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Institutional Conditions of Expansionary Fiscal Consolidations

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Abstract

Recently, the short-term effects of fiscal consolidation have attracted increasing attention from both the academia and policy-makers. Authors in the literature on non-Keynesian effects usually put the emphasis on the need for the devaluation of the national currency, the accommodating reaction of the monetary authority and favourable international economic conditions as the necessary accompanying tools of fiscal consolidation, in order to realise short-term expansionary effects in times of fiscal consolidations. Some also add the necessity of large-scale adjustment; while others support the view that a high and increasing debt ratio or increasing government spending, by triggering an unavoidable adjustment, is the key to experiencing short-term expansionary effects. The increased competitiveness of the economy via reduced real wage also became a crucial explanation for non-Keynesian effects. However, as our critical assessment of the concept of expansionary fiscal consolidations will reveal, institutional conditions, such as (i) the deepness of financial intermediation; (ii) the composition of adjustment; and (iii) the structure of the labour market and wage bargaining system, can prove to be crucial in the occurrence of the desired expansionary short-term effects. Without having an eye on these indispensable institutional factors, the desired short-term growth effects may prove to be illusionary, thereby preventing the success of fiscal consolidation.

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Chapter 1

Introduction

The launch of the single currency in Europe, along with the preparation, ratification and implementation of the Maastricht Treaty, put fiscal policy in the forefront of theory and policy research. In fact, after the delegation of monetary policy and exchange rate policy to a supranational level in eleven (and later twelve) countries in the EU, only fiscal policy has remained in the hands of politicians as an ultimate tool in influencing aggregate demand. Nevertheless, while in the past fiscal policy was considered as an exclusively national authority, the EMU-project changed this approach dramatically, emphasising the possibly controversial effects of autonomous fiscal policies with regard to the stability of a monetary zone.

The steadily increasing interest in the *efficiency* of discretionary fiscal policy, however, could not provide clear-cut statements concerning its long-term and short-term effects – in fact, it propagated the doubts. On the one hand, the traditional Keynesian view claims a positive correlation between government spending and private demand. With the assumption of excess capacity and price/wage stickiness, the multiplier effect – through the channel of aggregate demand – helps the economy to cushion the severe social consequences of economic downturns. On the other hand, the neoclassical view postulates just the opposite relationship between government consumption and private consumption; and in fact, in its radical form (the Barro-Ricardian equivalence), it claims unequivocally that fiscal policy is irrelevant in influencing aggregate demand, since any increase in government expenditure – financed by either debt or tax increase – will be fully offset by increased private savings.

Nevertheless, it might be claimed that a consensus has been formed in policy analysis, namely that the strict form of the Ricardian view – albeit theoretically appealing – does not correspond with reality. While the long-term ineffectiveness of discretionary fiscal measures may hold true, Keynesian effects can determine economic output in the short term. The government, therefore, is able to use fiscal policy as a tool in short-term stabilisation.

1.1 Motivation

The consensus proved to be short-lived, however. It was undermined by the experience of some countries in the last two decades, giving rise to another stream of arguments, the concept of *non-Keynesian* effects of fiscal policy, the topic of the dissertation itself. In the eighties, a large number of industrialised countries embarked on wide-scale reform programmes in their general budget – targeting a reduction in the debt-to-GDP ratio and reducing the level of deficit financing. It came as a surprise that fiscal adjustment was not accompanied with the much-echoed side-effect of economic slowdown, but instead (some) countries experienced a relatively quick recovery in economic activity, an immediate acceleration in economic growth. In their seminal paper, Giavazzi and Pagano (1990) were the very first to point out such unexpected outcomes, sometimes referring to the phenomenon as the “perverse effects” of fiscal policy. Later on, several papers have been published, arguing that major fiscal consolidations proved to be expansionary in relatively large numbers in the last two decades. Afonso (2001) and Giudice et al. (2003) for instance claimed that non-Keynesian effects are not that peculiar and rare within the EU. The preparation for EMU membership induced the bulk majority of countries in the EC/EU to commence on the consolidation of their general government budget. Besides the two general references of Ireland and Denmark, the Netherlands, the UK and to a lesser extent Finland, Portugal, Sweden, Greece and Austria also provided the earlier unexpected results, that is, fiscal consolidation culminated in accelerated economic growth in the short term.

