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## Tales of Expansionary Fiscal Contractions in Two European Countries: Hindsight and Foresight

*Abstract* – It is ironic that the potential expansionary effects of fiscal contractions have become known as non-Keynesian effects. This paper highlights the fact that Keynes and his contemporaries were aware of such potential perverse effects. It is clear that the important indirect effects of budgetary policy via expectation were known in the 1930s. Moreover, the economists of the time recognised the possibilities before they occurred. This paper supplements the existing research on the Expansionary Fiscal Contraction hypothesis by comparing the political and economic environments of two periods in economic history, Britain in 1930-1931 and Ireland 1986-1987, and the accompanying economic thought.

*Keywords* – Expansionary Fiscal Contraction, John Maynard Keynes, Arthur Cecil Pigou, Fiscal Policy.

*JEL Classification codes* – B2, E6, H6, N1

### 1. – Introduction

In the current economic environment of high fiscal deficits coupled with heavily indebted public sectors understanding the potential of fiscal contractions to have expansionary effects has become an urgent matter of bitter controversy. Given the constraints in sovereign bond markets the debate about contraction is as much about financial considerations as it is ideological as we still know «...relatively little about the effect of fiscal policy...» Alesina – Ardagna [2010, p. 35]. The current empirical, theoretical, popular media and policy interest in the potential for fiscal contractions to have expansionary effects has antecedents in the work of Giavazzi – Pagano [1990] and the papers that followed. The ideas were also present in the deliberation

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of the Committee of Economists established to advise on British economic policy during the late 1920s and early 1930s.

Following Giavazzi – Pagano [1990] the initial emphasis in the literature was on the theoretical considerations under which a fiscal contraction could be expansionary, a non-exhaustive list includes for example Blanchard [1990], Drazen [1990], Bertola – Drazen [1993], Barry – Devereux [1995], Sutherland [1997], Perotti [1999] and Barry – Devereux [2003]. These theoretical papers were followed or accompanied by a set of empirical papers that tested the Expansionary Fiscal Contraction (EFC) hypothesis in a variety of cross-country studies, including inter alia Alesina – Perotti [1995], Giavazzi – Pagano [1996], McDermott – Westcott [1996], Alesina *et al.* [1998], Perotti [1999], Alesina *et al.* [2002], Perotti [2004], Perotti (2007), Alesina – Aardagna [2010], Romer – Romer [2010], IMF [2010] and Perotti [2011].

There are a number of noteworthy features about the manner in which the literature developed. First, there were attempts to explain the hypothesis within the traditional macroeconomic models that up to this point were used to explain why fiscal contractions should have no effect or a contractionary effect. Second, in the standard pattern of most scientific work, the literature moved away from the almost case study approach of Giavazzi – Pagano [1990] to examine if the hypothesis might be more universally applicable. Third, there was little emphasis on the search for a precursor to the EFC hypothesis in the literature on economic thought<sup>1</sup>. The purpose of this paper is to supplement the existing research by examining: (i) in greater detail the political economy environment of the Irish EFC episode during the 1980s that spurred the Giavazzi – Pagano [1990] influenced literature and; (ii) to highlight the similarity in thinking of latter day economists and the Committee of Economists of Keynes and his contemporaries.

With regard to (i) our argument is that an understanding of the credibility of fiscal adjustment is dependent on more than whether the adjustment is large or small and whether it is expenditure or revenue based (particularly given the dispute over measuring these issues as highlighted by Perotti [2011]). We argue that an understanding of the political landscape is crucial in this regard. The political and economic environment of Ireland in the 1980s displays many parallels with that of Britain in the 1929/31 period. With regard to (ii) our argument is that John Maynard Keynes, Arthur Pigou, Lionel Robbins, Josiah Stamp and Hubert Henderson, in their deliberations on the Economic Advisory Council's Committee of Economists were aware of the

<sup>1</sup> Recently the US depression of 1920-21 has been held up as an historical example of an EFC, see Woods [2009] – Murphy [2009]. However Kuehn [2011] has argued that this example is flawed as most of the fiscal adjustment occurred prior to the peak of industrial production while the contraction during the depression was only modest in comparison.

potential perverse effects of fiscal policy. What is different is that Keynes and his colleagues identified the potential for an EFC before it actually happened, whereas the later literature was written after the event.

The next section outlines the recent literature on the Expansionary Fiscal Contraction Hypothesis. Section 3 identifies the similarities between the economic and political environment of the UK in the early 1930s and Ireland in the 1980s. Section 4 then presents the foresight in the Report of the Committee of Economists about the possible perverse effects of fiscal policy. Finally section 5 concludes.

