that the failure to undertake a close examination of available information often results in confusion, and this allows misinformation to become rampant. Much of the battle of economic austerity is ideological in the sense that the battlers are determined to perpetuate their prior beliefs. This means that each is reluctant to give ground to opposing beliefs. Misinformation need not be false; it can be inaccurate or misleading. This can occur if relevant information is left out simply because it might otherwise weaken the argument. It is important to think carefully about what we read even if it is written by well known experts.

A SELECTED, ANNOTATED BIBLIOGRAPHY

Alesina, Alberto F, and Silvia Ardagna, "Large Changed in Fiscal Policy: Taxes Versus Spending," National Bureau of Economic Research, Working Paper 15438, October 2009. Available at: http://www.nber.org/papers/w15438.

This is a somewhat technical paper and is not directly related to the recent austerity program in the UK. It is nevertheless relevant in indicating that the effects of macroeconomic adjustments by way of fiscal policy are different from those based upon tax changes. The research suggests that adjustments "based on spending cuts, with no tax increases, are more likely to reduce deficits and debt over GDP ration than those based on tax increases." Theoretical explanations for these results are somewhat thin so it would seem that further research will be conducted.

Gareth Hutchens, "New Treasury Secretary John Fraser Fan of Controversial Economic Theory," *The Sydney Morning Herald*, 4 March 2015. Available at: http://www.smh.com.au/business/comment-and-analysis/new-treasury-secretary-john-fraser-fan-of-controversial-economic-theory-20150303-13tlyj.html.

A noted below, Paul Krugman was aware that the Cameron-Osborne austerity program was quietly abandoned early in 2012, as noted from the charts displayed above. If John Fraser also knew that, it did not emerge in the interview by Gareth Hutchens. Perhaps the secret of success among bureaucratic economists is to say what is expected but also continue to think like an economist. For the latter we must wait and see, but we clearly need a broader and more open debate.

Krugman, Paul, "This Snookered Isle: Britain's Terrible, No-Good Economic Discourse," *The New York Times*, 23 March 2015. Available at: http://www.nytimes.com/2015/03/23/opinion/paul-krugman-britains-terrible-no-good-economic-discourse.html.

The discourse referenced in the title is limited to that which is disseminated by the UK media. Krugman refers briefly to Simon Wren-Lewis of 0xford University comments on his and fellow academics' critique of what Krugman calls the "narrative" of austerity. He is aware that the Cameron government put austerity on hold. That seems to be true elsewhere. Perhaps if we wait long enough it will no longer be an issue. Krugman is nevertheless concerned that it will be a key factor in the approaching elections in Britain and he makes a plea to focus on the "real problems".

Portes, Jonathan "The Economic Record of the Coalition Government: Introduction", National Institute of Economic and Social Research, February 2015. Available at: http://www.niesr.ac.uk/publications/economic-record-coalition-government-introduction#.VRHe4vnQoW8.

This is the introduction to a comprehensive review of the economic polities of UK's coalition government and the opinions express are generally unfavourable: For example, from page 82:

> Today, Britain is at a turning point. The decisions we make now will live with us for decades to come. For many years we have been heading in the wrong direction. Our economy has become more and more unbalanced, with our fortunes hitched to a few industries in one corner of the country, while we let other sectors like manufacturing slide.

The introduction may be freely downloaded. The full report is by subscription only.

Sargent, J R, "Economic Recovery in a Time of Austerity," *Economic Affairs*, Vol. 34, Issue 3 (October 2014), pp. 393-398. Available for purchase at: http://onlinelibrary.wiley.com/doi/10.1111/ecaf.12099/abstract.

The author is Honorary Professor of Economic History at the University of Warwick and, not surprisingly, approaches the austerity issue from an historical perspective. He was apparently one of the first to highlight the role of consumers in recent UK economic recovery experience. He pursued this by way of changes in household savings, which of course is the inverse side of household spending.

Solow, Robert M, "The Bigger They Are …" *Daedalus*, Vol. 139, No.4 (Fall 2010), pp. 22-30. Available for purchase at: http://www.mitpressjournals.org/toc/daed/139/4.

Robert Solow gives a clear and fundamentally sound assessment of the notion that large financial institutions are "too big to fail." This is indirectly related to the issue of austerity since the bailouts of financial institutions were a major cause of the rise in government debt following the global financial crisis. The cost of having such institutions therefore factors into the cost of carrying a large government debt. We tend to forget about this since the major push to get fiscal deficits under control comes from the financial institutions that seek to remain unregulated but nevertheless protected against future crises. Solow also reminds us in this closing paragraph that the issues surrounding banking regulation, and indirectly of austerity, are international"

It is worth adding that international cooperation and alignment are necessary in a globalised world. The temptation to set up pseudo-shop in places where regulations are feeblest would be irresistible –in which case the alternative to tough international agreement could be the Cayman Islands.