Why did the non-Keynesian effects of fiscal policy receive such a differentiated attention from both the academia and economic policy making, especially in international organisations such as the International Monetary Fund, the European Central Bank or the European Commission? Rodrigo de Rato (2004), the managing director of the IMF gives a simple but clear answer:

> It may be, then, that the oft-cited conflict between the long term benefits of adjustment and its short-term costs does not always arise. In other words, it is possible to have what we call *expansionary fiscal contractions*. [1]

[1] Speech delivered by Rodrigo de Rato, to the Real Academia de Doctores Barcelona, Spain, 25 November 2004. Emphasis as in the original.

If it holds true that the longer-term benefits of fiscal adjustment are not in a trade off with the short-term decline of output, life is indeed much easier than as it has been previously believed. From a purely *economic* point of view, the warm welcome of the perverse effects of fiscal policy can be explained by the apparent fact that in some instances fiscal retrenchment can end up in an expansion of economic activity even in the short run – a statement which sharply contradicts traditional Keynesian theory. However, one could go further in the argument and claim that based on the occurrence of non-Keynesian effects, fiscal adjustment can be made effectively costless for the politicians. With positive net gains at an aggregate level even in the short term, it would be easy to sell fiscal adjustment to voters without the government being threatened to be voted out from power at the following election – a *political economy* viewpoint.

1.2 Scope of this study

Accordingly, the dissertation tries to provide some clues as to how a government can embark on fiscal consolidation without being threatened too seriously by voters. Certainly, any stabilisation measure entails costs. However, the popularity of non-Keynesian effects can be derived from the fact that they mean by definition an increased economic growth even in the *short term*. That is, non-Keynesian effects refer to a surprising situation where the fiscal multiplier turns out to be negative: the indirect effect of fiscal impetus on private consumption offsets the direct effects of government action, thereby reducing the risk of a government's fall and consequently facilitating fiscal reform.

However, certain questions arise in the light of both the economic and the political economy perspective.

(i) If non-Keynesian effects are so attractive, why are governments still reluctant to embark on reducing the general government deficit, especially cutting the expenditures?

(ii) If we can talk about the expansionary effects of fiscal contraction, then why do only a few countries and only at certain times experience these effects, while others not at all?

Finding the proper answers to these questions means basically the identification of those circumstances and/or conditions under which a fiscal consolidation can boost economic activity even in the short term – making it appealing for politicians to undertake otherwise surely unpopular fiscal measures. Consequently, the aim of the dissertation is basically i) to show that non-Keynesian effects are not that rare, which might be a real puzzle in itself; and moreover ii) to map out the determining factors of a successful fiscal consolidation in the terms of positive and accelerating economic growth, that is, to identify those conditions and factors which can be responsible for delivering the non-Keynesian effects of a fiscal adjustment.

Authors in the literature on non-Keynesian effects usually (and mostly unanimously) put the emphasis on the need for the devaluation of the national currency, the accommodating reaction of the monetary authority and favourable international economic conditions as the necessary accompanying tools of fiscal consolidations in order to realise the perverse effects (see especially Giavazzi and Pagano 1990, Hagen et al. 2001). Some also add the necessity of large-scale adjustment, that is, size does matter (Giavazzi, Jappelli and Pagano 2000); while others support the view that a high and increasing debt ratio (Blanchard 1990, Sutherland 1997 and Perotti 1999) or increasing government spending (Bertola and Drazen 1993), triggering an unavoidable adjustment, is the key to experiencing the expansionary effects of fiscal stabilisation in the short term. Alesina and Ardagna (1998) and Alesina et al. (2002), on the other hand, place the emphasis on supply-side factors, such as the competitiveness and profitability of firms. A cut in government wages (or the level of public employment), they argue, makes it easier to lower the costs of labour in private companies, thereby gaining a more competitive position in the international markets. For them, it is the composition of adjustment that matters in providing non-Keynesian effects.

