Fiscal policy and austerity

Jo Michell with Rob Calvert Jump, Thomas Rabensteiner, James Meadway, Natassia Nascimento, Michael Jacobs, Frank van Lerven and others . . .

PKES Summer School 2025

FISCAL POLICY AND AUSTERITY

▶ Different approaches to fiscal policy
  ▶ Theoretical approaches
  ▶ Policy approaches

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  - ▶ 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

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PK macro: distinguishing features

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- ▶ 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
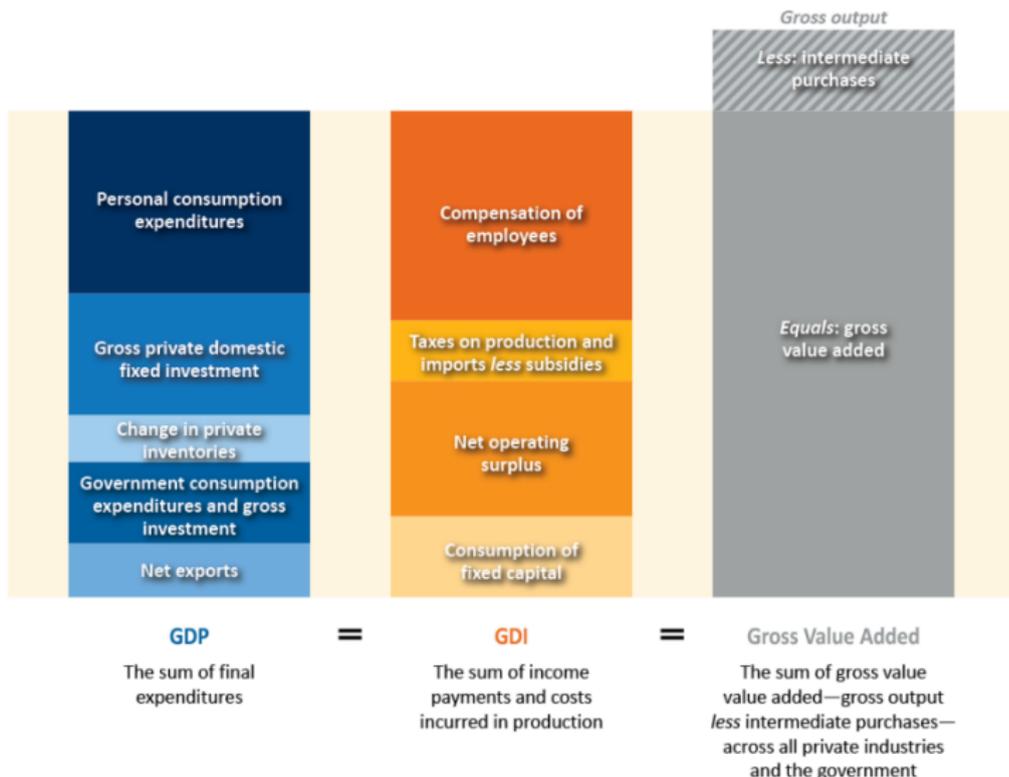
Simple closed economy model

Three ways to calculate GDP (A)

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

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Put it together:

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

Simple closed economy model

$$E = Y = 2.5 \times (G + I)$$

SIMPLE CLOSED ECONOMY MODEL

$$E = Y = 2.5 \times (G + I)$$

if $G = \pounds 500m, I = \pounds 500m,$

$$E = Y = 2.5 \times 1000 = \pounds 2500m$$

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if $G = \pounds 500m, I = \pounds 500m,$

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

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

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But employment is determined by expenditure, so

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

Simple closed economy model

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

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

  ▶ employment determined by nominal spending (for given output per worker and price)

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

SIMPLE CLOSED ECONOMY MODEL

EXPENDITURE | PRODUCTION

$E_1 = Y_1$

total nominal expenditure, E

total nominal output (production), Y

multiplier, m

productivity x price, λp

unemployed

$I_1 + G_1$

autonomous expenditure: I + G

employment, L

L_1 **N**
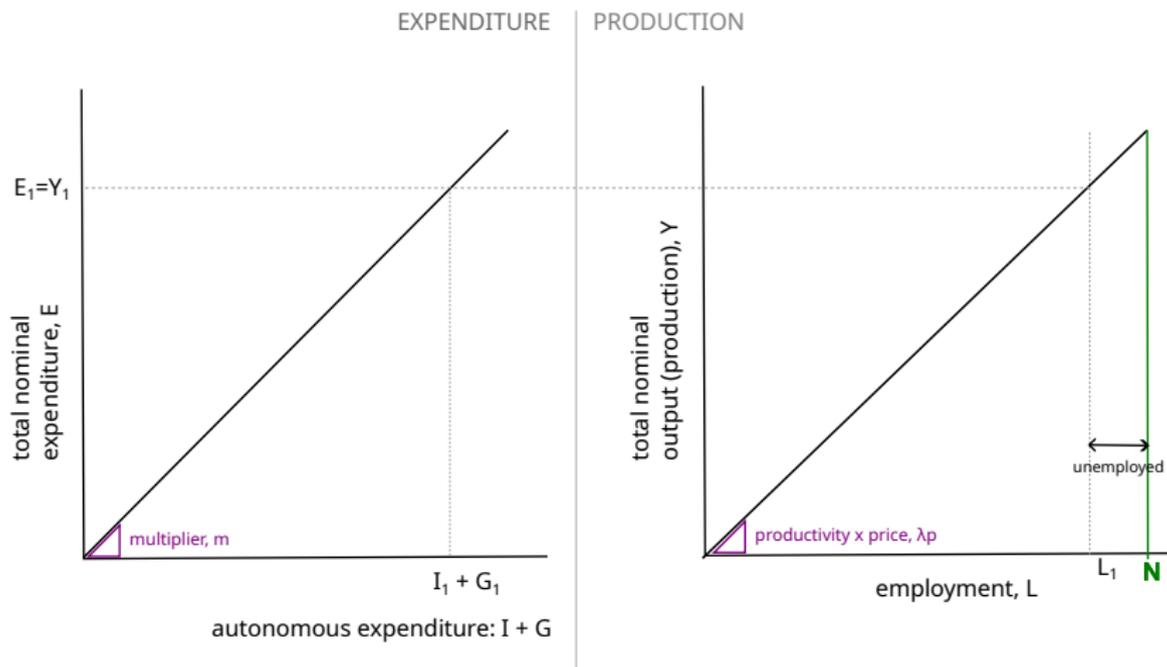
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▶ But what is 'full employment'?

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▶ looser inflation-employment trade off.

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  - ► Better employment outcomes can be achieved by supply-side interventions, 'structural reforms' AKA reducing labour bargaining power.
  - ► 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

IN TANDEM

THE CASE FOR COORDINATED ECONOMIC POLICYMAKING

MICHAEL JACOBS, ROBERT CALVERT JUMP,
JO MICHELL AND FRANK VAN LERVEN

FABIAN SPECIAL

I can think of many circumstances when the framework might prove inadequate. Let me take two extremes... If you get a real danger of recession, the Bank of England's freedom of manoeuvre is limited by what is called a zero interest rate barrier; it cannot get interest rates below zero and in practice not even there. This problem has been most extensively explored in the US Federal Reserve; and the consensus is, if you need to stimulate purchasing power in a big way, you need the Treasury and finance minister to come closer.

Samuel Brittan, 2004

Let me take another extreme: a horrendous oil price explosion that suddenly puts the general price level up by 10 per cent. In these circumstances people are very worried about high double-digit inflation and it is no use saying you are going to have a target of one, two or three percent inflation. What you have to do is to get it down by hook or by crook whenever you can. In these circumstances, too, the kind of rigid framework which appeals to the present Chancellor might not be suitable.

Samuel Brittan, 2004

Austerity in the UK

Britain's shorter children reveal a grim story about austerity, but its scars run far deeper

Michael Marmot

Since 2010, our five-year-olds have been showing signs of reduced growth, a likely symptom of policies that have led to impoverished lives

📷 Children make their way home from school on a housing estate in Glasgow. The social circumstances of early childhood are linked to height and educational and social success. Photograph: Jeff J Mitchell/Getty Images

That an age of austerity holds out the hope of a future of prosperity.

That we can be the change our country needs.

And that we can step up to the great challenge of our times.

George Osborne, Conservative conference speech, 2009

The age of irresponsibility is giving way to the age of austerity. . . .

So this is no time for business as usual.

This is no time for more of the same.

There is only one way out of this mess, and that is through massive change.

David Cameron, Conservative conference speech, 2009

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    - ▶ Cuts to government spending
- ▶ In the UK, austerity in the second sense used intermittently since 1970s.

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▶ Osborne 2006: 'stability before tax cuts':

For sound money is the oldest principle of all. As Margaret Thatcher herself said, 'I am not prepared to go on with tax reductions if it meant unsound finance'. She was right on that as on so much else.

