SNAPSHOT

- This article presents 10 compelling reasons why the Chancellor should stick with 'Plan A'.
- The case against a traditional Keynesian stimulus is very strong.
- In the current financial turmoil, relaxing deficit reduction is the last thing we should do.
- The headline deficit is already deteriorating because of the euro crisis and economic slowdown. Any significant discretionary fiscal easing on top of this would be folly.

Stick to your guns, Chancellor

IoD Chief Economist Graeme Leach urges the Government not to change course on fiscal policy, despite mounting pressure on the Chancellor resulting from the weak UK economy.

RIGHT AND WRONG FISCAL POLICY

The central economic and political battle over the coming year will be whether or not to stick with Plan A in fiscal policy. With the economy weakening in the wake of the euro crisis, the political cry will go out to slow the reduction in the deficit. And the political cry will be supported by legions of economists. Moreover, the case for an activist fiscal policy is very simple to make and connects with the electorate: public spending is part of GDP, less public spending means less GDP, more spending means more GDP. What could be simpler?

Keynes's biographer, the economist Lord Skidelsky, stated in 2009 that, "to get aggregate demand up, the surest way to do this is by the Government spending the money itself".[1] And IMF Chief Economist Olivier Blanchard has written that:

"…if one believes that aggregate demand determines output in the short run, which most of us do; that aggregate demand is C+I+G+(X-M), which most of us do; that Ricardian equivalence[2] does not hold, which most of us do; and that we stay away from high deficits and a high debt environment in which many things can go wrong, then it is very difficult to see how a decrease in taxes or an increase in spending would not lead to an increase in output".[3]

For those with long memories the situation closely parallels the 1981 Budget, when the then Chancellor, Sir Geoffrey Howe, tightened fiscal policy at the bottom of the recession. In response, 364 economists wrote a letter to *The Times* warning that "present policies will deepen the depression…and threaten social and political stability".

[1] Cited in T. Congdon, *Money in a Free Society – Keynes, Friedman & the New Crisis in Capitalism,* 2011, p. 188.

[2] Ricardian equivalence argues that a bond-financed tax cut simply defers tax payments until some future date when the interest and bond repayment fall due (five, 10, 20-year bond etc.) It does not change the present value of those tax payments because the present value of the future payments to the bondholders must be exactly equal to the market value of the bonds and therefore the tax cut. With an assumption that only present value budget constraints influence consumer spending, consumption will be unaffected by what is merely a change in the timing of tax payments. As Robert Barro argued in his seminal 1974 article, *Are Government Bonds Net Wealth?,* consumers will simply save their tax cuts so as to be able to meet the future interest and capital repayments when they fall due. In other words they see an increased budget deficit now, as a portent of a future increase in taxation.

[3] R.W. Kopke, G.M.B. Tootell & R.K. Triest, *The Macroeconomics of Fiscal Policy,* MIT Press, 2006, p. 63.

With “exquisite timing”,[4] the economic recovery began almost before the ink was dry on the letter.

The 364 economists were wrong in 1981 and even if Ricardian equivalence does not operate in full, partial effects will weaken the fiscal multiplier. Blanchard also acknowledges that in a high debt and deficit environment the textbook fiscal multiplier may not operate – many things can go wrong. Recognising these issues, the IMF has publicly endorsed the Spending Review and deficit reduction package.

Table 1 shows the impact of the Spending Review over the coming years. Whilst the Spending Review is clearly negative for growth, these are not vicious cuts.

TABLE 1

Public expenditure growth

% change	2011	2012	2013	2014	2015	2016
Government consumption	2.2	-0.1	-1.6	-2.3	-3.2	-3.5
Government investment	-6.8	-9.4	-4.2	-0.1	-1.1	-2.3

Source: Office for Budget Responsibility, *Economic and fiscal outlook*, Cm 8212, November 2011.

