Revisiting the evidence on expansionary fiscal austerity: Alesina's hour?

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In a succinct piece written on June 30, 2010, Peter Coy, Business Week's Business Economics Editor summarized the influence on European policy makers of the work of Harvard Economist Alberto Alesina. Coy observes:

'Alberto Alesina is a new favourite among fiscal hawks…This is Alesina's hour. In April (2010) in Madrid, he told the European Union's economic and finance ministers that "large, credible and decisive" spending cuts to rescue budget deficits have frequently been followed by economic growth. He was…influential enough to be cited in the official communiqué of the EU finance minister's meeting'.[2]

Alesina also seems to have influenced the former President of the European Central Bank (ECB) Jean Claude-Trichet who observed:

"It is an error to think that fiscal austerity is a threat to growth and job creation. At present, a major problem is the lack of confidence on the part of households, firms, savers and investors who feel that fiscal policies are not sounc and sustainable".[3]

The UK Treasury was not immune either. Jonathan Portes notes:

'Alesina … was particularly influential …and even (tentatively and briefly) influenced the (UK) Treasury here, who argued in the 2010 Emergency Budget that "These [the wider effects of fiscal consolidation] will tend to boost demand growth, could improve the underlying performance of the economy and could even be sufficiently strong to outweigh the negative effects".[4]

Christina Romer, who, in her capacity as Chair of the President's Council of Economic Advisors, led the design of the US Government's fiscal stimulus package to cope with the Great Recession of 2008-2009, acknowledges that Alesina's co-authored paper became 'very influential'. Somewhat exasperated, she declares: 'And every one has been citing it'.[5] Nobel Laureate Paul Krugman makes the same point in his high profile blog.[6]

Is this really 'Alesina's hour'? Is there unambiguous evidence of expansionary fiscal austerity? To borrow an emphatic expression from Alesina, the answer is a 'loud no' even if one overlooks the methodological critique of his work and even if one overlooks the ambivalent nature of the economics underpinning the thesis of 'expansionary fiscal austerity'.

Our point is that, contrary to what is popularly reported, Alesina merely demonstrates that, in some cases, one cannot detect a contractionary impact of fiscal austerity. As Alesina he notes: '…sometimes, not always, some fiscal adjustments based upon spending cuts are not associated with economic downturns.'[7]. It is unfortunate that such a modest proclamation made by the author has been overlooked by the cheerleaders of fiscal consolidation and, at times, even by the critics. For example, Romer writes that the much-cited study '..finds that output tended on average to rise after (fiscal) consolidations, particularly those focused on reductions in government spending' (p.18).[8]. This statement exaggerates Alesina's own summary of his findings.

We have critically evaluated the hypothesis of 'expansionary fiscal consolidation' in our previous voxeu commentaries.[9] We intend to revisit the thesis from two perspectives. First, we assume that Alesina – and his co-author's contributions – are methodologically sound and based on robust empirical evidence. We point out that, even in this best case scenario, the thesis of 'expansionary fiscal austerity' is found to be valid in a minority of cases. We then briefly review the methodological critique of Alesina's work. Such critique ranges from elementary factual errors in at least one of the historical case studies that have been undertaken by the author and his collaborators (Australia) to the pitfalls that follow from 'omitted variables' when studying the impact of fiscal policy on aggregate economic activity.

We conclude by suggesting that the findings of Alesina and his collaborators resonate so strongly with at least some policy makers because of an ideological aversion to counter-cyclical fiscal policy. This ideological aversion is reinforced by lack of accountability among technocrats who design policy experiments based on fragile evidence but are typically not held accountable for the consequences of such experiments.

The study that 'everyone has been citing' pertains to Alesina and Ardagna (2009). A predecessor is Alesina and Ardagna (1998);[10] Alesina (2010) provides a summary in the so-called Madrid paper which became part of the official communiqué of the EU finance ministers meeting of April 2010.

The 1998 Alesina-Ardagna study focuses on ten cases of fiscal adjustments. The 2009 study is broader and focuses on 107 periods of fiscal adjustment.[11] It draws on 21 OECD countries from 1970 to 2007. Hence, there are 5.1 episodes per country. Given that the 2009 study, rather than the 1998 study, seems to have influenced contemporary debates on fiscal policy, we will focus on summarizing findings of the 2009 study but refer to the 1998 paper when reviewing the views of the critics.

