Box C: Self-Defeating Fiscal Adjustment

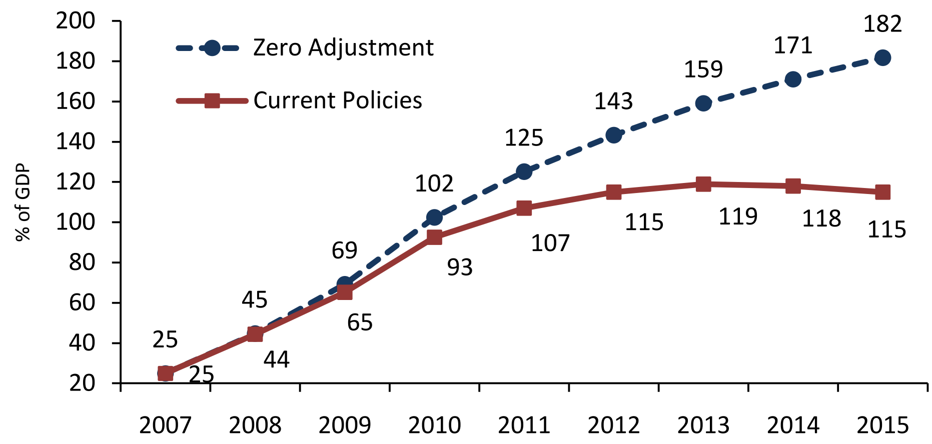
The existence of a demand-sustainability trade-off depends on two assumptions. The first assumption is that fiscal contractions actually reduce demand and output – that is, the expansionary fiscal contraction (EFC) hypothesis does *not* apply. If fiscal contractions are expansionary it would be possible, all else equal, to both improve growth performance while also reducing the deficit and improving underlying debt sustainability. As reviewed in the October 2011 report, the most authoritative international evidence does not tend to support the EFC hypothesis. The second assumption (and focus of this box) is that discretionary fiscal contractions do improve sustainability – that is, discretionary fiscal contractions are not self-defeating in terms of the underlying objective of improving the fiscal position.

The non self-defeating hypothesis comes in different forms depending on the focal fiscal measure.

One (weak) form of the non self-defeating hypothesis focuses on the **primary (i.e. non-interest) deficit as a share of GDP**. A discretionary fiscal contraction can be said to be non self-defeating provided that, all else equal, the primary deficit as a share of GDP does not rise. Not surprisingly, the empirical challenge comes from the "all else equal" requirement: numerous factors besides the discretionary fiscal stance can affect the actual primary deficit. In the Irish case, the primary deficit (excluding banking related fiscal costs) fell from 9.7 per cent of GDP in 2009 to an estimated 6.7 per cent of GDP in 2011, and is projected to fall further to 4.4 per cent of GDP in 2012 according to *Budget 2012* projections. This occurred despite weak growth and especially weak growth in domestic demand, with the latter being especially important for fiscal performance. Real GDP growth was -0.4 per cent in 2010 and 0.7 per cent in 2011; real domestic demand growth was -4.9 per cent in 2010 and -3.0 per cent in 2011. Most observers agree that the substantial discretionary fiscal measures adopted did contribute to the disappointing growth performance. However, growth was also held back by external factors, business/household deleveraging, an impaired credit system and weak confidence. The fact that the underlying primary deficit did decline despite these factors is not consistent with this form of the self-defeating hypothesis.

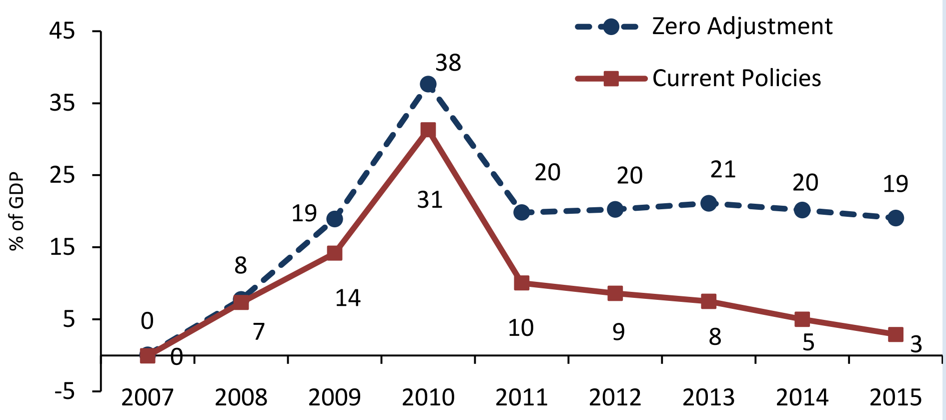
Using the fiscal feedback model, Figures C.1 and C.2 show the results of a simulation of how the main fiscal aggregates would have evolved if no fiscal adjustment had been pursued from July 2008.

Figure C.1: Debt to GDP Ratio:
Current Policies versus Zero Fiscal Adjustment



Source: Council simulations.

Figure C.2: General Government Deficit:
Current Policies versus Zero Fiscal Adjustment



Source: Council simulations.

This simulation should only be taken as a crude indicator insofar as it does not take account of adverse confidence effects as the main fiscal aggregates spin out of control. However, even ignoring these effects, the simulation shows the General Government deficit rising to over 20 per cent of GDP by 2012 under the zero-adjustment scenario with debt dynamics on a clearly unsustainable path.

A second (semi-strong) form of the non self-defeating hypothesis focuses on the **debt to GDP ratio.** A discretionary fiscal contraction can be said to be non self-defeating provided that, all else equal, the debt to GDP ratio does not rise. Owing to a potentially large negative effect on the denominator relative to the numerator, it is possible for the debt to GDP ratio to rise even if the primary deficit as a share of GDP falls with discretionary fiscal adjustments. Indeed, in the model there is a value of the deficit multiplier above which the debt to GDP ratio will rise due to large adverse growth effects. Simulations using the model show that the multiplier would have to be greater than 3.8 for additional discretionary fiscal contraction in 2012 to actually leave the debt to GDP ratio higher in 2015. Such a high value is not plausible for a small open economy such as Ireland's where the multiplier is generally considered to be about 0.5.

A third (strong) form of the non self-defeating hypothesis focuses on **creditworthiness** (measured, say, by secondary market bond yields). A discretionary fiscal contraction can be said to be non self-defeating provided that, all else equal, creditworthiness does not deteriorate. Owing to a possible additional adverse effect on market confidence from slower growth, a fiscal contraction could in principle lead to a worsening of creditworthiness even if the underlying primary deficit and debt positions improve (see, for example, Blanchard, 2011). Although care must be taken in interpreting movements in bond yields given its multiple underlying determinants, the significant decline in market spreads for Irish bonds since July 2011 does not suggest that the fiscal adjustment programme is undermining creditworthiness even if it is leading to slower growth.