THE ELEPHANT IN THE ROOM

The ‘elephant in the room’ in this debate is the money supply. The majority of economists place little emphasis on the role of the money supply. But over recent decades the economic consensus has also shifted away from operating discretionary fiscal policy. Inflation and the output gap are dealt with using monetary policy, i.e. interest rates. However, with near-zero interest rates the new consensus model is fatally flawed because it doesn’t allow for the fact that monetary policy is not a single instrument – the role of the money supply is ignored.

Re-discovery of the significance of the money supply, in quantitative easing, has been a difficult pill to swallow for many economists. But this reluctance to acknowledge the importance of the money supply means that far too many economists have only one default option left: fiscal policy. If near-zero interest rates can’t ensure recovery, we are told we need to operate an expansionist – or less austere – fiscal policy.

Below we give 10 reasons why we believe this view is wrong.

1. Quantitative easing

The recent launch of QE2 with £75 billion of additional gilt purchases is almost certain to be extended significantly. The continued weakness of the economy in early 2012, together with the long-awaited falls in inflation, combine to justify a further expansion in QE. It is quite plausible to see QE2 being on the same scale as QE1, in other words at least £200 billion. These sums swamp any potential fiscal stimulus measures – the Bank of England holds a bazooka whilst HM Treasury only has a spud gun.

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[4] Former Chancellor Lord Lawson’s description in his memoirs, *A View from No. 11*. Some of the signatories argued subsequently that standard Keynesian effects operated through the impact of lower interest rates on consumption, but this begs the question as to why they signed the letter if they believed this would happen.

The Shadow Chancellor has proposed reversing the January 2011 VAT rise to 20% for a temporary period. This temporary tax cut is meant to exploit inter-temporal substitution, i.e. it provides an inducement to bring spending forward. However, there are two clear weaknesses with the policy. The first is that it would involve a significant (around £15 billion) spike in public sector borrowing at a time when the last message you should be conveying to financial markets is a lack of resolve on deficit reduction. Second, whilst the policy would have a significant fiscal cost, the overall economic impact on growth is marginal compared with the scale of quantitative easing.

The Bank of England estimates that the macroeconomic impact of the first round of quantitative easing was the equivalent of up to 300 basis points off the base rate – and shaved 100 basis points off gilt yields and boosted the level of GDP by up to 2%.[5]

Alternative forms of fiscal stimulus, such as direct tax cuts, are hampered by the issues of precautionary saving and Ricardian equivalence (lowering the marginal propensity to consume).

The IoD has supported the ring-fencing of key infrastructure spending because of the beneficial effect on long-term potential output. The lags in implementing infrastructure investment make it a very blunt instrument for discretionary fiscal policy.

The central aim of economic policy at present should be to increase the rate of growth of the money supply to a 6-8% trend rate. This rate of expansion should be consistent with trend GDP growth and the 2% inflation target.

2. Deficit financing

The concentrated media focus on fiscal policy misses one fundamental issue, the nature of deficit financing. Any easing in budget deficit reduction, if it is financed by gilt sales to the non-bank private sector, will not expand the money supply. In the words of Milton Friedman: "A deficit is not stimulating because it has to be financed, and the negative effects of financing it counterbalance the positive effects, if there are any, on spending."[6]

3. Fiscal multipliers

Mention has already been made of the 1981 Budget, but we have seen more recent fiscal tightening in the 1990s as well. The Lamont-Clarke fiscal squeeze in the 1990s was almost as tough as the current Spending Review (peak-to-trough total managed expenditure fell by 6.6% of GDP in the 1990s, compared with a 7.5% fall under the Spending Review by 2015-16) and yet this was also consistent with the beginning of the longest upturn in the post war period. ONS statistics show that there were over 600,000 public sector job losses in the 1990s,[7] but overall employment expanded.

Gordon Brown's fiscal squeeze (yes, there was a squeeze during the first two years of the Labour Government when the Chancellor agreed to implement his predecessor's spending plans) over the 1997-99 period saw public spending fall sharply by almost three percentage points of GDP in two years. This period also saw one of the fastest spells of GDP growth in the past 20 years. Obviously, economic conditions are more difficult now and the international situation is far less positive, but these examples do show that the withdrawal of the state can coincide with an expansion of the private sector.

