Austere Illusions: Fiscal contraction is contractionary, period.

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In an article that originally appeared on Project Syndicate, **Robert Skidelsky** *explores the illusions of austerity economics. Not only has austerity failed in being expansionary, it has also hit those at the bottom of the income distribution far more severely than those at the top and may have destroyed not just current but also potential output by eroding the "human capital" of the unemployed.*

The doctrine of imposing present pain for future benefit has a long history – stretching all the way back to Adam Smith and his praise of "parsimony." It is particularly vociferous in "hard times." In 1930, US President Herbert Hoover was advised by his treasury secretary, Andrew Mellon: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system…People will…live a more moral life…and enterprising people will pick up the wrecks from less competent people."

To "liquidationists" of Mellon's ilk, the pre-2008 economy was full of cancerous growths – in banking, in housing, in equities – which need to be cut out before health can be restored. Their position is clear: the state is a parasite, sucking the lifeblood of free enterprise. Economies gravitate naturally to a full-employment equilibrium, and, after a shock, *do so fairly quickly* if not impeded by misguided government action. This is why they are fierce opponents of Keynesian interventionism.

Keynes's heresy was to deny that there are any such natural forces, at least in the short term. This was the point of his famous remark, "In the long run we are all dead." Economies, Keynes believed, can become stuck in prolonged periods of "under-employment equilibrium"; in such cases, an external stimulus of some kind is needed to jolt them back to higher employment.

Simply put, Keynes believed that we cannot all cut our way to growth at the same time. To believe otherwise is to commit the "fallacy of composition." What is true of the parts is not true of the whole. If all of Europe is cutting, the United Kingdom cannot grow; if the entire world is cutting, global growth will stop.

In these circumstances, austerity is exactly the opposite of what is needed. A government cannot liquidate its deficit if the source of its revenues, the national income, is diminishing. It is deficit reduction, not debt, that is profligate, because it implies wastage of available human and physical capital, quite apart from the resulting misery.

Austerity's advocates rely on one – and only one – argument: If fiscal contraction is part of a credible "consolidation" program aimed at permanently reducing the share of government in GDP, business expectations will be so encouraged by the prospect of lower taxes and higher profits that the resulting economic expansion will more than offset the contraction in demand caused by cuts in public spending. The economist Paul Krugman calls this the "confidence fairy."

The pro-austerity argument is pure assertion, but it is meant to be a testable assertion, so econometricians have been busy trying to prove that the less the government spends, the faster the economy will grow. Indeed, just a year or two ago, "expansionary fiscal contraction" was all the rage, and a massive research effort went into proving its existence.

Economists arrived at some striking correlations. For example, "an increase in government size by ten percentage points is associated with a 0.5-1% lower annual growth rate." In April 2010, the leader of this school, Harvard University's Alberto Alesina, assured European finance ministers that "even sharp reductions of budget deficits have been accompanied and immediately followed by sustained growth rather than recessions even in the very short run."

But two fallacies vitiated the "proofs" offered by Alesina and others. First, because the cuts had to be "credible" – that is, large and decisive – the continuing absence of growth could be blamed on the insufficiency of the cuts. Thus, Europe's failure to recover "immediately" has been due to a *lack* of austerity, even though public-sector retrenchment has been unprecedented.

Second, the researchers committed the arch-statistical mistake of confusing correlation with causation. If you find a correlation between deficit reduction and growth, the reduction could be causing the growth or *vice versa*. (Or both the deficit reduction and the growth could be due to something else – devaluation or higher exports, for example.)

An International Monetary Fund paper in 2012 brought Alesina's hour of glory to an end. Going through the same material as Alesina had, its authors pointed out that "while it is plausible to conjecture that confidence effects have been at play in our sample of consolidations, during downturns they do not seem to have ever been strong enough to make the consolidations expansionary." Fiscal contraction is contractionary, period.

An even more spectacular example of a statistical error and sleight of hand is the widely cited claim of Harvard economists Carmen Reinhart and Kenneth Rogoff that countries' growth slows sharply if their debt/GDP ratio exceeds 90%. This finding reflected the massive overweighting of one country in their sample, and there was the same confusion between correlation and causation seen in Alesina's work: high debt levels may cause a lack of growth, or a lack of growth may cause high debt levels.

On this foundation of zombie economics and slipshod research rests the case for austerity. In fact, the austerity boosters in the UK and Europe frequently cited the Alesina and Reinhart/Rogoff findings.

The results of austerity have been what any Keynesian would have expected: hardly any growth in the UK and the eurozone in the last two and a half years, and huge declines in some countries; little reduction in public deficits, despite large spending cuts; and higher national debts.

Two other consequences of austerity are less appreciated. First, prolonged unemployment destroys not just current but also potential output by eroding the "human capital" of the unemployed. Second, austerity policies have hit those at the bottom of the income distribution far more severely than those at the top, simply because those at the top rely much less on government services.

So we will remain in a state of "under-employment equilibrium" until policy in the UK and the eurozone is changed (and assuming that policy in the US does not become worse). In the face of clamor from the right to cut even more savagely, statesmen who are too timid to increase public spending would be wise to ignore their advice.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

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