Fiscal consolidation, exit strategies and budgetary institutions

David Dreyer Lassen
University of Copenhagen

Finanspolitiska Rådet, Stockholm, 3 juni

Outline

- Background: Do politics and institutions affect fiscal consolidations and exit strategies

- This paper:
- Survey of fiscal consolidation literature
- Adds to literature: Effects of fiscal transparency (and politics) on
  - Initiating fiscal consolidations
  - Exiting from large budget deficits
- Discussion of reform of budgetary institutions, with emphasis on Swedish budget rules

Causes of fiscal consolidations: The literature

- What is a fiscal consolidation? Many suggestions
  - EU (2007): Cold shower consolidation is improvement in cyclically-adjusted primary balance of at least 1.5 % of (potential) GDP in one year
- From the literature
  - Best predictor of initiating fiscal consolidation is the size of the CA-PB itself
  - More successful when based on expenditure cuts than when based on tax increases; but ”horizontal equity”
  - EMU, debt, regulation, size of adjustment …

Causes of fiscal consolidations: Fiscal Governance

Two novelties in analysis

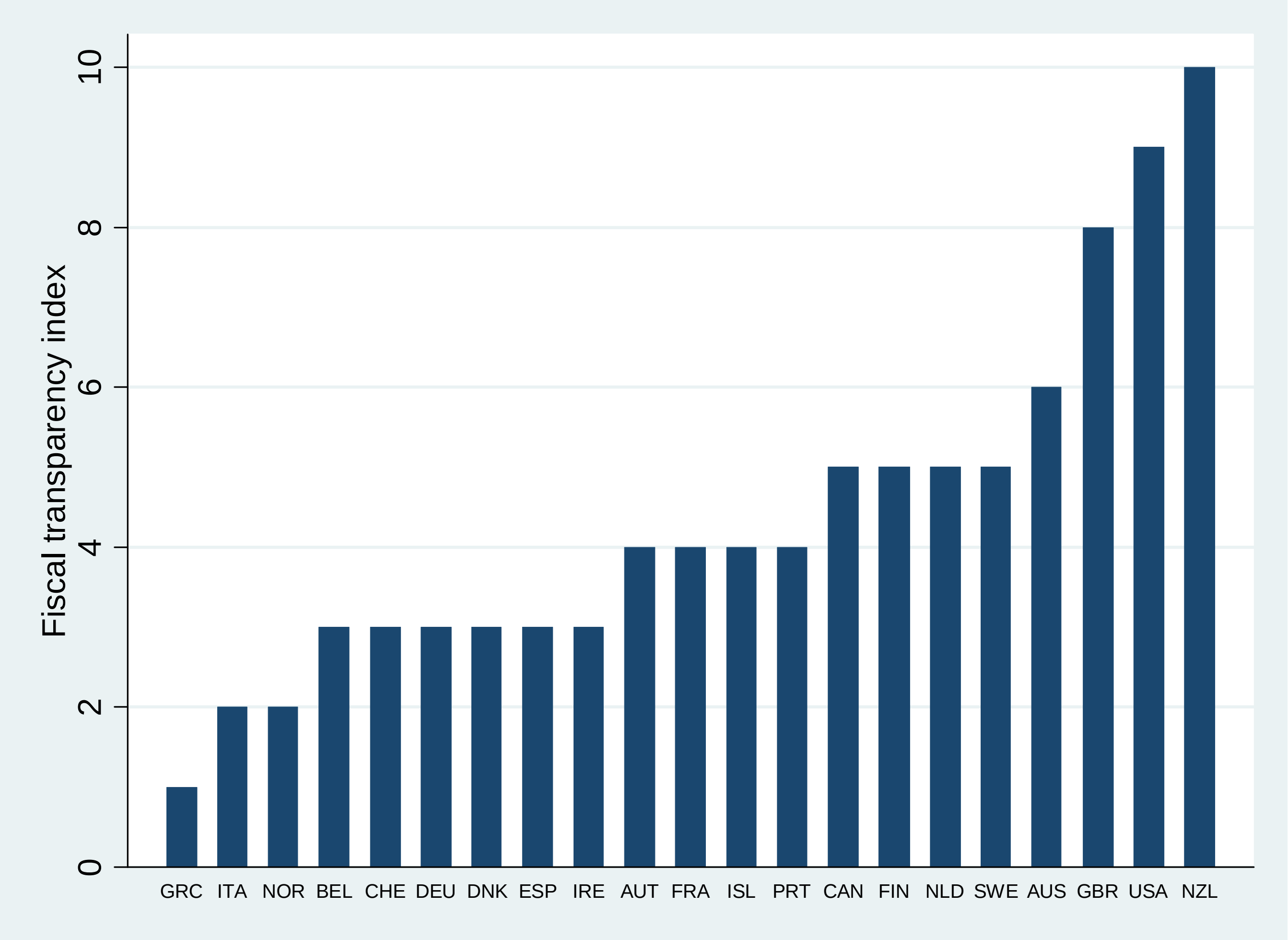
1. Distinguish effects of causes depending on initial situation; deficit creates salience among both politicians and voters. Focus on causes when running a deficit
2. Examine in detail interaction between deficit and contextual variables, incl. fiscal governnance and political environment (polarization, coalition and minority governments)

