David Oseni

Fiscal stimulus or austerity measures: which is more effective for economic recovery?

A profound schism exists between the schools of economic thought, wherein neoclassical economists advocate for austerity measures and substantial debt reductions during periods of economic recovery whilst Keynesians argue for fiscal reflationary interventions and the preservation of the circular flow as a means of economic rehabilitation (Krugman, 2009). An evaluation of the theoretical foundations and real-world implications of both policies is imperative to discern the optimum policy.

Is a fiscal stimulus the optimum option?

Common beliefs propose that episodes of fiscal consolidation tend to be followed, on average, by drops rather than by expansions in output (Ostry et al, 2016), highlighting the inherent drawbacks of austerity measures with them depressing economic growth rather than stimulating it. This was the rationale behind the US fiscal stimulus in 2009. With Keynesian thought as its theoretical underpinning, Obama would enforce the American Recovery and Reinvestment Act (ARRA) via a stimulus package of $787 billion, according to FTA reports (Federal Transit Administration, n.d.), targeting diverse projects, namely, Medicaid and infrastructure. Concurrently, expansionary monetary policy was employed of prolonged (0-0.25%) zero lower bound interest rates which served as an incentive for investment and to ward off deflationary pressures (Wright, 2012).

Keynes (1936) advocated for these so-called countercyclical fiscal policies, deeming budget deficits as necessary to spur growth and provide "unemployment relief". He discerns the inverse relationship between unemployment and inflation, highlighting the government's vital role, through expansionary fiscal policy mechanisms, in maintaining an equilibrium between the two. If failed to be implemented, the simultaneous decrease of public spending due to rising unemployment, high inflation and eroded consumer confidence can lead to the arrival of a much more dangerous threat; the paradox of thrift.

When applied to endogenous conditions, the fiscal stimulus, from a Post-Keynesian perspective, acts as a deliberate tool for demand creation, for it yields an increase in GDP in the short run and an expected Keynesian effect (Hernández de Cos & Moral-Benito, 2011). This mechanism operates via fiscal injections that augment prior aggregate demand levels; this establishes a new equilibrium along the LRAS curve, fostering economic growth and potential fiscal multipliers.

In the case of the US, the employed strategies led to a sustained upward trajectory of growth and recovery. In prioritising the survival of the circular flow through fiscally stimulated demand, the FED would offset any declines in private spending and consumption (Krugman, 2009) and thus prevent a further negative economic spiral from occurring, characterised by lower spending and further unemployment. The stimulus would add 2 million workers to US payrolls in its first year of imposition and a further 3.2 million the next fiscal year (Wilson, 2012). Additionally, the stimulus payments were estimated to have yielded a fiscal multiplier ranging between 1 and 2.5 (CBO, 2015); further studies identify the direct and indirect effects of fiscal spending with the greatest differentials evidenced by low-income tax cuts and the tax rebate system, also fostering a multiplier of 1.96 to 2.31 (Feyrer & Sacerdote, 2011). This fiscal strategy achieved great success by astutely capitalising on the sizeable MPCs observed in lower-income households subsequent to

increases in discretionary incomes, compared to higher-income counterparts. This not only catalysed a discernible surge in low-income consumption but also enhanced prospects for sustained growth with those most vulnerable reengaged in economic activity.

Employing the Moody's analytical model, Blinder and Zandi (2010) scrutinise the repercussions of a non-interventionist FED. Estimates indicate a staggering 16% surge in the unemployment rate compared to the official 10% figure in late 2008-2009, and a plummet in real GDP by -7.4% in 2009 and a further -3.7% in 2010. Under such conditions, the nation would likely have faced deflation, and the economy would have likely contracted until 2013, with more than 17 million jobs lost - more than twice the actual number.

