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The geographies of austerity

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From boom to bust

As late as mid-2007, to most observers, the global economic scene looked rosy. It seemed as though the laws of economics had changed: the advanced economies had rid themselves of inflation, the business cycle had been expunged and stable growth firmly established. Such was the conviction that a new economic era had arrived that in 2003 the Governor of the Bank of England described the previous decade as being NICE—a period of 'non-inflationary consistent expansion' (King, 2003). And in March 2007, Gordon Brown, the UK's Chancellor of the Exchequer confidently announced that ''my report to the country is of rising employment and rising investment, continuing low inflation, and low interest and mortgage rates … built on the foundation of the longest period of economic stability and sustained growth in our country's history'' (Brown, 2007). There was an optimistic assessment that the new economic order was being driven by new technology and new 'creative classes', supported by policies of financial prudence by states. Certainly, in terms of steadily rising levels of gross domestic product (GDP), especially in the USA and UK (see Figure 1), there appeared to be strong grounds for such optimism.

What we now know, of course, is that this 'long boom' or 'great moderation' (Stock and Watson, 2002) was built in large part on an unsustainable growth model. Underpinning much of that growth was a dramatic rise in household debt, in the case of the USA and UK to over 100% of GDP (Figure 2). The increase in household debt was driven by a perfect storm: asset price inflation in housing and stock markets; cheap goods from China and elsewhere in the Far East; a glut of savings, in China, Japan and the oil exporters; a global financial system, which unleashed from regulation, was developing ever more 'creative' ways of making money (partly by funding and fuelling the rising tide of household mortgage debt); and the optimism of the 'long boom' itself. The simple process was that consumers in many advanced economies could borrow cheaply to spend, and the resultant increase in consumer demand stimulated economic growth. Both the USA and UK in particular experienced rapid growth from the early-1990s onwards, much of it driven by consumption. In previous periods, such a process was kept in check by the 'balance of payments constraint'—whereby the growth of consumption would increase imports leading to a balance of payments deficit, which in turn would be corrected by a fall in a country's exchange rate or by deflationary policies. But from the early-1980s, and even more so from the early-1990s, this constraint no longer seemed to work.

During this period, while the emerging market economies (EME) appear to have had cyclical trade deficits, in many of the advanced countries the deficits have been increasingly structural. In contrast China, Japan and the oil exporters have had growing structural surpluses (Figure 3). Simply, the former were continually spending more than they earned whereas the latter were continually earning more than they spent. This is only sustainable if the deficit nations can borrow or can sell assets. And

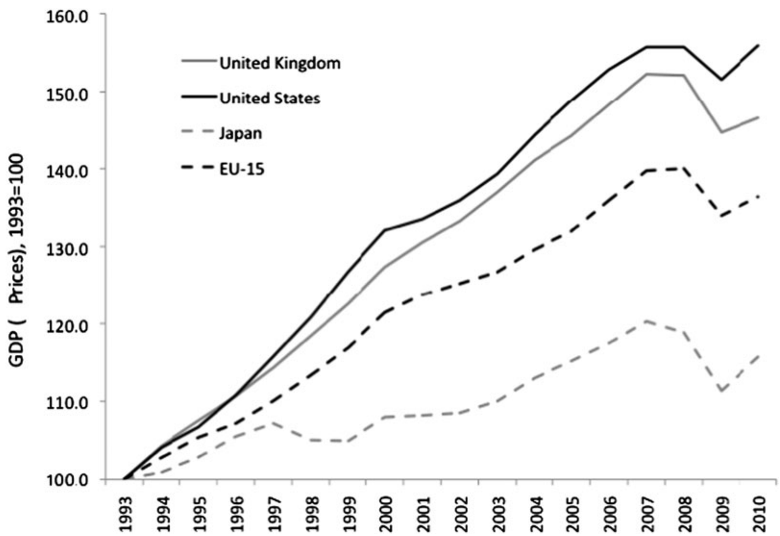

Figure 1. *The 'long boom' in growth: GDP, 1993–2010.*
Source: OECD (http://stats.oecd.org/OECDStat_Metadata/).

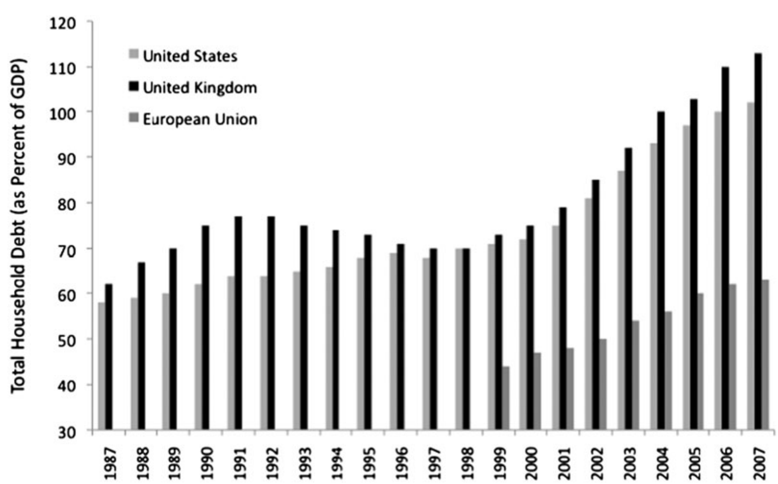

Figure 2. *The growth of total household debt, as a proportion of GDP: the USA, UK and Europe.*
Source: FSA (2009, 13).

