



Fiscal consolidation, exit strategies and budgetary institutions

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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 governance and political environment (polarization, coalition and minority governments)



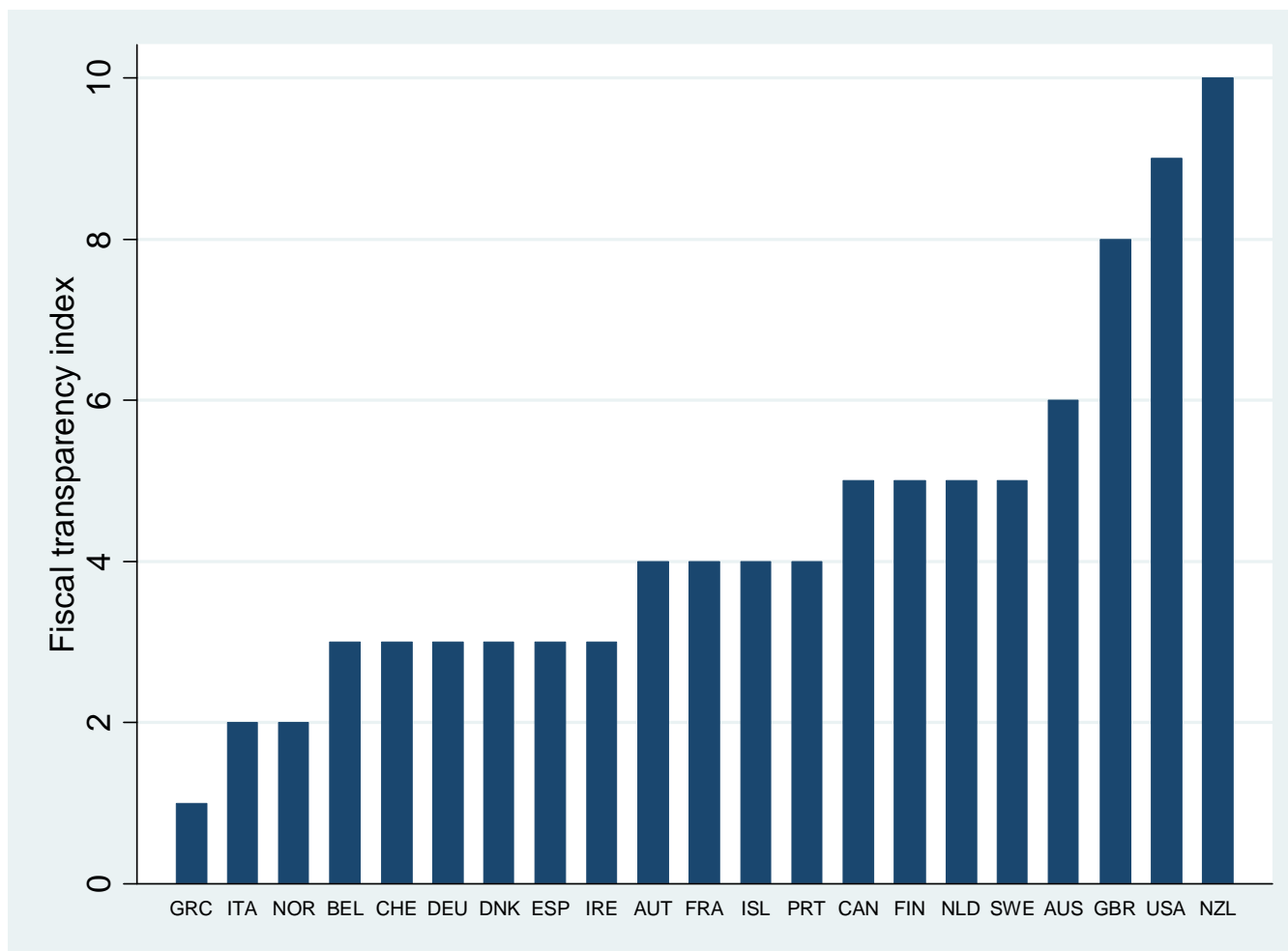
Fiscal Governance: Focus on fiscal transparency

