In (Partial) Defence of Fiscal Austerity

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There has been much debate recently over the UK coalition government's fiscal consolidation programme. A number of economists, including Robert Neild in the January 2012 Royal Economic Society Newsletter and John Weeks and Dennis Leech in the April 2012 Newsletter, have argued that the pace of fiscal consolidation is too fast and should be slowed down. 'A Manifesto for Economic Sense' published in the ***Financial Times*** on 28th June 2012 is similarly critical of austerity policies. This article is more sympathetic to the fiscal consolidation policy and argues that relaxing the policy is unlikely to have much of a positive effect on economic activity and could well be risky.

In any analysis of the current economic situation, it is important to acknowledge that we are not living in 'normal' economic times any more. The last few years have seen:

- a major global financial crisis;
- the largest banking crisis in the UK's history;
- the greatest worldwide decline in output (in 2008- 9) since the Great Depression;
- the largest ever peacetime public-sector deficits in the UK;
- a massive increase in private-sector indebtedness in many countries including the UK;
- a major ongoing crisis in the eurozone.

These events are of enormous importance in understanding what has been happening in the UK economy and in formulating appropriate policy.

Fiscal Policy Multipliers and the Possible Expansionary Effects of Fiscal Contraction

It is crucial to the arguments of those opposing austerity that the fiscal policy multiplier can be expected to be large in current economic circumstances. And indeed there are some recent papers which do argue for a large multiplier: for example, Romer and Romer (2010) estimate a

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multiplier of nearly 3 for tax changes and Christiano et al. (2011) suggest that a government-spending multiplier of 3.7 might be plausible when there is a binding lower bound on the nominal interest rate. However, a crucial question is whether these multipliers are large in times of high (and/or rapidly rising) public-sector debt, and there is evidence that in such periods fiscal policy multipliers may be much lower and could even be negative. This is the message of Perotti (1999), who argues that the effects of fiscal policy in 'good times' (i.e. low debt) may be very different from its effects in 'bad times' (i.e. high debt). Ilzetzki et al. (2012) present evidence that the fiscal multiplier is zero in countries with public debt-GDP ratios above 60%. It has in fact even been suggested that fiscal contraction may be expansionary: in a much cited paper, Giavazzi and Pagano (1990) argue that the fiscal consolidations undertaken by both Ireland and Denmark in the 1980s were expansionary.

In another well-cited paper, Reinhart and Rogoff (2010) argue that in countries with public debt-GDP ratios greater than 90 per cent economic performance deteriorates sharply. Their analysis has recently been criticised by Herndon et al. (2013). Nevertheless, when the flaws these authors have identified are corrected, it still seems to be the case that higher debt is associated with lower GDP growth, although the relationship between debt and growth seems more continuous than in Reinhart and Rogoff – there is not much evidence of a 'cliff effect', whereby growth falls sharply once debt exceeds a certain level, at least for developing countries. (This is argued by Ursúa, 2013, for example.)

The question that arises, of course, is why fiscal policy multipliers may be low and possibly negative with high and/or rapidly rising public-sector debt. One explanation is somewhat as follows. Suppose public debt is rising at an unsustainable rate. Some consolidation is necessary, but there is uncertainty over when it will be introduced. The longer the delay in introducing the policy, the more painful it will be. The sudden implementation of a fiscal consolidation programme removes the uncertainty and means that it is less painful than expected, and for both these reasons it is expansionary.

There is another, complementary, explanation why a fiscal consolidation programme can be expansionary: the programme reduces the budget deficit over a number of years, so that at the end of the programme, the stock of public debt is much lower than it otherwise would have been. If the debt takes the form mainly of long-term government bonds, and assuming that these bonds are imperfect substitutes for other assets,

including shorter-term bonds, the lower supply of such bonds means their price will be higher, and hence their yield will be lower. So future long-term interest rates will be lower than they otherwise would have been and with foresight current long-term interest rates will be lower as well. So the policy works by reducing current and expected long-term interest rates; it does this given the time path of expected short-term rates, meaning it reduces the term premium on government bonds. Lower long-term interest rates should increase both consumption and investment as suggested by the textbooks. They should also mean higher asset prices, and these will stimulate spending in a variety of ways. For example, higher share prices may stimulate consumption spending through a wealth effect and increase investment spending by making it easier for firms to raise equity capital. An increase in asset values will strengthen firms' balance sheets, and this may encourage bank lending. Also, a fall in long-term interest rates should result in a depreciation of the exchange rate (it raises the price of foreign currency, another asset) and this stimulates demand by raising exports and shifting domestic spending from imports to domestic goods. So there are several ways in which a reduction of longer-term interest rates may raise spending. For the overall policy to be expansionary, it is necessary that these expansionary indirect effects outweigh the direct contractionary effects of the policy. Even if these indirect effects do not completely offset these contractionary forces, they may offset them partially and make the contraction less severe than it otherwise would have been.

