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The Case for Austerity: A Primer

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The dismal economic data from the UK today prompted me to discuss the 'austerity debate' in **my last post**.

Here's a primer on the case for austerity.

The argument comes to us from **Veronique de Rugy**, a scholar at The Cato Institute, who makes the case rather eloquently in an article subtitled "Why left-wing economists' warnings against austerity programs are wrong".

Her argument begins with the familiar theme of bond vigilantes in revolt.

The basic premise is this: Nation-states finance their borrowing by issuing public debt. The bonds issued at those offerings must have buyers. If the economic situation of an issuer deteriorates significantly—due to excess spending or bad fiscal policy—investors will stop buying their bonds.

While economists of the Paul Krugman stripe tend to say that the risk of sovereign debt default is based on the size of a country's debt relative to the size of its total economy, de Rugy takes a different tack:

"Contrary to common belief, investors don't judge sovereign default risks based on public debt as a percentage of gross domestic product. Instead, bond professionals grade on a curve, assessing one country's fiscal behavior against another's. When investors lose confidence in a government's fiscal rectitude relative to its competitors, they withdraw, and the snubbed country suffers. Capital being a scarce good, the result is increased interest rates and a higher price for debt."

So funding for a country's debt can dry up based on its relative—rather than absolute—economic strength.

And here is the core balancing act that nations must bear in mind in order to be able to fund their borrowing in the future:

"One of the key signaling devices for international investors is how a government behaves under financial duress—how it balances the demands of its debtors with those of its welfare recipients. Announcements of lower spending and higher taxes tell investors a country is willing to go to great lengths not to default on its debt obligations. If the government instead focuses on preserving its welfare state and public employee benefits, investors know default is more likely and will shy away from that country's bonds."

That's it in a nutshell.

Counterexamples are discussed—and dismissed as exceptions to a general rule:

"Japan has the world's biggest debt as a percentage of GDP, at 227 percent, nearly four times the economist-recommended 60 percent ceiling. It has gotten away with its carelessness without risking default because the country relies more heavily than most on domestic investors to fund its follies. The United States, despite a dangerous debt burden relative to GDP (66 percent) and a structural deficit among the highest of developed countries (almost 4 percent), has so far also escaped investor censure, thanks to the perception that the dollar remains the safest currency in the world. European countries don't have that luxury."

De Rugy also dismisses the central tenet of the Keynesian argument:

"The notion that austerity is bad and stimulus is good rests on the Keynesian theory that if government spends a lot of money, that money will create more value in economic growth. This purported increase in gross domestic product is what economists call the 'multiplier effect.' It's a nice story, but like most fairy tales, it has scant basis in reality."

In fact, according to de Rugy, there is a divisor effect:

"Barro and Redlick also looked at the economic impact of raising taxes to pay for spending increases. They found that for every $1 in tax-financed spending, the economy actually shrinks by $1.10. In other words, greater spending financed by tax increases damages the economy. The stimulus isn't working, because the economic theory it is based on is fundamentally flawed."

Her argument continues to describe how job creation from stimulus spending is focused disproportionately in the public sector—and that public sector jobs crowd out 50 percent more private sector jobs than they create.

"Using data for a sample of OECD countries from 1960 to 2000, they found that, on average, the creation of 100 public jobs eliminated about 150 private-sector jobs, decreased by a slight margin overall labor market participation, and increased by about 33 the number of unemployed workers."

Her conclusion is unequivocal:

"The understandable temptation to take action in a time of recession should not lead lawmakers down unproductive paths. Stimulus by government spending doesn't work. European and American governments have tried it without success. Now is the time to tighten spending, no matter what some American economists might say."

Agree or disagree, this seems to be the playbook British Tories are following.