

# AUSTERITY

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12 MYTHS EXPOSED

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AUSTERITY



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## PREFACE

Austerity in the contemporary sense of taming welfare-state capitalism has been haunting states and societies around the world for quite some time. First imposed on a wide range of countries in the global south by financial institutions following the world debt crisis, austerity came to hit members of the European Union in particular with a vengeance following the global financial crisis. Budget consolidation, debt reduction, spending cuts, efficient spending and so on are mantras nobody can escape in the sphere of public finance. Presented as the solution to the problems of overly generous developmental and welfare states, austerity itself must be considered a problem in search of solutions. Many years of dedicated austerity-related policies—of budget cuts, of privatization and deregulation—have not led to a revitalization of the economy, to better development and faster growth. Lackluster private investment and a still increasing propensity to marketization and financialization suggest the bitter medicine of austerity is not working.

Despite all the evidence of failure, we hear the battlecry: ‘Austerity is dead. Long live austerity!’ Why do the architectures of austerity remain in place? What are their foundations and core pillars? Who is supporting austerity, and why?

*Austerity: 12 Myths Exposed* debunks commonly held beliefs in support of austerity as the solution to addressing stagnation and economic crisis. Austerity staples like ‘live within your means’, ‘Swabian housewife economics’, ‘public spending hampers private investment’ and the new authority of alleged maximum debt and deficit levels, such as the Maastricht criteria governing the eurozone, are tackled and taken apart. While this booklet does not provide a full recipe for an end to austerity, those who are looking for alternatives will find a range of arguments needed to clear the pathway toward paradigm change. One thing is clear: austerity is a tool of national and international financial interests—not a solution to the problems caused by them.

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## **BEYOND AUSTERITY: MYTH AND SUBSTANCE**

BY DIETER PLEHWE, STEPHEN MCBRIDE,  
BRYAN EVANS AND MORITZ NEUJEFFSKI

The global political economy continues to undergo rapid change in the wrong direction. Stagflation 2.0 translates into slow or no growth, into permanent and increasing austerity in many OECD countries and in major parts of the global south. Many members of the European Union in particular have been subject to severe internal deflationary adjustment, which saw wages and welfare-state transfers fall in absolute terms. While social inequality between countries has remained stable, more or less, inequality within countries has been rapidly rising due to the long and severe recession which followed the global financial crisis.

Stagflation 2.0 means economic stagnation and deflationary tendencies, rather than the stagnation-plus-inflation which characterized economies in the crisis of the 1970s. If deficit spending for public programs seemed to have little impact on employment and economic development a generation ago, this triggered the argument to try something else, namely austerity combined with deregulation.

lation and privatization. Three decades and a global financial crisis later, it has become obvious that austerity and intensified economic globalization, driven by deregulation and privatization, have failed to deliver. States are even more in a straitjacket of restrictive finance than they were previously.

According to the core ideology of austerity capitalism, neoliberalism and supply-side economics, taxes on the rich and mobile capital in particular can only be raised at the price of reduced international competitiveness of corporations and declining attractiveness of geographic locations. If demand on the public sector is nevertheless growing due to the return of mass unemployment, demographic change and additional needs for digital infrastructures and training, for example, spending still has to be cut and pressure needs to increase on those who need support or assistance to take care of themselves. Pressure is the true meaning of the euphemism ‘incentives’. Stagflation 1.0 ushered in paradigm change and the rise of neoliberalism. Why has stagflation 2.0 not led to similar change?

To be sure, the rise of right-wing populism in quite diverse countries and regions, such as the United States, Brazil, India and many countries in Europe, seems to indicate a change of political thinking. At the center of the messaging of right-wing populism, which has become the dominant mode of critique after the global financial crisis, is a new emphasis on economic nationalism. Economic nationalism can of course be considered the natural result of the neoliberal emphasis on globalization,

international competitiveness and locational competition. Yet, if right-wing populism takes exception to the claims of international co-operation to prevent climate change, for example, and declines to share the burdens of migration and misery as a result of war and devastation, it does not challenge the doctrine of austerity. Right-wing nationalism and populism rather appear to intensify further the pressure on the welfare state, through continued emphasis on tax cuts for corporations and a new stress on 'law and order'. Neoliberalism breeds austerity and austerity in turn breeds more authoritarian neoliberalism.

While globalization appears to have taken a beating, due to the impact of the global financial crisis, austerity continues to be strong. The joint monetary activities of the Federal Reserve in the United States and the European Central Bank—engaging in 'quantitative easing'—ultimately sufficed to stabilize the transatlantic economy and to take the edge off the pain for the moment, but the next downturn lurks around the corner. With it will come demands for further belt-tightening. Macro-economic fragility and a lack of state capacity to meet serious challenges at home and abroad characterize the status quo. There is and there will be an increasing need to tackle austerity's causes and consequences. We need to talk and think more about austerity and how to go beyond it.

Two English dictionary entries for *austerity* are telling:

1. sternness or severity of manner or attitude;

2. difficult economic conditions created by government measures to reduce public expenditure.

Living through the recent past, many if not most citizens can attest to the difficulties faced under conditions of permanent and increasing austerity, not only in the global or the European south. Those who came of age in the 1970s still remember the suffering of countries in the global south under the International Monetary Fund and World Bank regimes following the Latin American debt crisis. While it is normal to emphasize difficult economic conditions created by government measures, it is never clear to what extent difficult economic conditions have been created domestically. The first myth that needs to be exposed relates to debt and public finance as a purely domestic matter. Without the deliberate raising of interest rates in the United States, the world debt crisis of the late 1970s and early 1980s would not have occurred; nor without the global financial crisis would European states have needed suddenly to go deep into debt.

The postwar international financial regime (managed fixed exchange rates pegged to the dollar or gold-exchange standard, with adjustment mechanisms), agreed upon at Bretton Woods, was designed to prevent such instability. Following the Vietnam war and the dollar glut, the US government decided to abandon the system and move towards flexible exchange rates. By the 1980s, states were surveyed in terms of financial performance much like corporations, by rating agencies and international financial institutions, but no system was put in place to

prevent severe imbalances or to intervene if adjustment was needed. Instead of taking a systemic view, the burden was placed on the individual country. Political responsibility for global economic asymmetries was delegated to financial-market authorities.

As a result, many austerity programs have been imposed by mechanisms that are not governed by democratic decision making. The results are poor, both with regard to economics and democracy. If such things as vicious interest-rate fluctuations are externally imposed, and if one's own government is complicit but not fully responsible, citizens deserve greater insight into the international and domestic complexity of public finance and what's wrong with austerity.

In the dominant public discourse the message is simple: governments should not—and ultimately cannot—overspend. Wikipedia shares a mainstream technocratic definition: 'Austerity is a political-economic term referring to policies that aim to reduce government budget deficits through spending cuts, tax increases, or a combination of both. Austerity measures are used by governments that find it difficult to pay their debts.'

If only the world were so simple! Why do governments incur and accumulate debts? How did not just one or two, but many governments arrive in a situation in which accumulated debt became an issue? At the same time, why does it become an issue in one country (say Greece or Ireland), but not in another (say the United States or Japan)? And how does capitalist development rather than public-sector behavior affect taxes and spending? During

the 'golden age' of capitalism after World War II, full employment, a strong public sector and a mixed economy, combined with limited international competition, translated into rising income, which was made available for greater social integration through welfare-state capitalism. Economic stagnation and rising unemployment, following the great crisis of capitalism of the 1970s, reduced income and increased the public cost of unemployment, public health and education. Who decides if the imbalance is corrected by way of higher taxes and on whom, or by lower spending and on what? How has the preference and need for cuts in particular been constructed and by whom?

Austerity has *not* been the same throughout history. There has been austerity before the age of welfare-state capitalism, to be sure, mostly following war and economic crisis. State capacity to tax citizens was limited due to the extremely uneven distribution of wealth. Only with the rise of the modern industrial working class and public employment did a reliable and reliably broad tax base develop. Much of the income of the public sector is paid out of the pockets of those who are employed in the private and public sectors. The share of regressive taxes, such as value-added taxes, has however been raised in recent decades. Under these taxes poor and rich people pay the same tax on goods (unlike income taxes, for example, where the more affluent normally pay a higher percentage of their income). Average and less affluent citizens should be concerned about the future of public finance. After all it is their money which we are talking about. Those who demand tax cuts for the rich and

spending cuts for the poor need to be answered by those who, as a result, will pay more and receive less.

When we talk about austerity today, roughly since the 1970s, we are thus talking about more than simply balancing the revenue and spending of the state. We are talking about recalibrating modern welfare-state capitalism. The target was and remains the macro-economic capacity of the state, with regard to domestic matters and international economic relations. Welfare-state capitalism, rudimentary in the global south and more fully if unevenly developed in the north (varieties of the welfare state), created new conditions for public finance.

At the time of the crisis of the Bretton Woods monetary system even Milton Friedman recognized that welfare states would be unwilling to give up macro-economic leverage. Realistically, states needed room to maneuver to meet the contradictory needs of business and people in a globalized world. Unlike those who wanted to return to the rigidity of the gold standard, Friedman advocated the switch to flexible exchange rates. While flexible exchange rates provide a cushion in the case of asymmetrical balances—countries can devalue their currencies—they also subject states to the discipline of the global capitalist market, its power relations and its institutions.

Ever since, a mix of flexible exchange rates and quasi-gold standards, such as the euro-system or other forms of fixed exchange rates and currency boards, has governed public finance, for better or worse. We do not talk much anymore about the global monetary regime and its uneven distribution of power. Instead everyone talks

about the need for the state to limit public debt. The widely shared belief in the supreme importance of public debt—the overriding concern of public finance—underpins the hegemony of neoliberalism and austerity, the dominant ideology of our age. It is held together by a range of beliefs which are backed up by diverse neoliberal schools of thought, ranging *inter alia* from Austrian economics and Chicago monetarism to Virginia School public choice, Freiburg ordoliberalism and locational competition rooted in Kiel.

It is common to neoliberal ways of thinking to imbue the private sector with creative qualities and to scold the public sector for wasting money—even when most of the money ‘wasted’ goes to safe private-sector investments. This paradox of the neoliberal state is important in two ways. First, unlike a pure emphasis on law and public order in the age of *laissez faire*, neoliberals have come to embrace the state to keep capitalism safe. This requires state action and investment, including nationalization, in particular in times of extraordinary economic crisis but also during normal times of operation depending on challenges and challengers.

Secondly, the unique responsibility and capacity of the neoliberal state and public finance to act in this way and in meeting challenges of all kinds needs to be disguised—hidden behind a language of state failure, bureaucracy and self-interest on the part of the ‘political class’, to keep a lid on demands from the lower classes. The greater the state capacity, actual or potential, the greater the need perceived by neoliberals to control the purpose for which

it is used. If the welfare state was designed to increase spending for greater social equality and the integration of the lower classes (social citizenship), the austere state has been designed to transform, roll back and privatize the welfare state, in the name of competition and the alleged benefits of inequality.

This booklet has been designed to argue against the idea of general mechanics of public finance that are presented as a common set of equations valid for every country and across time. Sure, each state budget has an income side composed of tax and other revenue. And each state budget has an expenditure side accounting for what governments pay for welfare, public safety, security, education, health and so forth. But both the capacity to raise taxes and the purposes of public spending have changed fundamentally over time and can again be subject to change. To restrict the potential for future change, austerity is presented as a 'one size fits all' model, valid across time and space. To give the impression of general validity, a number of different yet overlapping myths can be discerned—the myths of austerity.

Once again two dictionary entries, under the term *myth*, are telling:

1. a traditional story, especially one concerning the early history of a people or explaining a natural or social phenomenon, and typically involving supernatural beings or events;
2. a widely held but false belief or idea.

The 12 widely-held but false beliefs with regard to social phenomena related to austerity capitalism and the transformation of the welfare state are grouped together in five categories: 1) the authority of austerity economics, 2) the construction of contemporary austerity's iron cage of public finance, 3) austerity and the explanation of the cause of economic crisis, 4) the impact of debt on economic development and 5) the impact of debt on society.

