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Keynesian and Non-Keynesian Effects of Fiscal Consolidation

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ABSTRACT

The fiscal sphere can be considered the quintessence of state participation in the economy. Fiscal regulation, respectively fiscal harmonization and control over national budgets, are considered as advanced coordination within the normative management. The impact of EU supranational fiscal regulation on the economies of member countries can be accomplished through budgetary consolidation. This article is dedicated to the analysis of the fiscal consolidation effects and the measures and instruments of fiscal regulation of the EU, which can theoretically be applied to the EU member countries, as well as the effectiveness of the supranational impact and national measures for the implementation and achievement of supranational solutions.

1. Introduction

Fiscal regulation is the practice of supranational control, adjustment and monitoring of the state of EU member states budgets, as well as of some poorly formalized fiscal harmonization elements. It is the practice of controlling and adjusting national budgets that has a real impact on the EU member states economies, of which the most salient action can be considered forced consolidation. Fiscal regulation in the EU has a double nature: from the management methods point of view, it is a hard and soft coordination, but from the national economy point of view, it is an indication of indirect economic management. Within the framework of the fiscal regulatory system of the EU, countries perform forced budget consolidation (namely, the consolidation is carried out under the influence of a supranational factor, and not based on exclusively domestic premises). Consolidation is considered effective if it leads to a cut in public debt and stabilization of the cyclically adjusted primary deficit. Theoretically, during the budget consolidation in the country, two types of effects can occur: the classic Keynesian ones, associated with an output decrease due to fiscal contraction, and the opposite type of effects, called non-Keynesian ones.

2. Literature review

A classic analysis of the impact of the fiscal policy of the state and its individual components on the macroeconomic situation in the country is contained in the works of such classics representing various theoretical schools as J. Keynes, J. Buchanan, A. Sutherland, O. Blanchard, R. Perotti P. Krugman, R. Hall, etc. The theoretical contribution of these researchers to the understanding of the relationship between the fiscal policy of the state and the development of the national economy is extremely important, but their research is mainly applicable at the national level, which leads to the need to supplement and develop them further.

The general theoretical aspects of economic integration are well developed. The logic, methods, and mechanisms of monetary integration, as well as its fiscal components are contained in the works of R. Mundell, M. Fleming, A. McKinnon, P. Kenen, B. Eichengrin and other researchers. Some issues of fiscal integration and fiscal regulation at the supranational level were considered by Alesina A., Heimberger. P., Langdana F., Mulas-Granados C., Yang W., Ardagna S., et al.

3. The Keynesian Effects of Fiscal Consolidation

The basis of the Keynesian approach to the analysis of taxes and budget policy can serve the *IS - LM* model, which characterizes the macroeconomic balance on commodity markets and money markets. This model was first proposed by J. Hicks, who provided a graphical interpretation of the views of J. Keynes. The *IS*

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curve is characterized through a negative slope. This is explained by the fact that, together with the decrease in the interest rate, investments enhance and, consequently, the level of national income.

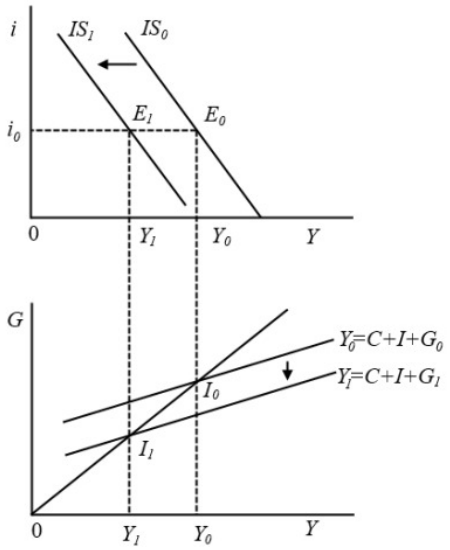

Figure 1. Movement of the IS curve when government spending changes

Source: drafted by the author based on Landagna F." Macroeconomic Policy: Demystifying Monetary and Fiscal Policy" pp. 130-133.

Among the factors that can influence the movement of the *IS* curve there is also a fiscal policy factor. [1] In the event of a rise in government spending *G*, the *IS* curve moves parallelly up and to the right, which in turn leads to an increase in national income. Consequently, in the case of tax contraction, expressed in a narrowing in government spending, the *IS* curve should move left and down (*Y0* → *Y1*), thus diminishing the national income level. In principle, only such a simple model can be followed to explain the occurrence of the classical Keynesian effects of fiscal consolidation.

