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Fiscal Adjustment and Growth—A Policy Dilemma

Parliament building in Bridgetown, Barbados: Stabilizing public debt in Latin America and the Caribbean will require some degree of fiscal consolidation in most countries (photo: Flavio Vallenari/iStock by Getty Images)

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Public debt has risen in many countries in Latin America and the Caribbean, precipitating a need for fiscal adjustment to place public finances on a sustainable path. But policymakers face a dilemma related to the potential negative consequences on growth of much-needed fiscal consolidation. In our latest research, we ask whether the quality of fiscal adjustment can be improved to help protect and support growth. The answer? A qualified yes.

A chapter from our latest Regional Economic Outlook: Western Hemisphere offers fresh evidence of the effects of fiscal consolidation. We employed three approaches to identify fiscal shocks and study the effects of fiscal consolidation in Latin America and the Caribbean by putting those shocks in a single, readily comparable framework to measure their impact on economic growth.

We discovered that while fiscal consolidation hurts short-run growth, the composition of consolidation plans across different fiscal instruments matters. For instance, compared to cutting primary spending, cutting investment has a more negative impact on growth. Therefore, policymakers should strive to preserve public investment to support growth and employment.

Slower growth in short term

First, a reality check: fiscal consolidation is likely to be more contractionary than suggested by previous research.

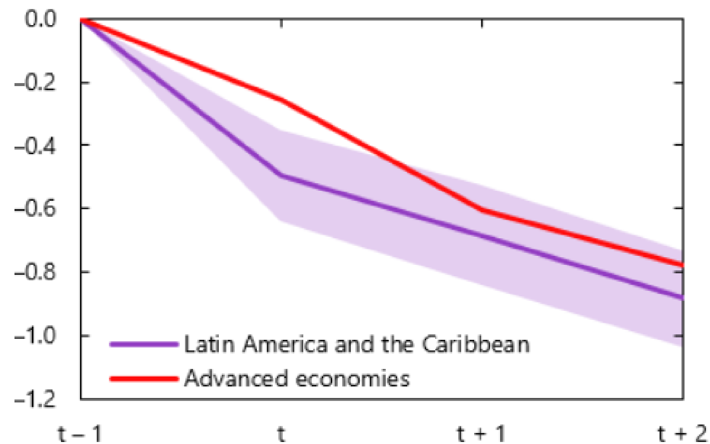
How large are the effects? A typical fiscal consolidation package that raises the primary fiscal balance by 1 percent of GDP reduces real GDP by an average of 0.9 percent after two years. This macroeconomic effect, defined as the *fiscal multiplier*, is larger than estimated in previous studies for the region, and similar to the impact estimated for advanced economies.

More generally, the three different approaches used in the chapter to identify fiscal shocks generate a range of multipliers from 0.5 to 1.1 after two years. The good news is that this range implies that fiscal consolidation is unlikely to be self-defeating and will indeed improve debt sustainability.

Impact of fiscal adjustment

Belt tightening will slow growth in the short term but improve debt sustainability.

(real GDP)



Sources: IMF, Information Notice System database; IMF, *World Economic Outlook* database; and IMF staff calculations.

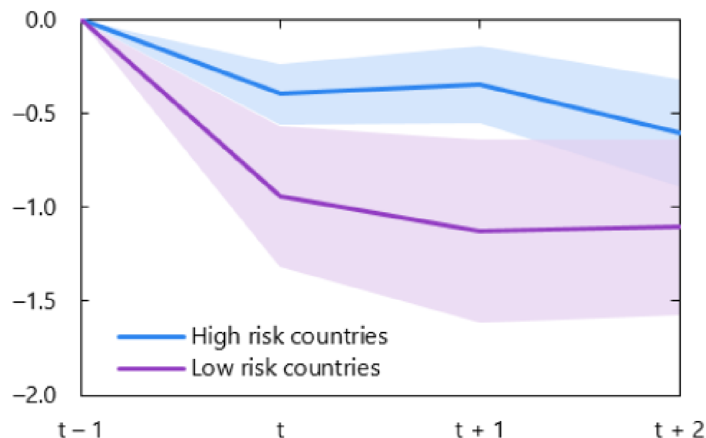
Note: Estimates based on identification of fiscal actions using narrative approach. Cumulative multiplier functions show deviations in percentage points for a fiscal shock with accumulated impact of 1 percent at each horizon in years. Shaded area indicates +/- 1 HAC standard error.