We start with two contributions written to challenge the authority of economics and economists who backed austerity following the global financial crisis. The myths of expansionary austerity—that cutting public spending is ultimately good not only to lower state debt but also to increase economic growth—and of an objective figure for the threshold of debt that can be considered detrimental to the economy (the 60 percent debt-to-GDP ratio laid down in the Maastricht criteria, the 90 percent 'calculated' by the two economists Carmen Reinhart and Kenneth Rogoff) are at the core of the contributions by Jim Stanford and the co-authors Dieter Plehwe and Moritz Neujeffski, respectively. While the great stagflation 2.0 (stagnation and deflation) period is not backed up by supernatural beings, the numbers that provide the dubious authority for austerity have indeed been invented, deliberately or due to errors.

The social construction of the iron cage of public finance comes next, with three contributions. The myths of the external constraint of international tax competition and the benefit of tax cuts for the rich govern the income side

of the austerity equation, as do those of the removal of spending obligations by way of privatization and by cuts the spending side. Alex Cobham explains why the arguments of an external constraint for lower taxes are a social construct, and who is constructing them. Heather Whiteside uses the Canadian example to show how privatization increases public expenditure in the long run, contrary to the claims of a reduced fiscal burden. Sheila Block summarily debunks the myth of consolidation, because tax cuts simply reduce state income, while spending cuts shift the burden from one state institution to the other rather than removing it.

Next are two contributions dealing with the claims regarding state debt as the cause of the crisis. Greg Albo explains why such a take confuses causes and impact, and why the single-minded focus on sound finance and fiscal consolidation does not provide the answer to key questions of public finance, before, during and after the crisis. Thomas Fricke utilizes the European Union member states to detail the reversal of causes and consequences. Sharply rising public debt was caused by the crisis—not the other way around.

On a more general level, those who advocate austerity claim that the private sector is good and the public sector is a problem. The famous crowding-out thesis suggests that state investments deprive the private sector of investment opportunities. Ingo Schmidt explains why this is not the case and what purpose the black-and-white claims of market populism serves. Louis-Philippe Rochon debunks the myth according to which the public sector must

behave like individuals with regard to income, spending, savings and debt. The fallacy of composition—according to which what is true for a part of the whole is true for the whole—desperately needs to be deconstructed in the case of public-sector finance. If all individuals save rather than spend in order to reduce debt, the result is an economic contraction made worse by a government that in addition cuts spending. This is a lesson which the Greeks had once again to learn the hard way during the last decade. For this reason Swabian-housewife economics do not work at the state level, and are actually not a good take on what is really going on at the micro-level either. The allegedly model behavior of Germany furthermore obscures the international dimensions and true reasons for Germany's austerity regime, according to Lukas Haffert: austerity-related pressure on wages and the labor market helps to keep German export industries competitive, at the expense of both domestic consumption and foreign unemployed.

The final section explains in more detail why austerity is not only bad for economic development but also for social development and society more generally. Contrary to the presentation of austerity as good, technocratic governance in the public interest, neutral with regard to distributional concerns, Stephen McBride shows how in reality it recreates two worlds which are moving further apart. The heart of the matter of austerity is not balancing budgets but shifting the burden and benefits in contrary directions. This can be seen in taxation and fees for services: the burden is shifted from the rich to the middle class and poor. Poor and marginalized people in partic-

ular have suffered from the cuts in benefits in the name of activation and greater self-responsibility. Austerity is class-based and contains a class character, revealed by its propensity to increase inequality.

The final chapter takes aim at the myth of the democratic character of austerity as a project jointly driven and implemented by the social partners, trade unions and employers. While coalitions for jobs and social concertation certainly played a strong role in the aftermath of the crisis, Bryan Evans, Stephen McBride and James Watson show how the organized working class has lost much of its capacity to influence relevant policy areas. This is partly due to its integration and subordination in austerity coalitions. The most visible result of the complicity of labor in neoliberal transformation projects has been the decline of the vote of traditional socialist and social-democratic parties. If leaders of such neo-corporatist experiments consider their projects successful, success has come at the expense of the political organization in many countries. Social concertation and national coalitions in support of consolidation and austerity have been eager to cope with austerity but have failed to develop a new spirit and a new capacity of the public sector. Many trade unions, traditional social democrats and other people left of center, old and young, have seen their influence wane within and across borders. The shift of power relations to the right, in individual countries and larger political regions such as the EU, leaves one conclusion only: coping is not enough.



**PART I**

**THE AUTHORITY OF  
AUSTERITY ECONOMICS**



## Chapter 1

# THE GREAT STAGNATION AND THE FAILURE OF BUSINESS INVESTMENT

BY JIM STANFORD

*The myth:* Reducing deficits through cuts in government spending will have only modest impacts on total output and employment, and in some cases will actually increase gross domestic product (GDP). This is because businesses and investors will be reassured by painful but necessary measures to repair government finances, and they will become more willing to make long-run investment commitments which will spur economic growth. Moreover, by freeing up both financial and real resources (which otherwise would be absorbed by government deficit-financing), austerity creates economic space for the private sector to assume its rightful, leading economic role.

*The reality:* Austerity has had large and lasting negative effects on output and employment. Those chilling macro-economic side-effects have undermined the stated goal of deficit reduction (since it's very difficult to improve fiscal balances in an economy with high unemployment and weak spending)—not to mention imposing painful, multi-

generational, human and social consequences. Far from leaping in to fill the economic void left by government retrenchment, business investment has remained lethargic across most OECD countries since the financial crisis. If anything, austerity is undermining the business case for new investments, by so badly undercutting aggregate demand and expected growth.

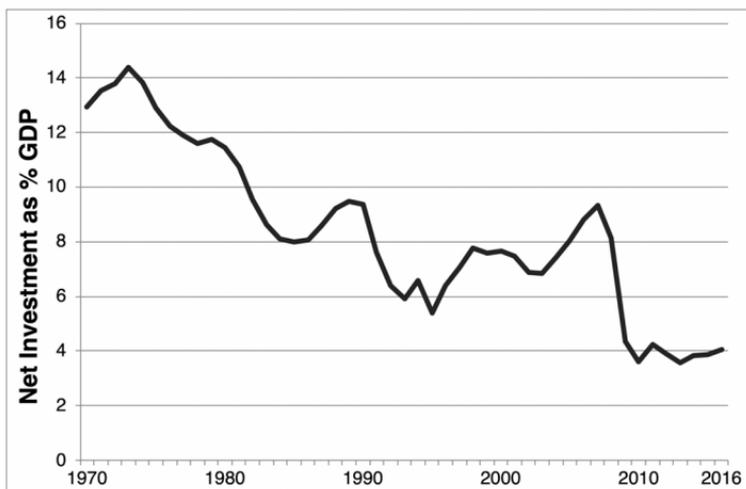
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The inability of most OECD economies to regain robust rates of economic growth since the global financial crisis is glaring and painful proof of the broader failure of austerity policies. The immediate downturn experienced in 2008-09 soon evolved into the 'great stagnation': successive years of disappointing growth, unemployment and underemployment, chronic budgetary deficits and historically low wage and price inflation.

One key cause of this sustained weakness has been an unprecedented downturn in capital spending by businesses. Adherents of austerity predicted that private investment would actually lead industrial economies to recovery after the crisis. Invoking the doctrine of 'expansionary austerity' (associated with writers such as Alberto Alesina), austerity advocates argued that reducing government deficits (especially through severe spending cuts) would facilitate a business-led recovery. Business confidence would be restored, fiscal and monetary stability would be re-established, and scarce resources would be freed from government's grasp, quickly channeled into productive private investment. Indeed, from the earliest

days of neoliberalism, conservative theorists (such as Robert Barro) emphasized the alleged ‘crowding out’ problem: government spending and borrowing is held to suck up resources which could be used more productively in private investment projects, thus squeezing out private-sector growth. By downsizing government, establishing a more business-friendly policy regime, and stabilizing credit markets, austerity allows business investment to play its rightful role.

But the reality of business-investment performance over the last decade utterly contradicts the neoliberal parable. Business investment across most OECD countries has been shockingly weak since the financial crisis. Figure 1 illustrates the trend in net business capital spending (after deducting depreciation on existing assets) in the OECD. A long-term decline in the pace of net investment was already visible even before the global financial crisis (GFC)—falling from around 12 percent of GDP before neoliberalism, to barely half that pace through the 1990s and early 2000s. After 2008, however, net investment declined sharply, and has not recovered at all. Since then OECD economies on average have allocated just 4 percent of GDP to incremental additions to the private capital stock—one-third the pace of accumulation in the pre-neoliberal era. In an economic system supposedly led by the deep urge of profit-seeking investors to ‘accumulate, accumulate, accumulate’, it is a dire sign indeed that modern capitalists are now hardly growing their real capital stockpile at all.



Business capital spending, OECD Countries, 1970-2016. Source: author's calculations from OECD National Accounts data; unweighted OECD average.

Incredibly, the pace of private investment since the GFC has been so slow that the overall capital intensity of production in many OECD countries is now declining. Capital intensity is measured by the ‘capital-labor ratio’—how much real capital (in all forms, including tools, machinery, technology, structures and so on) is available to supplement the labor effort of workers in production. Rising capital intensity has been the dominant engine of productivity growth and living standards throughout economic history, but now that engine has been thrown into reverse. New capital is being added more slowly than employment is growing; hence the capital-labor ratio is declining in many countries (including the US, Japan and even Germany). This trend poses major risks to future productivity and real incomes. It is especially surprising in light of popular infatuation with the supposed acceler-

ation of automation, robots and other labor-replacing technology: while some industries and occupations have certainly been transformed and disrupted by these innovations, overall investment in new machinery and technology is slowing down, not speeding up.

Yes, belts have been tightened—and business profits have rebounded substantially since the GFC. Business surpluses have regained historical norms in most countries and set new highs in some (notably the US). So the downturn in investment cannot be justified by a shortage of profits or cash flow. (In fact, after-tax corporate cash flow considerably exceeds the pace of reinvestment, creating an accumulation of excess corporate ‘saving’ and facilitating record dividend payouts and share buybacks.) Record-low interest rates for business lending (close to zero in real terms) should also have encouraged more investment. Nor can the investment slowdown be ascribed to a shift in investment to intangible assets (such as technology and software): research-and-development spending has also stagnated across the OECD and declined in many countries.

Capitalism is supposed to be propelled forward, first and foremost, by private investors who accumulate capital, initiate production and generate profits. Their hunger for profit supposedly facilitates output, employment, innovation and productivity—benefits which then should ‘trickle down’ through the rest of society (Ingo Schmidt takes a closer look at the false promise of market populism in chapter eight). There are a few countries where that dynamic is arguably still in play: Korea, for example,

continues to record strong business investment, rising capital intensity, rapid innovation, rising productivity and rising wages. Across the OECD as a whole, however, it seems the fundamental ‘engine’ of capitalist expansion is broken. The consequences are very slow growth, continued under-utilization of human and physical resources, fiscal imbalances, and social polarization and conflict. The myth of ‘getting government out of the way’, through spending cuts and other forms of austerity, has foundered on the rocks of macro-economic stagnation.

In retrospect, perhaps the goal of ‘trickle-down’ or ‘expansionary’ austerity was not actually to stimulate more investment and growth. Perhaps the true goal was to redistribute the economic pie—even further in favor of large businesses and the people who own them—rather than to grow it.

Proponents of austerity argue that still more must be done to improve the conditions for business-led growth. They call for continued fiscal austerity to enhance ‘investor confidence’ (even though, in practice, the chilling macro-economic side-effects of austerity on aggregate demand have undermined business capital spending). They demand more business tax cuts (like those implemented in the US under the presidency of Donald Trump), more employer-friendly changes in labor laws and employment standards, and more relaxation of business regulations (including climate policies).

The experience of the entire neoliberal period, however, gives ample reason to reject those demands, and to dismiss the promise that incremental business-friendly

policies will somehow *finally* unleash the dynamic power of private investment which has been so visibly absent. (Other research has confirmed the failure of public-sector austerity and business tax cuts to stimulate business-led growth, including work by Dean Baker; Sarah Anderson and Sam Pizzigati; Alan Auerbach and Yuriy Gorodnichenko; and even new research from the IMF itself, such as by Jamie Guajardo, Daniel Leigh and Andrea Pescatori.) Instead of accepting ever-more-painful demands for belt-tightening and cutbacks in a futile effort to entice capitalists to do what they are supposed to do, this is an opportune historical moment to question the economy's core dependence on private profit-seeking business investment in the first place.

