

## Fiscal Austerity

### *Lessons from Recent Events in the British Isles*

Giuseppe Fontana and Malcolm Sawyer

*As economic austerity threatens to sweep Europe, the highly unrealistic expectations about the benefits of government spending cuts are not fully appreciated by the public. It is unlikely that they will result in substantial expansion; to the contrary, potentially they are extremely contractionary. The strong analysis in this piece, using the British budget proposals as a key example, starkly shows that the required changes in investment, savings, and other variables by the private sector to produce growth are utterly implausible. Slow growth, or even recession, is the likely outcome.*

**I**N FEBRUARY 2010 Patrick Honohan, the governor of the Central Bank and Financial Services Authority of the Republic of Ireland, was asked to address students of Trinity College in Dublin about the economic crisis. Honohan asked himself what he could say to some of the most talented Irish graduates of their generation, who were seek-

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*GIUSEPPE FONTANA is a professor of monetary economics at the University of Leeds, UK, and the University of Sannio, Italy. MALCOLM SAWYER is a professor of economics at the University of Leeds. The authors thank Jeff Madrick and Philip Arestis for generous comments on an early draft. Any remaining omissions or errors are solely the responsibility of the authors.*

ing employment in one of the deepest recessions in living memory. He had one simple message for them. The Irish government, with the support of the Central Bank and Financial Authority, has embarked on the most severe austerity measures for decades. These measures will restore market confidence in the Irish economy, which in turn will boost job prospects in the near future.

The overall thrust of macroeconomic policy and the pace and scale of budgetary adjustment seems about right to me as a basis for building a sustained recovery. Few are now tempted here to suggest a Keynesian demand expansion fuelled by a larger budget deficit. . . . If we needed any reminder of how impossible such an approach would be, we need look no further than the recent movements in interest yields on the government debt of some other euro-area countries. . . . Interest rates on Irish government bonds, much lower than they were only a few months ago, have remained relatively unscathed during these past weeks of heightened tensions in the international markets for sovereign debt. This is clearly because of the degree to which foreign confidence has been building in Ireland's ability and determination to restore the public finances along a clearly defined strategy, as exemplified by the relatively tough measures already taken. Continued adherence to this disciplined path will result in lower borrowing rates for the government—and will help accelerate the budgetary correction and reduce the long-term drag of debt servicing as we come out of the recession. . . . [This] offers the best route to improved job prospects. (Honohan 2010a)

It is now well known that the situation evolved much differently from what Honohan expected. Despite the massive cuts in government expenditures and significant tax hikes in the 2009 budget (brought forward to October 2008), in a supplementary emergency budget in April 2009, and in the 2010 budget (in December 2009), on Nov. 28, 2010, the Irish government had to agree with the European Union and the International Monetary Fund (IMF) that it must accept a €85 billion (\$113 billion) rescue package to avoid defaulting on its own debt. As part of the rescue package, the Irish government also had to draft a four-year austerity program of further spending cuts and tax rises. Furthermore, these draconian measures do not seem to have boosted foreign confidence in the ability of the government to restore economic growth and sound public finances. In December 2010 the

major ratings agency downgraded the Irish sovereign credit rating to just a few places above “junk status,” which pushed the yield on Irish ten-year government bonds to 9 percent.

Nevertheless, the position of Governor Honohan has not changed (e.g., Honohan 2010b). The Central Bank and the Financial Services Authority will keep supporting the severe fiscal consolidation measures planned for the next four years in Ireland. Sadly, this is not an untypical position. A large and increasing number of economists and policy makers around the world argue that the government budget deficits experienced today by many advanced countries are unsustainable. The financial crisis that started in the summer of 2007 led world economies close to collapse. To avoid another depression on the scale of that of the 1930s, governments and central banks implemented support packages that included some discretionary fiscal stimulus programs, together with accommodative monetary policy strategies. The discretionary fiscal stimulus programs operated in addition to tax revenue losses and some rises in expenditure on unemployment-related benefits from the effects of falling incomes.

Non-Keynesian mainstream economic theory argues that under these conditions, interest rates on government bonds will increase, which in turn generates larger debt burdens and further increase in interest rates. This result will crowd out investment by the private sector and, worse, soon or later will lead governments to default on their debts. Furthermore, some economists defend the hypothesis that fiscal consolidation measures are actually expansionary, that is, that policy measures aimed at reducing government budget deficits and debt accumulation have positive effects on output and employment (for a recent statement of this view, see Alesina and Ardegnà 2010).

