Comment on:

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

by David Dreyer Lassen





















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Discussant:

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)

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"

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

- 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)

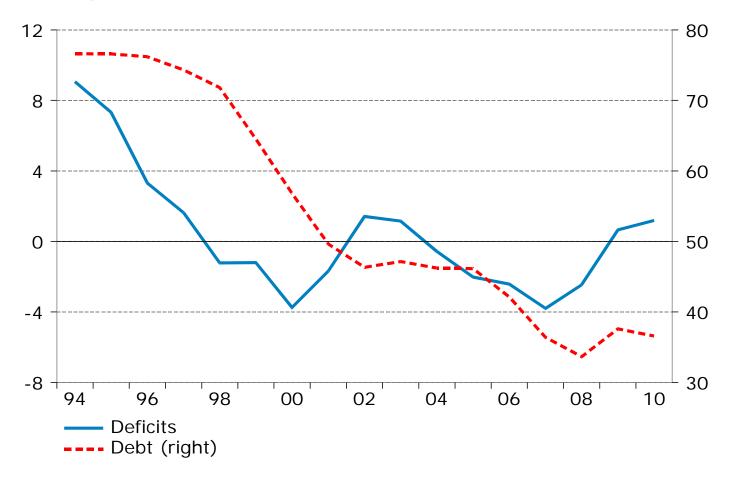
1. Long-lasting effects on debt and deficits

2. Strong macroeconomic development during the consolidation period



1. Long-lasting effects on debt and deficits

Percentage of GDP

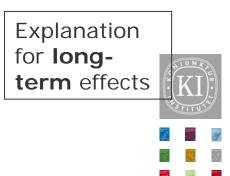




- 1. Long-lasting effects on debt and deficits causes:
- Size-effect: Widespread sense of a major crisis
 → agreement on the value of a strong fiscal position.
- Left-wing government → acceptance for expenditure cuts.

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



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.



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 longlasting 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.

