Fiscal policy and austerity

(Rob Calvert Jump) and Jo Michell

PKES Summer School 2024

FISCAL POLICY AND AUSTERITY

▶ What are the different approaches to fiscal policy?
  ▶ Theoretical approaches
  ▶ Policy approaches

Fiscal policy and austerity

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- ▶ What is the PK (theory) and progressive (policy) view?

FISCAL POLICY AND AUSTERITY

- ▶ What are the different approaches to fiscal policy?
  - ▶ Theoretical approaches
  - ▶ Policy approaches
- ▶ What is the PK (theory) and progressive (policy) view?
- ▶ What is austerity?
- ▶ Case study: austerity in the UK

FISCAL POLICY: THEORETICAL APPROACHES

▶ 'Textbook macro': variants of $IS - LM$, $AS - AD$ and/or 'crowding out'

Fiscal policy: theoretical approaches

- ▶ 'Textbook macro': variants of $IS - LM$, $AS - AD$ and/or 'crowding out'
- ▶ New Keynesian macro: a shifting target
  - ▶ Neoclassical general equilibrium models with 'frictions'
  - ▶ First generation (e.g. Woodford 2003) provide justification for independent inflation targeting central banks.
  - ▶ More recently: overlapping generations (OLG), heterogeneous agents (HANK), wide variety of market imperfections (e.g. credit markets, labour markets, capital markets).

Fiscal policy: theoretical approaches

- ▶ PK macro
  - ▶ Simple versions: IS without LM
  - ▶ More complex models: growth, finance, monetary-fiscal interaction etc
  - ▶ Interactions between **distribution** and **expenditure**.
  - ▶ **Demand-side**: determination of expenditure (private consumption, investment, government consumption)
  - ▶ **Supply-side**: determination of inflation; assumes that unemployment is a normal feature of capitalism

PK macro: distinguishing features

- ▶ Relationship between interest rates and investment unstable; importance of uncertainty and sentiment in investment decisions
- ▶ Rejection of 'loanable funds' theory in which rate of interest is price which regulates a) consumption and investment b) present and future consumption
- ▶ Emphasis on multipliers – consumption reacts to 'autonomous expenditures' so changes are amplified
- ▶ Assumption of markup pricing based on heuristics rather than known demand curves
- ▶ Rejection of fixed 'natural rates' of output, employment and rate of interest

A simple model ...

Figure 2.1. Three Ways to Measure GDP
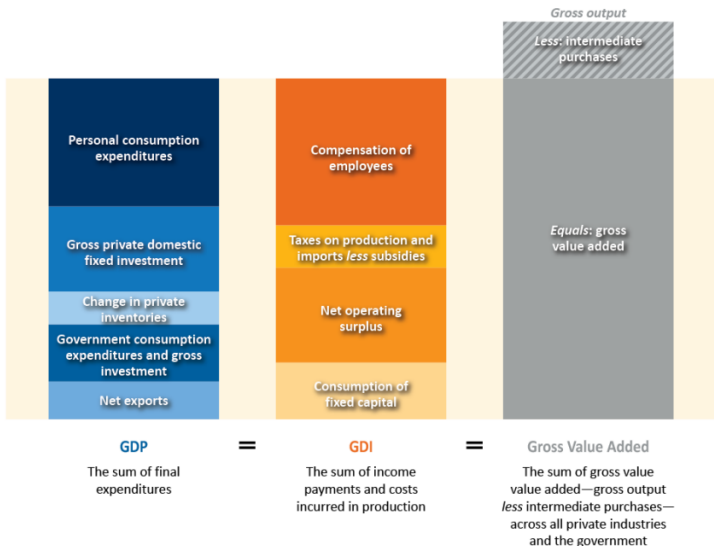
Simple closed economy model

Three ways to calculate GDP (A)

$$E = Y = VA$$

SIMPLE CLOSED ECONOMY MODEL

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'Autonomous expenditures': I and G exogenous, but
$I = f(r, \ldots)$

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$$m = \frac{1}{1 - 0.75(1 - 0.2)} = \frac{1}{1 - 0.6} = 2.5$$

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if both double, so $G = 1000, I = 1000,$

$$E = Y = 2.5 \times 2000 = 5000$$

A very simple closed economy model

Output per worker (productivity): λ
Employment (person employed): L
So:

$$E = Y = L\lambda$$

e.g. if $\lambda = 10$ and $L = 250$ then $Y = 2500$
But employment is determined by expenditure, so

$$L = \frac{Y}{\lambda}$$
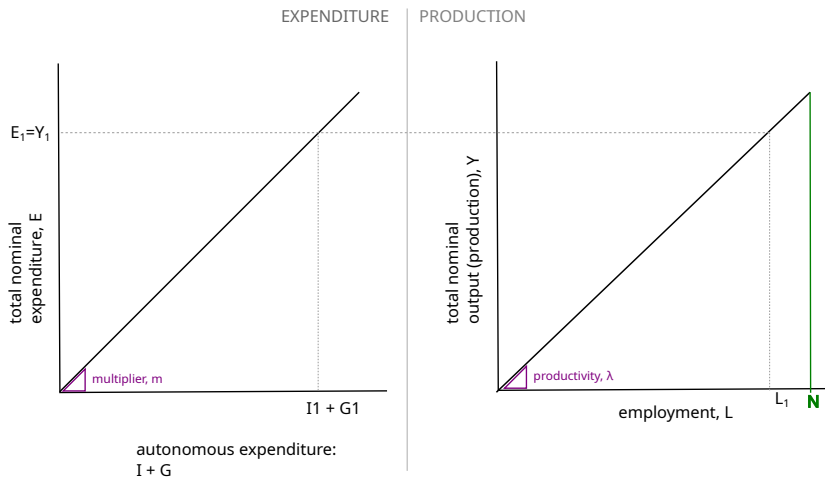
Simple closed economy model

