CENTRO STUDI SUL FEDERALISMO

research paper

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EXPANSIONARY AUSTERITY: IS IT STILL A VIABLE ECONOMIC POLICY OPTION IN EUROPE?

October 2023

ISSN: 2038-0623

ISBN: 979-12-80969-08-8

ABSTRACT

The expansionary austerity thesis (EAT) emerged and established itself in the 1990s, based on theoretical and empirical research, and was rapidly incorporated into macroeconomic theory. In a nutshell, fiscal consolidations, aimed at stabilising or lowering the public debt-to-GDP ratio, can stimulate growth, even during a recession. Simply put, expansionary austerity materialises. This is a counter-intuitive effect, that can significantly be defined as "non-Keynesian".

In this article, we attempt to summarise the debates around the EAT and argue for its critical evaluation through a discussion of its assumptions and functioning, with specific reference to the European Union. While much of the criticism has addressed various shortcomings of econometric techniques, less attention has been paid to the logical robustness of the theoretical underpinnings of the EAT. We provide an in-depth examination of austerity in terms of its evolution in economic thought and consider Europe as a reference point, highlighting the link between the Washington Consensus and the Berlin-Brussels Consensus. We conclude that the EAT ultimately proved to be an oxymoron, but the risks of fiscal austerity could recur in the EU, undermining the need for expansionary fiscal policy in times of crisis.

Keywords: Expansionary austerity, Keynesian counter-revolution, European austerity, Keynesian multiplier

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1. Introduction

The expansionary austerity thesis (EAT) emerged in the 1990s, based on theoretical and empirical research (Giavazzi and Pagano, 1990; Blanchard, 1990; Sutherland, 1997; Giavazzi, Jappelli and Pagano, 1999; Reinhart and Rogoff, 2010[1]; Alesina, Favero and Giavazzi, 2019) and was rapidly incorporated into macroeconomic theory. In a nutshell, the thesis states that fiscal consolidations, aimed at stabilising or lowering the public debt-to-GDP ratio and achieved through cuts in public spending, tax increases or a combination of both, can stimulate private consumption, investment and net exports. This is a counter-intuitive effect, which can significantly be defined as "non-Keynesian". Furthermore, this approach outlines that fiscal consolidation could be successfully implemented even during a *recession*; "successfully" indicates that not only is the objective of stabilising or lowering the public debt-to-GDP ratio achieved, but growth can also be promoted: in other words, expansionary austerity materialises.

Therefore, for the authors cited above, a well-designed austerity programme, implemented with spending cuts and strict budgeting, could be beneficial for economic growth, both in the short and long term (Giavazzi and Pagano, 1996; Alesina and Perotti, 1995; 1997; Alesina and Ardagna, 1998; 2010).

In this paper we try to summarise the debates around the EAT and conduct a critical evaluation, through a discussion of its assumptions and functioning. Indeed, while much of the criticism has addressed various shortcomings of the econometric techniques adopted by austerity's advocates to validate their theoretical propositions, less attention has been paid to the logical solidity of the underlying theoretical foundations.

In this regard, we underline the relevance of Botta's (2016; 2020) interesting contributions, which can be conceived as a starting point for our investigation into austerity as an oxymoron. In fact, we integrate the results of the aforementioned papers by Botta, with an in-depth analysis of the evolution of austerity in economic thought and with Europe as a point of reference for the debate.

We believe that the EAT is unfortunately still relevant: the principles of expansionary fiscal austerity are very much alive and far from a desirable debacle, despite the fact that the Covid-19 pandemic has led to massive government spending, particularly through the Next Generation EU

[1] Reinhart and Rogoff (2010) provide empirical support to the EAT showing that countries with high public debts - that is, with debts over 90% of GDP - have historically had negative growth rates. Although not explicit in supporting expansionary austerity, this paper has provided empirical support to the pro-austerity theses of economists and politicians.

(NGEU) programme in Europe. The temporary nature of measures adopted during the pandemic also applies to the suspension of European fiscal rules. As regards the reactivation and reform of fiscal rules, the German Finance Minister Christian Lindner, for instance, has returned to this point and together with other "frugal" countries is once again asking for strong guarantees that a minimum annual debt reduction target will be maintained: "As far as the capital markets are concerned, debt is debt. Capital markets are not interested in the motives for taking on debt, however worthy they may be. To preserve credibility vis-à-vis the capital markets, Member States need to avoid excessive deficits and debt levels or implement realistic, timely and sufficient reductions in deficits and debt ratios" (Federal Ministry of Finance, 2023). In contrast, the theoretical evidence in this paper shows that the constraints are once again too rigid (for example, the deficit target of 3%) and the hypothesis of not excluding investments for the ecological and digital transitions from the calculation of debt is a mistake.

The paper is structured as follow: Section 2 starts with a presentation of the concept of fiscal austerity. We try to show the surprising continuity between the "Treasury view", from the Washington Consensus to the Brussels Consensus, and the economic policies implemented by several European Countries, primarily by Germany, since the end of the 1980s[2].

Section 3 presents an overview of the mechanisms through which austerity measures are expected to produce expansionary effects in the short and long run, in accordance with the EAT. This section, in turn, offers a useful framework to prepare the ground on which critical theoretical (Section 4) and empirical (section 5) discussions will then be presented. The core of the debate on expansive fiscal austerity is analysed critically regarding the role of fiscal multipliers which has challenged advocates of expansionary austerity. Section 6 then deals with conclusions.

2. The origin and the evolution of a dangerous idea

As we outlined in the introduction, in this section we try to explain why the "dictum" of austerity in economic thought originated well before the 90s: it emerged from the orthodox British Treasury view that developed in the 1920s.

This dogma first of all firmly maintains that expansive fiscal policy is totally ineffective: whatever the political or social advantages, very little additional and permanent employment can in fact, and as a general rule, be created by Government spending and borrowing. The Treasury's original view has been further elaborated on to show how expansionary fiscal policies, implemented by the Government, were not only ineffective, but they were also harmful as they resulted in an increase in a country's debt without bringing any advantages to the real sector.

