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Growth-friendly fiscal consolidation

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Policy implications

Fiscal consolidation has become necessary following the rise in deficits and debt caused by the financial and economic crisis. Successful fiscal consolidation implies that the private sector and/or the current account compensate the public sector and move to lower surplus or even deficit, otherwise GDP will fall and the economy go back into recession. Given the worldwide nature of the crisis, an improvement in the current account cannot be a strategy for European countries as a whole, as Europe would then also contribute to global imbalances. A form of growth-friendly fiscal consolidation can be achieved, in which private demand compensates falling public demand but explicit policy action is required to achieve this. Such a result was successfully produced in Austria in the 1990s. A shift in public demand from transfers to investments is also recommended.

Introduction

How to consolidate budgets while avoiding negative growth consequences is a question currently subject to heated debate. Historical experiences – most prominently the USA in 1937 and Japan in 1997 – show that, if, in the aftermath of deep crisis, the fiscal stimulus is taken away, economies can easily fall back into recession. The IMF Managing Director Strauss-Kahn has thus warned that, in the current situation, a very fast elimination of fiscal stimulus will be negative for growth; in the specific case of Europe, the growth problems are more serious than the deficit problems.

The article is structured as follows. It shows that the financial crisis was the reason for the strong increase in budget deficits in recent years (1). It sets out the basic principles for a growth-friendly fiscal consolidation – specifically that, if the government reduces its deficit, other sectors must reduce their surpluses (2). By way of illustration, Austrian experiences – growth-friendly fiscal consolidation from 1995 to 1999 under an Austro-Keynesian paradigm (3) and growth-damaging fiscal consolidation in 2001 under a neo-liberal, paradigm – are described (4) and conclusions drawn (5).

1. Financial crisis causes fiscal deficit/debt explosion

It is not that public debts were at the origin of the crisis but the other way round: the financial crisis led to an explosion of fiscal deficits and public debt. Contrary to what happened in the Depression of the 1930s, this time around policymakers opted for expansionary fiscal and monetary policies: thanks to lessons learnt from the Great Depression, a repeat of this

1 The views expressed in the paper are those of the author and cannot be attributed to the OeNB.

experience was avoided by the pursuit of policy prescriptions that were Keynesian rather than neo-liberal[2].

Many crisis-hit countries did not have, before the crisis, high public deficits or debt but, on the contrary, relatively low deficits or even surpluses and relatively low public debt. This is true of Spain, of Ireland, of Iceland in the current crisis, and of Sweden, and Finland in the early 1990s. In these countries it was financial crisis which led to an explosion of budget deficits, debts and unemployment. The main reason for the explosion of the deficits was not discretionary fiscal spending but a decrease in GDP with its negative consequences for the budget. In the EU as a whole, the crisis will lead to an increase in public debt of about 25% of GDP.

After the breakdown of the Bretton-Woods-System in 1971 and the onset of the neo-liberal paradigm, the number of financial crises increased dramatically. Keynes' insight – in his *General Theory* – that deregulated financial markets are unstable and that this is systemic for capitalism was forgotten. "The *General Theory* is thus consistent with the widespread view in the early 1930s: that what had gone wrong had its roots in the imperfections of the monetary-financial system. The greatness of the *General Theory* was that Keynes visualized these as systemic rather than accidental or perhaps incidental attributes of capitalism" (Minsky, 1975: 143).

The IMF (Laeven and Valencia, 2008) counted 124 banking, 208 currency and 63 sovereign debt crises worldwide from 1970 to 2007, including some 42 cases of double financial crisis (banking and currency crisis) and 10 cases of triple financial crisis (banking, currency and sovereign debt crisis) in which the crises interacted with one another and therefore became especially severe.