► Summary:
  ► G and I 'autonomous'
  ► C and Y determined by multiplier

$$E = Y = (I + G) \times \frac{1}{1 - c(1 - \tau)}$$

  ► L determined by Y (for given output per worker)

$$L = \frac{Y}{\lambda}$$

SIMPLE CLOSED ECONOMY MODEL

EXPENDITURE | PRODUCTION

total nominal expenditure, E

$E_1=Y_1$

multiplier, m

I1 + G1

autonomous expenditure:
I + G

total nominal output (production), Y

productivity, λ

employment, L

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POLICY-RELEVANT IMPLICATIONS

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▶ If investment and consumption propensity are too low to generate full employment, must increase G, reduce τ or both.

▶ To achieve full employment, (persistent) deficits may be required

(My) PK/progressive macro policy programme

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▶ looser inflation-employment trade off.

CONTRAST WITH CONVENTIONAL POLICY VIEW

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  ► Monetary policy should be used to achieve inflation targets

Contrast with conventional policy view

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  - ▶ Fiscal policy should be used to manage the public finances.
  - ▶ BUT, if rates are at zero lower bound, fiscal policy should be used to raise output and inflation.

PK vs NK

	NCM	PKM
Monetary policy	Inflation targeting by means of interest rate policies, which affect unemployment in the short run, but only inflation in the long run	Target low interest rates affecting distribution, and stabilise monetary, financial and economic sectors applying other instruments (LLR, credit controls, ABRR, etc.)
Fiscal policy	Supports monetary policy in achieving price stability, balances the budget over the cycle	Real stabilisation in the short and long run, no autonomous deficit target, distribution of disposable income
Labour market and wage/ incomes policy	Determines the NAIRU in the long run and the speed of adjustment in the short run, focus should be on flexible nominal and real wages	Affects price level/inflation and distribution, focus should be on rigid nominal wages, steady nominal unit labour cost growth and compressed wage structure

PK vs NK

International economic policies	Free trade, free capital flows, flexible exchange rates	Regulated capital flows, managed exchange rates, infant industry protection, regional and industrial policies
Co-ordination	Clear assignment in the long run, co-ordination at best only in the short run	No clear assignment, economic policy co-ordination required in the short and the long run, both nationally and internationally

Progressive vs neoliberal policy regimes

- ▶ No clear mapping to PK/NK dichotomy
- ▶ Examples:
    - ▶ Eurozone 2010s, Greece in particular
    - ▶ UK 2010-2016
    - ▶ US during and post-pandemic

Figure 2.1. Three Ways to Measure GDP

Gross output

Less: intermediate purchases

| GDP | | GDI | | Gross Value Added |

Personal consumption expenditures

Gross private domestic fixed investment

Change in private inventories

Government consumption expenditures and gross investment

Net exports

Compensation of employees

Taxes on production and imports *less* subsidies

Net operating surplus

Consumption of fixed capital

Equals: gross value added

GDP = **GDI** = **Gross Value Added**

The sum of final expenditures

The sum of income payments and costs incurred in production

The sum of gross value added—gross output *less* intermediate purchases—across all private industries and the government

U.S. Bureau of Economic Analysis

Austerity

AUSTERITY

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▶ Soviet Union/China; UK post-WWII

Austerity

- Original meaning: squeezing consumption to make space for investment.
- Soviet Union/China; UK post-WWII
- More recently, either:
    - Fiscal consolidation: (raising taxes and/or cutting gov. spending)
    - Cuts to government spending

