Fiscal Consolidation: Issues and Evidence

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Introduction

The 2007–2009 global economic and financial crisis led to a sharp increase in public debt across various parts of the world, especially in advanced countries. This has heightened concerns about fiscal sustainability and their broader economic and financial market consequences. In particular, many believe that public debt has hit levels that are unsustainable and could lead to sovereign default risks. The fact that the peripheral economies of Eurozone did indeed face the risk of sovereign debt defaults starting around late 2009 appeared to vindicate this sense of apprehension.

The policy discourse, most notably in the rich nations, is that governments must engage in fiscal consolidation and bring back public finances to sustainable levels. As The Economist (2010) observed, ‘Across much of the rich world an era of budgetary austerity beckons’. But signs of budgetary austerity also seem to be emerging in a sizeable number of low and middle income countries – see, for example, Ortiz and Cummins (2013). The IMF Fiscal Monitor (May 2010) highlighted the need for major fiscal consolidation over the years ahead – a theme that is revisited in the April 2013 update (IMF 2013a). The 2010 Fiscal Monitor stated that, though the increase in budget deficits played a key role in staving off an economic catastrophe, as economic conditions improve, the attention of policy-makers should now turn to ensuring that doubts about fiscal solvency do not become the cause of a new loss of confidence. Moreover, an equally important risk to be averted is that the accumulated public debt, even if it does not result in overt debt crises, becomes a burden that slows down long-term potential growth. This message remains largely intact in the April 2013 update of the IMF.
Fiscal Consolidation. Thus, it notes: ‘High debt – even if stable – retards potential growth’.\(^2\)

This chapter critically examines the key empirical evidence that is assembled to support the fiscal consolidation argument. In particular, we review the evidence on the debt–growth relationship. The authors find that the negative relationship between debt and GDP growth is based on fragile empirical evidence. Historical experience does not lend support to the concerns that the current situation is likely to cause rapid upward spiralling of public indebtedness that will push up interest rates (as well as risk premium) on government securities, thereby putting greater pressure on deficits to widen and on public debt to increase. It is also found that the argument that fiscal consolidation is possible without adversely affecting growth is not based on robust empirical evidence.

Finally, the chapter briefly considers an emerging orthodoxy that fiscal consolidation can be combined with quantitative easing and structural reforms to ensure that both growth and austerity work hand in hand. It is argued here that this orthodoxy is of doubtful validity.

A caveat is in order at this juncture. The reader will note that the discussion and debate on fiscal austerity is being shaped by developed country experiences. This is understandable because, unlike past episodes, sovereign debt crises have emerged in the context of developed countries (most notably some Eurozone economies). Nevertheless, the chapter does offer, where possible, a global perspective.

**Debt–growth relationship**

The IMF’s *Fiscal Monitor* May 2010, which strongly advocated for fiscal consolidation, acknowledged that to date there are only a few studies that assess the magnitude and significance of potentially adverse effects of high public debt on growth. Thus, the IMF attempted to fill this gap by undertaking empirical analysis of the relationship between initial government debt and subsequent economic growth in a panel of advanced and emerging economies for the period 1970–2007.\(^3\) It involved examination of nonlinearities and threshold levels beyond which debt begins to have an adverse effect on growth. It also did a growth accounting exercise to explore the channels through which government debt may influence growth. The analysis paid particular attention to a variety of estimation issues – such as ‘reverse causality’ or the presence of a third variable affecting both growth and debt – that can have an important bearing on the estimation. The study also undertook various robustness