The "virtue of consumption spending" (Ahiakpor, 2001) is esteemed by Keynesians as the primary driver for growth. In times of economic adversity, the necessity for fiscal injection becomes imperative, with government spending emerging as the solitary linchpin of aggregate demand. On paper, this injection, ceteris paribus, revives consumption levels but also releases purchasing power to producers, affirming investment (Ahiakpor, 2001) and facilitating the recovery of GDP growth. In gauging the efficacy of this fiscal measure, one needs only to observe the US's rapid ascent in real GDP growth from -2.6% in 2009 to 2.7% in 2010 and the concurrent falls in unemployment during the first quarter of 2011 (World Bank, 2022) post-injection.

What are the criticisms of a fiscal stimulus?

The primary flaw of the fiscal stimulus lies in its absence of intergenerational equity. Applying the long-term fiscal analysis method of Generational Accounting (Auerbach et al, 1994), the proportional relationship between current deficit fiscal spending and the escalating tax burden upon future generations is outlined. Deeming US fiscal spending "unsustainable", Auerbach et al (1994) posit the tendency of fiscal stimuli to enforce a higher burden on future generations compared to those currently alive, in effect foisting an imprudent mortgage upon the shoulders of future generations (Watson, 2016). Rather, the trio propose, employing austere rhetoric, the imperative of sacrifice for the US populace to fulfil the goal of lifetime tax rate stability (Auerbach et al, 1994).

The US ARRA of 2009 and additional fiscal spending would cost the FED a total of $836 billion (CBO, 2015), nearly 7% of the then US GDP. While effective in spurring recovery and an end to the Great Recession, the critique here lies also in how it candidly "dumps" a tremendous tax burden on future generations. Seeding prosperity for today but sowing financial storms for tomorrow, the fiscal stimulus leaves behind a harmed and debt-laden future generation (Saint-Paul, 1992). This dynamic bears resemblance to the neoclassical perspective that budget deficits raise the total lifetime consumption of the present generation by shifting taxes away and towards subsequent generations (Bernheim, 1989). This is likely to depress future consumption levels and have deflationary consequences.

The classical argument entails that the use of expansionary fiscal policy does not create a lasting increase in aggregate demand; instead, it pulls forward expenditure into the present day that would have naturally transpired in the future (Watson, 2016). An opportunity cost emerges when weighing up the importance of economic stability for today compared to that of tomorrow; in the case of the US, one generation has effectively appropriated resources from another (Watson, 2016). The use of fiscal stimuli will, therefore, inevitably

lead to forthcoming austerity measures and high taxation down the line to consolidate the deficit created.

Despite the strength of the neoclassical counterattack, contrasting arguments, in favour of the fiscal stimulus, assert increases in current consumption need not entail borrowing from a future generation of taxpayers but can be sourced from the economy's existing untapped resources (Eisner, 1989). With this consumption will come more, not less investment, repositioning the economy upon a higher growth trajectory (Yellen, 1989). Should there be any future tax increases, they will be readily paid out of anticipated higher future incomes (Eisner, 1989; Shojai, 1999); a by-product of an augmented circulation of funds within the economy.

In addition, the Ricardian Equivalence principle also opposes the use of fiscal stimuli. According to Seater (1993), rational agents recognise the "equivalence" between the value of future tax rises and the value of a government stimulus. As a result, consumers proceed as if the debt were non-existent; these agents are more inclined to save than spend. This propensity to save equivalent to any fiscally stimulated increase in aggregate demand offsets any gains made in aggregate demand and results in the debt having almost no effect on overall economic activity (Seater, 1993). This deems the fiscal stimulus futile as a means of recovery, as the initial positive effect is counteracted, in later quarters, by an approximately off-setting negative effect (Andersen & Jordan, 1968; Friedman, 1972).

The fiscal stimulus is also vulnerable to both forms of crowding out: financial and resource.

Regarding the latter, the inverse correlation between increased government borrowing, financed through fixed-income assets, and private-sector investment levels is present. With the PES coefficient of loanable funds at zero and thus fixed in the short run, any form of fiscal deficit depletes the available pool of loanable funds (Middlemas & Barnes, 1969), hence diminishing the amount available for private-sector spending and investment. This exerts a detrimental effect on private capital expenditures for as long as the deficit exists (Carlson & Spencer, 1975). Embracing the perspective that private investment is more efficacious than state investment, the monetarist Friedman (1972) noted that any form of debt-funded fiscal spending would yield a reduction in the physical volume of assets created because of lowered private productive investment. This connotes a contraction in potential future output with government spending "absorbing capital stock" rather than generating it (Carlson & Spencer, 1975). Therefore, expansionary fiscal policy, run in pursuit of positive multipliers, is likely to curtail long-run economic growth by diminishing capital productivity, yielding a steady state government spending multiplier of near zero.

