THE ECONOMICS OF AUSTERITY

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Abstract

The 2007/8 financial crisis has reignited the debate about austerity economics and revealed that it is a highly contested yet poorly understood idea. This article locates the debate in its historical context, tracing it from the early 18th and 19th century Classical debates, which focused mainly on the means by which fiscal deficits should be financed. As capitalism evolved, so did ideas and theories about the economics of austerity. Following World War One, concerns about high levels of government debt produced the 1920s 'Treasury view' – that government deficits are economically damaging and austerity is required to rein them in. During the 1930s Great Depression, when unemployment was the main concern, this perspective was challenged by the 'Keynesian view' – that government deficits could be economically beneficial during the slump, when the private sector was unable to generate sufficient effective demand to pull the economy out of depression. From this perspective, austerity was the policy prescription for the *top* of the business cycle, to prevent the economy from over-heating and igniting inflation. The 'stagflationary' crises of the 1970s challenged this view; and during the decades preceding the 2007/8 crisis, austerity was considered to be a policy for the *bottom* of the business cycle, when the excesses of a bubble-inflated boom had been revealed by its collapse. In the aftermath of the 2007/8 financial crisis, however, austerity no longer has the *economic* objective of macroeconomic stabilization. Instead, it has become the *objective* itself – demanded by actors in the international financial markets as evidence that governments are serious about managing their deficits and paying back their debts, thereby protecting the financial interests of investors in sovereign debt. However, if austerity undermines economic growth – as it is doing at present – markets are unlikely to remain loyal to those countries suffering the effect. It is therefore important that policy-makers and political leaders learn the lessons of the 2007/8 financial crisis with regard to the economics of austerity – before it is too late.

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'The first requirement for an understanding of contemporary economic and social life is a clear view of the relation between events and the ideas which interpret them. … The hallmark of the conventional wisdom is acceptability … the approval of those to whom it is addressed. … The enemy of the conventional wisdom is not ideas but the march of events. … Keynes … noted that we are ruled by ideas and by very little else. … But the rule of ideas is only powerful in a world that does not change. Ideas are inherently conservative. They yield not to the attack of other ideas but … to the massive onslaught of circumstances with which they cannot contend.'

John Kenneth Galbraith 1999: 6-17

1. Introduction

Recent events have produced a 'massive onslaught of circumstances,' calling into question existing ideas about the relationship between the public sector and the private sector – finance, in particular – and the state's management of the economy. The collapse of the American sub-prime real estate bubble in 2007 was the catalyst for a chain of events, including the failure of a systemically significant financial institution, Lehman Brothers, in 2008. This triggered panic in international financial markets, the effects of which spilled-over into the real economy, creating a crisis of global proportions.

When the conventional wisdom is abruptly called into question, there is a spectrum of possible responses. In this instance, the first was unparalleled, internationally coordinated monetary and fiscal stimulus, followed by massive government rescues of those banks and financial institutions deemed 'too big to fail'. However, the resulting high levels of public debt swiftly led to a revival of the 1920s 'Treasury View', that government deficits are economically damaging (Barro 2009, Cochrane 2009, Fama 2009) – this time because of the likely response of bond traders – and within 20 months of the emergency expansionary measures, there was a sharp reversal of policy, as fiscal *austerity* replaced stimulus.

The catalyst for austerity was the Greek sovereign debt crisis. Fears of a possible Greek default raised concerns about the ability of other Eurozone countries – notably Portugal, Ireland, Italy and Spain – to manage their deficits. Thus, what had begun as a *private* debt crisis morphed into a European *sovereign* debt crisis; and in an effort to calm the bond markets, the European Central Bank (ECB) and the International Monetary Fund (IMF) imposed tough austerity measures as the condition for their assistance. This effectively shifted the burden of the crisis from the private (financial) sector to the state.

With increasingly strident demands for austerity – and equally vociferous arguments against – one might assume that the definition of austerity, its objectives and effects, are clearly understood. However, as Galbraith observed about the tendency for theory to follow events, ideas about austerity economics have similarly evolved – and in certain respects, they have changed beyond recognition since the earliest theorizing some three hundred years ago. The same can be said about the economies within which they were evolved. Yet this lengthy debate has failed to produce general agreement about *what austerity is*, much less *when* it should be applied.

The aim of economic austerity is to reduce a country's deficit – the difference between what the government spends and the revenues it earns. Austerity measures, therefore, include some combination of public expenditure reductions and increased taxes. However, it is not as straightforward as it might, on the surface, appear because public deficits must be financed; and the method of funding – borrowing versus money creation – has economic, social and political consequences of its own. Thus, the *economics* of austerity cannot be meaningfully separated from its social and political context.

The early debate about austerity economics focused on its role in facilitating the funding of national emergencies, such as wars and the national defence. However, with the evolution of capitalism, the debate shifted to encompass emerging expectations of the state and the use of public debt. From a social point of view, conditions produced by the industrial revolution led to the creation of a welfare state in many countries and, hence, an on-going commitment of public finances to social welfare provision. This served to politicise the debate about austerity because a publicly funded welfare state was likely to come under pressure during downturns in the business cycle; but cutting provision to voters would be something that no government could consider, without also taking account of the political implications.

In the wake of the 2007/8 financial crisis, the additional public debt associated with the rescue of financial institutions not only incurred the wrath of bond traders; it also provoked voters – and intensified the discussion about whose interests should take precedence. This has been accentuated by the social unrest precipitated by externally imposed austerity in some of the 'peripheral' Eurozone countries; in cases like Italy and Greece, in addition to a radical rolling back of the welfare state, democratically elected governments were replaced by 'technocrats' – often former Goldman Sachs bankers – charged with the implementation of increasingly extreme policies of austerity. However, as Keynes (1936) observed, financial markets are prone to irrational swings – between unbridled optimism and overwhelming pessimism. So if austerity fails to convince the financial markets that governments are capable of managing their deficits – especially if austerity undermines economic growth – further castigation will no doubt be handed out. This raises the fundamental question of what austerity is actually for.

Politicians contend that austerity is required to 'balance the budget;' it is also aimed at appeasing the bond traders, international financial markets and institutions, such as the IMF and the ECB. In any case, the objective is to make public debt more 'affordable'. However, the manageability of a national debt is not simply a question of the scale of that debt. Since it is determined by the balance between government spending *and* revenues, fiscal debt is easier to manage when times are good. Recognizing this, Keynes argued that austerity should be used at the *top* of the business cycle, to prevent the economy from over-heating and causing inflation. From this perspective, austerity is the counterpart to stimulus, which is the preferred strategy during the slump, when the problem is unemployment.

However, during the decades preceding the 2007/8 financial crisis, due to the reluctance of many politicians to rein in the good times of a boom – combined with the 'overwhelming pessimism' produced when successive boom-inflated bubbles have collapsed – calls for economic austerity have usually been associated with the *bottom* of the business cycle. At these points in time, austerity measures have been presented not only as an economic necessity but also as a *moral* obligation, with the message being framed by the unassailable logic that – having lived beyond our means for too long – it is now the time for frugality and restraint. Some have even gone so far as to argue that austerity can, in and of itself, be expansionary.

From the polarised debate about the economics of austerity, it is clearly far from a simple or well understood concept – and there is no general agreement about what austerity is, when it should be applied or in whose interests it is presumed to operate. The sections ahead examine the social, political and financial developments that have together shaped the debate about austerity economics, thereby locating the current debate within its appropriate historical context. Section two describes the origin of the national debt and its evolution during the 17th, 18th and 19th centuries in response to the changes produced by imperial expansion and industrial revolution. These developments produced the 'Classical' debates about austerity, in which calls for austerity are associated with balancing the government budget during peace-time. Thus, much of the debate revolved around the question of whether the public debt should be financed through borrowing or taxation.

Section three examines the growing concerns about the plight of the urban poor produced by the industrial revolution and the accompanying movements for social reform. This served to politicise the issue of austerity, since public debts, which had previously been primarily a consequence of national emergencies, were now also potentially related to expenditure on social welfare provision. Following World War One, the debate about austerity economics again rose to the top of the policy agenda, as a consequence of the resulting high levels of public debt and the economic challenges of the inter-war years. This is the focus of Section four, which explores the

British ‘Treasury view’ and the ‘Keynesian’ challenge which ultimately ushered in a ‘paradigm shift’ during the decades following World War Two. During this period, calls for austerity are associated with the *top* of the business cycle, when restraint is required to cool-off an over-heating economy and prevent inflation.

