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A Note on Economic Austerity in Science, Morality, and Political Economy

> Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back.
>
> —J. M. Keynes, *The General Theory of Employment, Interest and Money* (1964 [1936]): 383

THE ISSUE OF ECONOMIC AUSTERITY HAS BEEN MORE DEBATED today than at any time since the 1930s. Austerity policies have had longstanding support from economists, beginning with the writings of Hume, Smith, and Ricardo in the eighteenth and early nineteenth centuries, providing both microeconomic and macroeconomic justification for minimal state intervention and public debt creation. Given this long tradition, we might ask why the debate around austerity has not been satisfactorily resolved. I argue below that the fact that the debate is ongoing does not reflect a lack of theoretical effort. Debates over economic austerity go beyond the standard guideposts of scientific disagreement and reach down to conceptions of economic life, economic morality, and economic well-being. Social science cannot resolve disagreement at this level.

Notions of economic austerity are deeply connected to the discipline's concepts of scarcity and equilibrium. Keynesianism is no

exception in this regard, but Keynesianism constituted a break from orthodoxy at a deep, ontological level, and thus stands in strong opposition with orthodox conceptions of markets and morality. Despite the global turn to austerity, and the apparent intractability of the austerity debates within economics, the Keynesian/anti-Keynesian battle over the fiscal role of the state is minor compared to the larger Polanyian "pendulum swing" in the relation between states and markets that may be occurring in the wake of capitalism's Great Recession. Employment rates in the United States are at historic lows and income inequality is at a historic high. In this context, a rethinking of the social contract—rather than just a debate over threshold levels of debt to GDP associated with slower growth—may be the true challenge facing industrialized countries in the early twenty-first century.

VISIONS OF AUSTERITY

Economic analysis of the proper fiscal role of the state dates to the origins of economics. Blyth (2013) traces the lineage back to the eighteenth-century enlightenment thinkers David Hume and Adam Smith and then through the Austrian liberals and German "ordoliberals" of the nineteenth century. Hayek continues this line of thinking in the twentieth century. A series of econometric studies in the 1990s provided support for the idea that fiscal retrenchment can raise the growth rate.

In the United States in the post-World War II period, the case for fiscal austerity has been seen to hinge on how changes in the fiscal stance affect interest rates, and specifically on the idea that an improvement in the fiscal balance will lead to lower rates. Lower rates should bring about (1) an increase in private investment; (2) an increase in household consumption since saving is less desirable and consumer credit is cheaper; and (3) currency depreciation and an increase in net exports and thus aggregate demand.

There are a few versions of the theory. In one version—"Ricardian equivalence" or "consumption smoothing"—public sector borrowing will be offset by forward-looking households that reduce spending today in anticipation of future tax increases (see, for example, Barro

1979). In another version, public spending crowds out private investment: the multiplier effect of government spending is less than one and thus a 10 percent increase in government spending brings an increase in GDP of less than 10 percent as a direct increase in public demand is offset by a decline in private investment (see, for example, Barro and Redlick 2011). These theories, while underpinned by assumptions of rational individual behavior, never received enough empirical support to be widely accepted.[1]

Household Behavior and the State

No argument in economics—but especially no argument with a clear policy dimension—has ever been resolved by empirical evidence. The debate over the impact of fiscal stimulus and austerity on economic growth is no exception. But with the empirical evidence weighing strongly against the austerity view, and with the assumptions of the consumption smoothing models generating a general skepticism because of the unrealistic extent of information and certainty they presume individual agents to hold (see, again, Marglin and Spiegler 2013), economists have turned to the moral dimension of austerity that is most associated with household behavior. The argument is more sophisticated than the simple analogy that because households must balance budgets, the government should do the same. Instead, according to one recent rendering, household behavior reflects desired societal behavior, and thus the effort by households to reduce debt reflects a social predilection for lower debt levels. Household deleveraging (reducing mortgage, credit card and student debt) is, in this view, a "vote" for deleveraging for society overall. According to Mankiw and Weinzeirl (2011),