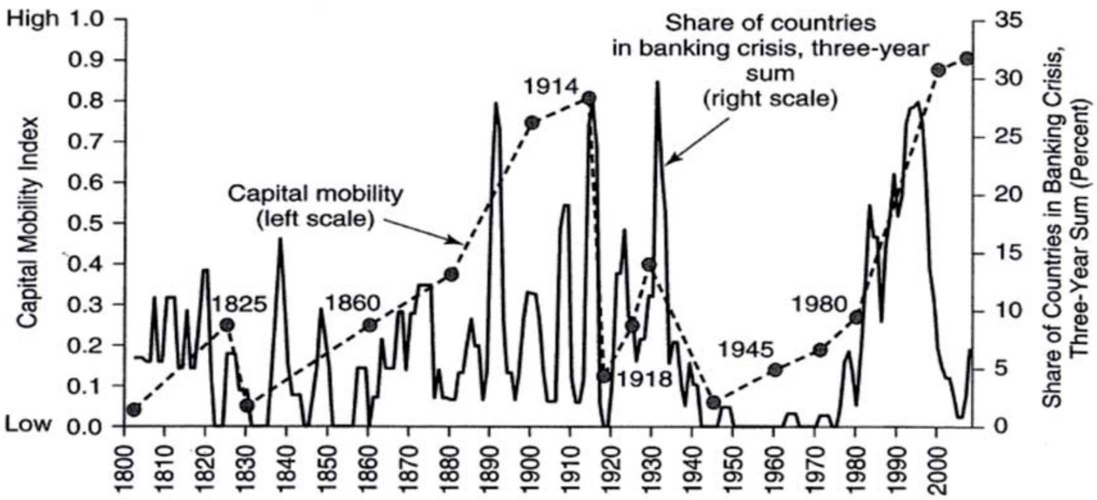
Reinhart and Rogoff (2009) show also the high correlation between capital mobility and banking crises (Fig. 1).

Critical voices were ignored. Already in 2003 (Nauschnigg, 2003), the present author concluded that neoliberal reforms – such as deregulation of the financial sector, or liberalisation of capital movements in conjunction with volatile capital flows – are generating financial crises. The reversal of capital flows leads to a worsening of macroeconomic conditions, not economic policy mistakes. As I concluded back then: 'The question is not if but when the next crisis and the next crash will come and how well we are prepared.' (Nauschnigg 2003: 284, own translation).

In Europe too we had boom/bust cycles entailing deep financial crisis after the liberalisation of financial markets, e.g. in Sweden and Finland at the beginning of the 1990s, in Iceland in 2008, in Central Eastern and South Eastern Europe (CESEE) in 2009. In all these cases, we witnessed a massive overshooting of capital flows. Again in the Euro Area crisis in 2010, starting with Greece and the subsequent contagion effects on others, we saw extensive market failure: first the countries were flooded with cheap capital through the under-pricing of risk, followed by reversal and overshooting into the other extreme of extremely high risk premia. Financial markets overshoot in both directions. This requires policy intervention to re-regulate and support financial markets. In early 2009 I argued for a strengthening of the European Financial Architecture as a lesson from the Icelandic crisis, a proposal that was generalised in a contribution to the ETUI's *After the crisis* publication earlier this year (Nauschnigg, 2009 and 2010).

The focus in this *Policy Brief* is on macroeconomic and especially fiscal policy. As noted already, decisive economic policy action has been taken and has prevented the crisis from turning into a repeat of the Great Depression of the 1930s. One consequence of this is that budget deficits have increased substantially, and need to be lowered in the next years. In the Euro area budget deficits increased from 0.6% of GDP in 2007 to over 6% of

Figure 1: **Capital mobility and banking crises**



Source: Reinhart, Rogoff 2009: 156

2 For an overview of the stimulus packages in Europe see Watt 2009.

GDP in 2010. Public debt has increased substantially during the crisis from already quite high levels: in the Euro area from 66% to 84% and in the EU from 58.7% to 84.7% of GDP between 2007 and 2010 (EU Commission forecast spring 2010). The reduction of fiscal deficits is necessary to avoid a situation in which the high costs of financial crisis lead to sovereign debt crises. Higher fiscal deficits could also lead to higher risk premia for government bonds, which would make financing more expensive and increase deficits. The case of Greece constitutes a warning in this respect.

