Has austerity been vindicated?

By Robert Skidelsky
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A correlation between fiscal retrenchment and economic growth tells us nothing about the underlying relationship between the two. This should be borne in mind in light of new research suggesting that austerity may well be the right policy in a recession.

Harvard University Professor Alberto Alesina has returned to the debate on budget deficits, austerity, and growth. Back in 2010, Alesina told European finance ministers that "many even sharp reductions of budget deficits have been accompanied and *immediately followed* by sustained growth rather than recessions *even in the very short run*" (my italics). Now, with fellow economists Carlo Favero and Francesco Giavazzi, Alesina has written a new book entitled Austerity: When It Works and When It Doesn't, which recently received a favorable review from his Harvard colleague Kenneth Rogoff.

New book, old tune. The authors' conclusion, in a nutshell, is that "in certain cases the direct output cost of spending cuts is more than compensated for by increases in other components of aggregate demand." The implication is that austerity – cutting the budget deficit, not expanding it – may well be the right policy in a recession. Alesina's previous work in this area with Silvia Ardagna was criticized by the International Monetary Fund and other economists for its faulty econometrics and exaggerated conclusions. And this new book, which analyzes 200 multi-year austerity plans carried out in 16 OECD countries between 1976 and 2014, will also no doubt keep the number crunchers busy. But that is not the main point. Correlation is not causation. The association of fiscal retrenchment and economic growth tells us nothing about the underlying relationship between the two. Does shrinking the deficit cause economic growth, or does growth cause the deficit to shrink? All the econometrics in the world cannot prove that one caused the other, or that both may not be the result of something else. There are simply too many omitted variables – that is, other possible causes of either or both outcomes. So-called statistical proofs always start with a theory of causation, to which the data are "fitted" to get the result the theorist wants. Alesina's theory rests on two conceptual pillars. The main one is that if deficits persist, businesses and consumers will expect higher taxes and will therefore invest and consume less. Spending cuts, on the other hand, signal lower taxes in the future, and thus stimulate investment and consumption. The second, supplementary pillar is the assumption that rising public debt leads investors to expect a default. This expectation forces up interest rates on government bonds, leading to higher overall borrowing costs. Austerity, by stopping the growth of debt, can bring about a "sizeable reduction" in interest rates, and thus enable increased investment.

This supplementary case cannot be regarded as a general rule. If a country has its own central bank and issues its own currency, the government can cause interest rates to be whatever it wants them to be by ordering the central bank to print money. In this case, low interest rates will be the result not of austerity, but rather of monetary expansion. And this, of course, is what has happened with quantitative easing in the United States, the United Kingdom, and the eurozone. Interest rates have stayed at rock bottom for years as central banks have pumped hundreds of billions of dollars, pounds, and euros into their economies.

So we are left with Alesina's main pillar: a credible commitment to public spending cuts today will boost output by removing the

expectation of higher taxes tomorrow. The same argument explains why, on Alesina's view, it is better to reduce the deficit by cutting spending than by raising taxes. Spending cuts address the "problem" of "the automatic growth of [welfare] entitlements and other spending programs," whereas tax increases do not. Alesina writes: "Modern macroeconomics emphasizes that people's decisions about what to do today are influenced by their expectations of what will happen in the future." John Maynard Keynes, too, understood the crucial importance of expectations: he is credited by John Hicks with introducing the "method of expectations" into economics. However, Keynes's expectational map was very different from Alesina's. His investors do not form their expectations by looking at the government's deficit and calculating what effect it will have on their future tax bills. In fact, they scarcely notice the deficit at all. What they do notice is the size of their markets. For Keynes, entrepreneurs' decisions to create jobs depend on their expected income from increasing employment. An economic downturn reduces their expected sales proceeds, causing them to lay off workers. A cut in government spending implies that they can expect still fewer sales, causing them to lay off even more workers, thus deepening the recession. Conversely, a rise in government spending, or tax cuts, increases expectations of sales and so reverses the downturn. For example, if the demand for automobiles falls, fewer will be sold, and fewer workers will be employed in making them. If the government increases its spending on public works, this will not only employ more workers directly, but also increase the demand for automobiles, so the output of the economy grows by more than the government's extra spending, thus reducing the deficit.In very simple terms, therefore, we have two opposite theories of the appropriate fiscal policy in a slump. Keynes says an announced reduction in public spending signals to businesspeople that their incomes will be reduced because fewer people will be buying the goods and services they produce. But Alesina says that an announced reduction in public spending signals to businesspeople that they can expect lower taxes tomorrow, and therefore will spend more today. Readers must decide which theory they find more plausible. Personally, I much prefer the characterization contained in the recent book Austerity: 12 Myths Exposed: "Austerity is a tool of…financial interests – not a solution to the problems caused by them."

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