## *2. – Hindsight: Recent theory and evidence on the EFC hypothesis*

At around the same time as Giavazzi - Pagano [1990] appeared in the literature there were a number of studies dealing specifically with the Irish EFC [MCALEESE 1990 – BARRY 1991 – GEARY 1992 – HONOHAN 1992 – MAWDSLEY 1995 and BRADLEY-WHELAN 1997]. However, the primary focus of the literature following Giavazzi - Pagano [1990] was on explaining how an expansionary fiscal contraction might arise within the traditional macroeconomic models. Most of these studies examined the direct wealth effects of a fiscal contraction using Blanchard's 1985 version of Diamond's 1965 overlapping generation model. They examined the direct wealth effects of a fiscal contraction. The theory suggested that if the fiscal contraction was a signal of better times ahead, because of higher wealth due to lower taxation, then it was possible for a fiscal contraction to have expansionary effects.

### *2.1 – Direct Wealth Effects*

Blanchard [1985] explained how a change in the profile of taxation had the traditional Keynesian or Neoclassical effects where individuals have finite time horizons. In other words, a fiscal contraction had a contractionary effect. An increase (decrease) in taxes in initial period  $j$  accompanied by an offsetting decrease (increase) in taxes in later period  $u$  made those individuals alive in period  $j$  poorer (wealthier). The size of the wealth effect depended on the probability of surviving from period  $j$  to period  $u$  and the time difference between the periods. In order for a fiscal contraction to have a positive wealth effect something else is needed. Two distinct explanations of the direct wealth effects are provided in the literature. First, there are explanations that depend on threshold effects. In these explanations fiscal contractions increase the expected wealth of individuals because they avert potentially larger negative consequences [BLANCHARD, 1990 – SUTHERLAND, 1997 –; PEROTTI,

1999]. Second, there are explanations that depend on a contraction in the overall public sector [GIAVAZZI – PAGANO 1990; BARRY-DEVEREUX 1995<sup>2</sup>; BARRY-DEVEREUX 1996]. One paper combines the threshold effects and a contraction of the public sector [BARRY-DEVEREUX 2003].

Blanchard [1990] examined a fiscal contraction where taxes are increased, changing fiscal policy from unsustainable to sustainable, and thereby, avoiding a forced future fiscal contraction that would have resulted in an increased tax rate that would have a distortionary effect on output. The individuals' expected wealth increases because the expected forced fiscal contraction, with its associated distortionary tax rate, was avoided. Recent work by Reinhart – Rogoff [2010] suggests Blanchard [1990] – Sutherland [1997] might have been on to something when they suggest that a debt to GDP ratio of 90% is a threshold level for growth effects. Reinhart – Rogoff [2010] find that historically debt to GDP ratios of greater than 90% are associated with slower growth rate.

Similar threshold type effects were explored by Sutherland [1997]. Like Blanchard [1985], Sutherland examines a change in the time profile of taxation. However, there are important differences between the change in the time profile of taxation specified by Sutherland and that specified by Blanchard [1985]. In the Blanchard model the tax changes are small, known, and offsetting, with the only uncertainty surrounding the life of the individual. In Sutherland's paper the timing of tax changes are unknown and potentially much larger. Sutherland allows the debt to GDP ratio to follow a random walk within upper and lower bounds. When one of the boundaries is reached there is a large 1-period wealth transfer between the private sector and the government in order to bring the debt to GDP ratio towards its mean level. The result is that for Sutherland fiscal contractions are contractionary when the debt to GDP ratio is away from the threshold but expansionary when the ratio is close to the threshold. In other words, 'non-Keynesian' effects dominate close to the threshold while Keynesian effects dominate away from the threshold. Perotti [1999] found support for a Sutherland type hypothesis for 19 OECD countries for the period 1965 to 1994.

Whereas Blanchard [1990] and Sutherland [1997] use threshold effects to derive an EFC, Giavazzi-Pagano [1990] – Barry-Devereux [1995] and Barry-Devereux [1996] derive an EFC by reducing the size of the public sector. By reducing both sides of the government's intertemporal budget constraint, individuals' are wealthier because they pay less tax. In the majority of these studies government expenditure is neither productive nor enters into the individuals' utility functions. The decrease in the present value of taxation results in an

<sup>2</sup> Barry – Devereux [1995] use a neo-Keynesian rather than the Blanchard model. However, the type of fiscal contraction employed is as outlined here.

immediate expansion in consumption. While it is the contraction in the size of the public sector, both expenditure and taxation, that drives the expansionary effects, it is classified as a fiscal contraction because of the timing of the changes. For example, the fiscal contraction is achieved in a number of ways: starting the decrease in expenditure before the decrease in taxation or increasing taxation in period  $t$  followed by decreased taxes in subsequent periods such that the overall reduction in taxation matched the decrease in government expenditure.

