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Expansionary fiscal consolidations?

An appraisal of the literature on non-Keynesian effects of fiscal policy - and an application to Austria

The study forthcoming in Monetary policy and the Economy 03/2004 is an abriged and slightly advanced version of *Non-Keynesian effects of fiscal policy- what can we learn?* presented at the Workshop on Fiscal consolidation in Europe, June 14th 2004 in Prague.

After the turn of the millennium a period of only very moderate growth has caused budget balances to worsen considerably in Europe. In order to comply with the fiscal criteria established by the Maastricht Treaty and the Stability and Growth Pact and in light of the implicit financial liabilities posed by ageing populations, many EU member states face the renewed need of strong fiscal consolidations

Policymakers are usually hesitant to introduce fiscal adjustments, because standard Keynesian textbook analysis indicates that a fiscal contraction would have a dampening effect on private consumption, out-put and employment. However, there is no consensus on the size or even the sign of the effects of fis-cal policy on the economy as a number of studies suggest that a fiscal consolidation might even stimu-late economic activity in the short run.

In Europe this idea of "non-Keynesian" effects of fiscal policy also called "expansionary fiscal consolidations" was first introduced by German policy makers and economists in the 1980s. However, it was only after Giavazzi and Pagano (1990) have published their often cited article on the effects of fiscal policy in Denmark and Ireland in the 1980s, that the idea of expansionary fiscal contractions received academic attention. The data on these two countries show that a drastic reduction in the cyclically adjusted deficit was followed by above average economic growth. Since then many studies have tried to identify whether and under which conditions fiscal contractions can generate a favourable economic response.

The paper reviews the major results of the existing literature on non-Keynesian effects of fiscal policy, both theoretically and empirically. More specifically, it tries to identify the reasons for the ambiguity of the results in the empirical literature. While some studies find significant positive effects of fiscal consolidations on variables like private consumption, investment, national saving and output, others fail to find any support for the idea of non-Keynesian effects of fiscal policy.

Judging from the empirical evidence surveyed in this paper, there is no clear evidence of "expansionary fiscal consolidations", rather a hint on the fact that fiscal policy might have lost some of its efficiency to stabilise the economy over the recent past.

In Austria, the fiscal consolidation of 1995-1997, which has been identified by the European Commission as expansionary, was characterised by significant one-off measures.

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