The Economist

Buttonwood

Far from the meddling crowd

Economists struggle to answer a vital question

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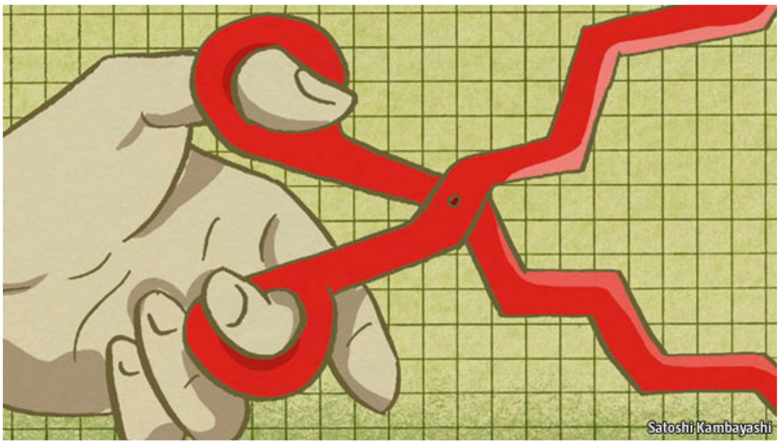

IT IS doubtless a source of great mystery to the public why economists are unable to agree on the answer to a simple question: will austerity plans, such as those announced in Britain this month, be good or bad for the economy?

There has been no lack of research on the issue. Alberto Alesina of Harvard University suggests that deficit-cutting should concentrate on spending cuts, rather than tax rises. It is possible, he says, for such plans to boost growth via an "expansionary fiscal contraction". Austerity enthusiasts often cite the Canadian experience of the mid-1990s when the deficit was cut by reducing spending by around six to seven dollars for every dollar raised in additional taxes*.

But Canada was cutting while America, its biggest trading partner, was expanding rapidly. This foreign demand surely cushioned the blow. Canadian exports rose from 33% of GDP in 1994 to 45% in 2000. Keynesian economists are also likely to counter the Canadian example with that of Ireland today, where a willingness to appease the bond markets with budget cuts has been accompanied by a fall in nominal GDP of almost a fifth.

The IMF casts doubt on the idea of expansionary deficit reductions in its latest economic outlook. On its definition of deficit-cutting, the fund finds that fiscal contraction tends to reduce GDP and increase unemployment. Although it agrees that spending cuts are better than tax rises, this may be down to the willingness of central banks to cut interest rates to compensate. But rates in the developed world are just about as low as they can go.

The lack of clarity reflects a fundamental problem in economics: the difficulty of isolating individual factors. The Irish government cannot rerun the past two years to see what would have happened had it let spending rip. Higher government spending tends to be associated with slower growth, but which is cause and which is effect? A recession pushes governments into the red as tax revenues fall and spending on unemployment benefit rises.

What of the long-term impact of government involvement in the economy? Bureaucrats are usually worse at allocating capital than the private sector. Higher government spending may also "crowd out" private investment. Capital that would have been lent to businesses is lent to the government. But this phenomenon is difficult to prove since the extent of crowding out will vary with the economic cycle. In recessions the private sector may have little desire to borrow anyway.

A recent paper** by three Harvard Business School academics devised an ingenious way around this problem. When American politicians become chairmen of congressional committees, they are able to direct federal spending to their home states. To take one example, Richard Shelby, a Republican from Alabama, became chairman of the Senate intelligence committee in 1997. Before that Alabama averaged $6m less in annual federal earmarks, or specific funding, than other states. After his appointment the state received $90m more than the average.

Chairmanships are based on seniority. They require another senator or congressman to lose their seat. Appointments have little relationship with economic activity in the state concerned, and extra spending will occur at all stages of the cycle. It is a truly independent variable.

The academics examined 232 appointments across 42 years. They found the average state receives a 40-50% boost in earmarks in the year following a chairman's appointment, an increase that persisted for the rest of his tenure. Private firms reacted by reducing capital expenditure (by 8-15%) and research and development (by 7-12%); employment and sales growth also suffered. This test appears fairly robust, as it covered a wide variety of states and was also reversed when the chairman stood down.

The Harvard study does not suggest that federal spending is completely offset by a fall in private investment. But that is the conclusion of a longer-term study*** by Davide Furceri of the OECD and Ricardo Sousa of the University of Minho. It found that a 1% rise in government consumption as a share of GDP eventually reduced private-sector consumption by 1.9%. Temporary spending to pick up economic slack may be useful but the long-term benefits of austerity seem clear.

* "Canada's Budget Triumph (http://mercatus.org/publication/canada-s-budget-triumph) ", by David R Henderson, Mercatus Center, George Mason University

** "Do Powerful Politicians Cause Corporate Downsizing? (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426106) " by Lauren Cohen, Joshua Coval and Christopher Malloy, Harvard Business School

*** "The Impact of Government Spending on the Private Sector: Crowding-out versus Crowding-in Effects (http://ideas.repec.org/p/nip/nipewp/6-2009.html) ", by Davide Furceri and Ricardo Sousa

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