Austerity Policies, Old and New: From the British Treasury to the Bundesfinanzministerium

Fernando J. Cardim de Carvalho
Senior Research Scholar, The Levy Economics Institute of Bard College and Emeritus Professor, Federal University of Rio de Janeiro

Abstract

Much of the criticism directed at austerity programs implemented after the 2007/2008 financial crisis have focused on the Anglo-Saxon critique of Keynesian ideas. New versions of Say’s law, nowadays rephrased as Natural Rate of Unemployment theories and argued in terms of General Equilibrium models and Rational Expectations hypotheses, have attracted the attention of Keynesian critics, such as Paul Krugman or Joe Stiglitz. Accordingly, UK’s policies under David Cameron (or more generally since Thatcher) are also discussed as if they were paradigmatic of austerity theories. We argue that this view is not only one-sided but it is also much less relevant than it is usually judged. The paradigm for austerity policies should not rely on the British experience but on the Eurozone experience, and the latter is inspired mostly by German economists, rather than Anglo-Saxon general equilibrium theorists. Lucas and his associates seem to be largely irrelevant to any discussion of Eurozone austerity policies, which are rooted in modern developments of ‘ordoliberal’ theses, with strong influences from Austrian economists, notably Hayek and Schumpeter. In this paper, we argue that criticisms of Cameron’s policies, based on North American neoclassical ideas miss completely the point of German proposals (supported by similarly-thinking government officials in Austria, the Netherlands, etc). We identify the fundamental tenets of “German neoclassical economics” and outline Keynesian criticism of it.

Key Words: Fiscal policy; Austerity; Business Cycles

JEL Classification Codes: E 32; E 62; E 63
1. Introduction

When the subprime crisis erupted in the United States, in the first semester of 2007, most analysts believed that it would be contained before it became a full-fledged financial crisis or, even more certainly, before it turned into a deep recession. The reason for the widespread optimism was that economists and policy-makers were supposed to have learned the “lessons” of 1930s. “It”, as Hyman Minsky used to refer to the Great Depression, would not happen again because now policy-makers knew how to prevent it. Subprime mortgages were a relatively small segment of a large financial market. A financial crisis would require contagion to other segments, particularly to banks. This was, however, judged unlikely given the healthy capital coefficients all the large banks exhibited in the United States at the time.¹ Without contagion to the banking sector, the financial distress would remain local, devoid of meaningful systemic repercussions. In the worst case, governments in the affected countries were expected to rapidly adopt expansionary fiscal and monetary policies to prevent the operation of distress-amplification mechanisms, such as debt deflations and income multipliers. This should stop any significant contractionary impulse on its tracks.

History, however, did not unfold in the way it was expected to. The securities markets crisis was in effect contained, but not before causing significant damage. Contagion did affect the whole financial system, not only in the United States but also in other countries, particularly in Western Europe. The near-collapse of financial systems paralyzed credit and capital markets causing output and employment to fall. Rising liquidity preference caused banks to hold increasing amounts of idle reserves as monetary authorities moved to increase market liquidity, and firms to pile up cash. Interest rates rose for practically everyone but the safest and most liquid borrowers, such as, notably, the US Treasury.

By late 2008 (and particularly after the Lehman Brothers episode), it was clear that the crisis had in fact become much more threatening than initially expected. It did affect productive activity and it was spreading worldwide. An extraordinary meeting of G 20’s political leaders² was called to coordinate a common global anti-crisis initiative. The participants of the meeting agreed that aggregate demand had to be supported by active demand management policies. Later, the newly-inaugurated Obama administration followed up the recommendations passing in early 2009 an almost one-trillion-dollar fiscal package consisting of new spending and tax reductions. Some measures were also taken in the same direction in Western Europe. It seemed that, in contrast with the 1930s, coordinated expansionary policies would prevail over beggar-thy-neighbor measures, global aggregate demand would be sustained and the world economy would sail out of the crisis scared but relatively unscathed.

¹ These were the times of Basel II, when a bank was considered safe by regulators when its capital as a proportion of assets weighted by their risk, estimated by banks themselves, reached a certain level. After the crisis, regulators finally found out that in-house risk calculations were deeply flawed, to say the least. This issue is examined in detail in Cardim de Carvalho (2015a).
² The G20 comprises the ten largest advanced and the ten largest emerging economies of the world.
These expectations were soon to be falsified. In the United States, the possibility of following up the first step with new programs of government spending was quickly buried by the remarkable hesitation of the Obama administration. After the loss of majority in the Congress for the republicans, in 2010, activist fiscal policy became all but impossible.

Developments in Europe were even more surprising. A few large banks, particularly in the United Kingdom, Switzerland and Germany, were affected directly by the subprime crisis, still in its early moments. But the worst was yet to come, after the failure of Lehman Brothers. Some countries, like Ireland and to some extent Spain, suffered contagion through their banking systems. Others, like Portugal for instance, were exposed to financial instability through their need for balance of payments financing. Still others had to finance fiscal budget deficits through the placement of bonds in international markets. Whatever the channels for contagion may have been, by 2010 some European countries were also facing serious crises, while others, like France or Italy, were judged to be in fragile condition, all of them hit by the deterioration in world financial markets. Paradoxically, this was also the time when some countries, led by Germany, broke the apparent “Keynesian consensus” established in 2008. Concern with output and employment ceded their place to concerns with fiscal deficits and public debt. The language of the G20 communiqués became ambiguous, trying to balance the demands of the two groups of country leaders, those pressing for reflation and adoption of expansionary policies, and those pressing for immediate budget consolidation and public debt reduction, in a word austerity.

The opposition between expansionists and austerity-ers was not confined to debates within the G20. As peripheral Eurozone countries saw their financial position deteriorate dramatically and demanded EU’s support, austerity was enshrined in the rescue packages designed by what became popularly known as the troika (a tri-partite group formed by representatives of the European Commission, the European Central Bank and the IMF).

At times, the confrontation between the pro-expansion and the pro-austerity partisans seemed to have been transplanted directly from the 1930s dispute between “expansionists” (today generally referred as “Keynesians”) and the “Treasury View” (hereafter TV). The strong return of TV in the 2000s took most people in the Anglo-Saxon countries by surprise. It was well known, of course, that orthodox economic theory had moved decisively towards the restoration of the prestige of Say’s Law among American academic economists in the last three to four decades. Few people believed, though, that policy-makers would actually propose austerity policies inspired by it. Continental Europe, however, was a different matter. Austerity never ceased to be the correct policy for Europeans. It was not an idea that was rediscovered. In fact, it never left the academic and political scene, especially, but far from exclusively, in Germany.