Section five examines the revival of pre-Keynesian ‘neo-liberal’ ideas during the turbulent 1970s and the sea-change in economic thought and policy it produced during the decades preceding the 2007/8 financial crisis. During this period, austerity is associated with the *bottom* of the business cycle, when ‘bubbles’ became engines for growth and the devastation caused when they burst produced calls for austerity on *moral* as well as economic grounds. Key dimensions of the post 2007/8 financial crisis debate about austerity economics are explored in Section six. During this period, calls for austerity were increasingly driven by the international financial markets, as ‘credible evidence’ that governments are able to manage their budgets and repay their debts, thereby protecting the interests of investors with financial stakes in government bonds. Section seven draws together the main threads of the analysis and the conclusions that follow from it.

2. The Origins of Long-term National Debt – and the Debate about Austerity

The national debt, in its modern form, is only about three hundred years old; and for much of its history, it has been used to pay for wars, of one sort or another (Graeber 2011). Among the first of the European countries to use public borrowing to fund military expansion was Great Britain. Ironically, the catalyst was a humiliating naval defeat by the French in the Battle of Beachy Head in 1690. This produced a determination to build a more powerful navy; and since funds could not easily be raised through taxation, the Bank of England, a private institution, was established in 1694 to provide the King with money. The industrial effort that followed transformed the economy and spurred domestic and international growth (Hobsbaum 1999). During the early 1700s, England and Scotland merged and the British Empire began to expand. By the end of the eighteenth century, Britain was the dominant colonial power in North America and India; and following the defeat of Napoleonic France in 1815, it enjoyed a century of virtually unchallenged global dominance during which the British Empire grew to span the globe (Parsons 1999).

From the early 18th century, other capitalist countries also embarked on imperial expansion to secure sources of raw materials and markets. Although this incurred public debt, wars for this purpose (if successful) were usually self-funding since the resulting gains in natural resources, markets and tax revenues far surpassed the costs of securing them. Once the new colonies had been acquired, however, they needed to be defended and maintained. These costs were less easy to recoup, especially if the colonies decided to revolt – as the Americans did during the War of Independence (1775-1783). The unpopularity of taxation, its tendency to provoke unrest and its short-term nature, encouraged exploration of alternative methods of public financing; and with these developments came new ideas and theories about public spending and debt.

For the Classical economists of the 18th and 19th centuries, fiscal policy was about balancing the budget; anything else was considered economically destabilizing. Frugality was a cardinal virtue; and it was reflected in the widely accepted principle that government budgets should be in balance, if not in surplus, and that deficits could be tolerated only in extraordinary circumstances, such as war. Substantial and continuing deficits – particularly during peace-time – were interpreted as the mark of fiscal folly. The Classical debate about austerity thus mainly revolved around the question of whether to finance public spending through taxation or borrowing. The fundamental difference was the timing of the payments: taxation placed the burden of payment on taxpayers during the period of expenditure, whilst debt postponed payment until the interest and amortization payments come due. Debt financing thus enabled the shifting of the burden of payment onto others, who (given the timing of payment) may or may not be the same people. The question was therefore about who should shoulder the burden of the debt – and when.

One of the earliest contributors to the debate about the potentially *beneficial* effects of government spending was Isaac de Pinto (1761). His *Traite de la Circulation et du Credit* argued that national debt and stock market speculation in securities played a positive role in fostering credit, increasing the circulation of money and promoting economic well-being. This contrasted sharply with the view of the 18th century British economists. David Hume (1752) and Adam Smith (1776) were concerned about England's sovereign debt crisis (brought about by imperial expansion) and the 'degeneracy' associated with public borrowing. For them, debt financing by government was evidence of profligacy; and it imposed fiscal burdens on future generations of taxpayers. David Ricardo, writing at the end of the Napoleonic Wars, referred to debt as '… one of the most terrible scourges ever invented to afflict a nation.' However, by this time, industrialization was much further advanced than in the late 18th century, when Hume and Smith were writing. Rulers, in league with the mercantilists, were no longer able to threaten economic progress and the national debt was considered less pernicious.

Ricardo's interest was mainly about whether there was an economic difference between the various means available to finance public debt. In his 'Essay on the Funding System,' Ricardo (1820) examined the relative 'equivalence' of financing a war by means of current taxes or by the issuance of government bonds. Although he concluded that there was no real difference, he doubted the practical consequences of this logical conclusion: if people had 'rational expectations', they would be indifferent between the two systems but since they do not, their decisions are distorted by a 'fiscal illusion.' He therefore concluded that 'during peace, our unceasing efforts should be directed towards paying off that part of the debt which has been contracted during war.'

Thomas Malthus took a different point of view. Although he did not devote a chapter to the subject of the public debt and taxation in his *Principles of Political Economy,* Malthus (1836) argued that those living on the interest from the national debt – the 'idle rich' for Smith and Hume – 'contribute powerfully to distribution and demand … they ensure effective consumption, which is necessary to give the proper stimulus to production.' (p. 400). Because employment and incomes for the many depend on the powers of production, Malthus maintained that 'it would be the height of rashness to determine, under all circumstances, that the sudden diminution of the national debt and the removal of taxation must necessarily tend to increase the national wealth, and provide employment for the working classes.' (p. 411)

John Stuart Mill, whose father was a close friend of Ricardo, took a position between those of Malthus and Ricardo. Whilst a proponent of free markets, Mill argued that government intervention was justified in the interest of society as whole. In 'Of National Debt', in his *Principles of Political Economy* (1848), he defended public debt in situations of under-consumption, when 'some amount of national debt is desirable, and almost indispensable, as an investment for the savings of the poorer or more inexperienced part of the community.' However, Mill believed that public borrowing was harmful if it destroyed capital that would otherwise be used for production and employment. In answering the question of whether it is 'expedient to take steps for redeeming that debt,' Hume contended that 'in principle, it is impossible not to maintain the affirmative'.

After Mill, the Classical economists devoted less attention to austerity economics and the national debt, which for Britain and the other developed economies remained relatively low and stable until 1914, with the outbreak of World War One. Although there was debate about the form of financing the national debt, there was general agreement that, except in extraordinary circumstances such as war – or, for those like Mill, social and economic exclusion – every effort should be made to maintain a balance (if not a surplus) in the government budget.

3. From Warfare to Welfare – The Politicisation of Austerity

From the mid 18th century, the industrial revolution brought widespread social and economic change that further influenced the direction of theory and policy with respect to the economics of austerity. In addition to growth, industrialization gave rise to mass urban poverty. According to Herrick (1944: 68), 'The *social problem* … was that created by the concentration of propertyless people in the centers of industry' (emphasis added). The 18th and 19th century emphasis on *individual* freedom, however, meant that solutions were not typically focused on the needs of the collective. But as industrialization progressed, things slowly began to change. In Britain, for example, the Great Reform Acts of 1832, 1867 and 1884-5 granted the right to vote – 'one man, one vote' – to the majority of males. There were also efforts to improve the economic plight of the poor through the provision of cheap food and the encouragement of commercial and industrial expansion; and there was some progress in protecting children. The Factory Act of 1834 and the Education Act of 1870 were the first to put collective interests above individual freedom; they also set precedents for the social reforms of the early decades of the 20th century (Herrick 1944: 70).

Although 19th century legislation had attempted to deal with urban poverty, there was 'growing concern over the obvious increase in the impoverished masses, hopelessly engulfed in city slums' (Herrick 1944: 69). The transition from an essentially agrarian to an industrial economy had brought both increasingly crowded cities and rapid population growth. This caused a sharp deterioration in living and working conditions – especially during the 'second' industrial revolution of the latter half of the nineteenth century. The new cash driven economy marked the beginnings of financialisation, as fewer and fewer people were able to subsist for themselves. Instead, they faced the uncertainties of inflation, securing employment, and the question of what might happen when they were too old to work – if indeed they were lucky enough to live that long.

