Indian Institute of Management Calcutta
Working Paper Series
WPS No 849/ August 2020

To Spend or Not to Spend?: The Austerity Debate in Retrospect

Parthapratim Pal*
Professor, Economics Group
IIM Calcutta, Joka, Kolkata 700104, India
Email: parthapal@iimcal.ac.in

Partha Ray
Professor, Economics Group
IIM Calcutta, Joka, Kolkata 700104, India
Email: pray@iimcal.ac.in

*Corresponding Author

Indian Institute of Management Calcutta, Joka, D.H. Road, Kolkata 700104

URL: http://facultylive.iimcal.ac.in/workingpapers

To Spend or Not to Spend?:The Austerity Debate in Retrospect

Parthapratim Pal[1] **Partha Ray**[2]

Abstract

The concept of the desirability of government expenditure has undergone a roller-coaster evolution over the years. This paper provides a longitudinal map of this evolutionary journey. The traditional skepticism against any role of government in classical economics has been seriously questioned and effectively done away with the advent of Keynesian macroeconomics during the great depression. This was epitomized in the US President Roosevelt's New Deal during the 1930s. While the notion of a fiscal stimulus was in vogue during the 1940s through the 1960s, with spiraling inflation, the efficacy of fiscal stimulus came to be questioned, and slowly the intellectual tradition of austerity was reborn. Theoretically, this got a fillip initially from Milton Friedman and later by the rational expectationists like Robert Lucas or Robert Barro. While the birth of the new Keynesians since the 1980s swung the austerity pendulum away from a hands-off policy of the government, absence of any major recession in the advanced world during the 1990s and first few years of the new millennium, gave credence towards a policy of fiscal minimalism and associated austerity. Meanwhile, in the policy space, Reagan-Thatcher policy experiments of privatization and supply-side economics during the 1980s effectively implemented such an orthodoxy in both sides of the Atlantic. The global financial crisis of 2008-2009 changed all that, and a serious debate on the issue of "austerity versus stimulus" took place in the context of handling the fall-out of the recession. The recent Covid-19 pandemic, too, provided continuity to this intellectual debate.

Keywords: Fiscal Policy, Austerity, Great Depression, Global Financial Crisis, Covid-19 pandemic

JEL Classification Number: E 620, H 62, H63.

---

[1] Professor , Economics Group , IIM Calcutta , Email - parthapal@iimcal.ac.in

[2] Professor , Economics Group , IIM Calcutta , Email -pray@iimcal.ac.in

To Spend or Not to Spend? The Austerity Debate In Retrospect

Parthapratim Pal and Partha Ray

1. Introduction

From time immemorial, a classical dilemma facing the government of any country is: to spend or not to spend. Underneaththis notion lies a concept of "government budget constraint,"*viz*., how flexible the government's budgetary envelope is. If it so happens that after spending the government is near-bankruptcy, then there may be a case when the associated costs of the stimulus (like zooming inflation or bond yields and downgrading of the country's credit rating and associated capital flight) are going to outweigh its benefits. It is here that the "austerity versus stimulus" debate comesin. Simplistically, this is a debate in economics about the usefulness of the fiscal policy and whether a fiscal deficit can be financed in a sustainable manner.

The debate on austerity versus stimulus has a phoenix-like trait that tends to come up whenever there is any recessionary situation. This essay attempts a sweeping review of the historical context of the debate in the context of the three major depressions / recessions, viz., (i) the Great Depression of the 1940s; (ii) the Great Recession of the 2008-2009; and (iii) the ongoing recessionary situation associated with the Covid-19pandemic.

The rest of this essay is devoted to a discussion of the three macroeconomic crises and the related austerity versus stimulus debate in sections 2, 3, and 4, respectively. Sections 5 presents some concluding observations.

2. The Great Depression and Thereafter

Some Old Strands

The debate in economics about government spending is old, and it is intrinsically tied to the role of public debt in financing government expenditure. The rudiments of the debate can befound as early as the late 17th century,when Great Britainstarted looking for funds for its military expansion (Graeber, 2011). As taxation alone was not enough for such resource mobilization, the Bank of England was established in 1694 to help government borrowing. Subsequently, other central banks were established across Europe for similar purposes.During that time, public debt was used effectively by erstwhile colonial powers for their industrial development and colonial expansion (Hobsbawm, 1999). During the colonial years, thesepublic debts were largely self-financing as the resource flows from the colonies more than offset the cost of acquiring them (Konzelmann, 2012).

