

Iyanatul Islam and Anis Chowdhury<sup>1</sup>

# Fiscal consolidation, growth and employment: What do we know?

The Great Recession of 2008-2009 triggered the enactment of expansionary policies in both developed and developing countries to combat the sharp decline in aggregate demand across the world.<sup>2</sup> Key international institutions, ranging from the IMF to the OECD, all became Keynesians and urged national policy-makers to adopt and sustain fiscal interventions and historically low policy interest rates throughout 2009 to stave off a depression. The verdict seems to be that expansionary policies staved off a depression, but could not avoid rather deleterious unemployment outcomes in developed countries and at least a transient increase in poverty in many developing countries.<sup>3</sup>

The Keynesian moment did not last very long. Some leading economists have decided to bid 'farewell to Keynes'.<sup>4</sup> The policy discourse, most notably in the rich nations, is that governments must now engage in fiscal consolidation and bring back public finances - wrecked by recession-induced declines in revenues and increased spending commitments - to sustainable levels. As the *Economist* observes, 'Across much of the rich world an era of budgetary austerity beckons'.<sup>5</sup> But signs of 'budgetary austerity' also seem to be emerging in a sizeable number of low and middle-income countries. One study finds that, in a sample of 86 low and middle income countries, about 40% are engaging in reductions in public expenditure in 2010-2011 relative to 2008-2009. The average projected spending cuts are around 2.6% of GDP.<sup>6</sup>

What should be the scale of the fiscal adjustments? Is it possible to have the best of both worlds, that is, a combination of successful fiscal retrenchments, no output and employment loss or, better still, growth and employment creation? We briefly review the relevant issues and evidence and conclude that neither current global economic circumstances nor historical experiences allow us to be confident about the scale of fiscal adjustments that have been proposed and the growth promoting capacity of such adjustments.

## **Fiscal consolidation:**

### **How much and with what consequences?**

The standard view, enshrined in the Maastricht Treaty, is that for a rich economy, a 60% debt-to-GDP ratio is considered to be prudent. Currently, the projected debt-to-GDP ratio among the advanced economies of the G-20 will reach 118% by 2014. These scenarios are used by the IMF to suggest that governments in the developed world need to improve their structural primary balance by 8 percentage points of GDP, on average, during 2011-2020 (i.e., a fiscal effort of  $\frac{3}{4}$  percentage points per year) and to remain constant for the following decade. Such an adjustment will enable them to reach the Maastricht Treaty norms by 2030.<sup>7</sup>

The announced plans by several European governments suggest fiscal consolidation measures as a proportion of GDP that range from 10.7 % of GDP (Greece) to 3.0 % of GDP (Germany).<sup>8</sup> It is difficult to ascertain the extent to which such announcements have been influenced by the 60 % target. Of course, this target is arbitrary as it is supported by neither theory nor evidence as a reasonable approximation of an optimal debt-to-GDP ratio. The scale of the fiscal adjustments will be much less draconian if a lower threshold is adopted. Consider, for example, the case of the United States. If the government wishes to stabilize the debt-to GDP ratio as it prevails at 2010, then the primary deficit should be around 1% of GDP. On the other hand, if it wishes to reach the 60% target, then the primary balance will have to move to a surplus of 4% of GDP by 2020, and be maintained at that level for another decade. Hence, it follows that the scale of the fiscal adjustments prescribed by some international institutions relies on mechanically derived benchmarks.<sup>9</sup>

Fiscal austerity measures are, of course, worthwhile if they are growth promoting or, at the very least, do not lead to a net decline in aggregate demand. Proponents of fiscal consolidation typically focus on so-called 'Ricardian equivalence' and 'crowding out' effects to make their case.

Ricardian equivalence maintains that public sector profligacy can be fully offset by private sector prudence if economic agents correctly anticipate that future tax liabilities will rise as a result of fiscal

expansion. It then follows that the contractionary consequences of a fiscal retrenchment will be offset by an increase in private sector spending as economic agents correctly anticipate a decline in future tax liabilities.

The ‘crowding out’ thesis maintains that fiscal expansions raise real interest rates, thus inducing less private sector spending because of its sensitivity to the higher costs of borrowing. A stronger version of this thesis insists that the decline in private sector spending will exceed the increase in aggregate demand induced by the increase in government expenditure. It follows that, under such circumstances, fiscal austerity boosts growth by stimulating private sector spending.