> many Americans (including quite a few congressional Republicans) are skeptical that increased government spending is the right policy response. They are motivated by some basic economic and political questions: If we as individual citizens are feeling poorer and cutting back on our

spending, why should our elected representatives in effect reverse these private decisions by increasing spending and going into debt on our behalf? If the goal of government is to express the collective will of the citizenry, shouldn't it follow the lead of those it represents by tightening its own belt? (Mankiw and Weinzierl 2011, 2)

Mankiw and Weinzeirl seek to move the austerity debate away from a discussion of objective outcomes, such as multipliers or economic growth, and toward an assessment of subjective evaluations of *process*. Social welfare depends on agents' subjective perception of economic policy. Thus the authors argue that "the commonly used 'bang for the buck' calculations are potentially misleading guides for the welfare effects of alternative social policies" (Mankiw and Weinzierl 2011, 1). This turn reflects an abandonment of the perfect foresight microfoundational approach inherited from the classicals and goes to the issue of the morality of deficit spending, precisely where Keynes's intervention in the 1930s had so directly confronted the economic orthodoxy.

MORALITY OVERTURNED: THE NATURE OF THE KEYNESIAN BREAK

Austerity economics has deep-seated appeal to politicians in part because it supports conservative notions of the need for a very limited role for the state in the economy and in part because it favors creditors over debtors. At a deeper, metaphorical level, the austerity theories appeal to notions of scarcity and equilibrium that have given economics its power as an intellectual device. These theories build off the analogy of government as a "household" and the belief in the need for a balanced budget and in the importance of scarcity—and thus of one type of spending crowding out others as the basis for thinking about political economy.

Breaking from Orthodox Notions of Scarcity, Equilibrium, and Causality

Keynes's theory reversed the logic and direction of causality in some of the most fundamental aspects of the classical model. Acceptance

of Keynes's approach also required a rejection of the moral principles associated with that model. Hayek (1931) had argued the opposite—that the slump resulted from an excess of investment relative to consumer demand. An economic downturn is the "process of eliminating the unsustainable investment" not financed by genuine saving. Once the downturn had ended, however, government intervention would only delay a sustained recovery; the quickest cure would be for people to save more, thus supporting a sustainable recovery in investment. For Keynes, underinvestment was the central feature of economic slump, and government spending to pump up demand was the necessary policy response. The seemingly simple shift in focus from the market-clearing price adjustment mechanism to the level of aggregate demand led to a rejection of the classic orthodox views on economic causality, a fallacy of composition from microeconomic agents' behavior to macroeconomic outcomes (the determination of the real wage and the paradox of thrift), and a reversal of the traditional view on fiscal austerity. These insights were driven by Keynes's radical conception of market equilibrium, itself underpinned by Keynes's view of capitalism as a "monetary production system."

Keynes's liquidity preference theory of the rate of interest gave the result that the interest rate could settle at a rate that would not bring an adequate level of investment for the attainment of full employment, thus producing a *persistent* state of unemployment: an unemployment equilibrium. For Keynes, saving was a leakage from demand and occurred not because people preferred to wait for a larger consumption bundle in the future (the classical explanation of saving) but because they felt uncertain or anxious about the future. As Skidelsky (1994) writes, "At this level Keynes felt he had overturned the classical paradigm. It was the hunger for money, not the hunger for goods, which controlled macroeconomic outcomes" (595). The Keynesian logic thus reverses the direction of causality assumed by the classicals between saving and investment. For the classicals, the former is required to provide the financing for the latter. For Keynes, the latter (investment or business spending) generates business and household income, which leads them to more saving.

Keynes's views on wage flexibility also cut to the bone of the classical conception of economics, and again provided a logic that reversed the classical conception. Pigou and most of his contemporaries saw the absence of wage flexibility as the greatest obstacle to solving the unemployment problem. Keynes attacked this view head on in the first two chapters of *The General Theory*, arguing, first, that workers bargain over the money wage, not the real wage, and thus have incomplete control over the real wage. Since it is the real wage that acts as the equilibrating price in the classical conception, no bargain will necessarily lead to the equilibrium outcome. More important for policy, Keynes implied that downward wage flexibility could worsen the unemployment problem since it would send a signal to businesses of declining demand and thus a reduced need for investment spending.

