

PRESS POINTS FOR CHAPTER 3:
WILL IT HURT? MACROECONOMIC EFFECTS OF FISCAL CONSOLIDATION
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Key Points

- **To restore fiscal sustainability, many economies need to reduce their budget deficit. This chapter analyzes the impact of fiscal consolidation—tax hikes and spending cuts—on growth in advanced economies.**
- **Fiscal consolidation typically lowers growth in the short term. Using a new data set, we find that after two years, a budget deficit cut of 1 percent of GDP tends to lower output by about $\frac{1}{2}$ percent and raise the unemployment rate by $\frac{1}{3}$ percentage point.**
- **Interest rate cuts and a fall in the value of the currency usually soften the impact of fiscal consolidation on growth. However, this cushioning effect is lower when interest rates are already near zero, or when many countries consolidate at the same time.**
- **Over the long term, debt reduction can raise output by bringing down real interest rates and allowing taxes to be reduced.**

This chapter focuses on the short-run effects of fiscal consolidation—tax hikes and spending cuts—on economic activity in advanced economies. We assess the impact of fiscal consolidation during the past 30 years on output and unemployment.

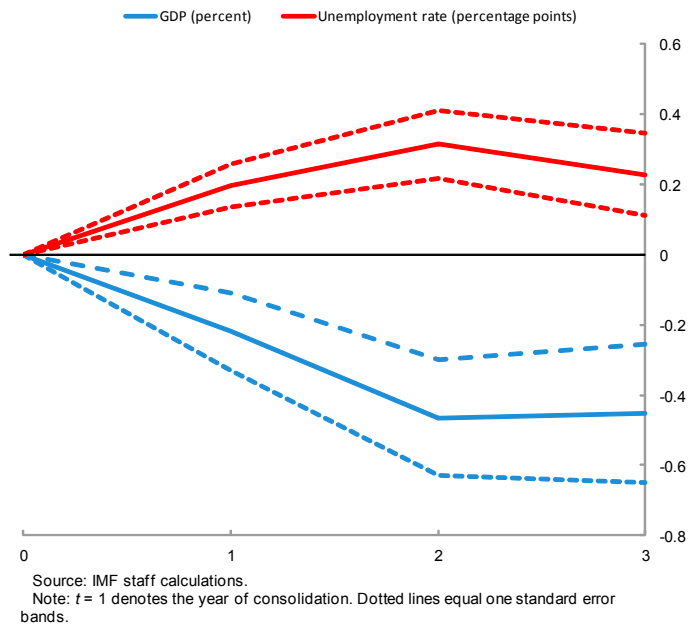
Given the importance of the topic, this chapter is not the first to address it. A number of studies present evidence that fiscal adjustments can be expansionary in the short run. However, these studies often identify periods of fiscal consolidation in a way that, as this chapter shows, tends to downplay contractionary effects and overstate expansionary ones. To obtain more accurate estimates of the effects of fiscal consolidation, we focus on historical accounts and records of tax hikes and spending cuts motivated by deficit reduction.

Our analysis suggests that fiscal consolidation usually dampens economic activity in the short term. Within two years of cutting the budget deficit by 1 percent of GDP, domestic demand—consumption and investment—is about 1 percent lower, and the unemployment rate is about $\frac{1}{3}$ percentage point higher. Because net exports—exports minus imports—tend to rise when budget deficits are cut, the overall impact on GDP is a decline of $\frac{1}{2}$ percent.

A number of factors usually soften the short-term impact of fiscal consolidation. First, central banks usually cut interest rates and the currency falls in value. This helps cushion the impact on consumption and investment, and boosts exports. Second, fiscal consolidation is less costly when markets are more concerned about fiscal sustainability. Third, consolidations based on spending cuts are less painful than those based on tax hikes. This is largely because central banks cut interest rates more after spending cuts.

Impact of a 1 Percent of GDP Fiscal Consolidation on GDP and Unemployment

Fiscal consolidation is normally contractionary. A fiscal consolidation equal to 1 percent of GDP typically reduces real GDP by about 0.5 percent and raises the unemployment rate by about 0.3 percentage point.



Over the long term, we find that fiscal consolidation has a positive impact on output. In particular, lower debt tends to reduce real interest rates and debt service costs, which allows for future tax cuts. By boosting private investment, this increases output in the long term.

Our findings suggest that in today's environment, fiscal consolidation is likely to have more negative short-term effects than usual. In many economies, central banks can only provide a limited monetary stimulus because interest rates are already near zero. Moreover, if many countries adjust simultaneously, the output costs are likely to be greater—since not all countries can reduce the value of their currency and increase net exports at the same time. Our simulations suggest that the contraction in output may be more than twice as large as our baseline estimate when central banks cannot cut interest rates, and when the adjustment is synchronized across all countries. But for economies considered at high risk of sovereign default, short-term negative effects are likely to be smaller.

There are a number of ways to reduce the impact of needed fiscal consolidation on the recovery. As is discussed in Chapter 1 of the WEO, measures that are legislated now but only reduce deficits in the future—when the recovery is more robust—would be particularly helpful. Examples include linking statutory retirement ages to life expectancy and improving the efficiency of entitlement programs.