Box B

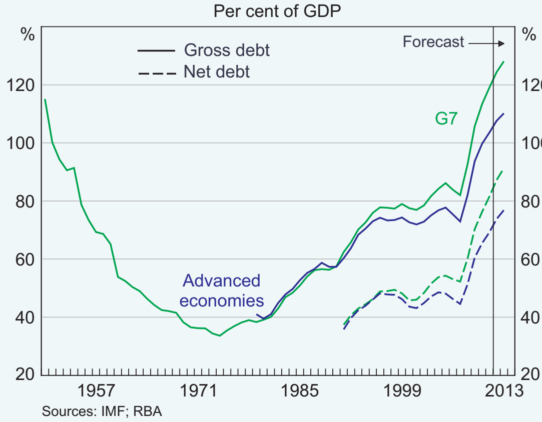
Fiscal Consolidation and Economic Growth in the Advanced Economies

Over the next few years, governments in most advanced economies are planning to undertake substantial fiscal consolidation to help put public finances on a sounder footing. This box outlines fiscal positions and consolidation plans in the euro area, Japan, the United Kingdom, the United States and Canada and discusses the implications of these plans for economic growth both within these economies and for the world as a whole. The focus is on the challenges of the next few years, rather than the significant longer-term issues resulting from the ageing population in the advanced world over coming decades.

Current Fiscal Positions and Consolidation Plans

Over the three decades leading up to the 2008–09 global slowdown, governments in most major advanced economies spent more than they collected in revenues. This was reflected in a marked increase in the ratio of debt to GDP in many countries (Graph B1).

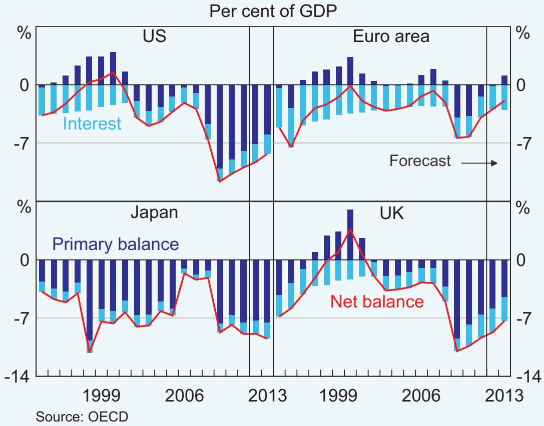
Graph B1
Government Debt
Per cent of GDP



Sources: IMF; RBA

The fiscal positions of most advanced economies then deteriorated substantially during the global downturn in 2008 and 2009, reflecting declines in the level of GDP, the budgetary impact of the automatic stabilisers, fiscal stimulus measures and government support for banking systems. Spain had a particularly large change in its fiscal position (moving from a budget surplus of 2 per cent of GDP in 2007 to a deficit of 11 per cent in 2009), while the budget deficit in the United States increased by 10 percentage points of GDP and in the United Kingdom by around 8 percentage points of GDP (Graph B2). The budget deterioration in the other large euro area economies was smaller, at around 4 percentage points of GDP. Although budget deficits have generally narrowed since 2009, they remain large in many economies and debt-to-GDP ratios have continued to increase (Graph B3).

Graph B2
General Government Balance
Per cent of GDP



Source: OECD

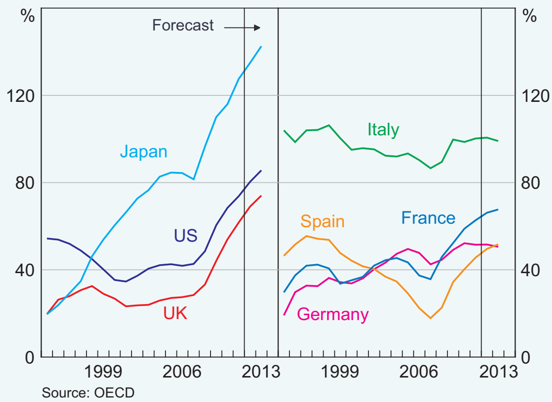


Table B1 provides estimates of the size of the fiscal consolidation expected to occur in the major advanced economies in 2012 and 2013. These figures are largely based on published International Monetary Fund (IMF) estimates and contain some judgement on the likelihood that legislated and announced fiscal plans will be implemented. Most notably, in the case of the United States current federal legislation implies a fiscal consolidation in the next couple of years equivalent to 5 percentage points of GDP; the IMF assumes that 3 percentage points of fiscal consolidation will actually occur, across all levels of government.