Keynes's disagreement with Pigou was thus not simply technical but about the basic conception of a capitalist economy. Pigou depicted the labor market as a naturally stable equilibrium system on top of which society might impose complications, distortions, and obstacles, such as the downward stickiness of wages. Removing these complications, in this view, would lead to a natural and efficient outcome: full employment. For Keynes, the social and monetary dimensions of the wage bargain could not be separated from the workings of the system, and so Pigou's conclusion was based on a fundamental misconception of the nature of the labor market. Understanding the market as Keynes did—that is, as an inextricable complex of social, monetary, and production institutions—led him to conclude that equilibrium unemployment was not a market failure that could be cured by making the market more pure, but rather a possible natural outcome of market dynamics in the face of radical uncertainty. Kregel (1977) reinforces this point, pressing the significance of the ontological divide between the methodology of the Keynesians and the post-Keynesians:

> [O]ne does not "tame" the problems of the real world by creating and analyzing a world in which they are absent, and then searching for the minimum conditions for the

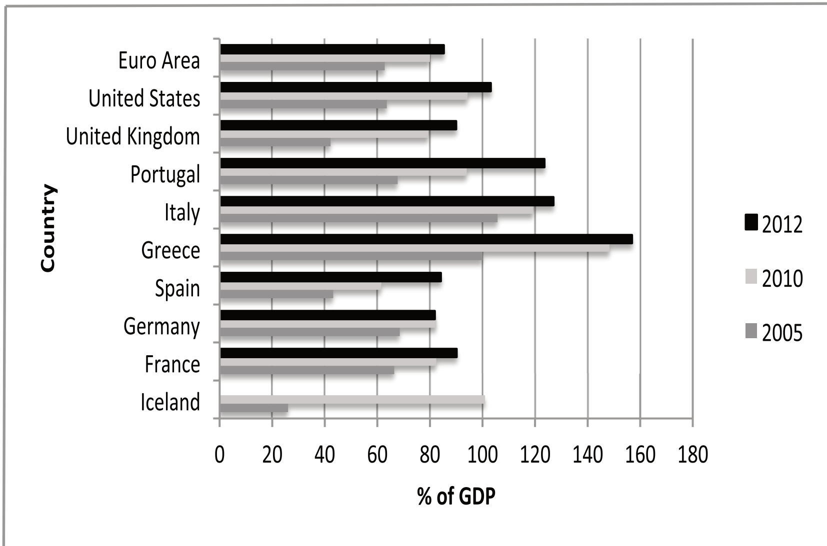
existence of such a world. Rather one attempts to make an ordering of the categories of the real world that are the object of analysis. . . . Keynes argued that his approach could not assume perfect foresight and full information, for under such an assumption his main theoretical contribution, the theory of effective demand, had no meaning (222).

Keynes's attack on the classical postulates was essential to his theory of effective demand. Keynes identified precursors to his view that demand determined the level of output (Malthus) and money played a prominent role in economic activity (mercantilists), but "Keynes was the first leading modern economist to focus analytical attention on the level of demand, or spending, as the determinant of the level of activity." (Skidelsky 1994, 544–545). This rejection of Say's Law had, again, deep implications for the nature of economic life: investment does not require prior saving and in fact the causality is reversed because of the dependence of saving on income. Shapiro (1977) brings out the radical nature of Keynes's departure from the classical conception of causality, since it is not rooted in the demands of scarcity. She writes that

> the differences between post-Keynesian and neoclassical economics are not so much differences in their subject matter as they are differences in their treatment of economic life. The neoclassicists' concern with [the problem of scarcity] is an expression of their view of the economic process as the adjustment of resources to the given needs of individuals, that is, "the allocation of scarce resources among competing ends." The problem of scarcity is absent in post-Keynesian economics precisely because this view is absent (552).

Keynes's contribution was at the ontological level, regarding the nature of uncertainty and expectations and the very conception of market capitalism.

