1. Introduction

The formation in May 2010 of the first coalition government in the UK for seventy years was followed by the pronouncement that public deficit reduction was the government's top policy priority. During the general election campaign the need for fiscal consolidation was accepted by all three major political parties. The conservative party however was the only party that argued for a program of accelerated deficit reduction and warned that if the election failed to produce a decisive outcome in the form of a government with an overall majority and with a ‘credible’ plan for deficit reduction, this could have dire consequences for the economy and the country. The fate of Greece was -and still is- offered, misleadingly in the case of the UK, as a stark warning to what could happen to a heavily indebted country when the markets lose confidence in its ability to repay
its debts. Indeed, after the election, the need for a stable coalition government, with an overall majority, capable of producing a ‘credible’ program of deficit reduction was one of the main justifications given as to why a coalition between conservative and liberal democratic parties was in the national interests. A coalition between labour and liberal democrats would have been more cohesive, in terms of its approach to deficit reduction but more fragile, in terms of parliamentary arithmetic, and therefore less ‘credible’ to the markets. Clearly the foundation and continued existence of the coalition government in the UK is based on the premise that the national interest is best served by the construction of a deficit reduction plan that the financial markets will find ‘credible’ which invariably means a tough and determined attack on the public sector and public expenditure.

The official document setting out the coalition agreement between the conservative and liberal democratic parties¹, states that “deficit reduction and continuing to ensure economic recovery is the most urgent issue facing Britain”. This objective is not unambiguous and it can be subject to alternative interpretations. It could be interpreted that accelerated deficit reduction and ensuring the continuation of the economic recovery are complementary objectives or it could be interpreted that

¹ See https://www.libdems.org.uk
they are conflicting objectives, requiring some kind of trade-off. According to the first interpretation, implementing immediate draconian fiscal austerity measures can aid economic recovery by calming the nerves of financial markets, thus preventing a ‘Greek-style’ market reaction, which will put an end to the recovery by increasing the cost and availability of credit to the government and the economy. According to the second interpretation, deficit reduction measures that are ‘too much, too soon’ can be an obstacle to continued economic recovery because the deflationary impact of severe public spending cuts and tax increases might abort the recovery and cause a double-dip recession. There are, therefore, dangers to economic recovery both from adopting and from not adopting a policy of accelerated deficit reduction: draconian fiscal austerity measures can prevent or cause an aborted recovery and a double-dip recession.

The dangers to economic recovery of cutting ‘too much, too soon’ are real and the rejection of the policy of accelerated deficit reduction during a fragile economic recovery is based on traditional Keynesian macroeconomic principles. (See, Davidson (2010), Skidelsky (2010). The dangers to the economy of not implementing immediate and additional cuts are only real if the inevitability of adverse market reaction to the absence of such measures is assumed. The case for immediate and draconian fiscal austerity measures, therefore, is fundamentally
based on the perceived need to appease and avoid the wrath of the financial markets, particularly the bond markets and the credit-rating agencies, who will ultimately determine whether the deficit reduction plan of a democratically elected government is ‘credible’ or not.

The aim of this paper is to appraise this perception not only in terms of its implications for democratic accountability and national sovereignty but also in terms of its logical and empirical validity. Section 2 briefly considers the implications for democratic accountability and national sovereignty of the subordination of public policymaking to market sentiment. Section 3 examines the theoretical arguments and evidence supporting the policy of accelerated deficit reduction and the logical basis of the ‘age of austerity’ strategy. Section 4 summarizes and concludes.

2. Deficit reduction policies and democracy

It was stated in the coalition agreement that the credibility of a deficit reduction plan does not necessarily depend on the depth of immediate cuts. It is now abundantly clear, following the emergency budget in June 2010 and the comprehensive spending review of October 2010, that the coalition government in the UK is fully committed to a program of immediate and deep fiscal austerity
measures. The Liberal Democratic Party’s position on deficit reduction has undergo a radical transformation since the election. It is claimed that this is not the result of a compromise, inevitable in a coalition government but a genuine conversion to the view that the ‘credibility’ of a deficit reduction plan does depend on the implementation of unpalatable immediate cuts and that without these cuts, the country will face a Greek-style economic disaster presumably from a similar adverse reaction of the financial markets and credit rating agencies. It is argued by the leadership of the Liberal Democratic Party that after taking a close look at the state of public finances they found them to be in a far worse state than they believed to be the case before the election. They therefore reached the conclusion, which the conservative party had already reached before the election without the benefit of a close look at the books, that immediate and savage fiscal austerity was the only policy option: failure to take immediate, resolute and tough action would result in loss of market ‘credibility’ which would trigger a disastrous adverse market reaction resulting in the imposition of the same or even tougher austerity policies by outsiders like the IMF and the EU. This theme that the nation must accept the ‘unpalatable’ in order to avoid the ‘disastrous’, has been repeated in numerous public statements by many senior members of the coalition government.