2. Lessons for growth friendly fiscal consolidation

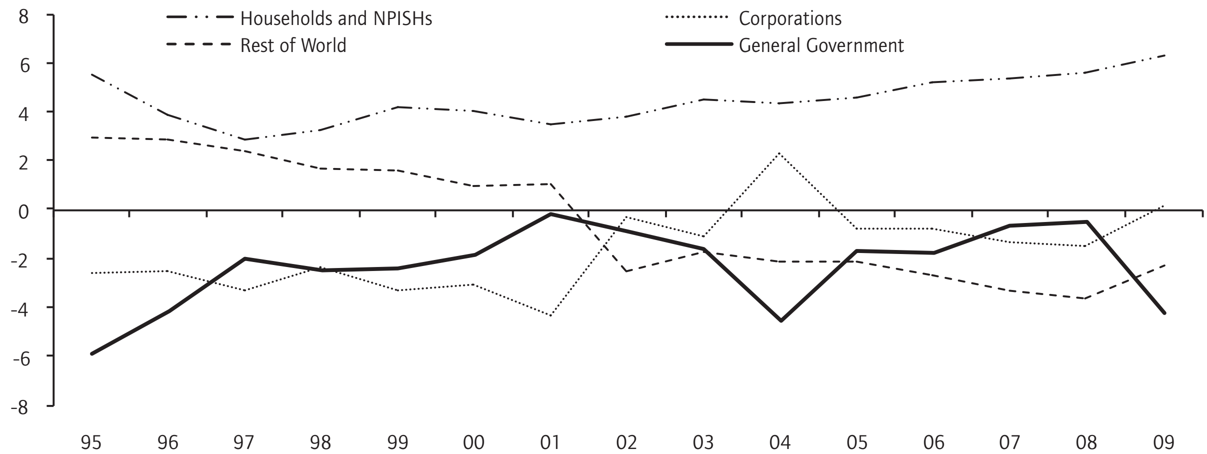
Only a growth-friendly fiscal consolidation will be successful in the long run as lower growth and the resulting rise in unemployment will increase deficits still further. Moreover, the rise in unemployment should be limited as far as possible, as the hysteresis effect will make it very difficult to lower unemployment again, with negative implications for fiscal consolidation in the longer run.

In designing a growth-friendly strategy it is vital to recognise an important economic fact, namely, an accounting identity between the financial positions of the three main sectors of the economy: the public sector, the private sector (firms and households) and the 'external sector'. The financial position (the savings-investment balance) of these three sectors of the economy must match. This is because the surplus (or deficits) of the two 'domestic sectors (public and private) combined must, by definition, be equal to the deficit (or surplus) of that country vis-à-vis the rest of the world. In the context of fiscal consolidation, this means that, if the public sector reduces its deficit, the other two sectors of the economy must either decrease their surplus or increase their deficits.

Two examples will serve to illustrate this point.

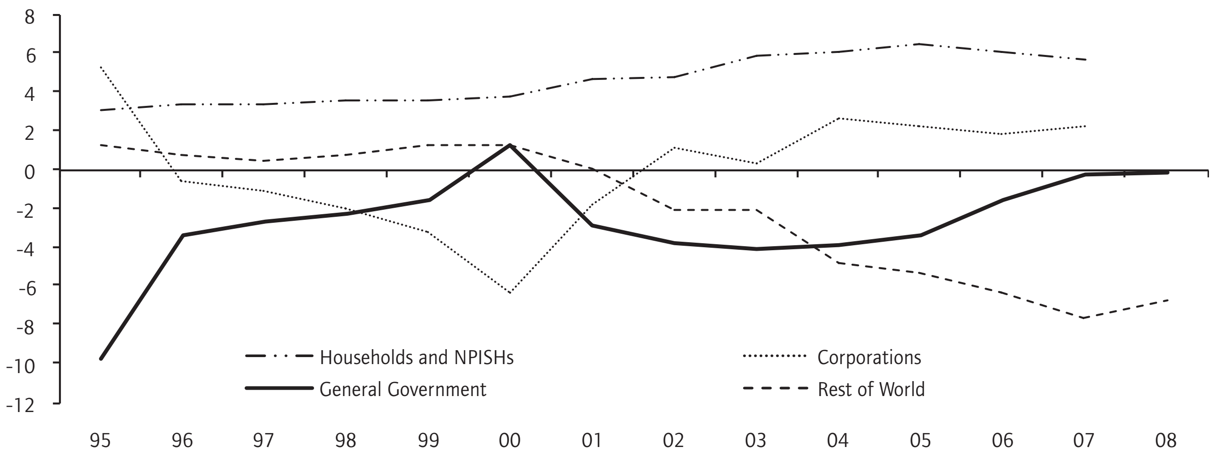
In the case of Austria, a scenario of this type – to which we will return in the next section – can be shown for the period after 1995 (Fig. 2). As the deficit of the public sector was lowered, private households decreased their savings ratio and spent a higher share of their income.

Figure 2: **Austria: financial balances of the different sectors in % of GDP**



Source: Statistik Austria. WIFO (December forecast 2009).

