

Austerity: Why, What and How – Lessons from the UK's Failed Experiment

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Introduction

Let me tell you a little bit about my adult life as experienced through crises. In 2008, I moved to the UK and the first crisis hit and was very apparent. The global financial crisis affected many demographic groups and my own economic outlook. It also resulted in an excessively large PhD cohort at the London School of Economics (LSE) at the time, because many decided to postpone their entry to the job market. Many of these PhD students decided to study this crisis and what came from it – and I was one of them.

The global financial crisis was followed by the debt crisis, which was very prominent in Europe. It was followed by the refugee crisis, the austerity crisis, and the COVID-19 pandemic, which had dramatically different outcomes across countries, depending on the handling of the crisis. More recently, we now have the Ukraine war and the ensuing energy crisis.

This multitude of cascading crises is happening in the context of a climate crisis as an overarching challenge, and a global demographic imbalance, where our social system and our economic and social organizations face a demographic pyramid that does not promise a demographic dividend. Hence, many institutions (i.e., the monetary system, unified

currency, the trading system) are challenged by something that mankind has not seen before. I see two extreme ways and many muddled ways that this can go.

It is in this context that my research on austerity has unfolded and continues to unfold. In particular, I have studied the origins and causes of austerity, as well as the consequences of austerity in the UK from a policy standpoint. Most recently, this work has been focused on the COVID-19 pandemic and its handling. I am currently working on an ambitious piece of work on the handling of the energy crisis that emerged from the war in Ukraine and the climate crisis more generally.

What crises have in common

Throughout my research, I was struck by the realization that there is something that connects it all, and this is something I came to realize last year while reconnecting with some of the readings from my youth, particularly those in psychology. The narratives behind the attacks on the democratic organization of society, particularly those coming from the political right, often tend to lean on the perception of government inaction, or its inability to deliver. For this reason, I believe that the empirical work many economists are doing to study and analyze the unintended consequences of policies is incredibly vital. This work allows us to understand why these unintended consequences exist in the first place. This type of loop is the common denominator that surrounds all of the above-mentioned crises. This is also what brings us here to this conference, to discuss the threats to liberal democracy and alternative social organizations that are being championed, such as illiberal forms of government and potential technologically augmented dictatorships or autocracies.

By living through and researching these crises, I have started looking for the commonalities they exhibit. We start with a shock, or a crisis, which is followed by a policy response that is often too little and too late, and has a specific signature depending on which party is in power (this is observed in particular in countries that possess a majoritarian two-party system, like the UK or the US). When they come from the political right, these policy responses are typically increasingly regressive. They are facilitating

or encouraging outright fraud or leakage of public funds. In other words, they tend to benefit larger firms more than smaller firms by being explicitly anti-competitive and reinforcing monopsony power or the market power of specific firms. They further actively erode state capacity and, to some extent, further skew relative prices, particularly intergenerationally. Because policy responses tend to come with a specific ideology, and oftentimes they are too little and too late in a specific flavor, they produce unintended consequences, which require costly fixes of these policy errors. Because of the development of the media ecosystem, in particular the emergence of social media, the narratives around what these fixes should be oftentimes result in two very unappealing options: the extreme left interpretation and the extreme right interpretation.

There needs to be a policy response in order to fix policy errors, which automatically creates an industry of action. My experience over the last three years suggests that there is something common here that governments oftentimes simply cannot deliver. This is where the connection to austerity comes in as I think it has eroded said state capacity. The consequence of producing biased and politically shaped policies produces intentional or unintentional errors that will also need fixing. This contributes to an erosion of trust and a reduction of resilience on the part of citizens. This, in turn, will produce voluntary political disengagement by some groups and potentially result in erratic shifts in voter turnout that make the process of predicting political outcomes and navigating political engagement increasingly difficult. I argue that this volatility in voter turnout and the difficulty of predicting election results is one of the features of populism. It is about activating a voter pool that has chosen to be disengaged. A consequence of the erosion of trust is the rise of extreme individualism, which undermines our ability to overcome collective action problems. The minimum group size threshold, as economists would call it, that one needs might increase and make the collective action problem more complicated. Other consequences in the form of exit also exist: instead of exercising their voices, some may "exit" due to deaths of despair¹

1 This concept was introduced by economists Anne Case and Angus Deaton in the context of the US in terms of drug overdose, suicide, alcoholism, etc.

or poor mental health, which ultimately puts us in a worse situation when the next crisis hits, triggering the same cycle.