Empirical support for the hypothesis that changes in the expected future level of government debt may significantly affect long-run interest rates is provided by Laubach (2009), who finds that (for the US) a one percentage point increase in the debt-GDP ratio raises interest rates by 3 to 4 basis points. Ardagna (2009) presents evidence that fiscal consolidation programmes have significant positive effects on asset prices.

An IMF study (IMF, 2010) has sometimes been cited as evidence that fiscal consolidation is contractionary; the main finding is that a 'fiscal consolidation equal to 1 percent of GDP typically reduces GDP by about 0.5 percent within two years' (op. cit., p. 94). But the contention of this article is not that fiscal contraction is never contractionary. Indeed, the evidence is overwhelming that on average the fiscal policy multiplier is positive. Rather, it argues that in the context of a 'problem' with the public sector debt, the fiscal policy multiplier may well be much smaller than on average and could possibly be negative.

Possible Consequences of Relaxing the Fiscal Consolidation Programme

The question arises whether the above hypothesis applies to the United Kingdom, which, according to the Office for Budget Responsibility, is forecast to have a public sector debt to GDP ratio of 79.2 per cent and a public sector net borrowing to GDP ratio of 7.5 per cent in 2013-14 (see OBR, 2013). We consider the effects of relaxing the fiscal consolidation programme in the light of the previous discussion.

1. Effects of a fully credible relaxation of the consolidation programme

Suppose we consider a package of a two-year reduction in VAT and some increase in public expenditure (relative to what has already been announced) for the same time period. Assume the policy is fully credible (i.e. it is believed that the programme will be implemented as announced). Then the direct effects of the policy should be expansionary. However, there will be some indirect effects going in the opposite direction; higher future taxes may be expected, and there will be the effects described in the previous section whereby the expectation of higher debt raises longer-term interest rates and reduces asset prices. All these effects will tend to reduce spending; but the net effect could still be expansionary.

2. Effects of a less than fully credible relaxation of the consolidation programme (with no possibility of default)

The above discussion assumed that the policy (of temporarily raising spending and reducing taxation) is fully credible. However, this is a dubious assumption. For example, suppose a two-year reduction in VAT had been implemented in 2012. This would require raising VAT in the year before an election, which politicians may be reluctant to do – perhaps they will claim that the recovery 'is not yet fully consolidated' and postpone restoring VAT to its previous rate. Having relaxed fiscal policy once, the government might be more inclined to do so again. So a greater increase in public-sector debt would be expected, and the contractionary forces discussed above would be stronger. This would be so even if there is complete confidence that the government will ultimately repay its debts. The contractionary effects might be still greater if the policy change erodes this confidence.

3. Effects of a less than fully credible relaxation of the consolidation programme (with some chance of default)

It might be argued that there is no chance of any UK government defaulting on its debt. This has never happened, in over 300 years! However, for there to be a problem, it is not necessary that a default is likely, it is merely sufficient that there be just a small probability that default might occur in certain circumstances, and markets would react negatively. Interest rates on government debt would rise, and there is the possibility of self-fulfilling expectations – interest rates rise, making financing the public debt more expensive, raising the probability of default still further, and so on. Several countries in the eurozone are familiar with this problem.

A scenario that might lead to a positive expectation of default is as follows: suppose a more lax fiscal policy is pursued, and a negative shock then sends the deficit still higher. The debt-GDP ratio is approaching 90 per cent (and rising rapidly) in early 2015 with a general election pending. Uncertainty about the outcome of the election (with the chance that the incoming government will not be tough on the deficit) could provoke a crisis of confidence. However, although default might occur with unchanged policies, what is much more likely is that the crisis would force rapid policy changes which would restore confidence but which would be much more painful than the current measures.

Why is Output Stagnant in the UK?

The recent low growth in output in the UK has attracted much attention. Why has output growth been sluggish? There are several reasons. Firstly, and perhaps most importantly, we should mention the consequences of the credit crunch itself. Recoveries from financial crises are often long and painful (see, for example, Reinhart and Rogoff, 2010). Many consumers and firms may be over-leveraged and take considerable time to reduce their debts and start spending at a more rapid pace. Many consumers may find it difficult or expensive to borrow and may adopt a more cautious approach to spending, saving to buy items they might previously have bought on credit. Banks may be unwilling to lend freely, and may be concerned about future regulatory changes. So it seems there will be a period of painful adjustment following a credit crisis which can last many years. However, as households adjust, one would expect them to spend at a higher rate. The second reason why growth has been sluggish is undoubtedly the eurozone crisis. This has affected exports to