Financial crowding out is an additional concern. In an effort to sell more securities, governments raise interest rates on their bonds to attract buyers and justify the investment risk. As a result, interest rates increase, which stimulates additional savings, increases MPS and produces a coveted wealth effect (Auerbach & Kotlikoff, 1987; Bernheim, 1989). Although positive, over time, this phenomenon culminates and reduces private investment at large until a new capital market equilibrium is established. Evidence of this includes the rise in EU bond yields in 2011 as markets suffered from low animal spirits due to escalating levels of EU debt, which hindered investment. Thus, unceasing deficits can and will crowd out private capital accumulation (Bernheim, 1989).

Applying Hickisian IS-LM apparatus, a classical perspective on the matter can be explored. Their exogenous view of the money supply entails a perfectly inelastic LM curve with a zero coefficient of interest elasticity (Balcerzak & Rogalska, 2014), thus being fixed in nature. Consequently, any increase in government fiscal spending shifts the IS curve and hikes interest rates; however, it falters in boosting aggregate demand or stimulating velocity - the rate at which the money stock circulates. This aligns with the classical axiom that "velocity is constant and can't be increased" via government intervention (Carlson & Spencer, 1975). Evidentially, one or more components of private investment are crowded out, by an equal amount to that of the government spending increase (Carlson & Spencer, 1975); for every £1 of government demand, there is a displacement of £1 of private demand, therefore, discouraging private sector investment.

Nevertheless, the contemporary fiat system prompts a more endogenous consideration of the money supply in today's economies. The Post-Keynesian assertion that "money is and has always been an endogenous phenomenon" (Rochon & Rossi, 2013), coupled with "the acceptance of endogenous monetary theory by supra-national institutions" (Keeble, 2023), yields a different graphical outcome. Any induced boost in liquidity arising from fiscal spending manifests in upward shifts in both LM and IS curves (although the change in IS may be negated by diminishing marginal efficiency of investment) (Carlson & Spencer, 1975). If endogenous, the money supply will increase due to fiscal spending, and aggregate demand will rise, but this is contingent on the relative magnitude of IS and LM shifts. This diminishes the pernicious impacts of the crowding out effect, rendering them either non-existent or at least negligible. However, the consequential rise in interest rates remains an inevitable outcome.

The open economy dynamics of a nation also inhibit the effectiveness of fiscal spending. In times past, notably during Keynes' era, the impacts of fiscal stimuli would have been more pronounced (James, 1994). The economy was predominantly domestically based within a substantial proportion of products purchased and manufactured in the UK. Any form of government injection would remain within the circular flow, elevating GDP and employment conversely, creating a desired fiscal multiplier. The contemporary era of globalisation inhibits the effectiveness of stimuli policies. In the UK's current case, the nation's high MPM and susceptibility to import penetration render fiscal stimuli ineffective in generating substantial economic growth or a high fiscal multiplier (Cantor & Driskill, 1996).

In a critique of the Marshall Plan, a historical example of fiscal intervention, Hazlitt (1947) challenges the efficacy of the fiscal injection, deeming it futile unless accompanied by drastic economic reforms. These reforms encompass tariff elimination, the endorsement of a government-balanced budget and the promotion of private enterprise and capital accumulation. Despite the Plan's acclaim as "History's Most Successful Structural Adjustment Program" (De Long & Eichengreen, 1991), credited with fuelling remarkable surges in agricultural and industrial production surpassing pre-war records and catalysing the fastest period of growth in European history, Hazlitt (1947) contends it remains inherently flawed. With rhetoric closely aligned with fiscal consolidation measures, he posits that unless a government's revenue equates to or exceeds its total expenditure it cannot prevent inflation, stabilise its currency, or address the factors that strangle EU production. Concurrently, research underscores the necessity of maintaining a sound fiscal position to foster long-term macroeconomic stability. Daniel et al (2006) state that this is also fulfilled