this is what happened. The global financial system developed increasingly innovative ways to recycle resources from surplus countries to fund the consumption habit in deficit countries and also novel ways to transfer the ownership of assets (land, property and businesses) from consumers in deficit countries to savers in surplus countries. But a debt-driven consumption boom is dependent on debtors repaying their debt. Once it became apparent that this was not going to be the case, the foundations of the global financial system—built on speculation, leverage and confidence—became increasingly vulnerable to collapse. As Keynes had observed in 1936 (159): ''when the capital development of a country becomes the by-product of a casino, the job is likely to be ill done''.

Yet, amidst the general euphoria over growth, there were some voices of dissent, even if they were largely ignored. In 2005, for example, the Bank for International Settlements warned that ''growing domestic and international debt has created the conditions for global economic and financial crises'' (FT.com, 2005). And a year later, in what proved to be a highly prescient assessment, Pettifor (2006) predicted

> a time, in the not too distant future, when the so-called First World will be mired in the levels of debt that have wreaked such havoc on the economies of the so-called Third world since the 1980s. This debt crisis … will hurt millions of ordinary borrowers, and will inflict prolonged dislocation, and economic, social and personal pain on those largely ignorant of the causes of the crisis, and innocent of responsibility for it. (2006, 1)

The financial crisis that struck less than two years later proved her right. The global banking meltdown that erupted in late-2007 and deepened in 2008 in turn brought the 'long boom' to an abrupt end and plunged the economies of much of the First World into what has been the longest and deepest recession of the post-war period. Several states found themselves having to bail out or nationalize failing banks (see Drudy and Collins, 2011; Monastiriotis, 2011). At the same time, bills for welfare, unemployment compensation and other social support measures rose because of the recession, and some governments were forced to pump money into their economies (so-called 'quantitative easing') in an attempt to kick-start recovery. And rising global oil and food prices have created new inflationary pressures. The NICE economy, it seems, has been replaced by the VILE (volatile inflation, little expansion) economy.

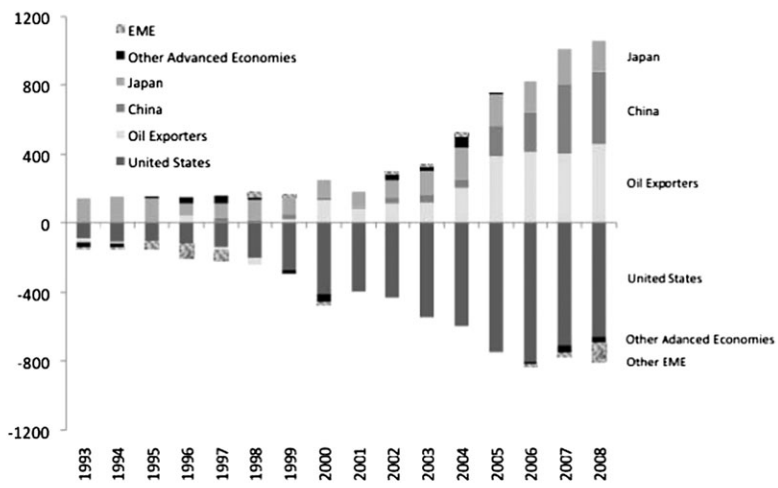

Figure 3. *Global trade imbalances, 1993–2008.*
Source: FSA (2009, 12).

From bust to austerity

One of the consequences of the banking crisis and the recession it provoked has been sharp rises in levels of gross government debt in almost every Western economy (for a selection of countries, see Figure 4). By 2010, the average general government gross debt in the Organisation for Economic Co-operation and Development (OECD) countries had reached almost 100% of GDP, with the average in the Euro zone countries not far behind (Figure 5). Within the Euro zone, sovereign debt/GDP ratios vary widely, from 148 and 127%, respectively, in Greece and Italy, to less than 60% in Finland, the Slovak Republic and Slovenia. Particular attention has focused on the debt of the so-called PIGS economies—Portugal, Ireland, Greece and Spain, and more recently also Italy (expanding the acronym to PIIGS). And even France has become a source of concern. The debt problems of this expanding group have been viewed collectively as calling into question the very existence of the single currency area and the inadequate economic governance mechanisms available to support it. Yet outside this set of economies, other countries have also witnessed rising debt/GDP ratios, especially so in the case of Japan, Iceland, the USA and the UK: as elsewhere, the ratio of government debt to GDP rose sharply after 2007, either because of the banking crisis or the recession or both.