[5] *The UK's quantitative easing policy: design, operation and impact*, Bank of England Quarterly Bulletin, Q3 2011.
[6] Interview with Milton Friedman in B. Snowdon and H.R. Vane, *Modern Macroeconomics: Its Origins, Development and Current State*, 2005.
[7] The total fall was actually greater, but included jobs reclassified to be outside the public sector.

TABLE 2

Expansionary fiscal squeezes

Country	Years	Peak-to-trough fall in cyclically adjusted deficit (as % of GDP)	Peak-to-trough fall in total deficit (as % of GDP)	Average GDP growth (when cyclically adjusted deficit falling)
UK	1993-99	6.9	11.7	3.5
Canada	1992-97	12.3	12.1	3.2
Sweden	1993-00	10.4	14.9	3.5
Denmark	1982-86	10.4	14.2	3.9
New Zealand	1991-95	4.0	7.2	4.0
Ireland	1981-89	11.4	9.6	3.1
Finland	1992-99	6.8	15.2	3.8
Netherlands	1990-99	5.1	11.2	3.1

Source: Capital Economics, *UK Quarterly Review*, Q3 2010.

Table 2 highlights a large number of international examples of expansionary fiscal squeezes over recent decades. Clearly, much was happening in each episode and a simple table can't tell the whole story. But what it does show, beyond dispute, is that sharp fiscal retrenchments can be consistent with sustained GDP growth.

Evidence against the use of discretionary fiscal policy can emerge in surprising places. Table 3 shows the underlying budget balances for the Nordic economies in comparison to the US and UK over recent years. It is clear from the table that the Nordic economies pursued tight fiscal policy over the course of the 'Great Recession' and remained in underlying surplus (with the slight exception of Norway), whereas the United States and the UK ran very large underlying deficits. Did tight fiscal policy prevent these economies from reducing their output gaps? No, quite the opposite.

Table 3 also shows that the output gap fell as much or more in the Nordic economies (excluding Norway where the output gap was

TABLE 3

Government underlying balance and the output gap – % of GDP

Country	2008	2009	2010	2009-2012 change in output gap
Norway	2.4	-0.4	-0.6	-2.2
Sweden	1.9	2.6	1.9	-6.1
Denmark	2.9	0.0	0.8	-2.6
Finland	3.4	0.8	0.5	-5.0
UK	-5.2	-8.4	-8.3	-1.9
USA	-5.9	-8.7	-8.6	-2.6

Source: *OECD Economic Outlook 2011*, Annex Tables 11 and 29. The underlying balance is adjusted for the economic cycle and the impact of recession/recovery on public finances.

always much smaller) than in the US or the UK. Fiscal policy failed to prevent a 'lost decade' in Japan in the 1990s – in the wake of a financial crisis. It is unlikely to be any more successful in the UK now.

Measuring fiscal multipliers is not easy, most obviously because of the problem of simultaneity – the two-way linkage between economic activity and the fiscal position. Furthermore, positive fiscal multipliers[8] do not hold at all times. As we have seen, expansionary fiscal contractions – with negative multipliers – are more common than received wisdom suggests.

A 2009 study of 107 fiscal adjustments in OECD countries over the past four decades found that a quarter were expansionary.[9] A European Commission study of fiscal tightening found that in nearly half the examples the squeezes were expansionary.[10]

This is not to argue that the Spending Review will definitely lead to a negative fiscal multiplier, rather that the case for a positive multiplier is often much weaker than generally believed. In addition, many of those arguing for strong positive fiscal multipliers are often doing so on the basis of new Keynesian models which omit any role for quantitative easing. If the models fail to take account of quantitative easing, how can one have any confidence they accurately capture the role of fiscal policy? Is the policy rule for an expansionary fiscal contraction a combination of fiscal retrenchment and simultaneous steady expansion in the money supply?