Fiscal Governance: Focus on fiscal transparency

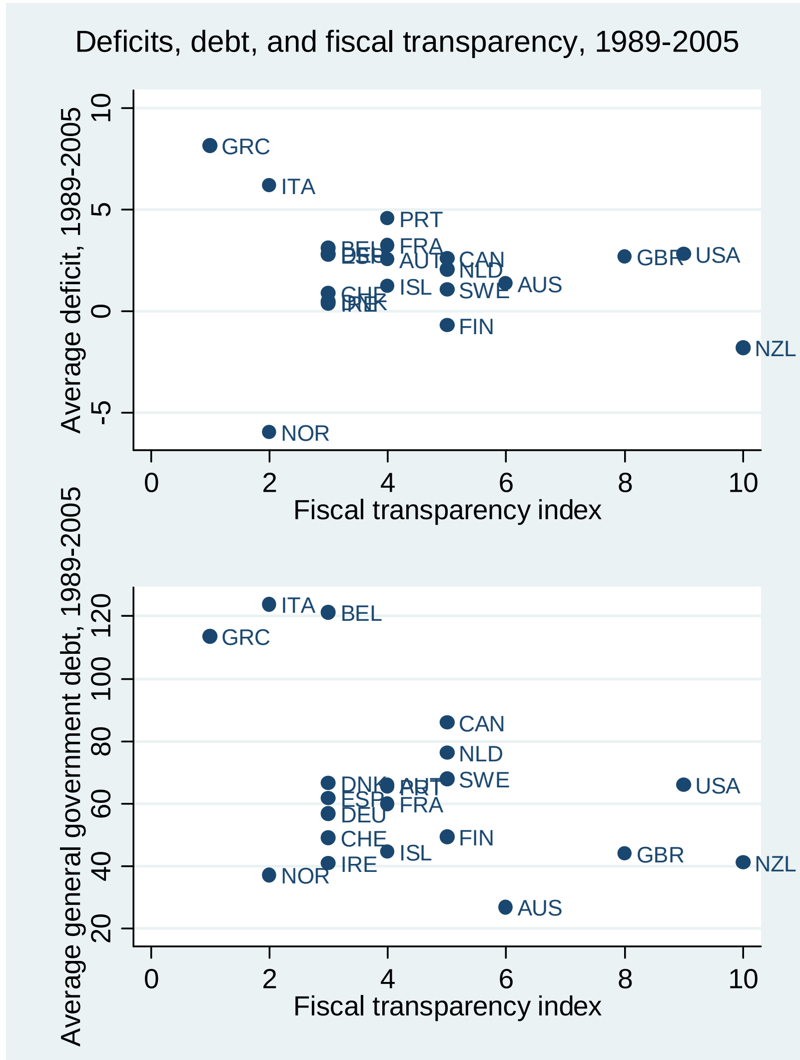
IMF: "Fiscal transparency [is] openness toward the public at large about government structure and functions, fiscal policy intentions, public sector accounts, and projections."