Case study: the UK

Public sector net debt
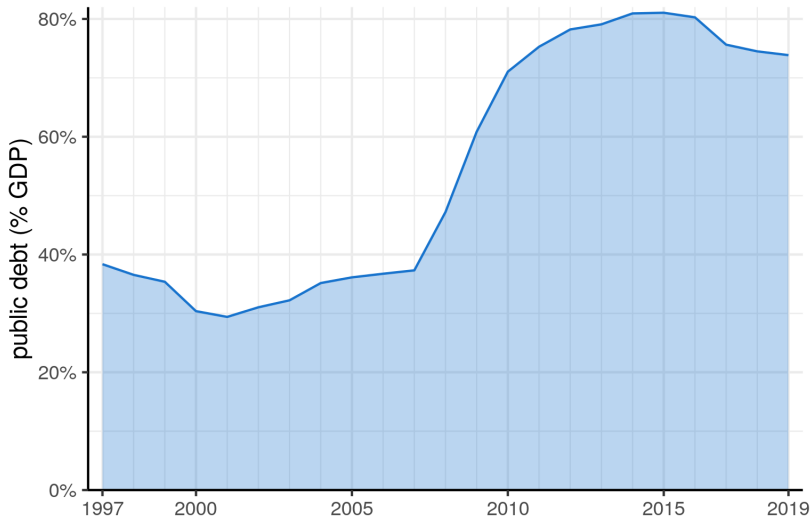
PUBLIC SECTOR NET BORROWING
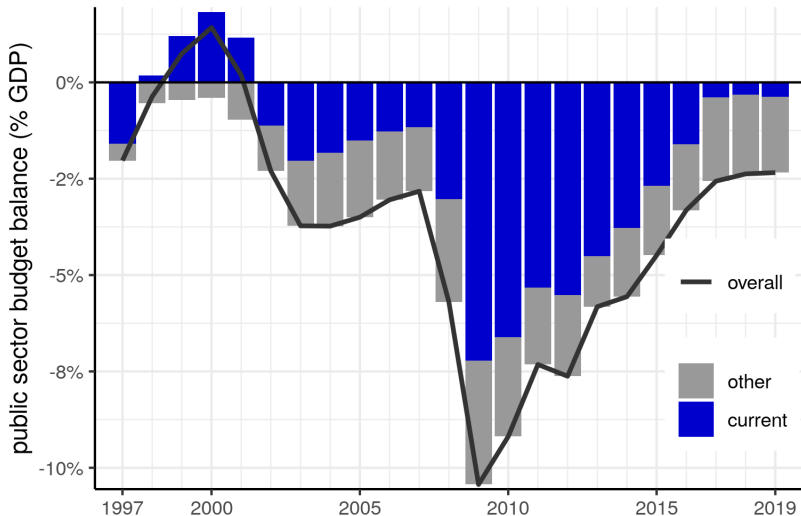
PUBLIC SPENDING PER PERSON

interest rate on governent debt

interest payments

government debt 2022-23

government debt 2023-24

deficit 2022-23

primary deficit

tax revenue 2022-23

government spending (excluding interest payments) 2022-23
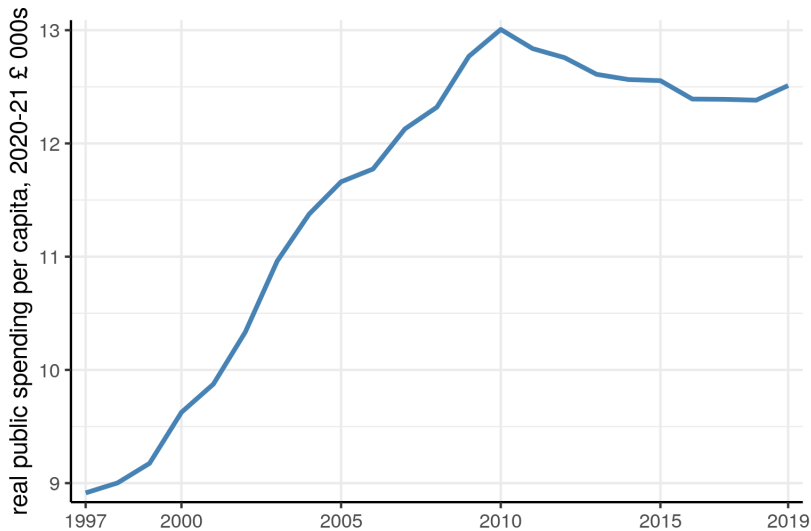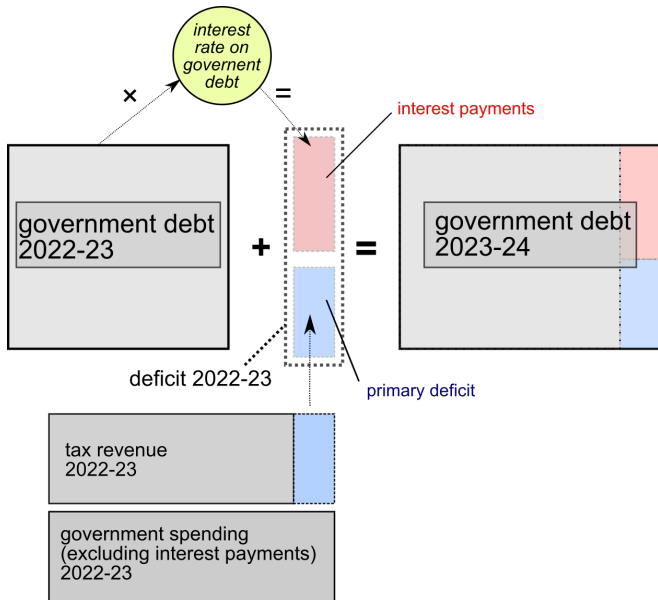
Expansionary austerity I

► Lower government borrowing increases the confidence of bond market
► Greater demand for bonds; lower interest rates
► This lowers the likelihood of a debt spiral requiring more severe future cuts or tax hikes
► Raises confidence
► Lower rates = higher spending, higher investment
► Central bank can always offset weak expenditure

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total nominal expenditure, E

