



AUSTERITY IS BAD ECONOMICS: WHY U.S. FISCAL CONSERVATISM DOES NOT HOLD

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EXECUTIVE SUMMARY

The United States is currently facing multiple, compounding crises. The coronavirus-induced health and economic crises have laid bare and amplified existing problems, among them racial health disparities, mounting climate disasters, an inadequate and underfunded childcare infrastructure, and a widening chasm between those with enough resources to weather downturns and those without them. All these call for immediate and bold government actions to mitigate hardships and boost an underperforming economy. Amid these problems, some commentators engage in fearmongering about the size of the federal debt and deficit, claiming that spending to curtail ongoing crises will, paradoxically, lead to more problems in the future (McBride, Chatzky, and Siripurapu 2020). Many economists and policy experts are rallying around the growing consensus that deficits are not of concern during economic downturns and that public spending is necessary to curtail the wide-ranging negative consequences of a plummeting economy. While this is a necessary and important starting point, it is not sufficient for the current moment and the long recovery ahead. A stronger case can be made against austerity,¹ based on mounting evidence and theory beyond recessionary periods. This paper lays out the main theories put forth by austerians (proponents of economic austerity), discusses why these ideas are wrong, and concludes that austerity measures are detrimental to our recovery and should not guide our economic thinking or policy decisions.

Different austerians make distinct claims about the interplay of certain economic forces in order to justify their ideological commitment to balanced budgets and reduced debt. Some argue that growing debt and/or deficits lead to inflation, others claim they increase interest rates, while others say they impede economic growth. Yet, for the past four decades, inflation and interest rates in the US have been on a long downward trend from their turbulent episodes in the 1980s, despite an increasing national debt and fluctuating deficits. The fears of inflation fail to account for the fact the US economy has been operating below capacity for a long time. Even before the current coronavirus-induced pandemic, the standard unemployment rate for the general population fell to 3.5% as of February 2020 (Bureau of Labor Statistics 2020), lower than the Federal Reserve Bank's 4.4% estimate of the natural rate of unemployment for the first quarter of 2020 (US Congressional Budget Office 2020). Yet, inflation and inflation expectations remained below the Fed's 2% long-run target (Powell and Wessel 2020). Furthermore, we know that availability of employment for all those who want a job remained out of reach for certain segments of the labor force, where the unemployment rate for prime-age (25-54) Black working people stood at 5.8% in February, a near recessionary figure if observed within the wider economy. Coupled with concerns of underemployment (Golden and Kim 2020), stagnation (Nikiforos 2020), weakening childcare and physical infrastructure (Kashen, Glynn, and Novello 2020), and other areas of needed investment, the economy is far from overheating. On top of that, not only do we have useful tools to address an overheating economy,² as the Fed chair Jerome Powell has noted repeatedly, but also the risk of doing too little to mitigate the current crisis (including, among other things, high unemployment) is far greater than overreacting (Timiraos 2020).

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¹ Austerity is the political economy agenda of balancing public budgets and reducing existing public debt, frequently through drastic measures. Although these can be achieved by raising tax revenue or reducing government spending, austerians typically push for the latter. Austerians are people in favor of and who advocate for austerity measures. Austerity is used interchangeably with the term fiscal conservatism in this paper.

² Primarily through Fed interest rate policy and also via progressive taxation.

Assertions regarding interest rates take a few different forms. Some commentators claim that deficits push up interest rates across the economy because the government competes with private investors for limited funds and, thereby, dampens private investment (the so-called “crowding out” effect). Empirically, we see little historical evidence of this during and after periods of higher US public deficit. Theoretically, this logic fails to account for the fact that government issuance of securities is primarily a tool to maintain the Federal Reserve’s target for the interest rate banks charge each other for overnight lending (i.e., the federal funds rate). Interest rates, in fact, are a monetary policy tool rather than a pure market outcome that puts government spending in check. Furthermore, one important factor that affects private investment is outlook regarding macroeconomic performance. Therefore, government spending that improves economic or GDP growth and infrastructure projects that improve productivity can actually “crowd in” private investment. Without a convincing case that interest rates will magically rise in the years to come, current low rates, which have been trending downwards for a long time, address the claim that debt financing obligations will constraint our ability for other types of fiscal spending (Blanchard 2019). The prediction of a debt-driven financial crisis caused by investors not wanting to hold US debt also does not ring true amid the conditions laid out here. The US government spends and borrows in its own currency, the buying and selling of which the Fed guarantees without constraint. What matters is the overall health of the economy, not the amount of debt or deficits.³

The point here is not simply to reveal austere arguments as economically unsound. We currently are in a moment when inaction and inadequate counteractive measures are highly detrimental. The policy discussions we need to have are unrelated to debts and deficits and should instead center on examining the kinds of spending that would be productive, sufficiently large, and equitable.