It can be argued that the adoption of policies that the financial markets dictate
represents a subversion of democracy and national sovereignty. According to Skidelsky (2009) this subordination of public policy-making to market sentiment is unacceptable:

“The government must cut its spending now, because this is what ‘the markets’ expect. These are the same markets that so wounded the banking system that it had to be rescued by the taxpayer. They are now demanding fiscal consolidation as the price of their continued support for governments whose fiscal troubles they have largely caused… The duty of governments is to govern in the best interest of the people who elected them not of the City of London”.

On the other hand, according to the coalition government doing what the markets expect is in the best interest of the electorate: adopting the ‘age of austerity’ strategy voluntarily, ensures that the inevitable deep cuts can be implemented in a ‘fair’ manner, by elected representatives rather than by unelected outsiders. Real loss of sovereignty occurs when countries reach a point where they need to be bailed-out by third parties.

It is undeniable that global financial markets, particularly the bond market, play a crucial role in influencing, either directly or indirectly, the economic policies of democratically elected governments. What is controversial, however, is whether this influence, is benign or pernicious. There are sharply contrasting perspectives about the way market power impacts on public policy-making. Sometimes the
behavior of international bond investors, known also as ‘bond vigilantes’, is seen as beneficial because of the restraining influence they exert on the ability of governments to engage in reckless borrowing and spending. More often, however, the activities of ‘bond vigilantes’ is seen as pure intimidation and bulling of governments by ruthless, opportunistic speculators and greedy gamblers interested only in a quick profit. There may be a great deal of truth in both of these perspectives: the bond market may act as a restraining influence not only when restraint is needed but also when is not needed.

At the most basic level, what the bond markets expect, like any lender, is a reassurance that borrowers will be able to repay their debts. Naturally when debts become excessive, lenders get apprehensive and nervous. This anxiety is usually translated into a demand by lenders that borrowers produce a deficit reduction plan which typically involves cuts in spending and increased revenue generally referred to as ‘austerity’ measures. The bigger the deficit the bigger the austerity demanded by lenders. The bigger the austerity adopted by borrowers, the less nervous the lenders feel about the prospect of debt repayment. The readiness of borrowers to adopt austerity measures can also be interpreted as a healthy sign that the indebted individual is taking the problem of indebtedness and possible insolvency seriously. Lenders naturally find the adoption of austerity measures as a ‘credible’ attempt by borrowers to reduce indebtedness. In the relationship between lenders and
borrowers, the aim of lenders is to ensure the repayment of the debt and the aim of borrowers is to avoid insolvency and maintain their ability to borrow in the future. Both aims can be achieved through the adoption of austerity measures by borrowers. When dealing with situations of individual indebtedness the logic of considering a deficit reduction plan which involves a combination of spending cuts and increased revenue as ‘credible’ is of course impeccable. Can the same logic be applied in the case of national indebtedness? Can the relationship between the bond markets and government policy be viewed in the same light as that of an individual lender and borrower with regard to the ‘credibility’ of a deficit reduction plan? Leaving on one side issues of democratic accountability and national sovereignty, is the adoption of draconian fiscal austerity during a period of fragile economic recovery the best means of achieving deficit reduction?


It was, of course Keynes (1936) who had warned us about the pitfalls of the logical fallacy of composition in formulating macroeconomic policy: what is true for the part is not necessarily true for the whole. The most famous example, of course, is the case of an individual household budget and a government budget. While it is sensible to counsel an individual household faced with economic difficulties, such
as unemployment, to ‘balance’ its budget by cutting down spending and living within its means, it is not a sensible advice to a government when the economy as a whole faces unemployment. In fact the solution to the country's unemployment problem is the opposite to that of an individual household's. What is needed in a recession according to Keynes (op.cit) is not a balanced but an unbalanced public budget. This simple Keynesian warning concerning the fallacy of composition, however, appears to have been forgotten by policymakers in dealing with the problem of national indebtedness. As I have argued elsewhere (Kitromilides, 2011), austerity is an effective and therefore ‘credible’ strategy for deficit reduction in the case of individual indebtedness but it may not be the appropriate strategy in the case of national indebtedness.

