The Crash of Austerity Economics

Reality keeps contradicting the sponsors of economic pain, but they keep dispensing their perverse advice.

BY J.W. MASON, ARJUN JAYADEV OCTOBER 8, 2019

THANASSIS STAVRAKIS/AP PHOTO

In a formerly busy Athens shopping arcade, closed stores are padlocked against a backdrop of hanging Greek flags, March 2017. Austerity measures left thousands of businesses shuttered across the country.

Austerity: When It Works and When It Doesn't

By Alberto Alesina, Carlo Favero, and Francesco Giavazzi

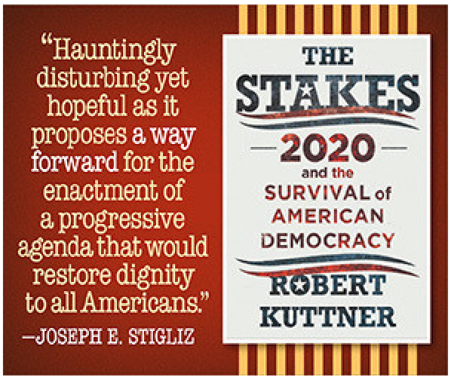
Princeton University Press

A decade ago, Alberto Alesina was one of the most influential economists in the world. His theory of "expansionary austerity"—the paradoxical notion that reducing public expenditure would lead to an increase in economic activity—was one of the hottest ideas in macroeconomics. He claimed to have shown that government surpluses could actually boost growth, but only if they were achieved via spending cuts rather than tax increases. At a moment when many governments were seeking Keynesian remedies to a global recession, his work (along with fellow Harvard economist Silvia Ardagna) reassured conservatives that there was no conflict between keeping up demand in a crisis and the longer-term goal of reining in the public sector. Not surprisingly, his ideas were taken up by right-wing politicians both in Europe and in the U.S., where he was widely cited by the Republicans who took control of the House in 2010. Along with the work of Carmen Reinhart and Kenneth Rogoff on the supposed dangers of excessive government debt, Alesina's work provided one of the key intellectual props for the shift among elite policymakers toward fiscal consolidation and austerity.

Right from the outset, other economists pointed to serious flaws in the case for expansionary austerity, and challenged almost every aspect of the statistical exercises underlying it. A partial list of criticisms includes: using inappropriate measures of fiscal balance; misapplying lessons from boom times to periods of crisis; misclassifying episodes of fiscal expansion as austerity; and generalizing from the special conditions of small open economies, where exchange rate moves could cushion the effects of austerity. The central claim—that austerity based on spending cuts worked better than tax-based austerity—was effectively debunked.

In 2009, Alesina suggested that Europe was likely to see faster growth because it was cutting public spending in response to the crisis, while the U.S. had embraced conventional Keynesian stimulus. But while the U.S. recovery was weak, in Europe there was hardly any recovery at all. In the countries that cut public spending the most, such as Spain, Portugal, and Ireland, GDP remained below its 2008 peak four, five, even six years after the crisis. By 2013, the financial journalist Jim Tankersley could offer an unequivocal verdict: "No advanced economy has proved Alesina correct in the wake of the Great Recession."

Macroeconomic debates have moved on since then. A large new empirical literature on fiscal policy has emerged over the past decade, the great majority of it confirming the old Keynesian wisdom that in a depressed economy, increased public spending can raise output by perhaps $1.50 for each dollar spent. New questions have been raised about central banks' ability to stabilize the economy, whether with conventional monetary policy or with new tools like forward guidance and quantitative easing. The seemingly permanent reality of low interest rates has changed the debate over the sustainability of government finances, with prominent mainstream economists suggesting that public debt no longer poses the dangers it was once thought to. The revived idea of secular stagnation has suggested that economic stimulus may not be a problem for occasional downturns, but an ongoing necessity. And the urgency of climate change has created big new tasks for the public sector.



It's a very different conversation from a decade ago. Can Alesina's ideas adapt to this new environment?

That's the challenge for his new book, *Austerity: When It Works and When It Doesn't*, which brings together work on government budgets that goes back now almost three decades. Through the years, Alesina has had a rotating cast of co-authors, often from Bocconi University; this book is co-authored with Carlo Favero and Francesco Giavazzi, both professors there. Given how the book has been advertised and promoted ("towering," a "counterblast"), one might expect a thorough response to the new arguments that have developed over the past decade about aggregate demand management and the appropriate size of the public sector, not to mention the failure of Alesina's past predictions.