The cost to governments of bailing out the banks has been huge. For the main countries involved, it is estimated by the International Monetary Fund (IMF) that the cost of direct support exceeded $1.5 trillion, equivalent to at least 5% of GDP, and in case of the Netherlands, Ireland and Germany more than 10% (see Table 1). Only now have these outlays begun to be recovered (at the time of writing around $380 billion has been repaid by the banks), and the depressed financial conditions of those banks partly or wholly taken over by the state may well mean that their re-privatization will either be at a loss to the public who rescued them or else delayed until their valuations improve.

If there have been common causes of the sovereign debt crisis that now afflicts much of the First world, a common response has also emerged, namely the new politics of austerity. Governments almost everywhere have embarked, or are embarking on, programmes of major cuts and reductions in public spending on a scale not seen for decades. At

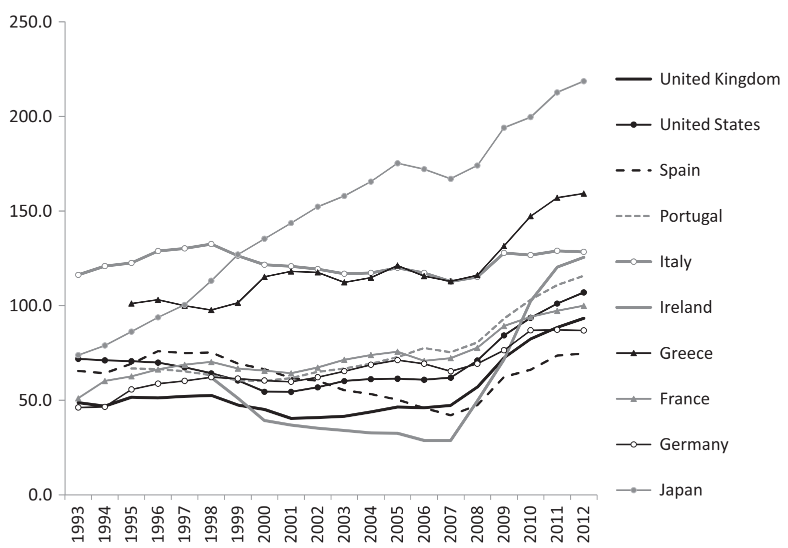

Figure 4. *Trends in general government gross debt, as percentage of GDP, selected countries, 1993–2012.*
Note: Figures for 2011 and 2012 are estimates.
Source: OECD (http://stats.oecd.org/OECDStat_Metadata/).

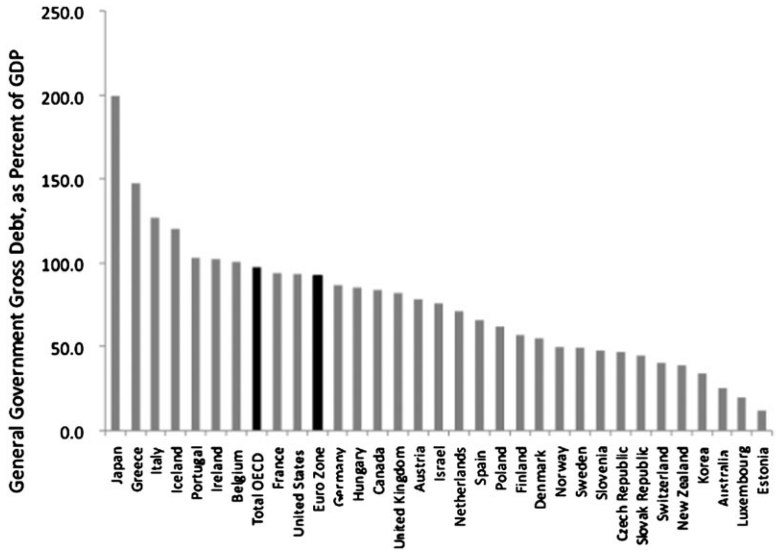

Figure 5. *General government gross debt, as percentage of GDP, 2010.*
Source: OECD (http://stats.oecd.org/OECDStat_Metadata/).

Table 1. *The costs of bailing out the banks: selected countries as at March 2011; percent of 2010 GDP*

	Direct support	Recovery	Net direct cost
Ireland	30.0	1.3	28.7
Netherlands	14.4	8.4	6.0
Germany	10.8	0.1	10.7
UK	7.1	1.1	6.0
USA	5.2	1.8	3.4
Greece	5.1	0.1	5.0
Belgium	4.3	0.2	4.1
Spain	2.9	0.9	2.0
Average	6.4	1.6	4.8
in billions ($)	1,528	379	1,149

Source: IMF (2011) *Fiscal Monitor*, April (p. 8).

both central and local government levels, support for public services, investment in public infrastructures and expenditure on welfare have all been targeted for major cuts and retrenchment. A new discourse of 'rebalancing' the economy has taken hold in government circles, of reducing the size of the state in favour of the private market. Reducing the scale of national debt is regarded as vital, to restore the fiscal integrity of states and prevent default, to appease the financial markets and stave off threats from the bond markets, and to restart economic growth. The mantra is one of 'renewing prosperity through austerity'. Some prominent critics have questioned this strategy, arguing that making major and rapid cuts in government budgets may merely prolong economic recession rather than stimulate recovery. Instead, these critics contend, governments should spend their way out of the recession, and worry about budget deficits later: growth would in fact help to bring those deficits down. This was the view taken by Paul Krugman in relation to the US economy early in the crisis: ''it's politically fashionable to rant against government spending and demand fiscal responsibility. But right now, increased government spending is just what the doctor ordered, and concerns about the budget deficit should be put on hold'' (Krugman, 2008).