Barry – Devereaux [2003] present a dynamic general equilibrium model showing that the effects of balanced budget fiscal spending are normally negative but are non-linear. This paper combines the threshold and the public sector explanations advanced above. The reason for the negative relationship between increased balanced budget fiscal spending and economic activity is due to the increase in the share of the public sector in the overall economy. The non-linear effects are due to the fact that at higher fiscal spending to GDP ratios the expansionary effects of fiscal spending cuts are largest. In other words initial conditions matter as in Blanchard [1990] – Sutherland [1997] and Perotti [1999].

It might be noted at this stage that the channel through which an EFC effect is produced is through an increase in wealth and consumption. Later it will be explained that for Keynes and his contemporaries the investment channel was seen as the important one for confidence.

## 2.2 – Credibility Effects of Size and Composition of Contraction

Rather than testing for the direct wealth effects of fiscal contractions the empirical literature on the EFC hypothesis tends to test what type of fiscal contraction signal lower taxes. One strand of the empirical literature might be seen as testing the theory proposed by Giavazzi – Pagano [1990] and Barry – Devereux [1995 and 1996]. If one interprets these papers as saying that cuts in government expenditure signal future cuts in taxation then testing if fiscal contractions composed primarily of expenditure cuts produce expansionary effects is one method of testing the EFC hypothesis. Support for the hypothesis that the composition of the fiscal contraction is important for expansionary effects is presented in Alesina-Perotti [1995] – McDermott-Westcott [1996] and Alesina *et al.* [1998] – Alesina-Ardagna [1998] and Alesina – Ardagna [2010]<sup>3</sup>. All of these studies involved examining over 17 OECD

<sup>3</sup> Some take a more detailed look at the composition of the fiscal adjustment highlighting the importance of some components of an expenditure adjustment. For example, Lane – Perotti [1997] focus on the cuts in the public sector wage bill, while Roy [2004] and Darby *et al.* [2005] examines the relative importance of cuts in central versus local government expenditure.

countries for periods of 25 years or more prior to the mid-1990s. However – Giavazzi *et al.* [2000] and Giorgioni – Holden [2003] found evidence that tax cuts were more important than expenditure cuts. While Perotti [2011] found that the role of spending reductions was less important than previously understood.

Another strand of the literature suggests that it is the size of the fiscal contraction that was important in signaling future fiscal policy [DRAZEN 1990; BERTOLA – DRAZEN 1993]. Many of the studies cited above found it was the composition rather than the size of the fiscal contraction that was important. Some studies did find that the size of the fiscal contraction was important for producing expansionary effects [MCDERMOTT – WESTCOTT 1996; GIAVAZZI – PAGANO 1996; COUR *et al.* 1996; GIAVAZZI, *et.al.* 2000]. While Von Hagen *et al.* [2001] found more traditional Keynesian effects of fiscal policy for much the same period as the above studies, and Van Aarle – Garretsen [2003] found that evidence for non-Keynesian effect was mixed.

### 2.3 – Exchange Rate

Perotti [2011] found the expansionary effects of fiscal contractions to be associated with exchange rate movements in Ireland, Sweden and Finland but not Denmark. His four detailed case studies of fiscal contractions examined two contractions carried out under fixed exchange rates (Ireland and Denmark) and two contractions after floating the currency (Finland and Sweden). The exchange rate channel was something that received only limited discussion in the literature previously. Although it should be pointed out that Hjelm [2002] identifies the importance of preceding exchange rate movements for the effects of fiscal contractions – something Alogoskoufis [1992]; McAleese [1992] and Kinsella [2012] identified as important in the success of the Irish fiscal contraction.

The importance of exchange rate movements in Perotti [2011] arose because the findings in his four detailed case studies contradicted the results of Alesina-Perotti [1995] and Alesina – Ardagna [2010] that the expansionary effects were due to cuts in government expenditure. Unfortunately, as acknowledged by Perotti [2011], the policy relevance of his findings is limited because depreciation is not now an option for Eurozone members.