2008: Financial Crisis

Sitting on the sofa in his office a couple of years back, the Shadow Chancellor took out a piece of paper and started drawing boxes on it. He drew quite a number."VAT cuts," read one little box, "spending," read another, "the top rate," read a third. Then his pencil hovered over the paper. "Only one of these boxes can be a fixed point," he explained. "My strategy for opposing Alistair Darling and fixing the economy depends on selecting that fixed point. The other boxes move around it." And then George Osborne brought his pencil down. **"And this is my fixed point," he said, stabbing the box that read "lower borrowing"**.

Finkelstein, 2010

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► G20 conference: international Keynesian response

the London Summit looks to have been an enormous success in stopping the drop in the global economy . . . Our prediction would be that in coming years, the London G-20 Summit will be seen as the most successful summit in history.

Brookings Institute, 2009

PUBLIC SECTOR NET DEBT
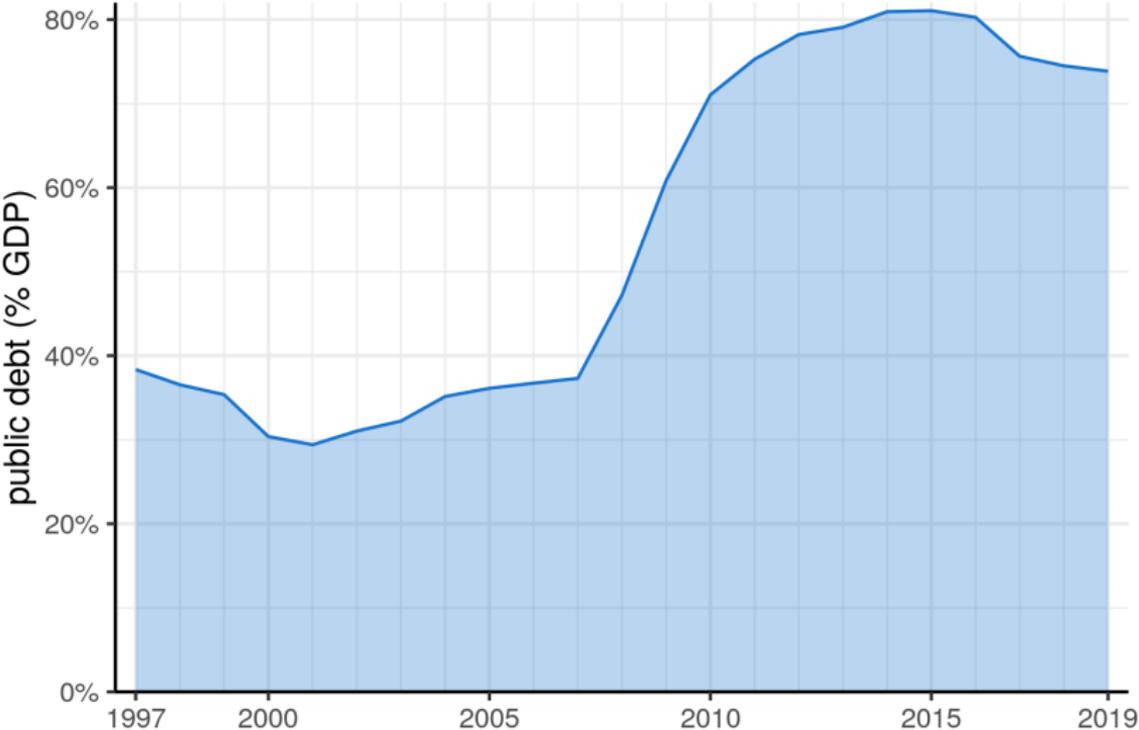
PUBLIC SECTOR NET BORROWING
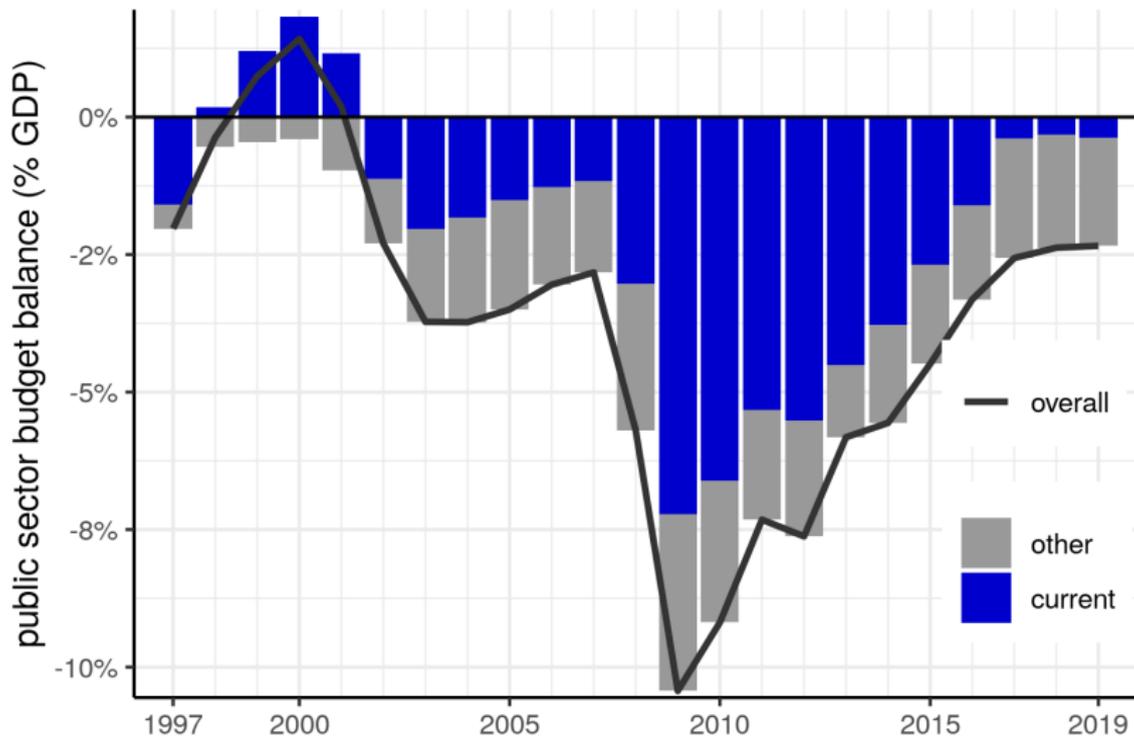
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- Result: Conservative - Lib-Dem coalition.
- Emergency budget of 2010

Expansionary austerity

fiscal stabilizations may be expansionary if agents believe that the fiscal tightening generates a change in regime that 'eliminates the need for larger, maybe much more disruptive adjustments in the future' . . . If agents believe that the stabilization is credible and avoids a default on government debt, they can ask for a lower premium on government bonds. Private demand components sensitive to the real interest rate can increase if the reduction in the interest rate paid on government bonds leads to a reduction in the real interest rate charged to consumers and firms.

Ardagna, 2004

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
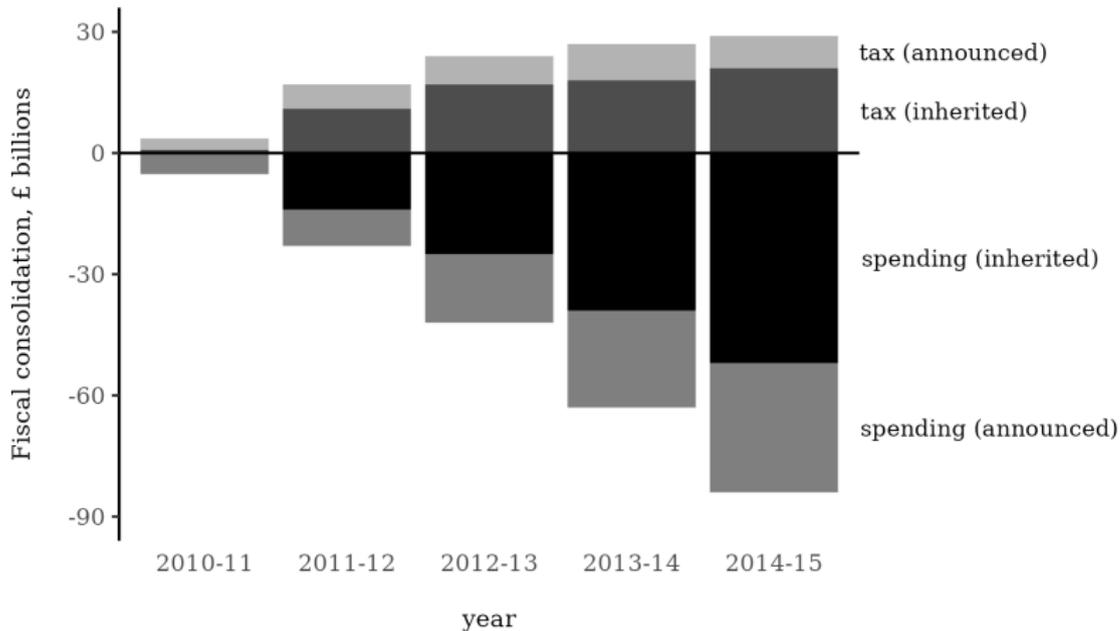
Figure 4.2: Spending cuts and tax increases announced
in / inherited by the June 2010 budget

