Comment on:

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

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Discussant:

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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 focuses 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:

  \[
  \Pr(\text{consolidation}_{it} = 1) = \Phi\left( \alpha_1 \text{CAD}_{it-1} + \alpha_2 \text{POL}_{it} + \alpha_3 \text{CAD}_{it-1} \times \text{POL}_{it-1} + x' \beta \right)
  \]

- “POL” = Political variables; Transparency, Polarization, Coalition gov., Minority gov.

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

• 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”

\[ \Delta s_{\text{deficit}}_{it} = \delta_0 + \delta_1 s_{\text{CRISIS}}_{it} + \delta_2 s_{\text{CRISIS}}_{it} \times POL_i + \alpha_i + \nu_t + \varepsilon_{it} \]

- **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

Percentage of GDP

Deficits
Debt (right)
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.

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


- Average growth 1994-2000: \textbf{3.5}\%  
- Average growth 1980-2010: 2.0\% 
- Change in unemployment 1994-2000: \textbf{-5.5 p.p.}
Twin-success of the Swedish consolidation in the 1990s (cont’d)

   → 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 *consequence* 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.