Middleton (1985: 180), echoing a point made by Robert Skidelsky, noted that economists, especially academic economists, tend to forget that the 1920s and 1930s debate around TV was not centered in universities or research centers. Rather, it involved civil servants, politicians and

---

3 Say’s law has reappeared in economic theory as the theory of the natural rate of unemployment.
some economists. Theoretical arguments most of the time took a back seat to operational and ethical concerns with legitimate government action. TV was frequently the object of caricatures because it was a difficult task to accurately portray its arguments. Civil servants in government seldom cared to produce doctrinal material of the kind one expects to examine in academic debates. Moreover, officials in function are not usually at freedom to engage in public debates as academic economists do. Most of what Treasury officials had to say was manifested in internal documents not meant to be seen by outsiders. Only recently a representative collection of documents prepared by Treasury officials from 1925 to 1946, edited by G. C. Peden, was published (Peden, 2004). It is a major contribution to the knowledge of how TV was structured and how it developed in time. The collection finally made it possible for researchers who do not have physical access to British government archives to know first hand what TV actually was after all.

In this paper we investigate how closely the “modern” austerity view reproduces the arguments of the “old” TV. To do it, in section 2 we present the points raised by Treasury officials themselves, rather than their academic critics, against expansionist fiscal proposals in the 1920s and the 1930s. Section 3 tries to do the same with the arguments raised by modern proponents of austerity. This time, however, the main source was no longer the British Treasury, but the Finance Ministry and other entities of, or connected to, the German Federal Republic. An evaluation of both sets of arguments is offered in section 4. Section 5 asks whether austerity works after all and how is success defined by austerity-ers. Section 6 concludes.

2. The Treasury View

The Treasury View was never articulated as a full-fledged school of thought on policy choices. There is no founding document or text where its principles are listed, articulated into a consistent whole, explained and justified. It was expressed mainly through memoranda prepared by Treasury officials to answer demands from higher authorities (most frequently the Chancellor of the Exchequer), presentations as expert witnesses in Royal Commissions or, less frequently, to counter proposals presented by people outside government in newspaper articles, speeches, open letters and manifestos. The closest one can get to a definition of TV was offered by Winston Churchill, in a 1929 intervention in his budget speech at the House of Commons. Churchill stated that:

“The orthodox Treasury view ... is that when the government borrow[s] in the money market it becomes a new competitor with industry and engrosses to itself resources which would otherwise have been employed by private enterprise, and in the process raises the rent of money to all who have need of it.” (quoted in Peden, 2004, p. 57)

---

4 One should not assume that TV was the position of the Conservative Party, even though the source here is Winston Churchill, then Chancellor of the Exchequer. It would be more accurate to say that it was the view of the civil service. Labor governments at that time shared the same view. Even some liberal critics, such as Hubert Henderson, Keynes’s co-author of Can Lloyd George Do It?, seemed to accept it, at least when facing Keynes’s implicit criticisms of TV in The General Theory of Employment, Interest and Money. Henderson became an implacable critic of The GT.
If we accept this statement at its face value, the Treasury View had a clear foundation in the loanable funds theory, which postulated that total credit supply was limited by the amount of savings made by income recipients, so that one borrower could only increase one’s share of credit at the expense of another borrower.

But in the same speech Churchill seemed to downplay the importance of a theoretical argument in the definition of TV by stating that when appealing to government expenditures

“... for the purpose of curing unemployment the results have certainly been disappointing. They are, in fact, so meagre as to lend considerable color to the orthodox Treasury doctrine which has been steadfastly held that, whatever might be the political or social advantages, very little additional employment and no permanent employment can in fact and as a general rule be created by State borrowing and State expenditure.” (ibidem)⁵

It was the experience with poor results that counted, rather than the theoretical principle enunciated earlier. That was the way supporters of TV preferred to present it.

Most of the officials that formulated the core of TV were not professional economists but career civil servants (see Peden, 2004; Middleton, 1985). Their perspective was mostly shaped by what they believed to be sound principles of public finance rather than of macroeconomics, which in fact was being created as an independent discipline precisely during those years. Perhaps even more important, Treasury officials saw as their mission to curb unreasonable demands of politicians on the resources of the State. Maintaining balanced budgets was a way to achieve this goal. It imposed the need to find new tax revenues to cover any increase in expenditures. (Middleton, 1985) Therefore, TV emerged less as a semi-formed doctrine than as a body of arguments raised against the expansionary policies proposed during the period between the return to gold standard in Great Britain in 1925, and 1931, when the country abandoned it.

Great Britain had returned to the gold standard at the same exchange rate of the pound to the US dollar used before World War I. The rate was consensually acknowledged to overvalue the pound. British authorities, however, believed that price flexibility would promote the required nominal adjustments to remove the disequilibrium. While waiting for those adjustments to happen, however (or if they simply did not happen at all), the economy would lose competitiveness and

---

⁵ Churchill also offered a more general summary of the Treasury View: “The classical doctrines of economics have for nearly a century found their citadels in the Treasury and the Bank of England. In their pristine vigour these doctrines comprise among others the following tenets: Free imports, irrespective of what other countries may do and heedless of the consequences to any particular native industry or interest. Ruthless direct taxation for the repayment of debt without regard to the effects of such taxation upon individuals or their enterprise or initiative. Rigorous economy in all forms of expenditure whether social or military. Stern assertion of the rights of the creditor, national or private, and full and effectual discharge of all liabilities. Profound distrust of State-stimulated industry in all its forms, or of State borrowing for the purpose of creating employment. Absolute reliance upon private enterprise, unfettered and unfavoured by the State.” (quoted in Clarke, 1988: 29)
output and employment would fall. As the 1920s approached their end, pressures mounted on the
government to stop relying on automatic adjustments and to implement expansionary policies.

Under the gold standard, monetary policy was constrained to protect gold reserves. Monetary
authorities, even if they wanted to, could not use interest rate policy to stimulate the economy.
For many economists, under these conditions, the only policy tool left was to implement a public
works program to counteract the deflationary forces of the overvalued currency. It was in this
context that TV emerged and its main focus defined: opposition to activist fiscal policy. In modern
times, TV is remembered only as an archaic argument against fiscally-induced macroeconomic
expansion based on an almost superstitious attachment to Say’s Law. Surprisingly, perhaps,
theoretically-based arguments, however, were in fact rarely raised by Treasury officials. There is
little reason to suppose that TV defenders were trying to hide their colors by avoiding the issue.
Internal documents of the Treasury published in Peden (2004) show the relatively little weight
carried by theoretical arguments even in internal memoranda not intended for publication of any
sort.6

In any case, if one is concerned with theoretical issues, it was not Say’s Law per se that inspired TV,
but the loanable funds theory according to which investment activity depended on the supply of
credit, which was itself dependent on the savings of the general public.7 In this context, public
investment was believed to withdraw resources from the available savings fund, reducing the
supply of credit for private endeavors. Crowding out could only be avoided if public investments
were to be financed by the creation of new money. In this case, however, inflation would ensue,
and private expenditures would be reduced because of the fall in real purchasing power held by
private agents. In other words, public investment would crowd out private expenditure, with no
positive net effect on the overall level of activity and employment in any case.8