through "high-quality" fiscal adjustment. Daniel et al (2006) suggest that governments tend not to reap the fiscal dividends of injected growth, as public investment often fails to generate self-sustaining returns. Namely, it's spending on social security schemes, grandiose projects and further subsidies that inhibit a full recovery, according to Hazlitt (1947); thus, he asserts fiscal responsibility as crucial for growth, not more "grandiose" spending and subsidy schemes. To spur growth, he proposes the elimination of restrictive regulations hindering trade, aiming to instead foster an environment conducive to entrepreneurship and robust bilateral foreign trade.

Despite the many adverse effects of the fiscal stimulus, one must refrain from hastily concluding that austerity measures are the prize-choice policy.

Is austerity any better?

Statistical evidence demonstrates that for every fiscal consolidation equal to 1% of GDP, there is an increase in the unemployment rate by 0.3% points and a 0.5% fall in real GDP (IMF, 2010). Nonetheless, the British populace and a significant portion of the Eurozone in 2010 would enter an age of austerity.

The revival of the 1920s Treasury View, the belief that government deficits are economically detrimental and necessitate austerity measures "to rein them in" (Konzelmann, 2012; Barro, 2009), due to elevated levels of public debt, infused new life into neoclassical and neoliberal thinking. Despite history offering scant examples of successful pro-cyclical fiscal-contraction programs (Davies, 2016), advocates Giavazzi and Pagano (1990) underscore Denmark and Ireland as the most compelling examples of expansionary stabilisations within the Eurozone.

Denmark's public debt surged from 29% of its GDP in 1980 to 65% in 1982; conversely, its current account had deteriorated with external debt peaking at 33% (Christensen & Hald, 2000). Paradoxically, the deficit was the bitter fruit of a misguided government fiscal injection attempt to stimulate aggregate demand amidst a global recession. Employing a "draconian program of fiscal retrenchment" (Giavazzi & Pagano, 1990), marked by drastic cuts in government expenditures (Bertola & Drazen, 1991) and tax increases, Denmark, after an initial currency devaluation, would peg the Krone to the German Mark. This incited disinflation and liberalised capital flows (Giavazzi & Pagano, 1990; De Bonis & Thimann, 1999). These decisions bore great resemblance to measures implemented by Ireland. Unexpectedly, the fiscal contraction coincided with an average growth of 3.6% in real GDP over the years from 1983 to 1986; conversely, the primary deficit decreased by 10% of GDP. In spite of discretionary income declines due to increased taxation, rapid upticks were witnessed in domestic demand and private consumption (Vastrup, 1989). Indeed, the stabilisation was expansionary (Bertola & Drazen, 1991).

When utilising the neoclassical growth model, characterised by dynamic prices, forward-thinking households and devoid of the rigidities found in the Post-Keynesian DSGE model (Cogan et al, 2013), it is identified that a reduction in future government spending permits future lower tax rates relative to the baseline. Anticipated long-run tax reductions fuel short-run consumption increases, prompting an increase in both employment and GDP (Cogan et al, 2013).

Alesina and Ardagna (2009) also identified the possibility of an expansionary fiscal consolidation, thereby challenging the Keynesian belief of stimuli-induced positive fiscal multipliers. Building upon prior research, notably Giavazzi's and Pagano's (1990) work, the pair cite the example of the US in the 1990s, where a modest increase in tax rates, coupled with minor spending cuts, resulted in the transformation of a substantial deficit to a substantial surplus (Alesina & Ardagna, 2009). Their thesis was that fiscal adjustments focussed on public expenditure rather than on the tax side are less likely to create recessions and will have "superior effects on growth" compared to the latter. This notion is rooted in austerity's ability to reshape the expectations of economic agents. For producers, reduced government spending eliminates the crowding out problem; thereby dynamising increased business investment, formerly hindered by economic uncertainty (Mohamed, 2023). For consumers, the diminished prospect of disruptive fiscal adjustments in the future alters their expectations channel (Blanchard, 1990). With a significant stock of savings in anticipation of a consolidation, consumers begin to draw down their savings to fund consumption and offset the expected decline in disposable income, thereby possibly increasing if not sustaining aggregate demand levels for an extended period (Geiger et al, 2016). Furthermore, if governments are committed to abstaining from future tax rises, consumers anticipate an increase in lifetime disposable income and thus increase consumption. The one caveat to this ideology is that the decision of when to engage in austerity measures must be endogenous to the state of public finances and of the economy (Alesina & Ardagna, 2009).