However, in the post-mercantilist era, there was a growing consensus among classical economists against public debt. The classical economists of the 18th and the 19th century were largely *laissez-faire* economists, and they strongly believed that the role of state should be minimum. For example, Adam Smith believed that government borrowings deprived a capital-poor society of revenue which could have been productively reinvested elsewhere. As Burkhead (1954) points out, according to Smith, "…The state was wasteful; it took funds from merchants and industrialists and spent these funds in riotous living. This deprived industry and commerce of capital which was badly needed for the furtherance of production and trade by diverting the national product toward consumer goods and away from capital good"(Burkhead 1954, p. 193).

In modern parlance, Adam Smith believed that government borrowing has a strong crowding-out effect.Smithand other classical economists also believed thatthere is acleardanger in the accumulation ofdebt. They believed that accumulation of public debt, beyond a certain critical level, can lead to a spiraling of debt and eventually to national bankruptcy. Moreover, as the classical economists implicitly assumed full employment, they believed any expansionary policy by the state would be destabilizing for the economy. The basic argument of the classical economists was that in the long-run, economies wouldautomatically gravitate towards full employment. According to the classical economists, in the long run, flexible wages and prices will keep the economy at or near its full-employment level.

Given this set of beliefs about the functioning of the economy, their policy focus was on a minimal expansionary role of the state, on balancing the budget and no use of anti-cyclical fiscal policies.It was suggested that a government should balance the budget and ideally equate itstotal expenditures to total revenue regardless of the cyclical state of the economy.

This line of argument also implied that in an economic downturn, when tax and non-tax revenues are likely to contract, the government should try to become more 'austere' and adjust its account by cutting back on expenditures.[3]This view has come to be known as the 'Treasury View'. The 'Treasury View' was the dominant policy view during the 1920s and 1930s.[4]As Peden (2004)shows, an exposition of the 'Treasury View' and the distrust of classical economists and policymakers of that ear can be found in Churchill's budget speech of 1929. Churchill said:

> "The orthodox Treasury view…is that when the Government borrow[s] in the money market it becomes a new competitor with industry and engrosses to itself resources which would otherwise have been employed

[3]https://www.thestreet.com/economonitor/emerging-markets/the-treasury-view-failed-in-the-1930s-why-should-it-work-now

[4] The orthodox Treasury view, and after all British finance has long been regarded as a model to many countries, is that when the Government borrow in the money market it becomes a new competitor with industry and engrosses to itself resources which would otherwise have been employed by private enterprise, and in the process it raises the rent of money to all who have need of it.

> by private enterprise, and in the process raises the rent of money to all who have need of it"(as quoted in Peden, 2004; p. 57).

Then he argues that if the government is indeed borrowing money for further expenditure, it must conclusively establish that such government expenditure would produce more beneficial results than if the money had been left available to private enterprises. Churchill then went on to say:

> "for the purpose of curing unemployment the results have certainly been disappointing. They are, in fact, so meagre as to lend considerable colour to the orthodox Treasury doctrine which has been steadfastly held that, whatever might be the political and social advantages, very little additional employment and no permanent employment can in fact as a general rule be created by State borrowing and State expenditure" (as quoted in Peden, 2004; p. 57).

It is sometimes alleged that the 'Treasury View' and its focus on minimizing budget deficits and focus on government 'austerity' during economic downturns was one of the reasons which prolonged the great depression of the 1930s(Arndt 2011).

Birth of Keynesian Macroeconomics

The challenge to the 'Treasury View' came from two Cambridge economists Kahn and Keynes, during the early 1930s. Richard Kahn, in 1931 developed the concept of an employment multiplier, which was later adopted and enriched by Keynes in his book *The General Theory*. The multiplier analysis suggests that, under certain assumptions regardingconsumption-saving behavior,a given amount of public expenditure will generate a much more significant increase in national income.This increased national income, in turn, will generate additional savings and taxesthatmay partly finance the initial public expenditure. Subsequent refinement of this analysis also showed that even when budgets are balanced, i.e., whenthe public expenditure is fully financed by taxation, the multiplier effect is still positive. The Keynes-Kahn argument strongly suggested that in a recession caused by demand deficiency, the government should increase its expenditure, and they should run expansionary fiscal policies to stimulate demand. Therefore, in an economic downswing, governments should increase their expenditure even if that leads to a budget deficit. This policy prescription of the Keynesians goes against the austerity measures suggested by the 'Treasury View', and this is the seed of the so-called'Austerity debate'. The Keynesian view also suggested that in an economic downturn, when the interest rates become extremely low and move close to the 'liquidity trap', conventional monetary policies will be less effective in boosting demand. Keynes suggested that fiscal policies should be a more effective policy instrument during severe economic downturns.

The Keynesian policies received attention in the rest of Europe and the United States. Sandwiched between the two World Wars, the Great Depression (August 1929 – March 1933) had a

profound effect on the US as well as the global economy.[5] In the US, contraction in industrial production was as much as 46.8 percent; in Germany, contraction surpassed 40 percent as well (Table 1).