Combined with the repeated failures of austerity to salvage slumping economies during the 1930s, Keynes, in "The General Theory of Employment, Interest and Money" (1936), was prompted to kill austerity as a respectable idea. As it is well known, Keynes was in fact in favour of reducing unemployment through a programme of public investment (Keynes 1929; 1936). Why, then, has austerity come back with such force more than 60 years later? Ideologically, it is the

[2] Although a more general austerity order was born in the aftermath of World War I, austerity as a fiscal measure within a broader framework is particularly strong in Europe.

intuitive appeal of austerity - of not spending more than you have - that really casts its spell[3]. Austerity is a seductive idea due to the simplicity of its core claim that it is not possible to repay debt with more debt. To answer that question, we need to examine the United States, where austerity thinking managed to survive by changing its "clothes" and promoting the long "Keynesian winter" and the surge of the Washington Consensus. As we will show later, the Washington Consensus, in turn, gives rise to the crisis response in the Eurozone called the Brussels Consensus[4].

The austerity programme, inspired by the Washington Consensus, was nothing more than a voluntary deflation in which the economy adjusts itself through the reduction of wages, prices and public spending to restore competitiveness, which is best achieved by cutting the state's budget, debts and deficits (Blyth, 2013). It was expected that these policies would inspire "business confidence" as the Government would neither "crowd out" the market for investment nor add to the nation's already "too large" debt.

Mattei (2018, 2022)[5] therefore rightly considers austerity not only in its fiscal dimension, but as a combination of three pillars: the over mentioned fiscal austerity (a reduction of the welfare state); monetary austerity (increasing interest rates to pursue a deflationary effect); and industrial austerity (with wage flexibility and wage repression)[6]. All of these result in distributional consequences, shifting resources from workers to financial investors, to preserve the capital order (Mattei, 2022)[7].

Now, looking at the European context and in order to better understand the concept of expansionary fiscal austerity theories and policies (i.e. the so-called Brussels Consensus), we need to return to Germany and the northern EU countries, where not only has this approach to macroeconomics circulated for several years, but it still circulates today.

When applied to the European context, not only is austerity synonymous with fiscal consolidation, but it includes structural reforms of the public sector and flexibilisation of labour

[3] Understanding how austerity came to be the standard policy in liberal economic thought when states get into trouble can reveal why it is so seductive and so dangerous.

[4] Our paper tries indeed to link closely and clearly the Treasury View, the Washington Consensus and the Brussels Consensus.

[5] Mattei argues that at the end of World War I, a wave of socio-economic disorder, characterised by political demands by workers for democratic rights and freedoms, bringing causing class conflict to be a threat to the order of capitalism. In her historical reading about the origin of austerity, she finds that this explosive social context provided the basis for a combination of austerity and technocracy to take hold as a tool to secure socio-economic stabilisation: "Austerity was an economic, moral, and technocratic message with which the economic experts sought to educate and civilise a restless post-war civil society." (Mattei, 2018, p. 11).

[6] We agree with Mattei's important point, which expands the understanding of austerity. Nevertheless, and unfortunately, Mattei in her book has misunderstood Keynes's critical vision against the Treasury Point of View and as regards the interest rate policy by the Bank of England during the 1920s. Keynes was indeed very critical both about fiscal austerity (and particularly during a recession) and about the monetary policy's restrictions and the return to the gold standard.

[7] This reference framework remains valid even if a stricter definition of austerity is adopted. Given the three channels through which fiscal consolidation produces its supposed benefits (see Section 3), expansionary fiscal austerity needs industrial austerity to be valid.

markets. It is easy to recognise the ingredients of the Berlin-Washington Consensus, a set of policies promoted since the 1980s by international organisations and academics, based on macroeconomic stability (balanced budgets and price stability); structural reforms aimed at increasing competition and openness; clear distinction between a short-term horizon and a 'natural' long-term position of the economy in which only supply factors matter (Fitoussi and Saraceno, 2013). Therefore, in Europe, the original prescriptions of the Washington Consensus have been widely internalised, in particular thanks to the intellectual environment marked by the neoliberal counter-revolution to Keynes that had begun in the US but had spread rapidly since the 1970s in many European countries.

To investigate the move away from Keynesian economics and to consider a reference point of the Brussels Consensus, we can examine the German case in more depth. Indeed, according to the vision promoted by the German Council of Economic Experts, a shortfall in investment that would be needed to reduce unemployment was attributed, not to a lack of aggregate demand, but to low profitability of firms, partly due to high wage costs, as was the case in the mid-1970s in Germany. The "German view" concludes that in the medium term, the unemployment problem could be solved if wage policy was sufficiently moderate, if the government managed to consolidate its budget, and if all regulatory constraints on investment were eased (Hellwig and Neumann, 1987).

An explicit policy of demand management through fiscal or monetary measures must be avoided as, in the long term, they would cause increased inflation, wage demands from unions, a fiscal deficit and more general uncertainty that would undermine investment. According to this supply-side approach, the level of employment depends on the production decisions of companies based on their capacity utilisation, and unemployment may occur if production at full capacity is not profitable[8].

Furthermore, the German Council of Economic Experts points out that in both 1974-75 and 1978-79, a counter-cyclical expansionary fiscal policy had been implemented without much success. Unemployment was hardly affected, and after a while the increase in the public deficit and public debt seemed to require corrective action. Indeed, the experience of 1978-81 was seen as an explicit confirmation of the Council's view that expansionary fiscal and monetary policy might reduce unemployment in the short run, but could increase it in the long run.

