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

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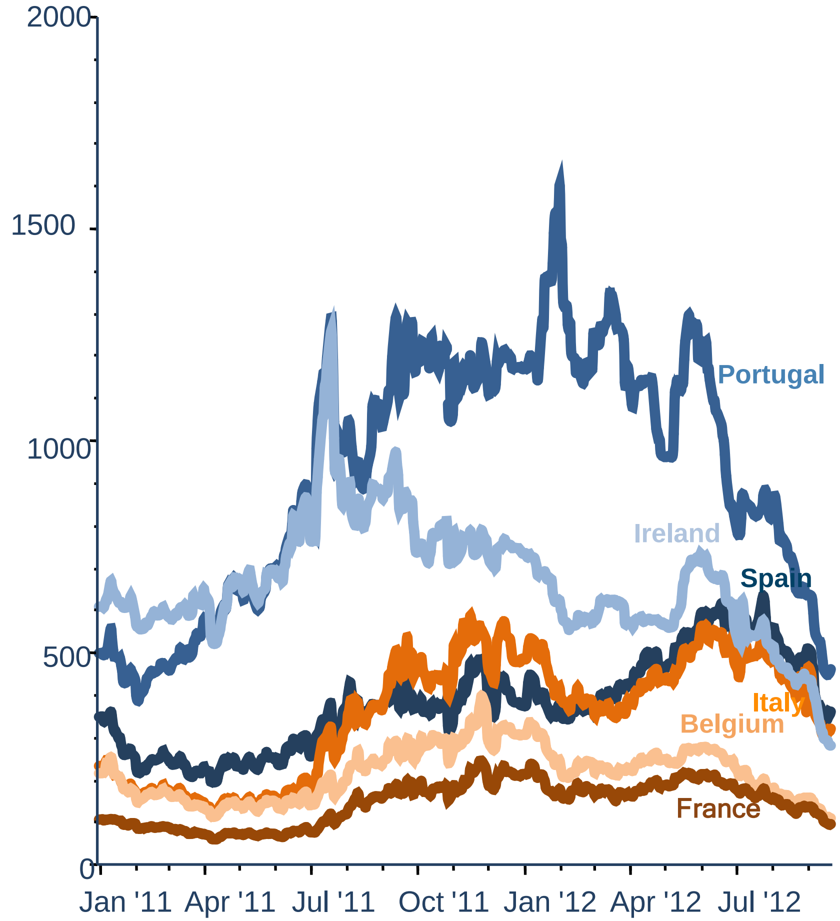
SAR PREM

Outline

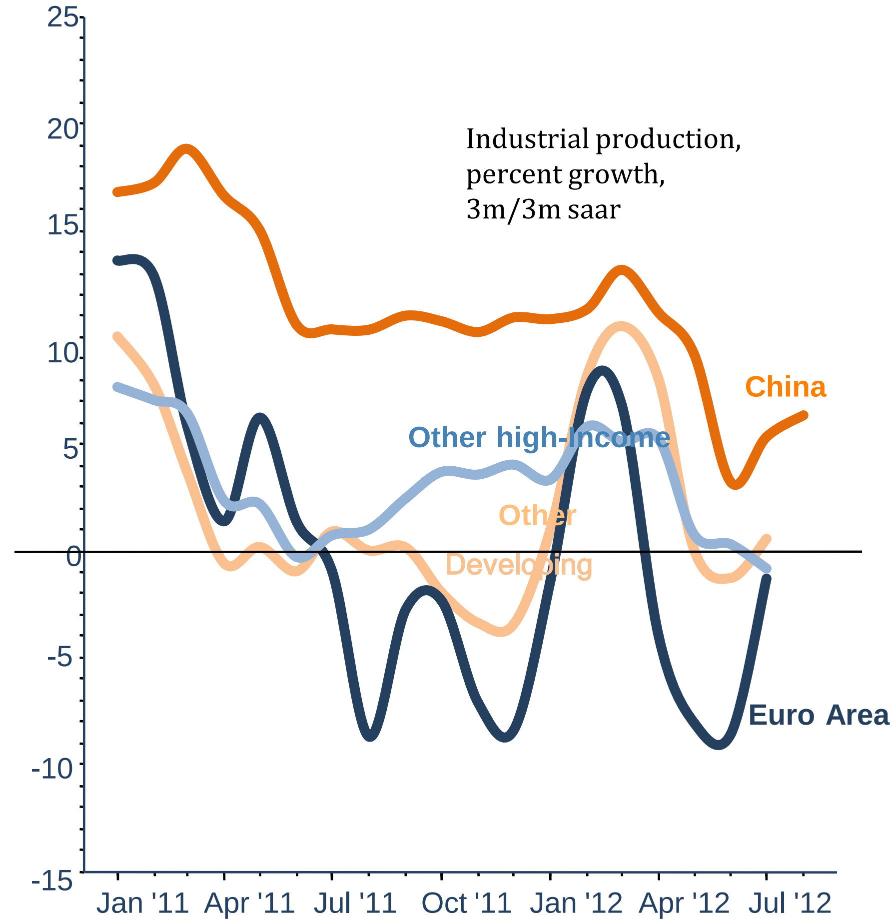
- Global context
- Fiscal consolidations
- Public spending and growth
- Conclusions