Figure 1: General Government Debt as a Percentage of GDP, 2005, 2010 and 2012, Selected Countries



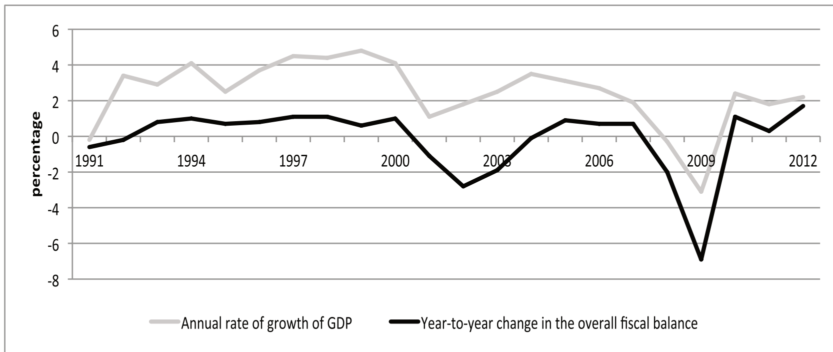
Source: Eurostat (2013) and White House Office of Management and Budget (2013).

THE CURRENT DEBATE

The concern in public debate is not the deficit but the debt. Since the fiscal deficit is the annual addition to the government debt, the former is the focus of policy. Figure 1 shows the ratio of government debt relative to GDP for selected industrialized countries. We see that debt in Greece, Portugal, and Italy has moved to above 120 percent of GDP, while the United States is around 100 percent, and the euro area on average is closer to 80 percent. We divide the level of debt by the GDP to be able to compare its scale across countries, but also because GDP reflects the ability to pay down the debt. The sustainability of a given level of debt is usually viewed in terms of the growth of the debt (the interest rate) and the growth of GDP (the rate of economic growth). If the growth rate exceeds the interest rate, then a given debt is considered sustainable. If the growth rate is less than the interest rate, it is unsustainable.

GDP is a useful benchmark against which we measure a nation's debt, but it is important to realize that debt and GDP are interdependent over time in the sense that the fiscal deficit depends on the rate of

Figure 2: US GDP Growth Rate and the Percentage Change in the Public Budget Balance, 1991–2012



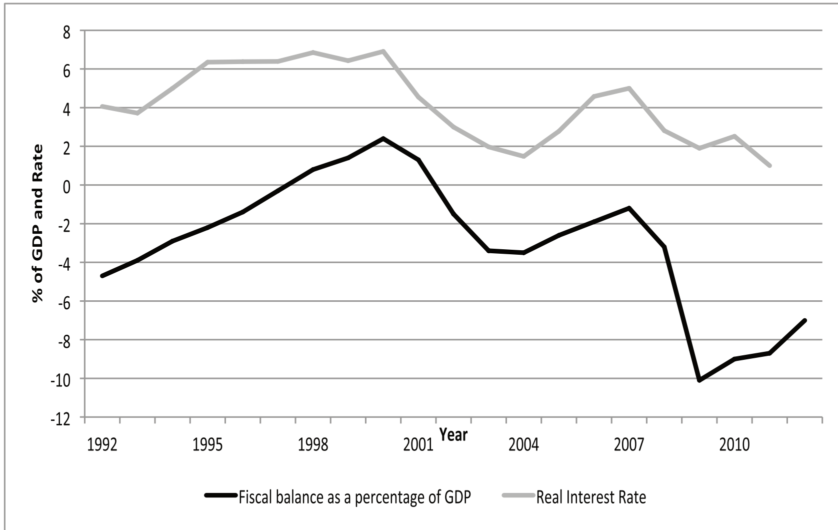
Source: US Bureau of Economic Analysis (2013) and White House Office of Management and Budget (2013).

economic growth, and the rate of growth can be influenced by the fiscal balance. Most important, and often ignored, is the endogeneity of the deficit in relation to GDP growth. In an economic upturn, tax receipts rise and automatic stabilizers (for example, unemployment benefits) fall; that is, the fiscal position improves. Conversely, in an economic downturn, tax receipts fall and automatic stabilizers rise; that is, the fiscal position deteriorates.

We see in figure 2 just how close this relation is by looking at the US fiscal balance and GDP growth. Of course, this close correlation does not tell us about causality, since the two are interdependent. Nonetheless, we can safely say that economic upturns have been associated with an improvement of the fiscal stance and downturns with deterioration.