Planned (real) % growth, 2010-11 to 2014-15
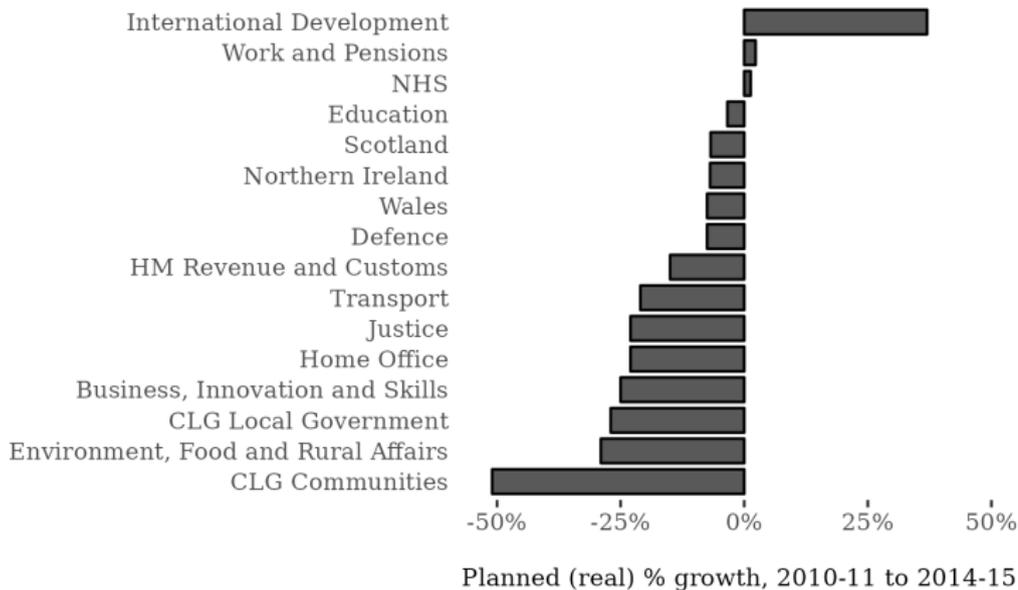
Figure 4.3: Planned real-term growth in day-to-day departmental spending, 2010 Spending Review

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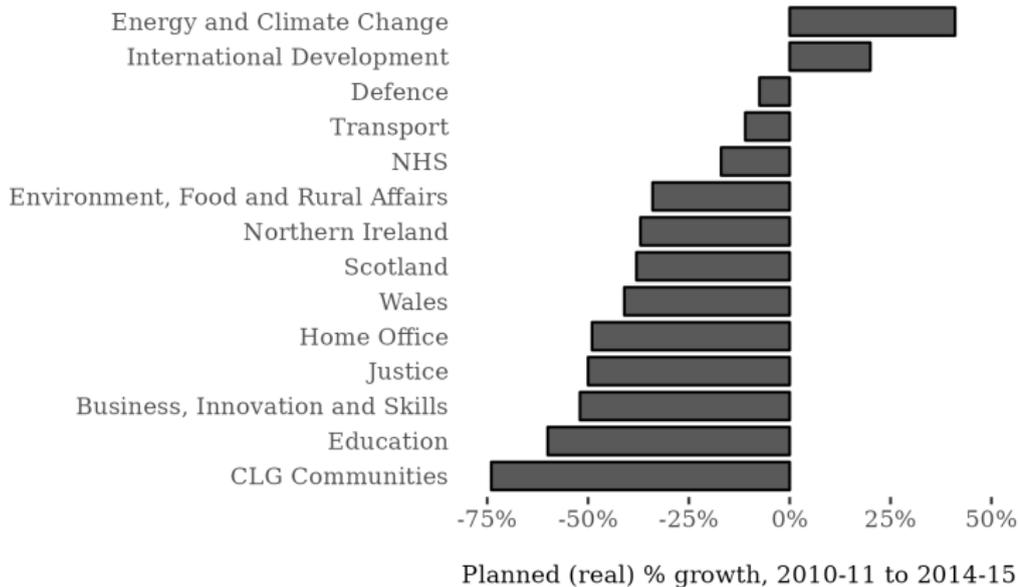
Figure 4.4: Planned real-term growth in capital departmental spending, 2010 Spending Review

Expansionary austerity

I'm too soon out of government to use a word like 'nuts'. I find the idea of expansionary fiscal contraction, in the context of the world in which we now live, to be every bit as oxymoronic as it sounds. And I think the consequences are likely to be very serious for the countries involved. . . . If Britain enjoys a boom over the next two years coming from increased confidence, I will be required to quite radically rethink my view as to how the macroeconomy operates and to be quite contrite about the seriousness of the misjudgements that I'm making.

Summers, 2011

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EXPENDITURE | PRODUCTION

$E_1 = Y_1$

total nominal expenditure, E

multiplier, m

$I_1 + G_1$

autonomous expenditure: I + G

total nominal output (production), Y

productivity x price, λp

unemployed

L_1 **N**

employment, L
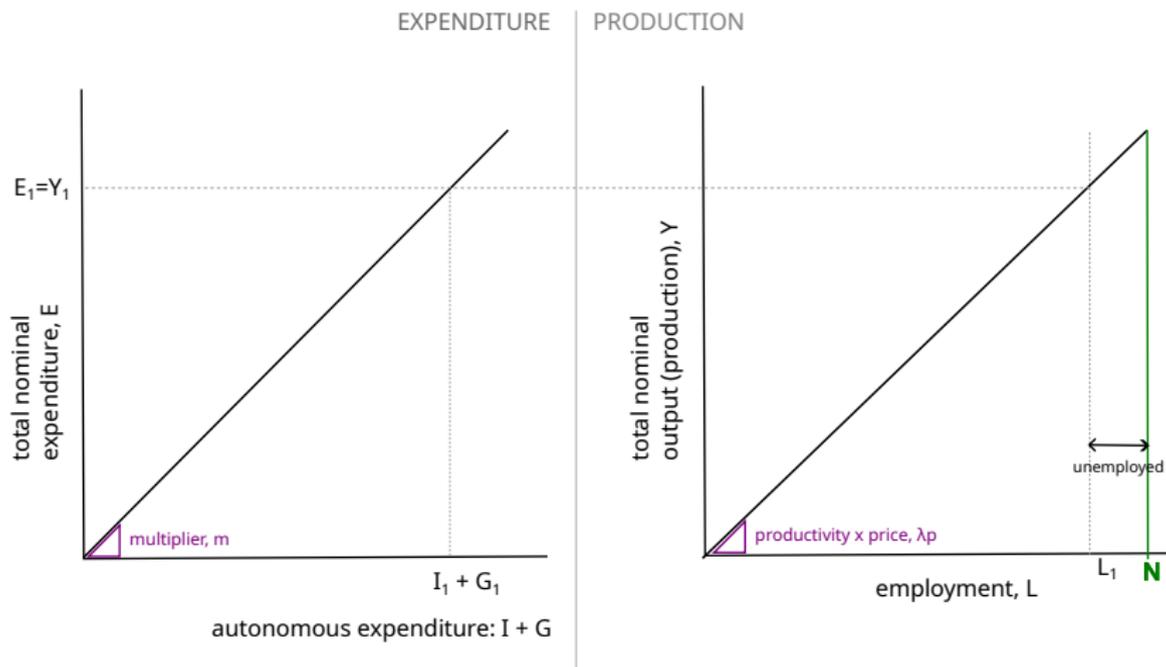
PUBLIC SPENDING PER PERSON
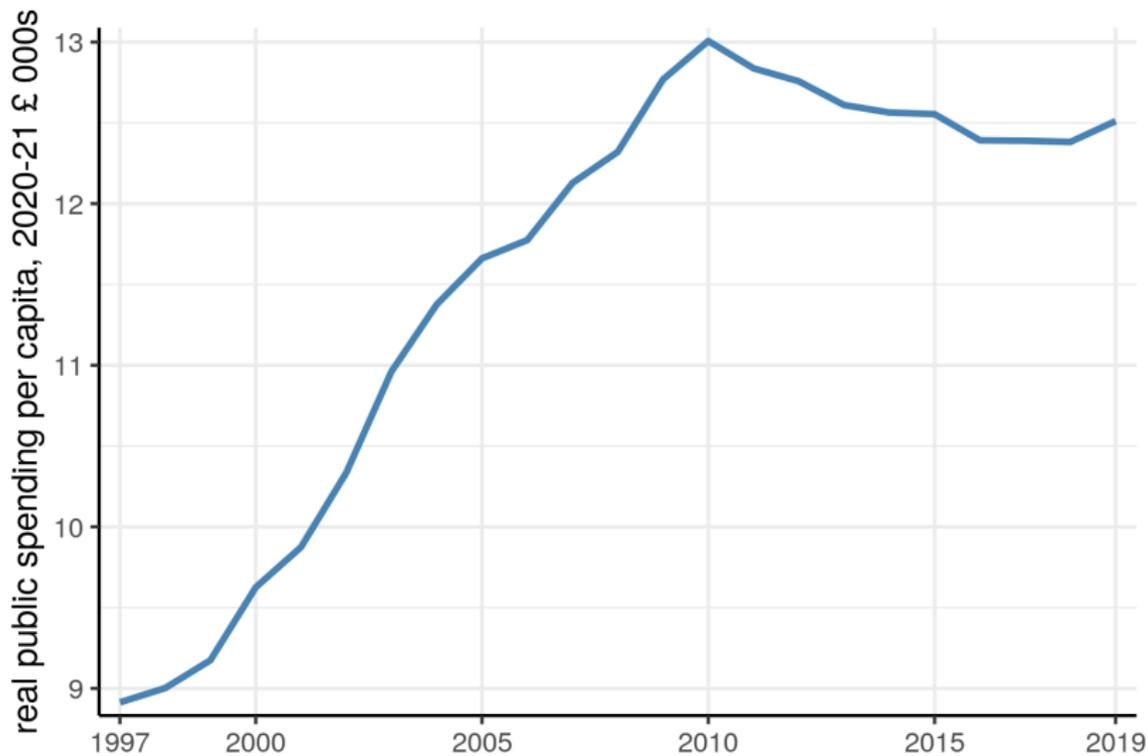
GDP PER CAPITA GROWTH
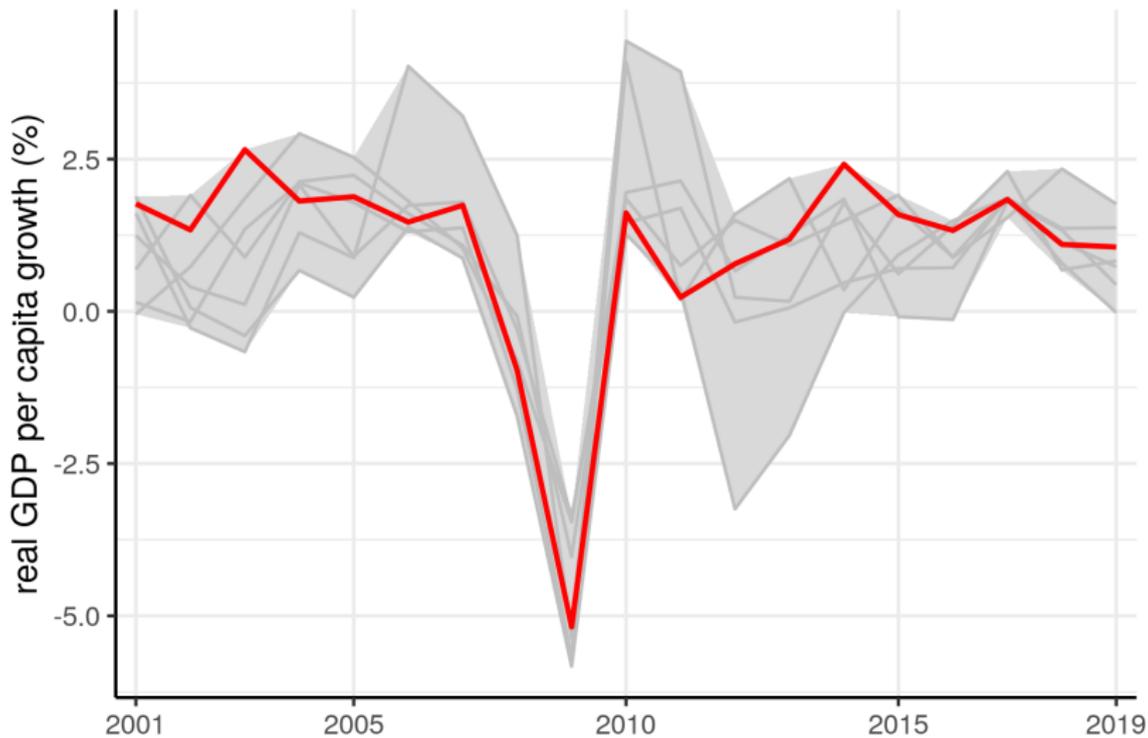
UK recovery from the 2008 crisis was weak

