SWEDISH ECONOMIC POLICY REVIEW 3 (1996) 135–138

Comment on Alberto Alesina and Roberto Perotti: Reducing Budget Deficits

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This paper is a comprehensive "event study" that tries to identify all major attempts of reducing budget deficits in the OECD economies since 1960. Even though I shall have to put on the hat of critical discussant, I would like to start by saying that I do find the paper very interesting. It obviously deals with an important issue and it provides a fresh look at the data. The main results should indeed be of direct interest to policymakers. They seem to suggest that successful fiscal adjustments, (a) rely on spending cuts rather than tax increases, and (b) do not entail major costs in the form of lost output or employment. In this brief comment, I will first point to a qualification: an alternative interpretation of the main results. I will also say a few words about the implications. Assuming that the results are correct, is it likely that any government can use the insights of the paper to design and carry out a successful fiscal adjustment program?

1. Qualifications

The authors' methodology starts by identifying what they call a "very tight fiscal stance": a year when the primary deficit (adjusted for unemployment effects) improves by more than 1.5 per cent of GDP. If followed by a large enough fall in the debt to GDP ratio three years later, such an event is labelled a "successful fiscal adjustment". For the results to

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be interpreted in the way favored by the authors, it is critical that their measure of very tight fiscal stance reflects *planned* fiscal adjustments, rather than other exogenous events. How convincing is their measure in this regard?

Clearly, a number of events – other than planned fiscal policy – could move the primary deficit enough to generate an apparent fiscal adjustment, as defined by the authors. For example, a rise in the inflation rate combined with a progressive non-indexed tax system, or a drop in the savings rate combined with a high VAT rate, could boost tax revenue substantially.[1] Some of the registrated very tight fiscal stances are thus likely to be misclassifications.

I would like to focus on a specific source of misclassification that is potentially more serious, however, in that it may bias the results in the direction of the authors' main findings. The authors measure the improvement in the deficit *relative to GDP*. For most OECD countries it is probably the case that tax revenue and government expenditures on goods and services tend to grow roughly at the same rate as GDP, in the absence of discretionary fiscal policy. For some transfer payments, controlling for the unemployment rate, as the authors do, is likely to pick up important cyclical effects. A difficulty arises with certain transfer payments, however, namely those entitlements that are likely to grow in proportion to the *past* trend in GDP rather than in proportion to current growth. The clearest such case is pensions, one of the largest – and fastest growing – budget items in virtually all the OECD countries. The authors do control for a deterministic trend in the ratio of transfers to GDP. But they do not control for changes in this ratio caused by GDP-shocks that are "permanent", in the sense that they shift future predicted GDP above its previous trend line.[2]

Now suppose that a country is hit by an exogenous shock that raises its GDP growth. Suppose also that the shock is permanent. What will we observe? When the shock occurs, we will observe a falling ratio of transfers to GDP, which – if the shock is strong enough – may be classified as

[1] Such events are indeed likely to have contributed to the tight fiscal stances registrated for Sweden in the mid-eighties. A clear indication that the improvements in the Swedish budgetary situation in 1984 and 1987 (two of the events classified as very tight fiscal stances by Alesina and Perotti) were not really the result of planned fiscal adjustments, is the difference between planned and actual budget outcomes displayed in M. Persson (1996).

[2] We know from the recent research on "unit roots" that shocks to GDP often have this property, which is often referred to as a *stochastic* trend. See, for example, Stock and Watson (1988).

a very tight fiscal stance. Moreover, the permanent rise in GDP above previous trend will make the cut in transfers to GDP permanent as well. *Ceteris paribus* this will tend to make the apparent fiscal adjustment successful. Finally, the permanent nature of the shock will mean that macroeconomic developments after the classified fiscal adjustment will not look unfavorable.

Thus, exogenous and permanent GDP shocks may cause successful fiscal adjustments (in Alesina and Perotti's sense) that are (a) characterized by cuts in transfer payments and (b) not followed by bad macroeconomic outcomes. That is, such shocks may create a pattern in the data that is consistent with the authors' main results, but where the causality runs in the opposite direction. The authors do acknowledge this possibility. But to settle this issue of causality, one has to go beyond the methodology of the present paper. One way would be to make detailed case studies of specific countries and time periods. Another would be to use statistical causality tests, which would require estimating time series models for the relevant budget items and for GDP.

2. Implications

Suppose we ignore the qualifications above and trust the main results. The message to a government in fiscal trouble then seems simple enough: "Make a significant cut in public transfers and government wages; this will increase the chances of a sustained fiscal improvement and decrease the chances of a macroeconomic backlash".

An interesting question is whether any governments can carry out such a policy program or whether specific requirements are needed for success. When it comes to the *political* requirements, recent theoretical work on the political economy of budget deficits suggests that certain political conditions are more conducive to sustained budget problems than others.[3] Interestingly, Alesina and Perotti briefly refer to results published elsewhere that are constant with theory and earlier empirical findings: coalition governments never succeed in implementing successful fiscal adjustments whereas unified governments do.

Let me end by a speculation on the *institutional* requirements. Recent research has also pointed to the importance of the budget process for im-

[3] See Alesina and Perotti (1995) for a comprehensive survey.

posing fiscal discipline. This suggests that governments who have access to a stringent budgetary process will have a much greater chance of success in their attempts to carry out drastic fiscal adjustments. Let me exploit the right of the discussant to "throw out some quick and dirty numbers" to shed some preliminary light on this conjecture. Combining the well-known study by von Hagen (1992) and the update on Sweden by Molander (1992), we find that the three European countries with the strongest budget process are France, the UK and Germany, whereas the three countries with the weakest budget process are Italy, Sweden and Greece. From Table 2.1 in Alesina and Perotti's paper, we can compute the "success rate" for these six countries in their fiscal adjustments – that is, the ratio of successful adjustments to very tight fiscal stances. Among the strong budget process countries, this ratio is 1/1 for France, 3/3 for the UK, and 0/4 for Germany. And among the weak budget process countries, it is 0/6 for Italy, 2/5 for Sweden[4], and 0/6 for Greece. To me, the fit looks good enough to warrant a further exploration of the conjecture.

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[4] The successful Swedish adjustments in the mid-eighties did not really turn out to be sustainable, though, which Swedes are painfully aware of.