Table 1: Peak-to-Trough Decline in Industrial Production in Various Countries (Annual Data) (Percent)	
Country	**Decline**
Unites States	46.8
Great Britain	16.2
Germany	41.8
France	31.3
Canada	42.4
Czechoslovakia	40.4
Italy	33.0
Belgium	30.6
Netherlands	37.4
Sweden	10.3
Denmark	16.5
Poland	46.6
Argentina	17.0
Brazil	7.0
Japan	8.5
Source: Romer (2003)	

Even if the major advanced countries are clubbed together, the Great Depression is reflected in all the major macroeconomic variables, viz., real GDP, price level, unemployment, and trade volume (Table 2). Lasting for five years, it is only in 1936, that the real GDP of the advanced economies were back to the 1929 level.

Table 2: The Great Depression in the advanced countries				
	Real GDP	Price level	Unemployment (%)	Trade volume
1929	100.0	100.0	7.2	100.0
1930	95.2	90.8	14.1	94.8
1931	89.2	79.9	22.8	89.5
1932	83.3	73.1	31.4	76.5
1933	84.3	71.7	29.8	78.4
1934	89.0	75.3	23.9	79.6
1935	94.0	77.6	21.9	81.8
1936	100.6	81.4	18.0	85.7
1937	105.3	91.5	14.3	97.4
1938	105.4	90.4	16.5	87.0
Source: Crafts and Fearon (2010)				

[5] Keynes (1931) observed that the world was then "in the middle of the greatest economic catastrophe . . . of the modern world . . . there is a possibility that when this crisis is looked back upon by the economic historian of the future it will be seen to mark one of the major turning points".

The Keynesian policies proved to be extremely effective in fighting the Great Depression of the 1930s. Increased government expenditure by the US government helped the US economy to recover from the Great Depressionquickly.As Hall (1989) documented, Keynesian ideas were widely implemented across all major developed countries during the post-depression economic recovery phase of the 1940s.

During this period, while Keynesian ideas were gaining ground, there were contrasting views also. One of the strongest oppositions came from Friedrich Hayek. Hayek was a supporter of laissez-faire economic policies, and he was of the view was that if a government tries to stimulate a flagging economy, it may end up causing more job losses than gains. He argues that in the face of large-scale unemployment, the market should be allowed to find its own solution.The differing views on Keynes and Hayek on the relative importance of market and state in the functioning of macroeconomics are still extremely relevant, and the debate keeps coming back every few decades.[6]

The post-WWII reconstruction period was largely dominated by Keynesian policies of large-scale state intervention. Butthe collapse of the Bretton Woods system and stagflation of the late 1960s and early 1970s moved the focus more towards monetarism. Keynesian policies were almost declared outdated during this period. The dominant mainstream economic thought of the Reagan-Thatcher era of the 1980s, embraced the free market doctrine suggested by Hayek. The role of the state was reduced, and there was more emphasis on the market mechanisms to achieve macroeconomic goals.In other words, since the decline of the Keynesianism since the 1970s, the role of state took a back seat the austerian policies gained mainstream acceptability among the developed countries.

The Resurgence of Austerians: Monetarism and Rational Expectations

Over the years, economists and policymakers debated about the relative effectiveness of monetary and fiscal policies to manage business cycles. The stagflation years of the 1970s brought 'Monetarism' back in favor over Keynesian dependence on fiscal policies. Rise of neoclassical economics once again tilted the debate towardslaissez-faire policies and against too much state intervention.In fact, calling for a minimalist government Friedman once famously said about government programs, "Nothing is as permanent as a temporary government program". Before we proceed further, it may be appropriate to locate Friedman in the earlier discussion of Keynes versus Hayek. We can do no better than to quote from Wapshott (2011):

> "Friedman's position offers clues on how best to gauge who won the Keynes-Hayek contest. In economics, Friedman was closer to Keynes and often praised Keynes's economics, in particular A Tract on Monetary Reform. Hayek conceded that "Milton's monetarism and Keynesianism have more in common with each other than I have with either." …. When it came to politics, however, Friedman was closer to Hayek.

---

[6]Wapshott (2011)chronicles the differing views of Keynes and Hayek and the debate on markets versus state that keeps coming back for the last 90 years.