Signs of improvement in the global environment

CDS spreads have come down considerably

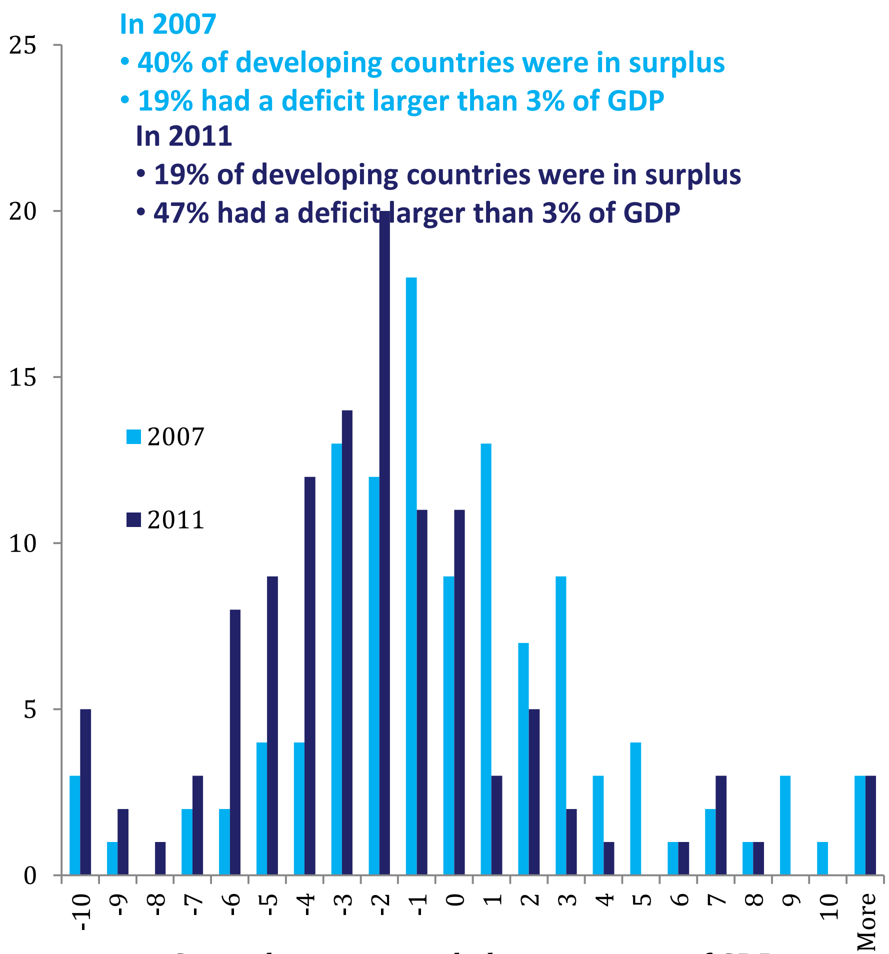


Industrial production is picking up

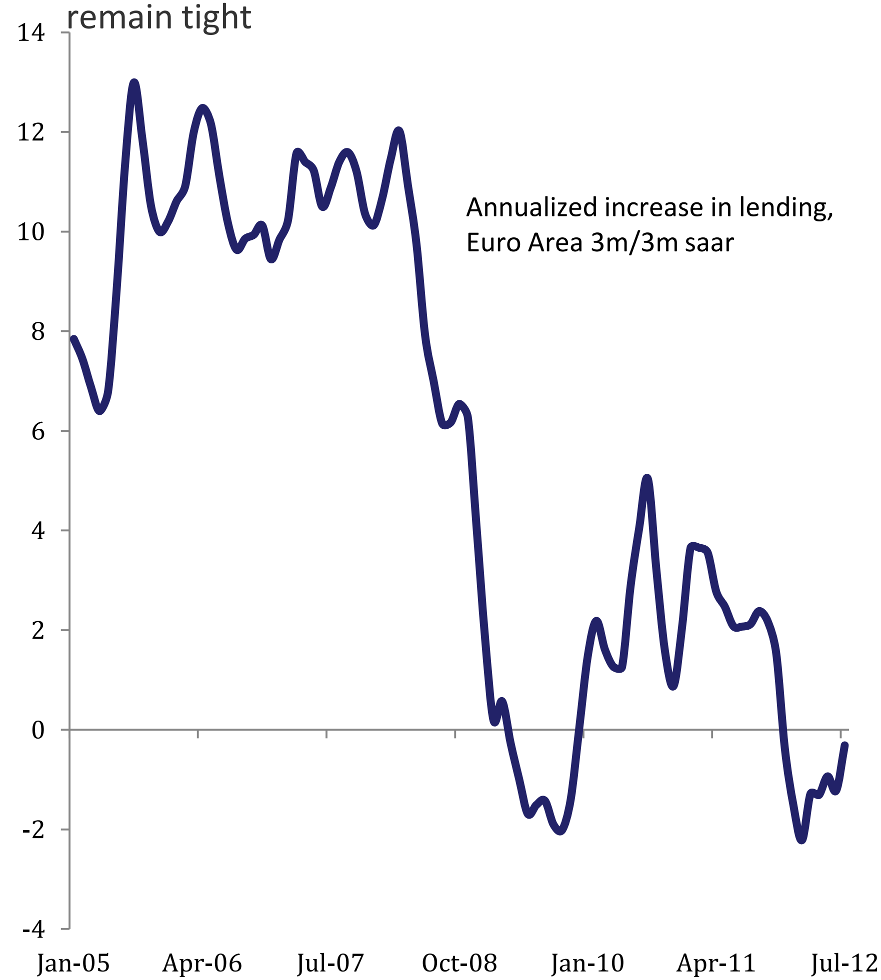