It is undoubtedly true that an individual household faced with mounting personal debts and pressures from lenders to repay the loans can avoid insolvency by putting in place a personal austerity plan. It should be emphasised that not all highly leveraged households or firms necessarily face pressures from lenders to reduce the deficit. If borrowing is used to finance productive investment the deficit will be eliminated through the flow of higher future incomes without the need for austerity measures. If, however, for whatever reason there is a real or perceived pressure from lenders for deficit reduction in the short run, a personal austerity plan may be the only option to prevent individual insolvency. The plan may
involve savage and unpleasant spending cuts and, ideally, an attempt to augment individual income through increased work effort. In principle such a plan, however unpalatable and painful, can eventually achieve its objective of reducing or even eliminating the deficit in due course thus avoiding personal insolvency. It is true that the choice facing a single individual attempting to reduce indebtedness is, unless bailed-out by friends and relatives, between the pain of austerity and the disaster of insolvency. The same is not true for the economy as a whole. Enduring the bitter medicine of austerity does not necessarily reduce indebtedness and prevent the disaster of insolvency. The reason is quite simple. In the case of a single individual, the mere fact of cutting down spending in order to repay debts does not affect an indebted individual's ability to maintain or seek an increase in his or her income, thereby facilitating the repayment of the debt. The ability of the economy as a whole, however, to maintain or increase its income will, in all likelihood, be affected by the very act of trying to deal with the problem of public indebtedness through fiscal tightening. By cutting down spending and increasing income an individual will eventually reduce the deficit. The same plan imposed on an indebted economy is not necessarily tenable. Public spending cuts and tax increases may, paradoxically, fail to reduce the budget deficit and public debt as a proportion of GDP, if they cause a slowdown or even a fall in GDP. Deficit reduction measures, therefore, that can achieve deficit reduction and prevent
insolvency in the case of an indebted individual may not necessarily achieve the same result in the case of national indebtedness, especially if fiscal austerity measures are replicated and synchronized across many interdependent economies with big fiscal deficits. If that is the case, why the financial markets insist on the implementation of immediate and draconian fiscal austerity as the only ‘credible’ deficit reduction policy? Before we attempt to discuss this question we must examine two further arguments in support of the ‘age of austerity’ strategy.

The first argument relies on the proposition of the New Consensus Macroeconomics (NCM) theoretical framework that discretionary fiscal policy is ineffective as a tool of stabilization policy (Arestis, 2007). What this means is that a change in fiscal stance has no impact on aggregate demand and the traditional Keynesian multiplier effect is close to zero or even negative. This conclusion is justified using theoretical arguments and empirical evidence based on the pre-Keynesian idea known as ‘crowding-out’ and re-enforced by the Ricardian Equivalence Theory as reformulated by Barro (1974): deficit spending by governments cannot have an expansionary effect on aggregate demand due to simultaneous offsetting reductions in private sector demand. First there is a fall in private investment demand caused by higher interest rates (‘crowding-out’); and second a fall in private consumption because rational, forward looking consumers increase their savings in anticipation of higher future taxes (‘Ricardian
Equivalence’). Similarly, a reduction of budget deficits due to fiscal tightening, will not affect aggregate demand for analogous reasons: the contractionary impact on aggregate demand of public spending cuts and tax increases will be offset by increases in investment demand and consumption demand stimulated by lower interest rates and lower savings in anticipation of lower taxes. This essentially is the modern version of the ‘treasury view’ opposed by Keynes (op.cit) in the 1930s: deficit spending in a recession is rejected because it has no expansionary effect on aggregate demand; fiscal tightening during a fragile recovery is acceptable because it has no contractionary effect on aggregate demand. The theoretical and empirical basis of these conclusions has recently come under considerable criticism. Arestis (2009), after reviewing recent theoretical developments and empirical evidence concludes that the downgrading of fiscal policy in the NCM is not justified and that there are “very little theoretical and empirical grounds to suggest that fiscal policy should not be used as an instrument of stabilization policy” (p 19).