> Keynes believed state intervention was a suitable means for improving the lives of citizens. Friedman agreed with Hayek that whenever the state intervened in the economy, it hampered the free market's ability to create wealth. Friedman approved of cutting taxes, not to pump more money into the economy, as Keynes recommended, but because he believed that government would shrink as a result. In this respect, Hayek made great strides. The communist tyrannies eventually collapsed, egged on by those inspired by Hayek's antistatist sentiments. While Hayek celebrated the demise of Soviet communism, he felt he had been defeated by Keynes in the widespread introduction of economic planning. According to Friedman, speaking in 2000, "There is no doubt who won the intellectual argument. . . . The intellectual opinion of the world today is much less favorable towards central planning and controls than it was in 1947. What's much more dubious is who won the practical argument. The world is more socialist today than it was in 1947. Government spending in almost every Western country is higher today than it was in 1947. . . . Government regulation of business is larger." Pp 286 (Kindle edition) (Wapshott, 2011).

The line of thinking was taken forward by the rational expectationists. Illustratively, Lucas (1986) said, "A coherent discussion of fiscal policy would thus require an opponent of deficit-reducing taxes today to indicate specifically which taxes he proposes to increase at future dates or, which comes to the same thing, which future revenues he proposes to sell, today, to the purchasers of new government bonds" and recommended, "On the fiscal side, adherence to the goal of budget balance (or at least peacetime budget balance) has been a traditional and effective device for enforcing time-consistency." Lucasian ideas on Keynesian stimulus has been best captured in Lucas (2004), when in commenting on his exposure to Keynesian macroeconomics he went on to say:

> "In writing the General Theory, Keynes was viewing himself as a spokesman for a discredited profession. . . .in a situation where people are ready to throw in the towel on capitalism and liberal democracy and go with fascism or corporatism, protectionism, socialist planning. . . . What he hits on is that the government should take on new responsibilities . . . for stabilizing overall spending flows. . . . And . . . for everybody in the post-war period – I'm talking about Keynesians and monetarists both – that's the agreed upon view... . So I think this was a great political achievement" (Lucas, 2004, pp 23-24).

However, later research by the New Keynesian macroeconomists showed that in presence of some wage-price inflexibility, demand management policies like fiscal policies might have a role in the short run. In a caricatured manner, in the short run, a fiscal stimulus may work to get the economy out of recession, but in the long-run, government spending will not work, and the new equilibrium will see the output to be back at the national rate with higher price / inflation.A further extreme position had been taken by Barro (1974). Under a fairly restrictive set of assumptions,Barro (1974) showed that rational optimizing agents will be indifferent between tax-financed and debt-financed government expenditure.[7]

[7] The assumptions for the validity of the equivalence results are: (i) successive generations are linked by altruistically motivated transfers; (ii) capital markets are either perfect, or fail in specific ways; (iii) the postponement of taxes does not redistribute resources within generations; (iv) taxes are nondiscretionary; (v) use of deficits cannot create value (that is, through bubble); (vi) consumers are rational and farsighted; and (vii) availability of deficit financing does not alter the political process.

Politically the Austeritians got massive support from the "neo-liberal" economic policies of Ronald Reagan in the US and Margaret Thatcher in the US.[8]The period also coincided with the fall of the USSR and the soviet bloc. Martin Feldstein, who was Economic Adviser to President Reagan summed up the following four principles of the economic thinking: (a) reduce inflation; (b) reduce high personal tax rates; (c) reduce the size of government; and (d) reduce regulation of the private sector (Feldstein, 2010). In fact, the non-defense discretionary spending of the US was reduced by one-third, from 4.7 percent of GDP in 1980 to 3.1 percent in 1988. In UK, Thatcher privatized a large number of large public sector companies, reduced tax rate, broke trade union power, and the UK economy ended up with a much smaller government.

Followed by macroeconomic success of the Reagan-Thatcher policies of the 1980s, and the subsequent wave of globalization, the received wisdom at the beginning of the new millennium was one of a minimalist government where, asBlanchard (2008) has said, "The state of Macro is good". But the Global Financial Crisis (GFC) of 2008-2009 brought back the 'Austerity Debate' in economics and policy discourse.

3. Global Financial Crisis (GFC) and Ghost of Keynes

The GFC of 2008-09 was one of the most severe economic downturns suffered by the developed countries in many decades, and the governments in these countries took recourse to Keynesian stimulus programs to boost demand in these economies.

In fact, countries all over the world belonging to varied geographies or economic blocks resorted to fiscal stimulus. In fact, in 2008 and 2009, fiscal deficits went all up (or extent of fiscal surplus came down) for all sorts of countries. There was a quantum jump in both fiscal expenditures as well as gross debt (as a percentage of GDP) (Table 2).

Interestingly, for some of the advanced countries like those in the Euro Area, these numbers did not improve much, even by 2011, because of the ensuing euro area crisis. With hindsight, it seems profound that Paul Samuelson in an interview in January 2009 (at the age of 92, a few months before death) said, "The Keynesian idea is once again accepted that fiscal policy and deficit spending has a major role to play in guiding a market economy. I wish Friedman were still alive so he could witness how his extremism led to the defeat of his own ideas".