But is this really the case?

## **Debates on Fiscal Consolidation**

There are two “facts” on which everyone should be able to agree. First, government budget deficits rise during economic slowdowns through the operation of “automatic stabilizers” and falling tax revenues,

and they fall during economic booms through rising tax revenues. Second, any attempt to reduce the government budget deficit can be successful only if there are corresponding changes in the component of domestic and foreign aggregate demand: attempting to reduce budget deficits (say, through expenditure reductions) will only lead to the maintenance of the level of output and employment if accompanied by some combination of increases in investment and net exports and reductions in savings (see, e.g., Fazzari 1994). And rises in output *require* that private components of demand rise substantially to offset the effects of decline in public demand.

The traditional Keynesian view is that tax hikes and government spending cuts have contractionary effects on economic activity. According to this view, the appearance of successful fiscal consolidation (that is, declining budget deficits and rising output and employment) can come from some combination of the following circumstances: (a) a decline in the budget deficit through operation of automatic stabilizers and withdrawal of discretionary fiscal stimulus, (b) “good luck”—for example, a surge in exports coming from a boom in world trade, and (c) a depreciating exchange rate. In contrast, the “fiscal consolidationists” would argue that announcements that the budget deficit is to be reduced through tax rises and especially public expenditure reductions spurs confidence in the economy, which stimulates investment and consumer spending. According to the fiscal consolidationists’ view, these positive non-Keynesian confidence effects offset traditional negative Keynesian effects, such that overall tax hikes and government spending cuts have expansionary effects on economic activity (Alesina and Ardegnà 2010). The fiscal consolidationists’ case would require examples of where budget deficits have declined over and above the operation of automatic stabilizers and recessionary tax revenues and where the rise in investment, exports, and consumer expenditure comes as a causal result of the announced intention to reduce budget deficits (and not by “good luck”).

Recently several academic papers have explored the consequences of large-scale budget deficit reductions. The theoretical and empirical evidence is controversial in parts because the macroeconomic theory

that has dominated for the past twenty years lacks a good normative theory of fiscal policy (Blanchard 2008, 11, n.5). Academics and policymakers around the world have in fact largely reached agreement, a consensus indeed, about monetary policy and its effects on the economy. But there is nothing even approaching a convergence of views about fiscal policy (Fontana 2009). There are at least two main and largely conflicting theories: Neoclassical theory and the “New Consensus Macroeconomics” (NCM) theory of fiscal policy.<sup>1</sup> Similarly, there are at least two main and largely inconsistent methodologies used for empirical analyses of fiscal policy: the “narrative” or “dummy variable” approach and the Structural Vector Auto-Regression (SVAR) approach.<sup>2</sup> Furthermore, the predictions of the Neoclassical theory and the NCM theory, as well as the “narrative” and the SVAR type of empirical analyses of fiscal policy, all rest on very shaky foundations.

First, the predictions of Neoclassical theory and the NCM theory of fiscal policy strongly rely on the acceptance of the intertemporal government budget constraint, which is the idea that over the (potentially infinite) future, financial markets impose the requirement that government borrowing will be zero. Second, Neoclassical theory and, at least in part, the NCM theory are grounded in the acceptance of the Ricardian equivalence hypothesis, which is the notion (rejected by Ricardo himself) that any increase in public expenditure, whether funded through tax increases or borrowing, will lead to a decrease in an equivalent amount of private expenditure because people anticipate that they will have to save money to pay higher taxes. This will leave total expenditure unchanged. These two theoretical assumptions are very restrictive and poorly supported by empirical evidence and case study analysis (e.g., Hemming et al. 2002). Third, the “narrative” or “dummy variable” methodology, which is often associated with the predictions of Neoclassical theory, usually assesses the effectiveness of “normal,” conventional fiscal policy measures through an analysis of “abnormal” or one-off fiscal events like military buildups. Fourth, the SVAR approach, which is often reported as supporting the predictions of the NCM theory, imposes severe restrictions on the data in order to

identify fiscal shocks.<sup>3</sup> Therefore, these last two controversial features raise serious doubts about the use of current methodologies to explain the effects of fiscal policy actions (again see note 2).