This is not the place to make a proper critique of the loanable funds theory.9 But one should keep
in mind that the question of how to finance public expenditure while avoiding crowding out
private expenditure was the central point of debate between Keynes and the Treasury in the late
1920s and early 1930s. It is only fair to acknowledge that Keynes himself took quite a long time to
present a more forceful consistent argument in this respect. Even then his argument was not
really absorbed either by civil servants or, in fact, by academic economists. The apparently

6 Some officials did believe in Say’s Law, most notably perhaps Otto Niemeyer, one of the few
professional economists in the Treasury’s staff. Others were less orthodox, such as Ralph Hawtrey.
In any case, contrary to the beliefs of some modern authors, the more abstract debate on the
nature and role of the state opposing Keynes to Austrians like Hayek seems to have had hardly any
significant role. This will be a significant difference between TV and the view of the
Bundesfinanzministerium, see below.
7 Churchill’s quote, above, would strengthen this interpretation.
9 A Keynesian critique of the loanable funds theory is presented in detail in Cardim de Carvalho
interminable debate between liquidity preference and loanable fund theories seems to bear witness to the inability of its participants to settle the question.\textsuperscript{10}

Treasury officials often pointed out that positive effects of an increase in public expenditure would be rather limited, in any case, given the degree of openness of the British economy and the need to finance fiscal deficits.\textsuperscript{11} Leakages would occur through two channels: an increase in incomes, if it could be achieved, would increase imports. Since British exports depended on incomes earned in the rest of the world, deficits in the trade balance would emerge that had to be financed. Financing the deficit could be difficult, however, because newly created financial resources could be used to increase external investment rather than internal expenditure, reducing gold reserves and threatening the value of the pound. This was the second leakage reducing the impact of government spending on domestic output and employment. The problem would be especially serious if an increase in public expenditure reduced confidence by private agents on the wisdom of political leaders, stimulating capital flight.

In fact, the impact of increasing government expenditures and deficits on private confidence was a central concern of Treasury officials and became an essential element of TV (Middleton, 1985: 185). Capital flight was not the only channel through which the loss of confidence would express itself. More immediately, interest rates on public securities issued to finance the expenditure would rise, increasing financing costs for private investors as well (quite independently of the more mechanical crowding out effect mentioned earlier). Maintaining fiscal discipline even in the face of adversity would signal virtuous intentions on the part of the authorities and would contribute to keeping interest rates low and financing conditions adequate for private and public borrowers. Treasury officials believed that the improvement of confidence would be more efficient in promoting recovery than increasing public spending.

But operational concerns also loomed large in the TV.\textsuperscript{12} Treasury officials insisted that Keynes, perhaps the most active proponent of increasing government expenditures at the time, underestimated the difficulties of using public expenditures as a management instrument by government authorities. Defining and implementing projects took longer than Keynes seemed to acknowledge, long enough, in the view of Treasury officials, to make it useless to try to smooth

\textsuperscript{10} To this day this remains a point of contention among Keynesian economists as well as among economic historians. Again, this is not the place to explore this issue, but a possible explanation for the difficulty of understanding Keynes’s point was the peculiar sense in which he used the word \textit{finance}. Middleton (1985), for instance, considers that by the end of his exchange with Bertil Ohlin in The Economic Journal around the determination of the interest rate, Keynes had accepted loanable funds theory. For an examination arriving at the exactly opposite conclusion see Cardim de Carvalho (2015b, chapter 6 cit.)

\textsuperscript{11} “In the considered view of the authorities, Keynes was judged unrealistic on the scope and schedule of public works; over-optimistic on the scale of secondary employment and the likely savings on the dole; and insufficiently mindful of the effect on international confidence of efforts to finance such a programme.” (Clarke, 1988: 293)

out fluctuations in unemployment (Peden, 2004: 103, 106, 107). Officials also called attention for
the fact that, in Great Britain, a large share of public investments was made by local
administrations. Under these conditions, it could be exceedingly difficult to coordinate an overall
expenditure strategy by the central government (Middleton, 1985: 18).13

Finally, TV also relied on the notion that most of British unemployment at the time was structural,
rather than cyclical.14 Moreover, it was distributed throughout the country in very unequal ways.
For both reasons, it could not be eliminated or significantly reduced by general measures to
increase aggregate demand. Treasury officials took solace in the thought, often repeated in their
memos, that FDR’s New Deal had proved that public investment does not offer an efficacious way
out of a large crisis.15

But arguments of a more political nature were also raised. Two points stood out. The first dealt
with the question of who should decide which investments governments should make. The
argument was raised that it would increase the power of the state over society if government
bureaucracies were charged with the choice of investment projects instead of private individuals
exercising their freedom to select whatever they considered to be best alternative. Besides, in the
case of Great Britain, a centrally coordinated public investment plan would trip over local
governments who were responsible for a large share of such expenditures.

The second argument still has strong echoes in the modern debate, as we will see in the next
section. Treasury officials were deeply concerned with the loss of control over public finances that
allowing expenditures to be made without previous provision of revenues would entail. This is
perhaps the most important of all TV features: the notion that the Treasury had conquered the
right to manage public finances on behalf of the nation against the anarchy and squandering of
resources that previous systems, dominated by undisciplined monarchs and politicians, entailed.
Breaching budget discipline created an unacceptable risk: it could become a precedent, rather
than an exception. Again, politicians could not be trusted (as kings before them) to contain their
impulse to put their hands in the public purse. Balanced budgets, to be executed under tight

13 Or so it was argued by Treasury officials, who, in fact, seemed to be remarkably ignorant of the
actual impact of President Roosevelt’s policies on the US economy. It may be interesting to
contrast the diagnosis offered by the British Treasury to the PWA experience in the first two years
of President Roosevelt’s first term in office. A large share of public works financed by the federal
government was actually decided and realized by local authorities. At least in some areas, the
program was considered to be quite successful. See, e.g., Williams (2013) for an extensive
examination of New Deal building works in New York City, and Smith (2006) for a detailed
examination of the public works initiatives of the New Deal.
14 Middleton (1985) is particularly insistent on the structural and regional character of mass
unemployment in Great Britain in the late 1920s and early 1930s.
15 The argument was sort of a cliché among Treasury officials, although the empirical basis for such
claim was not once presented, at least in the documents collected in Peden (2004). One should
note, anyway, that in the absence of macroeconomic theories that could explain what all the
experiences of unemployment had in common it was necessarily the particularities of each
situation that would attract attention.
control by civil servants, were a guarantee that this victory for modernity over aristocratic abuses would be preserved.\(^\text{16}\)

The “discovery” of the consumption multiplier by Kahn and Keynes did not change TV. Uncertain about how to react to the notion, Treasury officials did not consider acceptable to include estimates of the multiplier effect in their tax projections. The notion could make sense, but working with “theoretical” estimates could vitiate the whole budgeting process and open the door to the consideration of all kinds or politically-motivated views as to the strength of the multiplier (Middleton, 1985: 33).