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total nominal output (production), Y

productivity, λ

L_1 **N**

employment, L
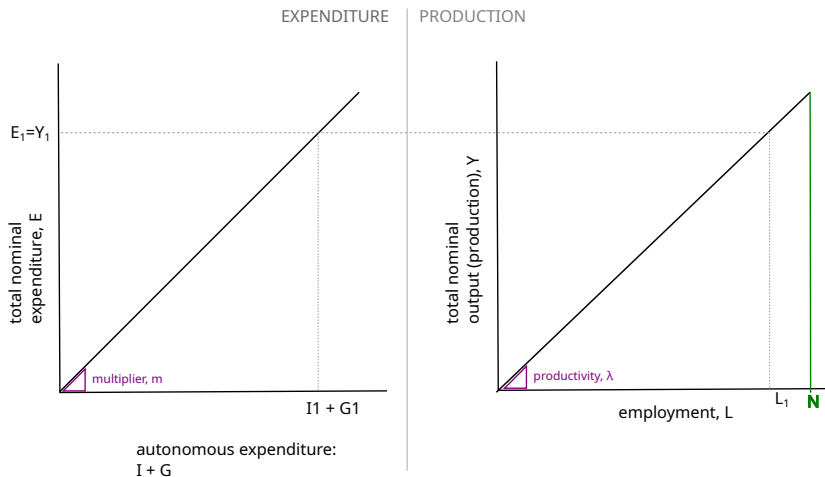
GDP per capita growth
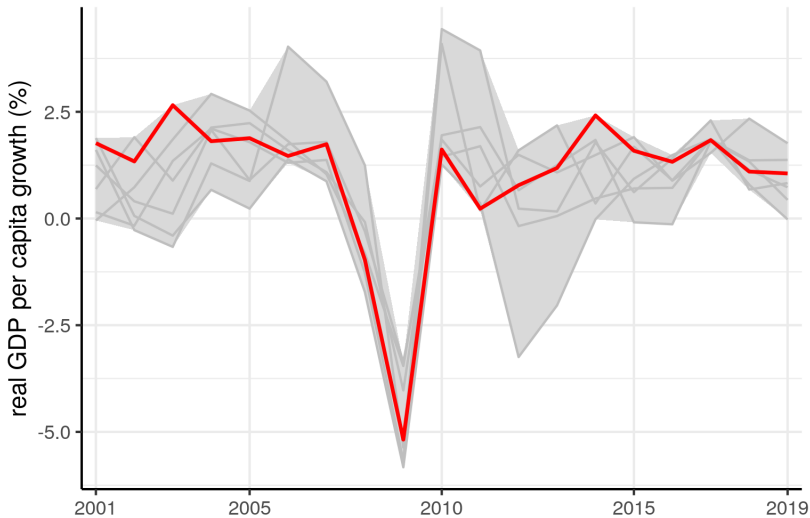
Lower growth than previously thought under austerity

Growth in real GDP per capita, 2010-2016

source: IMF
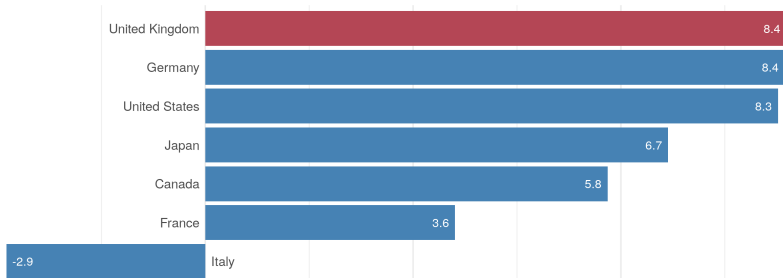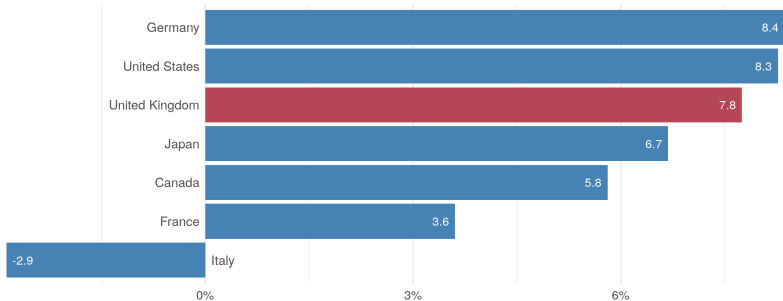
UK recovery from the 2008 crisis was weak

Per cent change in real GDP per capita compared to pre-crisis maximum

7.1% Germany
5.5% US
2.8% UK
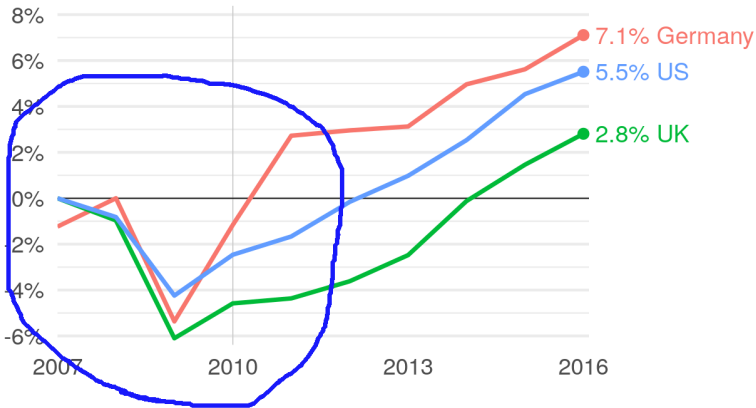
source: national statistical agencies
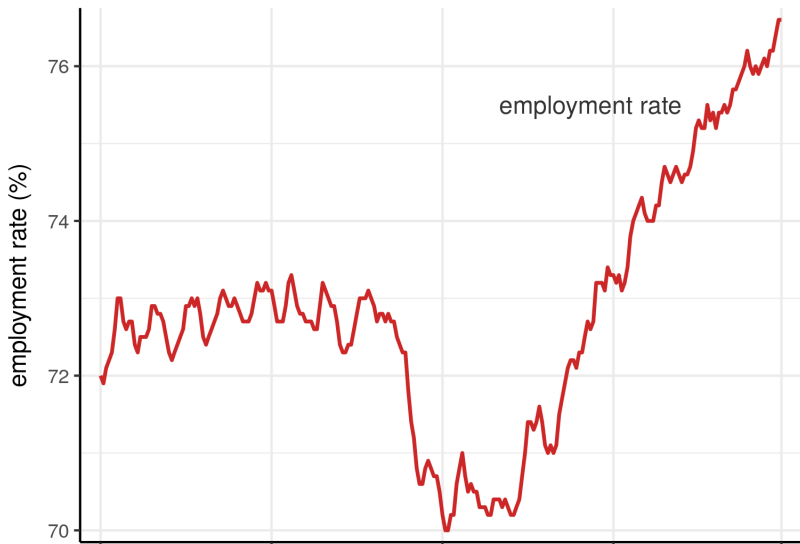
Expansionary austerity II