Why does the IS_1 curve move parallelly to the IS_0 curve? In order to explain this phenomenon, following the "Macroeconomic Policy: Demystifying Monetary and Fiscal Policy" paper [16] let us break down the classic formula of national income (1.1), where *Y* is total output (or national income), *C* is private consumption, *I* is private investment and *G* - government spending, for components (1.4). In this question, we omit the external factor (that is, net *NX* exports).

$$Y = C + I + G, \qquad (1,1)$$

given that

$$C = \underline{C} + bY \qquad (1,2)$$

and

$$I = \underline{I} - fi, \qquad (1,3)$$

We receive:

$$Y = (\underline{C} + bY) + (\underline{I} - fi) + G, \qquad (1,4)$$

Where *Y* - cumulative production, $\underline{C}$ - autonomous consumption (that is, which does not depend on *Y*) private consumption expenditure (which also reflects consumer expectations and is sensitive to future tax levels); *b* is the marginal proclivity to consume (which reflects an increase in *C* as a function of increasing *Y*), $\underline{I}$- investor confidence, *f* - elasticity of private investment as a function of changes in the interest rate *(i)*.

Transforming equality (1,4) for *i*, we get the equation of the *IS* curve

$$i = \underline{A}/f - Y(1 - b) / f \qquad (1,5)$$

Where $\underline{A} = \underline{C} + \underline{I} + G$. Equality (1.5) is a straight line with $\underline{A}/f$ slope and $(1-b)/f$ displacement factor (Fig. 2). Therefore, at $\underline{C}$, $\underline{I}$ or $\underline{G}$ change only the coefficient $\underline{A}$ is changed, the coefficient remains unaltered, that is why the *IS* curve with a change in government spending *(G)* moves parallel up and to the right by an increase in government spending and down to the left with a decrease of government spending.

Up until now, it has only been about spending cuts, although budgetary consolidation can also be displayed through tax increases. In this case, the *IS* curve behaves somewhat differently. In order to understand the significance of the change in the position of the *IS* curve after a taxes growth, we present the formula for consumption following taxation:

$$C_T = \underline{C} + bY_D, \qquad (1,6)$$

where *CT* is the level of consumption after taxation, $\underline{C}$ - consumer expectations, *b* - marginal propensity to consume and *Y* - available income, determined by the formula:

$$Y_D = Y(1 - t), \qquad (1,7)$$

Where *t* - tax. Consequently, the consumption formula will take the form:

$$C_T = \underline{C} + bY\,(1 - t), \qquad (1,8)$$

then the equation for the *IS* curve with the introduction of the tax variable will look as follows:

$$i = \underline{A}/f - [1 - b(1 - t)]Y/f. \qquad (1.9)$$

Taking into account that the $\underline{A}/f$ variable is the same as in the (1.5) equation, the tax growth should not affect this variable. Therefore, in the event of an increase in taxes, the *IS* curve will move as follows (Fig. 3).

As a result, along with the increase in taxes on the commodity market, a new balance is set, the interest rate remaining unchanged, accompanied by a decrease in the aggregate output.

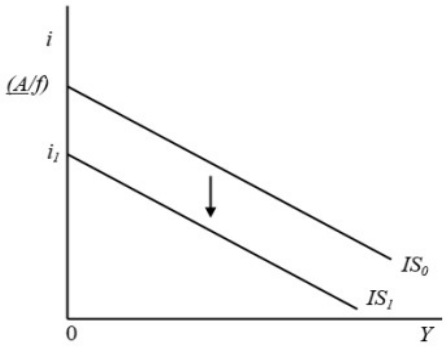

Figure 2. Movement of the IS curve to the budget consolidation through cost reduction

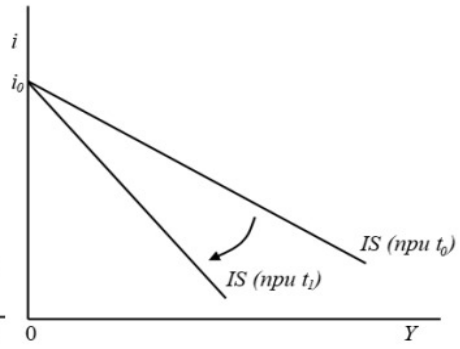

Figure 3. Movement of the IS curve to the budget consolidation through tax increase

Source: drafted by the author based on Landagna F. „Macroeconomic Policy Monetary and Fiscal Policy". pp. 133-136.