Let us try to summarize the arguments that defined TV before moving on. (1) TV was more concerned with proper rules of behavior than with theoretical notions about how modern economies work; (2) TV was developed for defensive purposes, to resist proposals to expand public spending during the late 1920s; (3) to the extent that economic theory was involved in the formulation of TV, it was the loanable funds theory, according to which the supply of credit is limited by current savings, that played the essential role; (4) the concern with proper rules of behavior was the main reason why TV insisted on balanced budgets: it was expected that allowing fiscal deficits to emerge would destroy any inhibition politicians could have of spending without limit the resources of the state; (5) theoretical innovations such as the consumption multiplier were irrelevant for the budgeting process: relying on its predictions would make budgets as reliable as any other theoretical speculation; (6) public works programs could not work in Great Britain because any worthy investment would require long planning and would infringe on the right of local governments to decide their own priorities; (7) to the extent, again, that economic theory had any relevance to the political debate, TV was characterized by a static view of efficiency, relying on the notion that private agents knew better than the government what was the best use of available resources.

\(^{16}\) The view that allowing fiscal deficits to emerge once, even if for good reasons, would open the door for fiscal irresponsibility of politicians is an old war horse of conservative criticism of Keynes’s policy proposals. See, e.g., Buchanan (1987: 142): “The Keynesian policy model seemed to offer an intellectual-moral argument for expanded public spending financed by debt (or money). But ordinary politics fails almost totally when the other side of the Keynesian policy norms are required for macroeconomic purpose. Political decision makers cannot increase taxes so as to generate compensatory budgetary surpluses. The bias toward deficits emerges directly from the most elementary application of public choice of principles. In this context, the net contribution of the whole Keynesian half century must be evaluated negatively. It is represented best by the regime of massive and continuing budgetary deficits that we observe, deficits that bear no relationship to any alleged macroeconomic purpose, and that are almost universally acknowledged to have adverse consequences for the economy as well as for the moral bases of modern society. These deficits emerged because the Keynesian impact was to dislodge almost totally the precept of budget balance from the effective fiscal constitution.” Notice that a similar inflationist bias is frequently denounced as characteristic of Lerner’s Functional Finance approach.
3. The Bundesfinanzministerium View

The virtues of austerity policies, particularly the view that budgets should be balanced even under increasing unemployment and falling output were “rediscovered” in the 2010s. This time austerity policies found a powerful sponsor in the German government which led a coalition of “northern” members of the European Union who forced them on the countries who were hit by the contagion of the American financial crisis. German authorities also tried to get the G20 to endorse the need for immediate fiscal consolidation, leading the opposition to attempts by the US government to push for global coordinated expansionary policies against the crisis.

Critics of the Germany-sponsored austerity policies in Europe, especially in the Anglo-Saxon countries, tend to suggest that they are a sign of how backward and unsophisticated economic theory is in that country. German economists had not read The General Theory and the debates that followed its publication eight decades ago and for that reason they still believed in the discredited Treasury View. To engage in debate with the German government and the large number of German economists who seem to support its policies it should be enough to re-heat Keynesian arguments. The Germans have the financial power to impose their superstitious beliefs on their weaker partners in the European Union. Intellectually, though, there was no substance in their views.

This diagnosis, however, is dangerously Anglo-centric. It assumes that developments in macroeconomic theory in the United States are universally acknowledged and accepted as scientific progress both among academics and economic policy-makers. The assumption is, however, wrong and goes some way to explain why most of the criticisms directed against austerity policies have been simply dismissed by German economists and authorities. Although the austerity policies sponsored by them are to a large extent similar to those adopted by British Treasury in the 1920s, their rationale is not, as we will try to show in this section.

It is as difficult to present an articulated view of the Bundesfinanzministerium View (hereafter BV) as it was the case with TV. BV proponents seem to believe that some principles are self-evident and demand little or no explanation (such as the temptations to which politicians are subjected) as much as their colleagues at the British Treasury did. In any case, their views are made public mostly through speeches, articles and interviews, and consistency and completeness are not always an essential concern for those presenting the case for austerity. If anything, BV is more frequently articulated as governments’ rhetoric than TV was given that we do not have the same access to the ministry’s internal memoranda as we did in the case of TV through collections such as...

---

17 Of course, austerity was rediscovered in the 2010s only by the advanced countries. Austerity was maintained as the default macroeconomic policy to be adopted by developing countries who had to ask for the IMF financial support throughout the period since the entity opened its doors for business.

18 One should notice, however, that this is a fragile position even for Anglo-centric economists, since economic theory in the United States has moved dramatically to reinstate the validity of Say’s law, the neutrality of money, the rationality of expectations, the efficiency of markets, etc.
as Peden’s 2004 volume. This may bias to some extent the evidence we can use: in public
documents, appealing to high moral principles and values, to proper behavior of citizens and even
to theoretical principles or economic theories is more likely to appear than practical arguments
about the feasibility of particular initiatives or types of spending.

As we did in the preceding section, using Churchill’s words to characterize the British Treasury
View, it may be German Finance Minister Wolfgang Schauble who better synthesized BV in an
article published in 2011 in the Financial Times:

“Whatever role the markets may have played in catalyzing the sovereign debt crisis in the
Eurozone, it is an undisputable fact that excessive state spending has led to unsustainable levels of
debt and deficits that now threaten our economic welfare. Piling on more debt now will stunt
rather than stimulate growth in the long run. Governments in and beyond the Eurozone need not
just to commit to fiscal consolidation and improved competitiveness – they need to start
delivering on these now. The recipe is as simple as it is hard to implement in practice: western
democracies and other countries faced with high levels of debt and deficits need to cut
expenditures, increase revenues and remove the structural hindrances to their economies,
however politically painful.”

BV academic champions enjoyed a direct line of influence on government policy-making, at least
from 1963 on, when the Committee of Economic Experts was created to give advice to
government authorities. The Committee’s advice was (and is) not binding. In a few times there
seemed even to be some more or less open conflict between its members and members of the
cabinet. Generally, however, there seemed to be a high degree of consensus between academic
economists who served at the Council and the government officials who spoke in favor of
austerity.

In part, the consensus is rooted in the German history in the Twentieth Century. The catastrophic
experience with Nazism, followed by defeat, foreign occupation and division of Germany by the
winning powers left, of course, a deep imprint in the political culture of the country. Germans
learned to see Nazism as a system which could only bloom in a closed economy. Many German
economists would develop an instant antipathy for Keynesian policies because they thought that it
also could operate only in closed economies. Nazism also created an administrative nightmare and
practiced far too much state intervention in the economy.