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

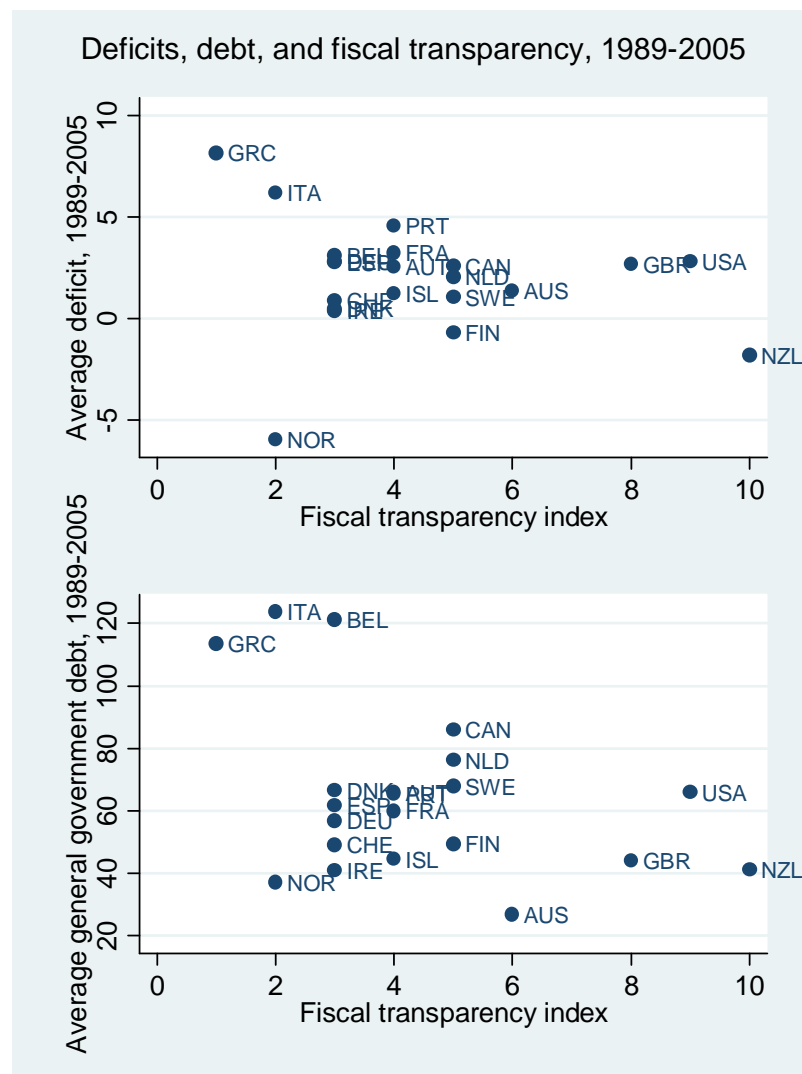
- I use: Alt-Lassen index of fiscal transparency (EER,AJPS)
- Based on 11 measures from OECD surveys; correlates well with other measures (von Hagen) very little change over time (but, Sweden)
- Associated with lower debt and deficits, smaller political budget cycles, less procyclicality



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 [0.055]**	0.141 [0.077]*
Output gap	-0.011 [0.035]	0.026 [0.042]
Public sector size	0.017 [0.013]	0.033 [0.020]*
Inflation	0.083 [0.022]***	0.146 [0.034]***
Debt	0.007 [0.005]	0.011 [0.006]*
Election	-0.195 [0.193]	-0.414 [0.245]*
Fiscal transparency	0.104 [0.068]	0.172 [0.120]
Fiscal transparency x ca_deficit	0.015 [0.008]*	0.027 [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**: Saliency, 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?