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These arguments also address the claim that there is a certain threshold beyond which debt deters economic growth. A theoretical basis for the mechanics of this claim does not exist and, as the discussion in the text shows, the empirical evidence for this argument has been debunked.

INTRODUCTION

The current growing consensus favoring federal spending argues that deficits are not of concern during economic downturns and that public spending is necessary to curtail the wide-ranging negative consequences of a plummeting economy. Although this is a necessary starting point to shift the conversation, a stronger case against austerity can be made based on evidence and theory beyond periods of economic crisis. This broader case against austerity economics is critical because the degrees and types of public spending necessary to rebuild and maintain an equitable and prosperous economy for all require ongoing action even outside of economic crises, and a clear case can be made for a large public sector that is not contingent on recessions. This is especially important in the present, given the years of work we know are needed to recover from the multiple crises triggered and amplified by the coronavirus pandemic.

Although the expanding support for bold federal spending during the current crisis is encouraging, it does not necessarily address the root claims of those who favor curtailing federal spending. We can safely assume these assertions will become central shortly after the most immediate and visible aspects of the coronavirus-induced economic crisis subside. As noted earlier, the primary motivation for this piece is to address certain theoretical questions regarding the relationship between public debt and/or deficits and some key economic variables.

We address common “austrian” arguments regarding the relationship between “excessive” public spending and interest rates, inflation, and GDP growth from four distinct angles,:

1. higher deficits lead to higher inflation;
2. deficits “crowd out” private investment by pushing up interest rates in the economy;
3. increasing debts bring fiscal crisis as investors become increasingly unwilling to hold public debt and require higher interest rates to compensate for “additional risk” of solvency, etc.;
4. that high debt levels hinder economic growth.

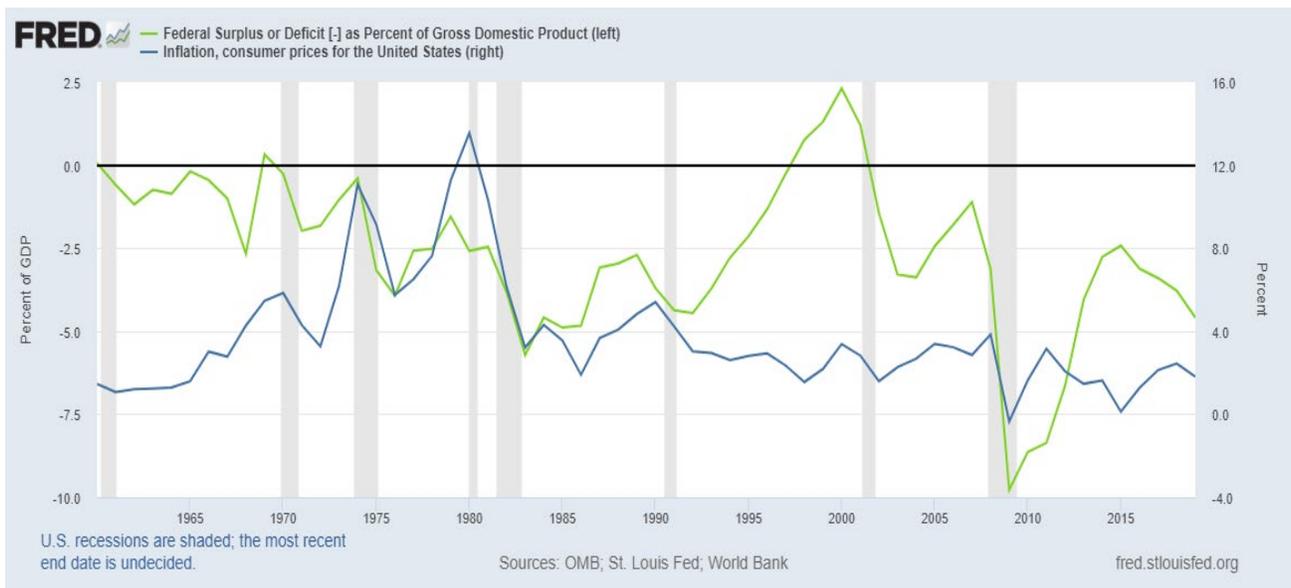
Although key austerians’ arguments have been fiercely contested in the economic literature, there appears to be a disconnect between arguments “won” within academic discourse and discussions in the wider public sphere. As Mason and Jayadev (2013) aptly note in their subtitle, “macroeconomics let austerity lose all the intellectual battles and still win the war.”