[8] Margaret Thatcher became Prime Minister of UK on 3 May 1979; one and half years later, on 4 November 1980, Ronald Reagan became the US President.

In reviewing the take-aways from the global financial crisis Izvorski (2018) has enumerated four lessons: (a) counter-cyclical fiscal policy can be an effective tool in crises; its impact is country- and situation-specific; (b)fiscal policy should be counter-cyclical in both good and bad times; (c) fiscal stimulus must be large enough, temporary, and targeted; and (d) fiscal policy alone cannot fix structural problems, and it may exacerbate them.

Table 2: Select Fiscal Indicators: 2007-2011 (% of GDP)

		2007	2008	2009	2010	2011
General Government Net Lending / Borrowing	Advanced economies	-1.3	-3.5	-8.7	-7.7	-6.3
	Euro area	-0.7	-2.2	-6.2	-6.2	-4.3
	Major advanced economies (G7)	-2.2	-4.5	-9.9	-8.9	-7.5
	Other advanced economies	3.4	2.0	-1.2	-0.5	0.2
	European Union	-0.9	-2.5	-6.5	-6.4	-4.5
	Emerging market and developing economies	0.8	0.8	-3.7	-2.3	-0.9
	Emerging and developing Asia	-1.1	-1.6	-3.3	-2.2	-1.6
	Emerging and developing Europe	1.2	0.3	-6.0	-4.2	-0.8
	ASEAN-5	-1.0	-0.4	-2.9	-2.0	-1.0
	Latin America and the Caribbean	-1.1	-0.8	-3.6	-3.3	-2.6
	Middle East and Central Asia	8.1	9.9	-2.0	1.5	3.9
	Sub-Saharan Africa	0.5	1.2	-4.5	-3.5	-1.2
General Government Total Expenditure	Euro area	45.5	46.7	50.8	50.7	49.3
	Major advanced economies (G7)	38.3	40.2	44.2	43.0	42.2
	Other advanced economies	30.9	32.4	34.3	32.7	32.6
	European Union	44.1	45.6	49.5	49.5	48.1
	Emerging market and developing economies	26.5	28.4	30.0	29.4	29.4
	Emerging and developing Asia	20.3	23.1	25.1	24.4	25.8
	Emerging and developing Europe	36.0	36.6	40.6	38.6	36.2
	ASEAN-5	20.9	21.2	21.7	20.6	20.5
	Latin America and the Caribbean	29.7	31.3	32.0	33.1	32.8
	Middle East and Central Asia	26.3	28.7	32.4	30.1	29.4
	Sub-Saharan Africa	22.9	23.2	24.2	24.4	24.3
General Government Gross Debt	Advanced economies	70.9	77.7	90.9	97.4	101.5
	Euro area	65.1	68.8	79.3	84.9	87.0
	Major advanced economies (G7)	80.6	88.6	103.5	111.8	116.9
	Other advanced economies	31.3	32.8	35.6	35.8	36.2
	European Union	58.0	62.4	73.2	79.1	82.0
	Emerging market and developing economies	35.7	33.8	38.8	37.7	36.9
	Emerging and developing Asia	40.2	36.8	41.5	40.1	39.6
	Emerging and developing Europe	23.6	23.7	29.2	29.4	28.2
	ASEAN-5	37.5	36.3	38.2	36.4	35.1
	Latin America and the Caribbean	46.0	46.1	48.9	47.5	47.0
	Middle East and Central Asia	28.2	24.6	30.5	27.6	24.8
	Sub-Saharan Africa	25.3	24.6	28.4	27.3	29.4

Source: World Economic Outlook Database, October 2019, IMF

Around 2010, economists started debating whether such expansionary policies, which led to high fiscal deficits and growing public debts, should be continued or curtailed.The arguments of the "Austerians" were as follows:

First, growing government debt is a problem. The GFC happened because of too much and an unregulated boom in private debt. Similar problems can happen if public debt grows unabated and is not brought under control. This view was supported by two influential works by Carmen Reinhart and Kenneth Rogoff (Reinhart and Rogoff 2009; 2011). Their works claimed that rising levels of government debt are associated with weaker levels of economic growth. Moreover, once the debt/GDP ratio crosses the mark of 90 percent, then an increase in public debt leads to a decrease in GDP growth rate. As a real-life validation of this work, the Greek crisis was highlighted as an example by the Austerians.

Second, there were worries that large fiscal deficits would lead to inflation and would impact long-term interest rates, the point which essentially brought back the crowding-out issues to the fore. As a back-up to this argument, it was suggested that fiscal probity would inspire more confidence among private investors.

