

# Marketplace



**Tim Congdon**

**‘To Keynesians such as Martin Wolf and Larry Summers, the theory is simple: cuts in public expenditure and reductions in deficits have deflationary effects. But what about the evidence?’**

A university course in Keynesian macroeconomics teaches that an increase in public spending stimulates demand, unless it is frustrated by an offsetting reduction in private spending. If the government accompanies the increase in public spending by an identical rise in taxes, private spending may be deterred. However, if the government increases public spending, leaves taxes unchanged and widens the budget deficit, its policy stance ought definitely to boost demand. More generally, Keynesian theory demonstrates—or is supposed to demonstrate—that increases in the budget deficit constitute fiscal relaxation and are expansionary, whereas decreases in the budget deficit can be seen as fiscal contractions which restrict demand. If an undergraduate were to suggest in an exam essay that fiscal contractions could be “expansionary”, he or she would lose marks for committing an egregious blunder.

Yet at present the British government’s forward plans are to combine a large reduction in the budget deficit with a period of healthy output growth. According to official documents, from 2010/11 to 2015/16 the budget deficit—as measured as cyclically-adjusted net borrowing—is to drop from 7.4 per cent of GDP to 0.5 per cent of GDP, while national output is to rise by 1.5 per cent more than trend. Like a badly-taught student, Her Majesty’s Treasury believes in “expansionary fiscal contraction”.

Larry Summers—the US Treasury Secretary in the final years of the Clinton presidency—is one of the world’s most prominent Keynesian economists. At a recent academic conference in Bretton Woods, he poured scorn on the notion of expansionary fiscal contractions. He condemned the British government’s programme of fiscal consolidation as “an experiment” in bad economics. In his words, “I find the idea of expansionary fiscal contraction in the context of the world in which we now live to be every bit as oxymoronic as it sounds...[T]his experiment is not going to work out well.”

In his column in the *Financial Times* on April 29 Martin Wolf, the paper’s chief economics commentator, chimed in with the same message. He was particularly worried about the persistence of planned fiscal restraint, since the tightening of 6.9 per cent of GDP would be cumulative and unremitting over the five years to 2015/16. He ended,

gloomily, with the observation that “stagnation, or worse, might be the best that the UK can do”. Summers and Wolf undoubtedly regard themselves as the orthodoxy in this area of public policy. Economics may not be a science, but—in their view and that of other Keynesians—the lessons of textbook theory are straightforward and uncontroversial: cuts in public expenditure and reductions in deficits have deflationary effects.

But what about the evidence? The historical record turns out to be fascinating. The last 20 years of UK statistics provide a decisive refutation of the Summers-Wolf position. They contain two lengthy periods in which fiscal policy was consistently moving in one direction. According to data from the International Monetary Fund, between 1993 and 2000 the UK’s cyclically-adjusted budget position was transformed from a deficit of 6.1 per cent of GDP to a surplus of 1.5 per cent. Every year was “deflationary”, in Keynesian terms, in this seven-year period. Yet the economy enjoyed strong growth and falling unemployment.

By contrast, from 2001 to 2009, the cyclically-adjusted budget position slithered from a surplus of 0.6 per cent of GDP to a deficit of 8.5 per cent. With two minor exceptions, every year was “expansionary”, according to Keynesian terminology. And what happened to economic activity over these eight years? The answer is that, whereas in 2001 the UK was as near to full employment as it had been for a generation, by 2009 it was suffering from the after-effects of the worst recession since the 1930s. Again, the Keynesian view is contradicted.

And do the American numbers have a different message? Summers became Treasury Secretary after a prolonged and remarkably successful effort under the two Clinton administrations to bring the US public finances back to health after the fiscal extravaganzas of the Republican period. Just as in the UK, in virtually every year of the Clinton presidency fiscal policy was restrictive and output grew at an above-trend rate. Summers and Wolf may mock the proposition of “expansionary fiscal contractions”. But the data show expansionary fiscal contractions to be far more common in recent Anglo-American experience than the deflationary fiscal contractions which the textbooks lead them and other Keynesians to expect.