- I use: Alt-Lassen index of fiscal transparency (EER,AJPS)
- Based on 11 measures from OECD surveys; correlates well with other measures (von Hagen) very little change over time (but, Sweden)
- Associated with lower debt and deficits, smaller political budget cycles, less procyclicality

Fiscal transparency index



Fiscal transparency index



Fiscal consolidations and fiscal transparency

Table 2: Determinants of cold shower consolidations.

	(1)	(2)
Lagged one period:		
Cyclically adjusted deficit	0.125	0.141
	[0.055]**	[0.077]*
Output gap	-0.011	0.026
	[0.035]	[0.042]
Public sector size	0.017	0.033
	[0.013]	[0.020]*
Inflation	0.083	0.146
	[0.022]***	[0.034]***
Debt	0.007	0.011
	[0.005]	[0.006]*
Election	-0.195	-0.414
	[0.193]	[0.245]*
Fiscal transparency	**0.104**	**0.172**
	[0.068]	**[0.120]**
Fiscal transparency x ca_deficit	**0.015**	**0.027**
	[0.008]*	**[0.013]****
Year effects	Yes	Yes
Observations	283	173
Sample	**Full**	**Deficit > 0**

Who responds to fiscal crisis?

Before: consolidations across the board

Now: The response to fiscal crisis

What constitutes a fiscal crisis?

- Alesina et al. (2006): actual deficit among the 25 % highest deficits observed in sample
- Why actual deficit: Salience, formal rules
- I use: Alesina's rule (4.1 %), worst 10 % (6.7 %), > 3%

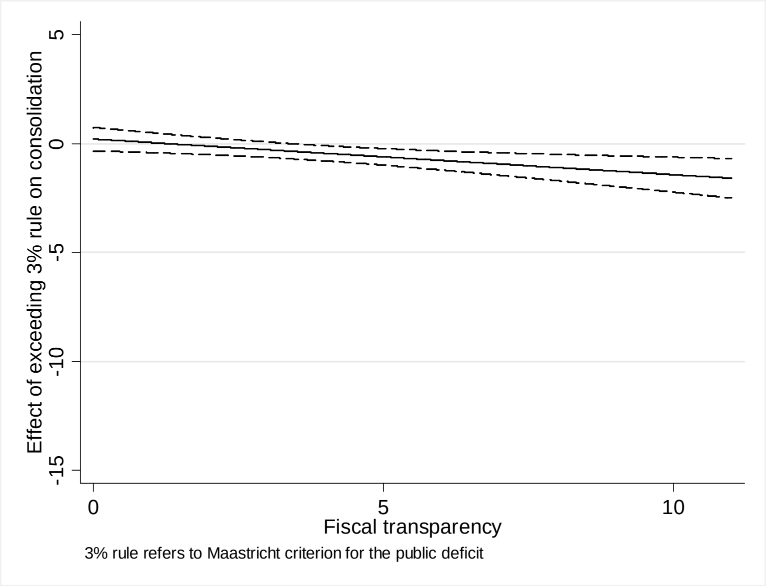
- Question: What is government deficit following a fiscal crisis, and is it affected by fiscal governance?

Transparent governments respond to fiscal crises!

Table 3: Deficit Increase from baseline year to year s, s=1,2,3,4.