INFLATION

Varying austere economic arguments attempting to justify balanced budgets or reduced public spending suggest that a relationship exists between public deficits and/or debts and different economic indicators. For instance, the risk of inflation (an increase in the rate of growth of the price level) is one of the most common austere claims regarding the dangers of high public deficits. Austere argue that the government⁴ finances its excess spending by “printing” more bills, in turn putting downward pressure on the value of the currency, thereby leading to a given amount of money purchasing fewer goods and services (Miller 1983).

Over the past four decades, inflation has been low and trending downwards regardless of the size of the deficit. Figure 1 details the movement of the federal deficit-to-GDP ratio in the past half-century, along with the US inflation level as measured by the annual percentage change in the average cost of purchasing a selected basket of goods and services.⁵ The right axis measures inflation and the left axis measures the annual federal surplus or deficit as a percentage of GDP, where a negative value indicates a deficit for a given year (i.e., when the green plot is below the black horizontal line). If increasing deficits push up inflation, then the two plots should move in opposite directions, where an increasing trend in the deficit (i.e., the green plot trending downwards) would be associated with an upward trending inflation rate. It is readily apparent that this has not been the case over the last half-century.

FIGURE 1: MOVEMENT OF THE DEFICIT-TO-GDP RATIO AND THE INFLATION RATE, 1960-2019



Sources: US Office of Management and Budget, and Federal Reserve Bank of St. Louis (2021); World Bank (2021)

Inflation increased sharply in the early 1970s, followed by notable decreases, leading to the trimodal peaks observed during the three recessionary periods of the decade. This economically-tumultuous decade included the 1973 oil crisis, the 1973 stock market crash, and the well-known period of “stagflation” in the US. Given these and other factors, inflation observed in the 1970s remains an anomaly in US economic history that does not readily inform today’s conditions. The period is an outlier—a unique instance of peacetime inflation that still haunts some economists four decades later.⁶ During this period, the deficit ratio fluctuated pro-

⁴ Unless indicated otherwise, the usage of “government” throughout this paper refers to US federal government spending and borrowing.

⁵ Inflation (the consumer price index) as represented here is based on World Bank data using the Laspeyres formula.

⁶ See, for example, Appelbaum (2021), DeLong (1997), and Beckworth and Ponnuru (2021) for more on this.

cyclically. Inflation dropped sharply after 1980 and has remained on an overall downward trend ever since, with minor cyclical fluctuations observed around recessionary periods. Since the 1981 recession, however, the annual federal deficit ratio has fluctuated sharply, with the most pronounced decrease observed in the 1990s, leading to the only surplus period since 1948 observed during the Clinton administration. The highest deficit ratio in the post-World War II period before the current ongoing crisis occurred during the 2007 Great Recession.⁷ The deficit reached nearly 10% of GDP in 2009 (approximately \$1.4 trillion). And yet, the inflation rate did not explode.

NON-AUSTERIAN INFLATION CONCERN

There is a non-austrian inflation concern worth noting briefly. It brings to light the real constraint we face in spending (i.e., in terms of goods and services) rather than a financial constraint. Increasing public spending when the economy is at or near capacity (i.e., full employment) can create inflationary pressure. Yet, we have tools to address an overheating economy, key among which are the Fed's power to adjust interest rates and the government's ability to decrease spending power via progressive taxation. As noted earlier, this is an easier problem to address than high unemployment, etc. Furthermore, inflation is currently not an issue precisely because the economy is performing notably below capacity (Bivens 2020).