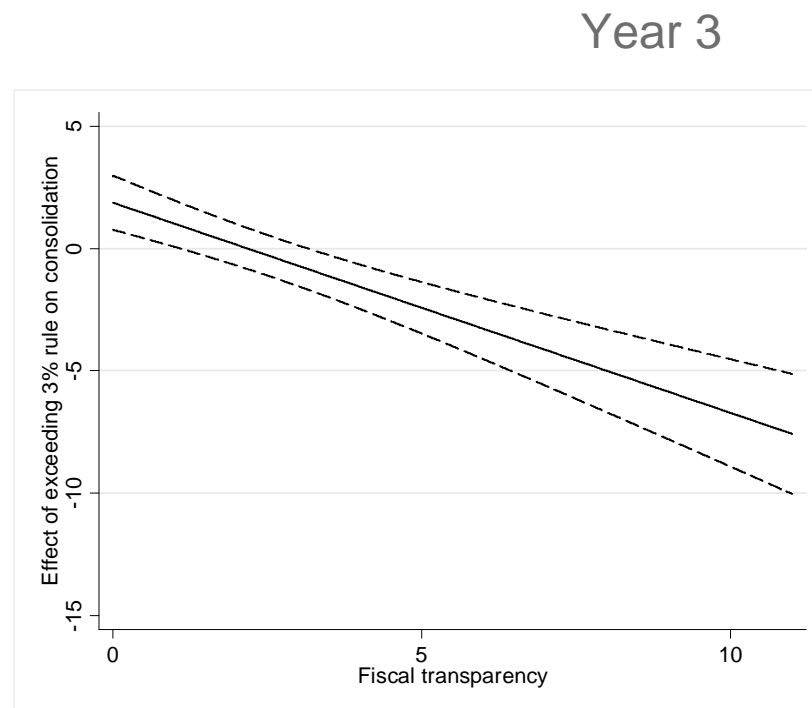
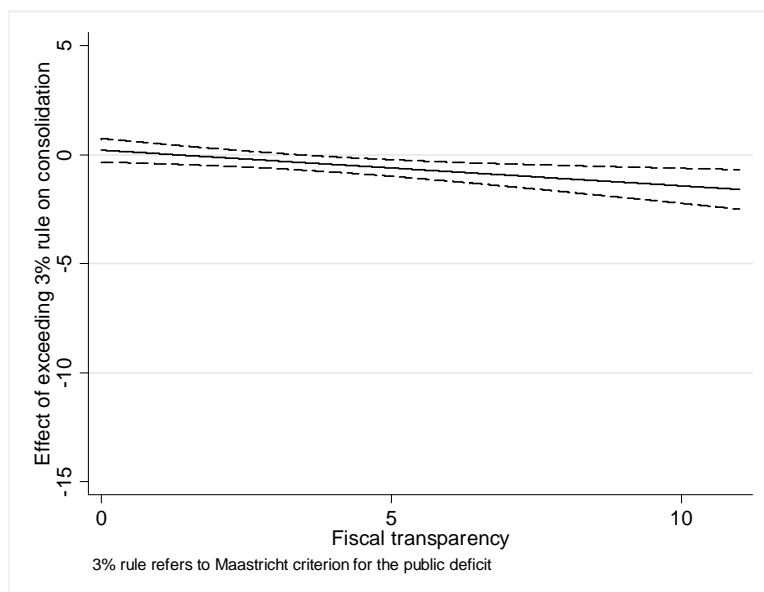
Transparent governments respond to fiscal crises!

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*** (0.511)	-2.732*** (0.753)	-2.975** (1.246)	-2.576* (1.457)
Crisis (top 10%) x Transparency	-0.054 (0.078)	-0.209 (0.139)	-0.475* (0.236)	-0.813*** (0.264)
Crisis (3% deficit rule)	0.196 (0.329)	0.849 (0.586)	1.871** (0.683)	2.500*** (0.726)
Crisis (3% deficit rule) x Transparency	-0.164** (0.069)	-0.501*** (0.146)	-0.860*** (0.168)	-1.068*** (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!