### 2.4 – Identifying Fiscal Contractions: The role of Case Studies

Central to Perotti's findings is the data and methodology used to estimate the cyclically adjusted change in the deficit. Perotti argues that Alesina-Perotti

[1995] and Alesina – Ardagna [2010] rely on statistical methodologies to calculate the cyclically adjusted primary balance that suffer from endogeneity problems. To counter these problems Perotti [2011] supports the approach of Romer – Romer [2010] and Devries [2011] who advocate ‘action based’ or ‘narrative’ measures of fiscal contractions. Using such measures the IMF [2010] find no evidence to support the EFC hypothesis in the short run, although higher debt levels are shown to reduce the contractionary effects of fiscal contractions. While focusing on taxation Romer – Romer [2010] similarly find no support for the EFC hypothesis although tax increases aimed at reducing budgetary deficits do not have large contractionary effects. Although these results are in line with Perotti [2011], in that fiscal contractions do not generate an increase in domestic demand, and the methodology is an improvement on the pure statistical method, Perotti [2011] argues that there is a need to go further and conduct detailed case studies on each country’s fiscal contraction episode. This line of reasoning is consistent with Perotti [1998] who highlights the importance of political economy considerations in determining the success of fiscal contraction and Favero *et al.* [2011] who have emphasised the importance of country heterogeneity in understanding the effects of fiscal policy. The heterogeneity of circumstances under which fiscal contractions take place means that «one can learn much from detailed case studies» Perotti [2011, p. 3].

What follows is an examination of the similarities between two case studies from economic history. The particular episodes examined in this paper are the events in Britain 1929-32 and Ireland 1982-89. What makes the British episode of added interest is that five of the leading economists of the day set down their views on the potential perverse effects of fiscal policy under these circumstances. In their deliberations it is clear that they acknowledged the possibility of an EFC. The material in the next section compares the economic and political climate of Ireland in the 1980s with that of Britain in 1929-32. The following section then outlines what the Committee of Economists believed were the likely consequences of fiscal policy in such circumstances.

### 3. – *Similarity in the events separated by over half a century*

Throughout the 1980s Ireland struggled to control imbalances on the public finances. The first sustained attempt to correct the situation took place between 1983 and 1986. While the success of this first fiscal adjustment is debated [DORNBUSCH, 1989 – HONOHAN, 1992] it is beyond doubt that it was not accompanied by expansionary effects. This first fiscal adjustment was undertaken by a Fine Gael – Labour coalition government with Alan Dukes

as Minister for Finance. The situation in Ireland had deteriorated to such an extent that control of the public finances became the primary target of fiscal policy. In particular, the target was the non-capital budget deficit called the Current Budget Deficit (CBD). The policy instruments used to achieve the target were tax increases and cuts in capital expenditure. The tax increases proved counter-productive, discouraging investment, distorting the labour market and encouraging vast levels of tax evasion and avoidance. The capital expenditure cuts did not enter into the calculation of the CBD. The result was that while the government managed to reduce the Exchequer Borrowing Requirement (EBR) to GDP ratio, the CBD/GDP and public debt/GDP continued to increase until 1986. The Prime Minister of the time, Garret FitzGerald, now accepts that his government's choice of the current budget deficit as the target for fiscal policy was ill advised and it would have been better to target the EBR [FITZGERALD, 1995].

While any ex-post evaluation of the government's policy would conclude that it was unsuccessful at achieving its own targets, a bigger problem at the time was that the policy hemorrhaged credibility from the beginning. As Minister for Finance, Alan Dukes was a relative political novice being only elected to parliament in 1981. His political standing and credibility as Minister for Finance were damaged almost immediately when the Prime Minister failed to support his announced deficit target of £750m. The announced target was challenged by the leader of the minority party in the coalition (who sought a larger deficit of £900m) and the Prime Minister supported the Labour leader. Dukes's credibility was further damaged by the failure to achieve the progressively looser fiscal targets he explicitly outlined in successive budgets.

This first attempt at fiscal stabilisation coincided with a downturn in domestic economic activity and an international economic environment that was less favourable than in the second half of the decade. The second adjustment was preceded by a large 8% devaluation of the Irish pound within the European Exchange Rate Mechanism in August 1986. This devaluation combined with positive implications of the fiscal adjustment for foreign direct investment helped the performance of Irish exports. Investment was further aided by the continued reduction of the interest differential with Germany, while exports were aided by the 'Lawson Boom' in Britain (Ireland's largest trading partner at the time).