Figure 3: **Germany: financial balances of the different sectors in % of GDP**



Source: Eurostat (autumn 2009)

In Germany, by contrast, the fiscal consolidation after 2004 took place largely to the detriment of the external sector. Demand by the state was replaced primarily by external demand: fiscal deficits decreased while the current account surplus increased. From 2004 onwards Germany consistently ran huge current-account surpluses.

Sweden and Finland also used this mechanism – decreasing current account deficits followed by rising current account surpluses – after their deep financial crises in the early 1990s. Fiscal contraction was accompanied by substantial currency devaluation. This allowed them to replace government demand by external demand, thereby reducing their budget deficits without any sharp negative impact on total demand.

It is vitally important to realise that this is not a viable alternative in the current crisis because the crisis has hit all countries and all of them need to consolidate their public finances. Moreover, global current-account imbalances must be reduced, with countries like Germany and Austria lowering their current-account surpluses and countries like Greece and Spain reducing their current-account deficits.

3. Growth-friendly fiscal consolidation-in Austria 1995 to 1999

In 1995 Austria was in a difficult situation after joining the EU. Counter-cyclical deficit spending before 1995, together with measures to help sheltered sectors of the Austrian economy to cope with the new competitive environment in the EU, had increased the budget deficit significantly.

EU membership brought with it the biggest structural reforms ever experienced – within such a short timespan – by the Austrian economy, as the sheltered sectors of the economy were exposed to competition in the single market. The restructuring of these sectors entailed short-term adjustment costs in output and employment. Only in the longer term would the benefits outweigh these costs (WIFO, 1989, 1994). A so-called J-curve effect developed (Nauschnigg, 2006) and unemployment increased.

The traditional Keynesian response of deficit spending was not possible, as the EU framework for fiscal policy severely curtailed the room for manoeuvre of fiscal policy. Austria had to lower the budget deficit to below 3% of GDP in 1997 to fulfil the convergence criteria and to qualify for EMU.

In the tradition of economic policy-making under Austro-Keynesianism[3],
which usually combined supply and macro policies, a restrictive fiscal policy package of around 100 bn Schilling (over 3% of GDP) was implemented in 1996 and 1997. This brought the deficit down from 5.8% of GDP in 1995, to 4% in 1996 and 1.7% in 1997. Austria had no difficulties fulfilling the convergence criteria. The restrictive fiscal policy was a combination of tax increases and expenditure cuts (lowering of transfers, reduction in the numbers of civil servants and the level of their pay increases, etc.), with the latter taking greater weight.

What is key, however, is that this process was accompanied by measures to offset the negative demand effects. Simultaneously, measures to lower the savings rate were taken – the tax rate on interest income increased from 22% to 25%. Savings subsidies were lowered and made countercyclical. Tax-exempt reserves in the real-estate sector had to be invested within two years, failing which they would be taxed, and, as a result, they were all invested.

Moreover, the restrictive fiscal policy was accompanied by an innovative expansionary package of 90 bn Schilling (7 bn euro), around 3% of GDP, that offset the negative impact of the restrictive fiscal policy on domestic demand. Infrastructure spending (roads, railways, buildings) which had traditionally been financed out of the budget was shifted to entities belonging to the private sector. Public demand was replaced by private demand, which had the effect of lowering the budget deficit. A new form of public/private partnership (PPP) was created whereby the state did not act through public bodies but through private entities owned by the state: for roads and motorways, the *Autobahnen und Schnellstrassen Finanzierungs* AG (ASFINAG) which was financed through tolls, vignettes, and road pricing for lorries; for buildings, the *Bundes Immobilien Gesellschaft* (BIG), financed by renting the buildings to their users in the public sector. As a result of these changes, transfers were cut and investments, financed through these private companies, increased, leading to growth in building and infrastructure investment. (Europäische Wirtschaft Nr. 5/2002).

Table 1: **Economic development Austria**

	GDP growth in %	Budget deficit % GDP	Public debt % GDP	Unemployment in %	Savings rate % GDP
1995	2,5	-5,8	68,39	3,9	11,9
1996	2,2	-4	68,3	4,3	9,3
1997	2,1	-1,8	64,4	4,4	7,7
1998	3,6	-2,4	64,8	4,5	8,5
1999	3,3	-2,3	67,2	3,9	9,8
2000	3,7	-1,7	66,5	3,6	9,2

Sources: Eurostat, ÖSTAT, OeNB

3 The author served as economic adviser to the Ministers of Finance Staribacher, Klima, and Edlinger, from 1995 to 1999.

The strategy proved successful. Austria integrated well into the EU single market, while the budget deficit was lowered by around 3% of GDP without losses in growth and employment. Additional infrastructure was created, increasing growth potential. In short, Austria achieved, on this occasion, a growth-friendly fiscal consolidation.