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

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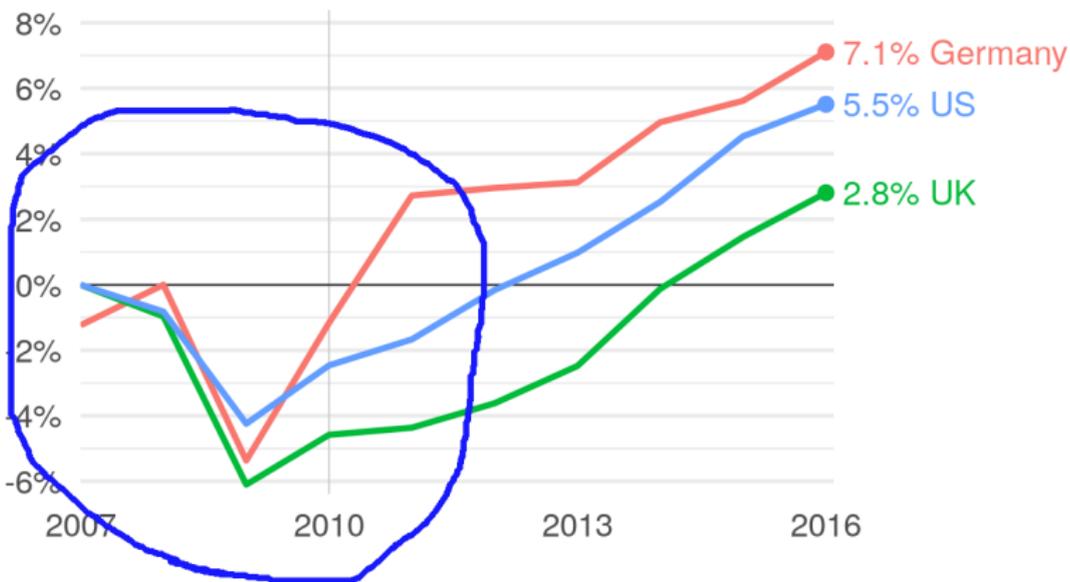
source: national statistical agencies
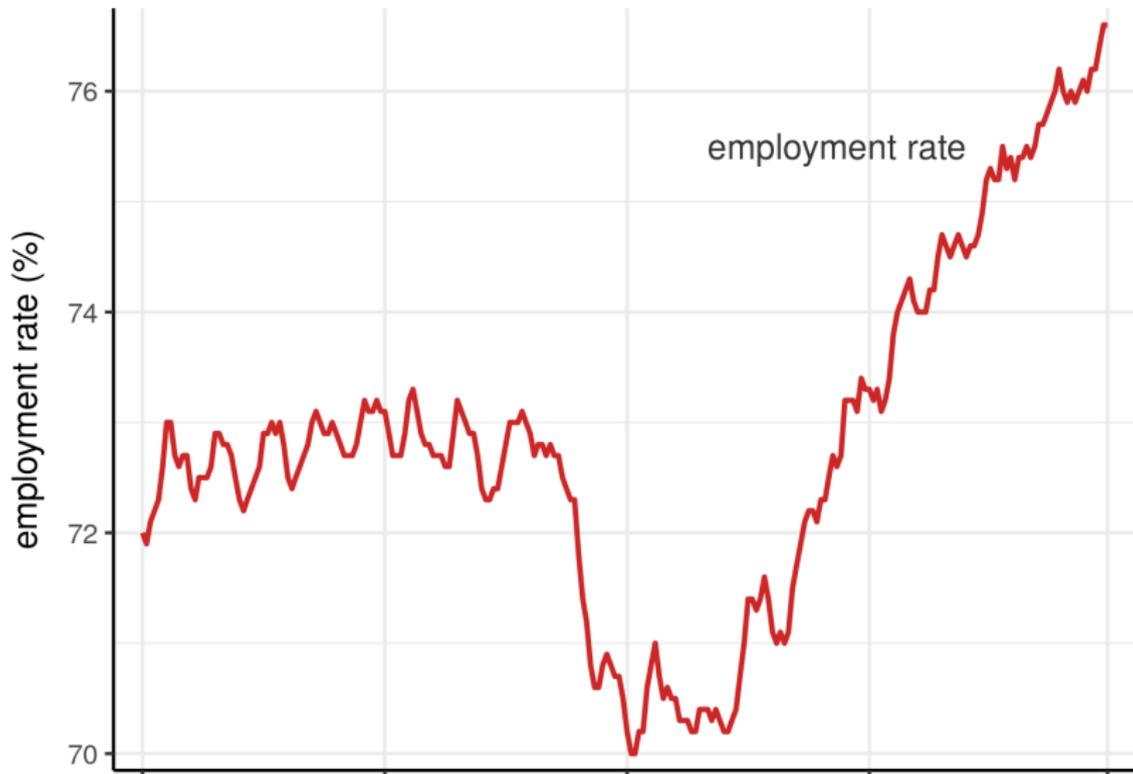
Expansionary austerity II