3.1. The 19th Century Social Reformers: John Ruskin

These relatively rapid changes in conditions produced both innovative thinking and forward-looking economic policies. Amongst those who contributed to early ideas about how society might evolve and be managed as industrialization progressed was John Ruskin. Studying both the history of public debt and the behaviour of successive governments, he concluded that governments had a propensity for expensive warfare:

> 'whether governments be bad or good, one general disadvantage seems to attach to them in modern times – that they are all costly. This, however, is not essentially the fault of governments. If nations choose to play at war, they will always find their governments willing to lead the game ... Nor have we the right to complain of our governments being expensive so long as we set the government to do precisely the work which brings no return.' (Ruskin 1862-63:11)

But Ruskin also had ideas about how government might be turned from being a cost to society, to being a benefit instead.

> 'If we were to set our governments to do useful things instead of mischievous, possibly even the apparatus might in time be less costly! ... Suppose it should

> turn out, finally, that a true government set to true work, instead of being a costly engine, was a paying one? That your government, rightly organized, instead of itself subsisting by an income tax, would produce its subjects some subsistence in the shape of an income dividend!' (Ruskin 1862-63:12)

In his collection of essays, entitled *Unto This Last*, Ruskin dissected the Classical economic theories of Mill, Ricardo and Malthus; and he set out a vision of society that outraged many conservatives. Ironically, whilst Ruskin considered himself to be a 'violent Tory', many of his ideas were eventually adopted by the nascent British Labour Party. Ruskin's 'political creed' – spelled out in the Preface of *Unto This Last* – anticipated the social reform movement of the early 20th century and contained many of the central components of the post-war social welfare state, with its commitment to full employment:

> 'First, ... there should be training schools for youth established, at Government cost, and under Government discipline over the whole country ... Secondly, ... in connection with these training schools, there should be established, also entirely under Government regulation, manufactories and workshops for the production and sale of every necessary of life, and for the exercise of every useful art. ... Thirdly, ... any man, woman, or boy, or girl, out of employment, should be at once received at the nearest Government school, and set to work as it appeared, on trial, they were fit for, at a fixed rate of wages, determinable every year. ... Lastly, ... for the old and destitute, comfort and home should be provided; which provision, when misfortune had been by the working of such a system sifted from guilt, would be honourable instead of disgraceful to the receiver.' (Ruskin 1862: 6-7)

3.2. The early 20th century social reform movement

The dreadful living and working conditions experienced by the urban working classes during the second industrial revolution produced significant social and industrial unrest – so much so, that politics were forced to evolve and accommodate, represent and ultimately channel the interests of the new urban proletariat. In Britain, the fledgling Labour Party emerged to join the established two party political system. This sudden visibility of the working classes strengthened the hand of social reformers such as Ruskin; however, it also ratcheted-up fears of uncontrollable social change.

This touched a nerve in Britain – and the result was a split within the British Liberal party. Whilst some felt that state intervention in free markets was still the biggest threat to civil liberty, a significant group, which included David Lloyd George and Winston Churchill, saw the concentration of capital and socialist revolution as the more important threats – a view that the Russian Revolution in 1905 did little to dispel. According to Herrick (1944: 76), '[t]he idea of individual freedom metamorphosed into the idea of social justice, which finally emerged as a guiding light of 20th century Liberalism'. The result was a rapid growth in state involvement in social welfare provision.

But rather than experiment with radical change, such as that envisioned by Ruskin, the British government instead took its inspiration from Germany's Otto Von Bismarck, who during the 1840s had responded to the challenges of rapid industrialization by initiating a process of social reform. Following Germany's lead, between 1906 and 1913, the British government enacted a succession of social legislation, including the Trade Disputes Bill and Workman's Compensation Act in 1907 and the Old Age Pensions Act the following year.1909 brought the Trade Boards and Labour Exchange Acts, the Children's Act and the Housing and Town Planning Act. The National Insurance Act followed in 1911, the Coal Mines Act in 1912 and the New Trade Disputes Act in 1913. According to Herrick (1944: 74),

> 'the question of social reform dominated public discussion in the years before the First World War … The level of debate in parliament and in the press was extraordinarily high … it reveals a clear and significant Liberal philosophy, neither radical nor socialist, which helped to create what has been called the 'welfare state'.'

Thus, by 1914, aside from the National Health Service (NHS), the British Social Welfare State was largely in place. The increased spending on social welfare, however, significantly politicized the issue of 'austerity' since any change in state welfare funding would now be likely to result in a negative reaction on the part of many voters. It would thus be necessary to 'sell' the idea of austerity rather more carefully.

In many respects, the social reform movement in Britain – which took place during a period of relative stability and fiscal balance – embodied developments that would be built upon after World War Two. Major contributors to the academic ideas about *collective welfare* – and the role of the state in its provision – included John Hobson (1909), William Beveridge (1909) and Clarence Ayres (1918), all of whom would play a part in the later 'Keynesian' discussion. For the social reformers, the focus was on the contribution of improved social welfare to the effective functioning of the economy. Thus, as it was for Ruskin, public spending on social welfare provision was seen to be of public benefit rather than cost; and, in a departure from the Classical doctrine of 'laissez-faire,' they assigned to the state a central role in reform.

The progress realized during the social reform movement of the early 20th century, however, was interrupted by the First World War (1914-1919). A ruinously expensive industrial war, World War One, although reinforcing Britain's commitment to collectivism, would produce renewed debate about public debt, with 'austerity' again taking centre stage.

4. The British 'Treasury View', the 'Keynesian' Challenge and the Politics of Austerity

During the 19th and early 20th centuries, fiscal deficits and surpluses were relatively small and short-lived. This was dramatically changed by World War One, during which, in a struggle to survive, its participants emptied national treasuries and borrowed heavily against the future. Renewed debate about the desirability and management of the national debt soon followed, and austerity moved rapidly back up the agenda.

Britain emerged from World War One victorious, but economically weak; and after a brief spell of euphoria, the economy fell into depression. In 1920, the Liberal Lloyd George government, assuming that the accompanying unemployment would be temporary – as it had been before 1914 – set up an Unemployment Grants Committee to encourage public works schemes. However, unemployment persisted longer than expected, raising concerns about the debt charge on the 1917 War Loan and reinforcing the deflationary bias in government policy. In 1922, the Conservative Chancellor of the Exchequer, Stanley Baldwin, warned that 'money taken for government purposes is money taken away from trade, and borrowing will thus tend to depress trade and increase unemployment.' (Middlemas and Barnes 1969:127). The theoretical justifications for this 'Treasury View' were provided by Ralph Hawtrey, the Treasury's economist, who argued that

> 'The original contention that the public works themselves give additional employment is radically fallacious. When employment is improved, this is the result of some reaction on credit, and the true remedy for unemployment is to be found in a direct regulation of credit on sound lines.' (Hawtrey 1925:48)

The British Government thus reverted to pre-war Classical laissez faire economic and financial orthodoxy. Public expenditure was reduced in an effort to balance the budget; efforts were made to re-pay large war-time loans and monetary policy was used to defend sterling. High unemployment and balance of payment deficits were attributed to the war, which had disrupted export markets and radically increased production costs. The Treasury reasoned that a return to economic 'normality' required wage reductions to restore prices to their pre-war levels. Assuming that full employment was the norm and that the economy had strayed from equilibrium, they believed that cost and price adjustments would restore it. However, efforts to cut wages were met with fierce resistance from the trade unions; and industrial action intensified, rekindling fears of socialism that had been brought about by the 1917 Russian Revolution.

The situation was made worse when, in an effort to support the financial sector, the Treasury restored the Gold Standard to its 1914 parity. The resulting price deflation further squeezed British firms, who tried to limit their losses by reducing labour costs. This precipitated the 1926 General Strike and a six month walk-out by the coal miners. However, despite the ensuing economic, social and political unrest, continued high unemployment and a persistent balance of payments deficit, the Treasury maintained its restrictive economic policy.