The old 'myth' of austerity therefore remains firmly anchored to this day. Although Keynes and Keynesian policies were resurrected for a while during the darkest moments of the 2008-2013 crisis, they finally left the scene. As an initial reaction to the 2008 financial crisis, governments pursued a fiscal stimulus that was considered the appropriate macroeconomic solution to save the economy from another Great Depression and contain the severity of the crisis. At that time,

[8] On the contrary, a demand-side approach has been promoted, without success, by German Trade Unions since firm's production is constrained by insufficiency of demand, and increasing investment would not solve the problem, as investment is capital-deepening. The solution is "that wages be increased in order to redistribute income to workers and thereby raise aggregate demand. Moreover, the proponents of the demand-side approach consistently asked for an expansionary fiscal and monetary policy" (Hellwig and Neumann, 1987, p. 111).

governments were urgently considering measures to bring the economy back from the brink and rebuild confidence in the market system. The EU launched a two-year European Economic Recovery plan worth €200 billion, based on a mix of short term national and European fiscal stimulus.

However, this initial reaction was mainly seen as a moment of political emergency, rather than a "Keynesian moment", in the true sense of a rehabilitation of Keynesian economics and a change from the neoliberal policy regime (Terzi, 2010). Furthermore, in the wake of mounting public debt in June 2010, the G20 marked a return to the focal point of fiscal consolidation[9].

During the sovereign debt crisis, the responsibility for the crisis was attributed to the State and not to finance. The State had accumulated too much public debt; the economic policies pursued by the State, to escape the crisis and support economic growth, were criticised as Keynesian measures. "Austerity" became the motto again; austerity will save us (Carabelli and Cedrini, 2015). This entails restrictive measures such as cuts in spending and demand. Only supply-side policies were suggested as the engine of growth: wage cuts, price cuts, improved competitiveness, increased productivity, increased competition.

Arestis and Pelagidis (2010, p. 58) highlight the counterintuitive development that took place after the brief Keynesian phase: "The answer, however, to the question of why the continent-wide approach has turned toward austerity can easily be explained. If state budgets are restricted, so the magical thinking goes, wonderful things will happen. Sovereign bond prices will rise, rescuing imperilled banks. Moribund interbank lending will be resuscitated. Government borrowing costs will decline. Economies will be reinvigorated."

In 2012, Paul Krugman mocked the idea of the confidence fairy promoted by austerity. However, although this policy has proved to be a failed economic solution after the financial crisis, it was difficult to abandon it, especially in Europe where "leaders spent years in denial, insisting that their policies would start working any day now, and celebrating supposed triumphs on the flimsiest of evidence" (Krugman, 2012). The reference was to policy makers such as Jean Claude Trichet, who in 2010 believed in the mantra "short term pain for long term gains" [10].

[9] "The global economy continues to recover faster than anticipated, although at an uneven pace across countries and regions. However, the recent volatility in financial markets reminds us that significant challenges remain and underscores the importance of international cooperation… The recent events highlight the importance of sustainable public finances and the need for our countries to put in place credible, growth-friendly measures, to deliver fiscal sustainability, differentiated for and tailored to national circumstances. Those countries with serious fiscal challenges need to accelerate the pace of consolidation." (G20 meeting, June 4-5, 2010)

[10] This approach was strongly favoured within European institutions. A case in point was again the then President of the European Central Bank (ECB), J. C. Trichet, claiming that "we have the experiences of fiscal consolidation episodes in less exceptional times, which make clear the long- term benefits of reducing sizeable fiscal imbalances. These experiences also suggest that, provided consolidation is pursued as part of a comprehensive reform strategy, the short- term costs for economic growth tend to be contained or very limited" (Trichet, 2010)

3. The expansionary austerity hypothesis and its transmission mechanisms

We now evaluate, from both a Keynesian and a non-Keynesian approach, how fiscal policy spreads to the rest of the economy. This point is, of course, well examined in the literature (Hemming et al., 2002; Briotti, 2005), but it is worth considering the underlying mechanisms regarding the EAT in particular. The literature has in fact focused on identifying whether fiscal expansion tends to be relatively effective in stimulating economic activity. In more detail, it investigates whether fiscal multipliers – defined as the ratio of a change in output to a discretionary change in government spending or tax revenue (Spilimbergo et al., 2009) – are positive, with high (Keynesian-effect) or low (weak-Keynesian effect) values, or even negative (non-Keynesian effect), and if so, under what conditions fiscal contraction can be expansionary. In simple terms, the literature investigates when fiscal expansion is expansionary and fiscal contraction is contractionary, as Keynesian theory predicts, or when the opposite is true, giving rise to expansionary fiscal consolidation.

The traditional Keynesian model assumes that a fiscal expansion has a multiplier effect on aggregate demand and output. Accordingly, the value of the multiplier is greater than one, it increases with the responsiveness of consumption to current income (the marginal propensity to consume) and is greater for spending increase than for a tax cut[11]. In case of fiscal consolidation, a reduction in public spending reduces GDP by a larger amount (multiplying it by a value greater than 1). To arrive at a multiplier of 1, it is necessary to consider the case of a reduction in spending and taxes by the same amount, so that the government budget balance remains unchanged. Haavelmo's theorem or the balanced budget theory shows that overall demand, and therefore GDP, would fall to the extent that spending and taxes were reduced (Haavelmo, 1945).

Low but still positive multiplier values (close to zero), while not expansionary, nevertheless imply that any fiscal restriction policies would have weak recessionary effects, just as the expansionary effects of policies to increase spending would be weak.

Different conclusions can be drawn based on new classical models that inspired the EAT. These models incorporate the theory that economic players have rational expectations. These models criticise the static and short-term nature of the IS-LM model and advocate for a dynamic model, in which typical Keynesian effects are less likely even in the short run, because they are offset by non-linear indirect effects on aggregate demand.

Rational expectations tend to bring forth adjustments in behaviours that would occur more progressively in case of adaptive expectations. In this way, the long-term effects of fiscal consolidation matter even in the short term. Therefore, agents are far-sighted enough to predict that a fiscal restriction in public spending decided today will eliminate the possibility of more extensive and painful fiscal adjustments in the future (considered certain prior to the current decision). With rational expectations, in the event of fiscal contraction, on the one hand, consumers, already feeling richer now since they no longer have to pay what they previously

[11] In an open economy, an increase in domestic demand is directed to the production of foreign goods, with the result that the effect of the multiplier is lower than in the case on a closed economy.

regarded as debt, would decide to consume more; on the other hand, companies, counting on higher profits deriving from lower future taxation, would decide to invest more.