---

20 Conflicts between the Committee and the cabinet are known to have happened under Christian
Democrat Chancellor Ludwig Erhard and Social Democrat Chancellor Willy Brandt.
21 Nazi economic policies are described and explained in detail in Tooze’s excellent book (Tooze,
2007). “In short, in Germany Keynesianism was effectively preempted by another set of policies,
oriented toward the supply side and the social market economy, that was progressively reinforced
– both institutionally and ideologically – over suc-ceeding stages in the postwar period. ... They return to an institutional pattern with roots in the late nineteenth century in which the state
established a general framework for a powerful and self-regulating private sector. But they
ideologically justified these policies with theories emanating from the antistatist Freiburg school of
center-leftists became deeply suspicious of political programs that promised to increase the powers of government to steer the economy, including Keynesianism.22

But history is also important for the fact that post-war Germany is evidently a success story, but this success cannot be ascribed to the adoption of Keynesianism in any sense. On the contrary, as Dillard once noted, the social market economy, the guiding concept of economic management adopted in the country after the war, is “is quite un-Keynesian in its emphasis on the unregulated market as the focus of economic policy.” (1985: 121)

TV and BV shared common political instincts against the enlargement of the State’s powers and the latitude Keynesianism was believed to give politicians to influence public spending. Nevertheless, the economic arguments for austerity proposed by BV has nothing to do with orthodox Anglo-Saxon neoclassical theory. The most influential German economists, such as the late Herbert Giersh, as well as influential political leaders, such as current Finance Minister Wolfgang Schaubale, present themselves as Schumpeterians in opposition to Keynesianism. Besides Schumpeter, Hayek is another essential reference for BV furnishing the arguments to sustain the notion that States are poor (and politically dangerous) managers of economic processes.

Being Schumpeterian means, to begin with, that BV is not as concerned with an assumed superior static allocative efficiency of freely operating market economies. Static efficiency was a minor concern of Schumpeter’s. It was the dynamic efficiency of a market economy that attracts the attention of Schumpeterian economists. Free market economies are not supposed to be superior to State-led economies because they allocate existing resources better but because they promote innovations and economic progress better. For Schumpeterians, it is essential to preserve the ways and means through which development takes place. Some instruments may give relief in crisis situations at the cost of compromising the mechanisms that promote change and progress. Schumpeterian policy-makers are not willing to accept such a tradeoff.

It is from this angle that the question of expansionary fiscal policies is examined. For the BV, being a Schumpeterian implies the opposition to appealing to demand management policies even as a

22 “The optimum size of government in this respect is a minimum government which concentrates on the protection of life and property, on external defense, on the enforcement of private contracts, and on the supply of socially valuable goods that neither the market nor free associations of individuals (clubs) can be expected to provide (public goods). The dividing line between what the government will do and what it will not do must be clearly drawn and must remain fixed so that entrepreneurial activity can fill the area left for the market without fear of nationalization, interference, or predatory competition by public authorities.” (Giersch, 1993: 76)

The left had different reasons to reject Keynesianism. As a legacy of Marxism, the left tended to focus on production, rather than on aggregate demand. Be it as it may, left wing parties never had enough power to impose its own views. In Germany, social democrats only governed in coalition with liberals. See Allen (1988) for the case of postwar Germany. See also Rosanvallon (1988) and Boyer (1985) for the case of France and De Cecco (1988) for the case of Italy.
relief during a crisis, let alone to lead a recovery or as a permanent tool to prop up growth. They
tend to think of downturns as the way the economic system gets rid of the excesses that mark the
cyclical peak. To prevent a recession from running its course means keeping in operation firms
that could not stand competition. The resulting misemployment of production factors impedes the
system from using its productive capacity more efficiently.  

But worse than allowing government expenditures to attenuate the competitive pressures created
by a recession is letting them to lead a recovery. That is the main target of Schumpeterian critics of
Keynesian expansionist policies. Here the argument seems to be somewhat confused by the fact
that austerity proponents most of the time seem to conflate two different problems. BV defenders
argue that recovery from a crisis must be led by the private sector to be sustainable in the long
term. Only by introducing innovations and increasing their competitiveness firms can generate an
economic recovery that will be translated into sustainable growth. Government expenditures
cannot lead a recovery because they cannot guarantee that innovations will be introduced to
increase competitiveness that could alone ensure continued growth for extended periods of
time.  

Of course, most Keynesians would point out that this argument misses the target. At least Keynes
himself never proposed that government expenditures should permanently lead capitalist
development or that capitalism could operate normally only if aggregate demand was sustained

\[23\] “Germany has indeed gone on to follow this course of action. We have used fiscal policy to
create a supply-side environment that is favourable to growth, monetary policy to control
inflation, while for the achievement of high employment we have relied on the moderation and
good sense of the German trade unions (which has generally been forthcoming) to hold wages
down to a level which is acceptable in relation to the price levels that the Bundesbank’s price and
exchange rate policies impose on German industry.” (Helmstadter, 1988: 414)

\[24\] “After governments have gone so far as to promise full employment at almost any costs and to
guarantee a reasonable minimum income to almost everybody at taxpayers’ expense, it is all too
likely that they will find themselves under increasing pressures to extend the welfare state to the
business community and to protect and subsidize more and more firms which have lost their
viability and their capacity to adjust. But we know for sure than this would be the wrong direction.
Whatever you subsidize, you make it grow in numbers. If you subsidize (65) unemployment, you
will have more unemployment; if you subsidize students you will have more students; if you start
subsidizing less developed countries you will soon have more of them; and if you extend the
welfare state to firms, you will quickly have more firms needing this welfare state to survive. At
the end of the road we see everybody relying on everybody else in a society which has lost its
internal strength and which is bound to suffer a decline in its standard of living. This is why more
and more ordinary people with sound judgment start to look for a turnaround. But the road
toward prosperity and growth through more reliance on self-help and innovative competition is
long and steep, not very attractive to politicians who need spectacular results well before the next
elections. The turnaround will, therefore, be delayed until the situation has become worse and
worse and until more and more people understand that there is no alternative.” (Giersch, 1993:
66)

\[25\] That is the reason why BV is not moved by arguments such as those of De Long and Summers
(2012).
by them *in the long term*. What The General Theory showed was that when an entrepreneurial economy finds itself in a situation of *unemployment equilibrium*, some “outsider” must break the impasse, reactivating aggregate demand. This outsider must probably be the state for several reasons: (1) governments do not fear the future as private agents do since they cannot go bankrupt; (2) they do not need to “earn” money before they spend; (3) they are big enough to move the economy towards a desired direction; and so on. Keynes believed that private investors would follow the government’s lead *once they began to make profits again* and then take over the growth process. When Schumpeterians argue that government spending cannot be a permanent solution for capitalism’s woes they would probably get from Keynes an approving nod. Keynes, however, would probably follow the nodding with the remark that this was right, but not the point.  

The BV argument is not that governments should not do anything. The right policies, however, are supposed to be those that help private firms to invest in innovations and to improve their competitiveness. First and foremost comes fiscal budget discipline intended to show that governments will not put any pressure on financial markets, not now, not ever. This should increase the confidence of borrowers to seek credit but also of lenders, leading to lower interest rates and a larger supply of finance. Confidence of lenders is as important for the BV as it was for TV. It is a key measure of success for both.