However, as our critical assessment of the literature on non-Keynesian effects will reveal, certain institutional conditions are not included (or not as clearly) yet in the recommended “package” of conditions and factors which can facilitate the occurrence of the desired short-term effects. *The ultimate aim is therefore to identify those necessary* (albeit surely not sufficient) *institutional conditions which can increase the likeliness of experiencing expansionary effects in the case of fiscal adjustment*.

As the dissertation will show, research on non-Keynesian effects can be divided basically into two streams: demand-side and supply-side explanations. By critically evaluating demand-side theories, it will be demonstrated that the importance of the lack of liquidity constraint and consequently the depth of financial intermediation has been generally neglected. By scrutinising the supply-side rationalisations of non-Keynesian effects, it will be argued that a flexible labour market and a coordinated wage bargaining mechanism can strongly support the occurrence of expansionary effects in times of expenditure-side fiscal consolidations. In short, the related explanations are severely conditioned on several implicit institutional assumptions which may or may not be met in reality, seriously questioning the relevance of policy recommendations based on simplified theories.

Summarising these points in a hypothesis, the following statement can be formulated:

> It is more likely to experience the occurrence of non-Keynesian effects if certain institutional conditions are met. Especially (i) the deepness of financial intermediation; (ii) the composition of adjustment and (iii) the structure of the labour market and wage bargaining system can prove to be crucial in the short-term realisation of expansionary effects of fiscal consolidation.

A further, similarly important objective of the dissertation is to test the relevance of the identified institutional conditions. Hungary has been selected for this specific purpose for two main reasons. This is the country in the EU (i) with the largest deficit at present which makes the early adoption of the singly currency highly unlikely; and (ii) the most in need to embark on a major fiscal consolidation without which there is no hope for the country to perform on its potential rate of economic growth. Nevertheless, the elaborated framework of the analysis is suitable for the scrutiny of any other country as well.[2]

Importantly, Hungary cannot opt out from introducing the single currency, the euro. Practically, what this means is that the country – along with the other new nine member states – has to reduce its deficit and debt level to the Maastricht reference values of 3 and 60 per cent, respectively, in order to qualify for euro-zone membership and to abide by the rule of “close to balance or in surplus”[3] fiscal position following the accession. The more the country waits with the introduction of the euro, the less benefits it can expect from having the single currency, since neighbouring economies such as Slovenia, Slovakia or the Baltic states are now close enough to adopt the euro, making these countries more

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[2] The international literature on non-Keynesian effects has analysed industrialised countries almost exclusively. Exceptions included Purfield (2003), Afonso et al. (2005) and Rzonca and Cizkowicz (2005), authors who, however, neglected the study of institutional conditions.

[3] See especially the Council Regulation no. 1467/97.

appealing for investment. Furthermore, independently from the changeover to the euro and the Maastricht numerology, the deteriorated fiscal performance seriously undermines the long-term sustainability of the Hungarian economy, devaluating substantially the potential growth rate of the country.[4]

As a corollary, Hungary has two options at the moment: either politicians realise the need for initiating fiscal adjustment or they take the position of wait-and-see. In the latter case, an exogenous shock will enforce the fiscal consolidation sooner or later, without providing any room for reducing the costs of adjustment. In the former case, however, there is still a chance to minimise the costs of the stabilisation attempts or possibly to implement a consolidation with positive short-term growth effects. Since one of the main objectives of the dissertation is to identify those institutional conditions which are inevitable in experiencing non-Keynesian effects, our findings may hopefully contribute to the exploration of whether Hungary is ready at the moment to experience short-term expansionary effects. Certainly, if the conditions facilitate the emergence of non-Keynesian effects, it can give an incentive to politicians to continue with the consolidation of the general budget without being threatened by losing their popularity substantially and consequently being voted out from power at the next general elections.