The improvement in the US fiscal balance during the second Clinton administration is often attributed to the growth in the US economy and its positive impact on tax revenues. But we have also seen the relation between the fiscal balance and the GDP work in the negative direction of late in Europe, with Greece being the most prominent case. Spain too has cut government spending in order to reduce deficits. But the effect has also been to reduce incomes with a multiplier effect, and the result has been a drop in tax revenues and a worsening of the fiscal deficit.

Figure 3: US Fiscal Balance as a Percentage of GDP and Real Interest Rate, 1991–2012



Source: White House Office of Management and Budget (2013) and World Bank (2013).

The Behavioral Dimension

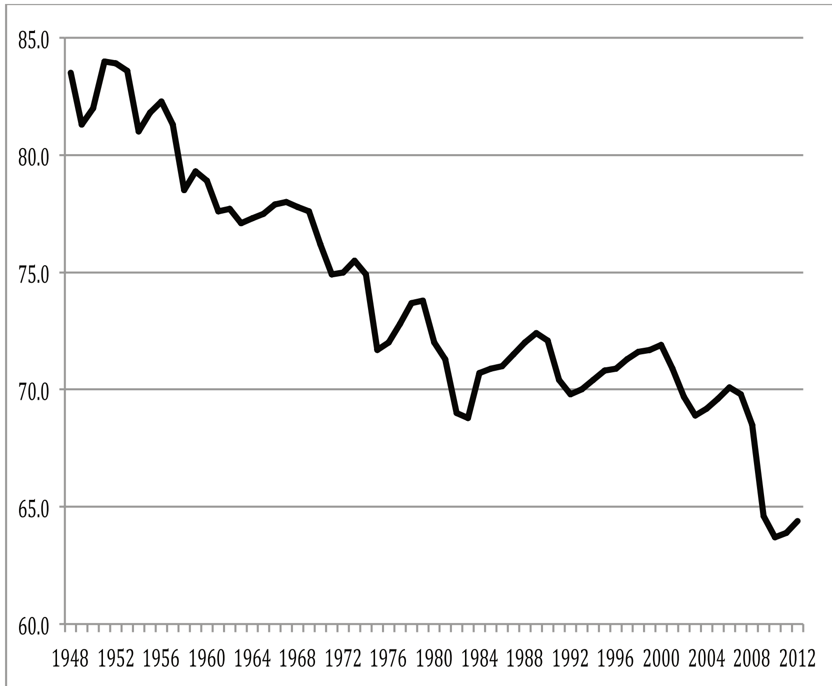
One response to this argument about the endogeneity of the fiscal balance to the growth rate is that it is overly mechanical, as there are behavioral dimensions of the relation between growth and debt, when market psychology plays an active role. In particular, it has been argued that debt may reach a level at which capital markets lose confidence, requiring a large increase in interest rates for continued attraction of capital. This would, of course, immediately affect the ratio of the interest rate to the growth rate and thus potentially alter the sustainability of any given level of debt. This was one possible justification for the (now infamous) Reinhart and Rogoff (2011) result that debt levels above 90 percent of GDP are associated with significantly lower rates of economic growth. Above that threshold level, public debt is nearing levels that will be unsustainable in the sense that the government will not be able to meet its debt payments or, at a minimum, would have to raise interest rates significantly in order to continue to borrow because of a decline in market confidence. Growth would be negatively affected.

The problem with the behavioral response is that it lacks empirical support in recent US experience. Figure 3 shows the US fiscal balance as a percentage of GDP and the real interest rate, measured as the five-year Treasury rate. We see that they broadly move in the same direction; a worsening of the fiscal deficit has generally been associated with declining real rates of interest. At a minimum, this graph shows that in the US case over the past 20 years, there is no clear support for the view that deficit increases are associated with hikes in the real rate of interest. Here again, one might raise the question of the direction of causality, especially given the generally countercyclical actions of the central bank.