Some of these controversial issues were analyzed in the latest *World Economic Outlook* (IMF 2010), aptly titled “Will It Hurt? Macroeconomic Effects of Fiscal Consolidation.” The essay is divided into two parts. In the first part, it reviews the history of fiscal consolidation in fifteen advanced countries, including Canada, France, Germany, Ireland, Italy, Japan, the UK, and the United States, during 1980–2009. In the second part, it uses model simulations to explore specific issues that are relevant today, like the effects of consolidation measures in the presence of very low interest rates (e.g., a zero floor on nominal interest rates). The methodology and results of the discussion are very interesting. First, it rejects the SVAR approach adopted by the fiscal consolidationists in favor of the “narrative” methodology based on historical records, because, the researchers claim, the former suffers from measurement errors that bias the analysis of fiscal consolidation measures toward finding expansionary effects. For instance, in its appendix, the standard measure of fiscal consolidation in the SVAR approach, namely, the ratio between the cyclically adjusted primary budget balance (CAPB)<sup>4</sup> and GDP records, shows a reduction by about 4.4 percent for Ireland in 2009. In other words, for the SVAR approach, this is a case of significant government spending. This increase in government spending is then claimed, in contrast to Keynesian theory, to be the cause of the annual decline of 7.6 percent in Ireland’s GDP for the same period. However, the historical records clearly show something different. There were tax hikes and government expenditures cuts of about 4.5 percent of GDP for Ireland in 2009. In other words, in 2009 Ireland experienced fiscal consolidation measures of about 4.5 percent of GDP, which, as in traditional Keynesian view, then led to a decline of 7.6 percent in GDP. The difference between the CAPB-to-GDP ratio and the historical record is mainly caused by the former failing to take into account the effects on tax revenues of the dramatic collapse in stock market and housing prices due to the financial crisis. Putting it slightly differently, after the dramatic

decline in capital gains taxes and stamp duties is properly accounted for, the reduction of government expenditure, due to tax hikes and public cuts, leads to an increase in the CAPB by about 2.3 percent (IMF 2010, 120).

Second, and arguably more important, the chapter finds almost no support for the fiscal consolidationists' hypothesis that fiscal consolidation, properly measured, is expansionary. The historical analysis and model simulations both show that within two years "a budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point" (IMF 2010, 113). Some of the contractionary effects of fiscal consolidation are offset by a decline in the real value of the domestic currency, which typically spurs net exports. Similarly, some of these contractionary effects are mitigated by accommodative monetary policies. Interestingly, the historical analysis shows that inflation-averse central banks are more likely to reduce policy rates when fiscal consolidation is achieved through spending cuts rather than tax hikes, possibly because central banks interpret the former as a signal of a stronger commitment to fiscal discipline (IMF 2010, 102–105). This helps explain the oft-quoted empirical finding by fiscal consolidationists that spending cuts rather than tax hikes spur confidence in the economy, which then stimulates investment and consumer spending. The chapter concludes by warning that when, like today, nominal interest rates are close to zero and countries cannot all simultaneously depreciate the real value of their domestic currencies, the cost of fiscal consolidation is highly likely to be especially contractionary.

## **The British Experiment**

Policy debates in many European countries are now heading firmly in the direction of fiscal consolidation. It is not only that there is a predominant focus on reducing the budget deficit (whatever the consequences for economic activity) but also that there is an attempt to enforce essentially structural budgets (at full employment). In this

regard, one of the most explicit examples of this new era of fiscal consolidation is the Comprehensive Spending Review (CSR) set by the UK government in October 2010.<sup>5</sup> In June 2010, the newly elected coalition government published its annual budget, in which it declared its intention to eliminate the structural budget deficit by 2015–16.<sup>6</sup> “Cyclically adjusted public sector net borrowing will be reduced by 8.4 percentage points, from 8.7 percent of GDP in 2009–10 to 0.3 percent of GDP in 2015–16” (HM Treasury 2010, 16). This target was then used to develop the spending review (CSR).

The June budget and the subsequent CSR with the goal of a balanced structural budget represented a significant fiscal tightening as compared with previous experience. It is certainly much more restrictive than the “golden rule” from the Code for Fiscal Stability, which was used by the previous UK government until November 2008. The “golden rule” allowed government borrowing to cover public investment, and the target of a current budget balanced over the business cycle. While there is dispute as to whether the previous government actually achieved that objective, budget deficits hovered around 2–3 percent of GDP until the onset of the financial crisis. There is no evidence that a budget deficit of this size led to crowding out of private expenditure or to inflationary pressures, or that it could not be readily covered by borrowing.