Thus, based on the analysis of the effect of consolidation on the economy using the IS curve, we can conclude that the classical Keynesian effects resulted from the lessening of government spending and/or the taxes enhancement represent a reduction in the aggregate output.

As E. Abel and B. Bernanke note, the standpoints of the classics and Keynesians on the *IS-LM* model coincide when it comes to long term. [1] Therefore, the specific character of the Keynesian approach to macroeconomic analysis consists in the presence of two well-known premises affecting the change in key short-term indicators. Among these assumptions are price rigidity and real salary rigidity. As a consequence, these two factors interfere with the balance setting in the *IS-LM* model in the short term. Therefore, from the Keynesian point of view, fiscal policy can be an effective tool for macroeconomic stabilization. It should be noted that less developed countries are characterized by faster inflation rates (for example, prices prove to be more flexible) than in developed countries [15], therefore, probably, when being analyzed the Keynesian price rigidity, attention should be paid to the development level of the country.

An expansive fiscal policy can be effective if the economy goes through a downward cycle. This is notably remarkable in the Keynesian model, since the Keynesian mechanism of the economic cycle is based on the mechanism of demand shocks (which can also be directly affected by fiscal policy). Accordingly, in the downward wave of the cycle, fiscal contraction (that is, budgetary consolidation) can be particularly dangerous, as it can lead to an aggravation and deepening of the recession.

But even though the economy is not in recession, but simply not functioning at full capacity, the fiscal contraction can significantly worsen this situation. Among the important indicators that economists use to determine how close an economy is to its natural level is the output gap. In the context of a negative output gap, consolidation can be significantly pro-cyclical (namely, it exacerbates the impact of the down wave of the cycle). [5] As F. Heimberger notes, the difference in output is considered a fairly clear indicator that the economy has problems precisely with the mechanism of aggregate demand.[12] Consequently, the negative impact of consolidation on it is likely to be quite strong, while expansionary fiscal policy could have a significant positive effect.

Thus, both traditional Keynesian analysis and more recent neo-Keynesian papers show that consolidation can have a negative effect on the economy (even in an apparently favorable situation for the

economy, such as setting a steadily low interest rate). (Neo)Keynesians attribute this to a rather high value of the multiplier (the higher it is, the more negatively budgetary consolidation affects the economy).

4. Non-Keynesian Effects: Concept, Channels and Occurrence Factors

For economists who are not supporters of the Keynesian view of discretionary policy, an expansionary fiscal policy will not always enhance output because of the possible occurrence of a substitution effect. Fiscal contraction that faces excessive deficits or public debt levels can have a positive effect on output. This is ensured to a large extent by the fact that non-Keynesian effects can theoretically lead to negative values of the budget multipliers. [18] M. Feldstein was one of the first to draw attention to this circumstance.[9]

It is believed that a significant reduction in the budget deficit and the level of public debt has the main positive consequences for the economy in the medium and long term. Nevertheless, some researchers argue that the positive impact of consolidation on the economy is also possible in the short term - this impact is called non-Keynesian effects.

The classic paper that puts clearly the question of non-Keynesian effects is the study by F. Javazzi and M. Pagano. [10] In it, the authors analyzed the paradoxical rise in consumption in Ireland and Denmark, which they attributed to the fact that the consolidation in Ireland was mainly based on a decrease in current government spending, and in Denmark - on public investment. A. Alesina and S. Ardaña examined panel data for OECD countries from 1960 to 1994. Their study concluded that consolidation based on tax increases is less likely to lead to non-Keynesian effects, but rather, on the contrary, will increase the possible negative consequences of fiscal contraction.

Thus, some researchers [11] have found that non-Keynesian effects are more likely to occur if consolidation is based mainly on spending cuts rather than tax rises. All these (the ambiguity of the conclusions of various researchers, the particular nature of the emergence of non-Keynesian effects) seem to be in favor of the fact that the consolidation cases should be considered separately from each other (both chronologically and geographically). That is, it can be assumed (and such an assumption will most likely prove to be true) that fiscal consolidations spread in time in a single country, as well as coincident fiscal consolidations in different countries, can bring different results as concerns both Keynesian and non-Keynesian effects. Therefore, in order to analyze these effects, it is more logical to be taken into account, not panel data (for all countries simultaneously), but individual cases of consolidation in certain countries (cases), which can already be seen in the literature. Moreover, research should be based not only and, perhaps not so much, on econometric models (since there is no consensus in science about which models to use) [3] but on the development of so-called narrative and descriptive approaches.