A main difference between the two approaches relates to the crowding out effect due to the increase in interest rates induced by an expansionary fiscal policy. In the traditional Keynesian model, business investment is negatively correlated with the interest rate, thus the positive effect of higher public spending will be crowded out by the negative effect of lower private investment. This investment effect tends to be higher if the investment is sensitive to interest rate variation, more than it is to current income, but in any case, the multiplier does not change its sign. In the Keynesian perspective, the effect of the interest rate on investment is small and lower than that of income, so the net result of fiscal policy would be positive for expansionary policies and negative for restrictive policies.

On the contrary, in the new classical model on which expansionary austerity is based, the crowding out effect could be even stronger, possibly bringing the fiscal multiplier into negative territory. This is true in case of permanent fiscal expansion and the impact it will have on expectations, because private agents will expect the initial increase in interest rates to last and became even larger.

In addition to rational expectations, the weak/non-Keynesian effects of a fiscal consolidation policy are also based on the concept of "Ricardian equivalence" introduced by Barro's (1974) seminal paper.[12] Under the assumption of Ricardian taxpayers and the permanent income hypothesis, inter-temporal changes of fiscal policy (lower current taxes, higher future taxes) have no effect on aggregate demand. In this case, the fiscal multiplier is zero, as no variation of output will follow the variation of the fiscal budget. It is worth noting that Ricardian equivalence is valid only under certain critical assumptions, as infinite horizon, lack of liquidity constraints, perfect capital markets and altruistic agents. Table 1 summarises the theoretical impact of fiscal policy on the rest of the economy based on the different values of the fiscal multiplier.

[12] According to Barro, a reduction of tax fails to stimulate households' consumption because consumers believe in a future increase of taxes needed to serve and repay the present new government debt issued to finance the tax cut. In other words, government financing decisions on taxes and debt have no relevance to consumption behaviour.

Table 1 Potential effects of fiscal policy on output

Value of the multiplier	Taxonomy	Definition	Main underlying assumptions
POSITIVE MULTIPLIER			
mm>1	Keynesian effect	Income increases after an expansionary fiscal policy and decreases in case of restrictive fiscal policy	Excess capacity, fixed price, short-run static model
mm=1 0<mm<1	Weak-Keynesian effect	Income increases (or decreases) after an expansionary (or restrictive) fiscal policy but to a lower extent, according to the crowding out effect that limits the size of the multiplier	Productive capacity close to potential output, investment sensitivity to interest rate variations, exchange rate appreciation
NEGATIVE MULTIPLIER			
Mm<0	Non-Keynesian effect	Income decreases in case of an expansive fiscal policy, while it increases after a fiscal consolidation (expansionary austerity)	Inter-temporal optimisation, rational expectations, credible fiscal policy, large fiscal imbalances
NEUTRAL MULTIPLIER			
Mm=0	Neutral fiscal policy	Fiscal policy has no effect on income, because of precautionary behaviour of private sector	Ricardian equivalence (inter-temporal optimisation, lack of liquidity constraints, infinite horizon)

Source: Briotti (2005) and own elaboration

Fiscal consolidation (i.e fiscal austerity) affects production through indirect effects, i.e. transmission mechanisms that work through three different channels: 1. the *expectation channel*; 2. the *financial channel*; 3. the *export-led channel* (Botta, 2020). The first two concern the *demand side* of the economy, while the third concerns the supply side. It is important to underline that the emergence of these effects depends on the underlying assumptions that are at play in the economy (rational expectations, crowding out, Ricardian equivalence, and unionised labour market).

The demand-side expectation channel concerns the effect of upfront public spending cuts on private economic actors, especially households, as they can signal a change in fiscal policy that can positively affect the behaviour of private agents, who can be induced to have positive expectations of future tax cuts.

1. As a result, this may incentivise them to increase current consumption, increasing aggregate demand and stimulating current production. Therefore, these non-Keynesian effects manifest themselves even in the short run.

Blanchard (1990) and Sutherland (1997) maintain that non-Keynesian effects could also be associated with tax increases at high levels of government indebtedness. This argument is known as the *expectation view of fiscal policy*. Under this hypothesis, the transmission channel is household income and wealth, driven by inter-temporal effects of expected changes in fiscal policy[13]. In general, the non-Keynesian results of fiscal consolidation are stronger in cases of high public debt, when extensive fiscal consolidation signals a permanent change in the stance of fiscal policy. Under the rational expectations hypothesis, permanent changes in fiscal policy modify the expected permanent income; in contrast, temporary fiscal changes have no effect.

2. The *financial demand-side channel* refers in particular to the case of high public debt. In these circumstances, a restrictive fiscal policy is expansionary thanks to changes in the interest rate of long-term risk premia on public debt. A strict fiscal consolidation that is effective in reducing the fiscal deficit and the stock of public debt can lower risk premia, as it reflects the risk of sovereign debt default. By lowering country risk, the reduction in interest rates can further stimulate private investment. Therefore, the reduction in interest rates not only benefits the public budget, but also leads to reductions in the cost of borrowing for businesses and promotes new investments. Moreover, lower interest rates would increase the financial wealth of households and businesses, contributing to an increase in effective demand. In this scenario, political credibility is a precondition, which depends on agents' belief that the government is credibly committed to debt reduction and lowering risk premia. As Hemming et al. (2002) observe, according to the empirical literature on expansionary austerity, sizable risk premia represent perhaps the clearest reason why the fiscal multiplier could turn negative, because private spending responds positively to a credible commitment to fiscal prudence.

3. The *export-led supply side channel* could work when public sector wage cuts would have non-Keynesian expansionary effects, due to the depressive effects of lower public sector wages establishing a climate of wage moderation in the labour market that spreads to the private sector. In this case, in accordance with the expansionary austerity approach, the reduction of wage costs could not only stimulate profits and therefore investments but, by reducing domestic prices, could promote an internal devaluation of the real exchange rate, stimulating exports and ultimately growth.