The 1920s Treasury View rested on the pre-Keynesian notions (that Keynes, himself, held when he wrote his 1927 *Treatise on Money*) that savings determined the level of investment and that monetary policy was the preferred approach for dealing with economic fluctuations (Laidler 1999:148-9). Keynes later changed his mind. In the Preface of *The General Theory,* he wrote

> 'I, myself, held with conviction for many years the theories which I now attack, and I am not, I think, ignorant of their strong points. The composition of this book has been … a struggle to escape from habitual modes of thought and expression. … The difficulty lies not in the new ideas, but in escaping from the old ones, which ramify for those brought up as most of us have been to every corner of our minds.' (Keynes 1936:xii)

In Keynes's evolving view, the solution to Britain's economic problems lay in increasing home demand to compensate for shrinking export markets. In 1924, he published 'Does Unemployment Need a Drastic Remedy?' in *Nation and Athenaeum*, arguing that 'there is no place or time here for laissez faire.' He believed that the cure for unemployment was to be found not only in monetary reform but also in 'the diversion of national savings from relatively barren foreign investment into state encouraged constructive enterprises at home.' In 1928, in 'How to Organize a Wave of Prosperity,' in the *Evening Standard*, he again argued for public spending to combat unemployment; and in 1929, with Hubert Henderson, Keynes wrote the pamphlet, 'Can Lloyd George Do It?', in support of Lloyd George's campaign pledge to reduce unemployment by means of major public works expenditure. Critical of academic argument as being separated from reality, Keynes and Henderson made the case that public works, financed by loans, would induce a 'cumulative wave of prosperity'.

The British Treasury refuted this contention in its 1929 White Paper; and Winston Churchill, then Chancellor of the Exchequer, re-iterated the orthodox Treasury view in his 1929 budget speech:

> 'Let us, first of all, by way of preliminary digression, address ourselves to the burning question of whether national prosperity can be restored or enhanced by the Government borrowing money and spending it on making more work. The

> orthodox Treasury view … is that when the Government borrow[s] in the money market it becomes a new competitor with industry and engrosses to itself resources which would otherwise have been employed by private enterprise, and in the process it raises the rent of money to all who have need of it. This orthodox view holds, therefore, that a special, even perhaps a double, responsibility rests upon the State when it decides to enter the money market as a rival to the ordinary life and trade of the country. The onus is laid upon the Government to prove either that the need is paramount as in the case of national safety being in danger; or that the work is necessary, and would not be otherwise undertaken; or that the spending of the money by the Government would produce more beneficial results than if it had been left available for trade and industry' (Churchill 1929).

John Maynard Keynes remains a towering influence in economics; but he was not the only voice advocating state intervention to stabilize the economy at both the top and the bottom of the business cycle – nor was he necessarily the first.

4.1. American Inter-war Economic Policy and Thought

The United States had emerged from World War One in much better shape than Britain; and from 1922 to 1929, the economy grew rapidly and employment remained high.[1] The driving force for growth was rapid organisational and technological change, high levels of investment in manufacturing and construction, and a sharp increase in consumer expenditure, especially on cars and consumer durables. However, this revolution was not confined to the level of expenditure and the way the economy was organised; it was also related to the way the economy was theorised.

In economics, there had developed a 'vigorous, diverse and distinctly American literature dealing with monetary economics and the business cycle' (Laidler 1999:211). The analysis was essentially institutional; and there was little opposition amongst American economists to counter-cyclical fiscal and monetary policy. There was, however, considerable debate about the effectiveness of such intervention – and how it should be financed.[2] The main academic centres where these ideas were developed were Harvard (where Lauchlin Currie, Paul Ellsworth and Harry Dexter White were important contributors) and Chicago (where contributors included Aaron Director, Paul Douglas, Frank Knight, Henry Simons and Jacob Viner).

Elements of American economic thinking during the 1920s in many ways anticipated Keynesian analysis and policy recommendations, particularly with respect to stabilizing the trade cycle. William Foster and Waddill Catchings, of the Frances D. Pollak Foundation for Economic Research, were among the first to articulate a case for using public works expenditure to counter a slump.[3] Their work attracted the interest of Chicago economist, Paul Douglas, who reasoned that:

> ‘the best way [to counter a slump] would be for the government to expend purchasing power for the construction of public works which would thus give purchasing power to the workers and stabilize the price level. Since the services of these public works would later largely be offered gratuitously to the public, they would not enter into the volume of commodities offered for sale and hence would not cause a fall in the price.’ (Douglas 1927:41)

Considering the alternatives for financing such expenditure, including government borrowing (the approach favoured by Keynes), Douglas concluded that:

> ‘if proper safeguards could be provided to prevent inflation instead of such borrowing, I would personally favour an issue of paper money on the part of the government to pay for the materials and the labor utilized. In this way, society could get needed public works constructed without any added cost to itself. Labor which would otherwise be largely unemployed would be used instead to construct needed roads, buildings, playgrounds, etc. … The issue should be so limited as (1) to prevent the index of unemployment … from rising above, let us say five per cent; (2) to prevent the general price level from rising by more than two or three per cent; (3) to prevent the foreign exchanges from being dislocated.’ (Douglas 1927:42)

The onset of the Great Depression reinforced these theories and added urgency to the debate about policy. Developing their ideas further, Douglas and his research student, Aaron Director, made the case for public works expenditure financed by expansion: ‘It is possible for government to increase the demand for labor without a corresponding contraction of private demand and … this is particularly the case when fresh monetary purchasing power is created to finance the construction work.’ (Douglas and Director 1931:210-11)

By 1932, Douglas believed that monetary policy had failed to deal with the depression, concluding that ‘the chain of revival runs primarily from the increased purchasing power of the consumers and greater demand by consumers to increased borrowings and bank loans’. Therefore, large-scale government spending was needed to satisfy ‘actual human needs and the necessity for stimulating increased purchasing by consumers, [and] larger expenditures for public works.’ (Douglas 1933:10-11) By January 1932, the Harvard economists, Currie, Ellsworth and White – having also concluded that the economic situation was now sufficiently serious that monetary policy alone was not capable of dealing with it – prepared a Memorandum explaining their perspective and outlining their recommendations for policy:[4]

> ‘[This Memorandum] sketches out an explanation of the then developing Great Contraction, as well as a comprehensive and radical policy program for dealing

> with it … the main domestic component of that program was to be vigorously expansionary open-market operations and substantial deficit spending that, particularly in its early stage, was to be financed by money creation; its international dimension involved a return to free trade and serious efforts to resolve the problems of international indebtedness that had originated in the Great War and in the Treaty of Versaille.' (Laidler and Sandilands 2002)

In April of that same year, at the request of Republican Congressman Samuel Pettengil, the Chicago economists drafted and signed a statement urging a public works program, financed by the creation of money:

> 'Recovery can be brought about, either by a reduction in costs to a level consistent with existing commodity prices, or by injecting enough new purchasing power so that much larger production will be profitable at existing costs. The first method is conveniently automatic but dreadfully slow … The second method … requires a courageous fiscal policy on the part of the central government.' (Committee on Ways and Means 1932)

When the Roosevelt administration came to office in 1933, the US was suffering 'from the most extreme prostration which any capitalist country had ever experienced in peace time' (Arndt 1944:34). Informed by the work of the American economists at Harvard and Chicago, the 'New Deal' reforms of 1933 through 1937 were introduced. According to Arndt (1944:34), the New Deal 'was the most spectacular attempt that was made after the Great Depression to promote recovery by means of a deliberate expansionist policy as the chief stimulus of economic activity, and without recourse to totalitarian control of the economic system'.

From 1933 to the third quarter of 1937, the American economy recovered. However, fears of possible inflationary effects checked New Deal expansionism, slowing the recovery; and in 1937, under pressure to reduce the fiscal deficit, there was a brief reversal – *to austerity.* This produced a sharp recession late in 1937 that almost returned the economy to depression. However, rearmament took over as the driver for growth and with the massive stimulus provided by the Second World War, the American economy recovered fully.

4.2. 'Keynesian Austerity' in Britain – A Policy for the Boom, not the Slump

During the late 1920s and 1930s, Keynes was often accused of ignoring the need to maintain confidence in both the authorities' financial policies and Britain's position in the international community (Middleton 1982:55). However, they misunderstood the fact that Keynesian *austerity* was the necessary counterpart to stimulus – to be applied during the boom or to avert inflation or the risk of financial collapse. Thus, in the wake of the 1931 financial crisis, Keynes 'wrote to Prime Minister (MacDonald) to say that a crisis of confidence was 'very near' and that the budget must be balanced.' (Middleton 1982:175)

The following year, as unemployment continued to climb, Keynes and colleagues at the University of Cambridge sparked a public debate about the economics of austerity. In response to the invitation from the Editor of *The Times,* soliciting economists' opinions about the problem of private spending, the Cambridge economists underlined the importance of private *and public* spending, funded by borrowing, to combat the unemployment caused by insufficient aggregate demand during depression.[5] Hayek and colleagues at the London School of Economics (LSE) were unimpressed and responded with the alternative position. Being 'of the opinion that many of the troubles of the world at the present time are due to imprudent borrowing and spending on the part of public authorities,' they argued for financing investment (supported by savings) through securities (rather than borrowing) and set out their case for fiscal austerity and the freeing-up of markets.[6]

In 'The Means to Prosperity,' containing four articles written for *The Times* in 1933, Keynes continued to call for fiscal stimulus; and in 1935, Lloyd George again proposed government borrowing and public works to address unemployment. By then, 'public support was sufficient to make ministers feel that they ought to be seen as doing something (Peden 1984:176) and the Treasury relaxed its resistance.