There are three key conclusions of the 2009 study. First, there are 21 cases (from a total of 107) of successful fiscal adjustment (that is, debt-to-GDP ratios decline by more than 4.5% of GDP). Second, there are 26 cases (from a total of 107) of 'expansionary fiscal adjustments'. Third, in terms of countries, 10 (out of 19) countries experience 'successful fiscal adjustments', while nine (out of 19) experience 'expansionary fiscal adjustments'.[12]

It is thus clear that in a minority of cases (24.3% of sample or 26 out of 107) can one conclude that fiscal adjustment has been associated with an output expansion. Not surprisingly, Alesina and his collaborators are careful in the way that they couch their conclusions: '…we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions' . Yet, influential media commentators gloss over this nuanced conclusion. One is told that 'Alberto Alesina has …found that, in many cases, large and decisive deficit reduction policies were followed by increases in growth, not recessions'.[13] It is not necessary to belabour the point that 'several episodes' is not synonymous with 'many cases'.[14]

There are several interesting and intriguing features that stand out in the work undertaken by Alesina and his co-authors. First, the 1998 study, focusing on 19 OECD countries and covering the 1960-1994 period, delivers somewhat stronger results: there are 51 episodes of fiscal adjustments; out of this 19 are 'successful' and 23 that are 'expansionary'. The 1998 study is also noteworthy for providing country-specific details on 10 cases of fiscal adjustments. One of the countries, covered in depth happens to be Australia which is classified as a 'clear case' of 'expansionary fiscal contraction'. Unfortunately, as John Quiggin, a leading Australian economist points out, this case is also marred by elementary factual errors.[15] Perhaps it is not surprising that Australia does not feature as a case of 'expansionary fiscal adjustment' in the 2009 study.

It is also worth pointing out that the 2010 Madrid paper that summarizes the results of the 2009 paper does not specify the number – either in relative or absolute terms – of successful cases of fiscal adjustment. The paper also contains contradictory conclusions. For example, on page 3 it states, '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'. While this is rather strong and hints causality, on page 5, it notes, '...In several episodes spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions'. This is much more modest with a focus on 'association' rather than 'causality'. We know that 'several' is not the same as 'many'. The 2010 paper does not allow the reader to judge whether to use 'several' or 'many' as the qualifier as the numbers are not given.

This is particularly important because of the influence that the 2010 Madrid paper wielded in European policy-making circles. Had it been made explicit, and had it been made amply clear in media commentaries that one can detect an association (but not proven causality) between fiscal austerity and lack of economic downturns in a minority of cases, perhaps it would have discouraged confident proclamations by some policy-makers.
There are, by now, growing critiques of the Alesina-Ardagna findings. Ironically, it is the IMF, normally regarded as a custodian of fiscal prudence that has made headlines in developing its methodological critique of 'expansionary' fiscal consolidation. The Economist has drawn on the IMF critique to dismiss the view that fiscal consolidation today would be 'painless' as 'wishful thinking'.[16] One of the associates of Alesina, Roberto Perotti admits that "IMF criticism … is correct in principle and represents an important potential advance'.[17]
One of the consequences of this methodological inadequacy is that it over estimates the expansionary impact of spending cuts and downplays the contractionary effects. Thus, using an alternative methodology, the IMF (WEO, 2010) finds that fiscal consolidation equal to 1% of GDP typically reduces GDP by about 0.5% within two years and raises the unemployment rate by about 0.3 percentage point. Domestic demand—consumption and investment—falls by about 1%.[18]
Recent IMF research[19] using data from the past 30 years found that fiscal consolidation raised both short-term and long-term unemployment, with its impact on long-term unemployment was much greater, hurting wage-earners disproportionately more than profit- and rent- earners. Thus, it concludes, "slamming on the brakes [fiscal consolidation] too quickly will hurt the recovery and worsen job prospects. Hence the potential longer-run benefits of fiscal consolidation must be balanced against the short- and medium-run adverse impacts on growth and jobs"
Even if one accepts that fiscal consolidation exercises have a reasonable chance of being accompanied by growth and employment creation, one should not attribute such an outcome to budgetary austerity alone. This is where pitfalls stemming from 'omitted variables' become critical. There are often complementary factors at work that might be more important than fiscal actions. They include: (1) the influence of the global and regional business cycle, (2) monetary policy, (3) exchange rate policy and (4) structural reforms. Indeed, when Arjun Jayadev and Mike Konczal from the Roosevelt Institute recalibrate the Alesina-Ardagna dataset to take account of growth conditions preceding a fiscal adjustment, they find that in most of the 26 cases of 'expansionary' fiscal adjustment, restrictive policy actions were preceded by above-average growth. This substantiates Keynes' dictum delivered more than 70 years ago that the best time to implement a fiscal austerity programme is during a boom rather than a slump. This is the essence of counter-cyclical fiscal policy.[20]