Third, there were also apprehensions about the signs and magnitude of government expenditure multipliers. As Blanchard and Leigh (2013) point out, several studies based on pre-crisis data for advancedeconomies indicatedfiscal multipliers to be roughlyaround 0.5. This raised the question of how effective the fiscal multipliers would be during the crisis.

Alberto Alesina, Carlo Fevero and FraccescoGiavazzi in their 2019 book titled, *Austerity* have advocated "expansionary fiscal contraction", whereby a fiscal contraction may paradoxically generate growth. Distinguishing between "Expenditure Based" (EB) and "Tax Based" (TB) plans, they found a large and statistically significant difference between the effects of EB and TB austerity on output. While EB fiscal consolidations have been associated with a very small downturn in output growth, TB plans tend to get associated with large and long-lasting recessions.

In response, Krugman and anti-Austerity economists have pointed out that the works by Rogoff and Reinhart have used questionable methodologies, and there are serious errors and omissions in their calculations(Herndon, Ash and Pollin, 2014). Once these are corrected, the results become less strong, and the correlation between high debt and slow growth breaks down to a large extent.[9]They also highlight

[9]It is interesting to turn to Cassidy (2013), who in summing up the controversy noted, "There may well be a threshold at which high levels of public debt tend to be associated with very bad growth outcomes and financial crises, but it isn't ninety per cent of G.D.P., or even a hundred per cent. Maybe it's a hundred and twenty per cent, although that figure isn't a firm one, either".

that Greece was a special case as it does not have its own central bank and the problems faced by Greece is unlikely to be replicated by other countries that do not suffer from the constraints of EU countries. Moreover, the impact of high government spending resulting in high inflation and high interest rates has not happened in practice.

Meanwhile, a new database of austerity measures derived from actual changes in spending and tax rates published by IMF (WEO October 2010), could not find support for Alesina's expansionary fiscal contraction but found that austerity has a consistently negative effect on growth. Finally, as IMF (2012) shows:

> "The main finding, based on data for 28 economies, is that the multipliers used in generating growth forecasts have been systematically too low since the start of the Great Recession, by 0.4 to 1.2, depending on the forecast source and the specifics of the estimation approach. Informal evidence suggests that the multipliers implicitly used to generate these forecasts are about 0.5. So actual multipliers may be higher, in the range of 0.9 to 1.7."(p. 41).

4. The COVID Pandemic: Austerity is Dead – Long Live Fiscal Stimulus

Coming back to the COVID crisis, even the staunch supporters of fiscal austerity have supported stronger fiscal stimulus. In an interview given to Bloomberg, when asked about growing public debt in major economies, Rogoff agrees that this crisis is different and replies, "It's not a free lunch, but there was no choice. This is like war. There is no debate that they should be doing all they can to try to maintain political and social cohesion, to maintain economies."[10]

Similar views are also expressed by the International Monetary Fund.The IMF is traditionally a pro-austerityorganization with a view that there should be less government intervention in the economy and greater reliance on market forces for attaining allocative efficiency. The IMF discourages governments from running high fiscal deficits, andits general emphasis has been more on Monetary Policy and supply-side instruments. However, during the Covid-19crisis, the IMF is suggesting a strong fiscal response from the governments. In a recent blog, IMF has pointed out that the ongoing pandemic triggered an unprecedented fiscal policy response of close to $11 trillion worldwide. It further suggests that as the crisis progresses, policymakers may need to increase their fiscal space even more to tackle the crisis.

The IMF Fiscal Monitor of April 2020 (IMF 2020) commented:

> "Fiscal policies are at the forefront of responding to the COVID-19 pandemic. Fiscal measures can save lives, protect the most-affected people and firms from the economic impact of the pandemic, and prevent the health crisis from turning into a deep long-lasting slump. A key priority is to fully accommodate spending on health and emergency services. Global coordination is for a universally low-cost vaccine and to support countries with limited health capacity. Large, temporary and targeted support is urgently needed for affected workers and firms

[10] https://www.bloombergquint.com/coronavirus-outbreak/harvard-s-financial-crisis-experts-this-time-really-is-different

> until the emergency abates. As the shutdowns end, broad-based, coordinated fiscal stimulus—where financing conditions permit—will become more effective in fostering the recovery."

In other words, strong state intervention in fighting the Covid-19 is needed. It is clear now that the Covid-19 crisis has caught the world unguarded and showed how underprepared the world's healthcare system has been to tackle a global pandemic. To tackle the medical emergency, the role of the state will be paramount in investment in public healthcare infrastructure and healthcare delivery systems. Once the virus is contained, the next challenge will be to manage the exit from the Covid crisis. This will require investments in acquiring drugs and vaccines and ensuring affordable and accessible drug delivery and treatment to the population. Moreover, the pandemic will lead to some irreversible changes in the economy. Some major sectoral shifts will happen, which will lead to job losses. There are also apprehensions of further concentration and consolidation of businesses across sectors. Given these possible developments, it will be the role of the government to reduce the transition cost associated with this transformation. Also, on top of these, there will be the overarching role of the state to generate additional demand in a demand-deficient global economy facing the most severe recession since the Great Depression of the 1930s.