4. Economic modelling exercises

Additional public spending – from a Keynesian perspective – is believed to induce additional private spending and, therefore, an effect on aggregate GDP which is greater than one-for-one. But, contrary to received wisdom, euro-area modelling exercises using traditional and new Keynesian models challenge this view and suggest that extra public spending is more likely to reduce private spending on consumption and investment.

A recent paper in the *Economic Policy Journal* summarised a comparative exercise of major Keynesian models and found that they provided no support for a traditional Keynesian multiplier effect in the euro area:

"We use(d) five different empirical macroeconomic models with Keynesian features…four of them suggest that the increase in government spending will reduce private consumption and investment significantly. Only a model[11] *that largely ignores the forward-looking behavioural response of consumers and firms implies crowding-in of private spending…New Keynesian dynamic stochastic general equilibrium models provide a strong case for government savings packages."*[12]

The results are clearly based on simulation exercises and, although open to challenge regarding the assumptions used and the nature of forward-looking behaviour by companies and consumers, do provide a warning for the UK. If traditional and new Keynesian models fail to make the case for 'Keynesian' policies, what else can?

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The authors of the study make the following policy recommendation:

"We would like to warn policymakers that discretionary fiscal stimulus is likely to crowd out private sector demand and that additional government purchases

[8] Positive multiplier: higher spending leads to higher GDP. Negative multiplier: lower spending leads to higher GDP.
[9] A. Alesina & S. Ardagna, *Large Changes in Fiscal Policy: Taxes versus Spending,* October 2009.
[10] *Can fiscal consolidations in EMU be expansionary?* European Economy, 2003.
[11] This model supports a strong short-term multiplier effect. However, the boom is followed by a bust that causes the cumulative effect on private spending to turn negative eventually.
[12] T. Cwik and V. Wieland, "Keynesian government spending multipliers and spillovers in the euro area", *Economic Policy Journal,* July 2011.

will raise GDP by less than one-for-one. In our view it would be rather unwise to pile further government debt on top of the debt needed to finance the huge deficit arising from automatic stabilisers at a time when governments' credit worthiness is needed to back up the private financial sector."

5. Gilt market yields

In the current febrile financial market environment there would almost certainly be an upward spike in gilt yields if the Government was seen to be backsliding on reducing the deficit. This would have knock-on effects for corporate bond and mortgage rates. The UK is not in the same fiscal situation as Greece or Italy, but it would be foolish to assume that the UK could slow deficit reduction and be unharmed by the financial market consequences. The direct (higher gilt yields) and indirect consequences (the damage to business and consumer confidence) would certainly undermine GDP growth, although we can only speculate as to the extent.

The risk to gilt yields is a widely held view. *Financial Times* economic correspondent Chris Giles has written:

"Do not panic Mr. Osborne, Plan B is in cloud cuckoo land…The Chancellor is right to reject the arguments of the Plan B brigade because the risk that investors would lose confidence in the deficit reduction plan far outweighs the likely small economic gains."

6. The cyclically adjusted deficit

Chart 1 shows the cyclically adjusted budget balance (the budget balance adjusted to remove the effects of the economic cycle) in the UK over the past 30 years. According to Keynesian theory, fiscal retrenchment (a lower structural deficit as a proportion of GDP) should be associated with deterioration in the output gap. However, Chart 1 shows this has not been the experience.

The fiscal tightening of the early 1980s did not prevent a sharp reduction in the output gap. Similarly, in the 1990s, fiscal retrenchment ran in parallel with a reduction in the output gap. Indeed, at the end of the 1990s the cyclically adjusted budget balance swung from a deficit of 2.8% of GDP in 1996-97 to a surplus in 1998-99. The output gap narrowed and closed completely over this period. Most recently, the adjusted deficit increased as the output gap increased.