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)
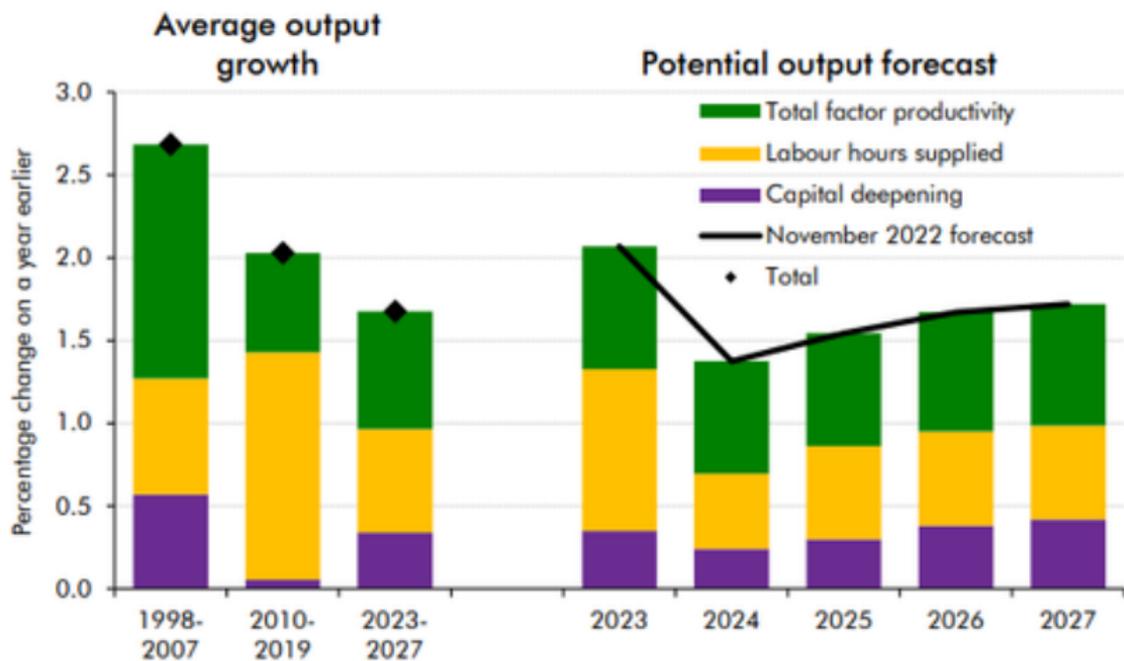
THE UK'S PROBLEM IN ONE CHART

hours worked % change   output per hour % change
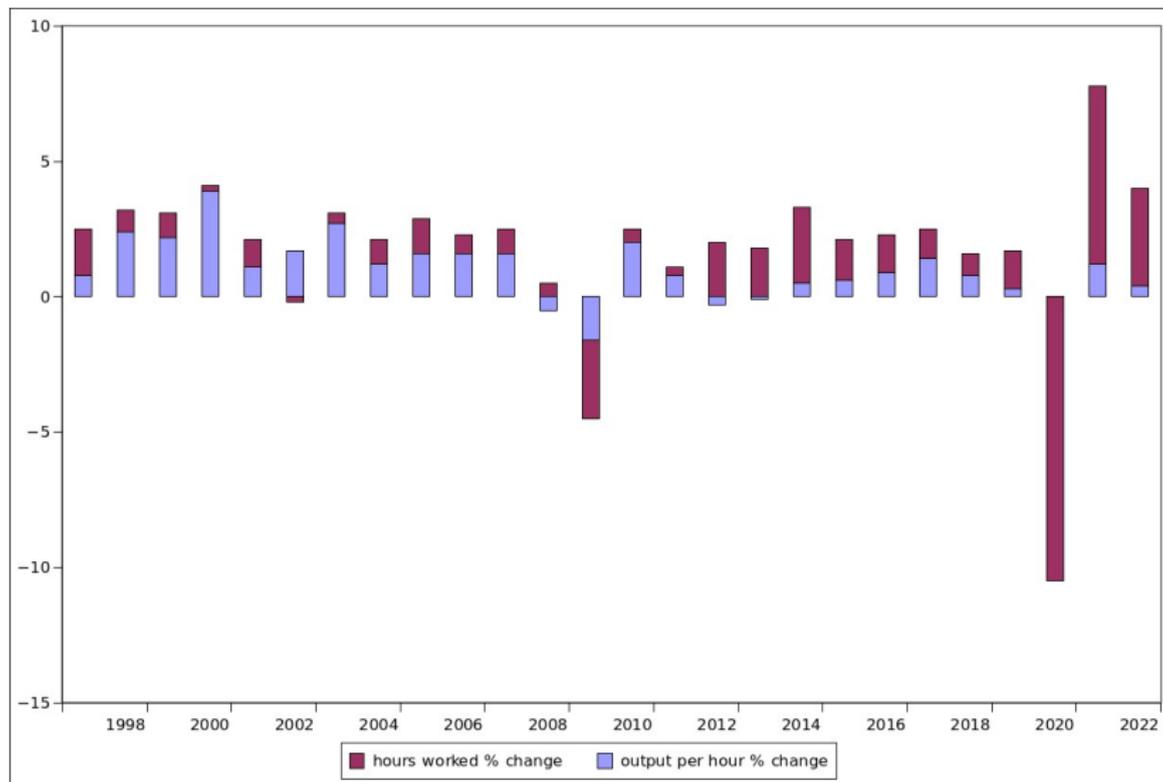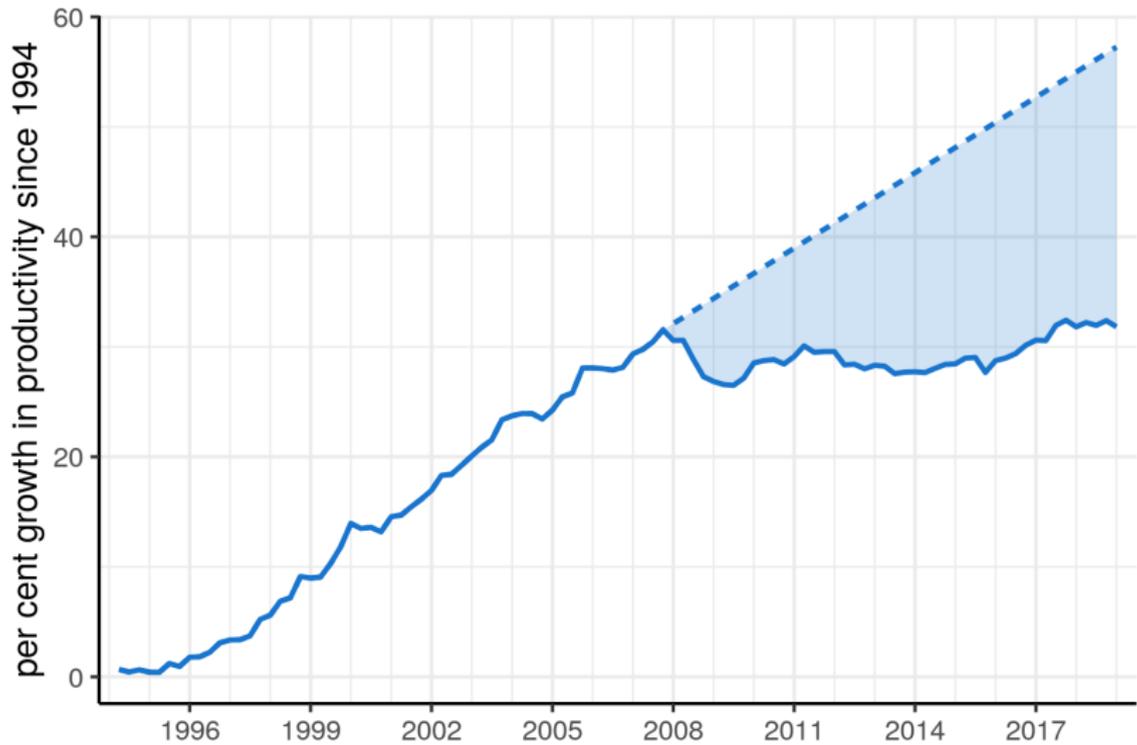
PRODUCTIVITY