Hence, the focus should not be on austerity or to adhere to a predefined target of fiscal deficit. As an IMF blog says: "In times of pandemic, fiscal policy is key to save lives and protect people. Governments have to do whatever it takes. But they must make sure to keep the receipts".[11]Economists like Paul Krugman, Joseph Stiglitz or Larry Summer, who have been writing against the austerity measures since the GFC, have quite predictably asked for more government intervention in this present pandemic (Krugman, 2020; Stiglitz, 2020; Summers, 2020).

Overall, from the present academic discourse and policy responses from most of the states, it can safely be concluded that the role of the state and fiscal policy measures have become the primary and most effective tool in managing the present crisis.

On the other hand, it will be difficult to depend on market forces in an emergency like this. Global lockdowns have ensured that most markets cannot operate, and therefore, price signals cannot be obtained in many of the markets. There is a lack of information and absolutely no clarity about how and when a medical solution to the COVID virus will come.And most importantly, there are huge negative externalities associated with the highly contagious virus and its spread. Each of these factors alone can be a major reason for market failure, and when taken together, they highlight why markets or the private sector cannot provide a solution to the present crisis. This also explains why economists and

---

[11]https://blogs.imf.org/2020/04/15/fiscal-policies-to-contain-the-damage-from-covid-19/

organizations with a traditionally pro-market viewpoint are arguing for an increased role of the state and against both 'Austerity' and dependence on market forces to tackle this pandemic.

But there are some concerns. The Covid crisis and the resultant economic downturn will lead to a steep fall in government revenues. However, as discussed, it is expected that there is a need for sharp increase in government expenditure in most countries. Therefore, fiscal deficits are likely to soar across the board. IMF projections show that fiscal deficits are expected to be more than five times higher in developed countries and more than double in emerging market economies.This will lead to a huge jump in public debt. Once the world comes out of the Covid crisis, it will be important to find a solution to this problem (IMF 2020).

5. Concluding Observations

It is difficult to conclude the evolutionary story of a concept called fiscal austerity. At the risk of a broad generalization and caricaturing the nuanced history, the present essay tried to identify the twists and turns in acceptance of the notion of fiscal austerity, that has nearly traversed a full circle and half since the initial days of the early twentieth century. While the great depression and the birth of Keynesian macroeconomics paved the path of fiscal stimulus and activism, the advent of Friedmanian philosophy questioned it; this was cemented by the rational expectation revolution later. Years of high inflation of the 1970s and 1980s gave made the world skeptical about the efficacy of fiscal stimulus. The Reagan-Thatcher experiments in the UK and the US gave credence to the doctrine of minimalist state intervention and associated fiscal austerity. The global financial crisis of 2008-2009 and the current Covid-19 pandemic rehabilitated the role of fiscal stimulus again.

There was a cartoon in *New Yorker* where two kids, one of whom resembling Keynes, were walking together on a hilly road, where the kid started telling Keynes, "You are old-fashioned and useless … modern economics have transcended you" – but the very next step, the kid slipped, and shouted, "Keynes help me". And Keynes pulled him up and the kid became stable and started walking, only to begin his earlier sermon, "Keynes, you are old fashioned and useless…..". The story of our evolutionary journey of the notion of austerity is perhaps best summed up in this cartoon.

References (all URLs have been accessed in July – August 2020)

Alesina, Alberto., Carlo Fevero and FraccescoGiavazzi (2019): *Austerity*, Princeton: Princeton University Press.

Arndt, HW (2011): *The Importance of Money: Essays in Domestic Macroeconomics, 1949-1999*, London and New York: Routledge.

Barro, Robert J. (1974): "Are Government Bonds Net wealth?", *Journal of Political Economy*, 82 (6): 1095-117.

Blanchard, Olivier and Daniel Leigh (2013): "Growth Forecast Errors and Fiscal Multipliers", *IMF Working Paper, No. 13/1*.

Blanchard, Olivier J. (2008): "The State of Macro", *MIT Working Paper No. 08-17*, available at http:/7ssrn.com/abstract= 1 235536

Burkhead, Jesse (1954): "The Balanced Budget", Q*uarterly Journal of Economics*, 68(2): 191–216.