Changes in overall government budget balances can arise from discretionary policy actions, 'automatic' fiscal responses to the economic cycle, and changes in interest payments. The change from discretionary actions (which are reflected in forecast changes in the cyclically adjusted primary balance) provides a widely used measure of fiscal consolidation. On this basis, the size of the fiscal consolidation over the next two years is estimated at around 2½ to 4 per cent of GDP in the United States, the United Kingdom, Italy and Spain. Estimates of fiscal consolidation in Germany, France and Canada are about half this size, while the consolidation in Japan is expected to

Table B1: Projections for Fiscal Consolidation

	Net debt	Budget balance		Change in budget balance 2011 to 2013	
		Per cent of GDP		Percentage points of GDP	
	2011	2011	2013	Total	Cyclically adjusted primary balance[(a)]
Euro area	61	–4.3	–2.9	1.4	2.3
– Germany	51	–1.1	–0.1	1.0	1.3
– France	63	–5.7	–4.4	1.3	1.5
– Italy	100	–3.9	–2.3	1.6	3.9
– Spain	46	–8.0	–6.3	1.7	3.4
United States	74	–9.5	–6.4	3.1	2.6
Federal law[(b)]	*62*	*–8.7*	*–3.7*	*5.0*	*5.1*
Japan	128	–10.1	–8.8	1.3	0.5
United Kingdom	62	–8.6	–6.5	2.1	2.8
Canada	34	–4.9	–3.6	1.3	1.2

(a) The budget balance excluding cyclical influences (automatic stabilisers), interest payments and one-off items; per cent of potential GDP
(b) Federal Government budget positions only; data are for fiscal year
Sources: Congressional Budget Office; IMF; OECD; RBA

be small, with government expenditure to remain elevated by repairs to buildings and infrastructure due to the March 2011 earthquake and tsunami. In aggregate, across all advanced economies, the fiscal consolidation is expected to be roughly equal in each of 2012 and 2013, with a larger euro area consolidation in 2012 broadly offset by a fiscal expansion in Japan.

While these fiscal consolidations are large, there are earlier cases of similar actions for many of these economies. However, what is particularly unusual about the current episode is the degree of synchronisation of the consolidations, with all of the eight largest advanced economies (the G7 economies plus Spain) reducing their cyclically adjusted primary deficits between 2010 and 2013. Data limitations make it difficult to be definitive, but in aggregate this appears to be the largest fiscal consolidation in at least 30 years, and possibly the largest since World War II. In addition, these fiscal consolidations are occurring when the degree of excess capacity in these economies (as measured by their aggregate output gap) is large.

The programs of fiscal consolidation generally consist of both revenue- and expenditure-side measures, though there is marked variation in the balance of these measures across countries. In the United Kingdom and Spain, consolidation is expected to occur mostly through reduced expenditures, whereas in Italy increases in revenues are expected to be more important. Increasing interest payments (relative to GDP) are expected to make the deficit reduction process more difficult in most of these economies, while the effect of the economic cycle is expected to differ across countries. Economic conditions are projected to contribute to an improvement in the fiscal position of many English-speaking countries (through a narrowing of the cyclical primary deficit), while the projections are for deteriorations in Europe and elsewhere. This in part explains why the change in the cyclically adjusted primary balance is much larger than the change in the overall deficit for Italy and Spain.

The Implications of Fiscal Consolidation for Growth

The empirical evidence on whether fiscal consolidation reduces output growth in the short term is mixed. Researchers have pointed to a few cases – such as Denmark (1982–86), Ireland (1987–90), Finland (1992–98) and Sweden (1993–98) – where fiscal consolidations have been associated with strong growth. In addition, there are also some cross-country studies of many episodes of large reductions in deficits that suggest fiscal adjustments are frequently associated with stronger-than-average GDP growth.[1]

Critics of the 'expansionary consolidations' view, however, have pointed to some specific factors applying in the case studies that are most often cited. These cases were all small economies, and the episodes were typically ones where the country benefited from a large depreciation and solid economic growth in their major trading partners. In addition, a recent comprehensive cross-country study by the IMF presents evidence that consolidations are usually associated with below-average growth.[2] In particular, the IMF study shows that consolidations equivalent to 1 per cent of GDP are associated with cumulative GDP growth being 0.6 percentage points below average after two years.

One caveat regarding this recent empirical work is that it does not control well for the initial (generally unfavourable) conditions for growth facing countries

1 See, for example, Alesina A and S Ardagna (1998), 'Tales of Fiscal Adjustments', *Economic Policy*, 13(27), pp 478–545.

2 Guajardo J, D Leigh and A Pescatori (2011), 'Expansionary Austerity: New International Evidence', IMF Working Paper WP/11/158.

that underwent large fiscal consolidations. Hence the existing empirical work needs to be interpreted with caution when considering whether fiscal consolidations are followed by less adverse growth outcomes than would have happened in the absence of the consolidation. The answer to this question most likely depends on the specific circumstances of each case.

In the current conjuncture, there are a number of elements that increase the probability that the large fiscal consolidations now in prospect could be significantly contractionary, at least in the short term, for activity in those economies. In particular, with most of the affected countries at, or near, the zero lower bound for policy interest rates, there is limited scope for the impact of fiscal consolidation to be offset by further conventional monetary stimulus. This is particularly the case for individual economies within the euro area, given the constraint of a single monetary policy for the region. There is also limited scope for currency depreciation to offset the effects of the planned fiscal consolidation on overall activity. Countries in the euro area by definition cannot depreciate in nominal terms against each other, and, given the combined size of all the advanced economies where medium-term consolidation is required, there is fairly limited scope for depreciations to boost growth.

If the currently planned fiscal consolidation does prove to be significantly contractionary for the affected economies, this will imply renewed pressure on government revenues and fiscal positions in these economies, a concern recently noted by the IMF and others. This suggests that fiscal consolidation in these countries will have to be carefully managed and highlights the desirability of policy measures to improve confidence, increase medium-term growth prospects and bring down bond yields, so as to offset the contractionary effects of the consolidation that is being undertaken.