Productivity
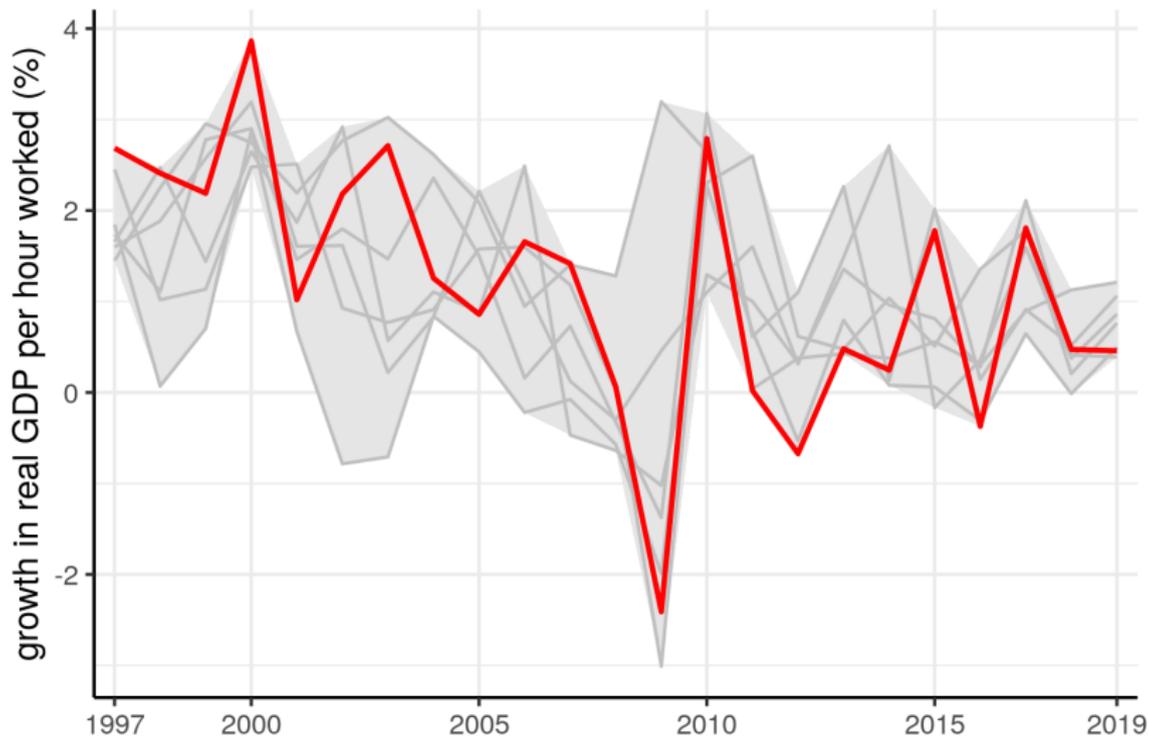
INVESTMENT
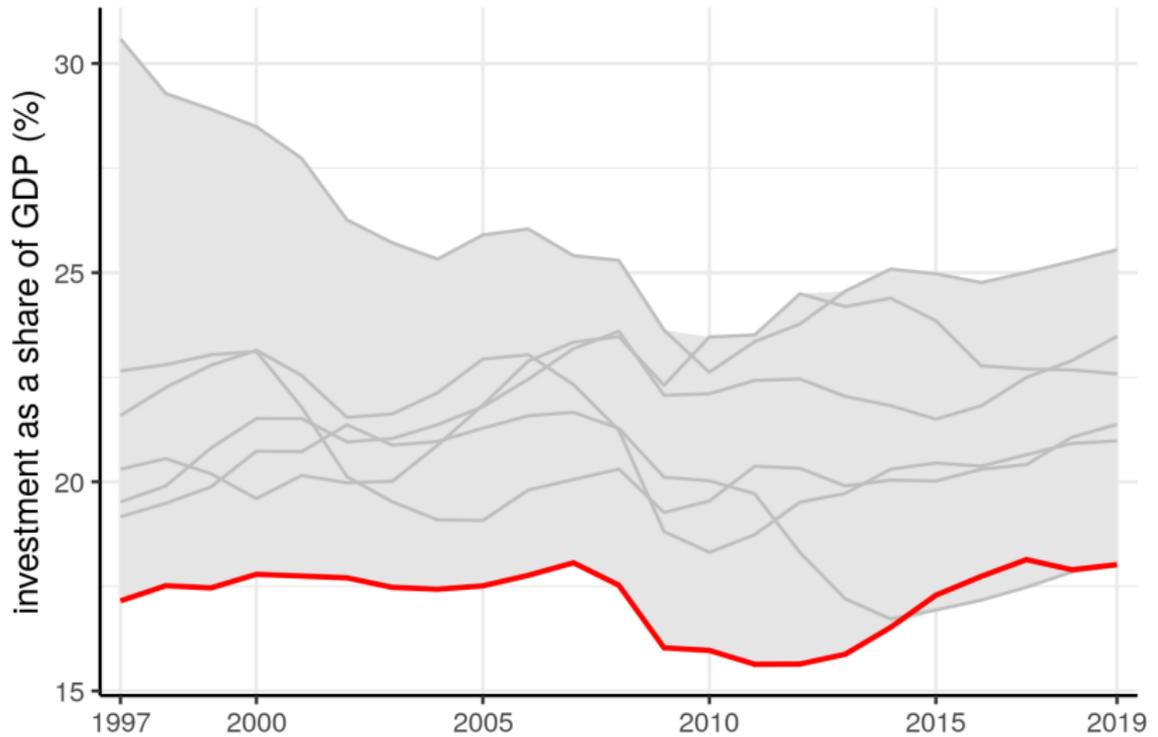
Exports