Therefore, if fiscal policy can be effective and fiscal multipliers are generally positive it cannot be assumed that the ‘age of austerity’ would not have significant deflationary macroeconomic impact. Even less plausible is the claim that deep public expenditure cuts could have an expansionary effect. The imposition of immediate and draconian fiscal austerity, therefore, may not only be painful and unpalatable but also ineffective. There is a great deal of wishful thinking that there
are no significant differences in the process of individual and national reduction in indebtedness. It is claimed that there is no significant risk of a double-dip recession which will derail national deficit reduction plans because resources released from the overblown public sector will be absorbed by a rejuvenated and full of optimism private sector. The source of such optimism is expectations, brought about by the ‘paradigm-shift’ or ‘regime-change’ in policymaking, of lower public spending, lower interest rates, lower inflation and above all lower taxes made possible by lower public debt (assuming, of course, that taxpayers will not be asked to foot the bill of another banking collapse). In recent years austerity measures have succeeded in reducing deficits in several countries such as Mexico in 1995, South Korea in 1998, Turkey in 2001 and Brazil in 2002. The bright and shining example of this process, however, is the so called Canadian model of deficit reduction. In Canada a budget deficit of 9.1% of GDP in 1993 was transformed in to a small surplus in 1996. This was achieved mainly through savage budget cuts, not tax increases, by a government that had just been elected with a huge majority. Above all it was achieved at a period, 1993-96, when the US, Canada’s major trading partner, was experiencing rapid economic growth. Countries adopting the austerity model of public deficit reduction face an entirely different global economic environment in 2010. Not only the US but also other advanced economies are slowly recovering from the worst recession for decades. If the fragile recovery is
destroyed and the global economy is pushed back into recession by the ‘age of austerity’ policies, the private sector despite all the optimistic prospects that fiscal austerity is supposed to generate of lower interest rates, lower inflation and lower taxes may not be in the mood of absorbing all the resources released by the public sector which will remain unemployed. It is not inconceivable that employment in the private sector may also contract. If that were to happen, even the financial markets, whose nerves these policies were designed to calm, might eventually realize that these measures, especially when replicated in a number of countries represent too big a gamble after all.

The second argument in support of the fiscal austerity strategy relates to the cumulative impact of budget deficits on the total public debt as a percentage of GDP. What is the relationship between total debt and economic growth? Is there a level beyond which debt accumulation can have a negative effect on economic growth? In a recent study Reinhart and Rogoff (2009) claim that once the debt-to-GDP ratio exceeds 90% economic growth is reduced by at least 1%. Indebted economies, therefore, need fiscal austerity measures in order to prevent debt accumulation from reaching or exceeding this threshold with its adverse effects on economic growth. In 2009 three Euro zone countries have exceeded the 90% threshold. The total debt-to-GDR ratio was 115.8 in Italy, 115.1 in Greece and 96.7 in Belgium. Another three Euro zone countries had ratios approaching the 90%
threshold. The debt-to-GDP ratio was 77.6 in France, 76.8 in Portugal and 73.2 in Germany. Outside the Euro zone the UK had in 2009 a ratio of 68.1%. (Source: Eurostat). In the US the equivalent ratio for 2009 was 83.29 projected to rise to 94.27 for 2010. (Source: US Treasury). If we compare the current size of public debt with the Rinehart and Rogoff (op.cit) threshold it seems that alarm bells should be ringing for those economies that have exceeded or are rapidly approaching this target ratio. However it should be noted that in the immediate Post-World War II period, debt-to-GDP ratios in both the US and UK had significantly exceeded the 90% threshold without adverse effects on economic growth, while more recently Japan was able to combine debt to GDP ratios of nearly 200% with low interest rates. In any case the Reinhart and Rogoff (op.cit) thesis, if accepted, is essentially an argument supporting the case for long term fiscal consolidation rather than a policy of urgent and accelerated deficit reduction during a fragile economic recovery. Rogoff (2010), however, disagrees with this assessment and insists that urgent measures are needed because the reaction of markets to debt accumulation can be sudden, unpredictable and severe. He claims that “the evidence generally suggests that the response of interest rates to debt is highly non-linear. Thus, an apparent benign market environment can darken quite suddenly as a country approaches its debt ceiling” (p.11). Therefore gradual fiscal consolidation is, according to Rogoff (op.cit), a risk not worth taking. Immediate
fiscal tightening is, therefore, needed.

The prospect of dark clouds gathering in the market environment as a result of growing public indebtedness brings us back full circle to the first argument supporting the speedy adoption of the ‘age of austerity’ strategy. According to this argument, record peace-time budget deficits and record peace-time debt accumulation make global financial markets extremely nervous. Financial markets, like any lender, are anxious and nervous about ballooning fiscal deficits. Since markets can suddenly lose their patience with devastating consequences for the borrowers, governments with big deficits, like individuals with unsustainable levels of indebtedness must implement austerity measures now in order to convince the lenders that they are serious about dealing with their debt problems. Governments, therefore, need to calm market nerves by formulating and adopting policies that the markets find ‘credible’.

