The effects of consolidation programs on public spending

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In terms of fiscal policy, the last seven years have been a period of fiscal consolidation. After a brief return of Keynesianism and expansionary fiscal policy during the great financial crisis, the aftermath of this crisis has been dominated by attempts to reduce public deficits and to stop the increase of the public debt. This has been the case in the United States, in the United Kingdom, and, in particular, in the Eurozone.

After roughly seven years of austerity, however, this period of massive consolidation efforts is coming to a close. As the European commission reports in its Spring 2017 European Economic Forecast: „The overall fiscal policy stance in the euro area, as measured by changes in the structural balance, has become broadly neutral. [...] the departure from the strong fiscal consolidation efforts undertaken in previous years continues." (European Commission 2017: 20; 35).

This change of the fiscal stance also affects the questions that policy-makers and social scientists need to ask when thinking about fiscal consolidation. At the height of the consolidation efforts, the main question was how consolidation should be designed in order to be successful, to be politically viable, and to not have negative economic effects. On these questions, there is a broad academic literature, which typically argues that expenditure-based consolidation is more successful than revenue-based consolidation (Alesina/Ardagna 2012, for a sharply dissenting view see Blyth 2013).

This literature would thus suggest that consolidation efforts should focus on the expenditure side. There is just one problem with that, and that is that governments pursuing expenditure-based consolidation often end up cutting investment. This is because cuts to investment tend to be less visible and the opposition to them is less well organized. Empirically, the welfare state is therefore relatively protected from expenditure cuts and consolidations instead focus on discretionary elements of the budget, including public investment (Breunig/Busemeyer 2011, Streeck/Mertens 2011).

That is problematic, as the literature on endogenous growth theory and social investment welfare states tells us that investment is a crucially important part of the public budget (Romer 1990, Morel/Palier/Palme 2012). Thus, cuts to investment are a steep price to pay for increasing the likelihood of consolidation success. Nevertheless, it might be worth paying, if these cuts are just temporary and if a successful consolidation allows for even bigger investment afterwards. The crucial question, however, is whether this is actually the case.

The fundamental question that motivates this contribution is thus: What happens after consolidations? As European countries stop cutting their budgets, is there reason to hope that seven lean years may be followed by seven fat years? Many people hope that cuts will be reversed and that investment will increase again. In fact, when forced to consolidate, progressive politicians usually justify expenditure cuts with the argument that they are only temporary and a way to restore the fiscal capacity of the state. I call this view the 'progressive consolidation view' (Haffert/Mehrtens 2015). In this view, consolidation is not an end in itself but a means to regain fiscal capacity. The argument behind this is very simple: deficits decrease the fiscal capacity of the state. Therefore, by analogy, surpluses will increase fiscal capacity again. This is pretty intuitive. But is it also correct? Does successful consolidation really form the basis for a re-assertion of activist fiscal policy and for greater public investment? Or is this just an over-optimistic assumption?

To answer this question, I look at countries that were particularly successful consolidators and are in that sense 'most likely cases' for the progressive consolidation view (Haffert 2015). In fact, these countries were so successful that they ran budget surpluses for an extended time. These six countries are three Scandinavian countries – Denmark, Finland, and Sweden – and three Anglo-Saxon countries – Canada, Australia, and New Zealand.

Thus, consolidation pressure in these countries was high, and the ensuing consolidations were correspondingly sharp. Moreover, they based their consolidation mainly on expenditure cuts. Of the improvement of the structural budget balance during the three years preceding the first surplus, about 80% came from expenditure cuts (Haffert 2017). Thus, these countries are a pretty good comparison group to study what happens after expenditure driven consolidations.

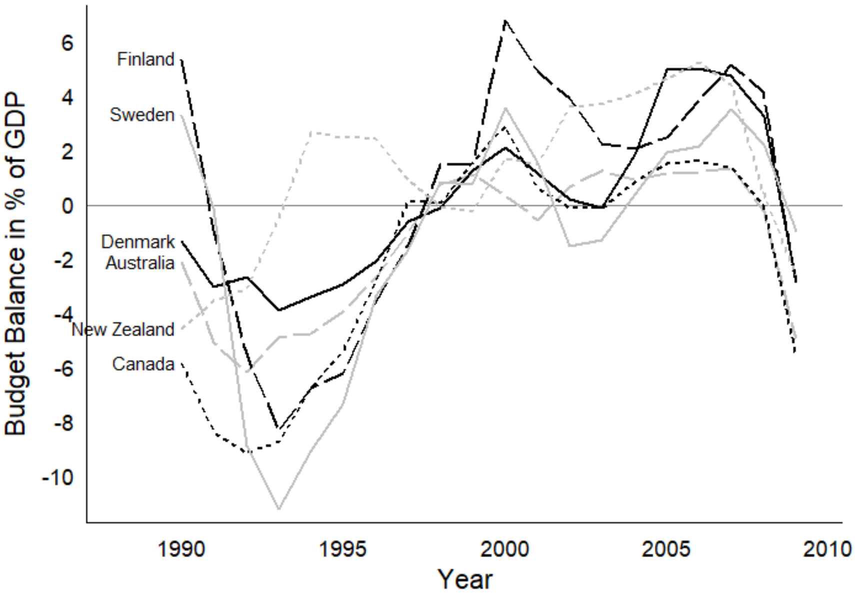

Figure 1: Budget balances from 1990 to 2010
Source: Own elaboration.

Therefore, I have analyzed how several important categories of public expenditure developed after the budget had been balanced. Here, I focus on net core expenditure, defined as all public expenditure that is neither social transfers nor interest payments (Figure 2). In the left part of Figure 2, the expenditure-driven character of the consolidation becomes clearly visible: net core expenditure declined sharply. Moreover, the fact that cuts focused on this category of public spending confirms the findings described above: while the consolidation was expenditure-driven, the welfare state was relatively protected.