---

26 To be fair, there were some influential Keynesian economists, as most notably Alvin Hansen, who interpreted deficiencies of effective demand as permanent pointing to the possibility of a stagnant economy in the future. Marx-leaning Keynesians, such as Steindl (1952) and Baran and Sweezy (1966), also raised the possibility that modern capitalism was characterized by a tendency toward stagnation. More recently, Summers () gets very close to the idea of secular stagnation as the “new normal”. The fear that such ideas could induce governments to take more direct roles in private decision-making on a permanent basis was an important element to explain the hostility of business sectors to Keynesian policies. See Collins (1981).

27 “We need a forward-looking recovery. Conventional government programmes are not the answer. What we need are the right conditions that will generate innovations to strengthen our competitiveness. We need to invest in research and innovation to create the jobs we need.” (Wolfgang Schauble, “Strategy for European Recovery”, Federal Ministry of Finance, Speeches, Interviews and Articles, 27 March 2014. Strikingly similar ideas were voiced in 2013 by Philippe Aghion, then advisor to socialist candidate to President of France, François Hollande: “... il faut remplacer l’Etat-providence par l’Etat stratégie qui investit dans le capital humain, l’innovation et la sécurisation des parcours professionnels. Un Etat qui gère le cycle par l’offre plutôt que par la demande, en aidant les entreprises et les individus à maintenir leurs investissements innovants en période de récession: de keunésien, il faut devenir ‘schumpetérien’.” “Ni austérité ni keynésianisme!”, Le Monde, 14 juin 2013.

28 “The basic paradigm that guides policy-makers should therefore not be one where the principal object is to spread cyclical stimuli more evenly through time. Stimuli should on the contrary be continuously reinforced so that dynamic forces are created which provide a sustained boost to the economy. ... The only solution is the creation of new products which offer a more favourable ratio of value-added to costs of production, and this goal will be best attained via dynamic competition. Governments can assist its operation by removing obstacles to competition through the
Another point of close identification between TV and BV is the notion that unemployment in the 2010s, as in the 1920s and 1930s, is structural, not cyclical, unemployment. Some of the BV champions prefer even to define it as classical unemployment, explained by the resistance of real wages to fall which forces firms into non-competitive positions and to suffer the loss of markets to competitors. Austerity is a way to force workers to accept lower wages so to lower labor costs and to recover firms’ competitiveness.

One novel argument in support of BV, frequently employed by German authorities, refers to demographic changes going on in Western Europe. It is alleged that Germany’s aging population imposes the need to ensure fiscal surpluses impeding the government to implement expansionary policies that could create budgetary deficits and increase public debt. Other countries with similar demographics should follow its example.

To summarize, BV is defined by the following essential characteristics: (1) it is concerned with the dynamic efficiency of market economies, rather than with the static efficiency that seems to concern Anglo-Saxon economists, it is growth, rather than resource allocation that matters; (2) recessions have a cleansing role in the economics process, uprooting inefficient producers to the benefit of society as a whole; (3) to prevent creative destruction condemns an economy to operate below its potential since factors of production would remain employed in uncompetitive firms; (4) it is innovation that induces growth, not government deficits; (5) government deficits create the risk of rising interest rates or higher taxes in the future, compromising the entrepreneurial spirit necessary to sustain growth; (6) unemployment results from workers losing (or never having) the skills they need to work in innovative firms, it is thus structural, not involuntary in the Keynesian sense; (7) Keynesian policies can only work in closed economies, because they allow uncompetitive firms to operate, and imply a rising participation of the government in the economy, which brings back the unpleasant memories of Nazism.

4. Evaluation

Both TV and BV approach balancing budgets first and foremost as a value in itself for political, rather than purely economic, reasons, in contrast with Keynesianism for which the fiscal budget is a policy tool. In Great Britain balanced budgets were the symbol of the modernization of the state achieved in the nineteenth century. Allowing fiscal deficits, or, worse, actively seeking fiscal elimination or simplification of government regulations, and improvement to incentive structures.” (Helmstädter, 1988: 417-418)

As observed by Allen (1988: 285), the success of Keynesianism is usually related to the relevance of unemployment, but in Germany unemployment was seen as a result not of an economic failure but of immigration.

Of course, labor costs could be cut if productivity increased. However, meaningful productivity increases may take much longer time to materialize than a reduction in money wages.

“Treasury officials’ criticism of Keynes were often motivated by determination of defend a system of what they conceived to be sound public finance. They had inherited a tradition, going back to Sir Robert Peel and William Gladstone, whereby, at least in theory, the state should be
deficits would open the door for the irresponsibility of politicians to roll back all the reforms that guaranteed that the state would maintain sound public finance. In Germany, if anything, the memory was even more dramatic, of nazis discretionarily intervening in the economy to promote rearmament and warfare. Eliminating the power to effect discretionary spending is seen as key to safeguard rule-based modern societies if not modern civilization itself.

Such views seem to find echo in the general population (or among voters). The public appears instinctively fear fiscal deficits and the growth of public debt on the belief (shared by political leaders as well) that a country is like a big family, of which the government is the head. The head of a family knows that he or she cannot permanently spend more than he or she earns because doing it will lead to bankruptcy. Many believe the situation may actually be worse in the case of fiscal deficits and public debt given the easiness with which it is possible to get into debt until it is too late to avoid.

The idea that governments are subject to the same constraint as a family is a fallacy of composition that Keynes and Keynesians have been obviously unsuccessful so far to dispel. The focus of the debate should not be fiscal deficits but government spending. Deficits (or surpluses) are results not instruments. As Keynes himself noted, in a perfect world governments would signal through their spending policies that they are prepared to support full employment and this should be enough to stimulate private spending and for income and tax revenues to rise, possibly arriving even at a balanced budget at the end.

Another common view shared by voters, political leaders, and some economists, is that to promote recovery through aggregate demand management is to believe that it is possible to create something out of nothing, an act of magic rather than of government. Nevertheless, the notion that in the presence of idle capacity and unemployed workers the goal must be to increase aggregate demand should not be particularly difficult to understand or to accept. It is appealing to intuition the proposition that one has to save before one can invest (how could one invest something that was not yet created?). The complexity of Keynes’s alternative argument prevents the clarification of the issue in the political debate.

While TV was clearly directed against anti-cyclical fiscal policies, BV’s target is not equally clear. Frequently, BV arguments are presented to oppose the notion that government spending can lead and sustain long-term development. Although it is certainly true that there are a few critics of politically neutral as between different economic interests, and should interfere with market forces as little as possible. (Peden, 2004: 3)

32 Collins (1981: 3) quotes Franklin Roosevelt criticizing Herbert Hoover’s administration for deficit spending ignoring that governments were no different from households, which FDR took for a fact.

33 The fallacy is to miss the fact that while a family’s expenditures are unlikely to affect their own income, the opposite happens with government expenditures. By spending, the government is able to increase aggregate income and, thus, tax revenues.