One obvious criticism of this approach is that it is too narrow and that econometric modelling is required to disentangle all the influences at work. But as we have seen, large econometric models provide little support for an activist fiscal expansion. The casual empiricism seen in Chart 1 is reflected in complex econometric modelling.

7. Sector balances and the flow of funds

The sum of the net acquisition of financial assets by all sectors (household, corporate, financial, government etc.) is zero. New debt issued by one sector becomes the financial asset of another. This begs the question as to why a reduction of the budget deficit should imply a net withdrawal of demand from the economy. If the Government's deficit moves into surplus, the other sectors will move into deficit. This of course assumes no change in the external balance.

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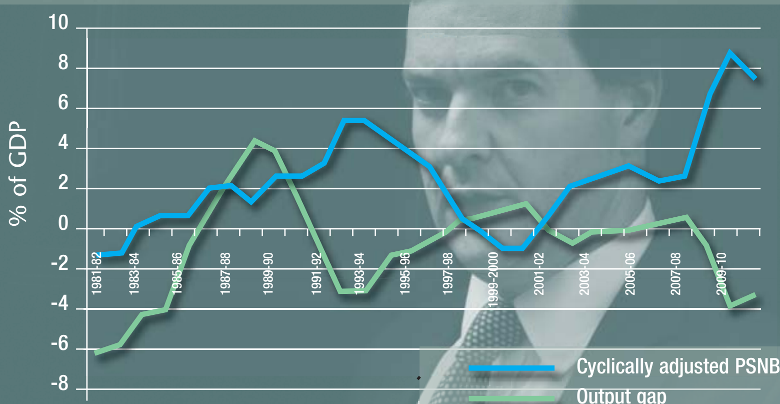
8. Ricardian equivalence

Whilst full Ricardian equivalence may not occur, it may at least be partially true. Taxpayers may see an increased deficit as a portent of future tax increases and respond with some degree of higher saving. Given the degree of economic turmoil at present and the scale of the media focus on it, higher precautionary saving by consumers could be



"Do not panic Mr. Osborne, Plan B is in cloud cuckoo land."

expected anyway, regardless of any changes in the fiscal stance. In an environment of precautionary saving, news that the Government was slowing reduction in the deficit, together with a possible adverse financial market reaction, could persuade households and companies to postpone spending decisions, thereby undermining the fiscal easing.

9. Public sector productivity

The public sector needs greater productivity, not more money. The scope for public sector productivity gains is enormous. Official statistics show that prior to the Great Recession, public sector productivity declined by 0.3% per annum between 1997 and 2008, whilst private sector productivity rose by 2.3% per annum over the same period. A 2010 report by KPMG showed that if the public sector had matched private sector productivity growth over the previous decade, the quantity and quality of public spending could have been delivered for £60 billion per annum less.[13] A relentless drive for productivity growth improvement is required, which goes well beyond the current Spending Review. Taking the foot off deficit reduction reduces the pressure for productivity improvement.

10. Supply side influences

A larger state means a lower rate of GDP growth and vice versa. The most recent economic research suggests that if the size of the state increases by 10 percentage points of GDP, the rate of GDP growth will be lowered by one percentage point. Compounded over time this has a hugely damaging impact on per capita GDP.

Estimates of this magnitude mean that the size of the state needs to be brought under control now, because in the long term there are additional upward pressures on public spending from the costs of an ageing population and higher debt interest payments on the national debt. Under the Spending Review, public expenditure falls back to 42% of GDP by 2014-15 and 39% by 2016-17 – hardly the small state! If we don't bring public spending under control over the next five years, we may never do so.

There is a wider philosophical battle in the debate over the Spending Review. Those who want to see a large public sector tend to favour slowing deficit reduction. Those who incline towards a small state – including the IoD – are more likely to want to maintain the Spending Review, or even to accelerate it.

[13] A. Downey, P. Kirby & N. Sherlock, *Payment for Success – How to shift power from Whitehall to public services customers*, KPMG, 2010.