



**Universität  
Zürich** <sup>UZH</sup>

**Department of Political Science**

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# **The effects of consolidation programs on public spending**

***Lukas Haffert***



## Motivation

„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.”

**-> What happens after consolidation?**





## Three (jointly) unpleasant findings

- 1) Expenditure-based consolidation is more successful
- 2) Expenditure-based consolidation hurts investment
- 3) It is hard to reverse cuts to investment



## Expenditure-based consolidation is more successful

- ❖ Expenditure-based consolidation less harmful to economic growth (but no expansionary austerity)
- ❖ Expenditure-based consolidation is more sustainable (stabilisation of budget balance and reduction of debt-to-gdp-ratio)
- ❖ Economic argument: confidence (of consumers and investors)
- ❖ Endogeneity: When is expenditure-driven consolidation possible?



## Expenditure-based consolidation hurts investment

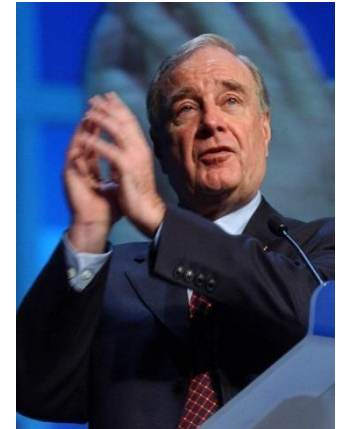
- ❖ Consumption expenditure tends to be „mandatory“ (Steuerle), supporters politically well organized -> difficult to cut
- ❖ Cuts often have no immediate effects
- ❖ Investment tends to be „discretionary“, supporters politically less well organized -> easier to cut



## What happens afterwards? The progressive consolidation view

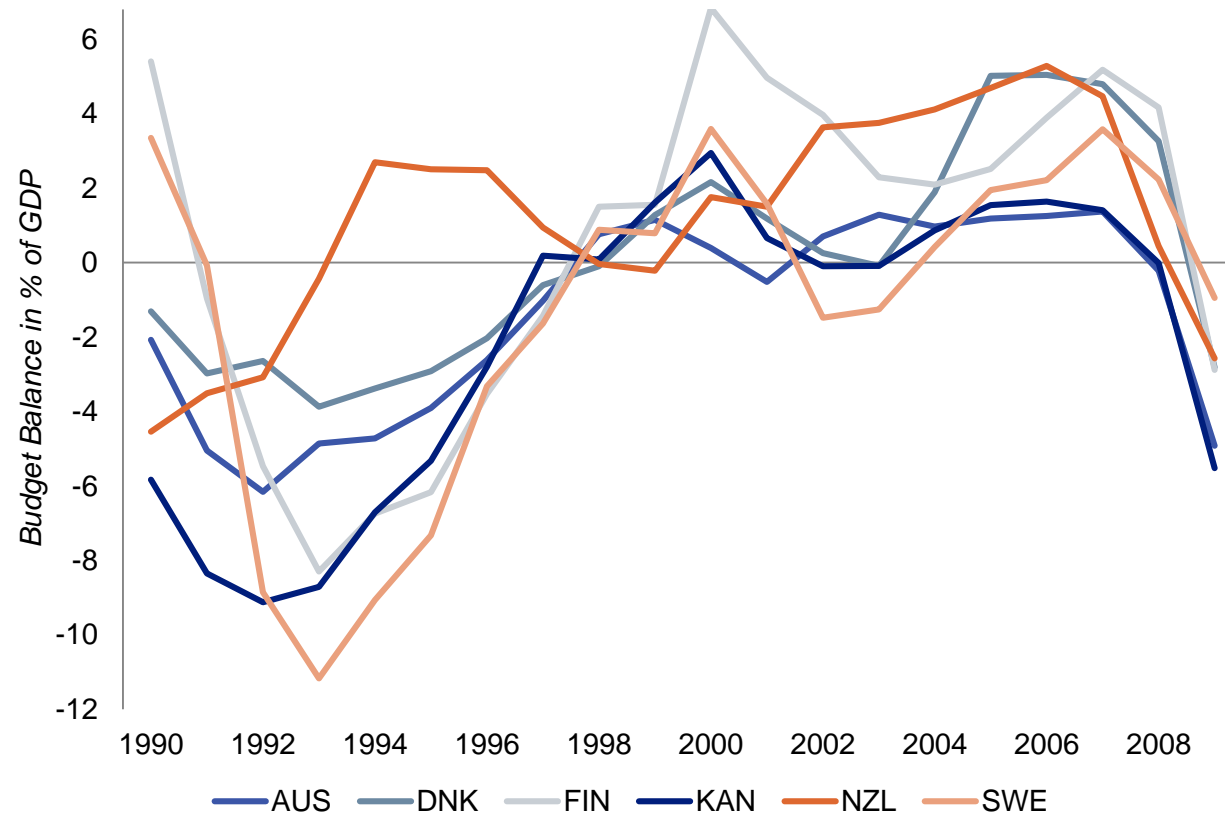
„But now, Mr. Speaker, having done what we had to do, we can see that the worst is behind us, that brighter days lie ahead. The era of cuts is ending. The finances of the nation are finally being brought under control. We are at the point where we are now able to forge a new destiny for ourselves.“