Researchers often ignore the fact that the various EU member states are characterized by different tax systems (with their own characteristics and problems). Another argument in favor of a separate analysis of each country is the difference among the consolidation tools employed. In the absence of consensus with regard to the effectiveness of certain tools, taking into consideration the country cases can contribute to the accumulation of different practices (including both positive and negative experience).

In the Keynesian *IS* - *LM* model, reductions in general public spending and tax increases directly affect aggregate demand, which naturally leads to a decrease in output. Non-Keynesian effects indirectly affect output through a number of channels and mechanisms. Strictly speaking, there are only two channels of influence: supply and demand.

The demand channel is primarily related to the problem of expectations. For non-Keynesian effects to occur, the behaviour of economic agents must be of a Ricardian nature. Current consumption may enhance if households are confident that an increase in the burden now will be offset by a significantly lower burden in the future (because of the diminution of debt levels): an increase in taxes in the current period will be tied up with the expectation of fewer (than accumulating even more debts in the absence of consolidation) taxes in the future, it can boost private consumption already in the short term. [8] Reducing spending associated with lower tax expectations (than in the current period) in the future may also stimulate private consumption. In both cases, the occurrence of these effects is most likely in conditions of a sufficiently high level of public debt. In Sutherland's interpretation [21], at sufficiently low levels of public debt, economic agents expect long-term debt relief, so the consolidation will have classical Keynesian-type consequences. At high levels of indebtedness (near thresholds), large-scale consolidation that delays reaching the threshold can encourage people to expect higher incomes in the future, which serves as a basis for enlarging consumption. [22]

Initially, this approach was applied to the analysis of expansionary fiscal policy. Thus, an economic agent who does not depend on adaptive expectations (as in the case of Keynesian interpretation of fiscal policy), but on rational expectations, is fully aware that, say, reducing taxes today will mean a growth of taxes in the future. As a consequence, people will compensate for the reduction of public savings by increasing private savings, since they expect larger taxes in the future. In such a case, the multiplier would be zero, and the stimulation of fiscal policy would be senseless. The same logic applies also to budgetary consolidation, but in terms of fiscal compression: economic agents expect taxes to not increase (but even decrease) in the future, which may contribute to the largeness of consumption and, consequently, aggregate demand, even in the short term. Hence, governments must ensure that they communicate to the public about the planned duration of

consolidation, as expectations of permanent fiscal consolidation (as well as permanent fiscal stimulus) may exacerbate the resulting exclusionary effect. [18]

Another channel for the occurrence of non-Keynesian effects is supply (explanations for their appearance are even vaguer than in the case of the demand mechanism, moreover, in the question of the ratio between taxes and labor costs, according to C. Mulas-Granados, there is not yet a clearly formulated conclusion). [18] The key mechanism for the occurrence of non-Keynesian effects is a drop in labor costs in the public sector, which leads to a decrease in salaries. This, in turn, will give impetus to employment growth in private sector and private investment (by enhancing profits due to smaller remuneration costs). An increase in taxes (first of all) should be reflected in a salary increment (through the amount of the tax increase), which will negatively affect investment. The occurrence of non-Keynesian effects in the case of consolidation based on higher taxes can be facilitated by agreements with unions to freeze or reduce salaries, which leads to lower salary costs.

In this manner, we can enunciate some conclusions with regard to the channels of occurrence of non-Keynesian effects. In the case of a demand channel, the occurrence of non-Keynesian effects is due to the Ricardian behavior of economic agents. The effects are most likely to appear at extraordinary levels of public debt and, therefore, have to be taken into account when considering post-crisis consolidation in the EU. Given the weakness of theoretical developments for the supply mechanism analysis, it seems that the main attention should be focused on the trust channel.

The main factors that must be present for the occurrence of non-Keynesian effects in the course of budget consolidation are summarized in the paper of V.M. Ostapenko. [19] Among them are the initial macroeconomic conditions, the structure (and size) of the consolidation package, the government credibility of the, the levels of budgets (in accordance with the division of powers within the fiscal system) that are subject to consolidation, the existence of structural reforms, endorsement of consolidation by the actions of the monetary authorities, political factors (cohesion level in governance, the decision-making process, the parliament structure, etc.). To these conditions should also be added the requirements proposed by the OECD (which can also be applied to any reform of the fiscal sector): the presence of a high-quality political leader (capable of building confidence in the effectiveness and efficiency of the measures taken), as well as factors of the "political economy" nature (for example, the presence and influence of local, regional and national pressure groups, political forces).

