Mitchell's Musings 4-29-13: The Appealing Macro-Masochism of Austerity

Daniel J.B. Mitchell

No, this musing is not about the now famous (infamous?) Excel sheet error in the article by Kenneth Rogoff and Carmen Reinhart, the article that supported the kind of austerity policy favored in the euro-zone and elsewhere. If you don't know about that tale of error, check out the many web references.[1] Or watch the Colbert send ups.[2] Instead, this musing is about the interesting question of why austerity has political appeal. Many economics papers are written by academics which have policy implications that do not catch on, even if no errors are involved. Moreover, in the case of the austerity policies that followed the financial crisis of 2008, it is clear that those policies were independently developed; their advocates subsequently referenced whatever academic support they could find.

Sophie Tucker

On the face of it, austerity isn't very attractive; it seems like a form of macro masochism. There is, after all, the old quote usually attributed to singer Sophie Tucker: *"I've been rich and I've been poor; rich is better."* The financial crisis and the Great Recession were themselves the direct bringers of austerity for millions. In simple terms, advocates of austerity <u>policies</u> (as opposed to the inherent austerity a recession brings about) were advocating *reinforcing* the pre-existing economic downturn. In contrast, advocates of stimulus policies were pushing for programs that would *resist* recession-caused austerity. So put aside the economic arguments. What political appeal is there for reinforcing the austerity of a downturn? The downturn's austerity is bad enough.

Let's note at the outset that at the micro level, austerity <u>is</u> a rational response to news of an economic downturn. That is, an individual consumer – even if he or she is not affected by economic trends immediately – might well cut back on purchases and save more in anticipation of what could happen. The simple news that the external economy is doing poorly suggests that you as an individual might lose your job in the future. Additionally, you soon would likely become aware that your wealth – say in stocks or real estate (including your home) – has declined in value. Therefore, you now have a smaller cushion in the event of an eventual direct impact. So adopting an austerity policy for yourself as an individual or for your household – cutting back on spending - is a natural outcome of recession.

The same is true for state and local governments. As economic activity declines, so does their tax revenue. State and local could try and follow "Keynesian" policies and continue to spend in the face of recession, or even ramp up spending, through deficit fiscal policy. But the smaller the jurisdiction, the less would be the stimulatory effect within its borders. Much of the stimulus would spill over into other

[1] For example: http://www.washingtonpost.com/blogs/wonkblog/wp/2013/04/24/inside-the-offbeat-economics-department-that-debunked-reinhart-rogoff/.
[2] http://www.colbertnation.com/the-colbert-report-videos/425748/april-23-2013/austerity-s-spreadsheet-error and http://www.colbertnation.com/the-colbert-report-videos/425749/april-23-2013/austerity-s-spreadsheet-error---thomas-herndon.

jurisdictions. And continued deficits, not to mention deliberately enhanced deficits, would raise the issue of credit risk. Credit ratings would decline. The cost of borrowing would rise. Eventually borrowing would become difficult, even at high interest rates.

At the national level, the calculus is – or should be – different, especially for large countries such as the U.S. which borrow in currencies that they themselves issue. Large countries inherently have fewer spillover issues; the stimulus tends to stay within their borders. And countries that borrow in their own currencies can always pay off their debts, unless they make a political decision not to do so.

Note, however, that within the euro-zone, member nations have made a decision not to have their own currencies and thus not to have independent monetary policies. They made that decision within an economic union – the EU - that really has no central government that is analogous to the U.S. federal government. Individual nations that joined the euro-zone have maintained their military and social insurance programs and obligations. But they have turned monetary policy over to a semi-autonomous European Central Bank. Absent guarantees for their borrowing from that central bank, austerity policies were rational for individual euro countries, just as they were for state and local governments within the U.S. (which also have no independent currencies or monetary policies).

In theory, the various nations within the euro-zone could have negotiated an arrangement whereby they all followed coordinated stimulatory policies which the European Central Bank would undertake to support. But such negotiations are easier to postulate in the abstract than to effect in reality. There are complicated distributional and re-distributional conflicts to work out that are difficult to resolve in practice. Even in the U.S., there were no coordinated compacts among state and local governments in the aftermath of the Great Recession. Essentially, to the extent there was coordination, it consisted of handouts to state and local governments from the federal government. And the stimulus from Washington was not fine tuned to favor the state and local jurisdictions that were most adversely affected by the downturn. Any such fine tuning would have entailed the kind of deal making in Congress that was so difficult for the euro-zone countries.

In the end, there was enough in the way of stimulus and bailouts from Washington to keep the economic ship afloat, but that left it still listing badly. The Federal Reserve, which is somewhat politically insulated, might have gone the way of the European Central Bank and favored austerity. But it didn't, largely because of leadership of Fed Chair Ben Bernanke who had studied the sorry impact of Fed austerity in the 1930s. Even with such leadership, however, there are legal constraints on what the Fed can do. The one advantage the Fed has is that it doesn't have to cope with regional distributional negotiations. If the Fed cuts short-term interest rates to near-zero, the rates are near-zero everywhere.

Nonetheless, there is more to the appeal of austerity policies than just negotiating difficulties. The fact that austerity is rational at the micro level creates a potential fallacy of composition.[3] What may be

[3] "The fallacy of composition is the fallacy of inferring from the fact that every part of a whole has a given property that the whole also has that property... A clear case of the fallacy of composition is this: (1) Every song on the

rational for you as an individual or for your household – or even for your city or state – is not rational for the collectivity. Yet if someone wants to argue for austerity, it is easy to argue by analogy. If you as an individual have tightened your belt, why shouldn't your city be doing the same? (And, as noted, your city acting rationally probably should.) Why shouldn't your state? (And, as noted, your state probably should.) Why shouldn't the federal government? There, however, the economic argument breaks down – *but not the appeal of the argument*. Human beings reason by analogy so the appeal of the austerity argument is evident; you shouldn't run a deficit during Hard Times so why should the federal government? You cut back on spending and saved more; let the federal government do the same.

Note, however, that the idea of belt tightening in the face of falling tax revenue has a political appeal in some quarters that goes beyond the simple analogy. If you think your city engages in wasteful spending and social programs, recession is a good time to argue that such spending should be curtailed. If you think your state engages in wasteful spending and social programs, again, recession is an opportune time to make the case for cuts. And the same is true at the federal level. If you think the federal government is too big, recession is a golden opportunity for reducing its size – even if the macro arguments run in the reverse at that level. If you can find an academic paper that seems to support your call for austerity – even at the federal level – so much the better.

It is important to emphasize that there was no grand conspiracy entailed in the politics of austerity policy advocacy. That is, no cabal decided to have a financial crisis and Great Recession just in order to promote government downsizing. But the financial crisis and Great Recession created the opportunity to make the austerity argument and the crisis was an opportunity too good to miss. To the extent there was a cabal, it was in the setting up of such artifacts as debt ceilings and fiscal cliffs. The crisis helped make the argument against welfare-state programs.

The result in the U.S. has been a sluggish recovery that might have been more robust had alternative policies been seen as politically possible. The result in the euro-zone has been a kind of stalemated non-recovery. If some negative economic shock were to occur in the near future – some kind of double dip recession – it is not clear that the kind of temporary unity that enabled the limited U.S. stimulus of 2008-2009 to be developed could again be replicated. And that fact means that from the viewpoint of individuals, households, localities, and states, austerity still has a rational appeal, even in the fourth year of recovery. In a rudderless boat, everyone needs a life preserver.

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album lasts less than an hour. Therefore, (2) the album lasts less than an hour..." Source: http://www.logicalfallacies.info/relevance/composition/.