Intelligence MEMOS

From: Alberto Alesina

To: Canadians Concerned about Government Budget Deficits

Date: March 12, 2020

Re: **Explaining Austerity**

For more in-depth discussion on this topic, listen to the C.D. Howe Institute podcast interview of Harvard's Alberto Alesina hosted by Michael Hainsworth, which is summarized here.

Austerity very simply is a policy or a combination of policies needed to reduce budget deficits. If governments followed appropriate policies, namely allowing deficits when necessary and compensating them with surplus when necessary, debt would not accumulate.

As I outline in my recent **book** (and summarized in an **Intelligence Memo**), austerity achieved through tax increases tends to trigger recessions and worsen a country's debt load. Whereas austerity accomplished through government spending cuts has only a limited impact on economic output.

My recent book looked at 16 OECD countries back as far as the 1970s. We found that austerity works when governments do it by cutting spending. When austerity works, most of the adjustment is on the spending side and not on tax side.

Why might this be? A fair reading of the economic literature would show that government spending multipliers are lower than tax multipliers. Spending multipliers are probably significantly less than one and tax multipliers are much larger than one.

Spending cuts telegraph to the investment community two things. One, that the government is attempting to be fiscally responsible. And two, maybe tax cuts are coming next.

Spending cuts boost investor confidence and that opens their wallets and that money that gets invested into the economy. That's what drives the economy.

In fact, we find that investor expectations improve after an announcement or an implementation of a spending-based plan and private investment picks up soon after the beginning of a plan. That compensates for the economic effect of the cut in government spending.

Future expectations that taxes are not going up – and may indeed go down because of reduced government spending – are important. When future expectations become optimistic it can be quite helpful to economic growth.

There is a commonly held view that the moment a government reduces a deficit by cutting spending or raises taxes it is finished, politically speaking. But this does not appear to be true. One example was Canada in the 1990s. It implemented a strict austerity program but was re-elected. There are many other examples of this from around the world.

We find that austerity programs based on increasing taxes seems to be more costly at the polls, particularly for right-wing governments. Spending-based austerity is on average, much less costly at the polls. However, such spending reduction plans are more politically costly for left-wing governments.

Alberto Alesina is the Nathaniel Ropes professor of political economy at Harvard University. These comments are extracted from the C.D. Howe Institute podcast.

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