I have observed policymaking in a range of countries, from the more democratic to the less democratic. I have engaged with policymakers, and many of them actually want to do evidence-based policymaking. But they do not seem to be able to do so, and I have a hypothesis about why this is the case. One thing that I have observed and find increasingly shocking is that a lot of the institutions that are archetypal institutions in rentier economies, such as heavily institutionally dualized labor markets, are seeping into Western market systems. The UK is actually adopting a lot of policies that are very similar to what you would see in the Middle East and North Africa, practices of bonded labor, which we know is shrinking the size of the pie, due to the inefficient allocation of workers to jobs. It is the rejection of individual freedom and a rejection of human relationships that could be built on an ethics of care and mutual respect.

All that raises the specter of some countries essentially importing a rentier economy and its institutions, just as I and many others are actively advocating for helping natural-resource rent-driven rentier economies cast off that institutional legacy or primal instinct and helping them build thriving economies. So, where are the rents if they do not have a natural resource origin? The answer may well be politics. Because every crisis provides short-term economic opportunities for money to be made by addressing the crisis. Yet even if this is done with the best intentions of all involved, within a highly polarized society that finds itself confronted with new and vulnerable technologies of mass communication, the invariable policy mistakes and errors that happen, intentionally or unintentionally, feed cycles of distrust, ultimately further eroding state capacity and resilience.

The energy crisis that we have seen in the wake of the Ukraine war and the different national policy responses to address it provide a unique opportunity to study and evaluate the quality of these policies across countries. This is essentially what I am currently working on and it brings together my own life experience, all of my past research through which I tried to illustrate the zero-sum failures of past interventions, and many more deep and very personal emotions.

In terms of the narratives around policy failures and inaction, there are typically three lines of argument: 1) the lack of data, 2) the lack of time, or 3) the lack of evidence. For each of these points, I believe we have a good understanding of why these barriers exist. On paper, all the right data exists, it may just not be available to those who can make best use of it from a societal perspective. In terms of time, typically, some crises are more predictable than other crises – the climate crisis, for instance, has been predicted for decades. In terms of the evidence, we know that this is heavily influenced by influence industries and the absence of experts, in particular the lack of incentives for experts to engage in the boring work of policymaking and working with government departments.

In the wake of the energy crisis, I systematically reached out to government entities across 165 local authorities in the UK as part of a randomized controlled trial. There was a lot of willingness on the part of these entities to engage with experts who proactively reached out. The problems of perceived inaction are often due to logistical issues. Around this framing and discussion of deliberative attacks on the government's response, which indeed exist, there are also a lot of logistical issues that impede effective, agile, and timely responses by the public sector, which is in charge of developing the menu of policies that politicians eventually evaluate. This is an important insight that we cannot ignore. Following my discussions with politicians and policymakers, it became clear to me that they *want* to listen to the evidence and to follow the signs, but very few are qualified or able to discern good quality research evidence from bad evidence. And again, these are normative terms. In general, and on average, designing policies for a country, for all citizens, is a highly complex task. Listening to the evidence is hard, especially when those who should be evaluating the evidence are not well-enough trained to tell good evidence from bad evidence, in terms of the quality. I think the research community can and should do more to offer their help and expertise, and our profession should get better at offering rewards for and recognition of this type of work.

What I have also noticed about policymaking is that with a lot of policies, the do-nothing scenario is often the counterfactual. That is “what is a specific policy proposal being evaluated against?” And obviously, if this is the framing that decision-makers use to approach a problem, then doing

nothing in most instances, around a crisis, is not an option. If this is the only counterfactual the public is informed about and that has been considered, and what the evaluations were, for example through mandatory economic impact assessments, that are routine practice in the UK, then this is a big problem. The public needs to demand more and demand better to understand the menu of options being considered by decision-makers.

And last but not least, I must emphasize that there is a lack of skills across tiers of government, in particular low analytical capabilities, which means that centrally planned policies that require local data/information may not be well implemented. The reason that many of my freedom of information requests take a long time in most instances suggests that they simply do not know how to extract granular individual-level data and to anonymize it in a way that is not disclosive. Protecting the right to privacy of those whose data is being represented is important, but that obviously is a barrier for the research community. We would not want to be in a world where access to data is available only to some private sector players and some people in government. This is why, I expect, in not too long, that there will be a discussion of privacy as a policy parameter. Neither too much privacy nor too little is desirable, in my opinion.