The local impact of the new austerity

It is important to recognize that the negative economic effects that have resulted from the move from boom to bust have not been felt equally across the population of the economies affected. Some people in some places have suffered disproportionately more than others. This has been particularly the case as the effects of the financial crisis have taken hold but also reflects the impact of austerity measures to reduce debt. In this section, we consider the geography of the impacts across the European Union (EU) and the USA.

The direct effects of the crisis

In the early days of the financial crisis, attention in Europe focused on what the consequences would be for employment in financial services. It was thought that there might be a significant impact on the traditionally prosperous parts of the European economies where many of these jobs are concentrated. However, it is now clear that the effect of the lending paralysis that afflicted the banking system as the crisis developed has severely hit employment in industry and many traditional service sectors. Housing and property market-related sectors have also been particularly badly affected since it was permissive lending to these sectors by the financial sector that was partly responsible for the crisis in the first place.

The breadth and depth of the recession has meant that the largest negative effects have been felt in the economically weaker regions of the European Union. Recent evidence produced by the European Commission (Bubbico and Dijksrtra, 2011), as shown in Figure 6, has examined how regional unemployment has changed since the onset of recession in 2007. As Bubbico and Dijksrtra comment, by 2010, one in three EU-27 regions had an unemployment rate above 10%. Unemployment in the economically weakest ('convergence') regions was 11.9% and had risen by 2.8 percentage points since the onset of the Crisis. The transition regions fared even worse with an unemployment rate of 14.8% in 2010 and a rise of 6.4 percentage points. The incidence of the recession on unemployment has a pronounced core–periphery dimension. Many Spanish regions have been particularly badly affected with unemployment rates of over 15%. However, as Bubbico and Dijksrtra also observe, regions in Austria, Germany, Northern Italy and the Netherlands have tended to fare much better with many having unemployment rates below 5%. The diversity of experience across the regions of Europe since the onset of the crisis represents a significant setback to one of the most central goals of the Union, namely to reduce regional variations in inequality and opportunity. It is also particularly worrying that the Transition regions have been hit so hard since this further delays their ability to be less dependent on funding from the Cohesion Policy.

In the USA, the recession has also had a highly differentiated spatial impact. The subprime mortgage crisis, which triggered the banking crisis and thence the recession, was not itself a US-wide phenomenon, but was concentrated in particular states, such as Florida, Nevada, California, Michigan and New Jersey (see Martin, 2011). It has been these same states that have witnessed the main impact of the recession (see Figure 7): there is a strong positive correlation between subprime foreclosure rates and unemployment rates across states and counties (Martin, 2011). Additionally, many states and counties have suffered from structural problems, associated with deindustrialization and slow growth, and the economic downturn has exacerbated and further exposed these problems (see, for example, Wilkerson, 2009).

The impact of the austerity measures

National Governments across the European Union have now deployed a severe set of austerity belt-tightening measures. The BBC's News Europe in July 2011 provided some insight into how the nature of the proposed cuts to public expenditure will pan-out across the European Union. Ireland has adopted ''the toughest budget in the nation's history [which], included a pledge to trim the deficit by 6bn euros in 2011''. In the UK, ''the Conservative-Liberal Democrat coalition government announced the biggest cuts in state spending since World War II. Savings estimated at about £83bn are to be made over four years. The plan is to cut 490,000 public sector jobs. Most Whitehall departments face budget cuts of 19% on average''. France ''plans to cut spending by 45bn euros (£39bn) over