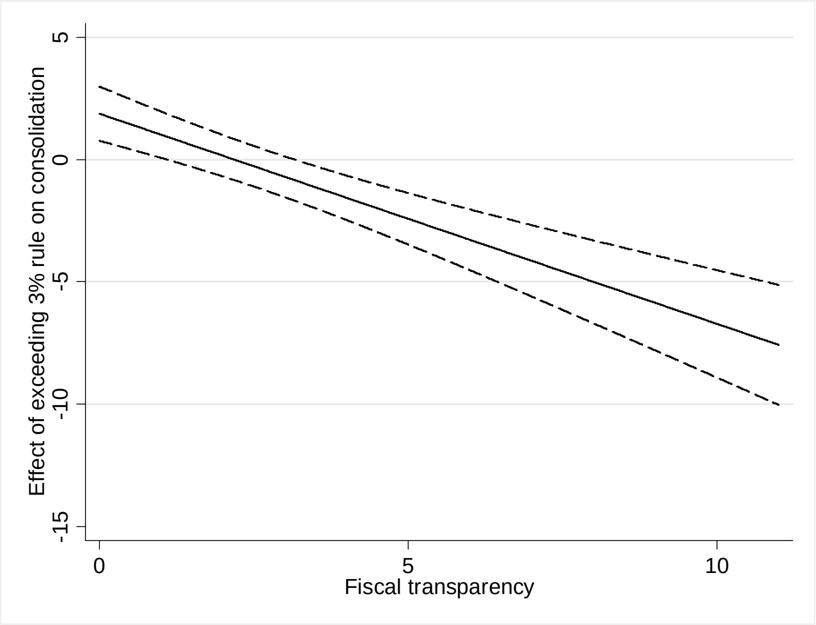
	Year 1	Year 2	Year 3	Year 4
Crisis (top 10%)	-1.621***	-2.732***	-2.975**	-2.576*
	(0.511)	(0.753)	(1.246)	(1.457)
Crisis (top 10%) x Transparency	-0.054	-0.209	-0.475*	-0.813***
	(0.078)	(0.139)	(0.236)	(0.264)
Crisis (3% deficit rule)	0.196	0.849	1.871**	2.500***
	(0.329)	(0.586)	(0.683)	(0.726)
Crisis (3% deficit rule) x Transparency	-0.164**	-0.501***	-0.860***	-1.068***
	(0.069)	(0.146)	(0.168)	(0.150)
Observations	333	312	291	270
R-squared	0.34	0.467	0.577	0.662
Number of group	21	21	21	21

Transparent governments respond to fiscal crises!