The recovery, however, came *not* from fiscal policy but from monetary policy designed for an entirely different purpose. In 1931, speculation had forced sterling off the Gold Standard. The resulting depreciation allowed for lower interest rates that both reduced the cost of financing the 1917 War loan and triggered a house building boom. However, the economic picture was not uniformly positive. Unemployment remained high in the north and the west, where Britain's traditional industries – cotton, coal, steel and ship building – were located.

Keynes recognized this[7] – and the need to prevent other parts of the economy from overheating. So in 1937, he wrote 'How to Avoid a Slump', a series of articles for *The Times,* on the subject of 'fine tuning', urging that any new productive capacity be located in Britain's distressed regions. In the second article, 'The Right Time for Austerity,' Keynes argued that the time had come for *austerity,* 'to protect us from the excesses of the boom and, at the same time, put us in good trim to ward off the cumulative dangers of the slump when the reaction comes, as come it surely will.' He thus made explicit the point that – whilst during the slump, the cure for unemployment was stimulus – once the recovery was established, austerity was required to prevent the economy from overheating and causing the equally damaging problem of inflation.

4.3. World War Two and Commitment to Keynesian 'Fine-Tuning'

The economic recovery during World War Two (1939-1945), generated by the massive stimulus to aggregate demand, seemed to justify Keynes's ideas about the role of the state in managing the economy. It also restored confidence in the West that capitalism could be restored. Whereas the Classical economists had focused on the effects of government borrowing and spending on the *budget* – so-called 'sound finance'[8] – 'Keynesians' focused on their effect on the *economy* – the 'new fiscal theory' of 'functional finance'. According to Abba Lerner (1943):

> 'The central idea is that government fiscal policy, its spending and taxing, its borrowing and repayment of loans, its issue of new money and its withdrawal of money, shall all be undertaken with an eye only to the *results* of these actions on the economy and not to any established traditional doctrine about what is sound or unsound. … The principle of judging fiscal measures by the way they work or function in the economy we may call *Functional finance.*' (p. 39)

Following the war, across the industrialized world, there was a major increase in state intervention in the economy, through public ownership and public spending on social welfare (and armaments, especially during the cold war). The state assumed a central role in managing the macro-economy; and there was widespread commitment to full employment and the welfare state.[9] Financial institutions were either brought into state ownership or more tightly regulated to ensure that they channelled capital to the productive side of the economy. And the 1944 Bretton Woods system was established to stabilize the international economic environment, and in so doing, create the conditions under which national governments could effectively manage their interventionist welfare states.

All of this helped to lay the foundations for high wage, mass production industrial economies, in which prices were stabilized and there was greater accord between capital and organized labour. The result, especially from 1952 to 1960, was full-employment, non-inflationary growth, rapidly rising living standards and reduced inequality; and this was a period that was widely considered to be the 'golden age' of post-war economic history (Marglin and Schor 2007).

5. Neo Liberalism, Deficit Growth and Exposure to Financial Markets

During the late 1950s, the academic debate about austerity economics re-emerged with the publication of James Buchanan's (1958) *Public Principles of Public Debt.* This ignited the 'burden of the debt' controversy over the long-term implications of national debt, and, in particular, the substitution of borrowing for tax financing.[10] Growing unease about the increasing absolute size (in money terms) of the public debt of many countries led to the resurrection of pre-Keynesian ideas about public debt. However, at this point, there was no general re-affirmation of Classical principles or repudiation of Keynesian ideas. Instead, according to Buchanan (2008:730) the '[academic] discussion of public debt ... remained confused by an admixture of the two contradictory models of analysis' – Keynesian and Neo-Classical. But he went on to describe the important *political* dimension of this debate:

> 'While confusion and ambiguity characterised economists' ideas of public debt, the politicians had learned the Keynesian policy lessons – but with a roughly two-decade lag. By the early 1960s, the 'old time religion' … had lost its constraining influence. Political leaders of the 1960s and beyond had learned that demand enhancing deficits may be justified … Their natural proclivities to spend without taxing constituents, caused them to look on economic settings in a biased fashion. The purist Keynesian policy set – deficits in depressions, surpluses in booms – proved unworkable in democratic politics … The regime of apparently permanent debt financed deficit spending was born.' (Buchanan 2008:730)

Under the Keynesian regime of 'fine tuning,' the economic cycle was characterized by a pattern of 'stop-go' – of austerity during the boom to counter inflation and stimulus (deficit (capital account) spending) during the slump to combat unemployment. Across the cycle, a current account balance (or surplus) was to be maintained. During the 1960s, however, especially in America, the focus of policy shifted – from full employment and high effective demand – to a 'new economics' based on growth (Perry & Tobin 2000). The normal peacetime aim of near fiscal balance gave way in almost every industrial country to large fiscal deficits. However, stimulus-fuelled prosperity masked growing imbalances, which by the end of the decade, were beginning to become apparent (Marglin & Schor 2007). According to Gardner Ackley, President Johnson's chief economic strategist, Americans were 'learning to live with prosperity and frankly, we don't know as much about managing prosperity as getting there'.

As it turned out, he was proven to be largely correct; and state intervention to cool the economy during the boom – *Keynesian austerity* – never came. With production scraping up against capacity limits, productivity slowed and by 1965, the economy was in serious difficulty. Labour costs rose faster than productivity; consumer and wholesale price inflation accelerated and the federal budget was stretched by the war in Viet Nam (Clark, 1979). On top of all of this, competition intensified with the re-emergence of Japan and the continental European countries as leading industrial economies and with the rapid increase in low cost manufacturing in developing countries. Manufactured imports into the other industrialized economies surged, causing a sharp deterioration in trade balances – especially in the US.

In 1971, in response to its first trade deficit since before World War One, and under pressure to devalue the dollar, President Nixon announced that the US would no longer provide gold backing for the American dollar.[11] This decoupled the other Bretton Woods currencies from gold, lifting exchange rate controls and allowing them to float. Another consequence was the removal of external constraints on governments issuing their own currencies. Whereas under Bretton Woods, governments were required to borrow from the private sector if they wanted to spend more than they collected in taxes, after 1971, they issued debt to cover their deficits (Mitchell 2011). Thus, any remaining control over the money supply was lost, and exposure to potentially hostile financial markets was greatly increased, introducing a powerful new influence into the debate about economic austerity.

The 1970s brought no shortage of events to influence policy, theory and economic stability. 'Stagflationary'[12] crises hastened sectoral and regional decline in many of the Western industrial economies, leading to the widespread destruction of jobs and rising unemployment. As a result, governments faced increasing budget deficits as tax revenues fell sharply and the costs of mass redundancies and failing industries increased. These problems, mostly due to the increasing liberalisation of financial markets – a process that had started as early as the 1950s with the emergence of the Eurodollar markets in London[13] – were attributed to fallacies in Keynesian theory and policy. This produced a further revival of liberal economic beliefs – about the monetary causes of inflation and the efficacy of unrestricted markets in determining real economic outcomes.

In reality, though, the main problem was that the ability of national governments to manage effective demand – the foundation stone of Keynesian policy – had been undermined by the progressive liberalization and globalisation of international finance, industry and markets.[14] It is thus possible to argue that the events of the 1970s were neither a consequence of Keynesian policy, nor random events with which the paradigm could not cope. With international capital controls gone, there was simply too much play in the steering for effective domestic macro-economic control.[15] Nevertheless, by the late 1970s, this new economic liberalism – 'Neo-liberalism' – became the conventional wisdom and monetarism was progressively incorporated into government policy.

