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ECONOMIC CONSEQUENCES

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Abstract: *Although things should be kept as simple as possible, Albert Einstein warned that they should not be simpler. The aggregates and averages that are a feature of macroeconomic presentations afford few, if any, insights into the complexity of behavioural interrelationships. Since macroeconomic aggregates can be tailored to reflect many different pre-judgements, they should be treated with great caution, if not entirely left alone.*

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In the early 1920s, the UK economy was plunged into deep recession by a deliberately orchestrated set of deflationary measures. The policy objective was to lift the international value of sterling before the restoration of the gold standard. The Chancellor whose shoulders bore responsibility for that policy was Winston S. Churchill. In giving expression to his opposition, John Maynard Keynes published a short pamphlet in 1925: 'The Economic Consequences of Mr. Churchill'.

In 2010, Victoria Chick and Ann Pettifor have expressed their opposition to the current Chancellor's proposals, also in a pamphlet: 'The Economic Consequences of Mr. Osborne'. The sub-title of their work is 'fiscal consolidation: lessons from a century of UK macroeconomic statistics'.

Although Friedrich Hayek described Keynesian economics as 'the pseudo-scientific economics of averages' (Hayek, 1972, p. 20), he could not have anticipated the use of eight pairs of averages to represent 'fiscal consolidations' in the UK over the course of a century. The width of these brush-stokes is breath-taking. For most recent times, three data points - across three years (1944-47), twenty-nine years (1947-76) and thirty-three years (1976-2009) - are concocted for

> the annual average change in (i) government debt as a percentage of GDP and (ii) the percentage growth in nominal government expenditure. (Chick and Pettifor, 2010, p. 2)

with the five other data points representing each World War and three subsets (1919-23; 1931-33; 1933-39) of the inter-war period. A linear regression equation fitted to these eight data points is the basis for the conclusions: (i) that a three percent rise in fiscal expenditure is associated with a five percent drop in public debt; and (ii) that 'fiscal consolidations have not improved the public finances' (Chick and Pettifor, 2010, p. 14).

A second presentation is even more parsimonious: just six observations. Here, a correlation coefficient of minus 0.5, (between averages for debt and interest for six sub-periods, between 1914 and 1947) is deemed to be sufficient to 'decisively rebut the notion that higher debt is associated with higher interest.' (*ibid.*)

Further comments are: that post-1945 government expenditure 'as a share of the economy' is twice that of the 1920s; that the 'quarter century after the war is rightly known as the 'Golden Age'' (*note bene*: its forced termination by rising unemployment and inflation receives no mention); and that the reversion to 'a more market-oriented economy from 1976' (*ibid.)* is associated with poor output performance but no reduction in the government's share.

The authors 'look to macroeconomics' to give an encompassing explanation for their findings, the nub of which is stated as:

> Given spare capacity, public expenditures are not only productive but also foster additional activity in the private sector. Productive activity generates revenue and economises on benefits (and then debt interest) expenditures. (Chick and Pettifor, 2010, p. 15)

The key assertion - that 'public expenditures are productive' - raises an important question: 'What is it that public expenditures produce?'

There can be little doubt that public expenditures produce public sector jobs. These currently account for over twenty percent of UK employment; but a more focused appraisal would relate production directly to the creation of value and only indirectly to the creation of jobs. Where, for example, private expenditures (more aptly cited as 'costs') succeed in creating net value, the relevant enterprises might prove viable. Where they are not, resources are reallocated by market forces. However, with public expenditures few activities are subjected to any market evaluation. The 'value' that is ascribed to those activities (by those public sector employees whose function is to compile the national income accounts) is simply by the levels of costs incurred. It is upon that basis alone that the national income accounts attribute value to public sector activities; which implies that poor cost control and lax procurement procedures raise levels of recorded value.

In referring to the 'additional activity' which public expenditures 'foster in the private sector', Chick and Pettifor invoke Keynes's income-multiplier as the mechanism by which public expenditure, if not directly productive of wealth, fosters growth elsewhere in the economy. The implication is that unproductive make-work schemes in the public sector can trigger sustainable private sector growth. Clearly, spades produced in the private sector (and

bought by the public exchequer) would have no value if used (by public sector workers) only to shift soil between adjacent holes. Certainly those workers are likely to spend their earnings on consumer goods produced by private enterprise. Unfortunately, that represents no net stimulus: if workers digging holes for the state were previously in receipt of welfare benefits provided by the state, there is no net gain. So there is nothing in that activity which 'economises on benefits'. Unless the initial activity creates value, 'gains' from the income-multiplier are a deception. Only if earnings exceed previous welfare benefits would there be additional expenditure; but that would require spending new money into circulation, which is to start an inflationary process.

Many allusions are made to the metaphor of 'priming the pump'. Whether or not this can be ascribed to Keynes, the metaphor is inappropriate: with a primus stove, initial priming is sufficient to sustain greater efficiency in fuel combustion; with a fiscal stimulus, output and employment revert to their original levels *unless the stimulus is sustained*. Ever-rising debt is necessary to support a constant level of employment; but ever-rising debt invokes a more-fitting metaphor. To engage with a Keynesian stimulus is to grab a tiger by the tail. Thereafter, '[i]f the tiger (of inflation) is freed he will eat us up; yet if he runs faster and faster while we desperately hold on, we are *still* finished!' (Hayek, 1978, p. 112). Even so, Friedrich Hayek largely exonerated Keynes for the post-war epoch of ever-rising price inflation:

> The only thing I blame him for is that what he knew was a pamphlet for the time, to counteract the deflationary tendencies in the 1930s, he called a general theory. It was not a general theory. It was really a pamphlet for the situation at a particular time. (Hayek, 1983, p.115)

Hayek recalls asking Keynes

> whether he wasn't alarmed about what his pupils did with his ideas in a time when inflation was already the main danger. His answer was, "Oh, never mind, my ideas were frightfully important in the Depression of the 1930s, but you can trust me: if they ever become a danger, I'm going to turn public opinion around like this." But six weeks later he was dead and couldn't do it. I am convinced Keynes would have become one of the great fighters against inflation.[1] (*ibid.*)

The fiscal consolidation currently being implemented in the UK and elsewhere in Europe is the alternative to currency debasement (that is, higher inflation) and the down-rating of sovereign debt (that is, higher interest rates). Whatever its importance 'in the Depression of the 1930s', Keynesian rhetoric has no current relevance to achieving a sustainable recovery.

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[1] The incident is alternatively reported: 'I asked him whether he was not concerned about what some of his disciples were making of his theories. After a not very complementary remark about the persons concerned he preceded to reassure me that he would again quickly swing round public opinion - indicating by a quick movement of his hand how rapidly that would be done. But three months later he was dead' (Hayek, 1952, 1967, p. 348)

References

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