The goal of a balanced structural budget is also at odds with the rather general practice of the UK governments to run budget deficits. In thirty-four of the past forty years, the budget position in the UK has been in deficit. Also, the slight change of wording from the objective of a balanced current budget to one of an actual balanced budget (over the cycle) means that the budget will be around 3 percent smaller than under the “golden rule” and historical precedent. The implementation of such a smaller budget deficit through public expenditure reductions would involve cuts on the order of 6–7 percent. When some allowance is made for reduction in tax revenues as a result of the reductions of incomes of those who would have been employed on public sector projects, then the public expenditure cuts could be on the order of 10 percent or more. This means a very substantial part of the public



expenditure cuts comes from the aim of a balanced structural budget rather than a balanced current budget.

At this stage it may be worthwhile to say a few words about these different targets. A government budget can be thought of as consisting of cyclical and noncyclical (or structural) components. The cyclical component refers to the automatic movements of tax revenues and fiscal expenditures in response to changes in the overall level of income. So, for example, in many advanced countries tax revenues from capital and labor income have fallen during the past few years as the economy slowed down and income decreased, while at the same time government transfers such as unemployment benefits rose. These major fiscal changes occurred automatically in response to the downturn in the business cycle, and hence they are part of the cyclical budget deficit. A cyclical budget deficit will be entirely compensated (by definition) by a cyclical budget surplus during the upturn in the business cycle. The noncyclical or structural component of the government is in effect the average budget deficit over the course of the business cycle (and as such is not sensitive to measurement of the business cycle). In other words, it refers to the level of deficit that will remain even when the economy is operating at full employment. Thus, aggressive countercyclical fiscal measures to combat rising unemployment can raise the structural budget deficit, as could the spending to finance a war. The goal of a balanced structural government budget eliminates de facto the possibility of any strategic, long-term investments by the government because, at least at first, they would cause a structural deficit. For instance, government investments in education, technology, and infrastructure, which have well-established beneficial effects on the competitiveness of a country, must be financed by the prevailing tax revenues.

This article maintains that seeking to achieve a structural balanced budget is undesirable in itself, as it will involve dramatic cuts in public expenditure. Moreover, it will require a set of changes in the behavior of the private sector. The drive to achieve a structural balanced budget is a failure to appreciate why budget deficits are generally necessary and a failure to appreciate that budget deficits can only be reduced if there is a set of changes in the behavior of the private sector. This is

another way of saying that government borrowing (budget deficit) is in effect funded by borrowing from the private sector, which in turn is the excess of savings over investment plus borrowing from abroad. But these relationships can also be read the other way around, namely, that the private sector can only save in excess of investment if there is an outlet for that excess in the form of lending to the government—thus, government borrowing is necessary. The statistics from the national accounts of the UK for 2007 to 2009 are organized in Table 1 to illustrate this fundamental identity.

It follows that if the budget deficit is to be reduced, there would have to be corresponding changes in the combination of savings, investment, and capital inflow. The oft-quoted “success stories” in a country reducing a budget deficit are generally associated with favorable changes in world demand (lifting exports), with an investment boom or a slump in savings.<sup>7</sup> The simple question here, then, is whether the changes in domestic and foreign aggregate demand are necessary to accompany a reduction in the government budget deficit are plausible. Table 2 indicates the changes that would have been required in 2007 and 2009.

The fiscal year 2007–8 is chosen as the last pre-financial crisis year, when, according to HM Treasury (2008, table 2.2), the output gap (for fiscal year 2007–8) was 0.3 percent (that is, the economy was operating at 0.3 percent above average capacity), and for that fiscal year the actual budget deficit was 2.6 percent of GDP (and cyclically adjusted 2.7 percent of GDP). It can be debated as to whether the fiscal position in that year conformed to the Code for Fiscal Stability under which borrowing was permitted for public investment, and specifically whether the budget deficit was consistent with a current budget balanced over the cycle. But the present goal of the UK government is closer to total budget balance over the cycle. Since public investment (relative to GDP) was around 2 percent of GDP, the “new” target represents a significantly tightening of fiscal policy as compared with the Code for Fiscal Stability.