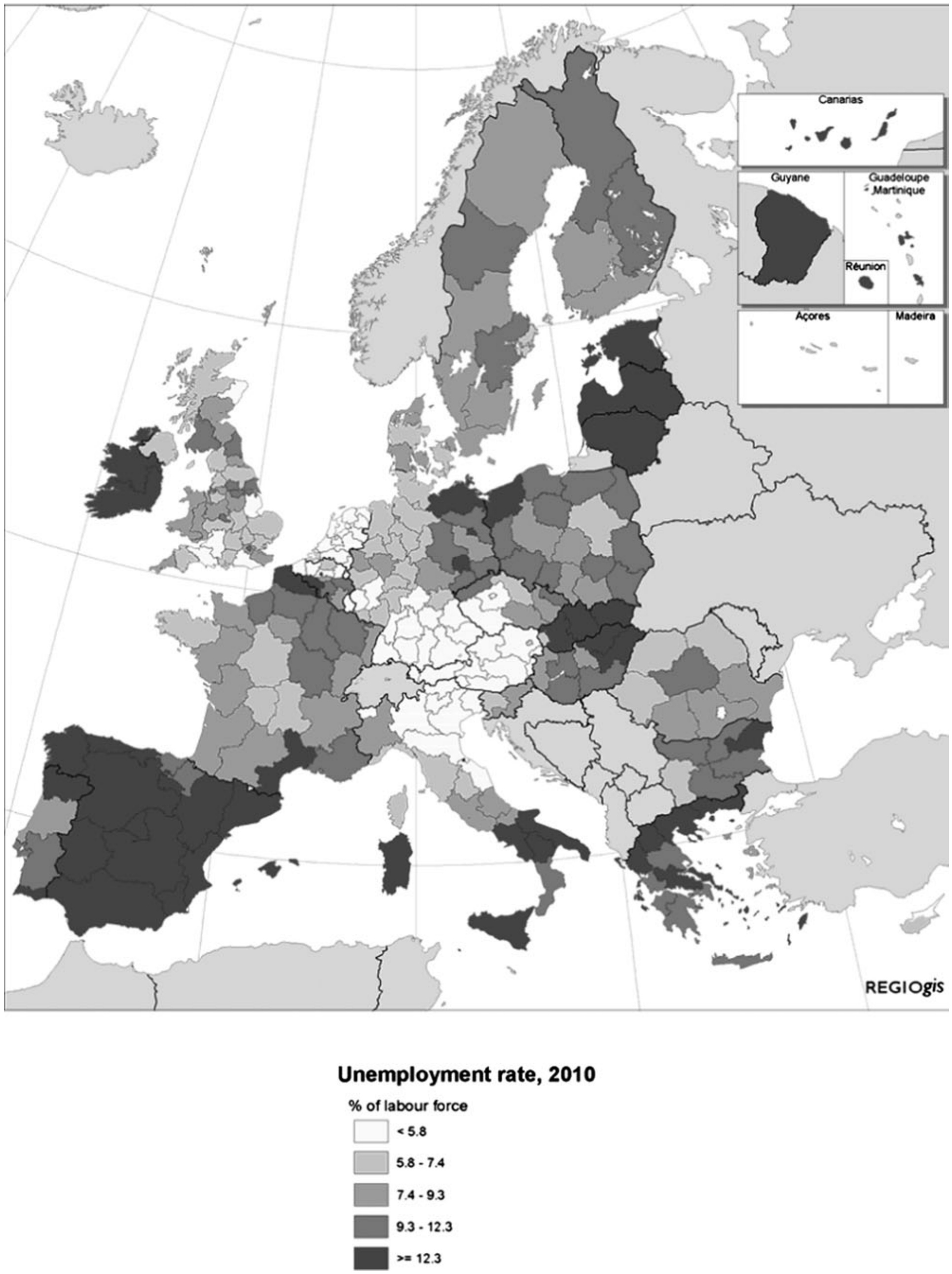

Figure 6. *The impact of recession across the European Union—the rise in unemployment, 2007–2010.*
Source: European Commission: Eurostat.

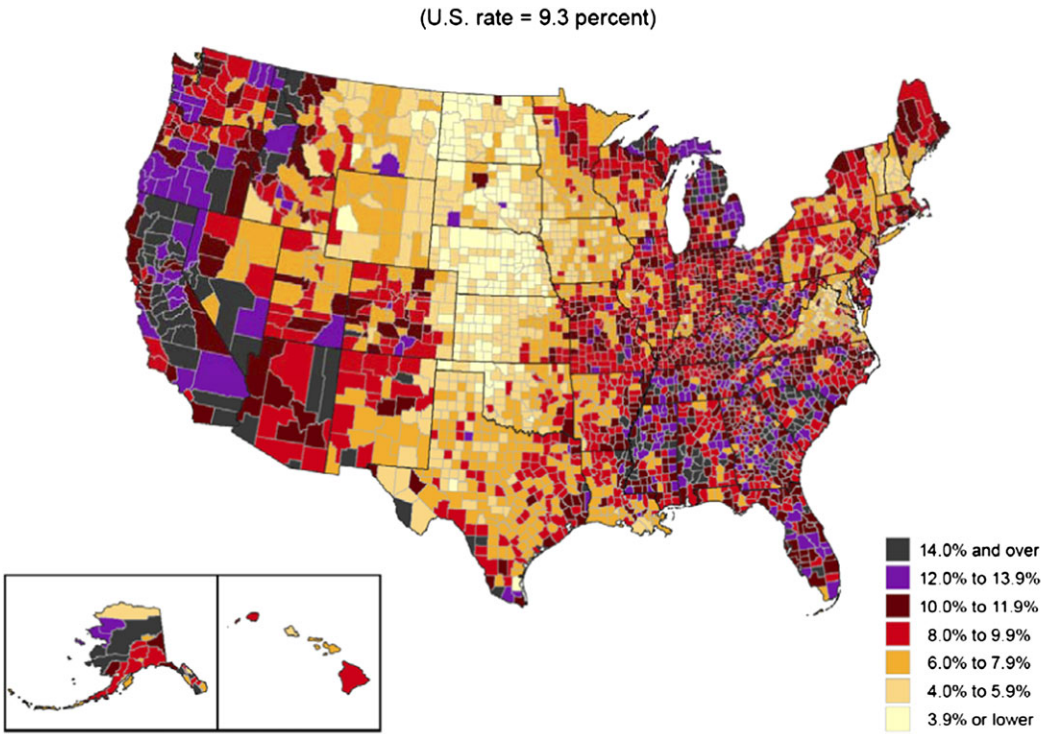

Figure 7. *The geography of recession across the USA (Unemployment Rates, July 2011–June 2011 Averages). Data from Bureau of Labor Statistics* (http://www.bls.gov.data).