Paul Martin (1997)





## Budget surpluses in rich democracies



Source: OECD 2014



## Before the surplus

Table 2 Rating downgrades and interest rate spreads in OECD countries, 1980–2000

Country	Downgrade by Standard & Poor's	Two-standard deviation hike of interest rate spreads
Australia	12/2/1986: AAA to AA+ 10/24/1989: AA+ to AA (neg)	1986–87 1989
Canada	10/14/1992: AAA to AA+	1990
Denmark	1/6/1983: AAA to AA+ 3/7/1985: AA+ to AA	1982
Finland	3/3/1992: AAA to AA+ 3/11/1993: AA+ to AA–	1990 1992
New Zealand	4/29/1983: AAA to AA+ 11/2/1986: AA+ to AA 1/22/1991: AA to AA–	1985 1986 1987
Sweden	3/22/1993: AAA to AA+	1990
Other OECD members	–	–

Sources: Standard & Poor's (2011); Baldacci et al. (2011).

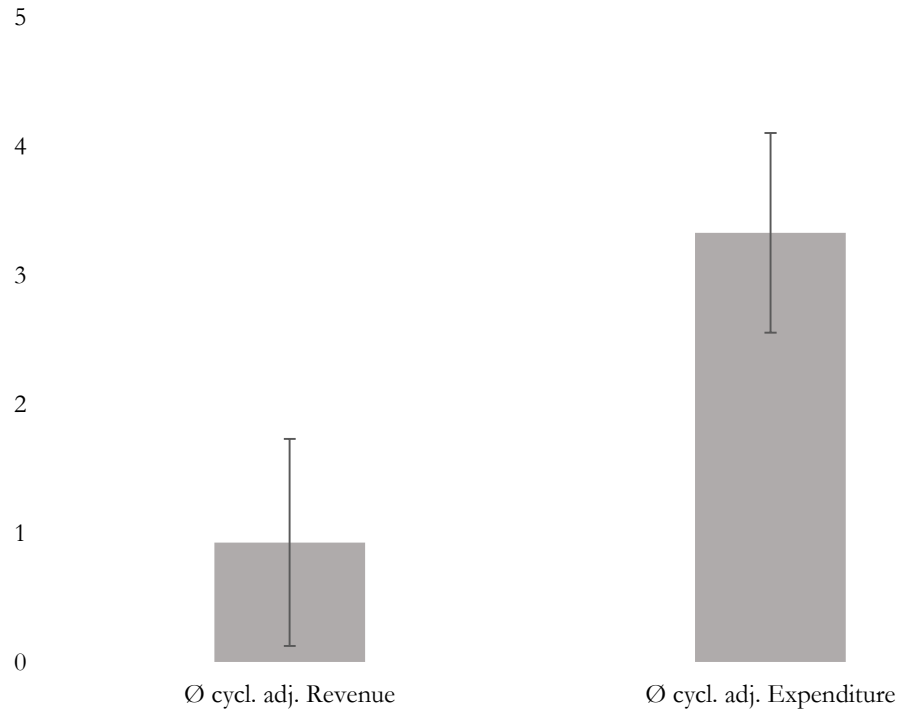
Source: Haffert 2016





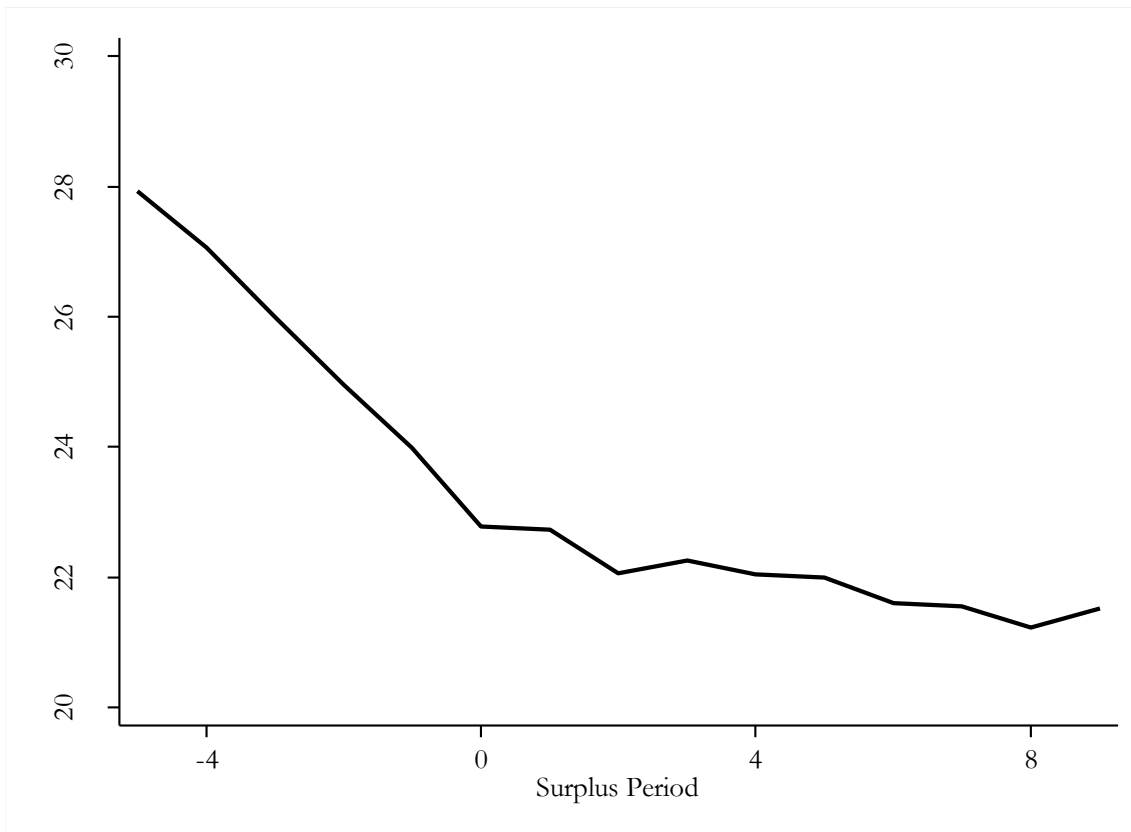
## Consolidation is expenditure-based

Contribution to the improvement of the structural balance in the three years preceding the surplus:





## What happens after consolidation?

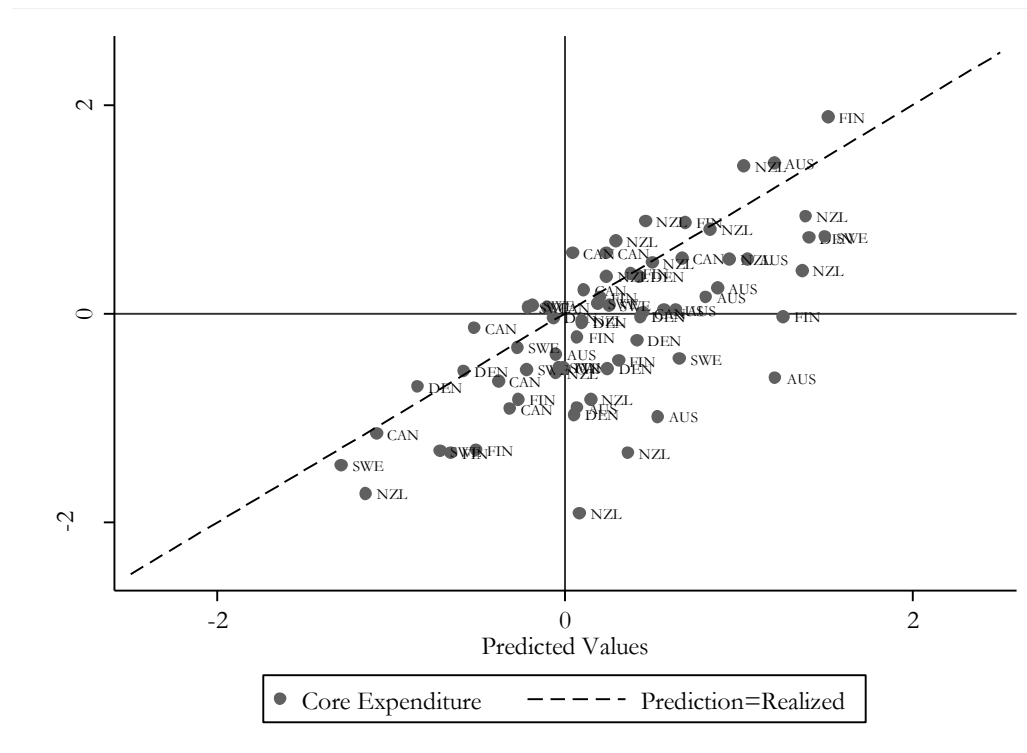




## Core Expenditure

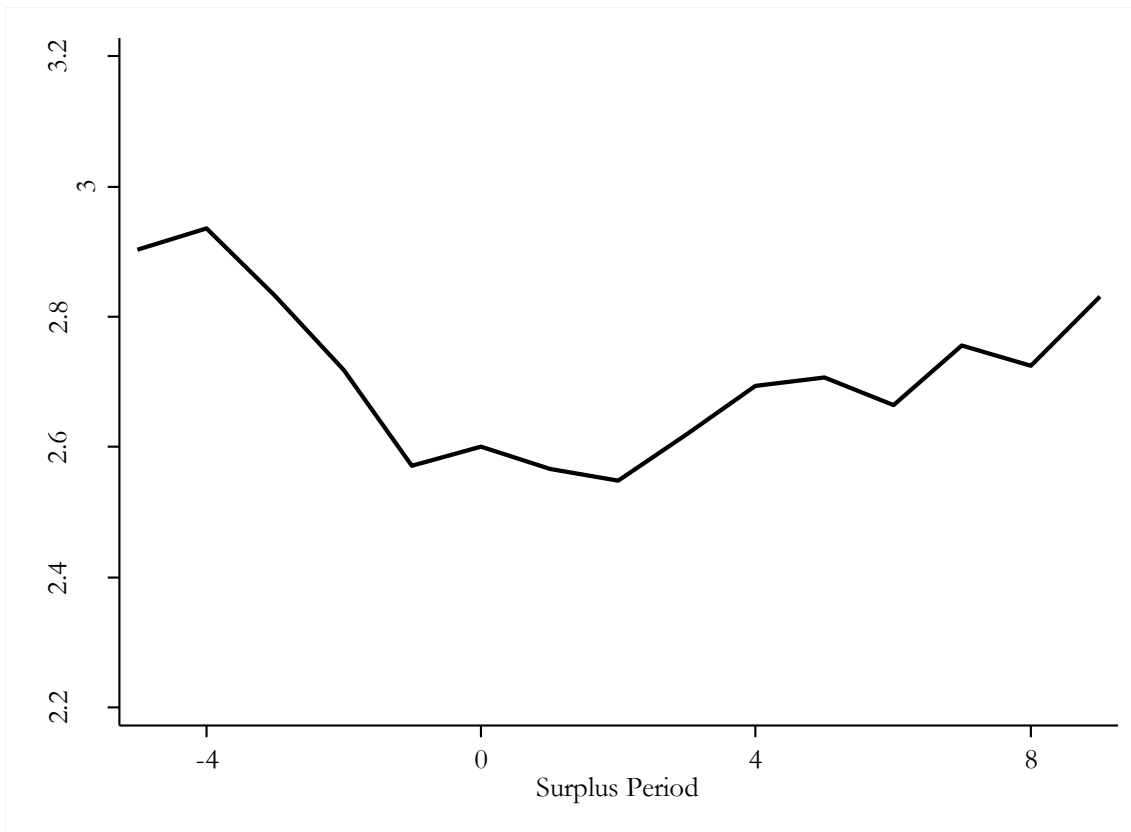
Residuals of a fixed-effect regression of the change in net core expenditure on the lagged budget balance in 19 OECD economies, 1980-2009.