Table 2 shows the compensating changes in the level of savings that are consistent with a zero budget deficit, assuming that invest-

Table 1

**Main Macroeconomic Aggregates for the UK, 2007–2009**

	2007		2008		2009	
	£ billions	% GDP	£ billions	% GDP	£ billions	% GDP
Private savings	224,792	16.00	236,917	16.39	264,129	18.97
Of which: Households	24,315	1.73	19,326	1.34	68,186	4.90
Corporations	200,477	14.27	217,591	15.05	195,943	14.07
Private investment	230,181	16.38	208,293	14.41	153,552	11.03
Of which: Households	82,107	5.84	67,307	4.66	50,672	3.64
Corporations	148,074	10.54	140,986	9.75	102,880	7.39
Savings – investment	-5,389	-0.38	28,624	1.98	110,577	7.94
Current account deficit	36,482	2.60	23,776	1.64	15,506	1.11
Government savings – public investment	-31,093	-2.21	-52,400	-3.62	-126,336	-9.07

Source: National Income Blue Book, 2010.

Table 2

**Compensating Changes in Savings, Investment, and Current Account Deficit to Accommodate Budget Deficit of Zero (in £ billions)**

	<b>Actual</b>	<b>Hypothetical case 1</b>	<b>Hypothetical case 2</b>	<b>Hypothetical case 3</b>
<b>2007</b>				
Government savings – public investment	-31,093	0	0	0
Private savings	224,792	193,699	224,792	224,792
Private investment	230,181	230,181	261,274	230,181
Current account deficit	36,482	36,482	36,482	5,389
<b>2009</b>				
Government savings – public investment	-126,336	0	0	0
Private savings	264,129	137,793	264,129	264,129
Private investment	153,552	153,552	279,888	153,552
Current account deficit	15,506	15,506	15,506	-110,830

(Statistical discrepancy for 2009 = 253)

ment and current account deficit remain unchanged. The exercise is then repeated for investment and for the current account deficit. The elimination of the budget deficit in 2007 would have had to be accompanied by a 14 percent lower level of savings (hypothetical case 1), equivalent to 2.25 percent of GDP, or a 13.5 percent higher level of investment (hypothetical case 2), or the virtual elimination of the current account deficit (hypothetical case 3). Table 2 also shows the compensating changes for 2009, which is used as a postcrisis year. It is not surprising to expect much greater changes than the figures for 2007, since this case would involve a move from a budget deficit of around 10 percent of GDP to balance. The elimination of the budget deficit in 2009 would have had to be accompanied by a 48 percent lower level of savings (hypothetical case 1), an 82 percent higher level of investment (hypothetical case 2), or the current account position moving to around 8 percent of GDP surplus (hypothetical case 3). These calculations have been undertaken on the basis of an unchanged level of economic activity to illustrate the shift in savings and investment behavior that would have to accompany a reduction in the budget deficit.

It is important to be clear that, in one respect, the outlook based on 2009 is rather less pessimistic than the figures in 2009 seem to imply. Any recovery in the global economy and revival of investment sentiment, easing of credit limits, and consumer confidence leading to higher spending (and hence lower savings) would aid a reduction in the budget deficit. This is little more than saying that recovery will aid the reduction in the budget deficit. There are ways, though, in which the picture is bleaker than portrayed in Table 2. The changes portrayed there were deemed to come from a change in savings, investment, and current account position. But another way in which savings could decline is simply through a lower level of economic activity: in effect, cuts in public expenditure and employment reduce household income, and the ability to save declines. Further, in such a scenario lower consumer demand would tend to depress investment. Such a scenario will not reduce the budget deficit. In terms of reducing the budget deficit, the difference between savings and investment is what matters, and if both declined by much the same amount, the

budget deficit would be left unchanged. The central argument here is that the budget deficit will not be eliminated because the corresponding changes in savings, investment, and current account position that would be required to accompany a balanced budget are highly implausible. The figures given for 2009 may rather overstate the case in that some recovery of investment and consumer expenditure can be anticipated. But the figures for 2007 tend to understate the case in that the tendency to save is likely now to be greater (through the rising consumer debt, which was associated with the position in 2007) and the tendency to invest likely to be lower (through the knock to confidence and the “credit crunch” effects).