Year 1

Year 3



Intermezzo

- So far: fiscal transparency (and less political polarization) associated with

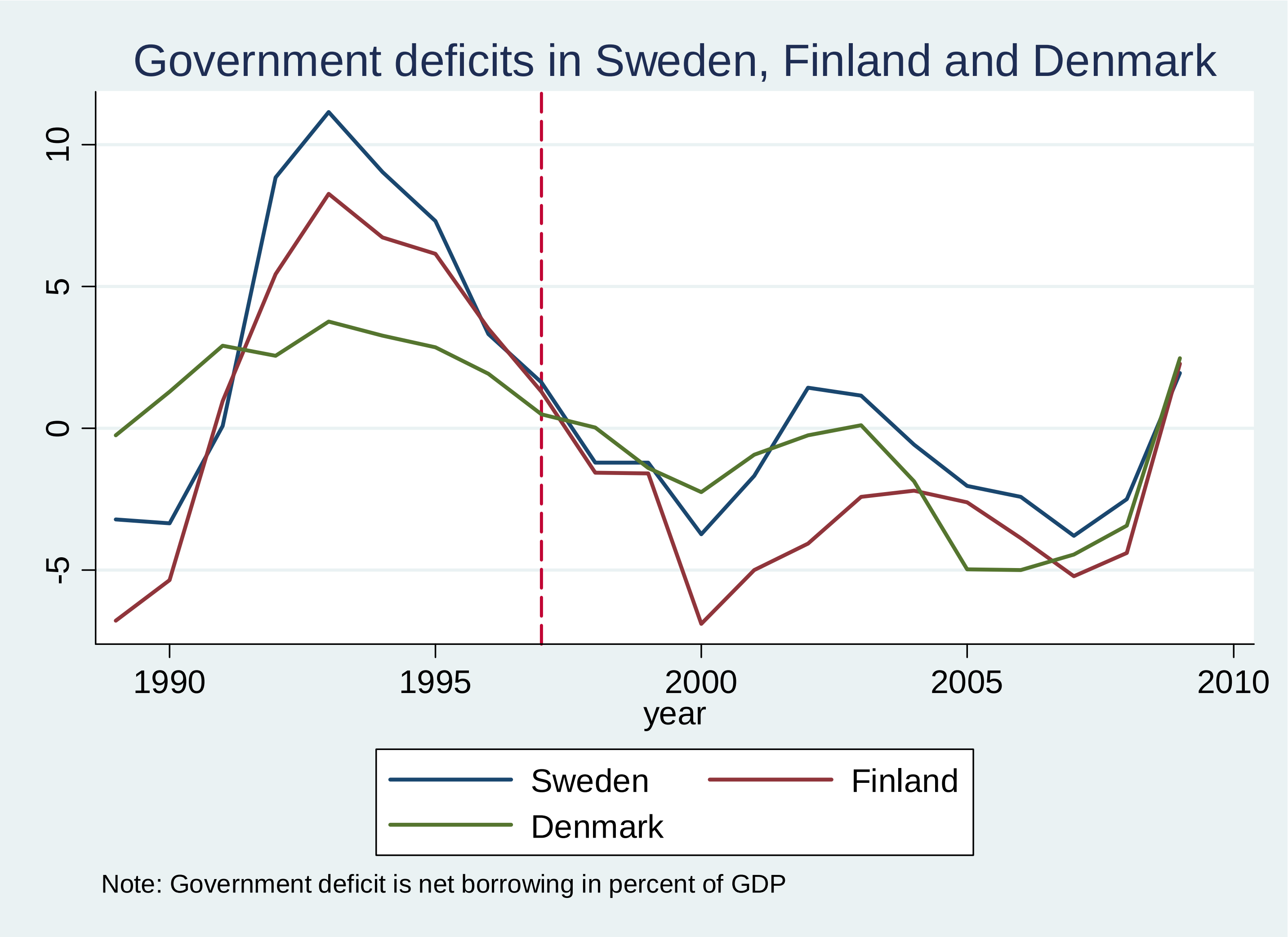
- Higher likelihood of fiscal consolidation for given level of CA-PB
- Larger response to fiscal crisis

- Does this mean that increasing fiscal transparency would improve public finances in low-transparency countries?
  - Endogeneity and incentive compatibility