One of the most important conditions is the initial macroeconomic parameters (for example, the public debt level, the size of the deficit, unemployment, etc.) and the phase of the economic cycle. In case the output gap is negative, fiscal consolidation measures can be pro-cyclical, for example, exacerbate the impact of the downward wave effect of the cycle. As a consequence, in such conditions, the occurrence of non-Keynesian effects is problematic. Most probably, in order to analyses the effectiveness of post-crisis consolidation in the EU, special attention should be paid to this indicator.

The public debt level may also be a necessary condition for non-Keynesian effects to occur. [20] If the debt level is drawing near the threshold, then a sharp drop in debt below the threshold can stimulate consumption as well as restore confidence in the government. Debt thresholds are chosen in different ways (for example, in Sutherland's paper, the threshold is 70% of GDP [21]), but in the European Union case, such a threshold should probably be considered the classic Maastricht criterion, fixed also in the Treaty on the Functioning of the European Union (TFEU, Article 126) and representing 60% of GDP.

The next factor that contributes to the occurrence of non-Keynesian effects is the structure and size of the consolidation package. It is believed that a pretty large-scale (and stable over time) consolidation can be the most efficient from this point of view. It is a signal for economic agents to begin revising their expectations. [7] As concerns the structure of the consolidation measures, it is probably impossible to speak of a clear and unitary position among researchers. Notwithstanding, as mentioned earlier, some researchers have found that spending-based consolidation is most likely to generate non-Keynesian effects. At the same time, the occurrence of these effects is not guaranteed. The taxes growth tends rather to negatively affect production. [22] Among other elements of the fiscal compression composition, salaries and employment in the public sector are usually highlighted. S. Ardanya believes that reducing salaries in the public sector are leading to relatively more dynamic growth rates. [6]. F. De Kos and E. Moral-Benito calculated that the decrease in salaries is the only factor that really contributes to the budget deficit narrowing.

The believability of the government and the confidence of economic agents that this government is able to implement the announced measures and stabilize the situation with the budget deficit and the public debt level are also very important factors for successful consolidation. Theoretically, in this situation it is possible to restore investor confidence in the government, which should lead to a decrease in the risk premium and, consequently, to interest rates on public securities. If such a decrease proves to be large enough, then it should lead to a decrease in the effect of exclusion in the economy. In case the government fails to restore confidence, then the situation, apparently, can only get worse. As mentioned above, this element seems to be fundamental for the EU countries, as a result, special attention should be paid to its analysis.

An important factor affecting the effectiveness of consolidation in general is the degree of decentralization of fiscal powers in the country (fiscal system), as well as the participation of budgets of

different levels in its implementation. So, if we assume that under conditions of significant decentralization of skills, the main consolidation measures are carried out only by the Centre, then a possible increase in spending (tax curtailments) at local or regional level can undermine all the efforts of the Centre. In the event that the positions of sub-national governments are strong enough and a significant part of their financing comes from transfers from the central government, then there is a risk that these transfers will not be reduced in the consolidation package. Moreover, dependence on transfers can cause so-called „Velcro effects", which implies that sub-national governments that depend on transfers of the Centre can enlarge spending without being covered by the corresponding tax rises. [13] But even though consolidation involves governments at all levels, it is likely that subnational governments not take sufficient action, alleging unforeseen increases in spending or other extraordinary circumstances. In connection with this, there is a need for independent supervisory bodies, which theoretically facilitate more efficient consolidation.