EMPLOYMENT
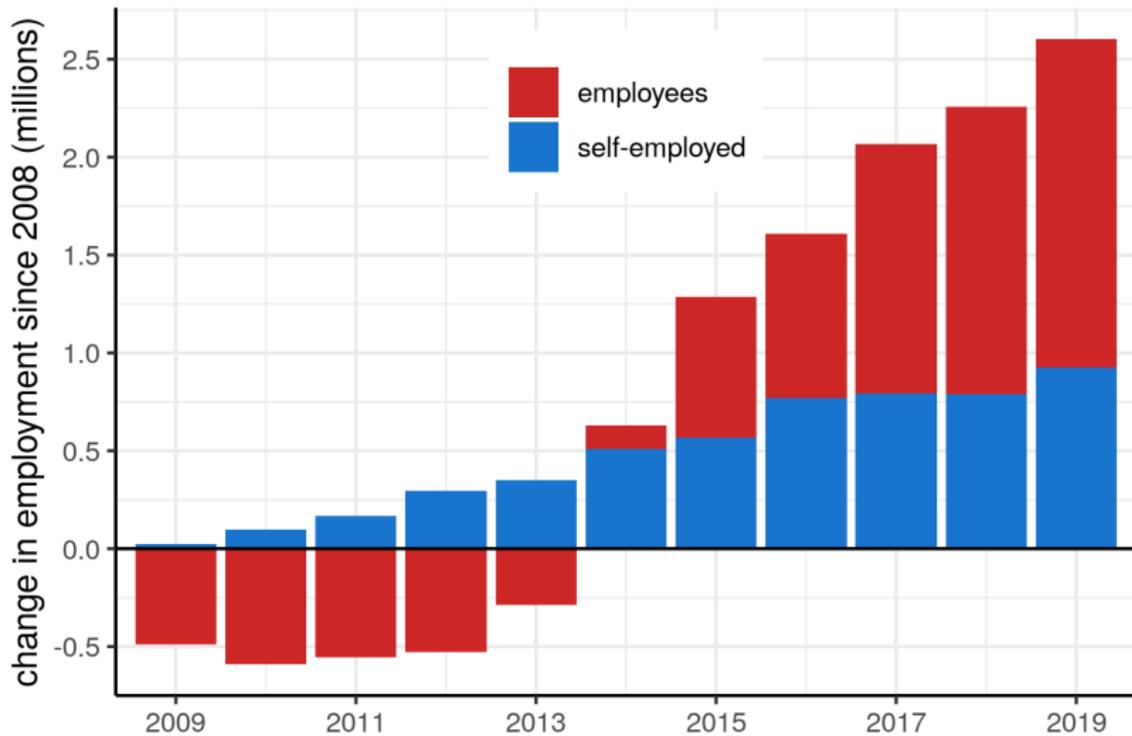
Zero hours contracts
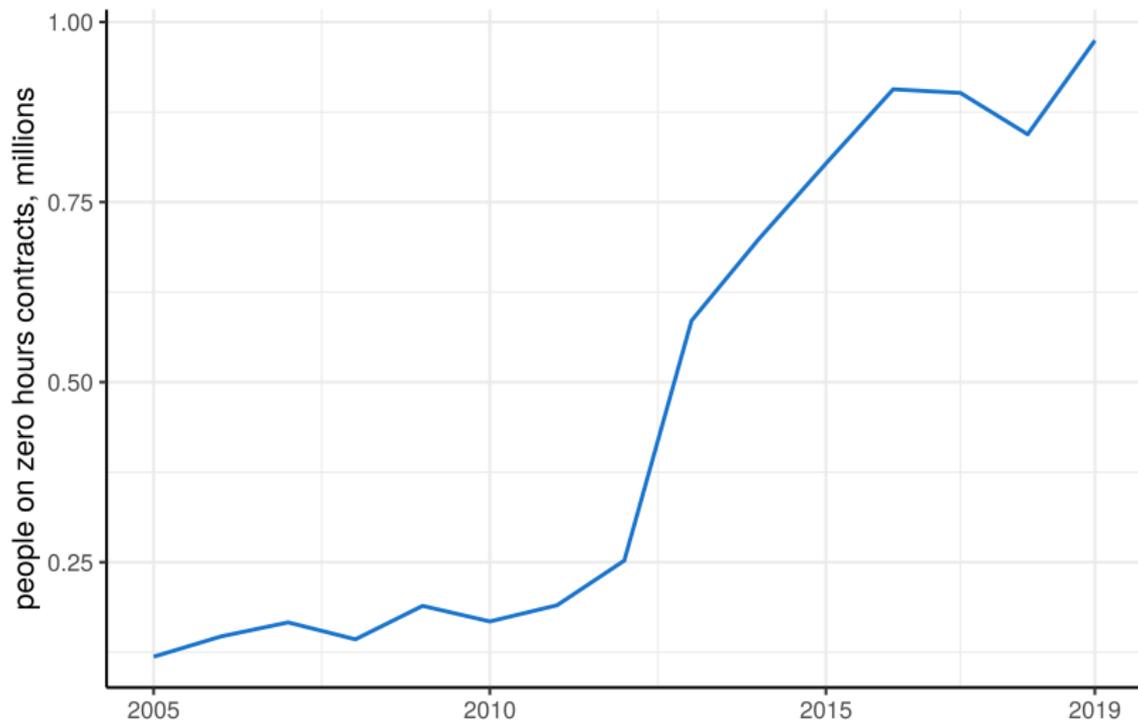
> *. . . if we reach the point at which interest rates can go no lower, or if it becomes apparent that the monetary policy lever is not working as it should, then we would be in dangerous and uncharted territory for the UK economy in modern times. But with interest rates still at 4.5% in the UK, we are a long way from that point.*
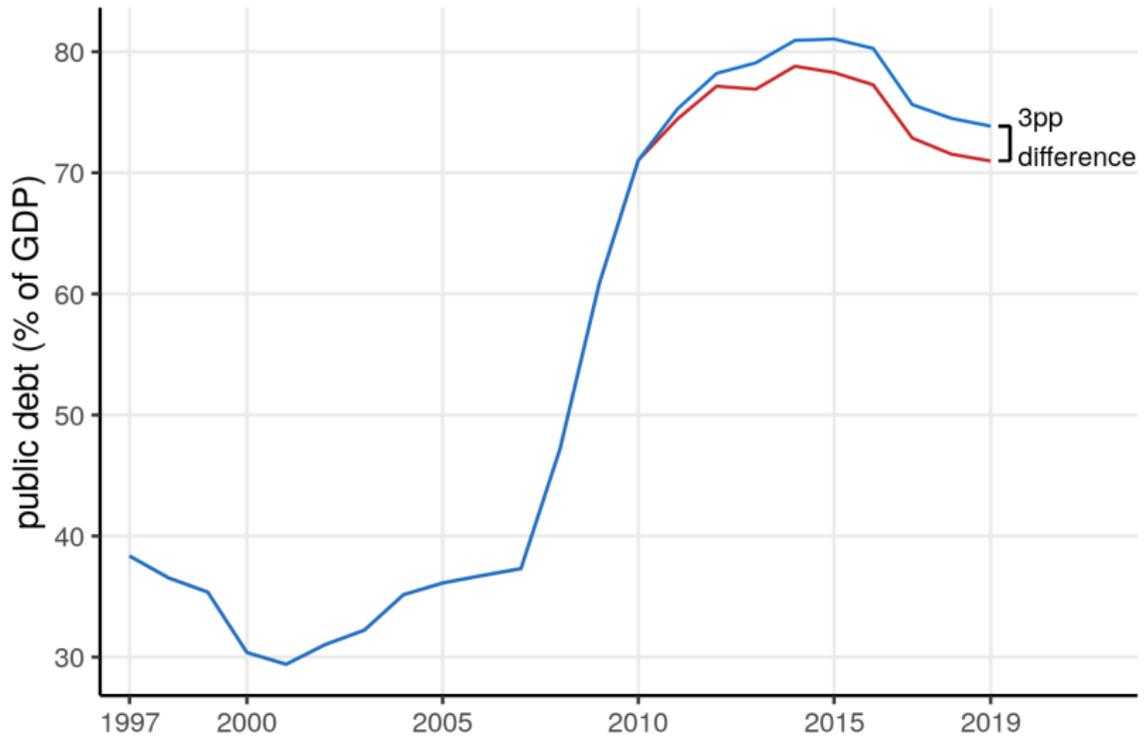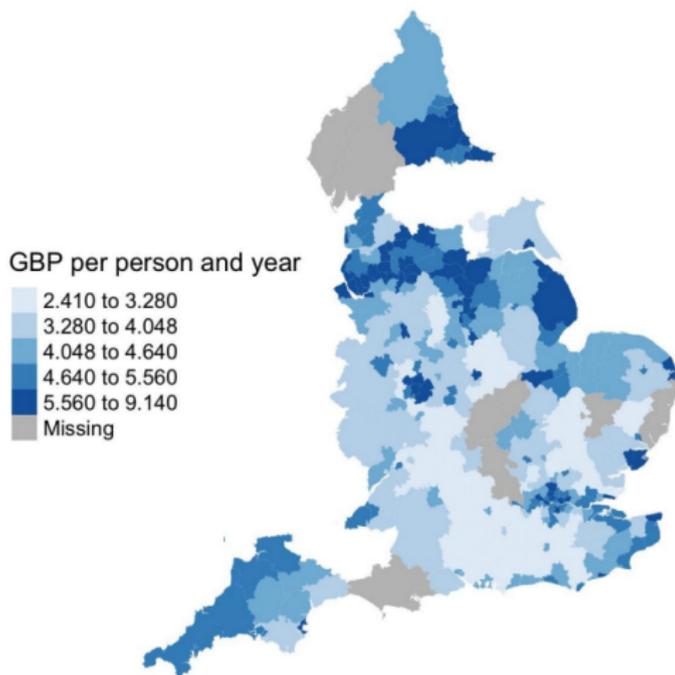
Osborne, Speech at LSE, autumn 2008
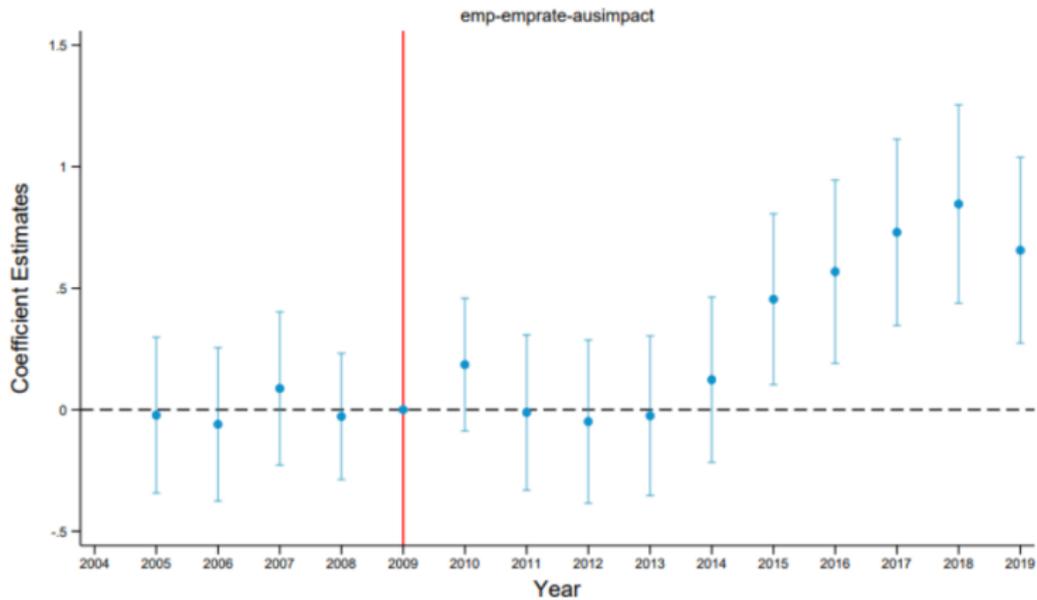
Zero lower bound
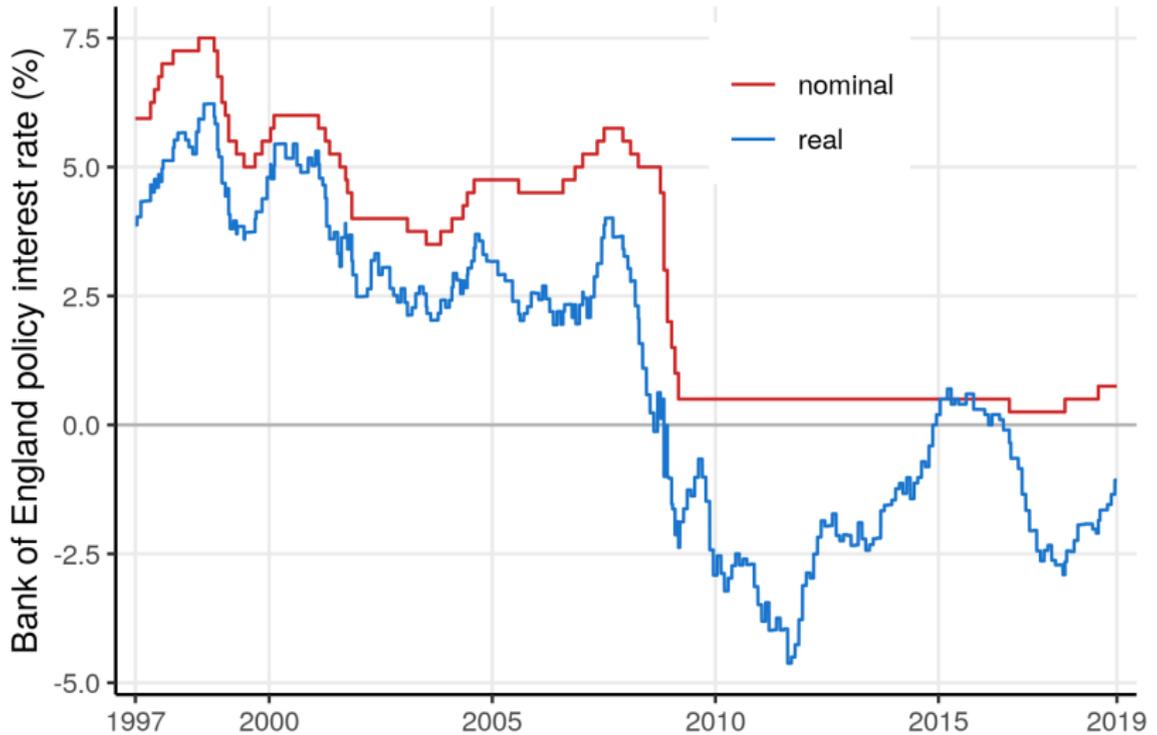
BALANCED BUDGET COUNTERFACTUAL
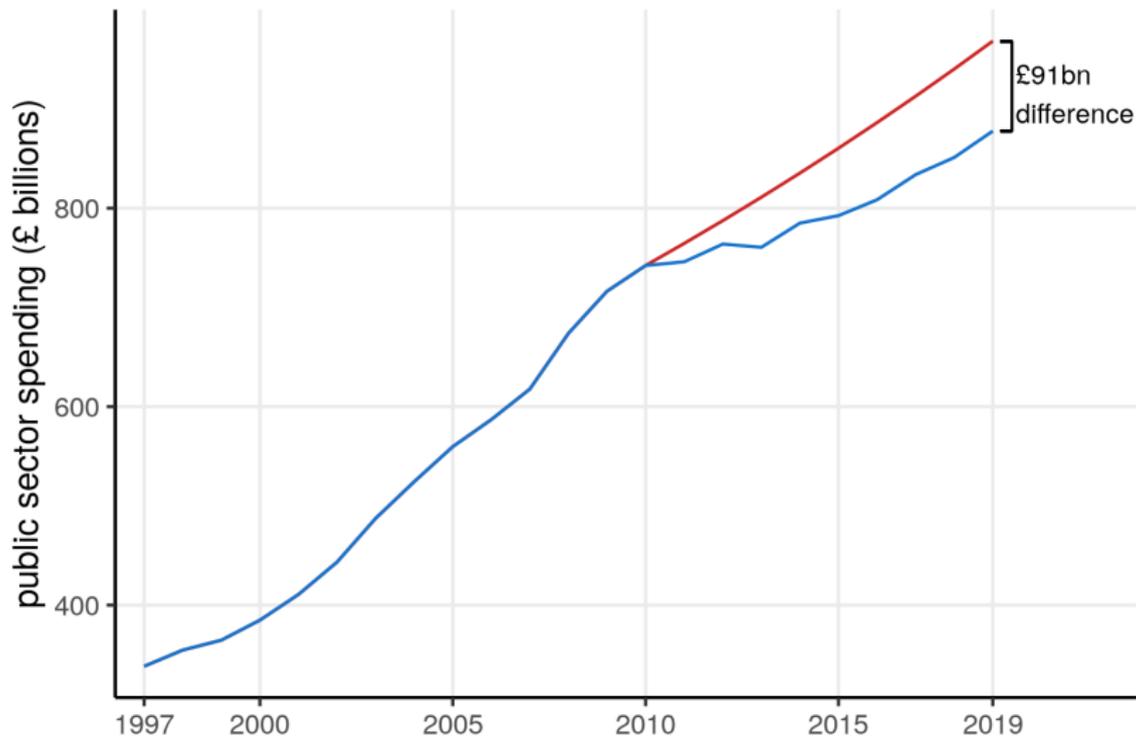
Balanced budget counterfactual
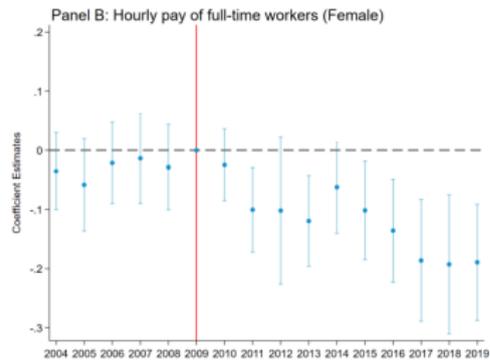
Loss from welfare reforms

