Austerity Can Kill You

Domenico Mario Nuti, July 9, 2013

In 1962 the RCP (Royal College of Physicians) published a Report on *Smoking and health* in the UK. Using research by Sir Richard Doll and Sir Austin Bradford Hill, the Report established conclusively the link between smoking - including passive smoking - and lung cancer, other lung diseases, heart disease and gastrointestinal illnesses. It caused a sensation, and received an ambivalent, often hostile response from the media, governments and society. In 1962 tobacco "smoking was omnipresent, accepted, established." "[In the UK] around 70% of men and 40% of women smoked". It was "a world suffocated by the swirling clouds of tobacco" - "in pubs, cinemas, trains, buses, on the streets, and even in hospitals and schools." [from the RCP-Royal College of Physicians report on *Fifty years since* Smoking and Health *– progress, lessons and priorities for a smoke-free UK, 2012*].

Gradually government action reduced this phenomenon. By 2012 "... smoking is no longer the norm. Our schools, hospitals, pubs, cinemas and public transport are subject to smoke-free legislation. [In the UK] Only 21% of the population smokes. Government, media and society have largely accepted the need to protect people, particularly children, from much of the harm associated with tobacco smoke." Still, in the UK it took fifty years to achieve such a large reduction in smoking incidence. Smokers are still 21% of the population too many, they represent glaring evidence of either irrationality or addiction or both, and the persistence of vested interests by tobacco and cigarettes producers.

Austerity - aiming at a balanced government budget, reducing expenditure and raising taxation even in the middle of an economic recession - also has been the norm for a very long time, and still is enshrined in the statutory policies of EU and EMU, of IMF and ECB. Yet we have known at least since 1936 (with the publication of Keynes' *General Theory*), indeed since 1933-35 (the dates of Michal Kalecki's anticipations of Keynesian propositions, see Robinson 1976 and Nuti 2004) that austerity can cause unnecessary, involuntary unemployment of labour and irreversible losses of income and consumption.

In our time and age austerity is more incomprehensible than smoking, were it not for the irrational fear of inflation in the middle of a recession, the generalised addiction to hyper-liberal ideologies and the vested interests of those who think they benefit from labour unemployment keeping workers "in their place". What is worse, austerity today is much more widespread than smoking, it is on the rise and is officially supported by our national and international authorities more than it ever was, while at least smoking is steadily declining not least because of progressive health policies worldwide.

Feasible full employment

In 1943 Michael Kalecki could write that “A solid majority of economists is now of the opinion that, even in a capitalist system, full employment may be secured by a government spending programme, provided there is in existence adequate plant to employ all existing labour power, and provided adequate supplies of necessary foreign raw-materials may be obtained in exchange for exports”. As long, of course, as such government spending programme is “financed by borrowing and not by taxation”. Kalecki even dealt with the case of highly indebted countries, which also could afford and attract loans to finance government expenditure as long as interest was paid out of a capital levy.

Opposition to such a policy of full (meaning high and stable) employment would be political: "(i) opposition in principle to government spending based on a budget deficit; (ii) opposition to this spending being directed either towards public investment – which may foreshadow the intrusion of the state into the new spheres of economic activity – or towards subsidizing mass consumption; iii) opposition to maintaining full employment and not merely preventing deep and prolongued slumps". Such objections subside in the slump, and are revived in the boom, thus generating what Kalecki called a "political cycle" and a generally lower average degree of employment over such cycle than otherwise feasible.

But the feasibility of Kaleckian-Keynesian full employment policies soon ceased to enjoy the support of a "solid majority of economists". The effectiveness of expansionary fiscal policy was challenged on an escalation of arguments.

From deficit spending to expansionary fiscal consolidation

First, it was argued that government expenditure would "crowd out" private investment. This idea neglects the possibility of private investment on the contrary "crowding in" additional expenditure due to the activation of its accelerator effect of higher primary demand. On the contrary, Dennis Robertson (in a talk given at Princeton in 1953) argued that at least some of the additional savings out of the income generated by government spending would not represent a leakage but would be channeled into additional investment, and called this "the Kalecki effect".