It was the success of the second fiscal adjustment in the 1980s that propelled Ireland to prominence in the international literature on the subject. The second fiscal adjustment was undertaken by a minority Fianna Fail government. However, Fianna Fail was offered conditional support by the main opposition party. On election night, Garret FitzGerald offered the support of his party to Fianna Fail provided they continue his party's attempt to correct the public finances. FitzGerald's successor, Alan Dukes, reiterated

this policy in a speech in Tallaght. Opposition support for the government retrenchment became known as the Tallaght Strategy and it limited opposition to the fiscal contraction to less than 20% of elected members of parliament. Moreover, the policy was fully supported by the leader of the government Charles Haughey. The new Minister for Finance, Ray MacSharry, opted to use expenditure cuts as his policy instrument including cuts in health expenditure and an embargo on public sector employment. The success of the fiscal adjustment and its associated expansionary effects formed the basis for Giavazzi – Pagano [1990].

To summarise, the successful Irish fiscal contraction was supported in parliament by the main opposition party. The previous effort was undermined because the then Minister for Finance received less than wholehearted support from within his own government and trenchant opposition from Fianna Fail. The McSharry fiscal contraction gained credibility from its use of expenditure cuts, rather than the tax increases used by the previous administration. There was a positive feedback between fiscal and monetary policy. The devaluation of 1986 aided an improved trade performance and the fiscal contraction provided a credibility bonus thereby aiding lower interest rates and encouraging investment. Fifty-five years earlier a similar pattern of events occurred in Britain.

### 3.1 – Britain and the Recovery of the Early 1930s

The 1929 General Election had failed to produce an overall majority for any one political party. Labour, the largest political party after the election, formed a minority government with Liberal support. The Chancellor of the Exchequer, Philip Snowden, and the other Ministers were sworn in on July 8<sup>th</sup>. Not alone was the government a minority one but it was far from agreed on the response required to the worsening economic environment following the Wall Street Crash of 1929. The Chancellor advocated a policy of retrenchment whereas his Labour colleague, Oswald Mosley, proposed greater government intervention in a paper presented to government in January 1930. Despite being Labour's first Chancellor of the Exchequer few doubted Snowden's willingness to take the appropriate action but his credibility was undermined by his party's position and his constant public cajoling of his colleagues on the need for greater retrenchment. His socialist leanings meant his budget of April 14<sup>th</sup>, 1930 included progressively tinged increases in taxation. Unfortunately, he also gave hostages to fortune with promises about future budgetary policy that he was unable to keep – something that later undermined his credibility [JENKINS 1998].

In the beginning of 1931 with unemployment at the two million mark it was clear that something needed to be done about the extent of expenditure on the Unemployment Insurance Fund. A Treasury Report in January implied that the need for action was obvious. However, Snowden was limited in his ability to undertake action by illness and calls by the Liberals for an independent Committee of Inquiry. Labour agreed to the Liberals' request and appointed Sir George May as head of the inquiry. This move only postponed the day of reckoning. As unemployment passed 2.5 million, Snowden produced a stopgap budget with no significant steps to deal with the problems. At the end of July, the May Report was published and it recommended a 30% cut in the unemployment fund. The May Report sought cuts of £96m but the cabinet would only agree to cuts of £56m including cuts in road building and a 20% cut in the salaries of public employees. The difference would have been halved if the cabinet agreed to a 10% cut in unemployment insurance. However, agree they did not. The result was the formation of a National Government on August 24<sup>th</sup>.

Snowden remained as Chancellor in the National Government and he introduced an emergency Budget on September 8<sup>th</sup>, 1931. An additional £81m of tax increases were imposed and the cuts agreed by the previous Labour cabinet were implemented plus the 10% Unemployment Insurance cut. The cuts were not enough to save Sterling. The run on the pound that had started with the publication of the May Report continued and on September 19<sup>th</sup> the currency was forced off the Gold Standard with an effective devaluation of 20%.

The National Government was replaced after the election of October 27<sup>th</sup> and Neville Chamberlain became Chancellor. The corrective measures introduced by Snowden were reinforced by Chamberlain's successful negotiation and conversion of the 5% War Loan to 3.5% stock the following summer. The result was the ushering in of Britain's cheap money period in the 1930s and the recovery led by house building.