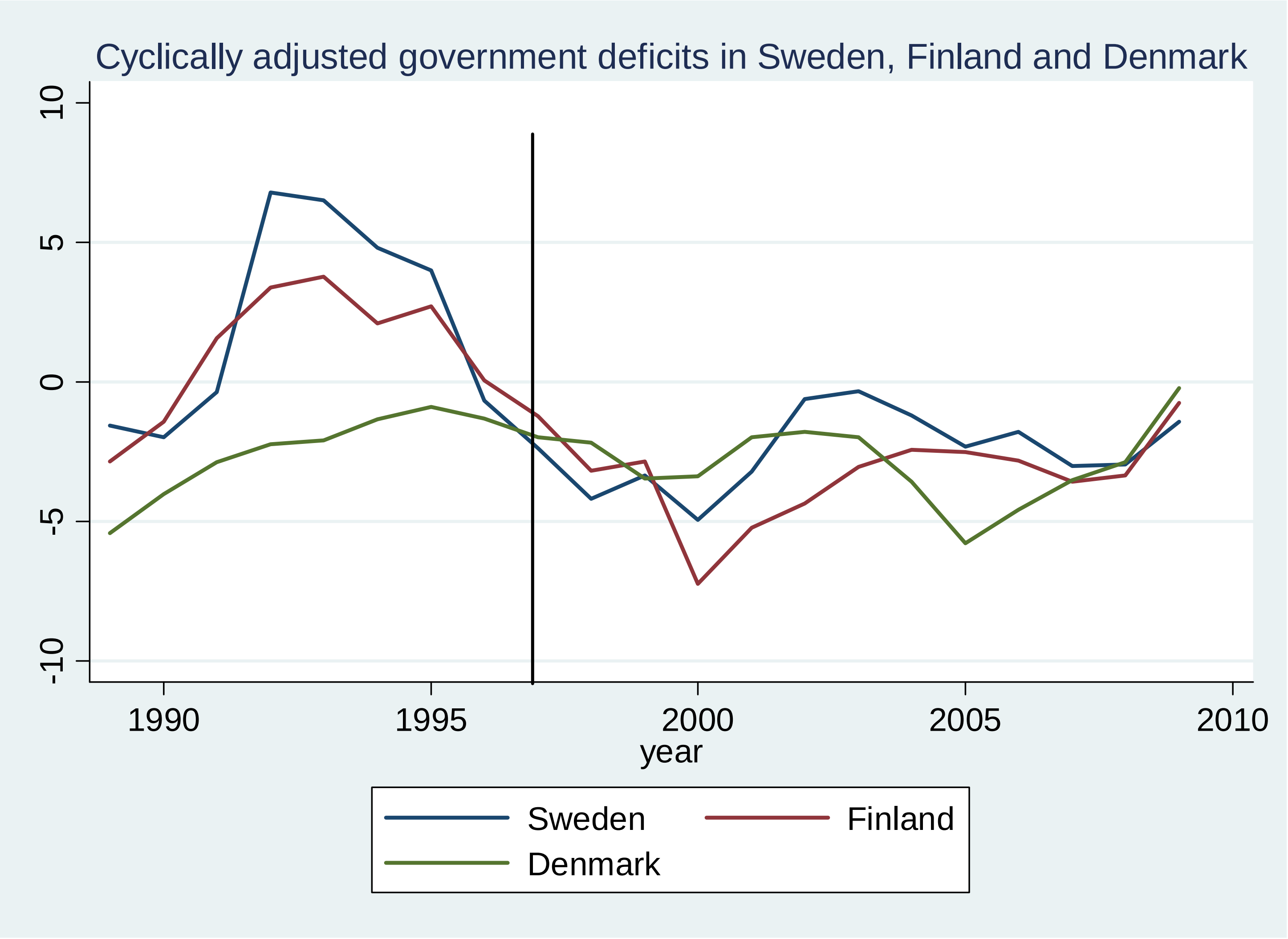
Does fiscal governance have causal effects?

- Example: Sweden
  - Sweden reformed budgetary process in 1997, public finances have been in good shape since
  - But: Fiscal crisis of early 1990s changed "culture of spending" (Hallerberg et al., 2009; Göran Persson)
  - So: which is it? New rules or new culture?
- Compare with Denmark and Finland
  - Concurrent changes?
  - Other factors??

Comparing deficits in some Nordic countries I



Comparing deficits in some Nordic countries II



Does fiscal governance have causal effects?

- Example: Sweden
  - Sweden reformed budgetary process in 1997, public finances have been in good shape since
  - But: Fiscal crisis of early 1990s changed “culture of spending” (Hallerberg et al., 2009; Göran Persson)
  - So: which is it? New rules or new culture?
- In general:
  - Fiscal crisis as predictors of institutional innovation (Alt, Lassen and Rose IMF-SP, 2006)
  - Some attempts at correcting for endogeneity (Alt and Lassen, 2006), but hard
  - Incentive compatibility?

Conclusions

- Fiscal governance and politics affect fiscal consolidations and exit strategies

- … but: Need more focus on causal effects of institutions. Quite hard.

- So far, Sweden’s performance similar to Denmark and Finland, but maybe true test is exit of current economic crisis