# Expansionary Effects of Fiscal Consolidation?

Fiscal consolidation, i.e. the reduction of a budget deficit, is most often regarded as having contractionary effects on aggregate demand and output and will, thus, tendentially reduce economic growth. If a fiscal multiplier above unity is assumed – the usual textbook assumption –, fiscal consolidation would even have a leverage effect on output. But also from this Keynesian point of view some factors must be (and have been) considered as potentially reducing the fiscal multiplier below one. This is, i.a., the substitution effect between the public and the private sector (crowding-out) and a possible response from interest rates.

That fiscal consolidation might even work in the opposite direction and increase – instead of decrease – the growth path of the economy has first been shown for some consolidation episodes in Denmark and Ireland by Giavazzi and Pagano in a study of 1990. Their analysis has been followed by numerous studies which are assessed and extended by a recent empirical analysis of Gabriele Giudice, Alessandro Turrini and Jan in't Veld (2003).

Why might fiscal consolidation not be contractionary and even expansionary? From the consumer's point of view (consumption channel of analysis) it is finally the Ricardian equivalence which is seen – under different assumptions about rationality and expectations – to be at work and offsets the contractionary effects of reduced budget deficits.

**Expansionary budget consolidations in EU countries: Description of episodes**

| Criteria | Consolidation: Size | Consolidation: Persistence |
|---|---|---|
| Number of **consolidation** episodes | 49 | 74 |
| thereof: number of **expansionary** episodes | 24 | 43 |
| thereof: number of **'pure'** expansionary episodes | 11 | 19 |
| **Description** of expansionary episodes (**'pure'** expansionary episodes in bold) | | |
| Austria | n.a. | 1995, **1996, 1997** |
| Belgium | 1984, **1985** | 1984, **1985**, 1986, 1987 |
| Denmark | **1983, 1984** | **1983, 1984** |
| Finland | 1993 | **1977**, 1998 |
| France | n.a. | 1995, 1996, 1997 |
| Germany | 1982 | 1982, 1983, 1984 |
| Greece | 1982, **1987**, 1994, 1996 | 1994, 1996, **1997, 1998** |
| Ireland | 1976, 1987, 1988 | **1984**, 1987, 1988, **1989** |
| Italy | **1976, 1977, 1993** | **1993**, 1995 |
| Netherlands | 1993 | 1982, 1983 |
| Portugal | **1986** | n.a. |
| Spain | **1986** | 1985, **1986, 1987** |
| Sweden | **1983**, 1987, 1995, 1998 | **1982, 1983, 1984**, 1987, 1994, 1995, 1997, 1998 |
| United Kingdom | **1997** | **1981, 1982, 1997** |

*Definitions of fiscal 'consolidation':*

Size: The primary cyclically adjusted budget balance improves by at least 2 percentage points of GDP at time t or by at least 1.5 points in each of two consecutive years (i.e., t and t-1 or in t and t+1).

Persistence: The primary cyclically adjusted budget balance improves by at least 3 percentage points of GDP over three consecutive years (i.e., between t-2 and t, or between t-1 and t+1 or between t and t+2) and in each year the change in the primary cyclically adjusted budget balance cannot be below -0.5 percentage points of GDP.

*Definition of an 'expansionary' fiscal consolidation:*

Growth: Average real GDP growth between t and t+2 greater than between t-1 and t-2.

*Definition of a 'pure' expansionary consolidation:*

An expansionary fiscal consolidation in which the average change in real short run interest rates between t-1and t+1 is non-negative.

Source: see reference.

But also from the investor's point of view (investment channel of analysis) there may be such an effect when one assumes that a reduced budget deficit might lower the wage pressure, increase the present value of future returns on capital and, thus, stimulate (at least short-run) investment.

Giudice, Turrini and in't Veld have studied the development of the budget balance in 14 EU countries (without Luxembourg) for 33 years. Budget balance is defined net of interest payments (primary balance) and cyclically adjusted. An episode of fiscal consolidation is either a year in which the budget balance improves by at least 2 percent of GDP or a period of two consecutive years in which the improvement is at least 1.5 percent per year and in both years. As an alternative to this "size definition" of consolidation, the authors use also a "persistence definition" of consolidation where consolidation is considered over three years (and also a temporary increase of deficits is allowed). An episode of fiscal consolidation is classified as expansionary when average real growth in the year of adjustment and in the two following years is higher than it has been in the two years before the consolidation.

Part of the results of the study is reproduced in the figure. There have been 49 (size definition) or 74 (persistence definition) consolidation episodes. About half of them (24 and 43, respectively) have been connected with higher growth. Again half of them (11 and 19, respectively) are considered as "pure" growth episodes when growth cannot be attributed to a concomitant monetary policy or devaluations of the exchange rate.

Consolidation plus growth episodes occurred in all countries analysed. If the persistence criterion is used the number of expansionary consolidation episodes is larger than that with the size criterion. The number of such episodes is especially high in Sweden and Greece. When the stricter size criterion is used, episodes of expansionary consolidation do not occur in France and Austria, but they do, when the persistence criterion is applied.

What causes a consolidation episode to become expansionary? The further analysis of the authors comes to the following conclusions. The size of the adjustment and the size of the initial debt (in percent of GDP) do not seem to play a significant role. The composition of fiscal adjustment, by contrast, is of high importance. Consolidation based on expenditure cuts is more likely to enhance growth than a consolidation based on tax increases.

R.O.

**Reference**

Giudice, G., A. Turrini and J. in't Veld (2003), "Can Fiscal Consolidations be Expansionary in the EU? Ex-post Evidence and Ex-ante Analysis", *Economic Paper of the European Commission* No. 195, Directorate-General for Economic and Financial Affairs.