# Fiscal consolidation: Too much of a good thing?

# [John Van Reenen](http://www.voxeu.org/index.php?q=node/312)27 April 2012

*Many policymakers in Europe seem to stick to the idea that fiscal consolidation might inspire confidence and help the economy to grow. This column argues these sentiments may be understandable but are basically wrong. For countries like the UK where borrowing is relatively cheap and sovereign default unlikely, slowing down the pace of fiscal consolidation would be a rational response. The obsession over the fiscal stance is a distraction from sustainable long-run growth.*

This week’s political events in the Netherlands and France which look likely to lead to government dissolution, have been interpreted as a set-back for the pace of fiscal consolidation in Europe with popular resentment punishing incumbent leaders (“Leaders in Austerity Backlash” was the headline of the *Financial Times* on 24 April 2012). The response of the European economic establishment has been to stay the course. In the words of the Bundesbank President, Jens Weidmann: “We can only win back confidence if we bring down excessive deficits and boost competitiveness….in such a situation, consolidation might inspire confidence and actually help the economy to grow” (*Financial Times* 2012).

These sentiments may be understandable, but I will argue that they are basically wrong. Germany is rightly concerned about past and future fiscal profligacy by countries like Greece undermining the euro. But the problems of Spain and Ireland, for example, stem not from public borrowing but rather high private debts due to the aftermath of the construction bubble. Forcing Spain down to a deficit of 3% of GDP by 2013 when the 2011 level is 8.5% is, as my colleague Luis Garicano describes it, “Mission Impossible”. Or as the *Economist* (2012) puts it “The misguidedness of today’s austerity obsession is clearest in Spain…Relying on austerity alone, in a shrinking economy after a huge private debt burst, is a recipe for deflation and depression that could easily end up worsening the underlying fiscal position”

Although it is sometimes possible for sharp fiscal consolidation to stimulate growth, this is very rare and nigh on impossible when your main trading partners are also embarked on similar austerity drives. The economic question is whether the current pace of fiscal consolidation should be slowed. Even if a slowdown is granted on pure economic grounds, austerity defenders would say that in some countries the risk of a sovereign bond crisis means the current path is justified ([Corsetti 2012](http://www.voxeu.org/index.php?q=node/7818)). Further, even if the markets are favourable, political credibility requires cutting fast now. In considering the case for slowing the pace of fiscal consolidation, I look at the straight economics first before examining the issue of bond-market psychology and political economy. All three aspects are linked, of course.

# The economics case for slowing austerity

The IMF (2012) recently made the case for slowing the pace of fiscal consolidation in countries where borrowing costs are low. “Overdoing fiscal adjustment in the short term to countercyclical revenue losses will further undercut activity, diminish popular support for adjustment, and undermine market confidence.”

The arguments for slowing the pace of fiscal austerity are relatively simple (*eg* Delong and Summers 2012). First, there is a sizeable gap between actual and potential output which monetary policy struggles to eliminate, even with quantitative easing, when interest rates are close to zero. Although the financial crisis is likely to have reduced the level of potential output the exact magnitude is much disputed. It is likely that depressed measured productivity in most of Europe is due to depressed demand as well as a negative supply shock (CEP 2011).

Second, the fiscal multiplier is likely to be much higher during the current deep downturn than in normal times (*eg* Auerbach and Gorodnichenko 2010). This implies that fiscal contraction has a much more damaging effect on economic output when activity is depressed as it is now than it would do during a stronger stage of the business cycle.

Third, the longer the recession lasts the more likely ‘hysteresis’ effects are likely to set in which prolong the period of slow growth. This may operate through the labour market as the numbers of long-term unemployed rise and these individuals lose their human capital; through capital scrapping or through credit constraints on innovative firms (Aghion *et al* 2009, Aghion *et al* 2012). This implies that short-run policies over demand may have long-run impacts on the productivity supply side of the economy. These hysteresis effects are typically ignored in the macro models of member states

These arguments imply that in the face of a slowdown in demand, adjusting the pace of a fiscal consolidation plan can be justified.

# Some caveats on the question

Before discussing why political and psychological considerations might cause a revision of opinion, I want to first raise some caveats to the whole [Vox austerity debate](http://www.voxeu.org/index.php?q=node/7817) relating to the long run, the medium run, the composition of cuts, and other Eurozone challenges.

## Long-run policies towards growth

In some sense the obsession over the fiscal stance is a distraction from the more fundamental question of how to establish sustainable long-run growth. Structural reforms to increase competition in labour and product markets are one way of helping here.[1](http://www.voxeu.org/index.php?q=node/7918#fn1) It would be a “waste of a good crisis” to fail to enact needed structural reform as Mario Monti is attempting to do in Italy by reducing barriers to entry and exit. More generally, attention needs to be refocused on these longer-run issues and this motivated setting up the [LSE Growth Commission](http://cep.lse.ac.uk/LSEGrowthCommission/) co-chaired by Tim Besley and me.