As noted, the intention of the UK government appears to be a structural balanced budget; that is, a budget that would be in balance when the economy is operating with a zero output gap (actual output equal to trend output). The exercise that has been undertaken in Table 2 for 2007 could then be seen as particularly pertinent, as the economy was operating in that year close to a zero output gap.

Another way to make the same point is to consider the forecasts recently produced by the UK government covering the next five years, during which time the intention is to eliminate the structural budget. As summarized in Table 3, these are the forecasts of the UK Treasury and the newly established Office for Budget Responsibility (OBR). These forecasts include business investment rising between 2010 and 2015 by over 53 percent, with total investment (including public investment) increasing by nearly 38 percent, which would take it to 18.5 percent of GDP, compared with an average of 16.8 percent over the past decade and would be higher than anything achieved so far in this century (18.2 percent in 2007). Exports are forecast to grow nearly twice as fast as imports; export growth in each year 2011–15 would be higher than the 4 percent average for 1999–2008, and import growth would be lower in each year than the 4.9 percent average for 1999–2008. A positive trade balance in constant prices is to emerge by 2015, which would be the most favorable since 1983. Consumer expenditure is to grow by around 10 percent, slower than the growth of GDP, and this could well reflect in part the squeeze on wages and

Table 3

**Forecasts of Main Macroeconomic Aggregates in the UK, 2010–2015 (in £ billions at constant prices)**

	Household consumption	General government consumption	Total investment	Of which, business investment	Exports	Imports	GDP at market prices	Trade balance
2009	845.5	296.3	197.6	115.7	330.8	360.8	1,295.1	-30.0
2010	854.6	301.6	201.6	117.1	348.6	390.0	1,318.0	-41.4
2011	866.0	300.6	208.0	127.1	372.7	404.8	1,345.9	-32.1
2012	878.6	296.7	221.5	137.8	399.0	418.5	1,381.2	-19.5
2013	895.4	291.4	240.0	151.9	424.7	434.8	1,421.3	-10.1
2014	914.2	284.2	259.9	166.9	449.7	451.6	1,461.6	-1.9
2015	934.4	279.6	277.2	179.6	474.9	470.0	1,501.3	4.9
Change 2015/2010 (in percent)	9.34	-7.29	37.50	53.37	36.23	20.51	13.91	

Source: Office for Budget Responsibility, Supplementary Data, available at <http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html> (accessed January 12, 2011).

the cuts in social security benefits. Household savings rates and overall savings decline somewhat, and these figures can be used to calculate that corporate savings have to decline on the order of £20 billion, which is around a 10 percent fall. This would come at a time when profits would be rising and investment rising sharply, but with the internal use of retained profits apparently declining.

The other route to a balanced budget is to depress the economy sufficiently and to produce a low enough level of income such that savings and imports fall: lower savings and lower imports (smaller current account deficit) would push in the direction of a lower budget deficit. But lower levels of investment would accompany a larger budget deficit. There is always the danger that the pursuit of lower budget deficits through expenditure reductions will reduce economic activity but have rather little effect on the budget deficit. In the period 1992 to 2008, according to the Organization for Economic Cooperation and Development (OECD) *Economic Outlook* July 2010 statistics (appendix table 28), the average cyclically adjusted budget deficit for the eurozone was 2.9 percent of GDP. If, over that period, attempts had been made to secure a 0 percent budget deficit, there would clearly have had to have been compensating changes in some combination of savings, investment, and net exports. As this is a cyclically adjusted position, this would have had to be achieved without any effects on the level of economic activity. It is then clear that there would have to have been a significantly lower level of savings or higher rate of investment to have made a zero budget deficit possible. In short, for a zero structural budget to be a credible objective of economic policy, it would need to be established that savings plus capital account position would be equal to investment where actual output is equal to potential output.

## **Concluding Remarks**

This new era of fiscal consolidation is based on two simple ideas. First, government budget deficits experienced today by many advanced countries are unsustainable. Second, fiscal consolidation measures are invariably expansionary; that is, massive cuts in government ex-



penditures and significant tax hikes have positive effects on output and employment. These simple ideas are wrong but very powerful. No policymaker around the world seems immune to them.