Second, Ricardian equivalence was invoked, tentatively put forward by David Ricardo in the early 19th century and re-discovered by Robert J. Barro in 1974. When government expenditure is raised, funded by borrowing, economic agents discount the future payments of higher taxes that they anticipate having to pay to service the higher debt. The effect is the same as it would be if expenditure was funded directly by an immediate higher tax: lower private consumption offsetting higher government expenditure. (The reader is invited to perform a mental experiment: is this how he/she responds to a fiscal stimulus by the government? I certainly don't).

Third, in the early 'seventies the theory of so-called rational expectations was introduced by Robert Lucas and others, which was a tendentious misnomer. They should have been called expectations *successful by definition*. The efficient utilization of all information available, by all economic agents, makes markets efficient. Nobody is ever surprised. Multipliers could then be lower than unity.

Fourth, in the 1990s and 2000s a series of empirical studies propounded the idea of "Expansionary Fiscal Contraction". They argued that closing the budget deficit via higher taxes and/or lower expenditure can be and by and large is expansionary: see Giavazzi and Pagano (1990, 1996); Alesina and Perotti (1997); Alesina and Ardagna (2010). Blanchard (1990, then Professor at MIT, before joining the IMF as Chief Economist in 2008) explained how this was due to the promotion of private sector-led growth, for the reasons already mentioned above: Ricardian equivalence, increasing confidence, a favourable impact on expectations, declining borrowing costs, a weaker currency. This would hold also for "extreme" fiscal contraction or consolidation.

Growth in a Time of Debt

But the culmination of the expansionary fiscal consolidation thesis, supported by the so-called "austerians"' - "advocates of fiscal austerity, of immediate sharp cuts in government spending" (Krugman's definition) - is a paper by Harvard economists Carmen Reinhart and Kenneth Rogoff, "Growth in a Time of Debt" (2010). On the basis of a new dataset of forty-four countries spanning about two hundred years, incorporating "over 3,700 annual observations covering a wide range of political systems, institutions, exchange rate arrangements, and historic circumstances", Reinhart and Rogoff find that "the relationship between government debt and real GDP growth is weak for debt/GDP ratios below a threshold of 90 percent of GDP. Above 90 percent, median growth rates fall by one percent, and average growth falls considerably more."

The notion that government debt exceeding 90 percent of GDP has a significant negative effect on economic growth became a decisive supportive argument for austerity by national and international leaders, from ex-vice-presidential candidate Paul Ryan, chairman of the USA Congress budget committee, to EC Commissioner Olli Rehn, and authoritative commentators. Thus Keynes's proposition that “the boom, not the slump, is the right time for austerity” was falsified, austerity becoming a good policy for all seasons in highly indebted countries.

The tide is turning

The proposition of "Expansionary Fiscal Consolidation" was immediately subjected to many criticisms and was gradually discredited both on theoretical and on empirical grounds.

Already in November 2008 the IMF Managing Director Dominique Strauss-Kahn took the initiative for a sizeable global fiscal stimulus of the order of 2% of Global GDP. In an interview with *IMF Survey Online* on 29 December 2008 Olivier Blanchard – by then IMF Chief Economist, and Carlo Cottarelli, Chief of the IMF Fiscal Affairs Department, called for bank recapitalization (time consuming) and monetary expansion (ineffective at low interest rates) and made a strong case for fiscal stimulus: "In normal times, the Fund would indeed be recommending to many countries that they reduce their budget deficit and their public debt. But these are not normal times, and the balance of risks today is very different"… "If no fiscal stimulus is implemented, then demand may continue to fall. And with it, we may see some of the vicious cycles we have seen in the past: deflation and liquidity traps, expectations becoming more and more pessimistic and, as a result, a deeper and deeper recession. If, instead, a fiscal stimulus is implemented but proves unnecessary, the risk is that the economy recovers too fast. Surely, this risk is easier to control than the risk of an ever deepening recession." The IMF raised its lending, increased its own resources and relaxed somewhat its conditionality, but its commitment was intermittent and short lived. The ECB, under the leadership of Jean-Claude Trichet, soon was advocating an early exit strategy from both monetary expansion and fiscal stimulus.