Nevertheless, the likelihood of achieving a successful fiscal consolidation without incurring both social and economic bads remains minuscule. A successful consolidation is usually underpinned by two pillars: a credible commitment to reform and sound design (Escolano et al, 2018). These consolidations typically adopt back-loaded strategies, assuming a gradual timeframe to mitigate immediate output losses by spreading it out over time, stabilising debt levels and ensuring a politically and socially acceptable outcome (Escolano et al, 2018; Molnár, 2012; Clements et al, 2004). In contrast, most consolidations fall into the front-loaded bracket, conducted swiftly under fiscal pressures. This results in large output losses. Tankersley's (2013) resounding verdict stands as a testament: "No advanced economy has proven Alesina correct in the wake of the Great Recession". Contrary to neoclassical beliefs, austerity measures, employed originally in 2008, have hindered growth potential, with output contracting in tandem with the severity of the austerity measures imposed (De Grauwe & Ji, 2013).

Additionally, in utmost Keynesian fashion, former Chancellor of the Exchequer (Stanley Baldwin) asserted that any money taken for government purposes via increased taxation and austerity measures is money taken away from the circular flow (Middlemas & Barnes, 1969). Such measures will only dampen private consumption, retrench domestic demand, and elevate unemployment rates by stifling business investment (Danish Ministry of Finance, 1983), according to Keynes' accelerator theory.

The neoclassical perspective, however, contends that reductions in government spending achieved through public sector cutbacks heighten the likelihood of unemployment for those not employed in the private sector. Conversely, a fall in public-sector wages makes private-sector work more attractive. In both cases, the reservation utility of trade unions falls, and

wage demands in the private sector fall due to an expanded pool of labour available. This fosters higher profits, increased investment and enhanced international competitiveness.

On the contrary, empirical evidence states otherwise. Nations such as Iceland, which rejected austerity via a national referendum (93% against it) (Sigurgeirsdóttir & Wade, 2011), and opted instead for a fiscal stimulus following the financial crisis, saw positive economic growth rates from 2011 onwards (World Bank, 2022). In addition, benefits would not be limited to an economic frontier with life expectancy, a measure of welfare, also rising by 0.2% annually from 2008-2013; hence reinforcing the pivotal role that government spending has in fostering economic and social recovery. Yet, for those nations that did adopt a strict fiscal austerity program, namely Greece and Spain, their economies persisted in contraction. According to a Eurostat (2013) report, the Eurozone unemployment rate surged to record levels of 12.1%, with the bulk of this unemployment concentrated in countries that embraced austerity measures. One can thus assume that a reduction in public debt, although it increases the growth rate, cannot be Pareto-improving (Saint-Paul, 1992), with it merely yielding more adverse economic effects.

According to Keynes (1936), austerity "belongs to the species of remedy which cures the disease by killing the patient". In the UK alone, studies suggest that an excess of 57,550 more deaths occurred due to healthcare spending cuts post-2010; analysis suggests that every 1% decrease in spending is associated with an additional 1569 deaths (Martin et al, 2021). Despite this study being disputed due to it not showing accurate cause and effect, its message is clear: austerity can kill. Keynes (1936) himself advocated for the addition of social investment (government spending) to private investment to maintain a more stable investment level and, thus, prevent social turmoil. Eisner (1989) also proposes that fiscally induced aggregate demand amplifies the profitability of private investments, resulting in increased investment levels and further positive multipliers at any prevailing interest rate. This at least guarantees an outcome where economic agents aren't merely suppressed.