[13] An increase of taxes has two opposite effects: first, a conventional short run Keynesian effect, through a reduction of taxpayers' disposable income and consumption; but, second, a timely fiscal consolidation could avoid the need for greater and more disruptive adjustments in the future, and this may in turn increase consumption (Blanchard, 1990).

4. Theoretical critique of the expansionary austerity approach

As we have highlighted in the previous section, the theoretical literature on expansionary austerity suggests that the fiscal multiplier tends to be very small and could become negative when the crowding out effect is high, thus fiscal consolidation, and not fiscal expansion, can be an engine of growth even during a recession: this is true to an extent, but not always. The underlying conditions and related effects can indeed be questioned from a theoretical point of view, in particular with reference to episodes of consolidation during the Eurozone crisis. Three less obvious factors undermine the simple argument that countries in the red need to stop and reduce spending.

The *first factor* is *distributional*; since the effects of austerity are felt differently across different levels of society, those at the bottom of the income distribution lose proportionately more than those at the top, because they rely much more on government services and have little wealth with which to cushion the blows.

The *second factor* is *compositional* (i.e. fallacy of composition); not everyone can cut their way to growth at the same time. To put this in the European context, although it makes sense for each state to reduce its debt, if all states in the monetary union, which are one another's major trading partners, cut their spending simultaneously, the result can only be a contraction of the regional economy as a whole. The results of the experiment are now apparent, and they are consistent: austerity does not work. Advocates of austerity are blind to this danger because they see the relationship between saving and spending backwards[14]. They think that public frugality will eventually promote private spending. But someone has to spend so that someone else can save, otherwise the saver will have no income to hold on to. Similarly, for a country to benefit from a reduction in domestic wages, thus becoming more cost competitive, there must be another country willing to spend its money on what the first country produces. If all states try to cut or save at the same time, as has happened in the Eurozone in recent years, then there would be no one left to do the spending needed to drive growth.

Furthermore, policies that try "to fool the neighbours" - export more to the detriment of someone else, like the model adopted by Germany several times (i.e. mercantilist policies) - do not work and lead to a recessionary process in the area, as is happening. If everyone tries to cheat their neighbor, as Keynes would say, the result is a "composition fallacy", in which no one succeeds!

The *third factor* is *logical*; the idea that slashing government spending boosts investor confidence does not stand up to scrutiny. As Paul Krugman and others have explained, this claim assumes that consumers anticipate and incorporate all government policy changes into their lifetime budget calculations. This assumption is as follows: when the government signals that it intends to drastically cut its spending, consumers will realise that their future tax burdens would decrease. This would lead them to spend more today than they would have without the cuts, thereby ending the recession despite the collapse of the economy taking place all around them.

[14] This, again, is contrary to a fundamental principle of Keynesian theory!

The belief that this behavior will actually be exhibited by financially illiterate, real-world consumers who are terrified of losing their jobs in the midst of a policy-induced recession is heroic at best and foolish at worst.

Therefore, austerity is a dangerous idea, as has been rightly stressed by Blyth (2013), because it ignores the externalities it generates: the impact of one person's choices on another's, and because of the low probability that people will actually behave in the way that the theory of expansionary austerity requires.

Moving now to an in-depth critical evaluation of expansionary fiscal austerity, we could re-consider each postulate of this theoretical approach.

4.1 Critique of the expectation channel

The "expectation mechanism" of expansionary fiscal consolidation is based on two fundamental conditions. The first requires that the index of the consumer's horizon tends to infinity, which is precisely the assumption underlying the Ricardian equivalence. However, this condition is necessary but not sufficient (Demopoulos and Yannacopoulos, 2018) for the validity of expansionary austerity, because if it were to hold, fiscal policy would be neutral at best. Furthermore, this condition seems to be too extreme to be accepted, but even if we assume a shorter than infinite horizon, the length of the horizon will be defined by two situations, (a) uncertainty and (b) financial constraints on private agents.

Regarding uncertainty, it should be noted that if we assume that the degree of uncertainty is an increasing function of the time horizon, it follows that uncertainty places a limit on the horizon of agents. Furthermore, uncertainty is incompatible with the rational expectation hypothesis. In a world characterised by uncertainty, it is almost impossible to know the probability distribution of the random error that characterises the rational expectation hypothesis, that is we cannot calculate the probability of future events. In this context, the crucial variable determining current consumption behaviour is current disposable income (Demopoulos and Yannacopoulos, 2018), not expected income. This means that in case of a tax-based consolidation, current consumption will decrease, because of lower disposable income; in case of spending-based consolidation, the expected future tax reduction following the current spending cut will certainly not materialise. Consumers would be unlikely to smooth consumption inter-temporally and increase current consumption for expected future income tax cuts. The reason is that we live in a world characterised by uncertainty, as originally formulated by Keynes[15].

Financial constraint is another factor that invalidates the Ricardian equivalence. Binding liquidity constraints have consequences on inter-temporal consumption smoothing if households' consumption expenditure increasingly relies on bank loans. For the proponents of the expansionary austerity approach, it matters little that various players, households or businesses,

[15] "The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the interest rate twenty years hence, or the obsolescence of a new invention, or the position of private wealth-owner in the social system in the 1970. About these matters there is no scientific basis on which to form any calculable probability whatever. We simply do not know." (Keynes, 1937, p. 214).

do not have the resources to increase spending at all, because they could borrow from the banks in any case. However, households might, conversely, be subject to liquidity constraints because of involuntary unemployment or when they fail to find banks willing to grant them credit. The same could be true for many businesses, especially in times of depression, when banks, having to cope with mounting insolvencies, tend to restrict lending[16].

According to the proponents of expansionary austerity, not only could expansionary fiscal policy be neutral on aggregate demand – if the Ricardian equivalence holds – but it could also be detrimental to the economy. Accordingly, fiscal contraction is particularly beneficial in case of high level of public debt. In this case, a credible and large fiscal consolidation (i.e. lasting at least three years) would have a positive effect if the current tax increase or spending cut creates expectations that future taxes will decrease.