One angle to see this through is to consider the unsettled question of the level of unemployment below which inflation will rise [the so-called non-accelerating inflation rate of unemployment (NAIRU)]. In the 1990s, full employment was estimated to correspond with a 6% unemployment rate (Galbraith 1997). Unemployment fell below that without evidence of accelerating inflation (Galbraith 2001). Before the current coronavirus pandemic, the headline unemployment rate for the general population fell to 3.5% as of February 2020 (Bureau of Labor Statistics 2020), lower than the Fed's 4.4% estimate of the natural rate of unemployment for the first quarter of 2020 (US Congressional Budget Office 2020). Yet, inflation remained quite low. These perceived misalignments are unsurprising when we consider, for example, the structural problems in the labor market that foster a persistent Black-white unemployment gap (Ajilore 2020). Further, we know that standard Fed employment policy for the general population has never led to full employment for Black workers and that persistent slack remains in the economy because of the labor market conditions faced by certain demographics, especially through underemployment (Schmitt and Jones 2012; Bernstein and Jones 2020). In addition, as discussed earlier, other notable areas of concern remain, including stagnation (Nikiforos 2020; Wray 2008), and the inadequacies of the care infrastructure as well as the economic precarity faced by care workers (Kashen, Glynn, and Novello 2020; Jones 2020).

INTEREST RATES

Interest rates are another central part of the discussion of debts and deficits. For clarity, we will address separately two distinct arguments regarding interest rates. The first claims that deficits dampen private investments by pushing up interest rates, and the other predicts fiscal crisis in the presence of increased debt financing.

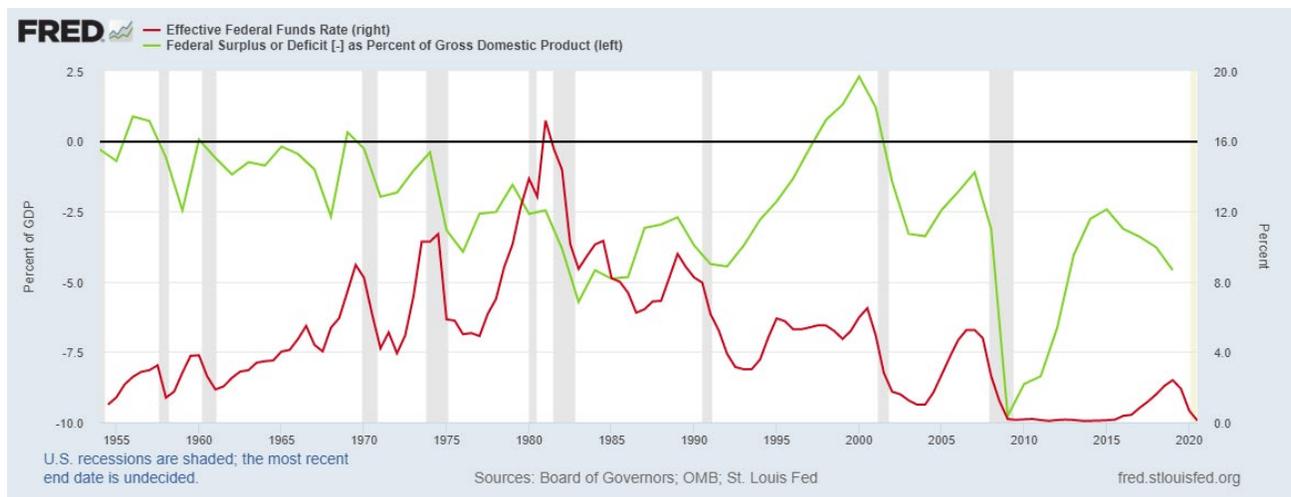
⁷ The deficit reached 26.9% of GDP in 1943 during World War II, the highest on record. Inflation was not a major issue during and after the war, though the government did enact price controls (Laguerodie and Vergara 2008). It increased after the war but began decreasing rapidly starting in 1946. See FRED's historical GDP implicit price deflator data for more (US Bureau of Economic Analysis 2021).