Macroeconomic buffers are largely depleted

Fiscal position much weaker than before

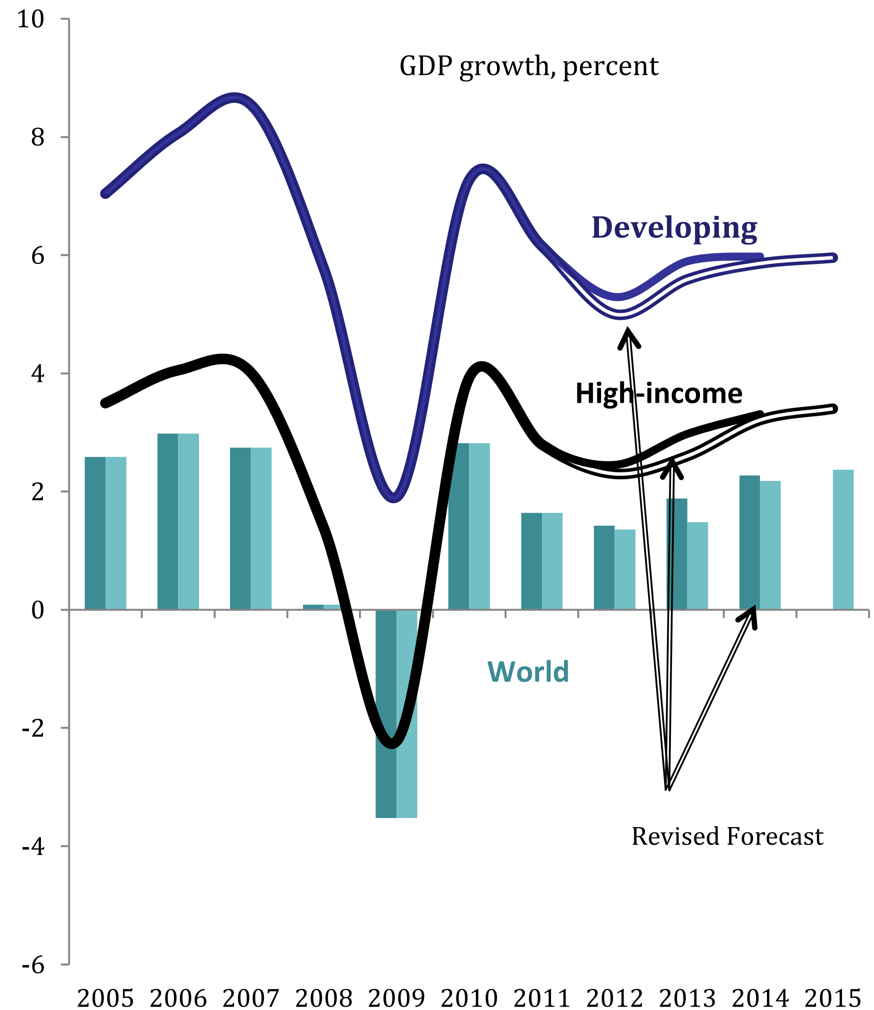


Despite slowdown in deleveraging, credit likely to remain tight



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!