34 See Cardim de Carvalho (1997) and Kregel (1983)

35 Arguments such as those advanced by De Long and Summers (2012). But, as noted, the point is not whether BV supporters understand the argument. The point is whether they think it relevant.
austerity who rely on a stagnationist view of modern capitalist economies (that some prefer to call mature) this by no means represents the mainstream of BV’s opponents. On the contrary, the point raised by defenders of expansionary policies is that this is the way not only to support private investment but also to generate the confidence entrepreneurs need to jump into the turbulent waters of innovative investment.\(^{36}\)

In fact, BV proponents seem to face difficulties to distinguish between: (1) normal fluctuations when fine tuning may or may be efficacious to maintain the level of activity and major crises; (2) expenditures planned as relief during social emergencies (as in the case of unemployment compensation) and a policy of stimulus to recovery, especially through public investment; and (3) the policy of stimulus to recovery just mentioned and the search for new patterns of growth dependent on continuing state initiative. BV arguments are used as all the terms in the three dichotomies were freely interchangeable.\(^{37}\)

A common point to TV and BV is that it is never explained where the demand will come from for the goods produced by the private firms, both the innovative ones and the others. TV seemed content to rely here on Say’s Law. Once wages were down and lenders’ confidence restored, firms would be able to produce more and in the process create the purchasing power required to absorb that additional production. If prices and wages were flexible enough, the adjustment process would proceed more quickly.

In the case of BV, it seems to be implicit in the policy strategy the appeal to exports as the outlet for increased production.\(^{38}\) It is by raising net exports that German authorities hope to recover the

---

\(^{36}\) One is not denying the importance of confidence. Nevertheless, recognizing the relevance of confidence does not take very far in the understanding of how can it be obtained. The now apparently closed debate around the possibility of expansionary fiscal consolidations, relied on the idea that budget discipline would increase private agents’ confidence and thus their willingness to increase consumption, investment, etc. Guajardo, Leigh and Pescatory (2011) showed that it did not work that way. Fiscal consolidation has been contractionary, as expected by Keynesians. Even one of the original proponents of the notion of expansionary fiscal consolidation has already acknowledged that the hypothesis was falsified in all experiments it was tested (Perotti, 2011 and 2014).

\(^{37}\) Helmstadter, for one, seems to be convinced that Keynesianism has been proven wrong to his satisfaction: “There have already been enough post-war experiments to bear witness to the fact that Keynesianism does not really have the sustained impact on unemployment that its advocates expect.” (Helmstadter, 1988: 425). Giersch (1993: 15-6) seems to consider those distinctions basically irrelevant: “a medium run time horizon, as distinct from the Keynesian short run and the classical, neoclassical, or Marxian long run ... entrepreneurial supply activities (supply pull) rather than demand mechanics such as demand induced accelerator investments or multiplier processes (demand push) as driving forces in economic development.”

\(^{38}\) Cf. Giersch (1993: 30-1): “Since the second half of the seventies at the latest, West Germany (and some of her neighbors) no longer enjoys the advantages of a catching up economy. In these circumstances there is reason to fear that a program of inflating demand without a concern for the capacity and productivity effects of investment will have much lower output effects and much higher price effects than the proponents of more government spending expect. ... A program of
economies of the European Union. There is here, of course, another obvious fallacy of composition: the notion that increasing net exports can be a general solution for the current crisis. BV’s arithmetic is rather obviously faulty.

BV is presented by its proponents as a supply strategy, in contrast with the demand strategy of Keynesians. The core of BV supply strategy for recovery is not really balanced budgets (other than the alleged effect on lenders’ confidence and interest rates) but stimulating private investment. BV contrasts this goal with what it assumes to be a Keynesian goal of using government expenditure to stimulate consumption. It is really unclear where such characterization of Keynesian policies originates. Most Keynesians, now as before, actually defend raising public investments, coupled with measures that could stimulate private investment, to jumpstart the economy. The point of contention is not that private investments should be stimulated but how it should be stimulated: Keynesians believe that nothing is more stimulating than the perspective of demand expansion is not needed as a public good supporting the market mechanism, because the problem is uncertainty about medium-run competitiveness in a situation of structural change. The weak spots in the economy are industries and firms, including some large corporations, which are suffering from the storm of innovative competition originating in technologically more advanced parts of the world, including Japan, and from import competition in standardized goods originating in low-wage countries. In these circumstances, economic policy has two polar options to stimulate growth (30) and promote unemployment: Lowering unit labor costs relative to other countries by restraining real wage increases (option 1), and accelerating growth of total factor productivity by rejuvenating the economy and augmenting the supply of highly productive jobs (option 2).

Helmstadter (1988: 416), himself a former member of the German Committee of Economic Advisors, arguing in support of Giersch’s views, offered a curious fusion of Schumpeterianism and classical Say’s Law: “The Council is concerned, not merely to utilize existing productive potential but that present production facilities should be continuously modernized which actually matters far more in the long term. The Council has often pointed to the lessons which can be learned from economic history which underscore the fact that ‘the primary impetus for expansion often originates in supply, which automatically creates equivalent demand’. This wording is reminiscent of Say’s law, a principle which is often misunderstood. What is meant here is that the right kind of supply creates its own demand. Indeed many of the present day problems involving growth and employment can be illuminated by the simple formula of Say’s law provided that this is interpreted qualitatively: ‘The right kind of supply invariably creates its own demand’. If producer and consumer goods are supplied which incorporate modern developments in science and technology, which work reliably, and most crucially of all, which fulfill a need that is felt by populations somewhere in the world, then the supplier will be able to obtain a price which more than covers his costs. This kind of supply is created in efficient and well managed factories and workplaces, and these, by designing and producing such goods, create more employment. This is the crux of supply-oriented anti-unemployment therapy.”

“The idea that Europe – and West Germany in particular – needs just a little bit of fiscal expansion supports populist pressures. This may very well weaken the efforts to reduce the waste element in public expenditures in order to free resources for productive investment in the private sector, which would be the right response to Europe’s capital shortage-cum-unemployment. Moreover, the concentration on vague macroeconomic concepts like deficit spending impairs the chances for tax cuts designed to promote capital formation and the creation of new firms on the old continent.” (Giersch, 1993: 340)
growing demand for the goods that will be produced by new plant and equipment, while BV seems to think that giving tax favors would be more efficacious (besides, of course, the expected confidence effect, allegedly to be created by virtuous and prudent governments).

BV is less insistent on the question of how to finance public expenditure than TV, perhaps because it already starts from a rejection of attempts to revive economies in crisis through government spending. True Schumpeterians, of course, would not rely on the same loanable funds view that informed the TV approach to finance. On other hand, the attachment of German government authorities, and in particular the monetary authorities, to the quantity theory of money seems to be much stronger than it was in the British Treasury in the 1920s and 1930s, making the concern with inflationary effects of expansionary monetary policies much sharper.