PRIVATE INVESTMENT CROWDING OUT

Some austerians claim that public deficits put upward pressure on interest rates, leading to a decrease in private sector investment. This argument follows the so-called loanable funds approach to interest rate determination. According to this approach, the interest rate is the “price” of loanable funds, and, as all other prices, it is determined by supply and demand forces in its market. Within this framework, the federal government is argued to borrow to fill its budget shortfalls, thereby competing with the private sector for the finite amount of loanable funds. By the laws of supply and demand, some argue, federal borrowing then increases the demand for funds, putting upward pressure on interest rates. Consequently, the increase in federal borrowing “crowds out” private sector borrowing, dampening private sector investment decisions and opportunities.

Empirically, this argument does not hold. Figure 2 shows the federal deficit-to-GDP ratio and the federal funds rate from the mid-1950s.⁸ As with the relationship with inflation, we again see very little resemblance in how these two variables move. Here also, if the loanable funds theory holds, then the interest rate and the surplus/deficit plot would move in opposite directions. The trends of the federal funds rate, unsurprisingly, resemble the movements of the inflation rate discussed above. The late 1970s to mid-1980s present the most dramatic movements in the interest rate as a direct result of Fed chair Paul Volcker’s experimentations with monetary base targeting and efforts to fight inflation (Feldstein 2013). The early 1980s also saw an accelerating increase in the deficit ratio under the Reagan Administration, primarily through sizable tax cuts, creating an instance of increasing debt financing obligations (Wessel 2017). The interest rate has since been on a long-term trend, currently at nine basis points (0.09%) as of December 2020. Thus, despite what standard macroeconomic theory suggests, the chart below shows no long-term relationship between the deficit-to-GDP ratio and the federal funds rate. At the very least, this suggests that the relationship between the two variables is complicated and that, as we have seen, it is entirely possible to have increasing deficits simultaneously with low or falling interest rates.

FIGURE 2: MOVEMENT OF THE DEFICIT-TO-GDP RATIO AND THE EFFECTIVE FEDERAL FUNDS RATE, 1954-2020



Sources: Board of Governors of the Federal Reserve System (2021a); US Office of Management and Budget and Federal Reserve Bank of St. Louis (2021)

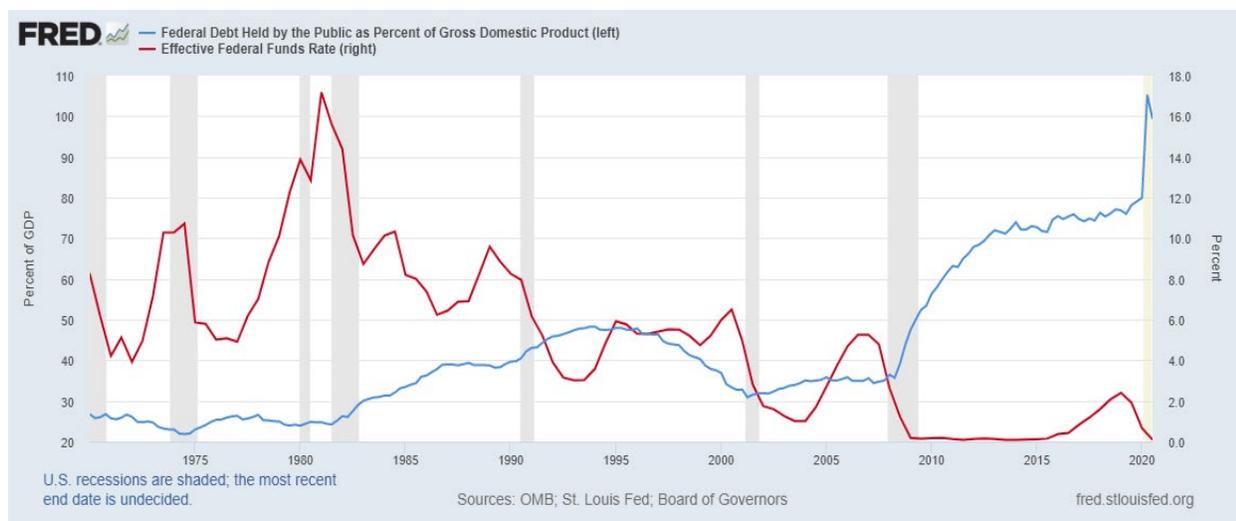
⁸ The federal funds rate is the rate depository institutions that have accounts at the Federal Reserve charge each other on overnight reserve lending.