Since the GFC, public infrastructure spending has already become much more important, largely by default, to the overall process of capital accumulation. Other forms of public and non-profit investment can also be nurtured in many parts of the economy, including in sectors such as housing, energy, utilities, food, and human and caring services, where the irrationality and inadequacy of private-led growth are especially evident. The legitimacy of the traditional ideology that economic progress relies on wealthy elites to make productive, job-creating real investments has been weakened considerably by the failure of private investment in the past decade. A long-term and holistic alternative to austerity must therefore feature, at its core, an alternative vision of how investment can occur—controlled by, and in the interests of, the masses of society, rather than the wealthy few.

## Chapter 2

# MICKY MOUSE NUMBERS IN ECONOMIC HISTORY: THE ORIGINS AND SPINNING OF 60 / 90 PERCENT DEBT-TO-GDP RATIOS

BY DIETER PLEHWE AND MORITZ NEUJEFFSKI

Humankind has always attributed mythical meanings to numbers. Take the famous inventor Nikolai Tesla, who regarded ‘the magnificence of the numbers three, six and nine’ to be the ‘key to the universe’. In terms of fiscal deficits and debt-to-GDP ratios, the values of 3, 60 and 90 percent came to play near-mythical roles too. Through the Maastricht criteria for economic and monetary union (EMU) in Europe, a 3 percent annual deficit and 60 percent debt-to-GDP ratio were set as authoritative thresholds. The star American economists Carmen Reinhart and Kenneth Rogoff further argued that the 90 percent debt-to-GDP ratio is a maximum threshold, above which accumulated government debt measurably stifled growth and significantly undermined economic performance in general.

Both ratios have played a key role in European and global economic governance, serving as significant parameters for rating agencies, for example, which oversee and (de-)legitimize public finance. In fact, the discursive power of

the 90 percent fortified the freely invented belief in a 60 percent debt-to-GDP threshold. Since there has been no serious economic justification for the validity of a desirable debt-to-GDP ratio of 60 percent, the apparently scientific discovery of a maximum level of debt-to-GDP appeared to fill a critical gap in the architecture of legitimate austerity. Readers may vaguely remember the miscalculation of Reinhart and Rogoff. Nonetheless, the debt-to-GDP and other ratios relevant for pro-austerity arguments need to be examined more closely to move a surreal debate nearer to a real one. Furthermore, we need to assess the circumstances under which debt can hamper economic performance and human development.

### **First we take Brussels...**

The myth of a reasonable debt-to-GDP ratio belongs to a more general class of pro-austerity arguments, according to which debt is simply a burden (see, for example, the chapters on crowding out and the Swabian housewife). These figures create a metric authority based on an allegedly accurate measurement of economic activities and public finance. Based on this figure, other parameters have been set to shape government behavior further, most notably the 3 percent Maastricht annual deficit constraint. Assuming a growth rate of 5 percent, a 3 percent deficit does not add new debt to the 60 percent stock. This is known as the combined 60 percent and 3 percent rule. But what exactly was the basis for these two figures?

The history is telling. Let's start with the 3 percent deficit

rule. The number was introduced by the French economist Guy Abeille back in 1981. After his landslide electoral victory that year, the French Socialist president, François Mitterrand, was facing high expectations from cabinet members and the public—and a soaring deficit, which stood at 2.6 percent of GDP. He called upon a group of junior economists to come up with a number suitable to put a lid on the boiling pot, to stop the overflow. Since it would have been hard to meet a 2 percent deficit target that year, due to the existing budget shortfall, the young expert at the Ministry of Finance suggested a limit of no more than 3 percent, which gave Mitterrand the fiscal cap he desired.

The selection of GDP as reference was arbitrary from a macro-economic calculation, being chosen simply as a figure everyone would immediately understand. Since the budget deficit's impact on total national debt depends on the growth rate, a 3 percent deficit ceiling does not make sense, in times neither of strong growth (as even a higher deficit would not add to debt) nor weak (when the deficit would need to be lower according to the simplistic rationale of austerity). Following the euro crisis, European authorities have kept with the logic of the 60 percent debt-to-GDP ratio and 'corrected' the initial French mistake by moving the maximum structural annual deficit down to 0.5 percent, in line with the more restrictive Stability and Growth Pact for the eurozone.

Surely the 60 percent debt-to-GDP ratio was not founded on an *ad hoc* political rationality as with the 3 percent rule? Alas, as DCM Platt once quipped, it is a similar

Mickey Mouse number in the history of statistics. The figure is based on neither thorough research nor excellent studies. It was simply invented as a reference point, much like the 3 percent rule, which would prepare the path for a monetary union focused on stability. According to the economist Luigi Pasinetti, the only reasonable explanation for choosing 60 percent was that it was the approximate average debt-to-GDP ratio of the EU member states at the time of negotiation of the EMU. Both Germany and France were close to this mark too. Once established, the arbitrary calculation however provided the legitimacy for an apparently authoritative reference point, an authority only numbers can provide.

### **...and then we take the world—the political influence of the 90 percent argument**

During the financial crisis, public finance was out of balance due to the bailout of private banks. Many countries added plenty of percentage points to their debt-to-GDP ratios. With no scientifically-based rationality for an optimal debt-to-GDP ratio at hand and rapid movement away from the 60 percent ratio in the wrong direction, the shaky grounds on which the debt-to-GDP rationale had been built were laid bare. But rescue was coming from the ivory tower of sound economics, Harvard University and from the University of Maryland.

In 2010, Carmen Reinhart and Kenneth Rogoff published the non-peer-reviewed article ‘Growth in Time of Debt’, which provided the desperately-needed academic expertise on the issue of sustainable debt-to-GDP ratios and

was soon cited widely. Analyzing the relation between public debt and GDP growth between 1946 and 2009, the authors claimed that public debt-to-GDP ratios of more than 90 percent decreased median growth rates by 1 percent. When measured in average growth, the effects were meant to be even more severe. While this must have caused the Greek government a serious headache (in 2010, its debt-to-GDP ratio shot up by 42 percentage points compared with 2006), it was music to the ears of pro-austerity authorities. The Republican 2012 budget plan used the paper as an exclusive reference; the former European commissioner for economic affairs Olli Rehn regarded the 90 percent finding as widely acknowledged and the former UK chancellor of the exchequer George Osborne praised Rogoff's influence on his economic thinking.

This general myth of how austerity and a balanced budget lead to economic success had been debunked before and would not need to be so again, had it not exerted such a strong intellectual backing for the random Maastricht debt-to-GDP ratio. In their 2013 critique of the Reinhart and Rogoff paper, Thomas Herndon, Michael Ash and Robert Pollin replicated the study based on data Reinhart and Rogoff had used. The new results challenged the very idea of negative effects resulting from high debt-to-GDP ratios. Herndon *et al* showed that major mistakes by Reinhart and Rogoff had led to serious errors, misrepresenting the relationship between public debt and growth. The errors included selective exclusion of time periods of data for Australia, New Zealand and Canada, unusual weighting techniques and simple Excel coding errors

which excluded entire countries, such as Belgium and Denmark, from the summary statistics. Appropriately recalculated, they derived a 2.2 percent annual growth rate for countries displaying a 90 percent debt-to-GDP ratio. This was contrary to the myth of automatic GDP reduction established by Reinhart and Rogoff, and only slightly lower than their findings for lower debt-to-GDP ratios.

Despite its inaccuracy, neither the European authorities nor the leadership of the international financial institutions took the opportunity to trash the 60 percent rule. Devoid of any substantive academic backing, European authorities still hang on to the '(excessive) debt diminishes growth' argument in general, and to the dogmatic fantasy of a 60 percent debt-to-GDP ratio in particular.

### **Necessary meditations on debt, growth and austerity**

The debunking of the authority of the 3, 60 or 90 percent figures does not imply that we should be comfortable with fast-rising debt and with high structural debt, public or private. Depending on such parameters as economic growth, the purpose of debt, reasons for deficits or interest-rate levels, debt matters immensely for economic development. Both absolute and relative levels can be detrimental to citizens' wellbeing. But there is a huge difference between when a country incurs high debt due to military spending or bailouts and when debt is incurred through, for instance, public investments in health care or CO<sup>2</sup>-reducing transport infrastructures. The latter increase a country's productivity, which conse-

quently enables the service of temporarily higher debt. Contrary to arbitrary ceilings, the so-called ‘golden rule’ of public deficits links additional government debt to productive investment. The golden rule still expresses the Keynesian spirit of state capacity, which runs counter to austerity logics and supply-side economics—balanced and minimized public spending.

Economists are aware that there is a major difference between a state financed by domestic or foreign lenders and one that is subject to monetary rigidity, which disables exchange-rate adjustment, and is consequently subject to economic power and decision-making from the outside. Countries such as Japan can carry more than 200 percent debt-to-GDP ratios owing to domestic lenders in national currencies, while other countries rely on foreign capital. The discipline of financial markets was introduced in the 1980s for most of the world, when rating agencies started to assess public finance and debt according to principles previously applied to commercial banks.

There simply is no authoritative number regarding debt-to-GDP ratios or annual deficits in general. Nevertheless, the rules applied are used to consolidate austerity capitalism and to deflect alternative discussions on the causes of debt, deficits and the purpose of public finance.

**PART II**

**CONTEMPORARY  
AUSTERITY:  
RECONSTRUCTING THE  
IRON CAGE OF PUBLIC  
FINANCE**



### Chapter 3

## THE MYTH OF INTERNATIONAL TAX 'COMPETITION'

BY ALEX COBHAM

One of the most pernicious economic myths of our times is that of international tax 'competition'—the idea that the process through which countries obtain investment is somehow equivalent to the model of perfect competition between firms which is taught in introductory economics courses. This myth has been given new life by the central myth of austerity, namely that a dramatic economic shock can best be addressed by a fiscal contraction. Needless to say, these myths are not 'neutral', in any economic, social or political sense. Their rise reflects an ideological triumph in the face of compelling contrary evidence—and the human impacts are the price.

The myth of international tax competition presupposes an entire agenda. Indeed, the choice of language is itself deliberately misleading. 'Competition' conjures up ideas of a productive struggle between companies to find an edge, a process that leads to innovation and better products for consumers at lower prices. We all love competition, right? But even at the level of pure economic theory,

only the hypothetical perfect competition among an infinite number of equally sized small firms can (hypothetically) deliver consistent benefits—a situation that can of course never occur among countries, which are limited in number and dominated by a few large and powerful states. As Martin Wolf, the economics sage of the *Financial Times* (and no left-winger), has put it, ‘The notion of the competitiveness of countries, on the model of the competitiveness of companies, is nonsense.’

The easiest way to see this is a simple comparison. Failed companies can be seen as an unfortunate but necessary part of the competitive process, with good prospects for the people and capital involved to be reallocated to (more efficient) competitors. ‘Failed states’, on the other hand, are the places where many of the most vulnerable, marginalized people in the world live. (The current US and EU fixation on migration shows the extent of rich-country enthusiasm for the ‘reallocation’ of citizens of failed states.)

In the austerity context, tax competition has taken on if anything a more exaggerated form. Following the financial crisis, tax revenues fell off a cliff and debt soared, due to bailing out the banks to protect market actors from their own decisions. But policy-makers were told, and themselves told their citizens, that this was the time to cut corporation tax—that the key to recovery was to attract international investment, and that the key to attracting international investment was to lower taxes.

Both elements of this are straightforwardly false. The crisis threatened confidence and demand, due to the

immediate loss of asset values and rise in unemployment. Additional international investment could indicate and support confidence, and generate employment, but both effects would be marginal compared with the overall economy. There was no serious macro-economic contention that governments were other than the only actor big enough to influence confidence and demand at scale. International investment could not be central.

Secondly, tax is not key to attracting international investment—a point so well established that such varied authorities as the IMF, Tax Justice Network and McKinsey's are in agreement. At most, tax treatment is a secondary concern, once core factors such as market access, human capital and infrastructure have determined the preferred investment location. Theory indicates that such tax 'competition' between jurisdictions offering investment incentives will result in a race to the bottom, with the eventual benefits to the 'winning' state being zero or even negative, while the investor captures abnormal profits.

