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The Austerity Chronicles

Apr 5, 2019 **KENNETH ROGOFF**

After years of mounting polemics against austerity policies, Keynesian dogma has become something close to a secular religion in popular economic-policy debates. But a new study of 16 advanced economies shows that, as with all dogmas, righteousness is no substitute for empirical facts.

- **Alberto Alesina, Carlo Favero, and Francesco Giavazzi, *Austerity: When It Works and When It Doesn't*, Princeton University Press, 2019.**

CAMBRIDGE – In *Austerity: When It Works and When It Doesn't*, the central conclusion reached by economists Alberto Alesina, Carlo Favero, and Francesco Giavazzi is one that most modern-day Keynesians and progressives will hate. In cases when circumstances have forced a country into fiscal retrenchment, the authors show, cutting government spending has cost less than tax increases in terms of foregone output and employment.

Readers should know that this is no ideological diatribe. Alesina, Favero, and Giavazzi have conducted cutting-edge empirical research on 16 advanced economies to draw lessons that could not have been garnered from analyzing any one country or episode in isolation. *Austerity* is a towering scholarly achievement, embodying decades of research and destined to serve as a touchstone for future studies – both by those who will build on it and by those who will try to tear it down.

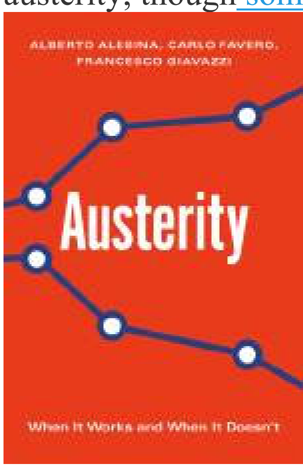
In the very first line of their book, Alesina, Favero, and Giavazzi surpass the many blunderbusses that are published about austerity when they actually define the term. "Austerity," they write, "indicates a policy of sizable reduction of government deficits and stabilization of government debt achieved by means of spending cuts or tax increases, or both."[1]

As opening lines go, this might not stack up with *Anna Karenina* or *Moby Dick*. But it is a breath of fresh air compared to angry polemics that carelessly toss around the word "austerity" to encompass a dizzying range of economic issues, ranging from fiscal retrenchment under market duress to any policy that slows the march to socialism.

It is important to mention that Giavazzi and I both had the late Rüdiger Dornbusch as our thesis adviser at MIT, and that Alesina and I are colleagues at Harvard University."

HARD TOPIC, HARD TRUTHS

That said, I do not agree with the authors of *Austerity* on everything. For starters, I think the book should have included more discussion of heterodox approaches to dealing with unsustainable debt, such as write-downs, inflation, and financial repression. As my Harvard colleague Carmen M. Reinhart and I showed in our book *This Time Is Different*, these options can sometimes be more attractive than fiscal retrenchment for countries in severe debt distress, and even many advanced economies have used them more recently than is commonly thought. Equally important, these measures are not the same thing as austerity, though some journalists and other commentators often treat them that way.



Of course, no single book can address the full scope of issues, especially if its purpose is to conduct high-level empirical analysis. Besides, in a great many instances, what policymakers in debt-distressed economies want to know first are their best options for pursuing orthodox fiscal retrenchment, before contemplating any heterodox measures. That is the question Alesina, Favero, and Giavazzi have set out to answer.

The question is a controversial one not least because the term "austerity" is often used polemically as a catch-all for almost any fiscal policy that accounts for the risks and realities around government budget constraints. And, unfortunately, in the current illiberal intellectual climate, merely suggesting alternatives to the mainstream progressive dogma can summon the anti-austerity thought police.

So, rest assured, Alesina, Favero, and Giavazzi will be tarred and feathered for daring to suggest that in countries with large, inefficient governments, a well-timed and well-designed fiscal retrenchment can sometimes be expansionary. In fact, a "cursory look at the data" tells them this has been the case in "Austria, Denmark, and Ireland in the 1980s," as well as in "Spain, Canada, and Sweden in the 1990s." Nonetheless, Alesina has been lambasted by the likes of Paul Krugman in *TheNew York Times* and political scientist Mark Blyth in *Austerity: The History of a Dangerous Idea* for raising similar points in his earlier work.

BARK OF THE DOGMATISTS

Macroeconomic issues are inherently complex, which means that definitively proving anything in the field is inherently difficult. Having not conducted serious empirical research on expansionary austerity myself, I don't bring strong preconceptions to the issue (and for the same reason, nor should Krugman). Still, I stand by scholars' right to explore and express their ideas freely without being subjected to personal attacks by other academics when they dare to disagree with narrow-minded Keynesian dogma.

Keynesian stimulus was clearly called for during the 2008 financial crisis. But it is odd that the dogmatists have given short shrift to complementary ideas such as write-downs for subprime debt – as economists Atif Mian and Amir Sufirecommend in their superb book *House of Debt* – and the suspension of inflation targets.

Worse, anyone not hewing exactly to the dogmatists' policy mix is immediately dismissed as a proponent of "austerity." For example, though it is difficult to fathom his logic, Robert Skidelsky has described the notion that governments might extend the maturity of their rising debts (to reduce long-term refinancing risks) as an argument for "austerity." A noted biographer of John Maynard Keynes, Skidelsky tends on occasion to neglect some of Keynes's most important writing on this topic, as Reinhart has previously noted.