Additionally, the ‘market confidence’ thesis emphasizes the role psychological factors in investment decisions. The standard argument is that financial markets reward fiscal probity. Hence, when governments demonstrate credible commitment to fiscal consolidation, they are rewarded by reduced *ex ante* and *ex-post* costs of borrowing in the sovereign debt market. This, in turn, stimulates private capital inflows that augment domestic private investment as a source of growth and employment creation.

In the contemporary debate on fiscal consolidation, some commentators have suggested a ‘forward-looking’ view of ‘market confidence’. This implies that governments have to be proactive and anticipate how markets might react in the future by adopting a ‘big bang’ approach to fiscal consolidation. Thus, ‘Given that the current levels of debt are high by historical standards and that they are very high in many advanced economies, *it might be that markets will soon ask for a strong signal of commitment* and, in its absence, risk premia on government bonds will increase. To avoid an increasing cost of rolling over the debt, *governments could be better off with a strong early adjustment*’ (emphasis added).<sup>10</sup>

There are thus various channels through which a fiscal consolidation programme can achieve its goal, either without imposing any output or employment loss or, even better, accompanied by growth and employment creation. These propositions, while valid in principle and contrary to the basic Keynesian perspective that fiscal retrenchments can be recessionary, ultimately need to be empirically substantiated.

However, the evidence does not support the strong claim of the advocates of fiscal consolidation. There is hardly any evidence that fiscal policy multipliers are either zero (as in the case of full Ricardian equivalence) or negative (as in the strong version of the crowding out thesis). Even proponents of fiscal consolidation agree that available evidence suggests that fiscal policy has ‘significant effects’ on output and unemployment, and that such effects are ‘likely to be larger during recessions’.<sup>11</sup> Furthermore, there is little

evidence that countries, such as the UK and Germany, which seem poised to embark on significant fiscal austerity programmes, are facing an impending increase in risk premia on government bonds.<sup>12</sup>

There is the more fundamental issue of whether the policy-making process should become hostage to the ‘confidence game’ in which evidence-based policy-making is replaced by financial markets mood swings. When this happens, fundamental macroeconomic policy errors are likely to be committed, as the mishandling of the 1997-98 Asian financial crisis by international financial institutions has shown.<sup>13</sup>

Using historical data, a number of cross-country studies, however, demonstrated that fiscal consolidation has been accompanied by growth and declines in unemployment. An IMF study of 74 cases of fiscal consolidation in 20 industrialized countries over the 1970-1995 period<sup>14</sup> concluded that 14 cases were ‘successful’ in the sense that they were marked by sustainable reduction (by about three percentage points over a period of three years) in the debt-to-GDP ratio as well as an increase in growth and employment creation. Second, Alesina and Ardagna study of 107 episodes of fiscal consolidation in all OECD countries in the 1970-2007<sup>15</sup>, found 27 cases of fiscal consolidation with growth. Thus, the probability of a successful fiscal consolidation may be between 19% (as in the IMF study) and 25% (as in the Alesina-Ardagna study).

Even if fiscal consolidation programmes have a reasonable chance of being accompanied by growth and employment creation, the latter cannot be attributed to budgetary austerity. Often, enabling factors more important than fiscal actions are at work, including: (1) the influence of the global business cycle, (2) monetary policy, (3) exchange rate policy, and (4) structural reforms. The IMF study found that ‘strong global economic growth helps to achieve a successful consolidation, and weak global growth reduces the chances that consolidation will cut the debt-to-GDP ratio’. Fiscal retrenchments combined with loose monetary policy seem to have offset recessionary consequences. One 2003 European Commission study found that, in more than 50% of cases examined, fiscal austerity programmes were accompanied by expansionary monetary policy that enabled growth to be sustained.<sup>16</sup> Similarly, combining fiscal retrenchments with devaluation that boosts net exports may help offset the decline in aggregate demand (due to ‘expenditure reducing policies’ and ‘expenditure switching policies’). Furthermore, expansion might well stem from structural reforms that alleviate binding constraints on growth rather than fiscal consolidation.

The post-crisis economic recovery is still fragile. The rich countries in particular are struggling with weak labour markets and tepid growth. Hence, the

business cycle is not conducive for fiscal consolidation to work. The Eurozone economies also do not have scope for devaluations or much room to cut interest rates further through expansionary monetary policy as policy rates are still at historically low thresholds.