In practice, states which have sought to use tax to 'compete' their way out of austerity and into prosperity have failed in all aspects. The UK has led the way since 2010, with successive finance ministers committing to lower statutory rates of corporate taxation. As I've written for #AltAusterity previously, this led the UK to a uniquely tax-averse approach to austerity—so that the UK made greater cuts to public spending than the eventual deficit reduction. The UN special *rapporteur* on extreme poverty and human rights, Philip Alston, has catalogued the

shocking and entirely unnecessary inequality and vulnerability which have resulted. (In chapter five, Sheila Block shows the effects of spending cuts on society in Greece.)

The UK government's own analysis, in line with those of the independent budget watchdog, showed in advance that the cuts in corporation tax—from a globally typical 28 percent, down to a most 'competitive' 17 percent—were expected to produce an investment impact of precisely zero. But each percentage point is estimated to cost an additional £2 billion or more in lost revenue, and therefore in further cuts to spending or rises in the deficit.

The corporate investment response makes sense in terms of real economic activity in the country—marginal changes in the distribution of potential profit can hardly offset major economic decisions which suppress incomes and demand—and multinationals' profit shifting. Our analysis with Petr Janský showed that the great majority of profit shifting by US multinationals reached just a handful of jurisdictions, including the Netherlands and Bermuda, where the effective tax rate was around 0-2 percent. Cutting statutory rates from 28 percent to 17 percent simply doesn't get a country into the game to attract inward profit shifting or remove the incentive for outward shifting.

With no other changes, corporate tax cuts are simply a giveaway of revenue—and an undermining of progressive tax more generally, since corporation tax provides a back-stop to income and capital-gains taxation, and differences in rates provide an incentive to reclassify income streams,

causing further revenue losses. Indeed, the UK has seen an explosion since 2010 in company formation and a corresponding loss in income tax.

International tax ‘competition’ is a myth. The evidence shows that it is a race which can only be won by companies, while the losers are competing states and the majority of their populations. In the toxic context of austerity politics, the competition myth has been used to justify even more regressive tax and spending shifts, with enormous human costs. This should be understood as purely ideological and debated in terms of preferences for poverty and inequality outcomes. Despite the misleading branding of the concept, there are no genuine competitive processes or benefits to consider.

## Chapter 4

# PRIVATIZATION REDUCES THE FISCAL BURDEN?

BY HEATHER WHITESIDE

Revenue-challenged states around the world often turn to public-asset sales as an easy way to pay down debt and balance the books. Auctioning off revenue-generating, state-owned enterprises and infrastructure to reap one-time, lump-sum payments is not only a desperate maneuver; it is also short-sighted and counter-productive in the long run. Whether it is Greece selling its airports, harbors or telecommunications systems at fire-sale prices, to meet the repayment demands of the 'troika' (the European Commission, the European Central Bank and the IMF), or less fiscally-troubled states, such as Canada, engaging in ideologically-motivated privatization efforts, the notion that privatization reduces fiscal burdens for the state can be challenged on three fronts. Asset sales cut into state revenues, corporate welfare endures in areas of strategic importance and privately-financed public works are often poor value for money.

Canadian examples are drawn on here. It is a country with decades of neoliberal- and austerity-inspired privati-

zation, at multiple levels of government, yet it has also retained a mixed economy with government involvement in public infrastructure, as well as in the delivery of other public goods. As such, Canada offers examples of how public ownership can benefit a modern capitalist economy, and provides a cautionary tale of how privatization can lead to higher costs and lower revenue for government.

**Myth: privatization reduces fiscal burden; reality:  
asset sales cut revenue streams**

In a University of Calgary School of Public Policy research paper of 2012, ‘The role of crown corporations in the Canadian economy’, Iacobucci and Trebilcock, two law professors, summarize the privatization urge as being ‘when either the rationale for government involvement no longer exists ... or when privatization ... has been identified as better fulfilling the government’s policy objectives’. Austerity objectives, such as paying down debt through one-time, lump-sum payments via privatized public assets, have frequently dominated ‘government policy objectives’ and provide the ‘rationale’ needed to end public ownership. Ideologically-motivated asset sales may be a boon for private investors but are often a bust for government.

For example, under the aegis of austerity, in 2012 British Columbia’s provincial government sold 101 government properties to balance the budget, through its Release of Assets for Economic Generation plan. Six years later, the auditor general found that these assets were undervalued

by upwards of two-thirds, concluding that government ‘should have done more to assess the costs and benefits of selling versus holding surplus assets prior to their sale’. Essentially government was targeting upfront revenue rather than long-run economic activity and cost savings.

Ontario, Canada’s largest province by population and income, has the largest subnational debt burden in the country, approximately C\$350 billion. In December 2018, the credit-rating agency Moody’s downgraded Ontario’s debt to Aa3 stable (from Aa2 stable), citing not only high debt and low growth but also cuts to revenue associated with austerity- and privatization-related maneuvers. While excessive public debt should be a concern for any government, this can be addressed not only through austerity cuts and asset sales but also through new revenue sources. For example, with cannabis recently legalized nationally, the Ontario Cannabis Store—a dividend-remitting, government-owned company—is now the legal pot dealer in the province, and society is anticipated to profit from this multi-billion-dollar market.

**Myth: privatization reduces fiscal burden; reality: corporate welfare is rampant in strategically important sectors**

Privatization does not necessarily mean fewer financial burdens for government in strategic areas of the economy. Once a state-owned enterprise, for Air Canada privatization has been a financial disaster. Despite slashing jobs, cutting unprofitable routes and increasing fares, Air Canada required bankruptcy protection in

2003. And privatization has yet to signify an end to public financial support: in July 2009 the company received a C\$250 million bailout from the federal government.

Likewise, in the important auto sector, public bailouts have led to a socialization of private debt. In December 2008, Ottawa and the province of Ontario announced they would provide GM and Chrysler with short-term repayable loans. By April 2015, reporting in the *Globe and Mail* assessed that ‘Canadian taxpayers will fall about \$3.5-billion short of breaking even on the money the federal and Ontario governments invested in the bailouts’. More recently, in October 2018, the Canadian Broadcasting Corporation uncovered that ‘the [federal] government has quietly written off a \$2.6-billion auto-sector loan that was cobbled together to save Chrysler during the 2009 global economic meltdown. The write-off [is] among the largest ever for a taxpayer-funded bailout ...’

**Myth: privatization reduces fiscal burden; reality: privately financed public works offer poor value for money**

Over several decades, the Canadian federal government has incrementally withdrawn from public capital investment and the ownership of public capital stock. As the economist Hugh Mackenzie showed in his 2013 report for the Canadian Centre for Policy Alternatives, *Canada’s Infrastructure Gap*, in 1955 the federal government owned 44 percent of the Canadian public capital stock but by 2011 its share had dropped to 13 percent. As early as 2004, groups like TD Economics and Deloitte began

pushing public-private partnerships (PPPs) as a ‘solution’ to the infrastructure gap. PPPs emerged in the 1990s as neoliberal ‘build now, pay later’ schemes, aimed at carving out markets for profit-making from private involvement in public-sector projects.

While the model has long been used, and widely criticized for its high cost and scandalous track record around the world, in the post-2008 context of very low prime rates, institutional investors—pension funds, mutual funds, insurance companies and so on—renewed the push for PPP investment, given its relatively low-risk, high-reward profile. And once again McKinsey, BlackRock and other finance-industry beneficiaries pressed the ‘infrastructure gap’ as one that had to be filled through PPPs, particularly in the context of post-2010 austerity (ignoring the reality that private financing must be paid back by government through taxes or by the public directly through user fees).

PPPs however offer poor value for money and have not performed as promised, a situation detailed in my recent books *Purchase for Profit* and *About Canada: Public-Private Partnerships*. Private finance is more expensive, PPP procurement involves complicated and lengthy negotiations, and project needs are often supplanted by profit necessities. A great many of the more deleterious aspects of privatization are also denied, downplayed or ignored by proponents, such as their impact on local control, democracy, unionization and service quality.

The 2018 bankruptcy of the global PPP infrastructure services giant Carillion provided a painful example of how problematic the privatization of public services can

be. It was also instructive. In October 2018, the UK, home of the Private Finance Initiative (PFI), abolished its PPP program, in large part due to the Carillion debacle and the mountain of PFI debt now strangling UK authorities. As the chancellor, Philip Hammond, put it, 'I remain committed to the use of public-private partnership where it delivers value for the taxpayer and genuinely transfers risk to the private sector. But there is compelling evidence that the Private Finance Initiative does neither ... I have never signed off a PFI contract as chancellor and I can confirm today that I never will.'

## Chapter 5

### **FISCAL CONSOLIDATION: CUT SPENDING, SOLVE FISCAL PROBLEMS AND INCREASE INVESTMENT?**

BY SHEILA BLOCK

At the start of the Great Recession of 2008-09, governments increased their role in the economy. A concerted and fairly consistent slate of monetary and fiscal policies was rolled out. Yet, only a few years later governments shifted into reverse gear and balancing budgets became the main policy priority. Every governmental budget has an income (mostly through taxation) and a spending side—it was the latter which was tightened the most. According to those who believe in the merit of austerity, spending cuts are the most effective way to balance budgets in the short run, and to consolidate public finances in the long run. Yet, the negative impacts on individuals and society at large are ignored.

#### **When spending is not questioned, and when it is**

Central banks pumped trillions into the economy following the global financial crisis (GFC). As a result, we did not see an extended collapse in financial markets as in

the Great Depression of the 1930s. This was accompanied by concerted fiscal policy interventions, which were shown to have a positive impact on the real economy. An example is the American Recovery and Reinvestment Act, which included investments in transportation, environmental protection and other infrastructure as well as increased access to social transfers. There was a return to stability in the financial system and in the real economy. This experience ran counter to the neoliberal narrative of the ineffectiveness of fiscal policy to stabilize the economy. From a macro-economic policy perspective, these government actions proved effective.

As a result of the stimulus program, government debt did go up post-recession: OECD data show increasing debt-to-GDP ratios in EU countries from 2007 to 2010. This is to be expected coming out of a period of economic downturn and increased government spending. The crisis caused rapidly rising debt—not the other way around (see Greg Albo and Thomas Fricke on the cause of the crisis).

Very shortly after these successful government policy interventions, a variation on an old myth in macro-economic policy regained prominence. It has a number of building blocks. The first was that any country that had a large budget deficit was now at risk of experiencing a government debt crisis. Using Greece's experience as an object lesson, countries coming out of recession with high debt were warned they would lose access to capital markets, which would make it very expensive—almost impossible in some cases—to finance or refinance government debt. The second was that

austerity was the solution to this threat of an ensuing debt crisis. Thirdly, the best way to balance the books again was by cutting public spending rather than increasing tax revenues. The final thread in this myth is that these austerity measures would not have a negative impact on economic activity. It was argued that spending cuts would boost the economy, while increasing taxes would increase the deficit—a variation on the debunked ‘Laffer curve’, associated with the Ronald Reagan US presidency, which argued that lowering taxes would have such a stimulating economic effect that this would lead to increased tax revenues.

How convincing are these arguments? First off, a commitment to eurobonds—or similar instruments designed to pool government debt—would have put an end to financial speculation targeting individual countries. Secondly, if coordinated stimulus ended the free fall, recovery could also have been aided by co-ordinated public-sector investment. Thirdly, increased progressive taxation would have contributed to *both* the budget balance and decreasing income and wealth inequality.

Government debt levels were in fact used to manufacture a crisis in the aftermath of the GFC—and to lever support for harsh and counter-productive austerity programs with real human costs and negative impact on the economy. Greece implemented some of the harshest austerity measures, predominantly driven by spending cuts. They included freezing the salaries of public servants, drastic cuts in minimum wages, massive public-sector layoffs and sharp reductions in the budgets of ministries such as

health and labour. Since 2009, Greek pensioners have seen their monthly retirement benefits cut drastically.