the next three years''. In the Netherlands ''the centre-right coalition formed after months of negotiation on 8 October said it wanted to cut the budget by 18bn euros ($24bn; £15bn) by 2015''. In Spain, ''the government has approved an austerity budget for 2011 which includes a tax rise for the rich and 8% spending cuts''. In Italy, ''the parliament adopted a new 70bn-euro austerity package on 15 July, 2011'' and this comes ''a year after the government had approved austerity measures worth 24bn euros for 2011–12'' and in Germany ''the government plans to cut the budget deficit by a record 80bn euros by 2014. The total deficit in 2009 was 3.1% of GDP, but it is projected to be above 5% for 2010'' (BBC News Europe, 2011).

There is much concern that these proposed cutbacks in government expenditure across Europe might well do more harm than good. As the Council for Europe has observed:

> Fiscal solutions to the current crisis need to ensure that the avoidance of current fiscal catastrophes does not simply lay the groundwork for future, perhaps bigger, social crises (New Europe, 2010).

Reductions in public expenditure will lead to job losses in the public sector and whilst it is not yet clear how they will be distributed across the regions of the European Union, it is important that the regional consequences for some of the most depressed regions be considered carefully (Centre for Cities, 2011). The UK provides some insight into this issue. The UK was relatively quick to cut public expenditure. Perhaps predictably, the axe has tended to fall heavily on capital expenditure and there must be concern as to what may be the consequences of this on economic growth and well-being in the future. However, there are also extensive cuts proposed to welfare benefits, housing and defence. Whilst no parts of government have escaped, some, like health and education, have fared better (HM Treasury, 2010). Despite assurances by government that the impact of reductions in expenditure should not fall disproportionately on those who are relatively less well off in British society, there are many who feel that this is a difficult promise for government to keep. Thus, the Institute for Fiscal Studies has observed that low-income households of working age have the most to lose from the UK Chancellor's 2010 Austerity Budget (Browne and Levell, 2010). MacLeavy (2011) also highlights how the cutbacks may present a particular challenge to the financial security and autonomy of women in British society. The geographical impact of reductions in public expenditure has also attracted recent comment (Centre for Centre for Cities, 2011). The evidence suggests that many of the local authority districts with the highest unemployment in July 2011 have relatively high concentrations of public sector jobs (see Figure 8). In fact, a simple correlation of unemployment in the districts of England with the relative concentration of public sector jobs shows that some of those parts of England that have historically been the most economically depressed and which have suffered the most from the recession are particularly exposed to reductions in job opportunities in the public sector. Figure 8 reveals a North–South divide in the concentration of public sector employment with the relatively disadvantaged North tending to have some of the highest concentrations.

In the USA, there are similar concerns (Wolff 2011). Wolff and Fraad-Wolff (2011) have commented recently that:

> A national campaign is now fully launched to make local public sector employees pick up a major share of the costs of the economic crisis. Years of rising spending and falling revenue have carved a path of destruction through federal, state, and local budgets. Deficits and debts have mounted, eroding taxpayer support for government spending, in general and for public employees particularly. In response to deep economic pains in middle class communities, major efforts are under way, from California to Maine, to balance budgets through major cuts in services, wages, benefits, and employment. (Wolff and Fraad-Wolff, 2011)

In the US, the economic downturn has depressed state tax revenues while increasing the need for higher social spending on unemployment compensation, social support and the like (see Lobao and Adua, 2011; Walker and Bardhan, 2011). In some cases, political considerations have also contributed to undermining state finances. For example, the fact that a qualified majority is sometimes necessary to approve major budgetary decisions can impede decision making, as in California. In some other states, tax reduction granted at the peak of the long boom has led to the emergence of large shortfalls during the recession: Arizona and New York are examples. And some local government entities also stopped contributing to public sector pension funds when they thought they were sufficiently funded, which resulted in subsequent shortfalls, as in the case of Illinois (Lucas, 2011)

The upshot is that there are a number of states in which local budget shortfalls are likely to exceed $1billion in 2011–2012. In some cases, the shortfall is predicted to exceed 25% of the 2011 budget (Lucas, 2011; see Figure 9). Many states have had to increase taxes and reduce spending, which have had further negative effects on their local economies (Glasmeier and Lee-Chuvala, 2011). And the new austerity measures announced by the Federal Government which will cut aid to states and local communities are almost certain to compound the problems in such areas still further.