Consider . . . a fiscal stabilization that relies on cuts to public spending. A decrease in government employment, in government wages, and in unemployment benefits can have positive effects on the economy because it makes the labor market less tight . . . Any decrease in these public spending items lowers pressure on the equilibrium wage with positive consequences for the economy.
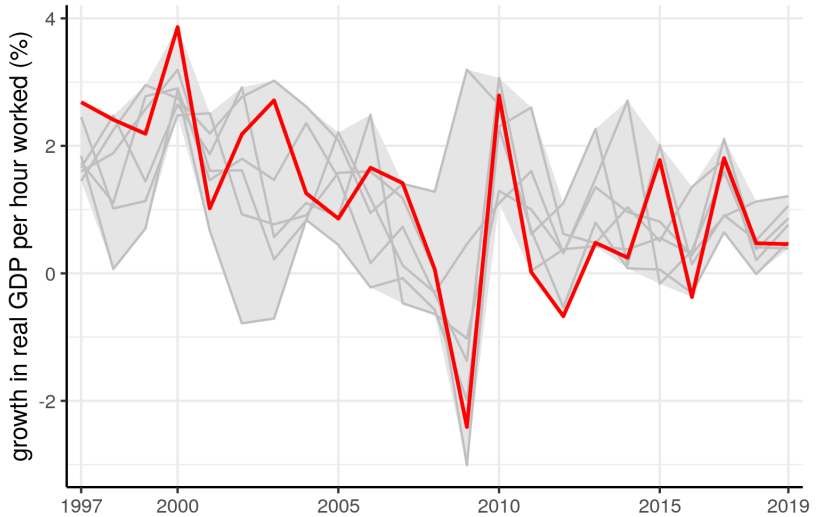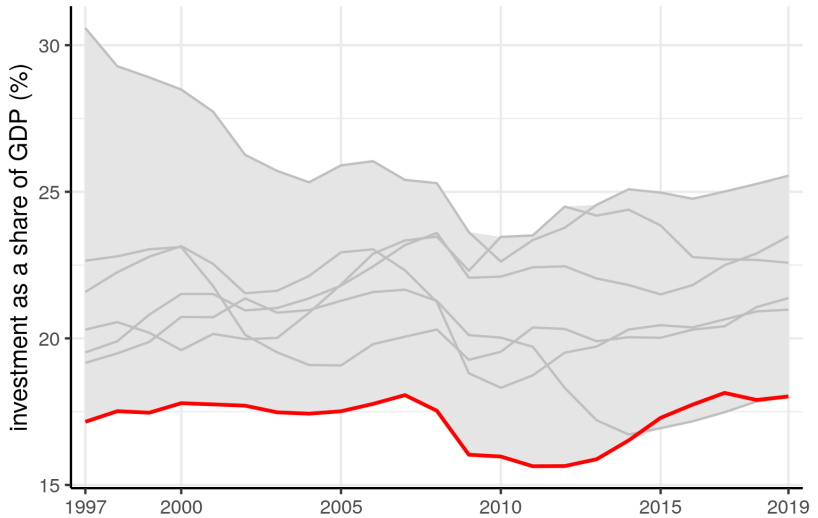
Ardagna (2004)
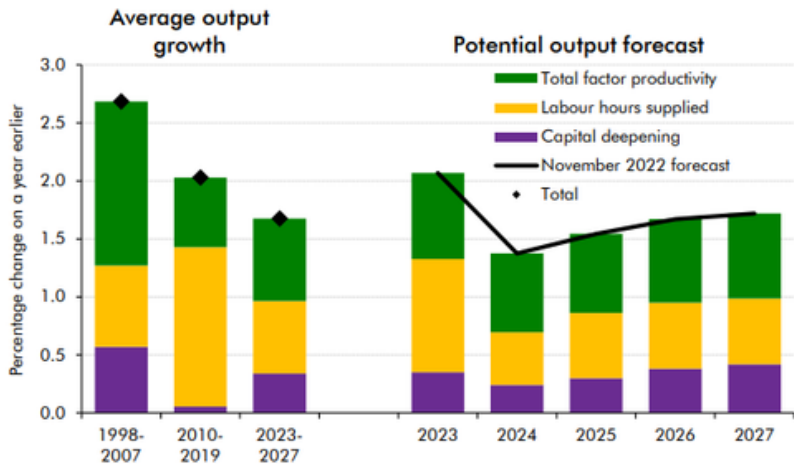
THE UK'S PROBLEM IN ONE CHART

