Austerity assumptions that public debt is bad for growth, and that the only way to reduce it is to cut government spending and debt by running a budget surplus, irrespective of the possible social cost. With debt down to an unspecified level and government finances “sound”, the private sector will be freed to reignite prosperity. The politics of austerity have framed the policies of successive Chancellors of the Exchequer and European finance ministers for almost a decade. In the US, from Newt Gingrich in the 1990s to the legally mandated downsizing the state. In line with the Maastricht Treaty, was to be limited to 60 per cent of GDP, with annual deficits (debt is the accumulation of annual deficits (debt is the accumulation of deficits) not larger than 3 per cent of GDP. These numbers purport to set objective limits to government indebtedness. But where do these numbers come from? Where do these numbers come from? The current debate about austerity has largely been urged to restore their competitiveness by “periphery” countries of the Eurozone have been self-defeating. Austerity assumes that public debt is bad for growth, and that the only way to reduce it is to cut government spending and debt by running a budget surplus, irrespective of the possible social cost. With debt down to an unspecified level and government finances “sound”, the private sector will be freed to reignite prosperity. The politics of austerity have framed the policies of successive Chancellors of the Exchequer and European finance ministers for almost a decade.

But this fixation on austerity to reduce debt misses a basic point: what matters is long-run growth, its source (what is being invested in), and its distribution (who reaps the rewards). If, through austerity, we over-invested to essential areas that create the capacity for future growth (education, infrastructure, care for a healthy population), then GDP (however ill-defined) will not grow. Moreover, the irony is that just cutting the deficit may have had little effect on the debt/GDP if the denominator of the ratio is being badly affected. And if the cuts cause more inequality — as the Institute for Fiscal Studies has shown was the case with austerity in Britain over recent years — consumption can only grow through debt (e.g. credit cards), which maintains purchasing power. Instead, if public investment is made in areas like infrastructure, innovation, education and health, giving rise to healthy societies and creating opportunities for all, tax revenues will most likely rise and debt fall relative to GDP.

It’s a magic number

Value creation versus value extraction

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likely rise and debt fall relative to GDP. It is crucial to understand that economic policy is not scientifically ordained. You can impose austerity and hope the economy grows, even though such a policy ignores the theory of value that underpins much “common-sense” understanding of market processes. A major reason for this lack of curiosity is that both camps seem to have been in thrall to the so-called magic numbers which have framed the debate. When, in 1992, European integration came into being through the Maastricht Treaty, there were various obligations that the countries concerned signed up to, one of which was to keep spending in check. Total public debt was to be limited to 60 per cent of GDP, with annual deficits (debt is the accumulation of deficits) not larger than 3 per cent of GDP. These numbers purport to set objective limits to government indebtedness. But where do these numbers come from? Were they arrived at through some kind of scientific process. These numbers are taken out of thin air, supported by neither theory nor practice. Let’s start with debt. In 2010 the American Economic Review published an article by two leading economists, professors at Harvard University: Carmen Reinhart, ranked the following year by the Bloomberg Markets magazine among the “Most Influential 50 in Finance”; and Kenneth Rogoff, a former chief economist of the IMF. In this piece the pair claimed that when the size of government debt (as a proportion of GDP) is over 90 per cent (much higher than the 60 per cent of the Maastricht Treaty, but still lower than that of many countries), economic growth falls. The results showed that rich countries whose public debt exceeded that percentage experienced a sharp drop in growth rate for the period 1946–2009. This was a very important finding, as so many countries’ public debt levels are close to or exceed this percentage. According to IMF data the US debt/GDP ratio stood at 64 per cent in 2007, and 105 per cent in 2014. For the UK the equivalent numbers were 44 per cent and 81 per cent; for the European Union 58 per cent and 88 per cent, and for the Eurozone 65 per cent and 94 per cent.

Aware that the argument clearly gave ammunition to advocates of a smaller state, the authors hastened to reassure their readers that they had no skin in the game; that their argument had no ideological foundation, but was based purely on empirical data. They even went so far as to stress that their research had no underlying theory of government: “our approach here”, they emphasized, “is decidedly empirical”. Predictably enough, politicians and technocrats eager to “balance” public spending seized on Reinhart and Rogoff’s research, which proved highly influential in the post-2008 crisis debate about austerity measures. In his Federal Budget Plan for 2013, passed by the US House of Representatives, the Republican Congressman Paul Ryan cited the study as evidence for the negative impact of high government debt on economic growth. It also informed austerity policies proposed by the then Chancellor, George Osborne, and the EU Economy Commissioner, Olli Rehn.