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

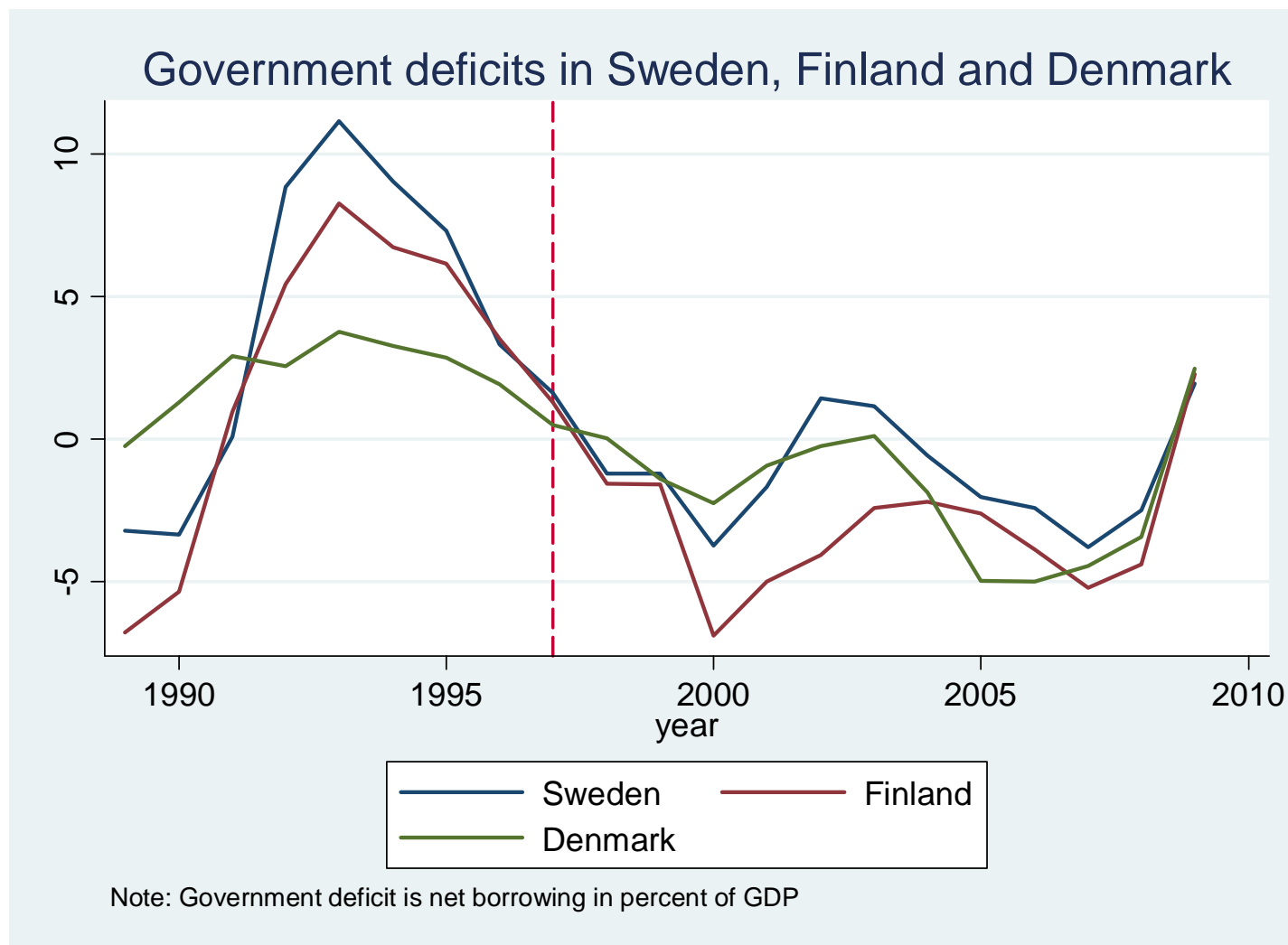


Does fiscal governance have causal effects?