The consensus view on the recovery that occurred in Britain in the 1930s is that the recovery was triggered by both the devaluation and the confidence effect engendered by the policy of budget balance, and that it was continued by the boom in housing and household durables driven by cheap money after the conversion of the War Loan [HICKS 1939 and 1952; WORSWICK 1984 – RICHARDSON 1962 – RICHARDSON 1983]. The significance of maintaining budget balance was important for two reasons. First, Snowden's statements on the potential for enormous deficits unless action was taken made the balancing of the budget seem like there was a fiscal contraction. Although what exactly 'balancing the budget' actually implied is not easy to ascertain given the treatment of the Sinking Fund. Second, the prevailing fiscal orthodoxy was budget-balance, therefore, to plan a deficit would have had greater significance than it might decades later.

The purpose of tracing this thumbnail sketch of the similarities between the British and Irish experiences is to highlight the economic environment and context within which economic thinking was taking place. While it would be easy to list the temporal and size differences between the episodes it is the similarities that are of importance here. In both cases the confidence effects of fiscal discipline were supplemented by the impetus of devaluation and lower interest rates. In both cases the improvement in the political position of the Minister with responsibility for budgetary policy was important. In both cases, the successful fiscal contraction was introduced by a Minister that commanded overwhelming political support in his legislative chamber.

The British experience has never been classed as an example of an EFC. This might be because the significance of the fiscal measures in the recovery is considered a poor third behind the arrival of cheap money and the devaluation of sterling. It is also possible that the British experience occurred at a time when the confidence effects of budget balance would attract little attention. Those who held the dominant view of the importance of budget balance saw little new in the events of 1931/2, whereas the supporters of the coming Keynesian revolution were unlikely to credit the fiscal orthodoxy of balanced budgets with the turnaround. By contrast, the Irish experience occurred at a time when the dominant Keynesian view had become less fashionable. However, what makes the British experience so interesting is the contemporary debate between the economists of the time about the potential consequences of fiscal policy. This debate crystallized in the Report of the Committee of Economists produced during a short period in 1930 - almost a full year before the lowest point of the crisis in September 1931. The Report was a compromise between the Classical economists and the 'Keynesian' economist. The conclusions show remarkable foresight and, read with the benefit of hindsight, it is possible to say that the distilled thoughts of the Committee of Economist concluded that an expansionary fiscal contraction was possible. It is to the Committee of Economists that we now turn.

#### 4. – *Foresight: Keynes and the Committee of Economists*

On the journey back to 1930 it is instructive to stop at one point. That point is 1950 where one member of the Committee of Economists published his reconsidered view on the work of another member. The publication of interest is *Keynes's General Theory* by Arthur C. Pigou. There is a passage from Pigou's monograph that captures the synthesis of views between his own classical tradition and the tradition that Keynes's *General Theory of Employment, Interest and Money* was to give birth. It is also a passage that probably captures

the potential for an EFC in terms that it is almost certain that later contributors would approve. The passage goes as follows.

«[T]here can be no doubt that in the period of the great slump many people did believe that thriftiness, or economy, would merely transfer employment from consumption to investment, thus not reducing it at the time and ultimately, in consequence of the contribution made to capital equipment, stimulating it. ... This was a gross blunder. Nobody doubts any longer that Keynes's argument, as I have set it out above, is not only correct on his premises, but is also applicable in a general way to the conditions of the actual world. There are, indeed, two important qualifications to be made in it. If business men at home believe that the country is going to the dogs on account of extravagant consumption, an economy campaign may restore their confidence and so cause the demand schedule for investment to rise. In like manner – to pass for a moment to an open economy – if foreigners with balances here hold a similar belief, such a campaign may check a drain of gold abroad, and so help money income. These reactions *may* be large enough to make the net effect on employment favourable. Thus it is not certain that in the first stages of the 1930 panic the Government's economy campaign was a mistake. But few economists would now deny that it was maintained too long» [PIGOU, 1950, p. 40-41, emphasis in original].

This passage was published 20 years after the Report of the Committee of Economists was published and 14 years after the General Theory was published<sup>4</sup>. In this passage Pigou confirms Keynes's argument, its applicability and its acceptance when he says that «Nobody doubts any longer that Keynes's argument ... is not only correct on his premises, but is also applicable in a general way to the conditions of the actual world». However, he makes a crucial qualification when he says that if it is believed «that the country is going to the dogs on account of extravagant consumption, an economy campaign may restore confidence» and that the overall reaction «*may* be large enough to make the net effect on employment favourable». Pigou identifies the investment channel as the one through which the expansionary effects flow rather than the wealth and consumption channels favoured by those using the Blanchard [1985] model. As will be demonstrated later, the emphasis on investment is consistent with Keynes's views (it is also consistent with Pigou's earlier writings on the importance of confidence and psychological factors for investment and economic activity as presented in his 1927 book *Industrial Fluctuations* [COLLARD 1996]).