The 1980s brought a strengthening commitment to the Neo-liberal political and economic agenda. 'Reaganomics' and 'Thatcherism' shifted the focus of policy from aggregate demand to the economy's productive capacity; and monetary policy was used to combat inflation. However, attempts to control inflation by monetary means triggered deep recessions during the early 1980s. In response – and in a sharp reversal of policy – large segments of the public sector were privatized and taxes on the wealthy were cut in an attempt to encourage enterprise. To address 'imperfections' in the labour market, trade unions were weakened and legal control of labour standards relaxed; out-of-work benefits were reduced (and made subject to more onerous conditions) and wage subsidization was introduced with the express purpose of powering unemployment and generating more jobs. The outcome was the steady expansion of public deficits, due largely to the reduced tax revenues and an inability to crystallise public sector savings – largely the result of the increased costs associated with social supports and government 'watch dogs' to police the newly privatised public services.

Despite high unemployment and low inflation during the 1980s, governments continued to target inflation, the logic of which was set-out in the then Chancellor of the Exchequer, Nigel Lawson's 1984 Mais Lecture:

> 'It is the conquest of inflation and not the pursuit of growth and employment, which is … the objective of *macro*-economic policy. And it is the creation of conditions conducive to growth and employment, and not the suppression of price rises, which is … the objective of *micro*-economic policy … This government is pursuing simultaneously both a macro and micro policy … [T]he macro policy is unequivocably directed at the continuing reduction in inflation, with the ultimate objective of stable prices … [T]he micro policy is equally wholeheartedly designed to make the economy work better and thus generate more jobs.'

He concluded that:

> 'The British experiment … to provide increasing freedom for markets to work within a framework of firm monetary and fiscal discipline … [was] in contrast to the post war trend towards ever more ad hoc interference with free markets within a context of increasingly financial *in*discipline ... *That* was the road that led to stagnation, unemployment and above-all accelerating inflation.'

5.1. 'Expansionary Fiscal Contraction' – Reality or Alchemy?

By the end of the 1980s, high levels of public debt again raised concerns about government deficits, renewing interest in the economics of austerity. As Harvard economist, Benjamin Friedman (1988) observed: 'We are living well by running up our debt and selling off our assets … The costs, which are only beginning to come due, will include a lower standard of living … and reduced … influence and importance in world affairs.' The resulting debate initially focused on the effect that high government deficits and debt might have on inflation and balance of payments problems. According to Giavazzi and Pagano (1990),

> ‘the high real interest rates of the early 1980s combined with the large stock of public debt inherited from the 1970s to create a potentially explosive debt problem. As governments started to tackle the problem with contractionary fiscal policies, public officials and economists voiced different beliefs about the likely effects of these measures.’

This coincided with preparations for the Eurozone, the centrepiece of which was the Maastricht Treaty, establishing strict limits on member countries’ deficits and debt levels. Heightened concern about public debt thus sparked interest in the experience of countries, such as Denmark (1983-1986) and Ireland (1987-1989), that had managed to grow despite sharp fiscal consolidations during the 1980s. From this research, emerged the novel idea of ‘expansionary fiscal contraction’ – the hypothesis that an economy could, in the short term, actually grow as a consequence of a policy of austerity. This counter-intuitive idea generated a flurry of studies of countries that had responded to very high debt-to-GDP ratios with fiscal austerity – that apparently generated growth.[16]

The research on ‘expansionary fiscal contraction’ produced three competing schools of thought about the economics of austerity, the first two being informed by studies purporting to find support for the idea that austerity has short-term expansionary (non-Keynesian) effects. The ‘Ricardian’ view is built upon Barro’s (1974) seminal article reviving the concept of ‘Ricardian equivalence’ – the notion that government borrowing is deferred taxation.[17] From this perspective, in response to government deficit spending, taxpayers could be expected to *save* in order to pay for expected higher future taxes;[18] and because any income created through government stimulus was assumed to be saved, the net effect of fiscal stimulus would be zero. Thus, because rational consumers were theorized to base their consumption decisions on expected *lifetime* income, government deficits would have no long term effect on consumption. However, short term *expansionary* effects might arise if fiscal austerity improved economic agents’ expectations about their future wealth and income and/or contributed to enhanced labour market efficiency and the competitiveness of the economy (Briotti 2005).

The ‘Neo-Classical’ school of thought[19] also assumes that rational economic agents plan consumption over their lifetimes and that budget deficits increase current consumption by shifting taxation to future generations. However, according to this logic, increased consumption means lower savings, causing interest rates to rise to bring the capital market into balance. As a result – and assuming that economic resources are fully employed – government spending is theorised to ‘crowd out’ private spending, with a detrimental effect on the economy. By contrast, austerity – reduced government spending – by making room for *more efficient* private spending, could be expected to have potentially expansionary short term effects.

In sharp contrast to Neo-Ricardian and Neo-Classical ideas about the short term effects of economic austerity, the 'Keynesian' view takes a different perspective[20]. Instead of assuming that human beings are rational agents who take a strategic view of their lifetime consumption, this perspective assumes that a significant proportion of the population is myopic or liquidity constrained, with a high propensity to consume out of current disposable income. Austerity would therefore be expected to produce an immediate and significant *contraction*, with multiplier effects on aggregate demand. On the other hand, if an economy's resources are under-employed, the deficit resulting from a temporary tax cut or stimulus could be expected to have an expansionary effect (with multiplier effects). Fiscal deficits are therefore not to be feared, in and of themselves; and the appropriate time for austerity is during the slump.

Although the research on expansionary austerity had only a modest impact when it appeared, following the 2007/8 financial crisis, with many European governments struggling with high levels of fiscal debt, advocates of austerity are again attempting to make the argument that the policies they propose will accelerate growth.

5.2. The 'Great Moderation'and Prioritization of Finance

Following the recession of the early 1990s, there was a prolonged period of expansion described as the 'Great Moderation' – a period of low and stable global inflation, high and steady global growth and low real interest rates. An important characteristic of the Great Moderation was rapid, but asymmetric, growth in world savings. High savings rates in China and Japan, and growing wealth in Saudi Arabia, Norway and other oil rich countries, created a 'wall of money' that flooded into the world's financial markets, driving down interest rates. In much of the rest of the developed world, low interest rates encouraged increased spending on credit, especially the US and UK, both of which also developed large and expanding trade deficits. It also fuelled housing bubbles that increased equity, which could then be withdrawn as collateral to support additional consumption (Wilkinson, 2012).

At the same time, low rates of interest created incentives for financial 'innovation' to generate higher yields than traditional instruments produced; and financial institutions increased borrowing, much of which was *off balance sheet* by means of increasingly complex financial instruments. According to Greenspan (2002), these were 'especial contributors to the development of a far more flexible, efficient and resilient financial system than existed just a quarter-century ago'. Apparently successful responses to recurring financial crises during the 1980s, 1990s and 2000s reinforced the view that monetary policy was '… well equipped to deal with the financial consequences of asset price busts' (Blanchard et al 2010:7) and asset bubbles were legitimised as engines for growth. Despite the havoc caused when they burst, the dominant view was that bubbles are difficult to identify, so policy makers need not concern themselves with detecting or preventing them. Rather, 'it is the job of economic policy makers to mitigate the fall out when it occurs and, hopefully, ease the transition to the next expansion' (Greenspan 1999).

Thus, despite the Neo-liberal view that state intervention is economically damaging, during the Great Moderation there was, in fact, increased intervention. But the aim was no longer Keynesian full employment and economic prosperity. Instead, policy was intended to restrain price (but not asset price) inflation and ameliorate financial crises, an important outcome of which was the socialisation of the risks and costs of financial speculation. Economic policy – which prior to the 1980s had generally served the broader political economy – thus increasingly favoured the narrow interests of the wealthy and financial elites.

6. The Post 2007/8 Financial Crisis Debate about Austerity Economics

The 2007/8 financial crisis – and the perceived risk of sovereign debt default by weaker members of the Eurozone – has moved austerity back up the academic and policy agenda. Whilst there is general agreement that reducing public deficits and fiscal debt has long-term benefits, there is sharp disagreement about the short-term effects of fiscal austerity, particularly in the context of economic recession. Whilst the academic debate has focused primarily on the economic effects of austerity versus stimulus, policy-makers (not necessarily politicians) recognize that austerity is slowing growth and recovery. However, they also know that, despite having been rescued from melt-down, the global financial markets are demanding austerity – not because of its *economic* effects, but as an objective in itself, to provide 'credible' evidence that governments (in which investors have financial stakes) can manage their budgets to prevent a default.

