Austerity, Growth, and Public Policy: Can Fiscal Consolidations Increase Output?

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Outline

- Global context
- Fiscal consolidations
- Public spending and growth
- Conclusions
Signs of improvement in the global environment

- CDS spreads have come down considerably
- Industrial production is picking up

Global context
Macroeconomic buffers are largely depleted

Fiscal position much weaker than before

In 2007
• 40% of developing countries were in surplus
• 19% had a deficit larger than 3% of GDP

In 2011
• 19% of developing countries were in surplus
• 47% had a deficit larger than 3% of GDP

General government balance, percent of GDP

Despite slowdown in deleveraging, credit likely to remain tight

Annualized increase in lending, Euro Area 3m/3m saar
Growing deficits and rising debt burdens could have lasting negative impacts

- The aftereffects of the financial crisis have not yet played out fully
- Growth-reducing effects of high public debt
  - Vast majority of high debt episodes coincide with substantially slower growth
  - Long duration of episodes
  - Slowdown in growth even without a rise in interest rates
- The twin deficit problem
  - Long-lasting effects of fiscal policy on external balances
  - Financing implications
How to stimulate growth without compromising long-term solvency?

- **“Normal times”**
  - Fiscal rules with numerical targets
    - EU: 3% general government deficit and 60% debt-to-GDP (Stability and Growth Pact SGP 1997, revised 2005)
    - Chile: 1% surplus (2000–07), 0.5% surplus (2008), balanced budget (2009–)
  - Front-loaded deficit reduction (e.g., early 1990s US)
    - Reduction of long-term interest rates
    - Looser monetary policy

- **“Current times”**
  - Protracted period of high unemployment and large output gap
  - Very low (real) interest rates
  - Hysteresis effects
Stimulus or consolidation?

- Growing out of the problem
  - What has been the primary cause of widening deficits?
  - Has austerity been paying off thus far?
  - Self-financing fiscal expansion

- Fiscal consolidation
  - Large fiscal consolidations plans in G7 countries (~4 percent of GDP per year)
  - What about countries with stronger fundamentals?

- Non-recessionary / expansionary fiscal adjustments
  - Identification problem
  - Type of adjustment could make a big difference
  - Timing and speed of adjustment may matter as well
  - Role of complementary policies?
How do consolidations affect output?

- Aggregate demand multipliers

- Wealth effects
  - Spending cuts reduce future expected taxation
    - Static effect: stimulate consumption
    - Dynamic effect: increase future stock of capital
  - Tax increases reduce wealth and may increase distortions

- Labor markets and profitability
  - Spending cuts can reduce real wages and increase profits

- Confidence
  - Permanent vs. temporary adjustments
  - Spending-based adjustments as signal of a stronger commitment
Tax vs. expenditure-based consolidations

- **Tax-based consolidations**
  - Slightly less common than expenditure-based (127 / 165 episodes)
  - Average adjustment of 0.6 percent of GDP per year
  - Often followed by (partial) reversal

- **Expenditure-based consolidations**
  - Somewhat more common (140 / 165 episodes), although the majority of episodes combine tax and spending consolidations
  - Average adjustment of 0.8 percent of GDP per year

- **Differing estimates of the consequences**
  - Fiscal plans vs. fiscal shocks
  - Type of adjustment may generate different monetary policy response
  - Magnitude of the multiplier may be business-cycle dependent
Does the type of spending cut make a difference?

- **Productive vs. unproductive expenditure**
  - Education, health, transport/communications
  - Links between public spending and productivity in the private sector
  - Positive interaction effects
  - Transfers, consumption, investment

- **Mixed empirical evidence on the spending-growth link**
  - Type of financing
  - Balance between recurrent and capital spending
  - Role of governance and institutions
  - Spending → public service output → growth
Conclusions

- Expansionary consolidations
  - May occur under certain conditions
  - May be more likely for spending-based consolidations
  - Elusive search for the multiplier

- What determines the final impact on output?
  - Credibility and expectations
  - Productivity of spending and tax distortions
  - Monetary policy
  - Export performance
  - Sequencing across countries
Thank you!