By logical deduction, one would rather assume the use of fiscal measures than austerity, with the latter serving as a breeding ground for "predominant economic and social dislocation" (Kinsella & Kinsella, 2018). Despite neoclassical models suggesting minuscule and possibly perverse impacts of temporary budget deficits with them potentially stimulating saving in the short run (Auerbach & Kotikoff, 1987; Bernheim, 1989), Eurozone statistics (World Bank, 2022) state otherwise, underscoring the profound human cost of austerity measures. These included elevated mortality rates among pensioners due to reduced fiscal and healthcare support, a surge in crime and antisocial behaviour following substantial police budget cuts and a notable increase in suicide rates, an additional 7,950 suicides occurred from 2007 to 2010, coinciding with regional unemployment patterns in the UK (Stuckler et al, 2017).

Austerity is also now known to be regressive (Stuckler et al, 2017), with the poorest 10% seeing a 38% fall in net incomes, while the UK's wealthiest 1,000 saw their wealth, in real terms, rise by £138 billion concurrently, emerging relatively unscathed from the crisis (2009-2013); this promoting Mattei's (2022) definition of austerity as a tool less utilised for economic repair and more of an ideological weapon of class suppression wielded by the elites for the elites. Its implementation within UK borders would foster one of the single

biggest upward transfers of wealth in history, solidifying the UK's position as a nation marked by increasing inequality and deprivation.

Indeed, the Great Recession exposed the inherent shortcomings of neoliberal ideology, with its pervasive inability to acknowledge the social repercussions of its economic decisions. However, given neoliberalism's steadfast dedication to curtailing what it deems an "unsustainable" welfare state, one might ask the question of whether this outcome was truly unexpected. For years, the neoliberal governments of the Troika advocated for a significant downsizing of the state (McKee et al, 2012), saying it necessitated radical restructuring/dismantling via the austerity mechanism (Newsinger, 2014). The financial crisis, therefore, provided the perfect backdrop to fulfil this ambition. Krugman (2013) would reduce the austerity agenda to an overt expression of upper-class predilections, "wrapped up in a facade of academic rigour;" in this context, austerity is an enforcer of social disorder but, in a way, also a political success.

Conclusion

The age-old mantra of "private sector good, public sector bad" has been too long overplayed by neoliberal theorists (Lansley, 2023) along with the counter-intuitive belief that austerity measures are the only viable means of economic rehabilitation. From the above, the fallacies in judgment become readily apparent. Despite the many flaws of the fiscal stimulus, namely intergenerational equity, the people of the Eurozone now recognise that the austerity experiment has failed, yielding many deleterious outcomes: "Social welfare would erode, populations pushed to the brink of poverty and the creation of a [bona fide] humanitarian emergency" (Fazi, 2024). In contrast, nations that embraced fiscal stimulus measures witnessed swift recoveries. For instance, Germany's annual GDP growth plummeted to -5.7% at the crisis's onset, but rebounded to 4.2% by 2010, maintaining positivity thereafter; this was propelled by a €50bn fiscal stimulus (World Bank, 2022).

The prevailing consensus remains that austerity is a failure-ridden strategy preventing both economic and social recovery; it engineers and inflicts both social and civil death (Giroux, 2014), however, there are nuances worth considering. Austerity measures acknowledge that countries cannot continue to simply throw money at their problems, and a total fiscal restructuring is necessary to ensure fiscal health in the long run. At the onset of the financial crisis, it was nothing but a stark sacrifice of the welfare of the people today for the people of tomorrow.

Austerity, therefore, is not to be consigned to the realm of perpetual disuse; it does have its place. Even Keynes (1983) declared that "the boom, not the slump, is the right time for austerity at the Treasury." One must thus understand that austerity is not a means of economic recovery but rather a countercyclical measure to be used during periods of economic prosperity within an endogenous framework.

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David Oseni

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David Oseni

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David Oseni

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