In October 2010, Chapter 3 of the IMF World Economic Outlook examined “the effects of fiscal consolidation — tax hikes and government spending cuts—on economic activity.” It found that fiscal consolidation typically reduces output and raises unemployment in the short term, especially if it occurs simultaneously across many countries, and if monetary policy is not in a position to offset them. Only in the longer term, can interest rate cuts, a fall in the value of the currency, and a rise in net exports usually “soften” but do not offset the contractionary impact.

Baker (2010) criticises Alesina and others (1995, 2006) for their use of cyclically adjusted deficits, while policy driven deficit adjustments behave in a keynesian fashion. He also criticises Broadbent and Daly (2010) on the ground that known cases of expansionary consolidation occurred for very narrow output gaps relatively to the large ones that occur in the current crisis.

The September 2011 IMF Fiscal Monitor warned that “too rapid consolidation during 2012 could exacerbate downside risks”: “Further tightening during a downturn could exacerbate rather than alleviate market tensions through its negative impact on growth”.

In 2012 Carlo Cottarelli stressed the “schizophrenic” attitude of investors with regard to fiscal consolidation manoeuvres: their initial enthusiasm is followed by the fear of consequent recession, so that governments are “damned if they do, damned if they don’t”.

The IMF World Economic Outlook (October 2012) contains a large Box by its Chief Economist Olivier Blanchard and Daniel Leigh arguing that fiscal multipliers have been under-estimated by IMF forecasts and policy documents, by the OECD and the European Commission. Recent IMF research suggests that fiscal multipliers are in the range 0.9 to 1.7, rather than the customary assumption of their being around 0.5. In other words, the cost of fiscal consolidation has been grossly under-estimated. In January 2013 Blanchard and Leigh presented a longer paper expanding their argument at the American Economic Association Annual Conference. However, according to the auhors "More research is needed."

But more research was already available to the IMF: Guajardo, Leigh and Pescatori (2011) investigated "the short-term effects of fiscal consolidation on economic activity in OECD economies." "We examine the historical record, including Budget Speeches and IMF documents, to identify changes in fiscal policy motivated by a desire to reduce the budget deficit and not by responding to prospective economic conditions. Using this new dataset, our estimates suggest fiscal consolidation has contractionary effects on private domestic demand and GDP. By contrast, estimates based on conventional measures of the fiscal policy stance used in the literature support the expansionary fiscal contractions hypothesis but appear to be biased toward overstating expansionary effects."

And Batini-Callegari-Melina (2012)
- discredit the need for cutting public/social expenditure, for especially in a downturn expenditure multipliers can be up to *ten* times larger than tax multipliers;
- find absolute values for multipliers of the order of 2.5 instead of 0.9-1.7 as in the IMF World Economic Outlook (2012);
- find aggressive consolidation much more expensive than gradual in terms of GDP.

In May 2013 Jeffrey Frankel criticized various papers by Alesina and other co-authors (Giavazzi, Ardagna and Favero), all claiming that fiscal consolidation is not contractionary in a recession. Frankel's objections are based on a recent paper by Alesina's original coauthor, Perotti, criticizing the dating methodology used, and pointing out that some of the fiscal consolidations used by Alesina et al. were announced by governments but never implemented. Thus Frankel concludes that Alesina "has not been receiving his fair share of abuse" (Eurointelligence.com, 22/5/2013).

At the same time Alesina and Giavazzi softened very considerably their original position. In May 2013 they actually recommended the Italian government to overstep the 3% deficit threshold for two years – for "that three per cent should not be a taboo" – offering the EC in exchange immediate tax reductions on labour incomes and planned gradual and permanent expenditure cuts in the following three years. The European Commission would not close the excess deficit procedure for Italy at end-May but should be willing to approve such plan and verify its implementation. At the same time, credit to households and enterprises should resume through bank re-capitalisation conditionally funded by the EMS.

The non-existent 90% threshold

The Reinhert-Rogoff notion of a critical 90% threshold of the debt/GDP ratio was immediately criticized by Irons and Bivens (2010) who argued that causation run backwards, in that slower growth leads to higher debt-to-GDP ratios rather than the other way round. Moreover "there is no compelling reason to believe … that gross debt of about 90% will necessarily lead to slower economic growth… In fact, the greatest threat to economic growth is policy inaction fueled by deficit fears."