Severe fiscal contractions do real damage. Research from the Global Burden of Disease Study in 2016 linked austerity to increased mortality in Greece. Similar effects were identified for the United Kingdom, in research led by King's College London in 2017. In economic debates on post-crisis austerity, even where the weakness of these policies is recognized, their human toll receives far too little attention. The abstract argument that spending cuts are a better way to balance budgets than tax increases needs to be interrogated with concrete questions: who pays, who benefits and how fair is the distribution of costs and benefits.

### **Contractionary consolidation—bad for the poor, not good for economic activity either!**

The last eight years have proved there is a continued appetite in bond markets for government debt. OECD data show interest rates remain at historic lows. Predictions from mainstream economists that the Greek crisis would spread like wildfire to other national economies never came true.

At the same time, government retrenchment since 2010 has been associated with higher unemployment and slower economic growth—the opposite of the increased confidence and high growth that was promised. Paul Krugman's research has shown that government austerity usually has this effect and that economic performance

worsens with the intensity of austerity programs. IMF research in 2016 concluded that neoliberal austerity had increased inequality, which reduces both the level and sustainability of economic growth. The authors concluded that periods of fiscal consolidation had been followed, on average, by contractions rather than expansions in output and by increased unemployment.

How can we understand the persistence of a policy like austerity? The answer needs to take into account the interests and ideas of the powerful. These interests are not served by an expansion of the role of government in the economy beyond the protection of property. They are served by a smaller role for the state. Rich people do not depend to the same extent on public services as the rest of us. Private security, private health care and private schools are available to affluent citizens. And any increased role for the state is likely to eat into their considerable wealth, through increased taxation or more protective regulation of their business activities.

Increasing taxation on capital gains or new financial transaction taxes designed to temper financial speculation will have very different outcomes than cutbacks in social programs. Fundamentally, the costs of reduction of government debt and deficits are borne by very different social groups with these different approaches. But the paradox of fiscal consolidation is this: reducing public spending and systematic budget constraints hamper both the state and economic activity.

**PART III**

**AUSTERITY AND THE  
EXPLANATION OF  
ECONOMIC CRISIS**



## Chapter 6

### **THE PRIORITY OF DEFICIT REDUCTION AND THE MYTH OF CONSOLIDATION**

BY GREG ALBO

It is hardly a stretch to contend that concern over government deficits—and hence the purported need for fiscal austerity—has been at the center of economic policy since the ideology of neoliberalism came to prominence in political discourse in the 1980s and in the state policies of governments of the right and center-left since then. Certainly, austerity has dominated economic policy as the emergency fiscal measures in response to the Great Recession, led by the US and coordinated through the G20, began to be reversed. One after another, states have been attempting to constrain annual budgetary deficits as a portion of GDP to avert a further accumulation of the stock of total public debt. They have done so with more or less political commitment.

The results have been mixed, to say the least, given the unrelenting stagnation of economic growth. The US under Trump is something of an anomaly in the attempt of his administration to drive up growth through massive corporate tax cuts and a further boost to military spend-

ing, with the consequence of a radical shift to a major deficit in the national budget. The deeply polarising division this is causing among political and economic elites suggests the US is, to invoke a phrase of economic sociology, an ‘exception that proves the rule’.

The focus on deficit reduction as the centerpiece of economic strategy has gone by the paradoxical label of ‘expansionary austerity’, as vigorously defended by Alberto Alesina, Ken Rogoff and others in numerous studies (Dieter Plehwe and Moritz Neujeffski discuss the ‘90 percent debt-to-GDP stifles growth’ thesis in chapter two), or by the more technical terminology of ‘fiscal consolidation’, as adopted by international agencies such as the IMF and the OECD and consistent with the so-called ‘Washington consensus’ of the 1990s (compare Jim Stanford’s chapter on the great stagnation).

As with so much of modern neoliberal economics, the propositions put forward are based on idealized abstractions of the expectations of individualized economic agents, responding to the actions of extra-market institutions such as governments, in determining the allocation of their asset portfolios and thus of their investments in the economy. In the hierarchy of information processed by these agents, a crucial marker is the level and direction of the fiscal deficits of states. Increasing deficits, it is argued, destabilize investments via negative expectations on interest rates and profitability, thus creating market uncertainty and turmoil. In contrast, fiscal consolidation re-establishes a policy framework and expectations about interest rates and

investment returns which promote economic growth and stability.

As Mark Blyth argues in his book *Austerity: The History of a Dangerous Idea* (2013), a 'credible program' of fiscal consolidation is supposed to 'shift expectations' to bring forth an expansion greater than the contraction caused by budget cuts.' Market stability and expansion depend, as much as anything else, on policies of fiscal conservatism restricting the profligacy of democratic states. In a fashion, the Maastricht fiscal-convergence criteria for EU member states, of annual deficits of no more than 3 percent of GDP and total debt no more than 60 percent, have become something of a technical global policy norm (compare the chapter on Mickey Mouse numbers in economic history). And the various parliamentary resolutions and mandates committing to balanced budgets serve as the most visible political symbol of the ideology and practice of fiscal consolidation.

The fiscal-consolidation strategy is misconceived, however, first in its diagnosis of the economic-policy history that preceded the Great Recession. As Wolfgang Streeck points out in his *Buying Time* (2014), fiscal consolidation had led to a decline in public debt from the policies of the Clinton administration in the 1990s to before the economic rupture of 2008. Streeck and many others have argued that government debt was only to be replaced by a 'privatized Keynesianism', as various forms of private debt exploded. As profits eroded and investment stalled at the top of an economic expansion, the conditions for a major crisis were set when the trigger of

mortgage and consumer defaults set off an uncontrollable wave of further defaults and bankruptcies across financial markets and the world market.

Indeed, emergency anti-crisis measures had to radically reverse a decade and more of the consolidation strategy: a massive bailout of banks; an unprecedented monetary policy of quantitative easing, to drive interest rates towards zero, to facilitate private and public borrowing and to reflate the asset values of the wealthy; massive subsidies to industrial sectors, such as autos, plunged into insolvency, and increased government spending to support effective demand and contain a huge spike in unemployment. It is utterly misleading to attribute any of this to fiscal profligacy. As even liberal financial commentators like Martin Wolf have noted, the state deficits were the necessary offsets to the collapsing spending of households and corporations. This was an economic policy of necessity, as the economic authorities saw it, to rescue financial capitalism—with fiscal deficits of far less concern. (Thomas Fricke takes a look at the crisis-induced increase of state deficits in the eurozone in chapter seven.)

The fiscal-consolidation strategy is equally misguided in suggesting that a policy of austerity is crucial at this time to restore stable, market-led growth by re-forming an appropriate fiscal environment for capitalist investors. As even the IMF now concedes, in more recent research on the limits of budget cuts, this is to leave to the side the impacts of deficit reduction on inequality and the questionable benefits for sustainable growth: the cuts strategy

transfers resources to the capitalist sector (especially finance) at fault for the crisis, while its working-class, small-business and taxpayer victims are dealt austerity (compare the 11th chapter on the two worlds of austerity). Keynesian and Marxian analyses have been adamant in rejecting the deficit-cutting strategy when consumers are deleveraging, corporations are using money hoards for stock buybacks and dividend payouts, and investment is stagnating. This is the well-known economic folly of generalizing from micro-economic changes to macro-economic outcomes. The slow growth in core countries, such as Britain and France, and the alarming underperformance in more peripheral countries—Greece, Portugal, Spain and others—are witness to the failings of fixating on fiscal deficits in circumstances which call for a radically different economic-policy regime.

There is, moreover, the misconception that the intent of fiscal consolidation is ‘sound finances’ (compare the chapters on ‘live within your means’ and privatization)—the alleged purpose being only to eliminate the ‘inefficiencies’ from state provisioning while allowing markets to provide dynamic gains in economic growth from competitive incentives (with tax credits addressing any redistributive shortcomings). This argument is not plausible. On theoretical grounds, there is no basis for claiming that cutting public services will be matched by available private providers able to supply similar goods with the same social mandates. Nor that private sector organization is by definition always more efficient and insulated from market failures (compare the chapter on ‘market good, public bad’). These are all ideological assertions:

numerous studies of privatization, from Public Services International and other researchers, have found a deterioration in provisioning for social housing, healthcare, public transit, public parks and even core utility services such as water, electricity and roads. Whatever the failings of the 'bureaucratic administration' of the mixed economy (and there were many in the level, quality and democratic controls over public services), the provisioning cuts and 'market administration' of the capitalist sector, resulting from the fiscal-consolidation strategy, have outdone them and more.

The most elemental misconception of the fiscal-consolidation strategy is, to conclude, the presentation of deficits as simply a 'technical problem' of sound budgetary management. Such a view elides the political role of fiscal consolidation in undermining the redistributive and market-sanctioning dimensions of state policy and mandating, as writers as diverse as Donald Savoie and Wendy Brown have observed, the re-engineering and monetizing of state administration to enhance market controls over the public sector. The intent of this remaking of the state is, as set out in neoliberal theory by thinkers such as Friedrich Hayek and James Buchanan, to shift the balance of class forces, enhance the political conditions for the extraction of value from workers, reinforce the allocative role of financial capital in distributing savings and credit into investments, and support industrial capital in the unilateral restructuring of industry without reference to workers or communities.

More than a decade after the financial crisis triggered the

Great Recession, the world market is again in danger of slipping into a downturn of unpredictable scale and consequence. Fiscal consolidation has been central to an economic-policy regime that has worsened inequality, reflat asset values and fostered a refinancialization which has rebuilt and even extended the stocks of global debt. There is now far less fiscal and administrative capacity available in central banks and treasury departments for crisis management. Coordination and cooperation between capitalist states is giving way to economic nationalism and new forms of competitive rivalry. The mythology of neoliberal fiscal consolidation has been one of cutting as a new path to prosperity. But the legacy of its theoretical and political misconceptions is one of hard right-wing populisms, authoritarian governments and anti-democratic practices spreading across all states. The search for economic alternatives cannot begin soon enough.

## Chapter 7

# WAS THE EURO CRISIS CAUSED BY EXCESSIVE SOVEREIGN DEBT?

BY THOMAS FRICKE

German banks have spent a lot of money and effort to prevent their public image from becoming tarnished since the financial crisis of 2008. But since the euro crisis which started in 2010, the most substantive help for this strategy came free of charge: suddenly, what originally was a banking crisis evolved into a sovereign-debt crisis in the public perception, with the Greeks and others framed as the indebted southerners. Since then, talk shows have not been focusing on issues such as bank-executive bonuses, high-frequency trading or shadow banking, as was the case after the Lehman Brothers crash in 2008, but rather on early Greek pensioners or Italian tax ethics.

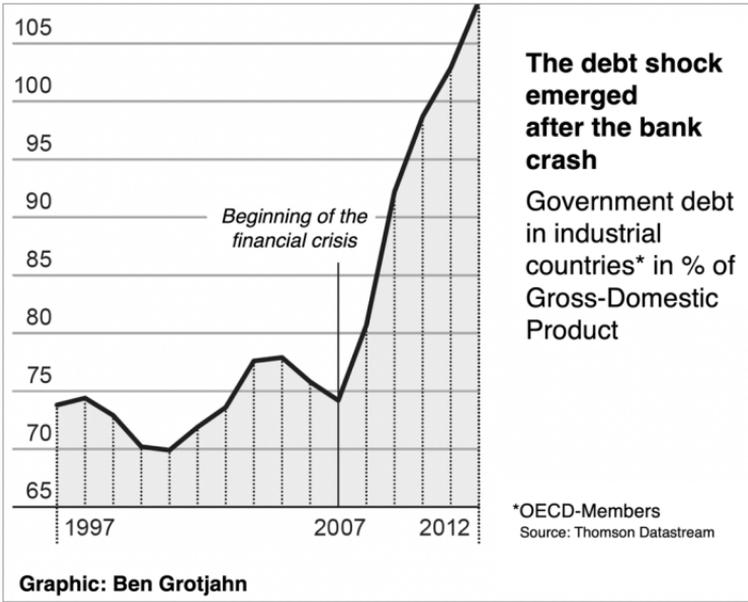
No other diagnosis has emerged to become so entrenched and embraced in Germany. It was years of sloppy southern-European government which plunged us into the crisis, so it goes—even worse, the (largely) virtuous German taxpayers have had to pay the clean-up bill.

