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Comment on:

”Fiscal Consolidations in Advanced Industrialized Democracies: Economics, Politics, and Governance”

by David Dreyer Lassen

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Contents

- A brief summary of the paper
- Some reflexions on the Swedish experience
- Some final reflexions

A brief summary of the paper

Several directions in the literature on fiscal consolidations

- Factors affecting the success of consolidations in terms of *reducing deficits in the medium term*

- Factors affecting the success of contractions in terms of *macroeconomic outcome* (“Expansionary Fiscal Contractions (EFC) hypothesis”).

- Political factors affecting:
  - the probability of initiating fiscal consolidation
  - the magnitude of the response to severe fiscal crises.

→ This paper focus on the *last* bullet point.

1. Factors affecting the probability of initiating fiscal consolidation

- "Fiscal consolidation" = a year which at least 1.5 p.p. improvement in cyclically-adjusted deficit / potential GDP (CAD)

- Empirical specification:

$$\Pr(consolidation_{it} = 1) = \Phi\begin{pmatrix} \alpha_1 CAD_{it-1} + \alpha_2 POL_{it} + \\ \alpha_3 CAD_{it-1} \times POL_{it-1} + x'\beta \end{pmatrix}$$

- *"POL" = Political variables*; Transparency, Polarization, Coalition gov., Minority gov.

- *Control variables* (**x'**)
  - Output gap
  - Public sector size
  - Inflation
  - Debt
  - Election year

1. Factors affecting the probability of initiating fiscal consolidation (cont'd)

<u>Main conclusions</u>

- Best predictor of a fiscal consolidation is (of course) the size of the lagged cyclically adjusted deficit (CAD) itself.
- Macro-variables have no or minor explanatory power
- *Fiscal transparency* increase, and *Political polarization* decrease, the likelihood of initiating fiscal consolidations.
- Coalition and minority governments have no/minor effects.

→ **In sum**, *lagged CAD*, *transparency* and *polarization* explain why fiscal consolidation takes place.

1. Factors affecting the probability of initiating fiscal consolidation (cont'd)

- *Is there other possible factors worth testing* for explaining the initiation of fiscal consolidations?
  - Lagged *increase* in the CAD and debt
    - The greater increase in CAD, debt, the higher probability of consolidation?
  - CAD-level compared to an average of "similar" countries (OECD, EU)
    - The greater CAD compared to others, the higher probability of consolidation?
  - Expected growth t+1, t+2
    - The greater growth expectations, the higher probability of consolidation?
  - *Real time* output gap, i.e. the gap known at the time of the contraction
    - The greater gap, the higher probability of consolidation?

2. Factors affecting the response to severe fiscal crises

- "CRISIS" = top 10% (25%) of the empirical distribution of deficits

- *Empirical question*: how do actual deficit-to-GDP ratio change 1, 2, 3 and 4 years after a "fiscal crisis"

$$\Delta_s deficit_{it} = \delta_0 + \delta_1 CRISIS_{it} + \delta_2 CRISIS_{it} \times POL_i + \alpha_i + \nu_t + \varepsilon_{it}$$

- **Main results**: Again,
  - *Transparency* most important,
  - *Polarization* less important
  - *Macro-variables* not important

2. Factors affecting the response to severe fiscal crises (cont'd)

- Remember, dependent variable:
  - change in **Actual** Deficit / **Actual** GDP

- Crucial need to control for other factors driving **actual** GDP (and thereby **actual** deficit through automatic stabilizers) during the period considered

  - World demand (export) growth
  - Real exchange rates
  - Monetary policy stance

- Also, control for the initial *deficit*-to-GDP ratio as well as initial *debt*-to-GDP ratio matters for the change in deficit-to-GDP ratio.

Summing up the empirics:
Transparency – the (new) golden rule for fiscal policy(?)

Transparency empirically associated with:

- More likely (when needed) to engage in fiscal consolidation
- Quicker response to fiscal crises
- Lower debt level on average
- Lower borrowing costs
- Less electoral cycles
- Less pro-cyclical fiscal policy

→ As for monetary policy, transparency is a win-win situation.

