COMMENTS ON SESSION 4
PUBLIC EXPENDITURE CONTROL

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According to the agreed division of labour among discussants, I will focus my comments on the paper by Fabrizio Balassone, Maura Francese and Stefania Zotteri, and the paper by Alfonso Arpaia and Alessandro Turrini. I found both papers and also the presentations very stimulating and well founded.

The two papers deal with quite different, almost contrary aspects of public expenditure policy: The paper by Balassone, Francese and Zotteri focuses on short-term aspects, namely the behaviour of fiscal policy in different cyclical states of the economy. The paper by Arpaia and Turrin,i instead, abstracts from cyclical fluctuations and concentrates on the relationship between cyclically-adjusted primary expenditure and potential growth. Therefore, I will deal with both papers separately.

1 Discussion of "Cyclical Asymmetry in Fiscal Variables" by Fabrizio Balassone, Maura Francese and Stefania Zotteri

The findings of this paper are especially relevant in the current situation where many countries have to guard against fiscal complacency. In my view it is important to show that often lax fiscal policies in good times are at the root of fiscal problems in the longer term. I begin with a brief discussion of the results, followed by some words on the policy implications and, finally, two questions.

The paper builds upon an earlier paper by some of the authors (Balassone and Francese, 2004). The main result of that earlier paper was that budget balances tend to deteriorate in contractions but do not improve symmetrically in expansions. Building upon these findings the primary objective of the presented paper is to identify the budget items responsible for this asymmetric behaviour of fiscal policy in good times and bad times.

The authors first confirm the results of the earlier paper concerning the primary budget balance: in good times the coefficient for the output gap is not significantly different from 0, while in bad times – that means whenever there is a negative output gap – it is –0.4. This means that the primary budget balance does not improve when the output gap rises, but it deteriorates when the output gap falls. The coefficients capture both the effect of automatic stabilisers and of discretionary policy related to the cycle. The authors therefore conclude that discretionary fiscal policy systematically offsets automatic stabilisers in good times.

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Analysing which revenue or expenditure items are responsible for this result, they find that the expenditure side, especially cash transfers, is the driving factor. The revenue ratio, instead, does not change much in good or in bad times. The explanation offered by the authors is that discretionary spending increases in bad times but becomes entrenched thereafter. So discretionary action in bad times – which is not undone in good times – would be responsible for the asymmetry.

However, looking at the data a different explanation would also be possible in my view. In fact, looking at table 6, the coefficient for cash transfers in bad times is almost –0.3. This means that the ratio of cash transfers to GDP increases by around 0.3 percentage points if the output gap deteriorates by one percentage point. As the ratio of cash transfers to GDP increases in downturns because of the denominator effect and cash transfers moreover include the highly cyclical unemployment benefits, this is roughly in line with what I would expect from automatic stabilisers. In good times, however, the coefficient for cash transfers is close to zero. In my view, this implies that discretionary policy offsets automatic stabilisers in good times by increasing cash transfers. This interpretation of the results would also be more in line with the conclusion drawn for the overall balance that discretionary fiscal policy systematically offsets automatic stabiliser in good times. The results confirm the general feeling that lax fiscal policies in good times are at the root of fiscal problems in the subsequent downturn.

In terms of the stabilisation function of fiscal policy it is interesting to note that the ratios to GDP of the other expenditure items besides cash transfers seem hardly to react to cyclical conditions. While this behaviour is symmetric it also implies a procyclical policy stance as automatic stabilisers are undone by discretionary policy in good and bad times.

Turning to the impact of fiscal rules the authors find no evidence that the introduction of European fiscal rules in 1992 changed the asymmetry of fiscal policy. This might be not so surprising as the initial rules focused on upper limits for unadjusted deficits. Only with the adoption of the Stability and Growth Pact and the introduction of medium-term objectives defined in cyclically-adjusted terms a first step towards a more symmetric fiscal policy was introduced. However, a look at fiscal policy in the expansion around the turn of the century reveals that the asymmetric behaviour might not have changed much with the SGP. Actually, it was one of the objectives of the 2005 reform of the Stability and Growth Pact to tackle pro-cyclical policy in good times. It will therefore be interesting to rerun the exercise in a couple of years possibly focusing on euro area countries only instead of EU-14. This way it could be check whether the new rules have indeed been able to reduce the cyclical asymmetry of fiscal policy.