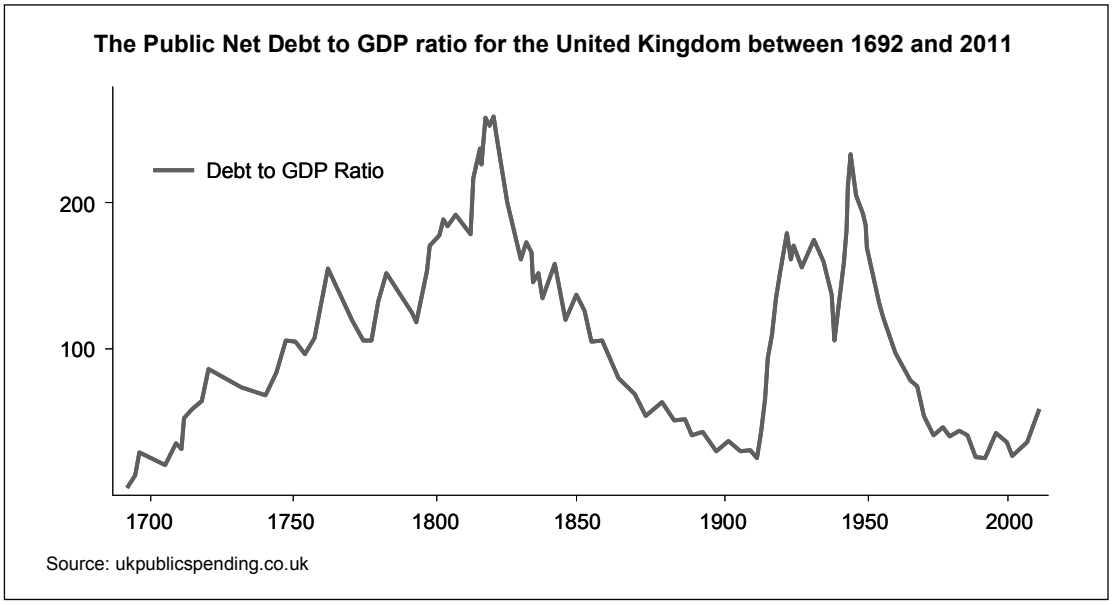
the eurozone and lending by banks that hold the debt of the countries which may default, or who are indirectly so exposed. A third plausible reason for sluggish economic growth is high and volatile commodity prices, which may have negative effects on output through both supply- and demand-side channels.

The fiscal consolidation programme may have been another factor. However, the fact that the UK economy now has record low interest rates (both short term and long term) may be to some extent a product of the programme and these may well promote expansion, as might the competitive exchange rate (sterling depreciated by about 25% between mid-2007 and early 2009).

As credit constraints gradually unwind, consumers may spend more freely, although this may take time. Confidence that the consolidation programme is working may be another force tending to expand output. If commodity prices fall this should also promote expansion.

History of Government Debt in the UK

One argument often used by opponents of fiscal austerity is that UK government debt is fairly modest compared to its level throughout much of its history. (In this section 'lower debt' always means 'lower debt relative to GDP'.)



For example, it was well over 200% of GDP after both the Napoleonic Wars and the Second World War (see Chart above for the debt-GDP ratio between 1692 and 2011), so it might be asked why a debt-GDP ratio of about 75 per cent, which is approximately its current level, should be a major concern.

This is undoubtedly an important question, to which the following remarks may provide a brief and less than comprehensive answer.

1. There is evidence (see Reinhart et al., 2012) that real long-term interest rates have been higher in times of high public-sector debt in the UK than in periods of lower debt.

2. Government debt was clearly on a downward path both between 1815 and 1914 and after 1945. For example, the post-war debt-GDP ratio peaked at 238% in 1947; in 1952 it was 162%, in 1957 122% and by 1962 it was just under 100%. Our earlier discussion has suggested that what may be relevant for crowding out is not the current deficit, nor the current debt, but the expected future time path of the debt. Possibly a high but rapidly falling national debt may be less damaging than a low but rapidly rising national debt.

3. Reasons for the downward trajectory of the public debt to GDP ratio in the Victorian period were conservative budgetary policy, and both economic growth and population growth. In the post-1945 period, inflation and economic growth combined with fairly modest budget deficits were the main factors. However, it is unlikely that either population growth or inflation will reduce debt significantly in the next few years.

4. Demands upon the state were much lower during these time periods. In much of the nineteenth century, over 90 per cent of central government spending was on debt interest and defence. In the period after 1945, when the welfare state was in its infancy, demands upon it were far more modest than they are now. There are a number of reasons for this. In the early post-war period, there were far fewer pensioners and university students and the proportion of children educated beyond the age of 15 was much lower. Spending on the health service (3 per cent in the early post-war era as compared to about 8 per cent today) was much lower as a percentage of GDP. (The list of reasons could surely be lengthened.)