Theoretically, the loanable funds theory is not particularly convincing. The US spends and borrows in its own currency, and the Fed can buy and sell public debt without constraint. The buying and selling of public securities are primarily to meet the Fed's federal funds rate target and the effects of federal spending and taxation on bank reserve holdings.⁹ The definition and mechanics of the federal funds rate provide useful insight. We know that the Fed targets an announced federal funds rate, which subsequently affects other interest rates in the economy. We also know that the Fed engages in the buying and selling of government bonds via open market operations to meet its target. Furthermore, the Fed can adjust interest rates in direct response to the budget deficit. This was the case in the 1990s when Fed chair Alan Greenspan conditioned monetary accommodation on drastic deficit reduction (Romano 2006, 60). Thus, the interest rate is a monetary policy tool. And yet, the claim that increasing deficits will push up interest rates persists, despite being theoretically and empirically implausible.

FISCAL CRISIS: RUN FROM US DEBT

The second claim that involves interest rates is that increasing debt brings fiscal crisis as lenders may no longer want to hold public debt, and those who do require higher interest rates to compensate for the increased risk. These so-called "bond vigilantes" are supposed to put the US government in check over its spending by threatening to take their investments elsewhere or demanding higher returns to put up with increased riskiness, thereby pushing up the cost of public debt financing. Empirically, we again see little evidence for this concern. Figure 3 below shows the publicly held debt-to-GDP ratio and the federal funds (or "fed funds") rate for the past five decades. The fed funds rate has been on a long-term downward trend even as the debt stock has increased. For a telling example on this issue, during the 2007 Great Recession, the interest rate plummeted (primarily due to quantitative easing operations) even as the rise of the debt stock accelerated.¹⁰ Theoretically, the discussions of US operations in its own currency and main purposes of bond selling and buying also apply here. At best, this understanding of public debt and money is also empirically refuted and theoretically fraught.

FIGURE 3: MOVEMENT OF THE DEBT-TO-GDP AND THE INFLATION RATE, 1970-2020



Sources: Board of Governors of the Federal Reserve System (2021b; 2021a)

⁹ See Bell (2000) for further discussion of this.

¹⁰ See Sheard (2013) for further discussion on this, including speculations of a sharp increase in inflation that was supposed to follow a supposed explosion of bank lending activity from historic reserve holdings, neither of which occurred.

ECONOMIC GROWTH

We will now focus on the proposed relationship between public debt, deficits, and economic growth. Austerians give little theoretical basis for the mechanics of how debt and/or deficits impede growth.¹¹ The most influential of the austere claims regarding debt and growth in recent decades rests on empirical studies that claim to show that countries with higher levels of public debt have slower growth rates relative to comparable nations. Such studies claim or imply that high public debts cause slower economic growth. The most influential among such works include Reinhart and Rogoff (2008; 2009; 2010), and Alesina, Favero, and Giavazzi (2019). During the Great Recession, the push for austerity was justified by the oxymoronic concept of expansionary austerity, based primarily on the work of Alberto Alesina. In their earlier work, Alesina and Ardagna (2009) claim to show that contrary to known recession remedies, tax cuts, in fact, stimulate economic activity and growth more than spending increases and that spending cuts are more effective to reduce debts and deficits than tax increases. Coupled with the works of Reinhart and Rogoff discussed below, this unsurprisingly became a rallying cry of theoretical and empirical support for politicians pushing for austerity policies during the Great Recession. In the decade to follow, these claims were refuted by a wide range of economists, including mainstream economists previously skeptical of conventional Keynesian stimulus policies (Jayadev and Mason 2019). As expansion failed to materialize in European countries that adopted austerity policies, macroeconomic consensus and empirical findings on fiscal policy shifted in support of Keynesian wisdom regarding the multiplier effects of public spending on output (Jayadev and Mason 2019).¹² In light of this, Alesina, Favero, and Giavazzi returned with their 2019 book *Austerity: When It Works and When It Doesn't* to revitalize their claims amid a new climate. In their book review, Jayadev and Mason (2019) lay out how the authors failed to address the criticisms of their earlier work and the existing empirical findings and economic conditions that refute their claims.

In tandem with the expansionary austerity arguments, Reinhart and Rogoff (2008; 2009; 2010) claim to provide empirical evidence to presumably settle the theoretical debates surrounding the relationship between public debt and growth. In their popular 2010 article, "Growth in a Time of Debt," Reinhart and Rogoff explicitly set out to trace the relationship between debt, growth, and inflation across 44 countries. They infamously claim that, among advanced capitalist economies, public debt greater than 90% of GDP reduces growth relative to similar nations with debt below this threshold (Reinhart and Rogoff 2010, 573).