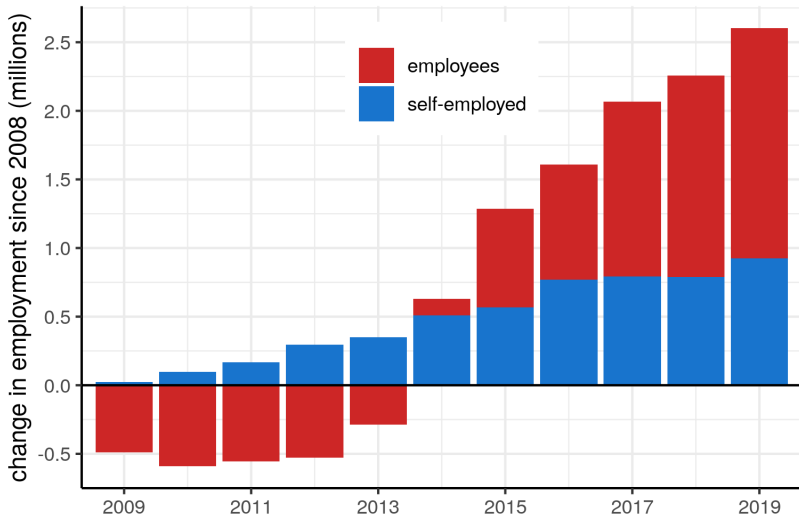hours worked % change | output per hour % change
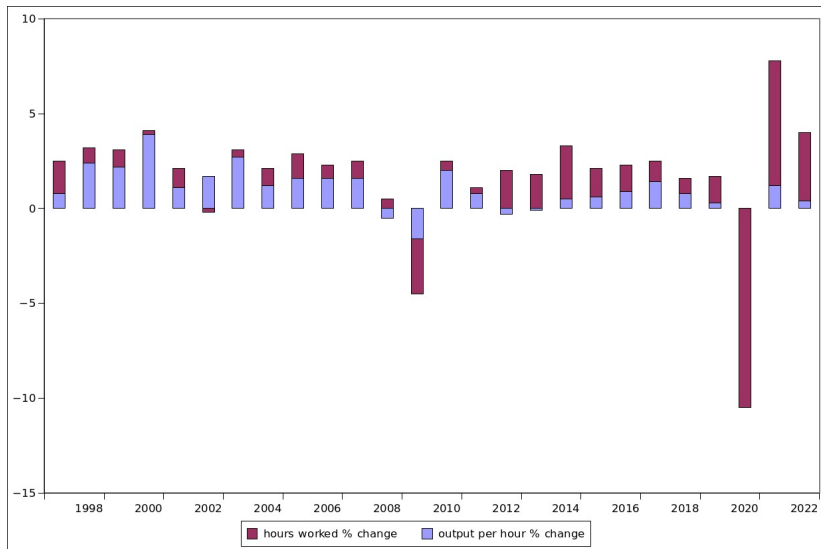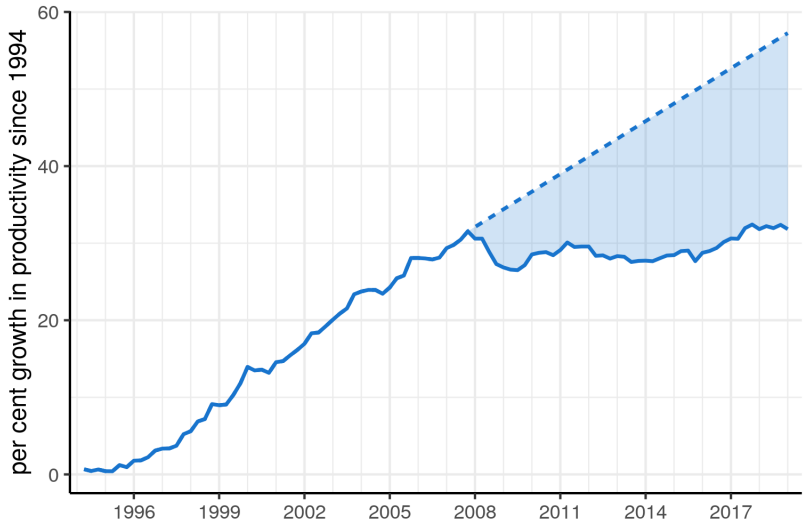
PRODUCTIVITY
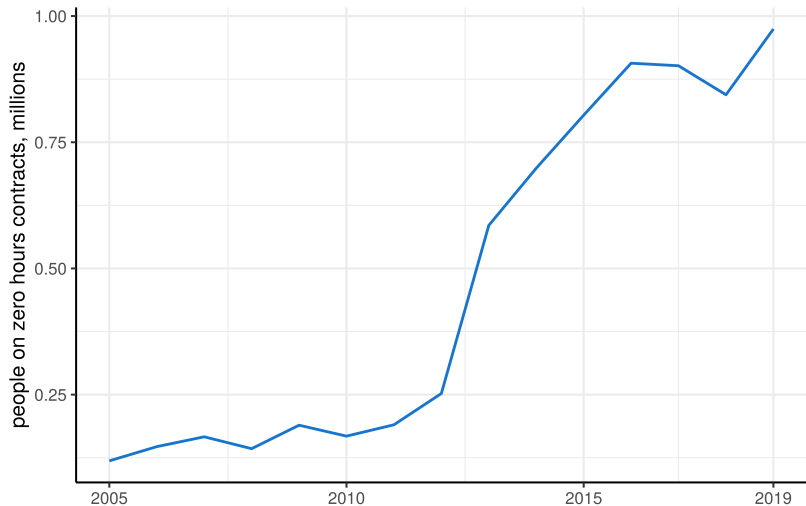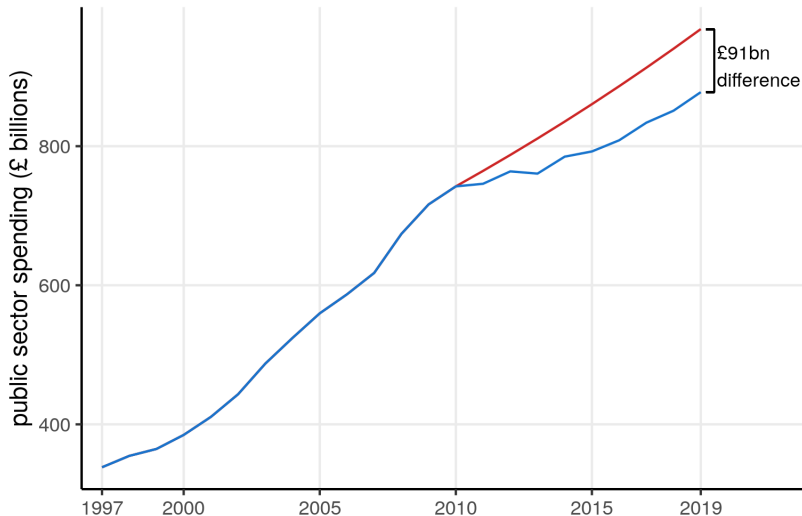
PRODUCTIVITY