POLANYI'S "PENDULUM SWING" AND THE CHALLENGE AHEAD

Were he alive today, Keynes might not have been surprised at the resurgence of the policy debate over his ideas and especially the global turn to austerity. "Practical men who believe themselves to be quite exempt from any intellectual influences," Keynes wrote in the last paragraphs of *The General Theory*, "are usually the slaves of some defunct economist" (383). Keynes is by any account more than just "some defunct economist," but the current economic challenges require a creativity of economic theory and policymaking that extends beyond Keynes. Market fundamentalism (Kozul-Wright and Rayment 2008) has led to unprecedented and unacceptable inequality of income and wealth, imbalances in international payments, and a misallocation of resources that overemphasizes financial speculation and underemphasizes entrepreneurship, innovation, and economic security. The employment-to-population ratio has fallen to levels not experienced since women began entering the labor force in great numbers in the 1960s (figure 4a). Income inequality has attained new postwar highs, as shown in figure 4b, with the steadily rising ratio of the top-to-bottom income earners. Today we face the challenge of creating a society that provides a more productive and sustainable use of resources at the same time that it generates a greater degree of economic security for its citizens.

Figure 4a: US Male Employment Population Ratio, 16 Years and Over, 1948–2013

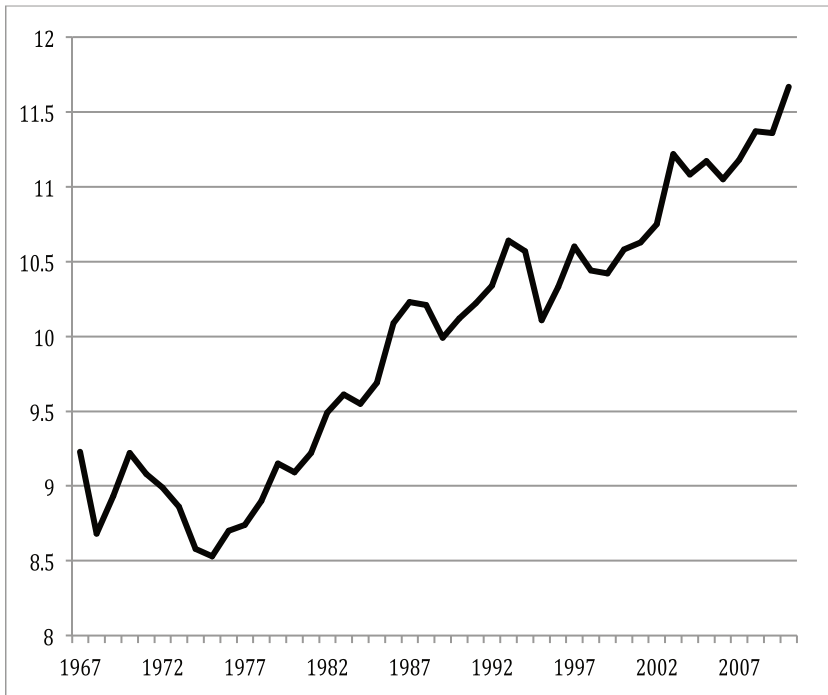


Source: Federal FRED (Federal Reserve Economic Data), Federal Reserve Bank of St. Louis; U.S. Department of Labor: Bureau of Labor Statistics http://research.stlouisfed.org/fred2/series/LNS12300001.

Economic austerity has been adopted during the current slump; the consequences have been devastating in Europe and have left the United States in what appears to be a prolonged period of slow growth.

New and creative thinking will be required to build true economic security. We might start with equitable sharing of productivity gains, universal access to quality education, health care, and adequate and secure retirement income. Further regulation of the financial markets would aim to channel financial institutions to do what they are designed to do in capitalism: allocate resources efficiently by providing credit for production, innovation, and long-term growth. We would redesign the architecture for the management of international finance to promote economic growth and stability globally. What may be required is a new

Figure 4b: Household Income Ratio of 90th/10th Percentile



Source: US Census Bureau (2012).

way of thinking, in short, a new theory of political economy. Despite the crisis of 2008 and the failures of austerity economics, however, no fundamental rethinking of economic theory is in the works (see Spiegler and Milberg [forthcoming] for an assessment and historical comparison).