This issue was actively promoted by the EC during the post-crisis consolidations in the EU. [14] The requirement for an independent supervisory body (which would supervise both subnational and central governments) was, also, included in the Fiscal Pact. According to A. Alesina and F. Javazzi, such supervisory authorities (by the way, as well as quantitative restrictions, such as the Maastricht criteria in the EU) are not mandatory and are not enough for a successful consolidation, although they can help. [4]

Monetary policy can be an important support lever during consolidation. This statement is confirmed by the calculations made by A. Afonso and L. Martins. [2] According to their papers, if fiscal consolidation is accompanied by monetary easing, there is an alteration of the traditional Keynesian impact of changes in government spending for final consumption, social transfers, and private consumption taxation on gross output. At the same time, non-Keynesian effects were not observed if monetary policy was not considered as a factor that acts. A similar viewpoint is shared by the OECD: if the Central Bank follows an expansionary monetary policy in the initial stage of consolidation, the success of such consolidation may be greater. [17] Nevertheless, it should be noted that for the member countries of the Eurozone, the applicability of this channel is pretty limited, since monetary policy is performed by a supranational body (ECB), whose main purpose is to maintain price stability and help consolidation. On the other hand, as already mentioned, in case actual rates grow under conditions of low nominal interest rates (as the Keynesians say), the consolidation effect can be negative.

Eventually, the consolidation success is also influenced by various political factors (from the parliament structure to the succession of elections). Thus, for a long time it was believed that a rise in the budget deficit (for the sake of increasing government spending) contributes to re-election, but there is no evidence for this fact. It should be noted that the degree of influence of political factors on consolidation (and vice versa) is also not obvious, since in this case the problem of "reverse causality" comes into play [3] it is impossible to determine exactly whether one factor is the exact cause of another (or vice versa). In general, it seems that political factors have quite serious country specific characteristics, and their analysis should also focus on certain cases in the country.

Thus, when analyzing post-crisis fiscal consolidation in the EU, it is necessary to be taken into account a number of factors that contribute to larger/less efficient consolidation (and the occurrence of non-Keynesian effects). Among these are the output gap, the public debt level, trust in government, monetary policy and a number of political factors.

5. The Role of Keynesian Methods in Crisis Management

The Keynesian approach to state crisis management formed the theoretical and methodological basis of the "New Deal" of US President F.D. Roosevelt during the Great Depression of 1933-1939. According to Keynesian theory, the cause of the crisis of 1929 and the following years was the lack of money supply. At the time, money was tied to the gold reserve, which limited the money supply. The main measures of state crisis management under the New Deal were the temporary closure of banks in order to streamline their activities and restore confidence in the banking system, as well as the organization of public works for the unemployed through state funding. The export of gold abroad was banned, the dollar was devalued, the banking system was expanded, and the largest banks received important loans and subsidies from the treasury.

In the post-war practice of state crisis management, neo-Keynesianism was most clearly reflected in two management models: the "social market economy" model (Germany) and the "Swedish model of socialism". The model of government regulation proposed by Keynes contributed to lessening cyclical fluctuations for more than two post-war decades. However, since the beginning of the 70s, in the 20th century, it began to appear a discrepancy between the regulatory possibilities of the state and the objective economic conditions.

The 2008 financial crisis made relevant again Keynes's ideas about the need for government regulation of the economy. During the crisis, many countries moved to stimulate aggregate demand by allocating funds from the state budget. There began to be discussed aspects related to the entering of controls on the movement of international capital and the state of the balance of payments. A number of researchers have paid attention to the analysis of the psychological reasons for the behavior, the basis of which was also laid by Keynes. Although the influence of Keynes' ideas was most visible in the use of fiscal policy in order to stimulate

aggregate demand, their impact was felt in several other fields. Since 2008, many countries have begun to exercise state control over the balance of payments. Although not all economists agree on the need to use Keynesian methods so as to regulate the economy, an active discussion of his ideas per se indicates that these ideas are still relevant and modern.

6. Conclusions

Keynesian effects are short-term decreases in the aggregate output, caused by government spending and tax rises. There are identified factors that may have a negative impact on aggregate output during consolidation, including a negative output gap, the problem of low nominal interest rates, the problem of fixed and floating exchange rates, the effect of built-in stabilizers, etc.

Non-Keynesian effects are an increase in aggregate output during short-term budgetary consolidation under the influence of demand channels, supply and expectations of economic agents. There are identified the factors contributing to the occurrence of non-Keynesian effects, including initial macroeconomic parameters, the business cycle phase, public debt level, structure and size of the consolidation package, government reliability, structure of the tax system in the country and of individual political factors.

Thus, in order to analyze the possible consequences of budgetary consolidation in the EU countries within the excessive budget deficit procedure, it seems logical to rely on country case studies based on a narrative approach. Under these conditions, it becomes possible to take into account both the tax systems peculiarities of each country, and the specific nature of consolidation in these, which will contribute to the accumulation of data concerning efficient and inefficient practices, as well as the formation of a new basis for the quantitative studies interpretation.

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