Obviously, there were southern-European countries

getting into trouble. There is, however, a small hitch. Through closer inspection, it becomes apparent that, except for Greece, there is no causal link at all between the outbreak of the crisis and public debt. And this had serious consequences. Regardless of the lack of evidence for the myth of debt as the cause of the crisis, the European Commission, the German government and other guardians of stability tightened the fiscal rules and ratcheted sanctions up against the crisis countries. The EU thus preferred dealing with symptoms rather than with the real cause of the crisis.

### **A question of sequence**

Why were countries like Spain and Ireland sucked into the whirlpool of the crisis? Before the outbreak of the global financial crisis in 2008, both states had budget surpluses. Back then, the accumulated public debt, measured against GDP, was at its historic lowest. Logically, this doesn't fit into the 'sovereign debt caused the crisis' argument. The sequence of events was actually the other way around.



Granted, in the case of Greece, the sequence fits. But why didn't the markets then start sanctioning the fiscal policy much earlier, through gradually increasing interest rates? Greece's public finance had been on shaky ground for a while. Why did the credit-rating agencies keep giving Greece A ratings until the end of 2009? This cannot be explained with the usual excuse, according to which the market actors believed the indebted states would be saved in any case, contrary to the no-bailout clause in the Maastricht treaty. Why, then, did the market actors not believe in the same safety net after the crisis?

A more plausible story would be that the markets did not even believe in the possibility of a crisis before its outbreak. Shortly before, international analyses were still reporting that Greece had the second highest GDP growth per capita among all OECD countries since the

inception of the eurozone. The OECD's 2007 *Economic Survey: Greece* report said on its first page: 'It is particularly encouraging that growth has been sustained over the last two years, despite substantial fiscal consolidation, mainly being driven by investment and exports.'

So why did the markets' opinion change in the fall of 2009? Why had the eurozone member states all of a sudden to pay 5, 10 or 20 percent interest rates, although the 2011 sovereign-debt ratio for the euro area was much lower than in the US or Japan? US and UK sovereign-debt ratios were 40 points higher in 2010 than in 2000; the eurozone only had a 15-point increase. On the other hand, why was Germany spared from rising interest rates—though its sovereign debt shot up by 20 percentage points and remained higher than Spain's for a while? In 2012, the euro crisis re-escalated despite the drastic austerity packages carried out among the crisis countries. Why did interest rates not decline at this point?

In July 2011, investors even suddenly fled Italy. This happened despite the fact that Italy had already achieved a primary fiscal surplus before interest payments for many years. The same analysts who trusted it before could suddenly recite reasons why Italy was ready to crash, without an ounce of shame.

If the crisis was due to original problems of the crisis countries, it had much more to do with the enormous deficits in trade balances. Numerous countries suffered from increasing deficits, with imports much higher than their exports, while Germany generated ever higher and unsustainable surpluses. Here, at least the sequence is

right: first trade imbalances, then the crisis. This is still not enough, however, to explain the peculiar dynamics which led to the escalation of the situation in the eurozone by the summer of 2012. This can only be fully explained in terms of another, deeper phenomenon—the dysfunctionality of the financial markets.

### **The magic of finance**

Either the finance community was wrong beforehand, when rating institutes awarded best grades to the eurozone members and their public finances, or afterwards. It could be both, though, since financial markets are typically known for their erratic switch between euphoria and panic.

Certainly, there existed fundamental reasons to judge countries of the eurozone (or their financial stocks) skeptically. Previous cases, such as the Asian crisis or the boom-bust drama of the ‘new economy’ tech stocks, reflected some basic imbalances of the countries involved. In each case, such skepticism nevertheless quickly developed a life of its own, breeding new problems, and came to plague states which had previously been perceived as solid. This is the so-called domino effect.

Everything that makes up the tricky procyclical logic of financial markets starts from here. Skepticism towards one country may be enough to be wary about the next one. Investors’ flight provides a sign for others to flee as well. Once the downward spiral gains momentum, the usual herd instincts, self-fulfilling prophecies, rating

downgrades and speculations within the financial markets suddenly result in crash and collapse. During the euro crisis, doubts about Greece's fiscal policy—the weakest link in the European chain—suddenly led to investors' flight and skyrocketing interest rates, which only deepened concerns about the crisis spreading to other countries and prompted more investors to flee. The more investors' trust in Greek sovereign bonds disappeared, the more restless were the investors holding Portuguese or Irish bonds.

The Nobel prizewinner Joseph Stiglitz said at the time: 'Had the Greek government bonds' interest rates initially been kept at 3 or 4 percent, the crisis would not have escalated.' This could have been achieved if, for instance, the German government had guaranteed the payment of Greek debt early enough. According to the Princeton economist Markus Brunnermeier, the same debt situation can develop in different ways: expected difficulties can exacerbate the fear of a crash, such as when interest rates skyrocket, which triggers panic, or that panic may be soon halted, interest rates stay stable and the situation can be controlled.

Both scenarios are possible outcomes for the markets. The phenomenon is called 'multiple equilibria'. The first option represented an escalation of the euro crisis, a so-called equilibrium of terrors. The second would have ended in a quick de-escalation, a soft landing. The downward spiral could, and should, have been stopped much sooner to support the second scenario. Who's at fault?

If the crisis followed the logic of a typical financial panic,

the main thing was to counter the malfunctioning of the market as quickly as possible. Then there could not have been any serious doubt about the solvency of a country. In this case, it was a fatal mistake to hold off financial aid to the states requiring it, as the German government did in early 2010. This led to even more panic among already uncertain investors who held southern-European sovereign bonds. It was also counter-productive to link each package of financial aid to conditions and so uncertainty—even more reason for restless investors to dump money. In such a crisis of trust, it was not a good idea to hesitate and chastise Greece with punitive interest rates, which made the servicing of debt only harder. Or to enforce ever further expenditure cuts and higher taxes—believing that it was simply a crisis due to high sovereign debt—which damaged the economy further and resulted in tax income evaporating. It is clear why so many new austerity packages and prime ministers did not help. The chancellor, Angela Merkel, and other European authorities seem to have underestimated the momentum of the financial markets in the face of all public-debt mania, and contributed greatly to the escalation.

### **The last resort**

In such a crisis, only one thing helps, suggested Charles Wyplosz of the University of Geneva—‘a lender of last resort’ which ultimately saves the system. When the loss of confidence turns into panic and people run to banks to collect their money, the system collapses because the banks concerned immediately go bust. At this point it’s

already too late. Previous experiences with bank busts have resulted in establishing deposit-guarantee funds.

How little the actual condition of public finances mattered was visible at the moment of the turn for the better. The real assurance came through the July 2012 announcement by Mario Draghi, head of the European Central Bank, that, if necessary, it would intervene massively in the sovereign bond markets—not through a sudden improvement of some public-finance data. Draghi's quasi-guarantee worked: the announcement itself was enough to save investors from their own fears, hence resulting in Italian and Spanish interest rates returning to normal levels.

It is a lesson that is missing from textbooks on how financial markets (dys)function. Regardless of all home-made problems, the euro crisis was yet another very bitter chapter in the history of the failures of financial capitalism. Sovereign debt increased after the onset of the crisis, not before. Therefore, sovereign debt could *not* have been the cause of the crisis and it is ironic that the mandated austerity cure increased rather than reduced sovereign debt in various countries.



**PART IV**

**THE IMPACT OF DEBT ON  
ECONOMIC  
DEVELOPMENT**



## Chapter 8

# MARKETS GOOD, PUBLIC BAD—THE FALSE PROMISES OF MARKET POPULISM

BY INGO SCHMIDT

Ruling elites stand naked. No more hoping for a rising tide to lift all boats. No more waiting for the trickle down. Fears of drowning in the maelstroms of global finance abound. Feelings of powerlessness among the have-a-little-bits and have-nots fuel the hate of the even more downtrodden and the yearning for the good old welfare state. Bereft of their market-populist cover, ruling elites publicly bemoan the rise of xenophobic populism on the right but are really concerned about flares of left populism that might develop into a challenge to the unbridled power of capital.

Yet the anti-populism from above is helpless in several ways. First, it is blind to the role its own brand—market populism—played in rolling back the countervailing powers of labor and other social movements. Secondly, it doesn't realize that telling the people that they shall not be populist confirms the populist charge of arrogant elites disconnected from the anxieties and aspirations of Main Street. Thirdly, professed anti-populism doesn't corre-

spond to a change in direction. Occasional avowals of understanding ordinary people's concerns, coupled with promises of change, always end up in the profit-enhancing policies which did so much to produce the economic crises, social inequalities and insecurities that undermined the legitimacy of market rule in the first place. In so many variations, the '*market über alles*' theme remains the same.

### **Private investment is better than public spending: three variations on one theme**

Since the late 1970s, when market populism replaced widespread trust in the social-engineering capacities of the Keynesian welfare state, the supposed superiority of private investment over public spending has presented itself in three variations: first, 'public spending is crowding out private investment'; then, 'selling off public enterprises and infrastructure gives private investors the room they need to propel economy-wide growth' (in chapter one, Jim Stanford shows how this did not occur after the global financial crisis); finally, 'bailing out banks is the only way to prevent the entire economy from collapse'. Admittedly, this last incarnation is very much at odds with the claim that private investments are superior to public spending.

Strangely enough, the bailouts weren't the last breath of failed '*market über alles*' policies but the first step in another round of privatizations and public-spending cuts. Since then, private investment, at least in the west, has largely been confined to stock markets where new

bubbles are blowing up and new crises are pre-programmed. As with previous crises, the bust next time will lead to a further loss of legitimacy but also more austerity. The bubble-bust-austerity cycle won't be broken until a big new economic idea rallies the discontented and exerts enough countervailing power to roll back or even overcome capital rule. The onus is upon us to develop suitable alternatives for this.

### **From crowding out to selling off**

Pro-market economists have always been convinced that private investments are the key to the wellbeing of everyone and that economic policies should focus on creating conditions conducive to such investments. This means securing private property, removing barriers to market access, and keeping regulations and taxes to a minimum. Next to a complete takeover by the state, welfare-state expansion was the second-worst thing pro-market economists could think of. As long as this expansion went hand in hand with high growth and profit rates, however, capitalists weren't too concerned with market principles. But when prosperity turned into stagnation, inflation accelerated and public deficits grew, they happily used pro-market ideas to rally workers and women, ethnic minorities and student youth who felt that the welfare state didn't deliver on its promises around an anti-welfare state program.

Part of these rallying efforts was to explain stagnation as the result of wasteful public spending which crowded out private investment. Much public spending, pro-market

economists declared, invited workers to collect welfare cheques instead of going to work. The small part of public spending used for investment purposes diminished private opportunities. Taxes were presented as a disincentive for private investment and the deficit-financed part of public spending as a cause of inflation and financial instability. The truth, of course, is that a lot of private investment and production relies on public investments in education, infrastructure and research and development. Private auto companies would not have been lead industries of the postwar boom if states hadn't built major highway and road networks. The same is true for today's showcase tech giants, who would never have gotten out of the garages of Bill Gates and Steve Jobs if publicly funded research hadn't created the required hardware.

The upshot of explaining 1970s stagflation by an over-extension of taxes, public deficits and welfare-state spending was that the best economic policy could do was to roll back the welfare state and open new markets by selling off state-owned firms and infrastructure. While the privatization of airlines and railways, housing and hospitals, telecoms and utilities in the west created some investment opportunities, the big bang for private investors came with the collapse of communism in the east. So excited were capitalists that profit expectations soon outpaced actually-existing profit opportunities. The clash between expectations and reality led to the bursting of the dot-com bubble in 2001 and, on a much larger scale, the world financial and economic crises of 2008-09. Investor confidence was shaken to the bone—it was public bailout money that got investors back on their feet.

## **From bailing out to economic alternatives**

A little bit of fiscal stimulus topped with a lot of bailout money stopped stock markets and economies from free-falling. Adding cheap central-bank money, this sort of crisis management also paved the way for new bubbles and crises. The socialization of private losses led to public deficits way beyond those caused by the clash of economic stagnation and expanded welfare states. Moreover, the asset-price inflation which was one of the causes of the 2001 and 2008-09 crises was much higher and had more severe effects on financial stability than the price-wage-spirals which pro-market economists blamed, along with allegedly excessive public spending and red tape, for the 1970s stagnation.