Articulating the *theoretical* case for economic austerity, University of Chicago Professors, Eugene Fama, and John Cochrane have been among the most prominent proponents. Focusing on the accounting relationship between national savings and investment, Fama (2009) has argued that government deficits 'crowd out' private investment: 'Bailouts and stimulus plans … absorb savings that would otherwise go to private investment … stimulus spending must be financed, which means it displaces other current uses of the same funds.' He concludes that austerity is therefore required to assure that more efficient private sector spending is able to drive economic recovery. Cochrane (2010) has also contended that fiscal austerity is necessary to counter the current economic malaise. In Cochrane's view, government currency is a form of debt; and inflation is the result of the belief on the part of bond holders that the government will be unable to raise enough revenue to cover its expenditures and debt repayments. The expectation of future inflation due to fiscal crisis may – when an unexpected tipping point is reached – trigger a 'run' on the currency well before the crisis, causing a rapid increase in nominal interest rates and inflation. Austerity is therefore required to reduce public debt, calm the financial markets and prevent a worsening crisis.

6.1. The Evidence Against Austerity

The renewed debate about economic austerity has encouraged a re-examination of the studies supporting the ‘expansionary fiscal contraction’ hypothesis. However, these have been largely discredited (Guajardo, Leigh and Pescatori 2011; IMF 2010). An important finding of this research concerns the method used to identify fiscal consolidation – the increase in the cyclically adjusted budget surplus – a statistical measure that has been found to down-play contractionary and over-state expansionary effects. In response to this finding, the IMF (2010) re-tested the expansionary austerity hypothesis using cases where the government’s *explicit policy objective* was to reduce its budget deficit. They found that the short-term effect of fiscal consolidation was contractionary, although it was less pronounced in cases with a high perceived risk of sovereign debt default, and could be reduced by cutting interest rates, devaluing the currency and reducing expenditure rather than increasing taxes.

Re-examining the experiences of Denmark (1982-6) and Ireland (1987-90), and adding the cases of Finland (1992-8) and Sweden (1993-8), Perotti (2012) found that ‘[t]he results cast doubt on some versions of the ‘expansionary fiscal consolidations’ hypothesis, and on its applicability to many countries in the current circumstances.’ (p. 42) He concludes that given the channels through which growth was realised, past experience is not a useful guide to the present: ‘Depreciation is not available to EMU members … An expansion based on exports is not available to the world as a whole. A further decline in interest rates is unlikely in the current situation and incomes policies are not popular nowadays.’ (p. 42)

Examining the more recent Icelandic experience, Wade and Sigurgeirsdottir (2012) describe how, when the 2007/8 crisis erupted, there were angry protests and the government shifted decisively to the left. The krona was deeply devalued but there were relatively small cuts in public spending as – in an effort to protect people at the lower end of the income scale who were finding it ‘very difficult’ to make ends meet – the government prioritised the welfare state and employment legislation. In sharp contrast to the more recent experience of Greece and other weaker members of the Eurozone, during the early stages of Iceland’s recovery, the IMF provided support: it ‘did not press for quick ‘fiscal consolidation’ … [and] went out of its way to consult widely and transparently; it supported controls on capital outflows; and it brought in technical experts to help restructure the banks.’ (p. 142-3) Wade and Sigurgeirsdottir (2012) conclude that ‘Iceland stands as a rebuke to the new-classical economics prescription for bank bailouts and steep public spending cuts as the way to satisfy financial markets and create jobs.’ (pp. 142-3)

Considering prospects for the Eurozone, Boyer (2012) argues that the international finance community in Europe may, in fact, be undermining its own basis and legitimacy by pushing for such extreme austerity measures. Not only does the growing interdependence of European countries make generalized austerity policies problematic, but austerity in the deficit countries (like Portugal, Italy, Greece and Spain) – which have traditionally absorbed the European exports from the surplus countries (like Germany) – will reduce the markets available to European exporters. In Boyer's view, austerity-generated recovery requires strong effective demand; and austerity policies in a context of weak demand will instead lead to a vicious cycle of lower output, lower tax revenues and increasing government debt-to-GDP ratios.

6.2. Austerity as the *Objective* of Policy

Despite the fact that the expansionary fiscal consolidation hypothesis has been largely discredited on economic grounds, the effect of austerity on the financial markets' assessment of governments' capability in managing their economies cannot be ignored. According to Callinicos (2012):

> 'In societies deeply permeated and reshaped by financialization, policy alternatives tend to oscillate between monetary and fiscal austerity and letting the (financial) markets rip. But this process is mediated by other factors, notably the relative economic and political weight of banks and other financial institutions in given societies and the location of particular states within the global political economy.' (p. 74)

Whilst the academic debate about the short-term effects of fiscal austerity continues, policy makers have largely acknowledged its contractionary effects. Olivier Blanchard (2012), chief economist at the IMF, has argued that fiscal consolidation 'is clearly a drag on demand, it is a drag on growth.' Similarly, the Bank of England's Monetary Policy Committee (2011) reported that '[g]rowth has been weak throughout the year, reflecting a fall in household incomes, persistently tight credit conditions and the effects of continuing fiscal consolidation.' Considering the broader effects of fiscal austerity in the current context, an ILO-IMF (2010) report argues that

> 'A premature fiscal retrenchment could damage growth and lead to even larger deficits and debts. Abrupt shifts in fiscal policy stances, in many countries at the same time, could destabilize recovery and weaken future growth. A credible and gradual return to fiscal stability over several years is likely to be a more successful strategy, not only for recovery and growth but also for deficit and debt reduction … Social dialogue is essential to avoiding an explosion of social unrest.' (p. 8)

It concludes that ‘high and long lasting unemployment … represents risks to the stability of existing democracies and hinders the development of new democracies in countries under-going political transitions.’ (p. 22)

The very recent shift to the political left within the Eurozone, reflected in the outcome of the May 2012 French presidential elections, may signal movement in the debate about austerity economics – opening it up to a wider spectrum of economic thinking and a more even-handed approach to macro-economic management of the crisis. This is also apparent in the recognition by European Union (EU) officials of the importance of ‘balance’ in responses to the Eurozone crisis. According to Olli Rehn, the EU’s Commissioner for Economic and Monetary Affairs ‘fiscal consolidation, while necessary, [needs to be] done in a growth-friendly way, in order to strike a balance between necessary fiscal consolidation and concerns for growth.’

7. Summary and Conclusions

The evolution of austerity economics is closely related to that of the national debt – and attitudes towards it. During the three centuries since the national debt first appeared in its modern form, extraordinary political, social and economic changes have shaped perspectives about what (if anything) constitutes the public good – and, hence, what should be publicly funded. Views about the business cycle have also shaped ideas about the economics of austerity. What seems manageable during good – or even fairly ordinary – times might well seem unwarranted during a downturn or economic crisis. There is also the question of *when* a policy of austerity should be used: at the top – or at the bottom – of the cycle.

The original purpose of the national debt was to finance state emergencies, such as war and the national defence. Whilst there was general agreement amongst the Classical economists that peace-time government budgets should be in balance, there was considerable debate about the financing of war-time debts. From the 17th century onward, during the period of imperial expansion, wars frequently paid for themselves and were expansionary, economically and territorially. However, after the war, governments struggled with the slowdown in national economic activity and the problem of absorbing those employed in the wartime effort into domestic employment. As warfare became progressively more industrialised, it became much more expensive and difficult to pay for. This raised concerns about the associated public debt, and the ability to fund it, thus raising austerity to the top of the agenda in economic theory and policy.

During the 18th and 19th centuries, the transition from an agrarian to an industrial economy expanded the scope of public spending. The accompanying urban poverty – and often abhorrent living and working conditions – resulted in significant and persistent social unrest. This – and anxiety caused by the 1905 Russian revolution –

produced major reforms, out of which emerged the social welfare state, the costs of which added to the national debt of many European countries. But unlike the debts from war, maintaining the social welfare state would constitute a substantial and on-going public financial commitment. Social change thus served to politicise the economics of austerity, especially as the right to vote became progressively more universal.

World War One was a ruinously expensive industrial war, which resulted in high levels of public debt for its participants. This, and the economic challenges of the inter-war years, which were punctuated by the 1929 Stock Market Crash and the Great Depression that followed, produced a lively debate about the economics of austerity. Out of this, Keynesian ideas emerged – about the use of deficit spending to stimulate economic growth and employment during a prolonged slump. These ideas clashed with traditional orthodox views that government deficits were economically damaging.