But these expectations may not materialise for at least two reasons: first, if public debt is particularly high and a prolonged period of fiscal consolidation is deemed necessary, people will likely expect future tax cuts to be very modest and take place much later (Botta, 2016); second, if the fiscal consolidation recipe is firmly anchored in a framework of sound fiscal policy, as is the case in the Eurozone, future tax cuts may not be easy to implement because of fiscal rules.

4.2 Critique of the financial channel

If the fiscal plan were to consist of deep, persistent, credible and well-designed spending cuts, particularly in public transfers and wages of public sector employees, credibility and confidence are crucial for non-Keynesian effects to materialise (Alesina, 2010). However, credibility and confidence could play a role later. It may be that, in the long run, the expectations of financial markets, which are rather negative when it comes to highly indebted countries, may change for the better and influence those of households and businesses. Then again, we are likely to have to wait a long time. According to the weak Keynesian view, the result of fiscal consolidation could be that the short-term effects are usually contractionary, but that expansionary effects may occur when government solvency is in question, or when the consolidation is structured to increase confidence. From a Keynesian point of view, this additional confidence effect on investments is far from automatic, as it depends on how financial markets react to the viability of an austerity plan, since, once again, great uncertainty prevails given the complex condition of success or failure of the strategies of public authorities (Boyer, 2012). Empirical evidence suggests that consolidation, and in particular its unanticipated components, negatively affect

[16] Since 2008, both the private sector and governments had accumulated high levels of gross debt. As Koo (2014) explains, when a debt-financed bubble bursts, a large number of businesses and households find themselves with liabilities that are still current in their balance sheets, while the assets they bought with borrowed funds have collapsed in value. To restore their financial situation in this typical balance-sheet recession, they have no choice but to pay off debt using their cash flow and "Although this is the right thing to do for individual businesses and households, when everybody does it at the same time the economy falls into a massive fallacy of composition problems.This is because in a national economy, if someone is saving money or paying down debt, someone else must be borrowing and spending the same amount for the economy to move forward." (Koo, 2014). Measures of fiscal consolidation therefore do not provide a way out of a balance-sheet recession when the private sector is seriously constrained in terms of liquidity in an attempt to deleverage.

confidence, and these effects are stronger for revenue-based measures and when institutional arrangements are weak (Beetsma et al., 2015). Fiscal consolidation could have a positive effect on reducing risk premia through the financial channel, but the final effect on output may ultimately not materialise (David et al., 2022).

If consolidation could have an effect on reducing debt service through risk premia, there could be some doubts about the actual ability to reduce the public debt-to-GDP ratio, without sustained growth affecting the denominator. According to Ali Abbas et al. (2013), the key driver of debt accumulation after the Great Recession was the collapse of fiscal revenues, which testifies to a direct cumulative Keynesian effect of contraction of the tax base and therefore an unintended rise in the public debt-to-GDP ratio. "Front-loaded consolidations, in particular, have tended to increase public debt in the short run, even as risk premiums fell… Front-loaded consolidation can lead to greater output loss than a gradual effort does, even though it can also reduce the overall magnitude of the adjustment needed. In addition, while credibility effects can ease the pain of fiscal adjustment through lower risk premiums, this is unlikely to fully offset the short-run adverse impact on economic activity." (Ali Abbas et al., 2013, p. 4). Austerity programmes in 2013 did not pay off. In many European countries, the level of production remained below pre-crisis potential for a long time, the recession lasted considerably longer and the recovery was weak.

As is well known, the fiscal consolidation phase after 2009 had an unexpected, substantial negative and persistent impact on GDP and potential output, particularly in the EU and the Eurozone. Not only has fiscal consolidation been costly in terms of reduced output (for every 1% increase in austerity, output declines by 1.4%), but a less emphasised result is that it has also been ineffective in terms of debt-to-GDP growth - a 1% increase in austerity only leads to a 0.5% improvement in the budget balance (De Grauwe and Ji, 2013).

4.3 Critique of the export-led channel

The expansionary effect through the competitiveness channel was particularly evident in the consolidation episodes of Ireland, Denmark, Finland and Sweden in the 1980s. But these episodes were characterised by the specific conditions of that period and in those contexts: a significant fall in interest rates, an income policy based on a sort of "social pact" that promoted national competitiveness at an international level, and a large devaluation (Boyer, 2012). However, these conditions were difficult to reproduce in the aftermath of the financial crisis, because of already low official interest rates and the decentralisation of industrial relations, implying that a rise in unemployment was necessary to lower wages and allow the necessary depreciation to stimulate exports. Furthermore, with the adoption of a fixed exchange rate, internal devaluation has become the only option to stimulate external demand. This is especially so in a monetary union, as in the Eurozone, where the adoption of an irreversible internal fixed exchange rate, the euro, eliminates the possibility to adjust the exchange rate for individual Member States' trading relations.

The German model has always been the benchmark for its success in managing sound fiscal balance permanently, with a long-term strategy in which "wage moderation, welfare reforms

including lower compensation for unemployment and countercyclical tax policy should sustain an export-led growth model, based not only on price competition but also on a permanent adaptation to the changing demand of the world economy." (Boyer, 2012, p. 300). This model of wage moderation, control of the fiscal balance and export-led growth has an internal consistency that relies on a national equilibrium between domestic (private and public) and external accounts, i.e. the current account. After reunification in the early 1990s, Germany pursued wage moderation policies aimed at generating rapid employment growth by limiting consumption in order to subsidise German manufacturing, and this resulted in large current account surpluses. At the EU level, with strict rules of sound fiscal policy, the fiscal consolidation pursued through the *competitiveness channel* of internal devaluation will require current account surpluses. However, as Kregel notes, "without the ability to improve external competitiveness through exchange rate adjustment, internal depreciation through wage reductions or productivity increases in advance of wage increases will be required. However, this is also a policy that reduces domestic demand, offsetting the benefits of higher foreign demand." (Kregel, 2018, p. 52).