Realized-Predicted = -0.38 (p = 0.000)





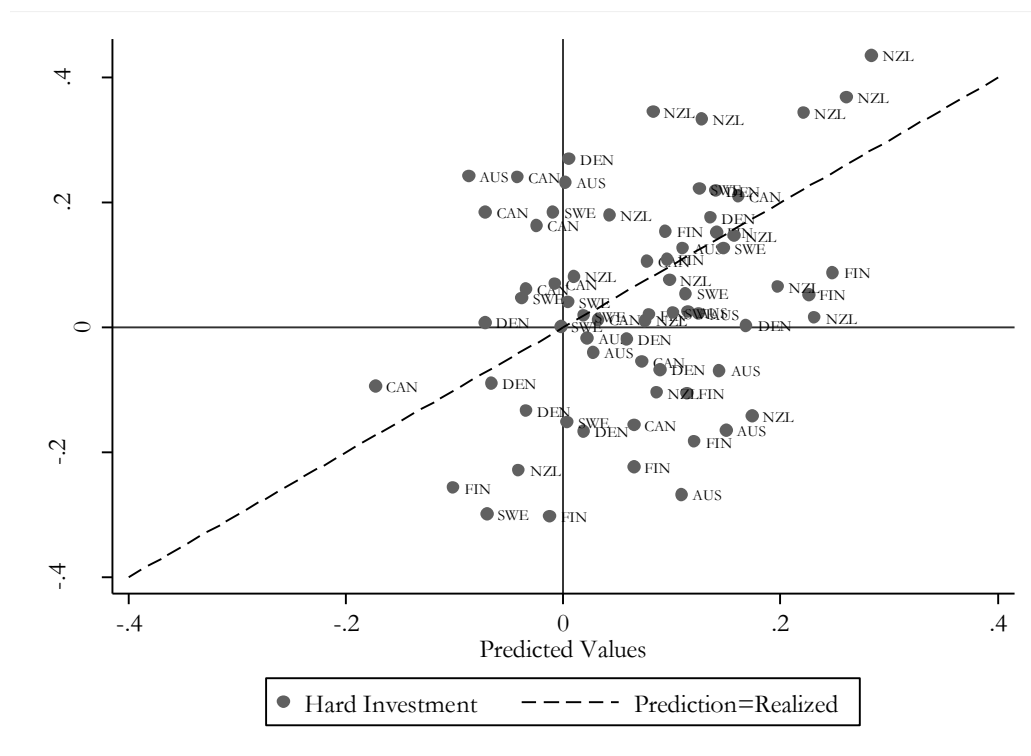
## Hard Investment



## Hard Investment

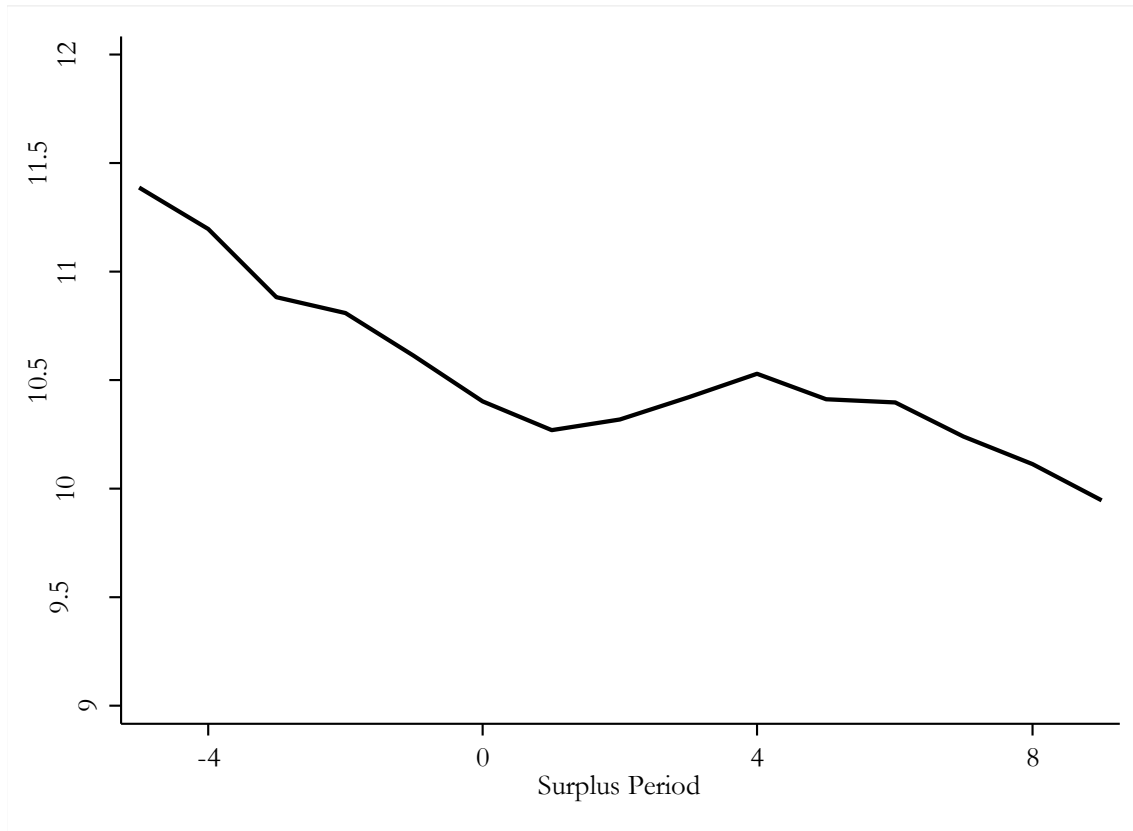
Residuals of a fixed-effect regression of the change in hard investment on the lagged budget balance in 19 OECD economies, 1980-2009.