5. Debt interest payments (at about 6 per cent of GDP) were relatively modest in the immediate post-war period in part because much of the debt was issued in 'forced lending' campaigns during the war. Also, as argued by Reinhart and Sbrancia (2011), the government managed to reduce debt servicing costs through various types of financial repression.

6. Demographic factors such as an ageing population may mean that government spending in the future (because of higher pension costs, extra health expenditures, etc.) may need to rise considerably, and this needs to be taken into account when formulating budgetary policy today.

It seems, then, that although debt was extremely high in the periods mentioned, it was clearly affordable, there was no risk of default and it was on a steady downward path. This contrasts with the current situation where firstly debt is rapidly rising; secondly there are considerable demands on the government budget; and thirdly a significant increase in the ratio of taxes to GDP may not be feasible politically. Therefore the fact that debt has been much higher in the past in the UK than at present is no reason for being sanguine about the current level of debt (or its prospective increase).

Qualifications

The Chancellor seeks to eliminate the 'structural deficit'. However, it might be argued that we do not need do much more than stabilise the debt-GDP ratio and then set it on a gradually declining path. A deficit of 3 per cent should do this – with public-sector debt peaking at about 85 per cent, and nominal GDP growth of about 5 per cent, this would produce a declining debt-GDP ratio.

Also, there is nothing in the above analysis to suggest that fiscal consolidation is appropriate for the eurozone. Indeed many of the mechanisms which might bring about an 'expansionary fiscal contraction' are neutralised by the fact that the countries are members of a common currency area, and hence unable to adjust their exchange rate or interest rates vis-à-vis the rest of the zone.

This article does not argue that it is never appropriate to use expansionary fiscal policy to combat a downturn in economic activity. Indeed, the expansionary fiscal policies pursued by many countries in response to the

2008- 9 financial crisis were almost certainly justified and prevented the recession, bad as it was, from becoming far worse. Rather the contention is that when the public-sector debt is high, and/or rising rapidly, expansionary fiscal policies are far less likely to be successful in boosting economic activity.

A further point is that the macroeconomic consequences of public-sector debt may well depend on what the debt is used for. For example, public-sector debt used to finance infrastructure projects may have very different effects from that issued to finance social security spending. This is certainly something that needs further research.

Conclusion

There is evidence that the fiscal consolidation programme is working in reducing the deficit: the deficit-GDP ratio was 11.2 per cent in 2009-10, but fell to about 7.9 per cent in 2011-12, a reduction of over a quarter. It is expected to decline further, to 2.3 per cent, in 2017-18 (see OBR, 2013, p. 6). However, although the deficit-GDP ratio may be declining, public sector debt is still rising rapidly, with a peak of 85.6 per cent in the debt-GDP ratio expected in 2016-17 (op. cit., p. 12).

This article has argued that a relaxation of the fiscal consolidation programme is unlikely to have a significant expansionary effect and could be quite risky. Government debt, even with current austerity policies, seems likely to rise above levels that might be considered desirable, and pursuing a policy which might allow the ratio to go much higher would be very risky indeed. Relaxation of the programme might well result in higher long-term interest rates, lower share and asset prices and an appreciated exchange rate, as well as expectations that there would eventually need to be higher taxation and/or lower expenditure, and these would exert a contractionary force on the economy. We have also argued that the fiscal consolidation programme is not responsible, in any major way, for the recent weak increase in output. Almost certainly a number of other factors are responsible for this, in particular the aftereffects of the financial crisis of 2008-9 and the eurozone crisis.

It seems that the economy is in a strange kind of trap, with both conventional monetary policy and fiscal policy unable to stimulate the economy any further, because of the ‘zero lower bound constraint’ and the deficit/debt problem, respectively. However, the Bank of England might be expected to continue to pursue unconventional monetary

policies such as Quantitative Easing, which may have some positive effect. The recently introduced Funding for Lending Scheme may have prevented bank lending from falling by more than it actually did in the last year. But there is not much else that can be done; the government needs to persist with its current programme, and, in due course, as credit constraints are unwound, the economy would be expected to recover. Prospects for output growth seem to have improved recently, with the Bank of England predicting a 'modest and sustained recovery in output' (Bank of England, 2013, p. 38).

One would not rule out relaxing the consolidation programme under all circumstances. Faced with a major eurozone collapse, for example, some strictly temporary and appropriately targeted government expenditure increases and tax reductions might be implemented. However, it would still be necessary to do this in a way which preserved the credibility of the government's deficit reduction policy. Maintaining the credibility of a deficit reduction programme is almost certainly key to its success. Credibility is not something that can be achieved easily, and politicians should be very wary of taking any actions that might jeopardise this credibility. This is something that has perhaps not been appreciated sufficiently in recent debates.

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