<sup>4</sup> Alternative views on the changes in economic thinking during this period can be gained from a reading of Buchanan-Wagner [1977] – Peden [1983] – Winch [1983] – Middleton [1982] – Skidelsky [1992] and Clarke [1998].

The possibility of an EFC was established at least as early as 1950. In fact, the views outlined by Pigou in 1950 were forming in Keynes and himself 20 years earlier. Pigou, Keynes and the Committee of Economists had accepted the possibility of an EFC even before the events of 1931. The Committee of Economists was a specialist subgroup of the Economic Advisory Council (EAC). The EAC represented a compromise between two ideas concerning reconstruction after the First World War: one, for the establishment of an economics general staff; two, for the creation of a representative deliberative assembly. Formed by the Labour government after the 1929 General Election, it was identified as the Prime Minister's idea but it actually «arose out of the experience of a wide spectrum of serious observers of the economic scene throughout the 1920s» [HOWSON - WINCH, 1977, p. 24]. It consisted of politicians, business people and economists. The EAC's Committee of Economists was established after the EAC had disagreed on its approach to a number of questions put to it by the Prime Minister, Ramsey MacDonald<sup>5</sup>.

The Committee of Economists was chaired by Keynes and the remainder of its membership were Pigou, Stamp, Robbins and Henderson. In the summer of 1930 the Committee set about producing, in Keynes's words, «an agreed diagnosis of our present problems, and a reasoned list of possible remedies» [HOWSON - WINCH, 1977, p. 46-7]. Keynes subsequently put a list of more focused questions to the Committee that formed the basis for their meeting of late September – by which time they were under pressure from the Prime Minister to report for October 20<sup>th</sup>.

The majority of this work was completed in the month following a late September weekend meeting in Stamp's house. The agreed report was a remarkable achievement given the level of disagreement between the members over the issues at stake. Given his views and role as chairman, and primary driving force, it is not surprising that most of the disagreements revolved around Keynes. Most disagreed with Keynes's revenue tariff proposal. Pigou disagreed with the potential for monetary measures to have any real effects on the economy. Henderson disagreed with Keynes on the benefits on the Public Works programme. However, the biggest disagreement came with Robbins. Basically, Robbins viewed the slump as a remedy of previous mistaken investment decisions and did not agree with Keynes that rigidities in the system were causing the slump.

Keynes kept everyone on board by getting individuals to draft the sections of the Report on which they held strong views. This strategy was stretched to the limit in the case of Robbins. Keynes allowed Robbins to agree to draft the

<sup>5</sup> Howson – Winch [1977] suggest that it was Keynes who convinced MacDonald to form the Committee of Economists while Skidelsky [1992] suggests it was Henderson.

opening section of the Report and allowed him to include a statement, at the end of the Report but before the Statistical Appendix, outlining his difficulties with aspects of the Report. When the Report was published on October 6<sup>th</sup>, it was a surprisingly coherent document despite all the disagreements and the fact that different individuals had drafted different sections.

For the purposes of this paper, the remarkable feature is that there seemed to be little disagreement on the importance of budgetary discipline for business confidence. In the first section, dealing with home investment, the second sentence says, «[s]o far as home investment is concerned, we would put in the forefront the restoration and maintenance of a state of business confidence» [MOGGRIDGE, 1981, p. 443]. While the Report stated that «[t]he best means of restoring business confidence is a psychological problem on which the opinion of this Committee is not likely to be specially valuable» [MOGGRIDGE, 1981, p. 443-4], it continued to say that in the short run some measures could be taken to aid the process. It is worth quoting the first two of the four stimuli suggested.

«(a) A solution of the Budget problem satisfactory to business sentiment – in particular, the avoidance of increased direct taxation, the avoidance of any serious reduction in the sinking fund, the avoidance of increased expenditure.

(b) A drastic reform of the system of the dole. It is widely felt that, if Parliament can suffer the present monstrous anomalies of the dole – as they seem to be to the general consensus of public opinion – without trying to do away with them, this would be symptomatic of a general unwholesomeness in the body politic. A far-reaching reform might cause a great revulsion of feeling as showing those fears to be groundless» [MOGGRIDGE, 1981, p. 444].