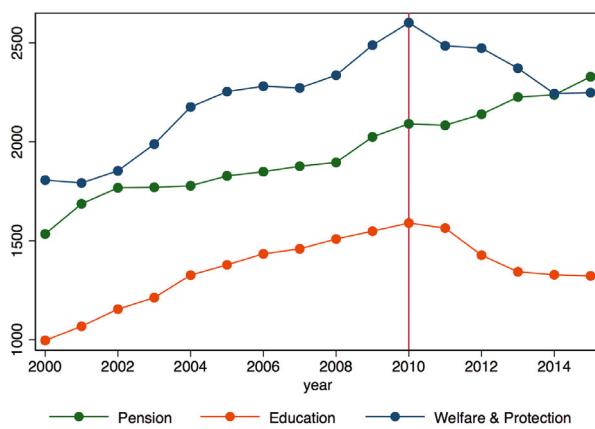
The internal organization of government is also a central challenge, as governments and executive branches of ministries are organized in silos with limited inter-operation, communication, and cooperation. The Cabinets are organized in silos, which makes combining and merging data necessary to design good policy options really difficult. This brings us to the challenge of systems competition. In my experience working with governments, I have seen data rooms hosted in countries that I would describe as being quite far from Western notions of (representative) democracy. Based on my observations, concerns about data governance are very strongly founded. Looking forward, I believe this is where Western societies need to develop an alternative view and significantly up their game.

Austerity as a signature zero-sum policy

Austerity is a signature zero-sum policy that showcases many of the aforementioned issues. The specific design of the UK's implementation of austerity was very much informed by ideology, shaky cross-country

empirical evidence, and cross-country regressions that I do not think uphold the quality standards of modern applied economics research. They would not stand up to scrutiny. And that, I think, is an important qualifier. Austerity, in particular how it was implemented in the UK, reflected the political realities of the time: old people turn out to vote while young people are disengaged (voluntarily or involuntarily, which is a different question). In terms of welfare reforms from 2010 onwards, we have seen a realignment of government spending along the age divide. Pension spendings have continuously increased, while spending that benefits younger generations (education) was drastically cut and increasingly privatized through higher tuition fees. This was followed by drastic cuts in welfare and protection spending, which mostly benefits the current working generation (see Figure 1). Those policies hit the poorest regions the hardest and exacerbated the existing divide. Those policies ticked all the boxes of what you would expect for the implementation of austerity. Looking at the data, it is consistent with what one would expect in a society that is organized by those who vote: those who turn out to vote get to have their say and influence policy.

Figure 1: Composition of Government Spending in GBP Per Capita in the UK (2000–2015)



Source: Fetzer (2019)²

2 Fetzer, Thiemo, 2019. "Did Austerity Cause Brexit?" *American Economic Review*, 109(11): 3849–86.

Now, what were the effects of these austerity policies? I have written a paper that I think very cleanly separated and showcased how austerity basically caused Brexit through a range of mechanisms.³ The most important mechanism is that due to austerity, sub-national politics in the UK evolved in a way that created the political pressures inside the Conservative party to put a referendum on the table in the first place. The vote that swung in favor of Brexit was quantified to around 10 percentage points, directly attributable to austerity, which is the signature of populist politics. The marginal voter was very much an accidental Brexiteer, someone who wanted to send a message, whereas the average pro-Brexit voter was one of those old signature demographic groups that we tend to associate with support for populism and nationalism. What we saw was the coalition bringing both of these groups of voters together during the campaign, which ultimately swung the result in their favor.

The bigger context is the economic challenges, and I argue that the welfare state as it was designed was just a Band-Aid for a larger, systemic problem. As seen in Figure 2, for low-skilled people, there has been a drastic decline in labor income that was stabilized by an expansion of benefit payments up to the point when austerity essentially put a halt to it. The cuts in the welfare state put the acceleration of benefit payments on hold, which resulted in a decline in gross incomes, eventually leading to polarization. This polarization is driven by many factors across the skill divide and can be observed across regions, age groups, skills groups, and ethnic groups, resulting in an increasing stratification of society.

The welfare state was a Band-Aid. Austerity ripped off that Band-Aid and Brexit was the consequence of it. And Brexit's legacy is the fact that the pain continues and the pain endures.