The austerity debates of today, while of great importance to human well-being, are perhaps only a part of the contemporary turmoil over economic and social policy. If Keynesianism is not enough, what will constitute the next great paradigm of political economy? To begin to understand the challenges, economists and policymakers might be well advised to take advice from another mid-twentieth century thinker, Karl Polanyi, whose 1942 book *The Great Transformation: The Political and Economic Origins of Our Time*, shows that industrial capitalism has exhibited a series of swings in economic and social policy from

free market fundamentalism to a more regulated system in response to the excesses and detrimental social consequences of the free market phase. Polanyi's warnings about the nature of this "countermovement" are useful to revisit and consider as the basis for an alternative theory of political economy to replace the failed market fundamentalism espoused by economists for decades. Polanyi describes how industrial capitalism has consistently fluctuated between free-market fundamentalism and excessive state involvement (recall that *The Great Transformation* was published in 1942. When free markets create social conditions that threaten social cohesion—massive unemployment or dangerous working conditions, for example—governments come under pressure to respond with a "countermovement" like the pressures against austerity that we are witnessing today. Polanyi's insights give a sense of how complex and contested this countermovement is and how much creativity and diligence its success requires.

Polanyi insists that markets function because they are embedded in social and political institutions that create trust and provide norms and limits. Institutions, in Polanyi's view, extend well beyond questions of property rights and legal contracts that are the main focus of institutional economics today. Market-based freedoms (consumer choice and business investment) must be balanced with attention to other freedoms, including the provision of such basic needs as adequate food, housing, health care, education, and income security. Our inability to provide many of these social freedoms could be said to have contributed to the current economic collapse. To ignore these social freedoms is to reduce the likely success of market-based reforms.

Polanyi also observes that while the move to laissez-faire often occurs as a result of careful deregulation and political change—for example the adoption of the gold standard in 1870 or the deregulation of industry and decline of unions in the 1970s and 1980s—the re-regulation of capitalism often occurs under emergency conditions and in an ad hoc manner. The passage of the $700 billion Troubled Asset Relief Program (TARP) without clear guidelines or sufficient over-

sight is a perfect example of the chaotic nature of the countermove. Polanyi argues for a solution that is sustainable in order to avoid a drastic reverse counterswing of the social pendulum.

Today we simply do not face the deadlock between the economic and political realms that confronted many countries in the 1930s when Polanyi eschewed the "idealist" extremes of both communism and fascism for a pragmatic approach. He insisted that democracy, accountability, and justice are crucial for government legitimacy in the eyes of its citizens. From this perspective, bailouts and stimulus plans must be transparent and regulations enforced. Our voting system must instill confidence. Executive compensation schemes must be more fair, especially when supported by taxpayers. International economic institutions too must be evenhanded and democratic, not promoting austere monetarism for poor countries in crisis and expansionary Keynesianism in the rich ones, for example (Chang 2007).

Economists too can learn from Polanyi that models of the optimality of free markets often ignore broader social consequences of market forces. There are a series of much heralded new developments in economic thought today: experimental economics, behavioral economics, complexity theory, and agent-based modeling. These are all impressive technical developments. But there is very little of substance about the economy in any of these, much less a coherent vision about social relations, and in particular the connections among states, markets, firms, and households—that is, about capitalism. Capitalism is a word that had until the last few years disappeared from the lexicon of economics—it is not mentioned once in Gregory Mankiw's bestselling, 500-page economics principles textbook (Mankiw 2011).[2] The previously unmentionable word has now resurfaced in legitimate academic and policy circles, an indication precisely of the broad questioning and rethinking currently under way (see, for example, Posner 2009; Barbera 2009; Akerloff and Shiller 2009).

The political and intellectual attacks on economic austerity of late are perhaps just a step on the path to a new theory of political economy that will be more rooted in institutional detail and more modest

in its predictions. Economists have already begun a debate over the failure of existing economic models and the likelihood of a new paradigm. Most indications are that change will be resisted. But without a new Keynes in the wings, it is hard to know exactly how the countermove will manifest itself in economic thought.

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NOTES

1. Blyth (2013) reviews the critical attacks on the Bocconi school of "growth-enhancing austerity." Marglin and Spiegler (2013) provide strong counterevidence to the consumption smoothing hypothesis.
2. This omission was noted by Heilbroner (1999) in a prescient essay entitled "The End of The Worldly Philosophy?" The essay was the final chapter of the last edition of *The Worldly Philosophers.*

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White House Office of Management and Budget (2013) http://www.whitehouse.gov/omb/budget/historicals table 7.1

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