INVESTMENT

EXPORTS

Employment
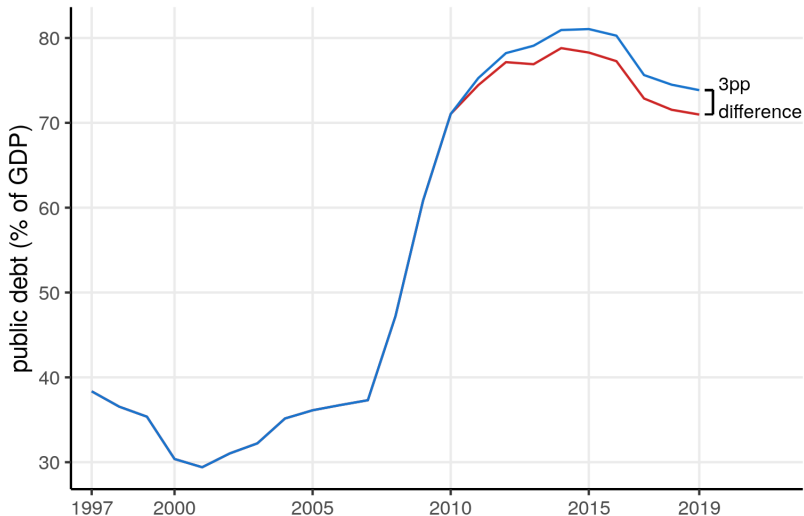
Zero hours contracts

Balanced budget counterfactual

BALANCED BUDGET COUNTERFACTUAL

Balanced budget counterfactual

Pre-existing inequality led to record UK Covid death rate, says health expert

Sir Michael Marmot says children's lives could be harmed for ever if deprivation not tackled

- **Covid exposed massive inequality. Britain cannot return to 'normal'**
- **Coronavirus – latest updates**
- **See all our coronavirus coverage**

Over 330,000 excess deaths in Great Britain linked to austerity, finds study

Research comes as government signals fresh round of public spending cuts

Children raised under UK austerity shorter than European peers, study finds

Average height of boys and girls aged five has slipped due to poor diet and NHS cuts, experts say

"But almost all serious economists now agree that George Osborne's austerity happened too quickly and was far too focused on spending cuts," he adds. "It proved economically damaging, not to mention socially and politically unsustainable."

Controversies on the public finances

▶ Balanced budgets, fiscal/golden rules and "payfors"

Controversies on the public finances

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- ▶ The limits to QE/yield curve control.

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► "Green" monetary policy, credit, financial regulation etc.

The limits to yield curve control

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- What determines monetary sovereignty?

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▶ Ultimate constraint is the exchange rate