Asset-price inflation is different from what we usually term inflation, when we think of rising prices for consumer goods such as food, gas or apparel. It refers to such commodities as stocks, real-estate or gold. Even though profits increased massively under neoliberal aegis, asset prices grew even faster. Once the ensuing stock-market bubbles popped, governments came to the rescue. The socialization of private losses pushed public households deep into the red. Propagandistically capitalists bemoaned these public deficits; practically they happily used them as levers to push for more privatizations and public-spending cuts. Austerity raises elite boats at the expense of everybody else—the bubble-bust-austerity cycle is their business model.

If the public sector cannot invest because of the high level

of accumulated debt, due to a lack of income as a result of international tax competition (Alex Cobham debunks this myth in chapter three) or due to debt-brake mechanisms and other constitutional limitations, the claims of supply-side economists—according to whom nationalized banks need to be quickly privatized because the state is not great at doing business—are not just plainly ideological but also perversely true. The private sector is certainly not good at doing business but it can still be bailed out by taxpayer money.

Right-wing populists who complain about arrogant elites but who really invite the discontented to escape into the dream-worlds of national and racial purity won't change the economic reality that produces ever more discontent. Left-wing populism might be successful in advancing real-world alternatives if it recognizes that welfare states in the 1970s were sandwiched between popular discontent, bemoaning injustices built into those welfare states, and capitalists fearing the detrimental effect of further welfare-state expansion on their profits. Alternatives need to be thought out beyond the welfare state and advanced in a way which captures the imagination of the fearful and hopeless discontented of today.

## Chapter 9

### **THE STATE MUST LIVE WITHIN ITS MEANS?**

BY LOUIS-PHILIPPE ROCHON

How many times have we heard politicians say ‘the government cannot afford it’ or ‘the government cannot live beyond its means’? These statements have become the foundation of austerity policies around the world, as they are used to justify fiscal restraint, under the assumption that less government spending somehow contributes to higher economic growth. This notion is known as fiscal consolidation or more generally ‘sound finance’ or fiscal responsibility.

Moreover, these warnings are usually accompanied by dire consequences: failure to follow these austerity policies, it is argued, will result in economic catastrophe. For instance, if governments spend too much and increase fiscal deficits and debt, the inevitable result, we are told, is that inflation will soar, interest rates will increase, economic activity will slow and unemployment will increase. Worse, governments may have to default on their debt, being unable to meet financial commitments. Worst of all, there are intergenerational consequences: by

spending too much today and living beyond our means now, it will be up to our children and grandchildren to pay back our debt. Hence, we will enslave our children and grandchildren, who will end up paying for our sins today.

At this point, governments begin cutting expenditures, the burden of which is usually asymmetrical—it is not shared by all equally. Governments usually begin by cutting social programs that serve the poor and less fortunate, that protect minorities and minority rights. Austerity also disproportionality affects women. If this is correct, then it suggests austerity is a class-based policy aimed at shifting the burden of fiscal consolidation on to those who depend on the generosity of the state (compare the 11th chapter on the two worlds of austerity).

What makes matters worse is the fact that there are very few credible studies supporting the idea that government spending leads to such economic problems. The most famous was that by Reinhart and Rogoff, *Growth in a Time of Debt*, in which the authors claimed that a debt-to-GDP ratio of over 90 percent would lead to slow or even negative growth. It was highly influential in persuading many governments in 2010 to revert back to austerity, having in 2009 initially embraced Keynesian stimulus policies, which were proving to be working. That infamous study was famously debunked by a doctoral student at the University of Massachusetts Amherst (compare the chapter on Mickey Mouse numbers in economic history). So where do these ideas come from? Essentially, they

emanate from two sources—one theoretical, one ideological.

On the theoretical side, the notion that governments cannot live beyond their means comes from an analysis which reduces the actions of the state to those of the individual worker or even of firms: since you and I cannot live beyond our means, then neither should the government. This confuses micro-economics and macro-economics and is a fallacy of composition—assuming that what is good for an individual (micro-economics) must also be good for the government or the whole economy (macro-economics). For instance, an individual may benefit from reducing his or her expenditures and saving for a rainy day: increased savings will undoubtedly make one more financially secure. But imagine what would happen if everyone started to save money—the economy would necessarily suffer.

Moreover, proponents of this myth suggest the same logic must apply to the state: it too would greatly benefit from reducing its spending (compare the chapter on Swabian-housewife economics). The analogy is quite misleading. An individual needs to live within his or her means largely because his or her income is fixed: workers cannot unilaterally raise their income. But government can increase its revenues, by raising various income or consumption taxes. These policies may not prove popular with voters, but the government can always raise revenues—it is not constrained in the same way the public are. Moreover, if a worker has a deficit, he or she has no choice but to reduce spending. In the case of the

state, it has the ability not only to raise revenues but can also find ways of financing a deficit, over many decades.

Also it is not entirely true to say that individuals cannot live beyond their means. While we cannot be overburdened with debt and 'live beyond our means' for an extended period, we nevertheless accept debt over the short run: we borrow to invest in our education, we borrow to buy a car or a house—these are good or productive debts. Students often will struggle to pay back their debt but, ultimately, they prosper: by borrowing to go to university, they are essentially investing in themselves, which will hopefully allow them to have a better job and a higher salary, which in turn will benefit society as a whole.

The same applies to the government: borrowing to build new bridges, roads or schools will improve our infrastructure, not only today but for our children. In other words, if used properly, government debt can benefit society for generations. In fact, the idea that debt is a burden on our children is not only wrong but deceptive. By *not* investing in our infrastructure today, we are in fact bequeathing to our children an economy deprived of the tools required to grow and prosper. It is by not spending today that we cripple our children's and grandchildren's wellbeing.

The ideological reasoning is perhaps more problematic, if not outwardly dangerous. Those who advocate austerity or claim governments cannot live beyond their means mask a desire to see smaller governments—for them it is the size of government that is problematic. The state is

seen as a beast which impinges on our wealth, rights and freedoms and, as such, cannot be trusted to manage the economy, which is best left to market forces. Capitalism is seen as a stable and self-reinforcing system—governments are the source of our economic problems.

This is a problem of vision. For many, the state is a generous institution capable of dealing with the shortcomings and uncertainties of capitalism, by protecting those who need it most, and by addressing the weaknesses of capitalism, which is seen as inherently unstable and tending towards periods of great instability. The state can mitigate the peaks and troughs by managing aggregate demand in a just and generous way.

In this light, austerity and associated reduction in public expenditure has a more sinister objective: to shrink the size of government and *de facto* the influence it has on markets, economic activity and individual wealth—if one believes in ‘free-market’ ideology, it makes sense to want to reduce the size of the state. Advocates propose lower taxes, claiming this will be stimulative. But lower taxes imply less government revenue, which, coupled with the austere desire to balance budgets, must lead to less expenditure.

Indeed, there is an enormous amount of literature which shows, convincingly, that government spending stimulates economic activity. Social programs serve not only social objectives but an economic one as well: providing daycare allows more women to enter the workforce; providing health care makes for a healthier workforce and can generate more efficiencies and productivity

gains. Higher wages increase productivity and support aggregate demand. In general, fiscal stimulus can lead to more private-sector activity.

In the end, the myth of comparing the actions of the state with those of an individual worker is misplaced. And the consequences, to paraphrase John Maynard Keynes, can be 'misleading and disastrous'.

## Chapter 10

### SWABIAN HOUSEWIFE ECONOMICS IS GOOD FOR EVERYONE?

BY LUKAS HAFFERT

*Swabia is a prosperous region in the south-west of Germany and its people, especially its supposedly thrifty housewives, became an emblem of German economic-policy orientation during the Europe crisis. According to the myth of the Swabian housewife, governments should follow the same principles as individual households when making economic decisions.*

When Angela Merkel invoked the Swabian housewife to criticize financial markets in 2008, she managed to popularize two myths with just one statement. ‘One should have just asked a Swabian housewife,’ Merkel proclaimed. ‘She would have told us that you cannot live beyond your means in the long run.’ While she was specifically referring to financial institutions, her statement seemed to elevate the economic myth that governments should behave like private households into a semi-official doctrine of German economic policy-making. By doing so, she also laid the basis for a powerful political myth about the sources of German policies in the euro crisis.

Similar to the fairytale of the brave little tailor, another mythical Swabian, Merkel created two myths at one blow.

The first is already familiar from the preceding chapter: it suggests that what is economically rational for an individual household will also be rational for an entire country and for its government. Since individuals must not spend more than they earn, neither should governments. Treating governments as if they were private households, however, misses the simple fact that an individually beneficial behavior can become quite harmful if everybody starts to adopt it. An individual may indeed benefit from spending a little less and saving a little more of her income. If everybody decides to spend a little less, however, aggregate demand decreases and many people's incomes will decline. In the extreme case of this 'paradox of thrift', the decision to save more will even lead to a decline in savings overall.

This is actually what happened in Greece, where the ratio of public debt to GDP increased throughout the euro crisis, despite incredibly harsh savings measures (compare chapter five by Sheila Block on the measures taken). The reason was that the Greek economy collapsed even faster than the government could impose new austerity programs, in part because austerity caused a steep decline in domestic demand. Since a country's capacity to repay its debt depends on the strength of its economy, austerity programs were thus self-defeating—and this does not even take into account the enormous harm they did to Greek citizens.

What is more, as the preceding chapter has pointed out, it

is even questionable whether an uncompromising policy of thrift would be good economics for a private household. This is a point that real (as against mythical) Swabian housewives understand very well. Indeed, an equally famous cliché characterizes Swabians as *Häuslebauer*—own-home builders. Building a home, however, requires a mortgage. Not unfittingly, the biggest German building society took its brand name from its Swabian hometown, *Schwäbisch Hall*. Moreover, Swabians are famous for keeping their house in good shape, which includes investments in renovation—in household infrastructure, so to speak.

### **A useful political myth: the Swabian-housewife narrative conceals hard material interests**

Despite its theoretical and empirical weaknesses, the myth about the macro-economic wisdom of the Swabian housewife is invoked so often that it has become the basis for a second myth. This tale, which is particularly popular among international commentators, elevates the Swabian housewife to a guiding star of German policy-making. Whenever international observers cannot make sense of the apparently illogical demands of German politicians in European negotiations, they turn to this narrative. The *casalinga sveva* even has her own entry in the Italian (although not the German) version of Wikipedia.

Assigning such an elevated role to this myth is attractive, as it makes German economic policy in the euro crisis seem a simple matter of wrongheaded economic theory: if Germans just understood that the individual household

cannot be the role model for whole countries—not to mention monetary unions—they would start to support more sensible economic policies. Thus, it offers not just a diagnosis but also a cure for the German stubbornness in European economic policy-making: convince them of the differences between households and states, and they will change their positions.

This interpretation, however, misunderstands the role of the Swabian-housewife rhetoric (as with the routine invocation of the traumatic hyperinflation experience) in German politics. These imaginations are not the root cause of German policy preferences, but rather a rhetorical tool to cloak hard material preferences in an aura of simple common sense.

After all, the German economy does not rely on domestic consumption but on exports as the main source of economic demand. Therefore, international competitiveness is the most important goal of German economic policy. In this export-driven growth model, restraining domestic expenditure may not be a matter of ideological choice but rather of economic necessity. To remain competitive on international markets, German export industries need to keep wage increases in check. This is even more attractive in the context of the euro, since this wage moderation translates into an effective devaluation of the German currency and thus further advances competitiveness. As the political economists Torben Iversen and David Soskice have argued, the government thus needs to signal that it will not support large wage increases with a loose fiscal policy. Swabian-housewife

rhetoric signals the intentions of the government—but it does not cause them.

This does not mean that Swabian-housewife economics is good for all Germans: rather it privileges the economic ‘insiders’ in the German export sector at the expense of ‘outsiders’ in domestic service industries. Since the interests of the export sector dominate German politics, however, policy-makers will often pursue policies which look as if they are inspired by a Swabian housewife. Hence, even if one could convince German politicians of the logical fallacy at the heart of this myth, it is unlikely that they would pursue substantially different policies. Indeed, while rhetorical allusions to symbols like the ‘black zero’ have become less common since the Social Democrat Olaf Scholz replaced the conservative Wolfgang Schäuble as minister of finance, the substance of German fiscal policy has changed very little.