This strategy posed two problems: it could not be pursued by all Eurozone countries, since an increase in excess saving in one country had to be balanced by decrease elsewhere. Secondly, the result of a depreciation of the real exchange rate or, in the case of the Eurozone, of an internal devaluation of the real exchange rate, may not translate into an improvement in the trade balance through an increase of exports, because it depends on the sensitivity of net exports to internal devaluation. But, as Botta (2016) highlights, in case of a country like Ireland in the 1980s, mentioned as one of the most successful episodes of expansionary austerity, net exports could react positively to a depreciation, thanks to a highly integrated economy with a large share of goods manufactured for export and also favourable conditions in key trading partners. On the contrary, in Eurozone countries the gains in competitiveness reached through wage austerity have been marginal, while the trade balance has improved mainly due to the reduction of imports, made possible thanks to lower domestic income. The result is that an economy may be trapped into a deflationary equilibrium, in which output and employment decline.

Austerity is completely wrong and the policy of austerity is more often than not exactly the wrong thing to do precisely because it produces the very outcomes you are trying to avoid.

5. Empirical critique of the expansionary austerity approach: non-Keynesian vs. Keynesian effects and a debate on the value of the multiplier

According to the advocates of austerity, the interest rate has a significant influence on consumption, investment and the value of the multiplier. During consolidation, it is the reduction in the rate that causes private spending on consumption and investment to increase, thus lowering the value of the multiplier and mitigating the decline in production levels otherwise caused by the reduction in public spending. However, the implicit assumption of high elasticity could raise some concerns, especially if this were to occur when the system has already entered, or is entering, a depression with sharply declining expected profits and manufacturing capacity

utilisation. The same would also be true for consumers who might not be convinced that they would actually be richer if they were to start thinking, for example, that with reduced government spending having immediate negative effects on production (and employment) levels. Furthermore, in situations where the nominal interest rate has reached values close to zero (zero lower bound), which cannot cause increases in either aggregate consumption or investments, the multiplier reaches very high levels (Woodford, 2011).

Empirical tests confirm that multiplier values are particularly high when the interest rate is quite close to zero, which was precisely the situation when the fiscal consolidation programme emerged in the Eurozone. As highlighted by Cozzi (2013), it is very likely that, rather than the low interest rate, it is the depression itself that causes the multiplier to assume high values. In fact, according to the Keynesian tradition, the elasticity of investment with respect to the interest rate is always very low in periods of depression – and also shortly before – when entrepreneurial expectations are negative. Multiplier values are particularly high because, during periods of depression, they operate almost exclusively in real terms and are not diminished by significant price increases, which are rather unlikely at such times. Indeed, negative expectations tend to reduce the spending levels of households and businesses, increasing the value of the multiplier when there is a programme of fiscal austerity (Corsetti et al., 2009).

The focus was therefore on the effects of expansionary policies, and the conclusion (certainly not at odds with the mainstream that had probably inspired it) was that increased government spending would have limited beneficial effects on manufacturing activity and would have significantly increased government deficit and debt instead[17].

The contribution by Blanchard and Leigh (2013) on the size of fiscal multiplier has brought attention to the size of multiplier during period of crisis. The authors regress GDP growth forecast errors on planned consolidation for European countries during 2010-11, to test whether the impact of consolidation has been underestimated. They find a strong negative correlation between consolidation policy and output revisions, implying that countries pursuing a broader consolidation programme faced more severe growth disappointments – in other words, multipliers were underestimated and fiscal policy was far from ineffective[18].

Expectations are key: they switch easily from optimism to pessimism, but vice versa with greater difficulty. Not only does depression severely dampen expectations, but it also creates much more

[17] When the crisis erupted, the International Monetary Fund (IMF) continued for some time to believe that expansionary policies could offer a weak boost to recovery. Later, IMF analysis began to find multiplier values to be significantly higher than those previously estimated, and it was only recently that they admitted that they had previously significantly underestimated them. It is worth pointing out also that the work by Reinhart and Rogoff (2010) has been sharply denied by Herndon et al. (2014).

[18] During recessions fiscal multipliers are well above 1, closer to a value of 2 instead of 0.5, as previously estimated. Fairly recently, research within the IMF (Batini et al., 2012) and in academia (Ramey, 2011; Parker, 2011; Auerbach and Gorodnichenko, 2012) had shown that multipliers were much higher during depressions than during albeit moderate expansions. Of particular significance is the change that has taken place precisely within the IMF even before Blanchard and Leigh's contribution: "multipliers for consolidations initiated during recessions vary between 1.6 and 2.6 per expenditure shock and between 0.16 and 0.35 per tax shock" (Batini et al., 2012, p. 23) and "during recessions, spending multipliers are significantly higher (up to 10 times) than tax multipliers but are somewhat less so during expansions (up to 6 times higher)" (Batini et al., 2012, p. 24).

alarm about public spending decisions that do not decisively alter the restrictive orientation of economic policy and are therefore perceived as being destined to significantly postpone the prospects of recovery[19].

The conclusion, which has since found increasing empirical confirmation, is completely in line with the Keynesian tradition. During depressions, multipliers tend to be particularly high also because interest rates tend to be rather low. Empirical investigations largely confirm this situation, although it is not easy to distinguish the depression effect from the interest rate effect. The conclusion reached by Christiano et al. (2011) regarding particularly high multiplier values remains valid. However, when a severe fiscal consolidation process is underway and interest rates have already been brought close to zero, the central bank no longer has the possibility to offset the negative effects of fiscal consolidation, so the multiplier takes on very high values.

During the Eurozone crisis, European institutions – European Commission (EC) and the ECB – did not agree with the findings of the research that estimated high values for the multiplier. They acknowledged that, in times of crisis, the multiplier takes on higher values than in "normal times", but not by much and always remains at levels well below 1[20]. With such low multiplier values, both the crisis effect and the interest rate effect which cannot be further compressed seem to count for very little (Cozzi, 2013).