### Concluding remarks

Historical studies of fiscal consolidation exercises suggest a high failure rate. Even in successful cases, there were enabling factors at play that offset the recessionary consequences of fiscal retrenchments. Furthermore, the usual arguments invoked to justify fiscal consolidation (Ricardian equivalence, crowding out and market confidence) lack robust empirical substantiation. A study estimating the net impact of fiscal consolidation on growth in eight European economies (Germany, France, United Kingdom, Italy, Spain, Netherlands, Portugal, and Greece) suggests that, even by 2016, all but one will suffer output contraction as a result of the switch from fiscal stimulus packages to consolidation.<sup>17</sup> Critics – and there are many – of the looming fiscal austerity in the rich world, and perhaps even in developing countries, are justifiably worried.<sup>18</sup>

---

*Anis Chowdhury is Senior Economic Affairs Officer, UN-DESA, New York and Professor of Economics, University of Western Sydney, Australia.*

*Iyanatul Islam is Senior Employment Policy Specialist, ILO, Geneva and Professor of International Business, Griffith University, Brisbane, Australia.*

---

<sup>1</sup> The views expressed here are strictly personal and do not necessarily reflect the views of the United Nations or any of its agencies/funds/programs.

<sup>2</sup> By April 2009, liquidity injections into the financial system and bailouts of some major financial institutions amounted to \$18 trillion, or almost 30% of world gross product (WGP), and fiscal stimulus packages amounted to about \$2.7 trillion, or 4% of WGP, to be spent over 2009-2011.

<sup>3</sup> Verick, S, and I Islam (2010). 'The Great Recession of 2008-2009: Causes, Consequences and Policy Responses'. IZA Discussion Paper No. 4934, May 2010. There are various estimates coming from different sources - sometimes from the same source. The initial 2009 World Bank (Press Release, February 12, 2009) suggested that "lower economic growth rates will trap 46 million more people on less than USD1.25 a day than was expected prior to the crisis". In an 'op-ed' for the *New York Times* (January 22, 2009), Robert Zoellick, the President of the World Bank, estimated 'the economic crisis has already pushed an estimated 100 million people back into poverty'. In *Global Economic Prospects 2010*, the World Bank revised its estimates of poverty due to the financial and economic crisis to 64 million. The UN's *World Economic Situation and Prospects 2010* suggests that "in 2009, between 47 and 84 million more people have remained poor or will have fallen into poverty in developing countries and economies in

---

transition than would have been the case had pre-crisis growth continued its course" (p. 10).

<sup>4</sup> Sachs, Jeffrey (2010). 'Farewell to Keynes'. *Financial Times*, June 8.

<sup>5</sup> *The Economist* (2010). 'Fiscal tightening and growth'. March 31.

<sup>6</sup> UNICEF (2010). 'Prioritizing Expenditures for a Recovery with a Human Face'. Social and Economic Policy Working Brief, April, New York.

<sup>7</sup> IMF (2010). 'Strategies for Fiscal Consolidation in the Post-Crisis World'. Fiscal Affairs Department, IMF, Washington, DC.

<sup>8</sup> Broyer, S, and C Brunner (2010). 'From economic stimulus packages to fiscal consolidation: what net effect on growth?'. NATIXIS brief no. 283, June 4.

<http://cib.natixis.com/flushdoc.aspx?id=53475>

<sup>9</sup> 60% was the average debt-to-GDP ratio among prospective members when the European Monetary Union was launched.

<sup>10</sup> Fatas, A (2010). 'The Economics of Achieving Fiscal Sustainability'. Paper presented to Board of Governors, Federal Reserve, April 9.

<sup>11</sup> Fatas, *ibid*.

<sup>12</sup> Wolf, Martin (2010). 'Fear of the markets must not blind us to deflation's dangers'. *Financial Times*, June 8.

<sup>13</sup> Krugman, Paul (2002). *The Return of Depression Economics*. New York: Penguin.

<sup>14</sup> Dermott, CJ, and RF Wescott (1996). 'Fiscal Reforms That Work'. Economic Issues No. 4, November, IMF, Washington, DC.

<sup>15</sup> Alesina, A, and S Ardagna (forthcoming). 'Large Changes in Fiscal Policy: Taxes vs Spending'. Cited in Fatas, *op. cit.* and Alesina, A (2010). 'Fiscal adjustments : lessons from history'. Harvard University, for Ecofin meeting, Madrid, April 15.

<sup>16</sup> As cited in A Posen (2005). 'Don't Kid Yourself about Fiscal Consolidation'. November 6, Peterson Institute for International Economics, Washington, DC.

<sup>17</sup> Broyer and Brunner, *op. cit.*

<sup>18</sup> A non-exhaustive list includes Bradford De Long, David Blanchflower, Dani Rodrik, Lord Skidelsky, Martin Wolf, Paul Krugman, Wolfgang Munchau, the editors of *The Economist* and the *New York Times*.