The final blow to the Reinhart-Rogoff 90% debt/GDP dogma came from Herndon, Ash and Pollin (2013), who replicated the analysis by Reinhart and Rogoff 2010 using the original data. Apart from a coding error, which made only a small contribution to their conclusions, Reinhart-Rogoff selectively excluded available data for several Allied nations—Canada, New Zealand, and Australia—that emerged from World War II with high debt but nonetheless exhibited solid growth. And summary statistics were all weighted equally regardless of the duration of high debt and growth performance. Herndon et al. (2013) conclude that "… when properly calculated, the average real GDP growth rate for countries carrying a public-debt-to-GDP ratio of over 90 percent is actually 2.2 percent, not 0.1 percent as published in Reinhart and Rogoff". It turns out that "average GDP growth at public debt/GDP ratios over 90 percent is not dramatically different than when debt/GDP ratios are lower."

Reinhart and Rogoff (2013) admitted some of their errors and omissions but argued that these do not alter their ultimate austerity-justifying conclusion: excessive debt depresses growth. But two subsequent studies have claimed that, on the contrary, slow growth appears to cause higher debt (as Irons and Bivens 2010 had already argued). Dube (2013) finds that growth tends to be slower in the five years *before* countries have high debt levels. In the five years *after* they have high debt levels, there is no noticeable difference in growth at all, certainly not at the 90 percent debt-to-GDP level regarded by Reinhart and Rogoff as the threshold of non-sustainability. Kimball and Wang (2013) present similar findings. This point is accepted by Reinhart-Rogoff (2013): "The frontier question for research is the issue of causality."

But suicidal policies persist

Such an amazing, cumulative and final discrediting of the alleged expansionary (severe at that) fiscal contraction approach, and the associated 90% threshold to debt sustainability, does not appear to have had much impact on actual policies, especially on German-led European policies, with EU and especially EMU countries tied to the "suicide pact" (Joseph Stiglitz) of so-called Growth and Stability.

The latest EU Fiscal Compact or TSCG – Treaty on Stability, Coordination and Governance – demanded a balanced budget provision to be inserted in member states' national constitutions, subject to a maximum structural deficit of 0.5% of GDP. There are penalties and automatic adjustments in case of inobservance, subject to the verification and rulings of the European Court of Justice. Financial assistance programmes under the ESM – the European Stability Mechanism that come into operation in March 2012 – from March 2013 are conditional on prior TSGC ratification.

From 2015 countries exceeding the statutory debt/GDP ceiling of 60%, required by both the Maastricht Treaty and the Stability and Growth Pact, are expected to reduce the excess debt by 1/20 of the current gap every year until the ceiling is reached – which for a country like Italy at over 130% involves a budgetary surplus of over 3.5% a year for 20 years.

The IMF (2013) Report criticized the Troika's [EC, ECB, IMF] handling of the Greek crisis over the last four years, but concluded that all was for the best and their policies would not be any different today in the same circumstances. In July 2013 a conference of German economists advocated that a debt/GDP ratio of 90% - Reinhart and Rogoff's fated but dubious threshold – should trigger off automatic debt re-structuring and bail-in.

Austerity is like compulsory smoking

In conclusion, the Keynesian-Kaleckian view of capitalist dynamics is alive and well. The IMF itself has been reviving it and providing theoretical and empirical backing for it, by stressing the high cost of fiscal consolidation, but at the same time continuing to officially recommend and impose such fiscal consolidation. While providing the strongest case for a fiscal stimulus, IMF research is being used even by their more enlightened officials to recommend gradual rather than abrupt fiscal consolidation, instead of the fiscal stimulus that would be appropriately needed. Obstacles to full employment policies are still of a political nature today (resistance to a capital tax to service exceptionally high sovereign debt, in addition to the drive to maintain workers' discipline through unemployment). The time for a Kaleckian (and Keynesian) over-due revival is now, but until it takes place we are all condemned to suffer from the impoverishment and the unemployment caused by the deepest, man-made, economic crisis in human history.

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