As Figure 1 shows, these countries all consolidated their budgets in the mid-1990s and turned relatively high deficits into balanced budgets in a short period of time. Afterwards, they managed to prevent a return of deficits and ran surpluses for a whole decade. Only when the great financial crisis hit in 2008, they returned to deficits.

As can be seen in the left part of Figure 1, these countries did not always have a strong budget balance. They are not Norway. Instead, they suffered from deep fiscal problems just a few years before their surpluses. Moreover, all six countries experienced strong pressures from financial markets. All six were downgraded by international rating agencies and all six experienced temporary hikes in the interest rates on their government bonds.

What is of interest here, however, is what happened after the consolidation was over. As becomes clear from the right part of Figure 2, net core expenditures did not increase again. To the contrary, they continued to decline, although slowly. Thus, hopes for a return of fiscal capacity proved unfounded.

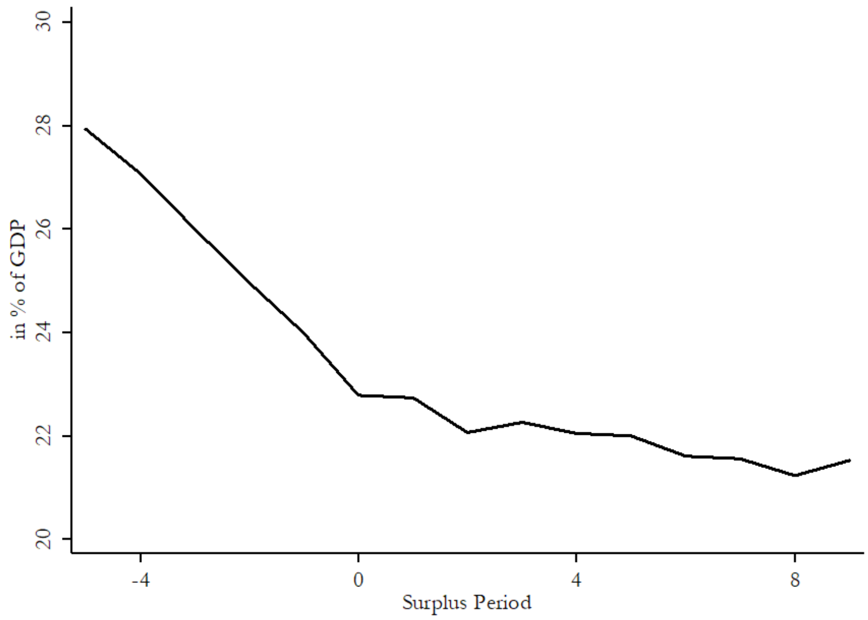

Figure 2: Public expenditure after budget balancing
Source: Own elaboration.

This finding from a visual inspection of Figure 2 can also be substantiated statistically. To do this, I have analyzed what the predicted effect of the budget balance is on public expenditure in the full set of OECD countries. That is, I have regressed the change in core expenditure on the lagged budget balance and a set of control variables. This regression finds that the budget balance is generally a strong predictor of movements in core expenditure: The bigger the deficit in t, the more does expenditure decline in t-1.

To test the progressive consolidation view, I then asked whether the same relationship also holds for surplus years. In other words: can we treat surpluses as the mirror image of deficits? If deficits cause expenditure to fall, do surpluses cause expenditure to increase symmetrically?

The brief answer is: they do not. A regression that uses deficits and surpluses symmetrically makes systematically too optimistic predictions for the development of core expenditure during surplus years. To give a numeric example: If a deficit of one percent of GDP predicts net core expenditure to decline by 0.2 percent of GDP in the following year, a surplus of one percent of GDP predicts it to increase by much less – if at all. If our benchmark is a symmetric development in deficit and surplus, the development in surplus years is thus indeed disappointing (for details on these calculations, see Haffert 2015).

This result can be extended to more specific measures of public investment, namely 'hard investment' in infrastructure (gross fixed capital formation) and 'soft investment', that is public spending for education, research&development, families and active labor market policies. While there are some differences in the details, the broad developments of these much more specific measures of public investment are very similar: They were cut sharply during the consolidation but did only increase very slowly – or not at all – after the budget had turned to surpluses. Empirically, the progressive consolidation view thus clearly has to be rejected.

Why is this the case? Why did public investment develop so disappointingly during surplus years? To understand this, one has to look at the political developments triggered by the consolidation. After all, the statement 'all other things equal, a country will invest more after a successful consolidation than before the consolidation', which formalizes the progressive consolidation view, is based on a highly implausible assumption. In a country that pursues a deep consolidation, all things will not be equal after the consolidation is over.

Instead, a fundamental consolidation will affect all elements of a fiscal regime. It will trigger institutional reforms that are intended to fight the deficit but also bind the hands of politicians during surplus. It will trigger a realignment of interests and will weaken political coalitions who fight for a strong and activist state. And it will also go together with an ideational crisis of a strong and activist state. Justifying consolidation measures to the public requires a discourse in which the state is too big and that is the problem. And that discourse will not simply disappear with the end of the consolidation.

The hope that consolidation can be a tool to regain the fiscal capacity of the state is thus unfounded, at least based on the evidence from my six cases. Deep consolidation is not a transitory phenomenon but has deep and permanent effects on a countries fiscal regime. To judge the political and economic effects of austerity programs, it is thus not enough to focus on the short-term. Instead, we need to take a long-term perspective and consider the path-dependent developments that consolidations can trigger.

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