Realized-Predicted = -0.029 (p = 0.157)





## Soft Investment

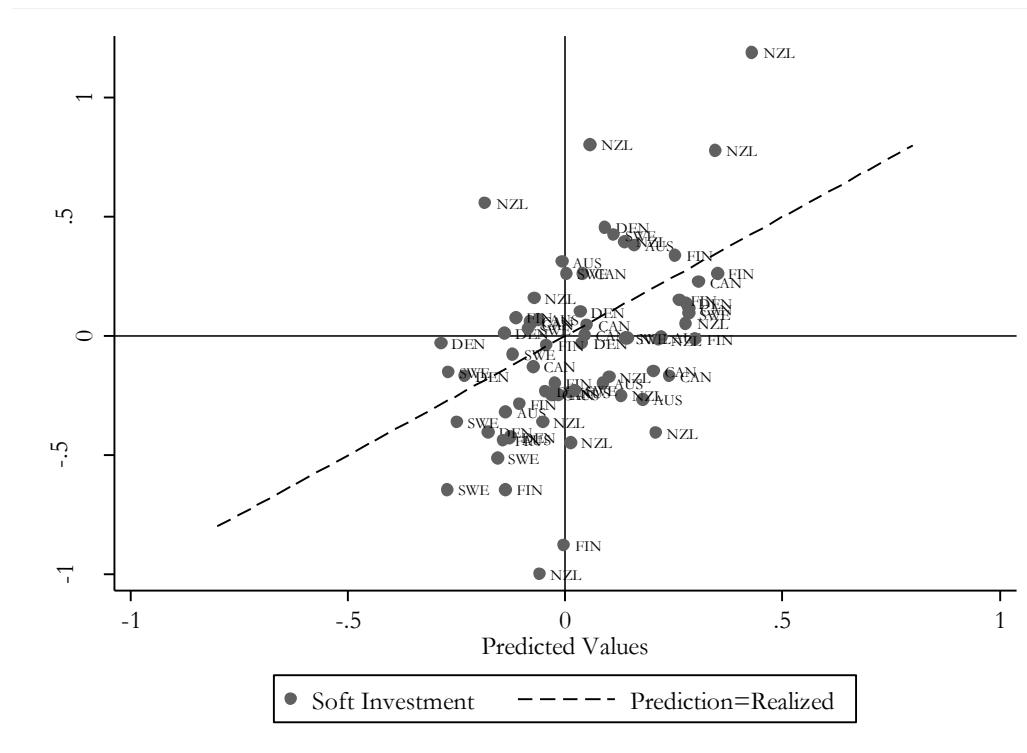




## Soft Investment

Residuals of a fixed-effect regression of the change in soft investment on the lagged budget balance in 19 OECD economies, 1980-2009.

Realized-Predicted = -0.079 ( $p = 0.049$ )





## Path Dependency

- ❖ Decision taken during the consolidation form the context for the surplus
  - Interests
  - Ideas
  - Institutions
  
- ❖ Consolidation success is not a sign of the state's growing capacity but rather of its shrinking ambition.





## Fiscal policy is asymmetric

- ❖ Surpluses and deficits are asymmetric
- ❖ Consolidation and post-consolidation are asymmetric.
- ❖ Most of the empirical literature about fiscal policy comes from a period of persistent



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Lukas Haffert

University of Zurich

Department of Political Science

lukas.haffert@uzh.ch