In a recent paper, I looked at the economic consequences of Brexit across regions.⁴ Not only did austerity give rise to Brexit, but the empirical evidence also suggests that the alleged cure may be making matters worse. Brexit led to a culling of small and medium-sized enterprises, a collapse in trade relationships, and a more concentrated and hence less competitive market. This was followed by the COVID-19 pandemic, which created a

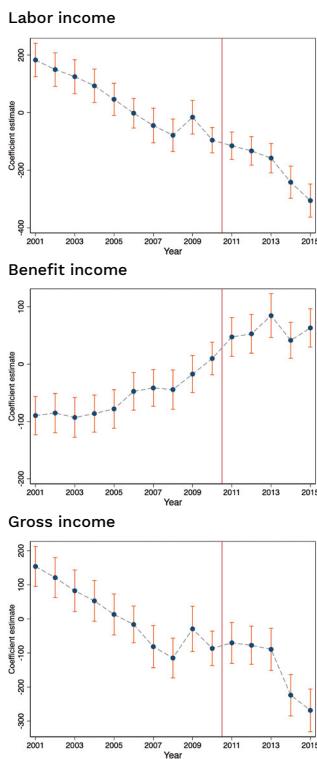
3 See Fetzer 2019, *ibid.*

4 See Fetzer, Thiemo and Wang, Shizhuo. 2020. "Measuring the Regional Economic Cost of Brexit: Evidence up to 2019". CAGE, Working paper no. 486.

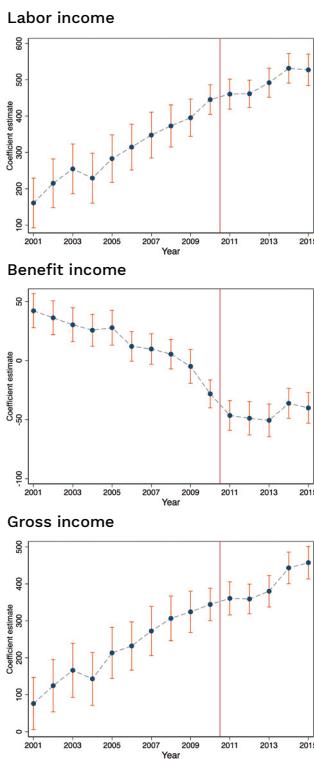
shock in international science collaboration that affected researchers and their work. Overall, the cure seems to be worse than the disease and it is estimated that any benefits of Brexit will not appear before 2050. Since the vote, the narrative has been completely shifted around, and this is why I argue it is so important to study the unintended consequences of policies rigorously and carefully. This requires a careful distinction of quantitative as well as qualitative work. As argued earlier, policymakers cannot deny evidence, at least in (somewhat) liberal democracies such as the UK, and high-quality research that is hard evidence and sheds light on unintended consequences in near real time can inform the policymaking process and become an effective constraint.

Figure 2: Erosion of the Welfare State was the Equivalent of Removing a Band-Aid

Panel A. Evolution of benefit and labor income for individuals with no qualifications



Panel B. Evolution of benefit and labor income for individuals with university degree



Source: Fetzer (2019)

With the change in the media landscape (i.e., professionalization of data journalism), informed research can constrain policymaking and serve as – and also reinvent – checks and balances. I am hoping to make a contribution here over the coming months and years.

Finally, it is crucial to remember that austerity itself is not a policy but rather a general reduction in government spending and that there are many ways of implementing it. Curiously enough, many of the policies that have been lumped together under the austerity bundle can be rationalized (i.e., in the context of fighting climate change). One must therefore not be blindsided by austerity's big label and understand that the devil is in the detail. It is the duty of the economics profession to make sure it equips its graduates with the skillset to do the right thing, know where to find which literature to read, which data to use, and how to analyze it – skills many policymakers of our time lack.

I would like to end on a note that reflects my ongoing struggle. I do not think humans are genuinely bad. We are all shaped by our own experiences and preconceptions and many more things. How we read evidence and interpret what is happening in the world is shaped by many factors, and the last twenty years have seen drastic changes to how information is produced and how it is consumed. We should not lose sight of this as this may create noise. I am a firm believer that the world would be better with more dialogue, more data, and more hard research as this can produce less polarized debates. We should speak more with each other, rather than about each other. Researchers need to do more to actively explain their work. And I also sense that society may need to face some debates that it has actively shied away from for a long time. Consensual approaches to policymaking empowered or constrained by rigorous evidence, though, may require giving up some of the spoils that come with political power, i.e., control over political rents, that may mostly be information rents. Humanity is facing an existential crisis and we simply cannot afford to succumb to narcissism. Strengthening and re-building state capacity is vital. And since the Global North is ultimately asking the Global South not to follow its specific development path – owing to the carbon footprint that it entails – it is vital that the Global North pushes ahead. The onus is on us.