It is also well-known that fiscal retrenchments can be combined with loose monetary policy to offset recessionary consequences. Similarly, the idea of combining fiscal retrenchments with devaluation that boosts net exports to offset the decline in aggregate demand (so-called "expenditure reducing policies" combined with "expenditure switching policies") is well known. Such benefits of competitiveness can be reinforced by wage moderation policies negotiated through a bargaining process. Furthermore, the expansion that accompanies fiscal consolidation might well arise from structural reforms that alleviate binding constraints on growth.

The importance of these enabling factors needs particular attention in light of current circumstances. To start with, the post-crisis economic recovery in the rich world is rather weak. The Euro zone is poised for a 'double dip recession' as is the UK.[21] Hence, the regional/global business cycle is not conducive enough for fiscal consolidation to work. The Euro zone economies also do not have scope for devaluations nor do they have much room to cut interest rates further through expansionary monetary policy as policy rates are still at historically low thresholds. These points are highlighted by Roberto Perotti (2011), a co-author of Alesina. He makes the important observation that even if one can demonstrate that fiscal consolidations in the past worked in some cases, they are unlikely to work today because the aforementioned enabling factors are not present.[22]

If the findings of Alesina and his collaborators are typically nuanced and modest, and if such modest findings are subject to considerable criticism, why did it resonate so much with policy-makers, especially in Europe? It beggars belief to suggest that influential commentators and technocrats who are in charge of fiscal policy design are unaware of the various concerns raised here. One plausible answer lies in collective and wilful ignorance driven by an ideological aversion to counter-cyclical fiscal policy because fiscal interventions are seen as an enlargement and encroachment of the state on the functioning of the private sector. As Simon Wren-Lewis (2011) points out, and as Romer (2011)concurs, one can find eminent economists objecting to counter-cyclical fiscal policy based on ideological proclivities, even though such economists support the idea of using monetary policy to stabilize business cycles. The irony is that the use of monetary policy is as much a case of state intervention as is fiscal policy![23] The net result, argues Wren-Lewis, is that by 2010, policy makers in various countries, especially in the rich world, switched prematurely to debt and deficit reductions even though the recovery from the global recession of 2008-2009 was rather weak. Political actors in positions of authority listened to Alesina because they wanted to listen to him.

There is an additional point that one can make. Policy experiments based on fragile evidence and tenuous economics can be undertaken by technocrats because they do not have to bear the consequences of their experiments. During the 1997 Asian financial crisis, for example, the IMF conceded that it made some strategic errors in advising national governments on how to cope with the financial crisis.[24] The costs of such errors, then and now, were borne by ordinary citizens, but also by some national politicians. The technocrats did not suffer reputational damage nor did they lose their privileges and positions. In such an environment, costly policy experiments can be based on dubious evidence and questionable economics.

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[2] Coy, Peter (2010) 'Keynes vs Alesina. Alesina Who?' Bloomberg Business Week, June 30

[3] See European Central Bank, Interview with Jean-Claude Tritchet, President of the ECB, and Liberation, July 8 2010

[4] Portes, Jonathan (2011) 'What does "Keynesian" mean'?, Not the Treasury View Blog (http://notthetreasuryview.blogspot.com/), January 27, 2012.