In their review of Reinhart and Rogoff's 2009 book, *This Time is Different*, Nersisyan and Wray (2011) build a theoretical critique that also applies to the 2010 article given its basis on the methodology and data from the book. Nersisyan and Wray (2011) point out that aggregating data across time and space in this expansive of a manner necessarily involves leaving nuance and specificity behind for the most part. Of particular concern is the broad conflation of crises under remarkably and consequentially different regimes of monetary and fiscal policy. Furthermore, the methodology behind the claims made in the 2010 article have been thoroughly critiqued by Herndon, Ash, and Pollin (2014) from an empirical standpoint. The authors systematically show - and correct for - key mistakes Reinhart and Rogoff (2010) make that drive their oft-repeated claim. In particular, Reinhart and Rogoff (2010) make three critical errors that drive their results:

¹¹ One claim is through the interest rate mechanism, where some argue that deficits would push up interest rates and crowd out private investment, reducing the rate of economic growth (Miller 1983, 8).

¹² See Mason and Jayadev (2013) for an important and detailed discussion of the "the intellectual failure of the most prominent arguments for austerity" (2013, 102) and the manner in which this new macroeconomic consensus still leaves room for austere policies to thrive.

they selectively exclude countries whose data do not support their thesis in their analysis of the post-World War II period, but whose removal significantly impacts their results; they make coding errors in their working spreadsheet that led to the inadvertent omission of five countries from all of their analyses; and finally, they use a weighting methodology that amplified the effects of short-term high public debt episodes in their calculations of cross-country means and medians (Herndon, Ash, and Pollin 2014). Correcting for these errors, Herndon, Ash, and Pollin (2014) find a reversal of Reinhart and Rogoff's main conclusion regarding average real GDP growth rate across countries.¹³

The focus on Alesina, Reinhart, and Rogoff's work¹⁴ follows from the outsized impact of their two articles during the Great Recession in justifying the growth-slowness, premature, and damaging turn to fiscal conservatism in the immediate aftermath of that crisis. Yet, as Herndon, et al. conclude succinctly regarding Reinhart and Rogoff's work, "their findings are neither accurate nor robust" (2014, 258). Whether they are cited or not, the logic and fear that accompany these authors' claims are present in contemporary warnings about the doom that awaits us if the deficit and debt remain on their current trajectory.

CONCLUSION

There are many examples of weak, uneven, and prolonged recovery that followed from the inadequacies of legislation and federal response during the Great Recession, including the limitations of the ARRA (Bivens 2016). To avoid repeating these mistakes, it is critical to make the case against austerity both now and later and to center the conversation on the types of public spending that are needed rather than asking whether we can afford the spending.

The merit of expansionary policies outside of recessions is—or should be—based on what the nation and specific sub-populations need, not on austere logic and financial constraints. Spending now does not and should not need to imply that we "tighten the belt" in the future. The need for different types of equitable public spending to build a more resilient economy are well documented (Mason 2020; Stiglitz 2020; Bivens 2020). Austere claims are wrong on the economics, detrimental to our recovery, and should not guide our economic thinking or policy decisions.

We should focus our policy conversations, instead, on the types of spending we make—not on the increase to the debt or deficit level. We need spending that reduces inequality, attends to people's material needs, and improves the long-term health and well-being of people and the economy.

¹³ Ash, Basu, and Dube (2017) also make similar conclusions, finding no robust relationship between public debt and GDP growth for advanced capitalist economies. The authors refute the results of Reinhart and Rogoff (2010) and three other influential empirical austere works, rigorously showing that their results were driven by inappropriate parametric specifications and the effects of outliers within small samples.

¹⁴ Rogoff was among the economists who expressed support for US federal spending at the onset of the coronavirus-induced economic crisis (Tankersley 2020). Along with their co-authors, Reinhart and Rogoff subsequently wrote a brief, in line with their previous work, detailing the dangers that could follow from the sovereign and other debt accumulated by countries during the ongoing pandemic (Bulow et al. 2020). Interestingly, this analysis mostly stays clear of advanced capitalist economies.

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