## Medium-run policies towards fiscal consolidation

There is no dispute that the escalating public deficit and debt position following the financial crisis of 2008–09 required a credible medium-term fiscal consolidation plan. This was also an opportunity to tackle longer-run issues such as entitlement reform (*eg* pensions), which could help lock-in expectations about the credibility of debt reduction. Some countries like the US have notably failed on this score. But European countries have generally adopted such a programme. The issue is, now that growth is stalling should these plans be adjusted in the light of the new circumstances?

## Consolidate: It ain’t what you do, it’s the way you do it

In an interesting contribution to the Vox debate [Alesina and Giavazzi](http://www.voxeu.org/index.php?q=node/7836) (2012) argue that achieving consolidation through spending cuts is much more effective that through tax hikes. I broadly agree that we should be as much concerned with the *composition* of consolidation as we are with the *level*. However I am unconvinced that the ‘taxes rise bad, spending cuts good’ mantra has sound theoretical or empirical basis. It seems likely that we need a combination of both, especially as they blend into each other when we think about tax deductions (*eg* overly generous employer-provided health insurance tax deductions). More important is the question of where spending cuts are made. Philippe Aghion (2012) has stressed the failure of both crude Keynesianism (it doesn’t matter how you keep demand up) and fiscal neo-liberals (fiscal stimulus is always ineffective). He argues persuasively for directing countercyclical spending on areas where growth is enhanced such as innovation and education. A classic mistake by the UK is achieving consolidation through huge reductions in public investment, such as the cancellation of the ‘shovel-ready’ schools buildings programme.

## Eurozone woes

Fiscal consolidation is one part of Europe’s troubles, but there are larger problems to do with the urgent need to properly regulate, recapitalise, and restructure the banking system. This certainly requires strengthening of the European Financial Stability Fund. Some sort of Eurobond is probably the best way forward (for some ideas see the [*Economist*](http://www.economist.com/node/21553009) and [Euro-nomics](http://www2.lse.ac.uk/newsAndMedia/news/archives/2011/09/safebonds.aspx)), although this inevitably relies on ‘northern Europe’ taking on the more risky debt of its fellow Eurozone members. The price exacted by Germany has been tough (and unsustainable) budgetary rules. It is economically and politically impossible for countries like Spain to make all the adjustment through budgetary means without some greater protection. The solution requires a closer economic union for Eurozone countries, something which all politicians seem to baulk at. But without ‘more Europe’ it is hard to see a long-term future for the euro.

But this brings us back to the politics

# The political dimension

A common response to the call for slowing down fiscal austerity is that retreat would fatally undermine a government’s credibility. This concern cannot be lightly dismissed – it is often too easy to delay taking any tough medicine into the future, when another government will have to bear the electoral pain.

There must be limits to this argument, however. If the economic data clearly shows that growth is slowing much more than forecast and an economically rational plan would be to slow consolidation, it cannot be wise to tie oneself to the mast and go down with the sinking ship come what may.

What governments should do is to maintain a balance of spending over the cycle, holding down current public spending as a share of national income during an upswing. Do excessively tough fiscal consolidations during a downturn make it more likely that such governments will behave sensibly during the upswing? It is equally possible that they will have a boom in public spending at this point to make up for the degraded public services in the past, a procyclical fiscal policy that is the worst of both worlds (for example, see Wren-Lewis 2012).

# Bond-market psychology

The most common defence of current austerity programmes is that even if the economic fundamentals suggest an adjustment and the government is credible, there is a risk that irrational bond markets might demand huge spreads for sovereign debt and possibly push a nation into default. Corsetti (2012) discusses the sovereign risk premium of highly indebted countries and how this may affect private sector lending. Models can be constructed where austerity in a recession is not so bad because fiscal multipliers are low and confidence can be restored.

Although other things equal, high public debt probably dampens fiscal multipliers (eg Ilzetzki *et al* 2010), there now seems abundant evidence that multipliers will be high in the deep recession we currently suffer through. This was certainly the experience of the Great Depression where underutilised resources and the low opportunity cost of public funds meant that the fiscal multiplier appeared large (*eg* Almunia *et al* 2009 and Crafts 2012).

Indeed, rather than excess austerity buying ‘insurance’ against a catastrophic event, it may feed into low growth causing the markets to doubt whether sovereigns can deliver on their pledges, thus forcing up bond yields. This is one part of the Spanish crisis. The relatively benign position for British gilts is mainly due to the fact that the UK is not in the Eurozone and can devalue its currency. Far from an insurance policy, excess austerity may make a catastrophic event more likely.

# Conclusions

Every country must look to its own situation in framing a policy response and all countries need a medium-term credible fiscal consolidation plan. This requires some guesswork as economics is an inexact science, yet it requires less guesswork than punditry over psychology and politics. In my view, the current evidence suggests that for countries like the UK where borrowing is relatively cheap and sovereign default extraordinarily unlikely (so comparisons with Greece are fatuous), slowing down the pace of fiscal consolidation would be a rational response. This is also true for most of northern Europe. For southern Europe belt tightening is necessary, but not on the scale currently demanded in Brussels and Berlin. Of course the facts may change, and I keep the liberty to change my view when this happens.

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# 1 For some ideas see Van Reenen 2011, Garicano *et al* 2012, Bloom *et al* 2012.

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