POLICY BRIEFING

Will fiscal consolidation drive the UK economy back into recession?

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Summary

The UK government has introduced a harsh programme of fiscal consolidation. Many observers argue that the government should postpone some of the expenditure cuts to ease the impact on the economy. Economic research about past experience of fiscal consolidations suggests that the impact on short term growth depends on how the consolidation programme is designed and on the prevailing economic conditions. This Policy Briefing identifies seven factors that have influenced the success or failure of fiscal consolidations in the past. Currently five of these factors are favourable for the UK. Reducing planned spending cuts would not necessarily increase short-term growth.

The world economy is recovering from the recession caused by the financial crisis. The UK economy has also showed signs of recovery, but so far at a slower pace than many other economies. UK GDP contracted by 0.6% in the fourth quarter of 2011.

One factor which could slow the economic recovery in the UK is the unprecedented programme of fiscal consolidation enacted by the new government last year. Critics argue that the huge reduction in government demand for goods and services, the reduction in public sector employment, and tax rises will push the economy back into recession. The government argues that economic recovery will continue despite the impact of fiscal consolidation measures.

This *Policy Briefing* summarises what economic research on fiscal policy and previous fiscal consolidations has to say about the impact of fiscal consolidation on economic growth in the short term. What are the chances of the UK economy surviving this phase of fiscal consolidation without falling back into a recession? The impact of fiscal policy on economic growth and the business cycle has been a thriving area of economic research for decades, and there is a large body of research that can be consulted to assess these chances.

The convential 'Keynesian' view of a fiscal consolidation is that a decline in government expenditures or an increase in taxes will inevitably lead to a decline in demand and, hence, a decline in GDP. When the economy is fragile, fiscal consolidation is likely to tip the economy back into recession.

However, this view has been challenged by the empirical observation that some countries have managed to carry out significant programmes of fiscal consolidation without a significant decline in GDP. One example is the fiscal consolidation programme in Denmark in the early 1980s which coincided with a strong increase in GDP growth, driven mainly by private investment demand along with surprisingly stable growth in private consumption.

The experience of Denmark and some other countries has given rise to a debate on the possibility of fiscal consolidations being expansionary: that fiscal consolidation may paradoxically increase economic growth. The arguments in favour of this view are based on the supply side of the economy, and the unsustainability of a large public sector deficit. There is broad agreement that a deficit such as the UK's must eventually be reduced. Apart from the cost of financing it, a large deficit could induce a rise in interest rates, crowding out private sector borrowing and investment. Further, not setting out a credible path for deficit reduction could add to uncertainty in the economy, further depressing investment.

There are a large number of empirical studies which systematically investigate the impact of fiscal consolidation on short-term economic growth. The different approaches taken and methods used in this literature are discussed in greater detail in a background paper[1].

Crucially, this research has identified a number of factors which have determined the impact of fiscal consolidations on economic growth in the past. The findings of this research can be summarised as follows.

1. High initial debt level

The chances of a fiscal consolidation having an expansionary effect are higher if initially public sector debt is high. A possible explanation for this observation is that, in the presence of high debt, investors and consumers are aware that fiscal consolidation has to come at some point. When a credible fiscal consolidation programme is announced, uncertainty is reduced which itself creates a stimulus to investment.

2. Credibility of the consolidation

A crucial part of this argument is that the fiscal consolidation must be credible: the government must be clearly committed to the consolidation programme. If this is the case, the private sector can be confident that the programme will be implemented. Where there is doubt that a fiscal consolidation will be carried through, the benefits of a reduction in uncertainty in the economic environment will be reduced, and may disappear entirely.

3. High interest rates

As noted above, higher government borrowing tends to increase the demand for finance, pushing up interest rates and thereby crowding out private investment. In this case, fiscal consolidation would

[1] See Bilicka, Devereux and Fuest (2011).

reduce the government's demand for credit, and thereby help to reduce interest rates and to create room for more private investment.

4. Spending cuts better than tax increases

Research indicates that a fiscal consolidation that relies more on expenditure cuts than tax increases is more likely to be expansionary. This may be due to the fact that higher taxes reduce expectations for long term growth, so that households and investors are less confident.

5. Size of the cuts

Perhaps surprisingly, research indicates that large cuts are less likely to have a contractionary impact on growth than smaller cuts. This may reflect the fact that large cuts more often represent a fundamental policy shift that affects long term expectations of consumers and investors.

6. Exchange rate depreciation before and after the start of the consolidation programme

An exchange rate depreciation may or may not be directly related to the programme of fiscal consolidation. Nevertheless, a depreciation will tend to boost economic activity by increasing the relative price of imports and reducing the relative price of exports, thereby boosting the demand abroad for domestic products. If this effect is simultaneously happening, then it is less likely that a fiscal consolidation would lead to a recession.

7. International fiscal policy environment

A final factor is the extent to which other countries are also engaging in fiscal consolidation. If economies are expanding elsewhere, then a reduction in domestic aggregate demand is less important, as there may be plenty of demand abroad for locally produced goods and services. But this is less likely if other countries are also undergoing fiscal consolidations.

What do these findings imply for the current situation of the UK economy?

Five out of these seven factors suggest that the UK economy might fare well in this fiscal consolidation.

- The stock of government debt in the UK is not excessively high, but the deficit certainly is. It is clear that fiscal policy was unsustainable prior to the consolidation.
- The government appears to be strongly committed to its programme of fiscal consolidation; and the plan is transparent and has high credibility.
- The programme places more weight on expenditure cuts than tax increases.
- The size of the consolidation is very large.
- Sterling has depreciated considerably both before and after the start of the consolidation programme.

All of these factors suggest that the impact of the programme on the economic recovery could be expansionary. However, two factors point into the opposite direction.

- Interest rates are low. A reduction in the government's demand for credit cannot reduce rates any further, so this is unlikely to be a channel for increasing private investment.

- The international environment is characterized by severe fiscal consolidations and slow growth in many other countries.

Of course, the overall impact on short term growth of the fiscal consolidation in the UK is uncertain. But, based on the importance of factors suggested by economic research, there is a good chance that the UK will escape being pushed back into a recession by the fiscal consolidation.

Relaxing spending cuts in the 2011 Budget may have a short-term Keynesian demand impetus, relative to existing plans. But relaxing current plans would reduce the credibility of the government in its determination to eliminate the deficit, and would reduce the size of the fiscal consolidation. Both of these factors could reduce the expansionary impact of the consolidation. The net effect of relaxing spending cuts on short term growth is therefore uncertain.

References

Bilicka, Katarzyna, Michael Devereux and Clemens Fuest (2011), Fiscal consolidation and growth: a can we draw policy implications for the current UK economic situation?, Oxford University Centre for Business Taxation.