In other words, the Committee of Economists proposed a fiscal adjustment by cutting expenditure and that far-reaching reform would restore confidence in the body politic. The above quote sits easily with those who suggest that the size and composition of a fiscal adjustment is important. It seems that the Committee of Economists were aware of the potential perverse effects of fiscal policy. That these proposed solutions were listed rather than explained in detail probably reflected the belief among the Committee that there was little need to do so. The budget balance orthodoxy of 19<sup>th</sup> century Gladstonian finance continued to dominate – particularly in the Treasury.

Keynes was one member of the Committee that did not have budget balance as his primary concern. His emphasis on public works rather than budget balance lies at the heart of his disagreements with Henderson. This is not to suggest that Keynes did not believe that there were important consequences on confidence arising from budgetary balance, or the lack of it. Rather it was a matter of priority and emphasis. Keynes emphasised the importance of a

public works programme for a positive shift in the marginal efficiency of capital. Henderson believed Keynes did not attach enough importance to the negative effects that his proposal would have on the same schedule via the budgetary situation. To suggest that Keynes was taking these possibilities likely is not to imply that he did not accept their potential existence. Clarke [1998] notes that even during the summer of 1930, in correspondence with the Prime Minister regarding the PM's questions to the EAC, Keynes clearly identified the importance of confidence [CLARKE, 1998, p.164]. Clarke goes even further suggesting that the inclusion in the Report of the measures to improve confidence is more likely to have had Keynes's approval.

Perhaps the greatest indication that Keynes himself attached importance to the confidence effects of budgetary policy came in March 1931 when he published his *Proposal for a Revenue Tariff*. In this proposal Keynes indicated his willingness to sacrifice his free trade principles in preference to unbalancing the budget. His primary goal remained that of the previous autumn – a public works programme. Keynes accepted that without the extra revenue from a tariff, the expansion of the public works programme would (i) damage budget balance and business confidence and (ii) damage the trade balance and the currency. The link with Pigou's 1950 passage is obvious. These are the 'two important qualifications', Pigou highlighted.

It would seem that despite all their arguments during the drafting of the Report of the Committee of Economists, Keynes, Pigou, Robbins, Henderson and Stamp, were all aware of the possibility of fiscal policy having what are now known as perverse effects. These five economists recommended a course of budgetary action designed to capture the benefits of budgetary discipline by proposing budgetary balance via expenditure cuts on the unemployment fund. When expenditure cuts were forced on the government, almost a year later, they produced the desired effect. Along with the devaluation of 1931 they kick started the British boom of the 1930s. It would be hard to imagine that the Committee of Economists would be surprised by the successful Irish fiscal contraction of the late 1980s.

## 5. – *Conclusions*

Recent events have given renewed interest in the EFC hypothesis literature that started with Giavazzi – Pagano [1990]. The enduring influence of Ireland's 1987 adjustment means that it is widely revisited in academic literature and popular public discourse<sup>6</sup>. The most recent literature highlights

<sup>6</sup> Whelan [2010] – Krugman [2010].

data and methodological problems with cross country approaches based on purely statistical techniques [PEROTTI 2011 – ROMER- ROMER 2010]. The case study approach taken in this paper draws attention to the wider political economy context of the Irish fiscal adjustment. In this respect the political support for the Irish fiscal adjustment was crucial to the success.

This paper also demonstrates that there are some remarkable similarities between the economic and political environments of Britain in 1931 and Ireland in 1987. While the similarities, rather than the differences, are emphasised here, there are enough similarities to suggest that the UK experience might prove another useful case study in the circumstances under which a fiscal contraction might be expansionary.

In addition what this paper demonstrates is that the debate on the effects of fiscal policy that Giavazzi – Pagano [1990] started, and which has taken on renewed vigour during the current crisis, surfaced previously. Eighty years ago The Report of the Committee of Economists clearly identified the importance of budgetary policy on investor and consumer confidence at a time when Keynes was advocating the expansionary possibilities of a public capital programme. However, at this point in time Keynes was struggling to get his ideas on the agenda. Keynes and the Committee of Economists needed to convince their peers that the indirect confidence effects could outweigh the direct contractionary effects of policy. Giavazzi – Pagano [1990] had the opposite problem. Giavazzi – Pagano [1990] raised the question about the directional effects of fiscal policy when it was likely to get a favourable hearing and when it was sufficiently novel to promote widespread interest. History has proved that their paper is identified with the confidence effects of fiscal policy. Somewhat ironically these confidence effects are known as non-Keynesian effects. Our paper has shown that they could be known as indirect Keynesian effects.

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