In my view, the paper tackles an important question for the design of fiscal rules. If we know which budget items are driving the asymmetric behaviour of fiscal policy it could be easier to detect the underlying reasons. As possible candidates for these reasons the authors mention political economy reasons, mistakes in assessing cyclical conditions or unemployment persistence. Knowing the source of the problem would in turn make it easier to develop fiscal institutions to counteract the

asymmetric behaviour. In this respect it would be interesting to see what components of the cash transfers are responsible for the results. After all cash transfers are a rather broad category, including anything from unemployment benefits and pensions to child benefits.

The authors recommend an expenditure rule as a complement to a deficit rule. While I tend to agree with this conclusion it could be a second best solution as it cures a symptom – asymmetric expenditure policy – but not necessarily the underlying cause. This bears the danger that the disease pops up at a different place (revenue side, creative accounting), as discussed yesterday and this morning in Wierts' presentation.

Let me conclude my comments on this interesting and stimulating paper with two questions: As fiscal policy is not symmetric over the cycle, the cycle itself might become asymmetric taking into account short-run growth effects of fiscal policy. Were these possible feedback effects from asymmetric fiscal policy on the cycle taken into account? As mentioned by the authors themselves, in the literature different definitions of good times are used. Have you checked whether the results change, if defining good times as years with growth above potential instead of years with a positive output gap would change the results?

2 Discussion of "Government Expenditure and Economic Growth in the EU: Long-run Tendencies and Short-term Adjustment" by Alfonso Arpaia and Alessandro Turrini

The paper by Alfonso Arpaia and Alessandro Turrini, which I also enjoyed reading very much, analyses the long- and short-run relation between cyclically-adjusted primary expenditure and potential output in EU countries.

Compared to the existing literature on the link between potential GDP and expenditure, the authors employ more sophisticated econometric techniques. Moreover, by using cyclically-adjusted data, the authors hope to contain the issue of reverse causality. They claim that the impact of government expenditure on GDP is mostly cyclical, so that no impact of cyclically-adjusted primary expenditure on potential growth is to be expected and the relationship can be interpreted as expenditure adjusting to potential GDP and not vice versa. I am not fully convinced that using cyclically-adjusted data fully solves the problem of reverse causality. After all, higher cyclically-adjusted expenditure ratios should lead to either higher revenue ratios which might have negative feedback effects on potential growth via increased distortions or to higher deficits and debt which also could be detrimental to potential growth.

Concerning the long-run relationship between cyclically-adjusted expenditure and potential GDP, the authors find that Wagner's law does not hold for the data set considered, as the long-run elasticity is slightly below one. Having read the previous paper, I was surprised by this result. The asymmetric behaviour of fiscal policy over the cycle seems to imply a ratcheting up of the expenditure ratio over time.

Therefore, I initially expected to see a long-run elasticity of above one. Indeed, looking at the sub-periods of 1970 to 1989 and 1990 to 2003 in Table 6 of the paper, this is actually the case. What puzzled me was that only for the whole period the long-run elasticity is slightly below one, but not for the individual sub-periods.

Concerning the short-run elasticity, the interpretation was not clear cut to me. The authors find an average adjustment time to the long-run relationship of three years and interpret this as the time fiscal authorities need to adjust public expenditure to a change in potential output. However, potential output usually does change abruptly and therefore it is not easy to understand why some countries need a number of years for relatively minor adjustments of cyclically-adjusted expenditure to the long-run relationship. A possible explanation could be real-time misperceptions of "true" potential GDP. Another possibility would be that discretionary fiscal policy itself is responsible for temporary deviations from the long-run relationship.

Concerning the policy conclusions drawn by the authors I first want to point out that I agree with many of them. Nevertheless, the high variability of the long-term elasticity over time and the high dispersion of the short-term elasticity over countries in my view make it advisable to be cautious with respect to lessons to be learned for the future. In particular, I would be cautious with regard to implications of the evidence on the speed of adjustment of expenditure for budgetary surveillance in the EU context. First, the adjustment speed observed in the past might neither be the maximum feasible nor the desirable speed for a country in excessive deficit. For the same reason the finding of large differences in adjustment speed between countries in my view is not sufficient to argue for country-specific adjustment efforts. Second, countries need not necessarily rely only on the expenditure side for the necessary fiscal adjustment. At least countries with lower revenue ratios could also resort to revenue increases.

Let me close by pointing out that the paper by Arpaia and Turrini is, in my view, an important contribution to the literature on the relationship between government expenditure and growth. An interesting question that remains to be answered by future research is what drove the observed reduction in the long-run elasticity. Is Wagner's law really not valid any longer? Or do governments still increase their impact on economic activity, but this does not show up in public expenditure as they increasingly rely on regulation and outsourcing of production to the private sector? Analysing developments for individual expenditure items as in the first paper might give first indications in this respect.