Some reflexions on the Swedish experience

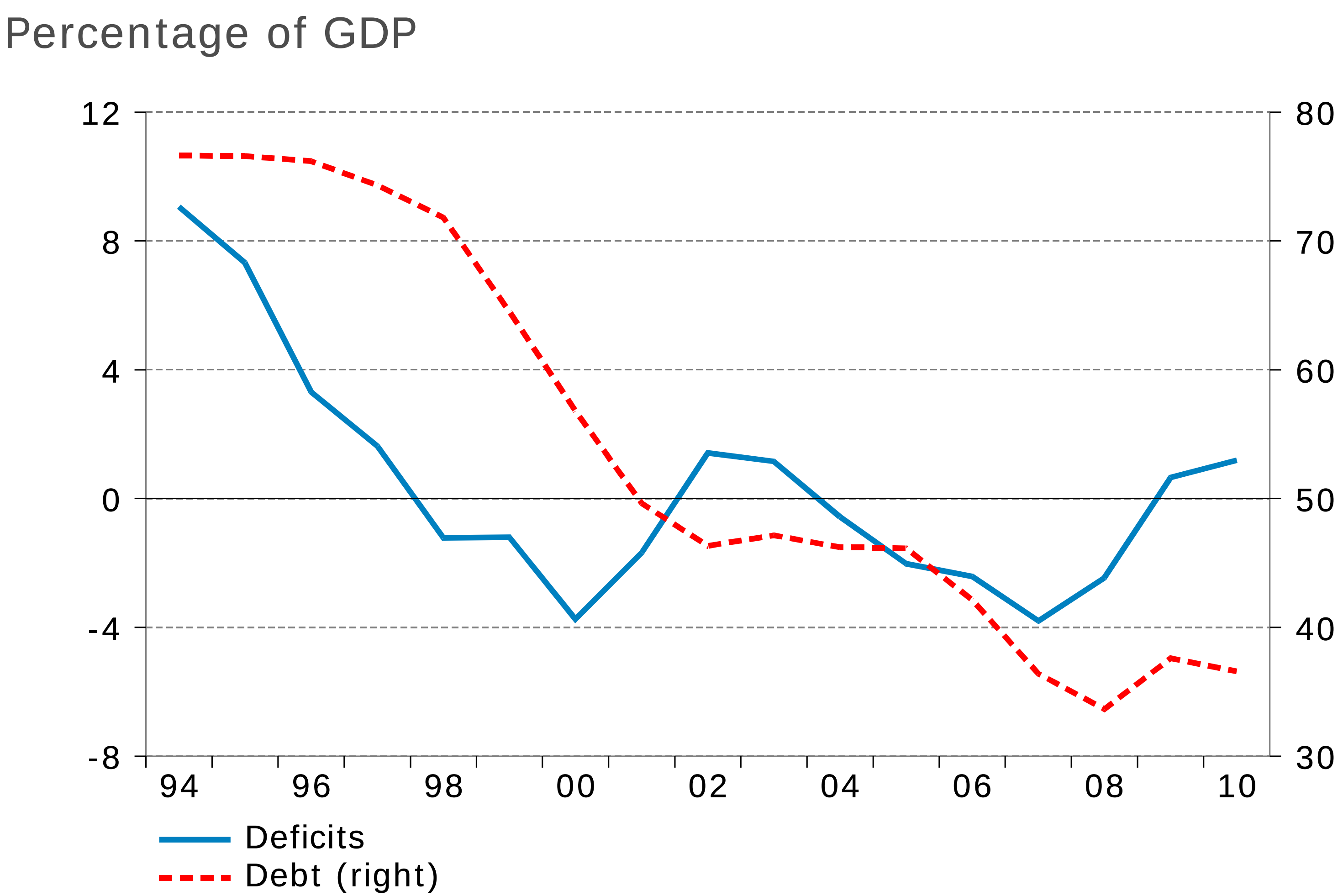
Twin-success of the Swedish consolidation in the 1990s (my view)

1. Long-lasting effects on debt and deficits

2. Strong macroeconomic development during the consolidation period

Twin-success of the Swedish consolidation in the 1990s (cont'd)

1. Long-lasting effects on debt and deficits



Twin-success of the Swedish consolidation in the 1990s (cont'd)

1. Long-lasting effects on debt and deficits – *causes*:

- *Size-effect*: Widespread sense of a major crisis
  → agreement on the value of a strong fiscal position.
- *Left-wing government* → acceptance for expenditure cuts.

Explanation for **short-term** effects

- *More and more Fiscal rules 1997-*: Expenditure ceilings, Surplus rule, Budget balance rules on local governments, Fiscal policy council
  - Improved *evaluation* and *transparency*
  - No political *polarization* on these rules
- *Focus on expenditure cuts* compared to tax increases.
- *The 90s-crisis in memory*, still an issue in public debates

Explanation for **long-term** effects

Twin-success of the Swedish consolidation in the 1990s (cont'd)

2. Strong macroeconomic development 1994-2000

- Average growth 1994-2000: **3,5%**
- Average growth 1980-2010: 2,0%

- Change in unemployment 1994-2000: **-5,5 p.p**.

Twin-success of the Swedish consolidation in the 1990s (cont’d)

2. Strong macroeconomic development 1994-2000

→ non-Keynesian effects? **No! Mainly luck…**

…i.e. *exogenous* explanations (in my view)

- Real depreciation of about 30%
- Strong world demand
- World demand bias toward ICT-related products (Ericsson…)

Perhaps some *endogenous* explanations

- Focus on cut in expenditures
- Credible consolidation
  - Left-wing government
  - Cooperation with the centre party which belongs to the “right-wing block”

Some final reflexions

- Is *Transparency* the hen or the egg? How to get a strong long-lasting fiscal position?
  - *Fiscal rules*

    → *Independent evaluations* (SGP/Fiscal Councils)

    → *Transparency* a natural <u>consequence</u> of *rules* and *evaluations*

- So, the **explanations** for consolidations in the near future in many EU-countries is not “transparency” in itself but rather
  - *High lagged deficit*
  - The existence of *Fiscal Rules* and *Evaluation* (*SGP)*

  → *Transparency* will make consolidation more effective.

Finally, are we lucky so that today's high deficit countries are the most transparent ones? Unfortunately, no.