Nevertheless, the second part of the dissertation does not aim at providing an answer to the question whether Hungary will indeed experience short-term growth effects in the case of fiscal consolidation because it is almost impossible to predict precisely the ultimate effects of an adjustment effort. Yet the framework of analysis presented in the first part of the thesis can hopefully provide a good starting point in the assessment since it will be possible for us to investigate those institutional conditions which can prove to be crucial in the emergence of non-Keynesian effects.

It is worth underlining once again at the very beginning of the dissertation that it is the short-term stabilisation and its macroeconomic consequences, especially economic growth, that are investigated here. Fiscal tightening means a significant reduction in the deficit of the general government and a curtailment of a debt-increase. Accordingly, no medium or longer-term perspective of fiscal reform will be considered in the dissertation as relevant.

4 See especially Erdős (2004).

The focus is therefore not on the restructuring of the subsystems of the general government – which indeed cannot be simply equated with a reduction of deficit. In fact, reform can trigger even an increased imbalance of the general government budget in the short term. [5]

1.3 Sources and data

The concept of non-Keynesian effects is a rather new phenomenon, yet the literature on the issue has proliferated substantially in recent years. Articles were published generally in the form of working papers, written mostly by the staff of the IMF, the OECD or the ECB. In addition, the most respected journals, such as the *American Economic Review* or the *Quarterly Journal of Economics*, were ready to publish articles on the topic, which clearly indicates that the short-term perverse effects of fiscal consolidation has become part of the mainstream fields of interest of theoreticians and policy-makers.

The dissertation embarks heavily on quantitative statistical analysis. The main sources of data have been the following: the *European Economy* (especially its statistical annex) published by the European Commission and the OECD's most recent *Economic Outlook*. Data and information on Hungary were collected from the OECD's country reports, the IMF's country reports, the European Commission's country assessments and the *Country Profile* and *Country Report*, both issued by the Economist Intelligence Unit.

The collection of the relevant materials was completed in December 2005, therefore articles published after that date were not taken into consideration while working on the dissertation. More importantly, the latest data sets which were used in the dissertation were published in 2005. Therefore, data on 2005 are only estimates.

1.4 Structure of the thesis

Following the introduction, Chapter 2 will show that non-Keynesian effects are indeed not rare phenomena in the EU. This puzzle requires an explanation. In the following two chapters, therefore, the relevant theoretical explanations are systematically and critically assessed and some empirical research will also be carried out in order to test the relevance of the theoretical rationalisations of non-Keynesian effects. Since explanations can be

[5] Furthermore, the dissertation does not deal with the reaction of the monetary authority (inclusive of the exchange rate policy) or the role of the international economic environment while discussing the short-term effects of fiscal retrenchment. These issues are not part of the research project either.

divided basically into two, first Chapter 3 looks at the various ways scholars – focusing on the demand side of non-Keynesian effects – have treated this problem with more or less success, and also delineates the possible way forward in the analysis of the unexpected short-term effects of consolidation. Emphasis will be on the so-called expectational view of fiscal policy, which attributes the emergence of expansionary effects of fiscal tightening to the concerns of private actors regarding the solvency of the state. Factors such as the size of the adjustment, the initial conditions, the prevalence of liquidity constraint and the depth of financial intermediation will be analysed in length accordingly. Chapter 4 turns to a different method of explaining the expansionary effects of fiscal consolidation, focusing on the supply side of adjustment. The relevance of the fall of business cost, providing a positive supply shock in times of adjustment will be reflected upon in the chapter. Here, the importance of the composition of adjustment, the structure of the labour market and the system of wage bargaining will be elaborated on in detail.

After the thorough critical study of both the demand- and the supply-side explanations of non-Keynesian effects, the dissertation turns to the investigation of Hungary and asks whether the previously identified necessary (albeit not sufficient) conditions are present in the country in order to experience non-Keynesian effects in the case of fiscal tightening. Chapter 5 gives a short overview first of the development of Hungarian economic policy in the last few decades, arguing that the hesitance is nothing new in Hungarian policy-making, while Chapter 6 provides a detailed and painstaking analysis of the country's financial intermediation system, its labour market structure and wage bargaining mechanism and the composition of the general budget. Chapter 7 summarises the main findings of the thesis.