Cassidy, John (2013): "The Reinhart and Rogoff Controversy: A Summing Up", *New Yorker* (April 26), available at https://www.newyorker.com/news/john-cassidy/the-reinhart-and-rogoff-controversy-a-summing-up

Crafts, Nicholas and Peter Fearon (2010): "Lessons from the 1930s Great Depression", *Oxford Review of Economic Policy*, 26(3): 285–317.

Eric J. Hobsbawm (1999): *Industry and Empire: From 1750 to the Present Day* (Revised and updated by Chris Wrigley), New York: New Press.

Feldstein, Martin (2010): "Is the Reagan-Thatcher Revolution Over?", Project Syndicate, Available at https://www.nber.org/feldstein/projectsyndicatejan2010.pdf

Graeber, David (2011): *Debt: the first 5,000 years*, Brooklyn, NY: Melville House Publishing.

Hall, Peter A (1989): *The Political Power of Economic Ideas: Keynesianism across Nations*, Princeton: Princeton University Press.

Hayek FA (1944): *The Road to Serfdom*, Routledge Press, UK and University of Chicago

Herndon Thomas, Ash, Michael and Pollin Robert (2014): Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogof, *Cambridge Journal of Economics*, March 2014.

Hobsbaum, E. (1999):*Industry and Empire: The Birth of the Industrial Revolution*. New York: New Press.

IMF (2010): *World Economic Outlook, October 2010*, International Monetary Fund, Washington DC, October 2010.

IMF (2012): *World Economic Outlook, October 2012*, International Monetary Fund, Washington DC, October 2012.

IMF (2019): World Economic Outlook, October 2019, International Monetary Fund, Washington DC, October 2019.

IMF (2020): *IMF Fiscal Monitor, April 2020,* International Monetary Fund, Washington DC, April 2020.

Izvorski, Ivilo (2018): "10 years Later: Fiscal Policy Lessons from the Global Financial Crisis", *Brookings Working Paper*, available at https://www.brookings.edu/blog/future-development/2018/06/25/10-years-later-4-fiscal-policy-lessons-from-the-global-financial-crisis/

Keynes, J. M. (1931): “An Economic Analysis of Unemployment”, in Q. Wright (ed.), *Unemployment as a World Problem*, Chicago, IL, University of Chicago.

Keynes, J. M. (1936): *The General Theory of Employment, Interest and Money*. London: Macmillan.

Konzelmann, Sue (2012): “The Economics of Austerity”, Centre for Business Research, *University of Cambridge Working Paper No. 434*.

Krugman, Paul (2019): “Peacocks and Vultures Are Circling the Deficit”, Op-ed in *New York Times* (April 27, 2020), available at https://www.nytimes.com/2020/04/27/opinion/republicans-deficits-coronavirus.html

Lucas, Robert (2004): “My Keynesian education” in M. De Vroey and K. Hoover (eds.): *The IS-LM Model: Its rise, Fall and Strange Persistence*, History of Political Economy (Annual Supplement to Vol. 36), Durham, NC, Duke University.

Lucas, Robert E. (1986): “Principles of Fiscal and Monetary Policy”, *Journal of Monetary Economics*, 17: 117-134.

Peden, G. C (2004): *Keynes and his Critics: Treasury Responses to the Keynesian Revolution, 1925-1946,*Oxford: Oxford University Press (for the British Academy).

Reinhart, Carmen M., and Kenneth S. Rogoff (2009): *This Time Is Different: Eight Centuries of Financial Folly*, Princeton, New Jersey: Princeton University Press.

Reinhart, Carmen M., and Kenneth S. Rogoff (2011): “From Financial Crash to Debt Crisis,” *American Economic Review*, 101(5): 1676–706.

Romer, Christina D (2003): “Great Depression”, Entry in *Encyclopædia Britannica*, https://eml.berkeley.edu/~cromer/Reprints/great_depression.pdf

Samuelson, Paul (2009): “Don’t Expect Recovery Before 2012”, Interview (16 January 2009), NPQ Archives, available at https://web.archive.org/web/20181105214833/http://www.digitalnpq.org/articles/economic/331/01-16-2009/paul_samuelson

Stiglitz, Joseph (2020): *Rewriting the Rules of the European Economy – An Agenda for Growth and Shared Prosperity*, Brussels: Foundation for European Progressive Studies.

Summers, Lawrence H (2020): “Covid-19 looks like a hinge in history”, *Financial Times*, May 14.

Thomas Herndon, Michael Ash, Robert Pollin (2014): “Does high public debt consistently stifle economic growth? A critique of Reinhart and Rogoff”, *Cambridge Journal of Economics*, 38(2): 257–279.

Wapshott, Nicholas (2011): *Keynes versus Hayek: The Clash That Defined Modern Economics*, New York/London: W.W. Norton & Co.

****