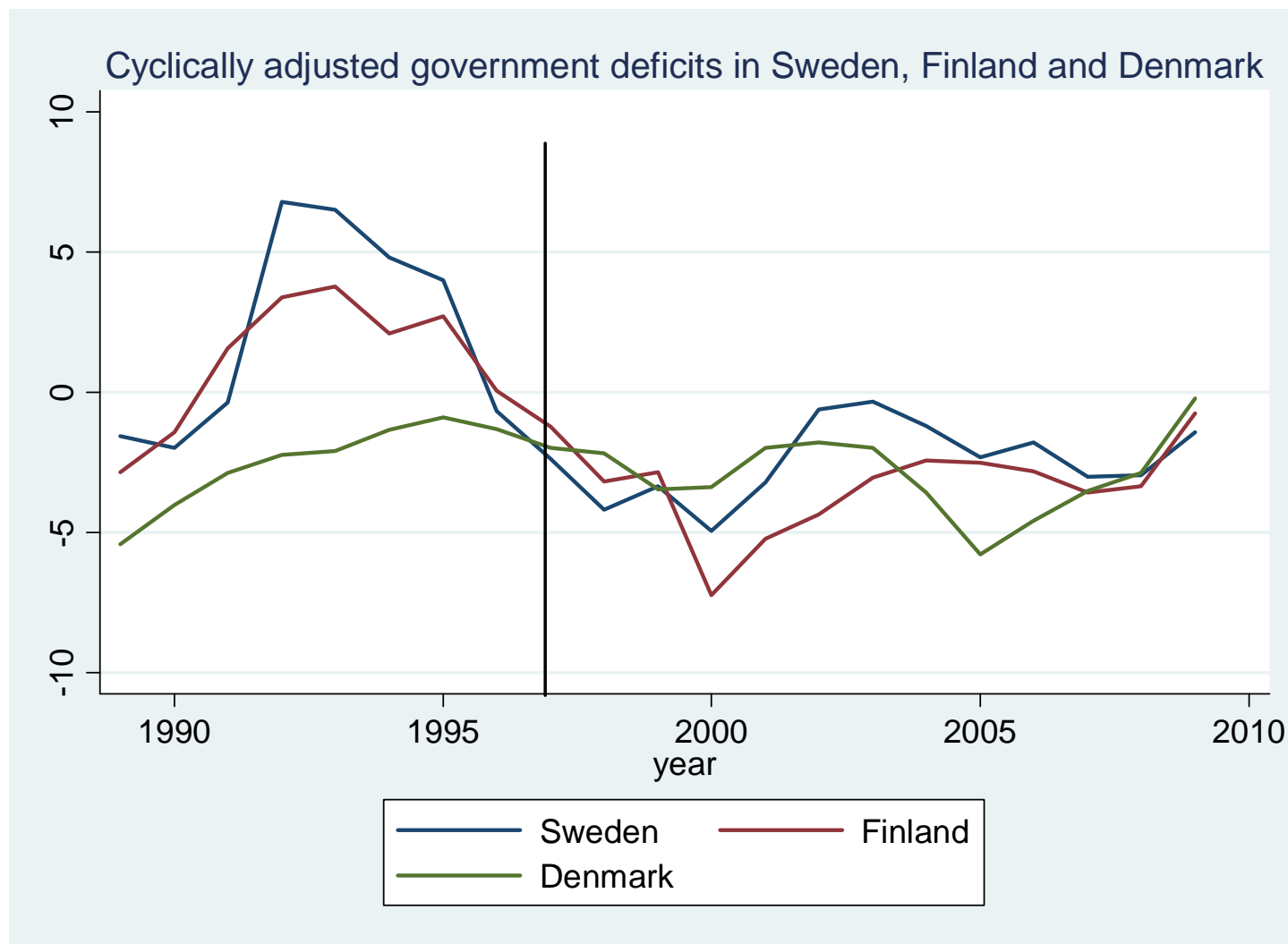
- Example: Sweden
 - Sweden reformed budgetary process in 1997, public finances have been in good shape since
 - But: Fiscal crisis of early 1990s changed “culture of spending” (Hallerberg et al., 2009; Göran Persson)
 - So: which is it? New rules or new culture?
- Compare with Denmark and Finland
 -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



Comparing deficits in some Nordic countries I



Comparing deficits in some Nordic countries II



Does fiscal governance have causal effects?

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- 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