▶ Who is a monetary sovereign? (Are we all EM now?)
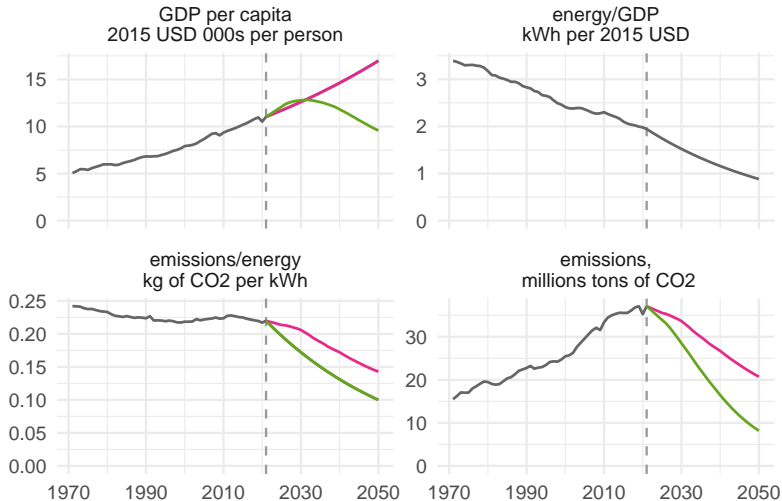
Energy per dollar of GDP
kWh per 2015 USD
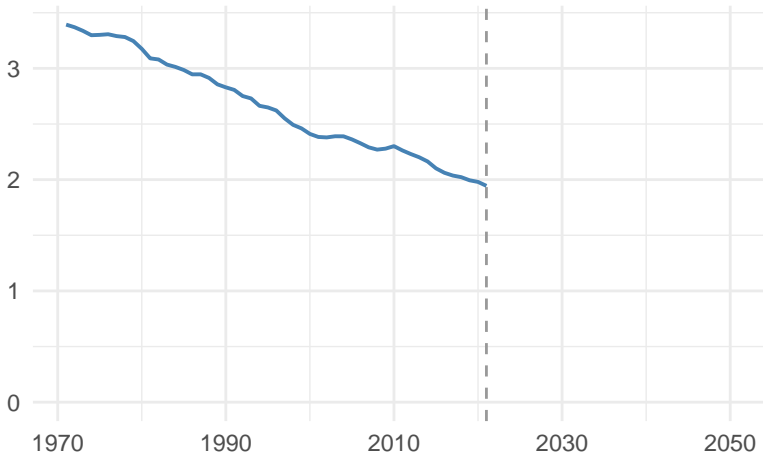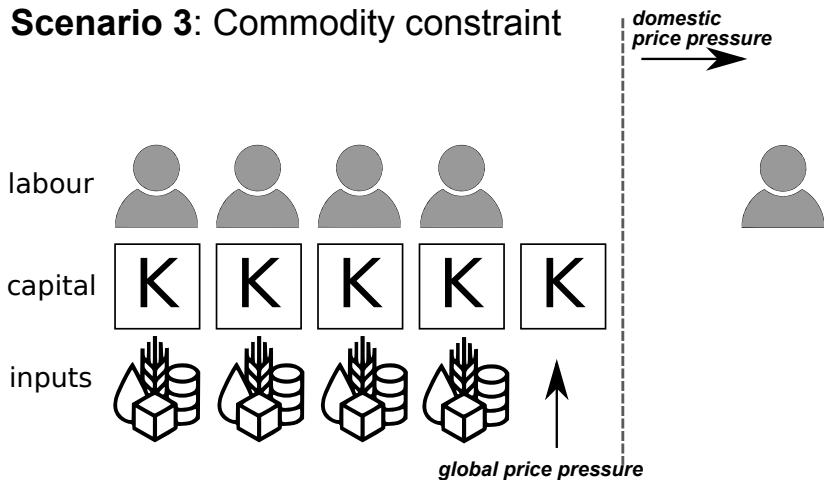
Emmissions intensity of energy
kg of CO2 per kWh
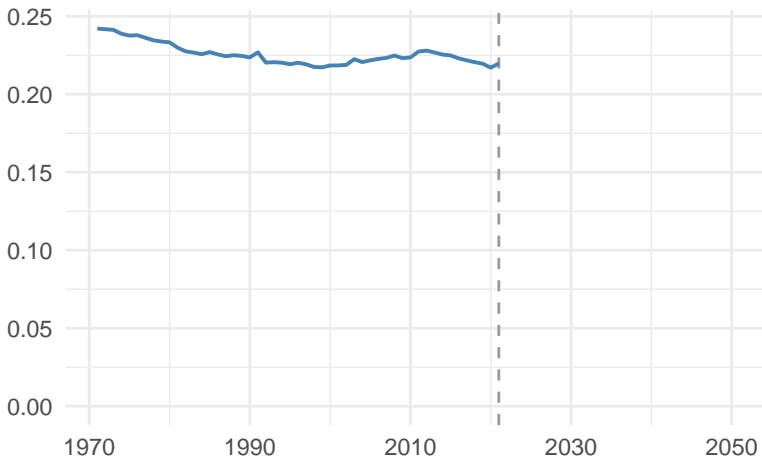
Scenario 3: Commodity constraint

domestic price pressure

labour

capital

inputs

global price pressure

WHERE NEXT?

▶ An updated PK/progressive macro policy programme:

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    - Incentives for personal saving (i.e. not-consumption)
  - Full employment plus investment growth implies deficits, but size is not irrelevant
    - Avoid explosive debt/GDP dynamics
    - Use taxes on wealthy to moderate size of deficit
    - Accept that high debt/GDP ratios are here to stay – growth unlikely to be sufficient to lower ratios substantially.
    - Aim for tolerable interest payments/GDP ratios.

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▶ Tolerate higher headline inflation/alternative metrics

	traditional	updated
primary policy objective	high employment via high growth	high employment alongside investment for climate transition
capacity	excess capacity	constrained capacity
target GDP growth	high	indeterminate but potentially low or negative
fiscal multipliers	positive	low or negative
public debt	eroded by GDP growth	persistently high
distributional conflict	incomes policy	incomes policy, taxation, tiered pricing, savings incentives