The negative effects on output appear somewhat smaller in countries with higher sovereign risk, where the need for fiscal adjustment may be more pressing. This finding indicates positive confidence effects in markets that reward improvements in fiscal sustainability with lower interest rates.

The confidence effect

For high risk countries, the impact of fiscal consolidation might turn out to be less negative than expected, because better prospects for fiscal sustainability can reduce interest rates.

(output multiplier, by perceived sovereign risk)



Source: IMF staff calculations.

Note: Estimates based on identification of fiscal actions using narrative approach. Shaded area indicates +/− 1 HAC standard error. The Latin America and the Caribbean sample is split at the median of the empirical distribution for the index of perceived sovereign risk constructed by Institutional Investor LLC.

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Does the growth impact of fiscal policy vary during recessions and expansions? We looked at whether fiscal multipliers depend on the sign of the output gap at the onset of the adjustment, and our results point to little difference over the business cycle. In other words, the effect on growth looks similar across good times and bad times. With economic recovery now underway in the region, this is an excellent opportunity to make progress on fiscal adjustment while avoiding policies that are procyclical.

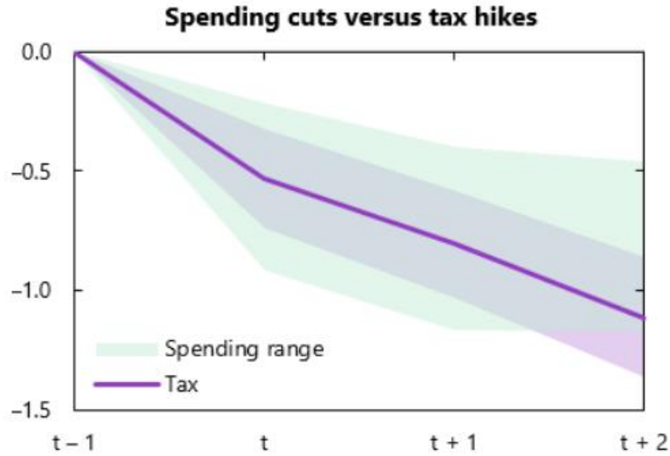
Moreover, many countries will need to keep up their fiscal adjustment effort over a number of years to achieve fiscal sustainability, due to the high levels of debt already reached. This is one more reason not to delay adjustment.

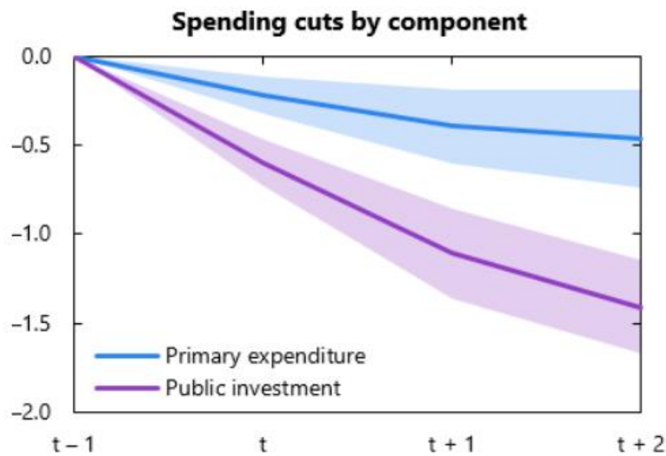
Getting the composition right: What to cut?

How does the composition of the fiscal adjustment across tax measures and spending types affect the near-term effects on growth? We find little compelling evidence that multipliers for tax increases are generally different from multipliers for expenditure cuts in the region.

However, the composition of spending measures seems to matter, with multipliers for public investment of almost 1.5, compared to only 0.5 for generic primary expenditures. Beyond these short-run multiplier effects, public investment should also be supportive of medium term potential GDP, particularly if it addresses key structural bottlenecks (e.g., infrastructure gaps) in the region. The design of fiscal adjustment, safeguarding public investment, is thus critical to helping solve the policy dilemma around fiscal consolidation.

Composition of adjustment
Cutting investment has a larger negative impact on growth than cutting primary spending; thus, preserving public investment is key for supporting growth.
(cumulative multiplier)





Sources: IMF staff calculations.
Note: Panel 1 compares the range of spending multiplier estimates with the tax multiplier estimate using the narrative approach. Panel 2 reports estimates based on identification of fiscal actions using forecast errors for a sample of 19 LAC countries. Shaded area indicates +/− 1 HAC standard error.

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