4. Growth-damaging fiscal consolidation in Austria in 2001

In 2000 the social democrats lost power, as the conservatives (ÖVP) forged a coalition with the right wing party (FPÖ). Austro-Keynesianism was abandoned and replaced by the neo-liberal paradigm. To achieve their goal of a zero deficit, the new government implemented a pro-cyclical fiscal tightening. Investment incentives were cut and corporate taxes lowered. In addition, a number of one-off measures (e.g. privatisation, using returns from sale of central bank reserves for budgetary window dressing, etc.) were implemented.

Even though Austria had no bubble on the stock market (no boom/bust cycles under Austro-Keynesianism from 1970 to 2000), the negative economic consequences of the new approach to fiscal policy were dramatic. Austrian growth fell and unemployment increased dramatically. In 2001 Austrian growth compared to the old EU members (EU15) was 1.5%-points of GDP lower, and unemployment, which had been markedly lower in Austria than in the EU, as a result of Austro-Keynesian policies, increased dramatically. At the same time investments decreased strongly as investment incentives for firms were cut and corporate tax rates lowered. Public assets – firms, reserves – were sold.

Under the neo-liberal paradigm from 2000 to 2006 Austrian growth and unemployment performance was, for the first time since 1970, worse than the average of the old EU members (Fig. 4).

5. Conclusion

The reduction in the budget deficit needs to be compensated by one of the other sectors of the economy. Otherwise, the economy will fall back into recession, as GDP adjusts downwards to bring the desired but incompatible savings-investment decisions of the private and public sector and the current account into line. Therefore the economic impact of deficit-cutting measures, especially on domestic demand, should be considered, and not their budgetary consequences alone. The Austrian experience also shows that undifferentiated neo-liberal fiscal consolidation with pro-cyclical fiscal policies damages growth substantially.

Yet a growth-friendly form of fiscal consolidation is possible, as the earlier Austrian experience shows. It is possible to compensate public demand by private demand but this requires policy action: it is hopeless to pin one's faith in unspecified confidence or non-Keynesian effects. This is essential if budget consolidation is not to damage growth. At the same time, a shift in public demand from transfers to investments is also recommended. Bolstering private demand is all the more vital in that an expansion via currency depreciation and current account surplus alone should not, in the current context, be attempted for the EU as a whole. The EU, which up to now has had a balanced external position, would start to contribute to global imbalances.

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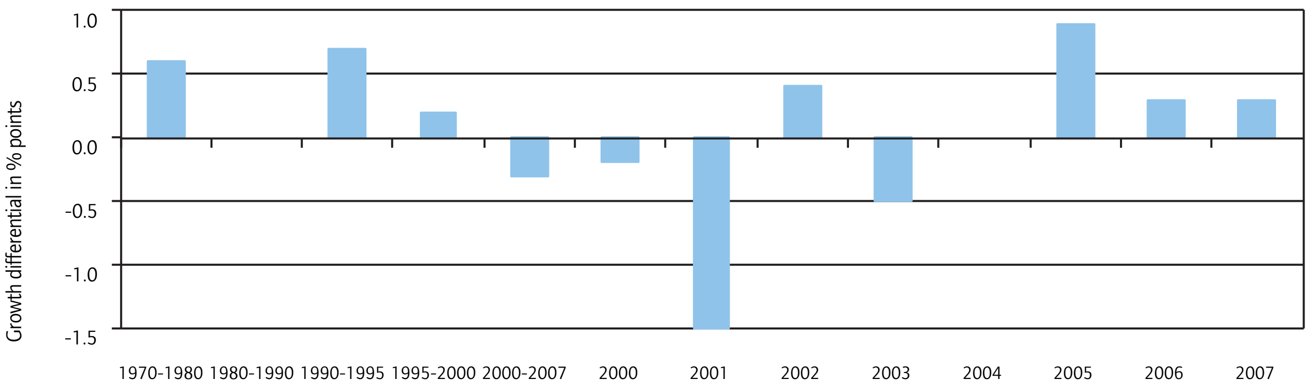
Figure 4: **Growth differential Austria-EU15**



Source: Aiginger, WIFO Monatsbericht 6/2005 for data until 1999; from 2000 Eurostat

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