It is very likely therefore that the impact of the new austerity measures announced by the Federal government will be felt most by those very areas that have already suffered most from the recession. Recent analysis undertaken by the Centre on Budget and Policy Priorities (Johnson et al., 2011) indicates that ''at least thirty one states have implemented cuts that will restrict low-income children's families' eligibility for health insurance or reduce their access to health care services, at least twenty nine states are cutting medical, rehabilitative, home care or other

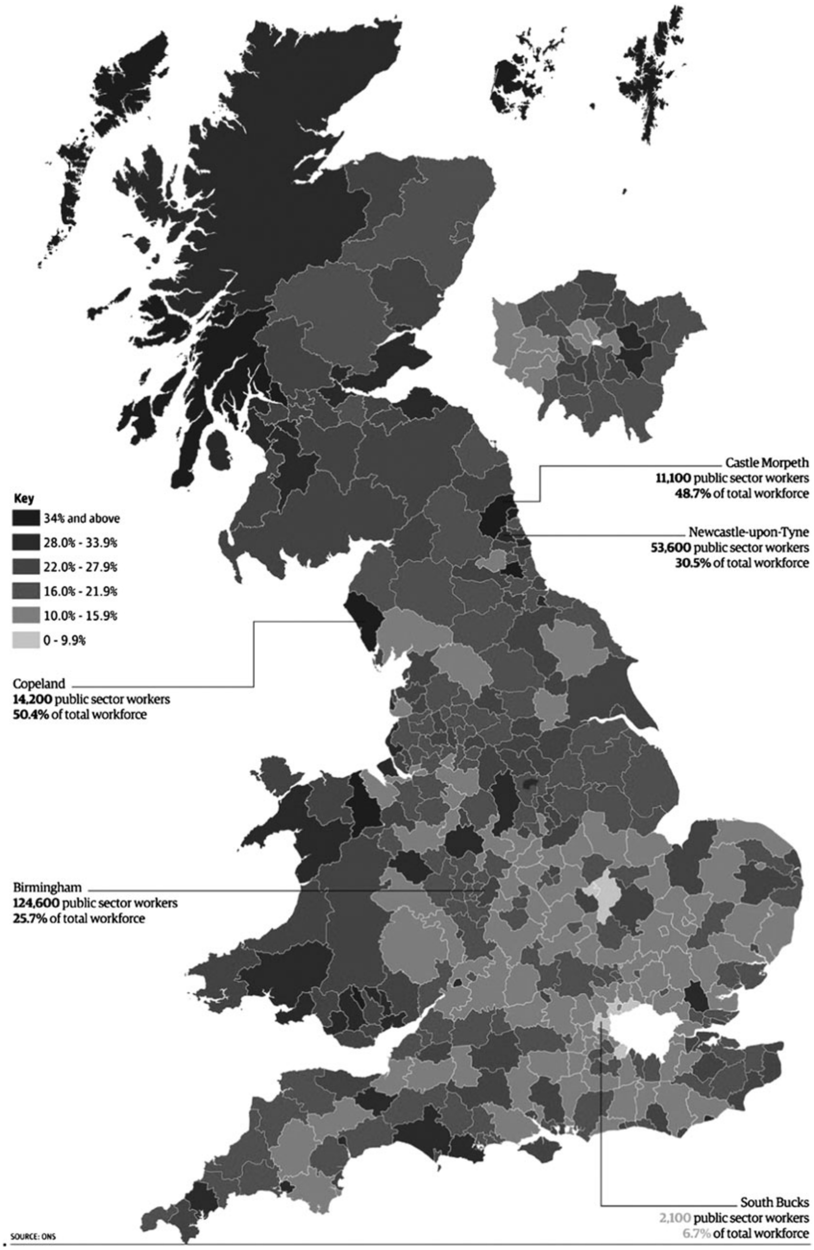

Figure 8. *Local variations in the dependence on the public sector in UK, 2010 (Proportion of local employment accounted for by public sector activities).*
Source: Copyright Guardian News & Media Ltd (2010).

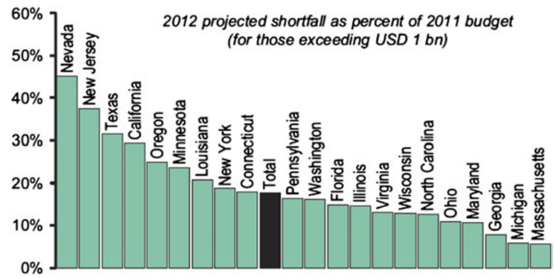

Figure 9. *Predicted 2012 State Budget Shortfalls, as percent of 2011 budgets.*
Source: Lucas (2011).

services needed by low-income people, at least thirty four states are cutting educational programmes, at least forty three states have cut assistance to public colleges and universities and overall some forty six states have made reductions in services'' (Johnson et al., 2011).

Alternatives to austerity

The financial crisis ushered in a return to Keynesian economics; in response to a massive negative demand shock, governments increased expenditure and borrowing to boost aggregate demand that helped to dampen the extent of the global downturn. But this return to Keynesian economic thinking has been short lived. During the Great Depression of the 1930s, the prevailing orthodoxy was captured in the 'Treasury view' in the UK whereby fiscal policy was considered ineffective and Governments pursued balanced budgets. In his 1929 budget speech, the Chancellor of the Exchequer Winston Churchill stated: ''The orthodox Treasury view, and after all British finance has long been regarded as a model to many countries, is that when the Government borrows in the money market it becomes a new competitor with industry and engrosses to itself resources that would otherwise have been employed by private enterprise, and in the process it raises the rent of money to all who have need of it'' (Hansard, 1929).