Current ‘war-time’ levels of public indebtedness may be unsustainable but so were the levels of public indebtedness during the last world war. As Blanchflower (2010) points out if the country was fighting a real war now would the coalition government have abandoned the war effort in order to reduce the deficit and appease the financial markets? In any case, as was argued in this section, the proposition that savage austerity during a fragile economic recovery will result in rapid deficit reduction is questionable. Even more questionable is the expectation
that deficit reduction policies will stimulate growth. As Stiglitz (2010) points out this belief is as fanciful as the belief in fairies. It seems that the financial markets also realize that savage austerity is not that ‘credible’ as a strategy of deficit reduction. Indeed, at least in the case of Greece, Ireland, Portugal and Spain, the imposition of the ‘age of austerity’ proved to be only a temporary tranquilizer and sedative, not a long term cure for market jitters regarding budget deficits and public debt. In fact countries that have dutifully taken the bitter medicine of austerity are, in fact making the markets more not less nervous and instead of being rewarded for their pains, they get even more punishment from the markets. In a way this is to be expected because ultimately what the markets want is *deficit reduction* not *austerity measures* per se. In other words, at some point the markets, who are supposed to be not only omnipotent but also omniscient, start taking on board the ‘fallacy of composition’ argument and actually stop treating the deficit reduction process of a country in the same way as that of a single individual or firm: it is surely not re-assuring for a lender to know that a borrower has an austerity plan in place if, at the same time, the borrower is about to lose his or her job or being forced into part-time work. The so called ‘unavoidable’ painful measures, therefore, might not only fail to promote growth but also and as a consequence, fail to placate the markets which, paradoxically, was the initial justification for the accelerated deficit reduction strategy.
3. Summary and conclusions.

If fiscal policy is ineffective and fiscal multipliers are zero, as claimed by the NCM theoretical framework, then fiscal austerity measures can in fact achieve deficit reduction because there will be no net deflationary effect. Furthermore, the austerity measures may even have an expansionary effect in the long run if optimistic expectations ‘inspired’ by the measures stimulate private sector growth sufficiently to neutralize any deflationary impact of ‘savage’ public spending cuts. However, after examining the relevant theoretical arguments and evidence (Arestis, 2009), we do not find this argument plausible and it does not invalidate the general conclusion of this paper that a deficit reduction plan that is appropriate in the case of an individual debt may not be appropriate in dealing with government debt, especially when there is ‘synchronized’ fiscal austerity.

With regard to the fear-mongering that the markets will react adversely to the absence of immediate and savage fiscal austerity, the markets themselves appear to be providing a different answer. At least in the case of Greece, Ireland, Spain and Portugal it appears that the markets are not pacified by the imposition of the ‘age of austerity’ because there are serious doubts whether the ‘age of austerity’ will in fact achieve the intended outcome of rapid fiscal consolidation. The problem of ballooning public debt is a long term problem requiring long-term solutions. The
solution to the problem should not be based on a short-term reaction to market jitters. It is above all, as the Irish crisis has revealed beyond any doubt, a problem that is inextricably connected with the problem of reforming the global banking and financial system. The two problems need to be tackled together not separately. The policy debate about the ‘age of austerity’ is not simply a technical dispute between opposing schools of thought in macroeconomics or another example of economists advocating diametrically opposite solutions to policy problems. There is a much wider debate about the respective roles of the public and private sectors of the economy. In this wider debate an attempt is made to persuade the public to accept a smaller public sector by accepting the ‘age of austerity’. In the battle to win over public opinion a great deal of what Krugman (2010) calls ‘fiscal scare tactics’ are being deployed. Part of this fear-mongering is the claim that austerity is the appropriate policy for preventing both individual and national insolvency. The public is being bombarded with frightening images and dark comparisons between individual and national insolvency.

“Spain has had the banks step in. Greece had the bailiffs round. But in Britain we are determined not to let that happen”, declared Mr. Clegg,² stirring-up more deficit hysteria, as if Spain, Greece and Britain are indebted individuals facing

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2 In a speech to the Institute for Government on June 14th, 2010.
nothing short of a long term in a Dickensian debtors' prison unless they accept the lesser of the two evils which is savage austerity.

The analogy between individual and national indebtedness, however inappropriate and misleading, is indeed very powerful and persuasive and helps to conceal the real objective of this strategy, which is not deficit reduction but reduction of the public sector whatever the cost in terms of unemployment.

References