Moreover, as Alesina, Favero, and Giavazzi point out, some of the best candidates for expansionary austerity after 2008, notably Italy, did not even give it a try. Meanwhile, they find that "the two countries that did better with austerity were Ireland and the United Kingdom," despite Ireland's huge banking problems. Specifically, Alesina, Favero, and Giavazzi show empirically that UK growth increased from -1% in 2011 (two points below the EU average) to 3.5% in 2013 (four points above the EU average), even as the International Monetary Fund and many Keynesians insisted that the UK was heading for a second recession.[1]

I suspect that many Amazon reviewers will read the title of Alesina, Favero, and Giavazzi's book and conclude that it was written by some dark lords of neoliberalism who love austerity for its own sake. But this would be a bit like saying that doctors who deal with pandemics must love plagues. If readers could only make it to the second paragraph, they would encounter this key point: "If governments followed adequate fiscal policies most of the time, we would almost never need austerity."[1]

In other words, when governments do not follow basic fiscal prescriptions, they can be forced into circumstances in which there are few or no alternatives to belt-tightening. "The bottom line," the authors write, "is that austerity measures are sometimes required because of past policy mistakes, or a combination of past policy mistakes […] and unexpected negative shocks. The latter are fortunately relatively rare, so austerity is almost always the result of poor foresight and overspending relative to tax revenues."

RIGOR AND RIGMAROLE

Alesina, Favero, and Giavazzi's book makes a number of important methodological contributions. It introduces a data set for 200 multi-year austerity plans across 16 advanced economies from the late 1970s to 2014. In each case, the authors refer to the original documents to determine policymakers' intent. Moreover, the book assesses the success or failure of each plan from a multi-year perspective, instead of year by year, as has been customary in the literature until now. And, perhaps most important, the authors are rigorous in addressing questions of cause and effect, and controlling for monetary policy, deregulation, and other factors that would affect ultimate outcomes.

In fact, back in 2011, three IMF economists published a study critiquing Alesina's earlier work, arguing that the secret sauce of expansionary austerity is really just a low-interest-rate policy. But, as anyone who knows anything about monetary policymaking understands, with the exception of a few safe-haven countries, it is much easier to keep interest rates low when fiscal policy is under control.1

At this point, knowledgeable readers might be wondering if Alesina, Favero, and Giavazzi have read former IMF chief economist Olivier Blanchard's recent address at the American Economic Association. Blanchard made headlines by endorsing the view that future growth will almost invariably be sufficient to cover future interest payments, implying that the debt in most advanced economies is far below the level that would ever cause problems.1

A less coherent version of this idea can be found in so-called Modern Monetary Theory, which holds that as long as a country issues debt in its own currency, that debt can never pose a serious threat to macroeconomic stability. In any case, those advancing such arguments are essentially saying, "this time is different": the need for policies to reduce debt-to-income ratios – much less the kind of deficit-reduction policies considered in *Austerity* – is a thing of the past.

WAITING FOR THE OTHER BOOT TO DROP

There is a serious debate to be had here when it comes to the United States, which has become increasingly dominant in global financial markets even as it becomes less dominant in terms of global output. On one hand, global demand for US government debt could well continue to outstrip US growth for some time to come. On the other hand, as my colleagues Emmanuel Farhi and Matteo Maggiori have shown, issuers of dominant currencies will be more vulnerable over the long term than is commonly recognized, largely because they have an incentive to run up debts and take risks that could result in negative global externalities.

More to the point, with the possible exceptions of Germany, Switzerland, and Japan, most countries do not share America's "exorbitant privilege" when it comes to borrowing. Though this fact has eluded many American economists, it is certainly not lost on *Austerity's* three Italian-born authors, each of whom has followed Italy's macroeconomic instability for decades.

Italy is a country of great wealth and potential. But with a debt-to-GDP ratio of over 130%, it has experienced essentially zero growth in the twenty-first century and is in steep demographic decline. Worst of all, Italy has extremely high levels of tax evasion and corruption compared to Northern European countries, and it suffers from frequent bouts of near-total government dysfunction.

Against this backdrop, it is little wonder that Italy also suffers periodic episodes of financial-market panic. If global real (inflation-adjusted) interest rates ever were to rise, Italy could be an early casualty, dragging the entire eurozone back into crisis. Yet Anglophone anti-austerity economists miss the point when they try to blame Italy's growth problems entirely on the Germans or the European Central Bank. For the world at large, Italy is more the rule than the exception when it comes to debt.

THE BOTTOM LINE

Austerity challenges the conventional dogma in a host of other ways that are too numerous to include here. Though I hope to address them all at some later point, two examples deserve to be highlighted.

First, it has been widely argued that government spending multipliers are larger at the zero-interest-rate bound, a claim for which there is strong theoretical support and some empirical evidence. Nevertheless, Alesina, Favero, and Giavazzi find that their main conclusions are valid even at the zero bound for the bulk of countries in their sample. That is, expenditure-based austerity programs tend to impose lower costs on output than do programs based on tax hikes. Second, the authors devote an entire chapter to challenging the popular notion that any politician who tries to adopt an austerity program will be kicked out of office.

Empirical results in economics are constantly being re-evaluated and refined, so it is always difficult to predict how research in this area will unfold. One important topic that demands further study is income distribution, a topic the authors do not take up in large part because they have far less data on it. And, again, a comparison of heterodox policies involving debt write-downs would be a major contribution.

But the nature of any pathbreaking scholarship is that it sets the agenda for further research. Alesina, Favero, and Giavazzi have written a fundamentally non-ideological book that raises the bar for future studies of fiscal retrenchment policies. No doubt it will continue to set the standard for such research for many years to come, however much left-leaning polemicists try to dismiss it as blasphemy.

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Writing for PS since **2002**

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