In the same vein, BV and TV take as a given that one is dealing with open economies. However, while TV treated the balance of payments as a constraint on policy choices, BV sees foreign trade as the key to the success of the strategy. Expanding the economy through rising exports not only solves the problem of where is the demand for the national output coming from but it also removes the possibility that growth can be constrained by the need to increase imports. For both, in contrast, Keynesianism can only be applied to closed economies being therefore hopelessly inadequate for advanced economies.

5. Does It Work?

At the end of the day, the essential test for any policy strategy must be whether it works or not. But answering questions like this is not so easy and cannot be properly tackled in the space left in this paper. A few remarks, though, may be in order.

Austerity is a policy recipe to fight crises. Did it lead to actual recoveries? Austerity policies were imposed on the so-called peripheral countries of the eurozone since 2010. They all present a similar picture: drastic expenditure cuts and rising taxes lead to a sharp fall in the level of activity and an increase in unemployment. Once a country reaches pitbottom, a measure of stabilization, where the downward spiral is contained and some weak and volatile expansion ensues, may be observed. Starting from very low levels of activity, “recovery” is not enough, however, to return to past peaks of production, let alone past growth trends. Notwithstanding, political leaders committed to austerity tend to present the recovery as proof of its efficacy. The question remains, of course, how far the previous collapse itself was caused by austerity policies. The fragility of recovery in the recent eurozone countries’ experience has been associated with the dependence austerity creates on external demand. On the other hand, growth of net exports has also been dependent on the fall of imports which accompanies the contraction of the economy and may not be sustained if the economies someday truly recover. This has affected not only peripheral economies, but also at least some of the core economies of the Eurozone.

40 For Schumpeter’s view of the role of savings and finance in capitalist development, see his Theory of Capitalist Development.
The claim that austerity may stimulate innovation and productivity increases is much harder to evaluate. BV proponents are vague about the actual connections between them. Austerity seems to be an important element in a context that favors innovation. Possibly, one is referring to the idea that austerity is associated with the notion of responsible government, one that remains in the wings, trying to be as neutral as possible with respect to actual economic activity. Another possibility is the idea that an austere government will not raise taxes on firms taking away their profits. But BV proponents mostly emphasize the negative aspect: Keynesianism is supposed to favor consumption, not investment, closed, not open, economies, government intervention, not entrepreneurial initiative, and therefore creates an anti-business climate that does not support productive investment. It is a cultural, rather than strictly economic, question.

One final point that may be relevant to this discussion is how far austerity has actually become an alibi for conservative governments to roll back some of the institutional changes observed in the last decades, generally referred to as the “welfare state”. In BV’s rhetoric is frequent the mention to moral hazards created by labor market regulation and social security systems to reduce workers’ disposition to get jobs. In the Eurozone, rescue packages imposed by the troika regularly rely on the assumption that austerity cannot be softened under the pain of reducing the stimulus to reform in the peripheral countries. In the United States and the United Kingdom, the political right states clearly its goal to reduce the size of the state as a political, rather than economic, objective.41

But, as Boyer (1985: 78) wisely noted, debating similar issues to those treated in this paper, “the revival of pre-Keynesian concepts is not simply a matter of propaganda or ideology. However debatable are the policies of monetarist, supply-side, or rational-expectations schools, they do point to the presence of real macroeconomic problems.” The difficulties faced by Keynesians to sell their alternative policies to voters and political leaders cannot be entirely due to the difficulty to understand the complexities of modern capitalism and the role of the state. There are at least two real problems to be faced by any Keynesian alternative, especially in peripheral countries, both related to the balance of payments.

The first has to do with net exports. A domestic growth expansion, based on public investment (or, less likely, on private expenditures) will face the problem of paying for imports, since there will be no reason for exports to grow pari passu with imports. President Mitterrand actually tried to grow

---

41 As stated by a conservative newspaperman: “In the end, you are either a big-state person, or a small-state person, and what big-state people have about austerity is that its primary purpose is to shrink the size of government spending. ... The bottom line is that you can only really make serious inroads into the size of the state during an economic crisis. This may be pro-cyclical, but there is never any appetite for it in good times; it can only be done in the bad.” (quoted in Eichengree, 2015: 366).
by stimulating domestic demand in the first year of his first term, and the policy had to be abandoned.\textsuperscript{42}

The second problem is related to the first. Under the euro, it is even more difficult to promote recovery by domestic stimuli. The common currency imposes a hard liquidity constraint not only on external deficits but also on domestic deficits. The euro rules are, in fact, much tougher than those in force in the 1920s and 1930s, since a country could leave the gold standard when it was convenient while the adhesion to the euro is sustained by a treaty. When fiscal and balance of payments deficits and public debt are already large the perception that a country really has no alternative but to submit to austerity becomes overwhelming.

One alternative is left, of course, in the form of what German Schumpeterians derisively called “international Keynesianism”: that is, an institutional framework that favors internationally coordinated expansion instead of austerity. In fact, it was such a goal that inspired the Bancor Plan Keynes prepared for the Bretton Woods conference but that was rejected because of United States opposition. The prospects for such initiatives remain, to say the least, very limited.

6. Conclusion

The German government insistence on the adoption of radical austerity policies by crisis countries in the Eurozone has been the target of hard and equally persistence criticism. The Germans, however, are undaunted and in fact are bent on trying to convince the international community to follow such path, as their interventions in the G 7 and G 20 meetings bear witness. Of course, policy discussions cannot be settled on theoretical issues alone, but one should notice that many of the criticisms leveled at austerity policies defended by the German Finance Ministry seem to view them as simple revivals of the old British Treasury View. We tried to suggest in this paper that this is a mistake. BV is, if anything, more complex than TV ever was. It cannot be faulted for believing in old-fashioned ideas such as Say’s Law. The quote from Helmstadter (fn 26) shows that for many important German economists Say’s law is not even fully understood, let alone being a foundation of their policies. In contrast, TV was more accurately focused in its opposition to expansionary fiscal policies. While TV combatted the idea that fiscal policies could restore full employment during a crisis, BV seems to oppose the notion that fiscal policies could replace private investment as the engine of growth in the long term, which is not the concern of most critics of austerity. The weakest spot of BV seems to be precisely the core of the austerity strategy: the notion that austerity favors innovation. No causal mechanism is actually proposed. In fact, no argument is provided about how the two phenomena are connected and why an increase in

\textsuperscript{42} “It is now clear what are the advantages of an upswing stimulated by means of securing a surplus in foreign trade. It is worth mentioning that the ‘natural’ upswing based on the automatic increase in investment activity does not enjoy these advantages, and if there is no influx of foreign capital, it will be confronted with the same balance of payments difficulties as the upswing based on ‘domestic exports’ [by which Kalecki meant government expenditures].” (Kalecki, 1971: 25)
aggregate demand caused by an increase in, say, public investments in infrastructure would imply any discouragement to private investor, including Schumpeterian entrepreneurs.

References