Despite Keynes (1936) showing the limitations of the interwar orthodoxy, modern macroeconomic policy around the globe is today heavily influenced by a New Treasury View that has many similarities to its failed predecessor. First, governments should balance their budgets. If they do not then confidence in the economy will wane and financial markets will penalize such fiscal profligacy. Second, the burden of adjustment should take the form of cuts in government expenditure and not increases in taxes. Third, the overall share of government expenditure in the economy should be cut to reduce the 'burden' on the 'wealth creating' private sector.

The modern case for balanced budgets has been termed 'expansionary fiscal contraction' as it is argued that fiscal tightening will promote private sector confidence and facilitate expansionary monetary policy including low interest rates. Conversely, any Keynesian fiscal boost would be punished by financial markets and by the bond market in particular. The 'Greek tragedy' has been a convenient veil for exponents of this view. According to the UK Chancellor of the Exchequer, ''Greece is a reminder of what happens when governments lack the willingness to act decisively and quickly, and when problems are swept under the carpet. The result is sharp increases in interest rates, worsening recession, growing unemployment'' (Osborne, 2010). However, in many ways, this ignores the many differences between the Greek and UK economies—in particular the different levels and characteristics of debt and the different efficiencies of the two tax systems. Furthermore, it is not clear that financial markets prefer fiscal tightening to the slow growth that such tightening produces. According to head of the IMF: ''We should remember that markets can be of two minds: while they dislike high public debt—and may applaud sharp fiscal consolidation—… they dislike low or negative growth even more''

(Lagarde, 2011). Financial markets, of course, act in volatile and unpredictable ways—often with no regard to economic fundamentals. Even so, in the current era of very cheap money, it is highly unlikely that, for most advanced countries, the positive impact of maintaining fiscal deficits in a period of slow growth would be offset by tantrums in bond markets.

The other aspects of the New Treasury View focus on the need to reduce government expenditure and not to increase taxation. The case for this might be argued to be driven more by prejudice than by sound macroeconomic analysis. If government deficits need to be reduced, then increasing taxation causes less pain than cutting expenditure—it has a smaller depressing impact on domestic expenditure as part of the increase in taxes would otherwise have been saved or spent on imports. So why the arguments for cutting government expenditure—be they those of the Tea Party in the US or seemingly more reasoned arguments from the EU or from the British Government?

Frequently, the case is made that the private sector creates wealth and the public sector does not. This is simply wrong-headed, not just in terms of national income accounting but also in terms of analyzing what workers do. The notion that the work of a hairdresser or a management consultant produces wealth but the work of a teacher or a doctor does not is simply not tenable. Another argument is that taxes should not or cannot be raised. Even some of the very rich refute this. In the US, Warren Buffet has argued: ''My friends and I have been coddled long enough by a billionaire-friendly Congress … it's time for our government to get serious about shared sacrifice'' (quoted in Fifield, 2011).

Arguably, cuts in government expenditure are bearing the brunt of the austerity agenda not because of fiscal expediency, but because governments and politicians in many countries are pursuing a long-run agenda to reduce the role of the state in the economy. But this will be difficult and painful. The share of government in the economy has increased in all OECD countries since the Second World War—primarily because of increases in expenditure on education, health and social protection. There are powerful economic drivers that have led to increases in expenditure on health and education: they are highly income elastic services—as countries become richer, citizens want better education and to live longer and healthier lives, and they are services that can be often be supplied more efficiently by the state than by the private sector. For both economic and political reasons, it will be very difficult to make major permanent cuts in expenditure on health and education. This suggests that the burden of fiscal retrenchment will fall on social protection. It will be the poor, the unemployed and the sick who will feel the pain. And as the previous section showed, some places will suffer far more than others.

The current turmoil in the world economy has led many commentators to conclude that all policy options have been exhausted. This is wrong: there are alternatives. First, governments could slow the process of fiscal retrenchment until economies show sustained recovery. Second, when economies have recovered more of the burden of adjustment could be borne by increases in taxation—and, of course, this will happen automatically through fiscal stabilizers as economic growth is one of the best methods of increasing tax revenues. Third, governments could invest in rebuilding the capacity of their economies.

Although much of the focus has been on the cyclical impact of the crisis, it has also harmed the long-term growth potential of many economies through reducing investment and the erosion of capital stocks. National investment strategies are required to build and modernize infrastructure and capacity. The private sector cannot be relied on to invest in such areas—not simply because of chaos in financial markets but because the returns to such investments are economy-wide rather than investor specific. The returns will be manifest in economic growth in the future, which of course will lead to higher tax revenue. Currently, there is much concern about the burden of debt that will be passed on to future generations. It would be better to pay attention to the burden of slow growth that will be passed on to others if fiscal retrenchment and stagnant investment continue in the present. Promoting growth will not only depend on sound macroeconomic policies, but a rethink of the role and design of regional and local policies in order that all people in all places both contribute and benefit from economic recovery.

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