Drawing on current research and recent events in the British Isles, this article has argued that these ideas have very little theoretical or empirical support. Government budgets naturally change overtime in response to changes in domestic and foreign components of aggregate demand. The current goal of a structural balanced government budget is being carried out with little regard to whether it can be realistically achieved. Achieving a structural balanced budget requires not only that government expenditure and tax revenues be broadly equal but also that the sum of domestic private savings plus borrowing from abroad be equal to private investment. The main lesson to be learned from our discussion of the recent UK budget proposals is that the achievement of the policy goal of a structural balanced budget over the next five years depends on very bold and highly unlikely assumptions about the behavior of the private sector, requiring rapid economic growth. Second, recent research at the IMF shows that there is very little support for the hypothesis that fiscal consolidation measures are expansionary. As noted, it concludes, "A budget cut equal to 1 percent of GDP typically reduces domestic demand by about 1 percent and raises the unemployment rate by 0.3 percentage point" (IMF 2010, 113). Furthermore, the IMF research warns that when, like today, nominal interest rates are close to zero and countries cannot all simultaneously depreciate the real value of their domestic currencies, the costs of fiscal consolidation are likely to be especially contractionary. The overall conclusion here, then, is that the current "consolidation dogma" lacks both theoretical and empirical support. It is simply based on the political argument that the smaller the size of the government, the better!

## Notes

1. The point of contention between Neoclassical theory and the NCM theory is about the effects of government expenditure on private consumption and real wage. The standard Neoclassical model assumes that all goods and factor markets

are perfectly competitive, prices are perfectly flexible, the production function has constant returns to scale, and, importantly, the utility function is separable in consumption and leisure. Furthermore, credit constraints are assumed away by assumption. Under these assumptions Neoclassical theory predicts that an increase in government expenditures raises output but decreases private consumption and real wage. The standard NCM model is similar in structure to the standard Neoclassical model, but it introduces two additional features—nominal rigidities and monopolistically competitive firms in the goods market. The NCM model predicts that an increase in government expenditure raises output, real wage, and private consumption.

2. The “narrative” or “dummy variable” econometric approach uses narrative records (e.g., news reports and other historical accounts) to study a series of “abnormal” fiscal events, which, because of their specificity, can be assumed to have an economic impact. These postwar “abnormal” fiscal events are the dummy variables of the empirical analysis. Typically, a dummy variable is a variable that takes value one at quarters when large fiscal expansions take place, and value zero in all other cases. The alternative SVAR econometric approach constructs a testable model and imposes restrictions motivated by economic theory or institutional features that help to isolate the random or exogenous component of the government budget. The theory generally concludes that only random exogenous events cause economic fluctuations. A typical SVAR model in this context would be a three-equation model for output, government spending, and taxes.

3. These restrictions de facto exclude from SVAR-type analyses the possibility of studying the effects of cyclical and systematic components of the government budget.

4. The cyclically adjusted primary budget balance (CAPB) is calculated by subtracting the estimated effects of business cycle fluctuations from the actual primary government balance, i.e., non-interest tax revenue minus non-interest spending. The cyclically adjusted primary budget balance is so-called because it allows explicitly short-run cyclical deviations from balance. Therefore, a sharp increase in the CAPB is evidence of deep spending cuts (fiscal consolidation), while a dramatic decrease in the CAPB indicates a public spending bonanza (fiscal expansion).

5. Possibly the most extreme case of the recent movement toward fiscal consolidation (though the relevant constitutional change was conceived before the onset of the financial crisis) has been the German requirement for a federal budget deficit of 0.35 percent of GDP by 2016, and a balanced budget from 2020 onward. The European Union is proposing much more stringent restraints on national budget deficits and more stringent application of the rules of the Stability and Growth Pact, which has within it notions of overall budget being in balance or small surplus over the cycle.

6. “The Government has therefore set a forward-looking fiscal mandate to achieve cyclically adjusted current balance by the end of the rolling, five-year forecast period” (HM Treasury 2010, 1). However the figures given in their table 1.3 for 2015–16 indicate a cyclically adjusted current budget surplus of 0.8 percent of GDP, and cyclically adjusted net borrowing of 0.3 percent of GDP (and implies public investment of 1.1 percent of GDP, which is rather below the figure for recent years).

7. Canada in the 1990s has frequently been held up as an example of successful

reductions in budget deficits without harm to growth. It is the case that from 1992 through to 2000 the budget deficit was greatly reduced (though to almost exactly the same extent as in the UK) but was accompanied by a very sharp drop in household savings and an export boom linked with membership in the North American Free Trade Agreement (NAFTA) and devaluation.

## For Further Reading

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