source: Beatty & Fothergill (2013) via Fetzer (2019) via
Hasenberger 2025)

emp-emprate-ausimpact

Panel A: Employment Rate (Male)

Panel A: Hourly pay of full-time workers (Male)

Panel B: Employment Rate (Female)

Panel B: Hourly pay of full-time workers (Female)

What next?

need to raise investment

expenditure

I   C

domestic
price pressure

labour

capital

K K K K   K

inputs

global price pressure
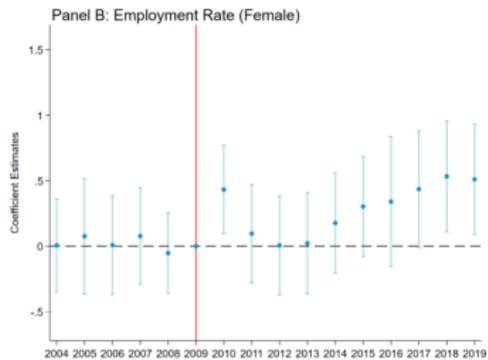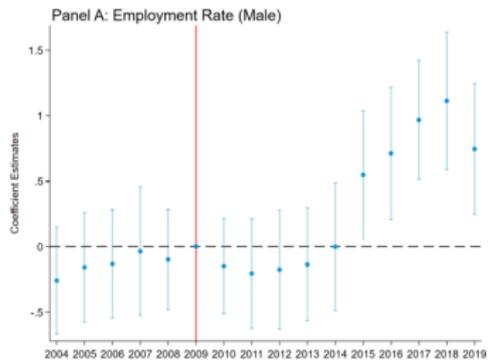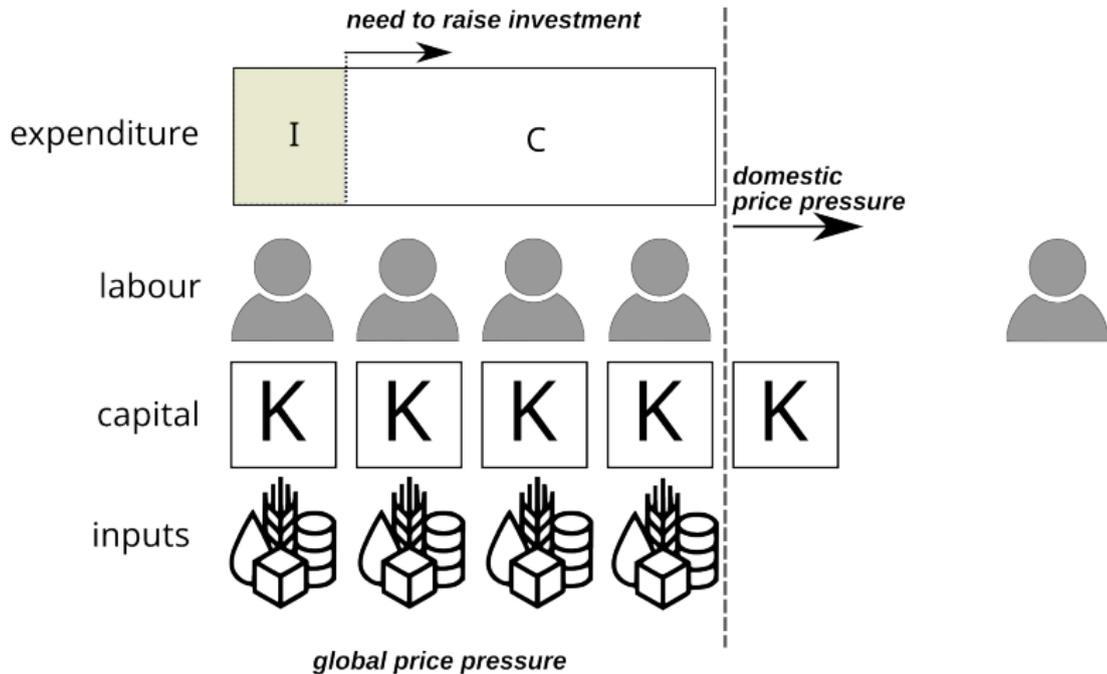
Fiscal controversies

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▶ The problem of global monetary hierarchies.
▶ "Green" monetary policy, credit, financial regulation etc.

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▶ Who is a monetary sovereign? (Are we all EM now?)

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