**PART V**

**THE IMPACT OF DEBT ON  
SOCIETY**



## Chapter 11

# **TWO WORLDS OF AUSTERITY: MYTHOLOGIES OF ACTIVATION AND INCENTIVES**

BY STEPHEN MCBRIDE

Many think that austerity is a technocratic, economically scientific project aimed at balancing budgets and establishing limits to public debt. The appearance of technocratic neutrality is however a bit of a myth. Others frame austerity in moral terms: practices and behaviours which promote individual responsibility, self-discipline and restraint. This too turns out to be more myth than reality.

Austerity as a response to the 2008-09 financial crisis has a number of dimensions. Its reach extends to fiscal matters of budget balances and debt ceilings, repurposing and privatizing (or marketizing) as much of the public sector as possible, and restructuring social and labor-market policies. The language of balanced budgets and debt limits is presented as a contribution to sustainable public finance, as principles necessary to avoid profligacy by government spending beyond its means. Implicit, of course, is the erroneous notion that the financial crisis was caused by excessive government spending and debt,

rather than resulting from hazardous private-sector activities which eventually came home to roost.

Austerity has both a scientific face (increasingly discredited) and a moral one (which, as we shall see, is applied only to some). Its scientific face includes a number of propositions which depict austerity as a rational response to economic crisis but which, on investigation, turn out to be flawed and incorrect (many are explored elsewhere in this volume). Austerity's moral tone continues to be influential because its focus on individual responsibility is deeply embedded in liberal and neoliberal thinking—which, in turn, is well established in the public consciousness of most western states, as Mark Blyth demonstrates in his book *Austerity: the History of a Dangerous Idea*.

Austerity's moral tale requires people to adapt to circumstances; should they fail to do so, pressures may be applied to produce behavioral change. But the moral imperatives are applied quite differently to different groups in society. Specifically, the type of pressure imposed on the jobless and marginalized (innocent victims of the crisis) is quite different from measures applied to the wealthy in general, and the financial sector in particular (those who bear responsibility for the crisis).

Austerity as practised after the financial crisis represents a moment in the neoliberal transformation of the post-war welfare state, one goal of which was to limit inequality. Neoliberal restructuring and austerity policies have led to massive and persistent inequality.

Those at the lower end of the income spectrum—the

unemployed, under-employed and recipients of social benefits—are subject to activation. Activation means that those living outside the labor market (whose number increased dramatically in most countries as a result of the crisis) must if possible be removed from social-support mechanisms and (re-)attached to the labor market. Such a transition would have two beneficial effects from the point of view of austerity's fiscal agenda: expenditures on social programs would be reduced and, to the extent that low-income earners pay taxes, revenues would increase. In moral terms, such measures are seen as preferable to passivity (decommodifying labor), since working or actively searching for work fulfils an individual's obligation to society, in particular to provide for themselves. From a public-order perspective, the activation measures provide a means to monitor and discipline a group which has much to be angry about.

At one time, the adjective in 'active labor-market policies' applied to the policies themselves. In the heyday of the much-admired 'Swedish model' of labor-market policy, it evoked an active government role—provision of a portfolio of training programs to upgrade skills and efficiently reattach individuals to a full-employment labor market. Training was used to redeploy labor from inefficient, uncompetitive and low-wage firms to higher-quality, high-paid jobs in competitive sectors. But over the years the 'active' designation has become attached to individuals as the objects of government policies. These individuals need to be motivated or 'activated' to move back into the labor market by some mixture of encouragement, nudging and coercion.

To encourage or force a return to work—making the rather large assumption that there is actually work to be found—governments have pursued some combination of cutting benefits, reducing the length of time for which they may be claimed and tightening eligibility. This has a negative impact on recipients' capacity to hold out until a suitable job appears (suitable in terms of equivalent salary, skill level or geographic location). Obliging a well-qualified person to take a lower-paid, lower-skilled job may temporarily reduce the burden on the public finances but it is an inefficient use of labor power.

The increased use of activation reflects a redefinition of unemployment from a systemic issue (such as Keynes' theory that it was due to insufficient aggregate demand) to one where individuals are responsible for their own labor-market problems. This may be because of poor skills or poor attitudes. If the deficiency is skills then training might be the solution. This could be viewed as a 'high end' activation strategy, depending on the nature of the training provided.

More often activation is 'low end'. Program design problems may reduce the incentive for people to exit social programs and find low-waged work (for example, loss of some benefits when returning to the labor force). Through redesign programs can increase incentives to work and thus 'make work pay'. Alternatively, the low-skilled may be induced to work at whatever income their skill level is able to generate, by reducing benefits.

The focus on purportedly poor attitudes among the jobless arises from the perception that the unemployed

are that way from choice: they don't want to work, lack motivation and are lazy. The answer lies in close disciplinary monitoring, imposing conditions such as job search, participation in some sort of training or 'workfare' (having to work in exchange for social benefits). Then come sanctions for failing to adhere to the conditions and requirements that job offers not be declined ('a work-first strategy'), however poorly they fit the attributes of the unemployed person.

Labor-force attachment and participation is a condition of full citizenship. Society has the right to demand that its members work. Previous conceptions were configured around society's obligation to protect its weaker members in cases of unemployment and other disadvantaged situations. Rhetorically, the increasing compulsion to work is justified in the name of 'inclusion'. Having a job, any job, is seen as better than having no job.

Under the new welfare-state and labor-market regimes the lot of those at the bottom of the class structure is not a happy one. What does all this have to do with recovery from the crisis? Nothing. Except, perhaps, the contribution to lower public expenditures, on the one hand, and the support of the low-wage sector of the economy in which employers of limited efficiency may continue their operations, on the other.

Different measures apply to the wealthy, however. Governments were quick to buy up bad debts through asset-purchase programs and to rescue failing banks. The owners and managers of these enterprises thus escaped the consequences of their inept and reckless decision-

making. Their taxes were cut, in the hope of inducing them to invest and thus create economic growth and, ultimately, employment. Typically no conditionality was imposed: the tax concessions were supplied in the expectation or hope that the desired activity (investment) would occur and that the benefits would ‘trickle down’ to the rest of society—described by John Kenneth Galbraith as the idea that ‘if one feeds the horse enough oats, some will pass through to the road for the sparrows’. But in reality there is nothing to prevent hoarding, or investment (or, for that matter, consumption) taking place outside the jurisdiction of the country providing the tax relief. In contrast to austerity programs which diminished support for those at the bottom of the income distribution, policies of quantitative easing inflated asset prices and benefited those (the wealthy) who owned them.

Rather than applying moral rectitude, policies for the wealthy created a classic moral hazard: one set of people engaged in the behaviors that led to the crisis; a different set pay the costs. This provides little incentive for behavioral change. These two worlds of austerity politics show it to be a class-based project, which aims to discipline labor and advantage the wealthy.

## Chapter 12

### DEMOCRATIC AUSTERITY? SOCIAL CONCERTATION IN THE NEOLIBERAL STATE

BY BRYAN EVANS, STEPHEN MCBRIDE AND  
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The myth of austerity dealt with here is that the working class and trade unions were simply crushed in the process of the global financial crisis and the following deep recession—that workers and their organizations had no role in the shaping and implementation of austerity. The reality is more nuanced than this formulation. A demobilized and relatively powerless working class had few options but to retreat and attempt to save what could be saved.

In the years following World War II, the so-called golden age of capitalism, the working class in much of western Europe and north America was able to exercise a serious degree of political agency to win an array of reforms. Among the mechanisms of working-class influence were neo-corporatist institutions (typically tripartite, representing the state, capital and labor). Precise arrangements differed but, as neoliberalism evolved, its project became, as David Harvey suggested in his work *A Brief History of Neoliberalism*, one of reconfiguring the state's relationship to non-state forces. The result is that neo-corporatist

mechanisms have largely been transformed from interest representation or intermediation into vehicles of neoliberal hegemony (or transformation?).

### **From social to competitive corporatism**

Establishing political mechanisms to redistribute wealth, through the expansion of public services and social bargaining, in a way that would not undermine the economic dynamic responsible for growth, was the contribution of social democracy. It provided the institutional arrangements that seemed to ensure economic expansion would lift all boats—or, more narrowly, those of the organized working class.

As Philippe Schmitter noted in his 1974 article ‘Still the century of corporatism?’, the neo-corporatist mechanisms linked elements of civil society to the state’s policy-setting institutions. Of central importance was the *concertation* of goals and objectives of the state, business and labor. The most developed neo-corporatist institutions gave labor voice and influence in policy areas previously beyond its reach. As competition intensified through the 1980s, however, the negotiated bargains came to be redefined to ensure profitability. By the 1990s, dialogue within neo-corporatist structures had been transformed. This ‘competitive corporatism’ was one where the state co-ordinated the compromises necessary to protect profitability as a primary goal.

Through these decades, neo-corporatism was unable to address the new realities and consequently declined.

Market forces were now singularly capable of imposing discipline on labor. In her work *Business and Banking*, Paulette Kurzer notes that, in the EU in particular, integration required governments to dismantle or restructure institutions and political arrangements which were not acceptable to capital. Corporatism was thus not abandoned but rather reformed to meet a newly emerging dynamic, where wage restraint was exchanged for employment security.

### **Austerity corporatism**

Through and following the 2008 financial crisis, a third period in the history of neo-corporatism is discernible. In some cases these institutions were bypassed entirely, as governments imposed unilateral measures. But, where they survived, a crisis corporatism emerged, which turned to social partnerships and social pacts in negotiating the terms of austerity, after aggressive fiscal consolidation followed the short-lived, pragmatic, Keynesian revival. Social dialogue in several European countries enabled a negotiated response to the crisis, where trade unions often agreed to reduced working time and flexibilization of pay. In his article 'European labor: the ideological legacy of the social pact', Asbjørn Wahl describes trade union participation in such neoliberal corporatist structures as a 'policy of powerless social dialogue'.

Austerity social partnerships were mechanisms for concession bargaining, as well as labor-market and social policy reforms, in exchange for reduced taxes and a commitment to employment security. The goal was to

meet the inflation and deficit targets of the economic and monetary union. The consequence of austerity corporatism has been to reinforce the declining share of wages as a proportion of GDP.

More than defensive bargaining, the 'social partnership' approach of the European labor movement marked a further loss of working-class agency and capacity to mobilize against the crisis. In 2008, Italian workers declared 'We are not paying for the crisis', a slogan soon taken up by workers across the EU. The renewed militancy across Europe was marked by large mobilizations in several capitals. German unions organized a 'Capitalism Congress' to initiate an ideological challenge of the social-market economy which served to gloss over the fact that capitalism was premised on basic inequality between labor and capital. The Irish Congress of Trade Unions, which had, to this point, had eagerly participated in a social pact with business and government for 20 years, called for a campaign of opposition. But such militancy was for the most part short-lived, as unions returned to allocating priority to social dialogue over militancy.

Since the 2008 crisis, the institutions of social partnership have increasingly been used as a means to implement and legitimise austerity measures—or they have been bypassed through unilateral state action. That these mechanisms have proved so effective in implementing austerity speaks to the weakness of the organized working class. As such, austerity corporatism is significantly different from either social or competitive variants.

## Conclusion

The refashioning of neo-corporatist structures as a mechanism for negotiated austerity expresses the profound shift in class power relations. This perspective punches a very large hole in the rationale that social pacts, partnerships and coalitions for work served to protect workers from the worst of the crisis. The result was concessions which served the international competitiveness imperatives of capital under the guise of a socially inclusive framework. The neoliberal status quo is thus preserved while simultaneously deflecting any mobilization for paradigm change.

In this sense, austerity is the latest in a series of measures which hollow out democratic decision-making and lock in place asymmetrical relations between social classes. Obviously, the remnants of democratic government remain and neo-corporatist institutions continue. Increasingly, however, significant areas—including all the major levers of economic policy—are rendered remote from the public and unaccountable to democratic processes. And institutions formerly used to advance working-class interests are converted into top-down legitimation devices.

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