Disappointingly, this is not the case. There has been no marking of beliefs to market. For the most part, the book restates the same arguments that were made a decade ago: Countries with high public debt must adopt austerity, and this will not hurt growth if it takes the form of spending cuts rather than tax increases. Alesina et al. do make some effort to respond to specific methodological criticisms of the earlier work. But they don't engage with—or even acknowledge—the larger shifts in the landscape. Tellingly, all the book's formal analysis and almost all of its text (as well as the online data appendix) stop in 2014. For what is supposed to be a definitive statement, it's an odd choice. Why ignore everything we might learn about austerity and government budgets over the past five years? The book also operates at an odd mix of registers, which makes it hard to understand who the audience is. Exoteric chapters seemingly intended for a broad readership are interspersed with math-heavy esoteric chapters that will be read only by professional economists. You get the feeling this is mostly material that sat in a drawer for a long time before being fished out and stapled together into a book.

To be fair, there are some advances from the previous iterations. Instead of relying on purely statistical measures of association between fiscal positions and growth, the book offers some case studies, and makes use of a "narrative" approach in which periods of austerity are defined by the stated intentions of policymakers and not just by changes in the budget. But this is no substitute for a real historical analysis, and the great bulk of the argument is still based on statistical exercises.

Those who are not convinced by the econometrics in Alesina's earlier work will not be convinced here either. Even people who share the authors' commitment to rolling back the public sector will soon suspect that they are in the presence of what is politely called motivated reasoning.

For Alesina and colleagues, austerity episodes almost always reflect countries persistently spending beyond their means, with debt rising until a tipping point is reached. But in Europe—surely ground zero in any discussion of contemporary austerity—this story lacks even superficial plausibility. On the eve of their crises, Ireland, Spain, and even Portugal had debt/GDP ratios below that of unscathed France; Spain and Ireland were well below Germany. (The fact that Germany consistently ran large deficits in the decade before the crisis is not mentioned.) Indeed, until 2011 Ireland, now an austerity poster child, had the lowest debt ratio of any major Western European country.

The crisis came first, then the turn to austerity; big deficits were a response to the downturn, not precursors to it; the rising debt ratios came last, driven mainly by falling GDP. Even Greece, perhaps the one country where public finances were a genuine problem before the crisis, is a case in point: From 2010 to 2015, deep cutbacks in public services successfully reduced public debt by about 15 billion euros, or 5 percent—but the debt/GDP ratio still rose by 30 points, thanks to a collapse in GDP.

It would be easy to debate the book point by point. But it's more useful to take a step back and think about the larger argument. While the book shifts erratically in tone and subject, underlying all of its arguments—and the larger pro-austerity case—is a rigid logical skeleton. First, a government's fiscal balance (surplus or deficit) over time determines its debt/GDP ratio. If a country has a high debt to GDP, that is "almost always … the result of overspending relative to tax revenues." Second, the debt ratio leads to market confidence in the government's debt; private investors do not want to buy the debt of a country that has already issued too much. Third, the state of market confidence determines the interest rate the government faces, or whether it can borrow at all. Fourth, there is a clear line where high debt and high interest rates make debt unsustainable; austerity is the unavoidable requirement once that line is passed. And finally, when austerity restores debt sustainability, that contributes to economic growth, especially if the austerity involves spending cuts.

If you accept the premises, the conclusions follow logically. Even better, they offer the satisfying spectacle of public-sector hubris meeting its nemesis. But real-world debt dynamics don't run along such well-oiled tracks.

PRESS ASSOCIATION VIA AP IMAGES

Londoners demonstrate against the British government's austerity measures, April 2016.

First of all, as a historical matter, differences in growth, inflation, and interest rates are at least as important as the fiscal position in determining the evolution of the debt ratio over time. Where debt is already high, moderately slower growth or higher interest rates can easily raise the debt ratio faster than even very large surpluses can reduce it—as many countries subject to austerity have discovered. Conversely, rapid economic growth and low interest rates can lead to very large reductions in the debt ratio without the government ever running surpluses, as in the U.S. and U.K. after World War II. More recently, Ireland reduced its debt/GDP ratio by 20 points in just five years in the mid-1990s while continuing to run substantial deficits, thanks to the very fast growth of the "Celtic Tiger" period. In situations like the European crisis, extraordinary actions like public assumptions of private debt or writedowns by creditors (as in Cyprus and Greece) can also produce large changes in the stock of debt, without any changes in spending or taxes. Ireland again is an example: The decision to assume the liabilities of private banks catapulted its debt/GDP ratio from 27 percent to over 100 percent practically overnight. Cases like this make a mockery of the book's claim that a country's debt burden reliably reflects its past fiscal choices.