But by the end of the 1930s, Classical 'laissez faire' economic theory and policy had been largely blamed for the crises of the 1920s and 1930s, causing a sea-change in economic theory and policy. The state was assigned an active role in stabilising the economy. In practice, this meant that austerity policy was used to cool the economy when it was over-heating, to prevent inflation and to deflate asset bubbles – and stimulus was applied during the slump, to support employment and ameliorate the downturn. Austerity was thus a policy for the *top* of the business cycle (and stimulus for the bottom).

Following World War Two, this 'interventionist' approach was extended to the international trading community. Since the objective was stability – and free markets in goods and services were held to be incompatible with those in finance – trade barriers were lowered by the General Agreement on Trade and Tariffs (GATT) whilst finance was constrained by the 1944 Bretton Woods system of fixed exchange rates and international capital flow controls. Throughout the industrialized world, this laid the foundations for post-war macro-economic prosperity, steadily rising living standards and increasing economic equality; and this was described as the 'Golden Age' of post-war economic history.

The turbulent and economically intractable events of the 1970s, however, produced another sea-change in economic theory and policy. Whilst governments wrestled with stagflation, increasingly uncompetitive industries, oil shocks and industrial unrest – none of which appeared to be responding to Keynesian intervention – no one seemed to have noticed the significance of President Nixon's removal of gold backing for the dollar, which effectively removed controls on international capital flows. The result was the inability to control the money supply. In this context, interventionist economic policies became increasingly ineffective, not because they were flawed, but because the system within which they could operate was being eroded.

The result was a general repudiation of state interventionism and a return to pre-Keynesian Classical ‘laissez faire’ economics. Under ‘Neo-liberalism’, the focus of policy shifted – from a commitment to full employment and growth in effective demand – to consumption-based ‘supply side’ economics, focused on the economy’s productive capacity. This was also a period during which there was an almost evangelical reliance on free markets – in both goods and finance. The view that ‘Government is the problem’ discredited policies of state intervention. Tax cuts (especially for the wealthy) were used to encourage consumption and enterprise; and there was little or no concern about economic cooling.

From the early 1990s, growing global savings imbalances resulted in large amounts of cheap credit being made available to institutions, consumers and governments in the West. The resulting low rates of interest, investment returns and tax receipts combined with stagnating incomes to contribute to burgeoning levels of private and public debt, re-igniting the debate about austerity economics. At the same time, consumption-based Western economies produced asset bubbles that came to be accepted as legitimate engines for growth. The economic damage caused by one bubble’s collapse was camouflaged by the inflation of successively larger bubbles – until the one that burst in 2007/8. Also accepted was a role for the government in ameliorating the damage caused by a bubble’s collapse with the use of public money – and in so doing, socialising private losses. From this perspective, the 2007/8 financial crisis is not a spectacular ‘one off’ incident, but merely the most recent in a series of similar crises requiring public intervention.

Under Neo-liberalism, austerity economics also shifted – from being a policy for the top of the business cycle (to prevent over-heating and inflation) to being a policy for the bottom, after the excesses of debt-fuelled over-consumption had been revealed by a bubble’s collapse. Yet in spite of the weight of evidence against austerity policy to counter a downturn – and rejection of the ‘expansionary fiscal consolidation’ hypothesis – some continue to argue that austerity can be expansionary.

This raises the question of why a government would pursue a policy of austerity in the context of economic recession – when there is no *economic* basis for such a policy and persistent macro-economic imbalances threaten to further destabilize the global economy. The answer can be found in the considerable political and economic influence of liberalised global financial markets. During the period of Neo-liberalism, fiscal policy was largely driven by narrow private sector interests of the wealthy and financial elites. In the aftermath of the 2007/8 financial crisis, it has been dictated by unpredictable financial market traders, with their own interests at heart and very little loyalty to any national social or political economy. Demanding austerity as evidence that national governments are capable of managing their deficits and repaying their debts, austerity has become the *objective* of policy, rather than a policy whose objective is macro-economic stabilization. However, if economic austerity further undermines macro-economic performance, the financial markets are unlikely to prove supportive of those countries suffering the effects.

What has been missing from the current debate about austerity economics is acknowledgement of the fact that stimulus is not the only alternative to austerity – and that reducing a country's deficit and debt can be achieved not only by reducing public expenditures but also by increasing tax revenues. Further, public spending can be divided into current and capital account expenditures, which themselves have very different macroeconomic effects.

Despite very recent evidence (at the time of writing) from political developments in the Eurozone – suggesting that the debate about the economics of austerity may be shifting in a more balanced direction – the current situation is a highly unstable one. There are continuing significant and growing imbalances within the global social, political and economic system that remain unresolved. Reviewing the historical record on how the world economy has attempted to deal with macroeconomic imbalances like those it confronts at present, Frieden (2009) warns that

> 'It is not the purely economic features of rebalancing that will be difficult: markets will clear, one way or another. It is, instead, the political implications of the coming adjustments that will test the capacity of national governments, and of international institutions. If national leaders grasp the political stakes, they may manage the unwinding of imbalances in a way that reinforces an open international economic order. If they fail to grasp those stakes, the recent financial crisis may be a harbinger of even greater dangers to come.' (p. 7)

Let us hope that the world's political leaders are able to learn the lessons of the prolonged financial crisis that began in 2007/8 before it is too late – and that they find the wisdom, courage and strength to lead the world economy forward from it.

Notes

[1] The exception to this was agriculture which was in recession throughout the 1920s

[2] For analysis of US policy in the inter-war years see especially Arndt (1944) and Laidler, (1999)

[3] Important contributions of Foster and Catchings to this emerging literature are *Profits* (1925) and *The Road to Plenty* (1928).

[4] Both Lauchlin Currie and Harry Dexter White became key policy advisors during the Roosevelt era. At the Federal Reserve Board and later at the Treasury and White House Currie became a leading advocate of expansionary fiscal policy, and White was a co-architect with Keynes of the Breton Woods system (Laidler, 2002, p 515).

[5] Macgregor, et. al. (1932a and b)

[6] Gregory, et. al. (1932)

[7] Whereas *The General Theory*, published in 1936, had been concerned with nationwide macroeconomic aggregates, recognition of the uneven nature of the recovery had moved Keynes's thinking on.

[8] For the Classical economists, the government account was essentially the same as the account of an individual or private firm. The Keynesian logic rejected this analogy. (See Buchanan 2008:727-31 for a useful overview of the evolution of public debt).

[9] No such commitment was made by the USA until the 1960s. However, as the dominant world economy whose economic infrastructure was undamaged by the war, and who became the major supplier of capital and resources for European and Japanese recovery, the American economy had little need of government intervention to secure full employment following the war.

[10] See Ferguson, J.M (1964) for a representative set of contributions to this debate.

[11] Under the Bretton Woods system, most countries sought to maintain an overall balance of trade, settling international trade balances in US dollars, with the US's agreement to redeem other central banks' dollar holdings for gold at a fixed rate of thirty-five dollars per ounce. The US, however, had not been not overly concerned about maintaining a balance in trade since it could pay its export deficits in dollars. Nor had it taken action to prevent the steady loss of American gold. By 1971, under pressure to devalue its currency, due to the decline in US gold reserves, instead of devaluing the dollar, President Nixon removed gold backing from the dollar. (See Helleiner, 1994: 115-21 for a further discussion).

[12]'Stagflation' is the coincidence of accelerating inflation and rising unemployment.

[13] See Konzelmann and Fovargue-Davies (2012) for a further discussion.

[14] For a further discussion see Konzelmann and Fovargue-Davies 2012 (especially Chapter 2); Konzelmann, Fovargue-Davies and Schnyder 2012; and Konzelmann et. al., 2010.

[15] See Konzelmann and Fovargue-Davies 2012, especially Chapter 2, for a further discussion.

[16] See, for example, Alesina and Ardagna (1998); Alesina and Perotti (1995, 1997); Giovazzi and Pagano (1990); Blanchard (1990); and Bertola and Drazen (1993).

[17] See, for example, Barro 1989.

[18] As noted earlier, Ricardo, himself, was doubtful of the reality of this hypothesis.

[19] See, for example, Bernheim 1989.

[20] See, for example, Eisner 1989.

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