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History holds answers to the impact of Tory fiscal tightening

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With the election campaign properly under way and the polls having generally leaned in favour of a Conservative government in recent days, questions are being asked about whether a speedier tightening in fiscal policy - as advocated by the Conservatives - could endanger the fragile economic recovery.

Fortunately, history provides us with two relatively recent episodes of fiscal consolidation - both overseen by Conservative governments - which could help shed light on the impact that stricter policy might have on economic growth. The first was effected in the 1981 Budget, when then Chancellor Geoffrey Howe decided to raise taxes aggressively at the tail end of a deep recession. So austere was the Treasury's Budget that it prompted the famous letter in which more than 300 economists expressed their reservations that, "present politics will deepen the depression".

Then there was the fiscal tightening of the mid- to late-1990s under the Chancellorship of Kenneth Clarke - continued under Gordon Brown into the first two years of Labour's new term in office. This was different to the early 1980s in two ways: it was focused more on spending restraint than tax rises (European Commission and IMF research suggest spending cuts lead to longer-lasting budgetary improvements than tax increases) and the consolidation was much more prolonged than that of the 1981 Budget.

The efficacy of these deficit reductions can be judged by examining how the cyclically-adjusted primary budget deficit changed over time. In 1979 this measure of the deficit stood at about 2 per cent of potential GDP, before moving to a more than 2 per cent surplus in 1982. Looking at the more recent tightening, in the immediate aftermath of the 1992 ERM crisis the deficit had risen to over 4 per cent. From 1993 it began to shrink, evolving into a surplus by 1997 which rose above 3 per cent of potential GDP by the end of the decade.

How did overall economic growth perform following these big policy shifts? The answer is exceptionally well. While output continued to contract in the first quarter of 1981, it grew at an average rate of close to 3 per cent in 1982 and 1983. As for the 1990s tightening, the economy grew at a blistering average rate of 3.5 per cent annually during the period of budgetary improvement.

To what can we attribute this strength? Some put it down to "negative fiscal multipliers". In contrast to Keynesian doctrine, this Ricardian argument suggests that addressing the deficit in a timely fashion should reduce the need for future fiscal tightening, in turn raising confidence, expected incomes and private sector spending. Or we might argue lower deficits mean reduced borrowing costs as the government's fiscal credibility in the financial markets is maintained, again supporting growth.

These are not bad arguments, but there may be other explanations. It could be that the negative multiplier view is wrong about the causation - in other words, strong growth may be associated with, but not necessarily the result of, fiscal tightening. To explain, fiscal rectitude often follows on from recessions as falling output tends to cause deficit blow outs which need to be addressed. GDP also often bounces back following a recession for reasons not always related to fiscal policy. Of course, growth is not just a function of fiscal policy but of monetary policy too. Prior to government tightening of fiscal policy in 1981, official interest rates stood at 17 per cent, but by the end of 1982 they had been cut to "just" 10 per cent, surely offsetting some impact of fiscal tightening. In the 1990s tightening phase, official rates ended the decade at the same level as at the start of 1994, but a host of other factors supported growth - including globalisation, an improved macroeconomic policy framework and increased competition in the banking sector. Moreover, in the second half of the 1990s mortgage rates fell by up to 250bps.

This time round, too, there are sizeable monetary offsets to the impending fiscal tightening with official interest rates close to zero, the Bank of England having extended quantitative easing and these policies having helped induce a significant decline in sterling.

There is an important caveat. As Carmen Reinhart and Kenneth Rogoff note in their recent paper *Growth in a Time of Debt* , rising government debt ratios (particularly above 90 per cent of GDP) are often associated with substantially slower economic growth. Last month's Budget shows it coming very close - 89 per cent by the end of the next parliament.

What can we conclude? The aftermath of a recession seems a good time to begin the tightening needed to reduce a large deficit. But with the Conservatives advocating swifter consolidation than Labour, and the Liberal Democrats suggesting tightening should be contingent on economic recovery, there is plenty of room for debate in the election campaign about the most appropriate speed, scale and type (taxes versus spending) of fiscal tightening during the next parliament.

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