In general, supporters of fiscal consolidation underestimate the fact that public investments could have higher fiscal multiplier and lasting effects. Multiplier effects of investments tend to be significantly higher during economic downturns, with core infrastructure (roads, railways, telecommunications, etc.) having a relatively stronger impact on output than other physical capital investments (de Jong et al., 2017). Under such circumstances, fiscal multipliers are significantly higher than one, thanks to *crowding in* of private investment and spending. Although projects need to be examined on a case-by-case basis to determine their performance and effect on growth, social infrastructure and intangible investments are also generally assumed to be positively correlated with long-term growth[21].

After strong evidence supporting high and positive fiscal multiplier during the Eurozone crisis, early supporters of the EAT, Alesina, Favero and Giavazzi (2019), drew conclusions on their in-depth research into expansionary austerity, particularly focusing on the Eurozone debt crisis. They summarise the conditions influencing the (un)success of each episode of austerity: the composition of the consolidation, the existence of accompanying policies, the level of the interest rate and the implementation of structural reforms. Their main conclusions are: first, consolidation programmes in the peripheral Eurozone countries mainly created deep and long recessions because they implemented mixed fiscal plans, that were mostly tax-based ("bad

[19] For aggregate government spending "the multiplier is between 0 and 0.5 during expansions and between 1 and 1.5 during depressions" (Auerbach and Gorodnichenko, 2012, p. 19). But for some spending components, the gap is much wider and the multipliers in recessions are much higher. The value estimated ranges from 0.17 during expansion phases to 2.11 during recessions.

[20] In normal times, the multiplier "for the entire EU aggregate is around 0.4. It can increase to 0.5-0.7 in times of crisis, e.g. at a time of global fiscal austerity and with nominal interest rates restrained by the proximity to zero" (ECB, 2012, p. 89).

austerity") and not expenditure-based ("good austerity"). Second, the fact that monetary policy was at the zero lower bound, hampered the possibility of further reduction in interest rates. Third, many countries implemented the same restrictive measures at the same time, with a typical coordination failure undermining each countries' export channel. In their words "the large recessions experienced in some European countries are not *prima facie* evidence against our previous findings… Obviously this does not imply anything regarding the question of whether austerity in general was too severe. It might have been." (p. 141). In conclusion, supporters of the EAT acknowledge that austerity in 2010-2014 was recessionary and more costly in term of GDP losses than the previous consolidation implemented during the 1980s and 1990s, although they remain in favour of austerity as a necessary measure in cases of very high debt and when faced with irresponsible governments that fail to address the problem of mounting cumulative debt.

6. Conclusion

The EAT has enjoyed some appeal among academics and policy makers since the 1990s. It was very influential in the EU as a response to the financial crisis and the ensuing sovereign debt crisis. Empirical research has focused for years on identifying cases of successful fiscal consolidation, even during the Eurozone crisis. However, the events of peripheral and other countries have shown that expansionary austerity is an oxymoron: in cases of high uncertainty, high debt and a non-accommodative monetary policy, as in the case of 2010-2014, fiscal consolidation cannot lead to an expansionary effect on output, as the direct Keynesian effect will prevail over indirect non-Keynesian effects.

We have tried to provide further theoretical evidence on the inadequacy of austerity as an economic and fiscal policy, underlining the fact that even leading proponents of austerity during crisis admitted that it did not properly work during the Great Recession. Fiscal austerity has proven to be ineffective, both in reducing public debt and in promoting growth. Just as in the United Kingdom, with its Treasury view, austerity in the Eurozone did not work. It was put into practice here too, but it failed, further triggering a slump in the area's economy.

Can we be sure that the idea of expansionary austerity at any cost will be abandoned from the political menu?

On the one hand, it is true that after years of discrediting, fiscal policy is back and a new macroeconomic activism seems to be taking place in the EU (Saraceno, 2022). After the Covid-19 crisis, a new instrument of fiscal stimulus has emerged at the European level, such as the NGEU, with the aim of supporting not only structural reforms, as was the case in the past, but also investments. Further, a reform of European fiscal rules that have not worked properly is underway, with the aim of providing a more flexible, gradual and decentralised approach to debt sustainability, avoiding the "one size fits all" view. On the other hand, the risk that austerity could become popular again – if it ever goes away – is not ruled out. First, more recent crisis caused by the pandemic and the war in Ukraine have led to an expansion in the role of the government and in fiscal expansion. In the EU, fiscal and State Aid rules have been temporarily suspended and public debt has increased, although the debt-to-GDP ratio is recovering thanks to an improvement in the GDP growth rate. However, it remains to be seen whether this growth is

related to a temporary recovery or whether our economies are in an era of secular stagnation and are facing a polycrisis, requiring further government intervention. Secondly, the EC's proposed reform of fiscal rules has sparked a heated debate in European capitals. Germany has taken a very conservative position, fearing that debt relief obligations could be relaxed following a possible reform of fiscal rules. However, this old approach is not compatible with the looming economic recession that Germany is experiencing. The causes are both contingent, such as rising gas prices and slowing demand, and structural. Moreover, heavy bureaucracy, an aging population and a lack of skilled workers are hampering the productivity of the German economy. A crucial factor is the need to renew tangible and intangible infrastructure. Unfortunately, public investment is the first part of the budget that fiscal consolidation usually aims to cut. As *The Economist* observes "Too often infrastructure has suffered as the government has made a fetish of its balanced-budget rules" (The Economist, 2023). This hinders the role that fiscal policy could play in supporting and steering the economy towards crucial projects such as those related to the green and digital transitions.

Thirdly, one of the narratives around the EAT is that although austerity is painful, all alternatives to it would be worse, supporting the TINA argument – There Is No Alternative. This logic prevailed during the Eurozone crisis, after the massive state intervention to stabilise the financial sector. Now, with an even more challenging situation of international geopolitical tensions, deglobalisation and (not least) climate change, the question of how governments will support and finance these challenges without risking debt sustainability requires a different narrative. It is necessary to rethink the fiscal restriction and export-driven wage-devaluation model that has prevailed up to now and imagine a different role for the state in a post-Covid, post-Ukraine world.

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