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First Trust

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Monday Morning Outlook

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The Good, Bad and Ugly of Austerity

Governments all over the world have hit the wall. It doesn't matter where we look: national, state and local government budgets are in crisis. This cannot continue. Major policy shifts are underway. The time for austerity has come.

There are three types of austerity. Good, bad, and ugly. Good austerity is the kind that puts the pain on the government sector. Bad austerity is the kind that tries to spread the pain across the public and private sectors. Ugly austerity is the kind that tries to put all the pain on the private sector.

The extent of the crisis first became apparent in Europe where governments have pushed taxation to the limit and then promised and spent even beyond that. Pensions are unaffordable, spending is out of control, and government regulations to try and keep it all glued together are unbearable.

The problems are now spreading to state and local government in America. So far, at least, the backlash against US federal government spending is political, not financial. The US government can still borrow at 3%, or less, for ten years. But Americans are looking around the world, and at their own state budgets, and seeing the eventual problems to come.

The problem is that taxation can only go so far. No matter how many government programs are deemed "necessary" and a fundamental right of "social justice," the economy can only support so much redistribution before falling apart.

Ugly austerity comes in the form of higher taxes. It requires workers and investors to transfer more resources to the government today, so that the government can continue to transfer money to politically favored groups. In a way, policymakers who favor this course of action are saying that in order to avoid higher taxes in the future we should just start paying higher taxes today. (What a bargain!)

The other problem with this course – which is what will happen in the U.S. at the start of next year if all or part of the 2001/03 tax cuts are allowed to expire – is that economists across the political spectrum agree that higher taxes will slow economic growth compared to what it would otherwise be. Maybe that's why several Congressional Democrats have recently gone public with their opposition to raising tax rates next year.

Higher taxes, by cutting growth, don't generate as much revenue as estimated. A vicious cycle of higher taxes, slower growth, more debt, and even higher taxes is the result.

Bad austerity mixes in spending cuts. Prominent examples of this can be seen in Europe. In the United Kingdom, spending is being cut back, but the value-added tax is going up by 2.5 percentage points to 20%. Greece did a mixture as well. The problem in Europe, and in many US states, is that spending is so high already that taxation cannot possibly pay for it all. Many of these government entities have already gone into a death spiral, where tax rates are already too high and higher tax rates end up reducing the size of the economy.

This leaves good austerity, which comes in the form of spending cuts, which quite literally force policymakers to transfer fewer resources to those they favor. Politically this is very difficult, but the real argument against it is economic.

Keynesians (like Paul Krugman) argue that spending cuts hurt the economy. But nothing could be further from the truth. The benefit of spending cuts is that they can set off a virtuous cycle, reducing expectations of future taxes while invigorating the incentive to participate in the private sector. Every dollar less in government spending, whether financed by taxation or borrowing, means a dollar more in private sector spending. This is unambiguously positive for the macro-economy. Of course, those who have counted on government for business or transfer payments do not see it this way.

But voters and taxpayers, who were not around when promises were made, don't feel beholden to support them. This is why political pressure to hold the Bush tax cuts in place is so plainly visible. The age of austerity for government has arrived. The only question is what form that austerity will take.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-26 / 9:00 am	New Home Sales – Jun	0.311 Mil	**0.325 Mil**	0.330 Mil	0.300 Mil
7-27 / 9:00 am	Consumer Confidence - Jul	51.0	**48.4**		42.9
7-28 / 7:30 am	Durable Goods – Jun	+1.0%	**+1.0%**		-0.6%
7:30 am	Durable Goods (Ex-Trans) - Jun	+0.4%	**+0.7%**		+1.6%
7-29 / 7:30 am	Initial Claims - Jul 24	460K	**457K**		464K
7-30 / 7:30 am	Q2 GDP Second Report	+2.5%	**+3.4%**		+2.7%
7:30 am	Q2 GDP Chain Price Index	+1.1%	**+0.8%**		+1.1%
8:45 am	U. Mich. Consumer Sentiment	67.0	**67.0**		66.5
9:00 am	Chicago PMI – Jul	56.0	**58.4**		59.1