In 2013, as part of his PhD studies, Thomas Herndon, a twenty-eight-year-old student at the University of Massachusetts Amherst, tested Reinhart and Rogoff’s data. He couldn’t replicate their results: his calculations showed no steep drop in growth rates when debt was high. Examining the professors’ data sheet, Herndon found a simple spreadsheet error. He also discovered inconsistencies in the countries and data cited. In two articles in the New York Times, the professors defended their general results, but accepted the spreadsheet error. Magic numbers were not so magical after all. Now on to the other magic number held so dearly by EU economists: the number 3. The “periphery” countries of the Eurozone have been urged to restore their competitiveness by downsizing the state. In line with the Maastricht criteria, bailouts for countries like Cyprus, Greece, Ireland and Portugal have...
been conditional on their cutting spending. If that spending goes above 3 per cent of GDP then bailouts are jeopardized. Between 2010 and 2017, Greece received €260 billion in bailout aid, in exchange for cutting state expenditure. However, since its problems were too structural to be solved by a simple “austerity” measure, the cuts pitched it into a deep recession, turning into full-blown depression. And, rather than decreasing Greece’s debt, the lack of growth has caused the debt/GDP ratio to rise to 179 per cent. The cure is killing the patient.

This obsessive focus on countries’ deficits ignores a stark reality. Some of the weakest Eurozone countries have had lower deficits than the stronger countries – Germany, for instance. What matters is not the deficit but what government is doing with its funds. As long as these funds are invested productively in sectors like health care, education, research and others that increase productivity, then the debt/GDP denominator will rise, keeping the ratio in check.

Yet Eurozone policy blindly persists in the conventional view that austerity is the solution, and that inadequate growth indicates insufficient austerity. In 2014, in a stinging attack on Eurozone political economy, Joseph Stiglitz wrote: “Austerity has failed. But its defenders are willing to claim victory on the basis of the weakest possible evidence: the economy is no longer collapsing, so austerity must be working! But if that is the benchmark, we could say that jumping off a cliff is the best way to get down from a mountain; after all, the descent has been stopped”. The austerity policy of cutting taxes and government spending does not revive investment and economic growth, when the real problem is weak demand. And in countries like Greece and Spain, where 50 per cent of young people cannot find work, pursuing policies that don’t actually affect investment – and hence jobs – means that an entire generation can lose its right to a prosperous future.

Questions of government debt and budget deficits are often also confused with ones about the size of government, usually measured as the ratio of government spending to the size of the economy. And yet there are no magic numbers for what is too big or too small. France, frequently touted as an example of big government, has a government expenditure/GDP ratio of 58 per cent. The UK government’s spending is also often regarded as quite big, but at about 40 per cent its ratio is not much different to that of the US at 36 per cent – although the US is often cited as an example of small government. Surprisingly, China, often perceived as a state-run economy, has a ratio of only 30 per cent.

However, recent research into the impact of government size on economic growth has found almost unanimously that small government is “bad” if, for example, it cannot even maintain basic infrastructure, the rule of law, and the educational needs of the population. Conversely, the same research concludes that bigger government might be bad if it is a result of activity that inhibits the private sector or unduly restricts private sector activity and interferes too much in people’s lives. But within these rather obvious limits, the ideal size of government is hard to quantify – not least because it depends heavily on what you want government to do and how you value government activity. And here we have a problem: there has been a dearth of thinking by economists – both historically and in recent decades – about the value created by government.

Value has gone from being a category at the core of economic theory, tied to the dynamics of production (the division of labour, changing costs of production), to a subjective category tied to the preferences of economic agents. Many ills, such as stagnant real wages, are interpreted in terms of the “choices” that particular agents in the system make; for example, unemployment is seen as related to the choice that workers make between working and leisure. And entrepreneurship – the praised motor of capitalism – is seen as a result of such individualized choices rather than of the productive system surrounding entrepreneurs – or, to put it another way, the fruit of a collective effort. At the same time, price has become the indicator of value: as long as a good is bought and sold in the market, it must have value. So rather than a theory of value determining price, it is the theory of price that determines value.

Along with this fundamental shift in the idea of value, a different narrative has taken hold. Focused on wealth creators, risk-taking and entrepreneurship, this narrative has seeped into political and public discourse. It is now so rampant that even “progressives” are critical of the system sometimes unintentionally espousing it. When the Labour Party lost the 2015 election, leaders of the party claimed they had lost because they had not embraced the “wealth creators”. And who did they think the wealth creators were? Businesses and the entrepreneurs leading them. Feeding the idea that value is created in the private sector and redistributed by the public sector. But how can a party that has the word “labour” in its name not see workers and the state as equally vital parts of the wealth creation process?

Such assumptions about the generation of wealth have become entrenched, and passed unchallenged. As a result, those who claim to be wealth creators have monopolized the attention of governments with the now well-worn mantra of: give us less tax, less regulation, less state and more market. By losing our ability to recognize the difference between value creation and value extraction, we have made it easier for some to call themselves value creators and in the process extract value. Understanding how the stories about value creation are around us everywhere – even though the category itself is not – is essential for the future viability of capitalism.