[5] Romer, Christina (2011) 'What Do We Know About the Effects of Fiscal Policy: Separating Evidence from Ideology', Lecture Delivered at Hamilton College, November 7, p.17

[6] Krugman, Paul (2010) 'Alesina on Stimulus', February 6, http://krugman.blogs.nytimes.com/2010/02/06/alesina-on-stimulus/

[7] Alesina, Alberto (2010) 'My Answer to the Economist' http://www.economics.harvard.edu/faculty/alesina/Alesina

[8] Romer (op.cit)

[9] "The fallacy of austerity-based fiscal consolidation", August 2, 2010, http://www.voxeu.org/index.php?q=node/5312; "Fiscal consolidation, growth and employment: what do we know? ", June 21, 2010, http://www.voxeu.org/index.php?q=node/5216

[10] Alesina, Alberto and Ardagna, Silvia (1998) 'Tales of Fiscal Adjustment', Economic Policy, October, pp.498-545. Alesina, Alberto and Ardagna, Silvia (2009) 'Large Changes in Fiscal Policy: Taxes Versus Spending', National Bureau of Economic Research (NBER), Working Paper No. 15438. Alesina, Alberto (2010) 'Fiscal Adjustments: Lessons from Recent History', Prepared for the Ecofin Meeting in Madrid, April 15. A Google search shows 143 citations for the 2009 paper and 387 citations for the 1998 paper.

[11] They also study 91 cases of fiscal stimuli but the results are not discussed here.

[12] See Alesina-Ardagna (2009: Tables A1 and A2, appendix) for the full classification.

[13] Brooks, David (2010) 'Prune and Grow', New York Times, June 10

[14] Kayne, Richard S. (2007) 'Several, Few and Many', Lingua, 117(5), pp.832-858

[15] Quiggin, John (2012) 'Tales of austerity ring hollow, Australian Financial Review, February 16

[16] The Economist (2010) ‘Does Fiscal Austerity Boost Short-Term Growth? A New IMF Paper Thinks Not’, September 30. Alesina was clearly stung by the Economist’s airing of the IMF critique and decided to write a detailed response. We quote from that response in the text.

[17] Perotti, Roberto (2011). ‘The “Austerity Myth”: Gain Without Pain?’ paper
produced as part of the project “Growth and Sustainability Policies for Europe” (GRASP)

[18] IMF (2010). “From stimulus to consolidation: revenue and expenditure policies in advanced and emerging economies”. Washington DC: IMF. April 30.

[19] Ball, Laurence, Daniel Leigh, and Prakash Loungani (2011). ‘Painful medicine’. Finance & Development September 2011.

[20] Jayadev, Arjun and Konczal, Mike (2010) ‘The Boom Not the Slump: The Right Time For Austerity, August 23, The Roosevelt Institute. In fact, Keynes himself did not rule out completely the possibility of expansionary fiscal consolidation. His 1930 report, as a Chair of the Committee of Economists, a specialist subgroup of the Economic Advisory Council (EAC), to the Labour Government of Ramsey MacDonald, did acknowledge that “[s]o far as home investment is concerned, we would put in the forefront the restoration and maintenance of a state of business confidence”; but it also noted “[t]he best means of restoring business confidence is a psychological problem on which the opinion of this Committee is not likely to be specially valuable”. What is implied here is that i the ‘confidence fairy’ does come with its magic wand, the rise in investment may outweigh the decline in consumption and government expenditure to create an expansionary impact; but the panel of economists, which included the heavy-weights of the time, Pigou, Stamp, Robbins and Henderson, did not have much clue as to how to court the confidence fairy.

[21] OECD (2011) Economic outlook, 2011/2012, November

[22] Perroti, Robert (2011). “The “Austerity Myth”: Gain Without Pain?”. Paper produced as part of the project “Growth and Sustainability Policies for Europe” (GRASP), funded by the European Commission’s Seventh Research Framework Programme, contract number 244725

[23] Wren-Lewis, Simon (2011) “Lessons from failure: fiscal policy, indulgence and ideology”, National Institute Economic Review No.217, July, pp.R1-R16.

[24] Islam, Iyanatul and Chowdhury, Anis (2000) The Political Economy of East Asia: Post-Crisis Debates, Melbourne and Oxford: Oxford University Press