At the second step, market demand for government debt clearly is not an "objective" assessment of the fiscal position, but reflects crowd psychology, self-confirming conventional expectations, and all the other pathologies of speculative markets. The claim that interest rates reflect the soundness or otherwise of public budgets runs up against a glaring problem: The financial markets that recoil from a country's bonds one day were usually buying them eagerly the day before. The same markets that sent interest rates on Spanish, Portuguese, and Greek bonds soaring in 2010 were the ones snapping up their public and private debt at rock-bottom rates in the mid-2000s. And they're the same markets that are setting interest rates for those countries at historical low levels today (Greece now pays less to borrow than the U.S.!), even as their debt ratios, in many cases, remain extremely high. Alesina and colleagues get hopelessly tangled on this point. They want to insist both that post-crisis interest rates reflect the true state of public finances, and that the low rates before the crisis were the result of a speculative bubble. But they can't have it both ways: If low rates in 2005 were not a sign that the state of public finances was sound, then high rates in 2010 can't be a sign that they were unsound.

If the authors had extended their analysis significantly beyond 2014, this problem would only have gotten worse. What's really striking about interest rates in Europe in recent years is how uniformly they have declined. Ireland, which has managed to reduce its debt ratio by 50 points since 2010, today borrows at less than 1 percent. But so does Spain, whose debt ratio increased by almost 40 points over the same period. The claim that interest rates are mainly a function of a country's fiscal position just doesn't fit the historical experience. It's hard to exaggerate how critical this is for the whole argument. Rising interest rates are the only cost ever mentioned for high debt, and hence the only reason for austerity; and reducing interest costs is the only intelligible mechanism on offer for the supposed growth-boosting effects of austerity—vague invocations of "confidence" don't count.

And this brings us to the third step. One of the clearest macroeconomic lessons of the past decade is that market confidence doesn't matter: A determined central bank can set interest rates on public borrowing at whatever level it chooses. In the years before 2007, there were endless warnings that if the U.S. did not get its fiscal house in order, it would be faced with rising interest rates, a flight from the dollar, and eventually the prospect of default. (In 2005, Nouriel Roubini and Brad Setser were bold enough to predict that unsustainable deficits would lead to a collapse in the dollar within the next two years.) Today, with the debt ratio much higher than even the pessimistic forecasts of that period, the federal government borrows more cheaply than ever. And there hasn't been even a hint of the Fed losing control of interest rates. Similar stories apply around the world. Perhaps the clearest illustration of central banks' power over financial markets came in 2011–2012, when a series of interventions by the European Central Bank—culminating in Mario Draghi's famous "whatever it takes" moment—stopped the sharp spike in southern European interest rates in its tracks. With an implicit guarantee from their central banks—which other developed countries like the U.S. and U.K. also enjoy—governments simply don't need to worry about losing access to credit. To the extent that governments like Greece remained locked out of the markets after Draghi's announcement, this was a policy choice by the ECB, not a market outcome.

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If countries can face financial crises even when their debt ratio is low, and can enjoy ultra-low interest rates even when they are high, then it's hard to see why the debt ratio should be a major object of policy. Alesina's central question—whether expenditure-based or tax-based austerity is better for growth—is irrelevant, since there's no good reason for austerity at all.

In a world of chronically low interest rates and active central banks, government debt just isn't a problem. At one point, this was a fringe position, but today it's been accepted by economists with as impeccable mainstream credentials as Olivier Blanchard, Lawrence Summers, and Jason Furman—the former chief economist of the IMF, Treasury secretary, and chair of the Council of Economic Advisers, respectively. But not by Alesina and colleagues, who just go on singing their same old songs.

"Sound finance" is no longer the pillar of elite opinion it once was. As we write this, Christine Lagarde, the new head of the European Central Bank, is calling for European governments to spend more during downturns—something hard to imagine when Alesina's ideas were in vogue. In the U.S., meanwhile, concerns about the federal debt seem almost passé.

This is progress, from our point of view. The intellectual case for austerity has collapsed, and this book will do little to rebuild it. But that has not yet led to an expansion of public spending—let alone one large enough to restore genuine full employment and meet the challenge of climate change and other urgent social needs. The austerity machinery of the euro system and IMF still churns away, grinding out misery and unemployment across southern Europe and elsewhere, even if it no longer commands the general assent that it once did. At the level of ideas, Keynesian economists can point to real gains in the decade since the crisis. At the level of concrete policy, the work has barely begun.

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J.W. MASON

J.W. Mason is assistant professor of economics at John Jay College, CUNY and a fellow at the Roosevelt Institute.

ARJUN JAYADEV

Arjun Jayadev is professor of economics at Azim Premji University and senior economist at the Institute for New Economic Thinking.

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