COMMENTS ON SESSION 2
FISCAL CONSOLIDATION

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1 Comments on "What Affects Fiscal Consolidations? – Some Evidence from OECD Countries" by Stéphanie Guichard, Michael Kennedy, Eckhard Wurzel and Christophe André and "Fiscal Adjustments: Determinants and Macroeconomic Consequences" by Manmohan S. Kumar, Daniel Leigh and Alexander Plekhanov

This contribution very briefly summarizes the papers presented in Session 2, which all deal with fiscal consolidations, before discussing the topic of successful fiscal consolidations and specifically commenting on the two papers presented by Eckhard Wurzel and Daniel Leigh. These two papers try to identify, in an OECD context, determinants that facilitate successful fiscal consolidations – defined as an improvement in the deficit or debt ratio. The contributions by Afonso and Mohr *et al.* assess the macroeconomic effects of fiscal episodes. They show that different consolidation strategies may have different macroeconomic effects and contrast short-run effects with long-run consolidation effects on growth and its components. Skrok *et al.* analyse how successful ECA countries are in utilizing their tax capacities. The papers by Brender, Herrera *et al.*, and Vicente *et al.* respectively, focus on fiscal consolidation experiences in individual countries. In particular, these papers assess the role for fiscal rules and inflation in reducing fiscal imbalances and deal with the relationship between fiscal policy and economic activity in the countries selected.

The remainder of this comment will focus on the two papers by Wurzel *et al.* and Leigh *et al.*, which contribute to the literature on successful fiscal consolidations.

2 Findings from existing literature on successful fiscal consolidations

Since the seminal contribution of Alesina and Perotti in 1995 a fairly rich literature has emerged on the topic of fiscal consolidations. The main and almost unambiguous findings are that a successful fiscal adjustment is characterized by primary expenditure cuts rather than tax increases; that the initial state of public finances and of the economy plays a role; and that successful consolidators tend to cut transfer payments and government wage expenditure.

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However, there is no consensus on how much the size of the fiscal consolidation, the monetary stance, exchange rate movements and GDP growth rates affect consolidation outcomes.

Moreover, Ardagna (2004) has even questioned the "conventional wisdom" linking the likelihood of success to the composition of consolidation measures. Based on country cases, she suggests that both expenditure- and revenue-based consolidations may be successful. Recently, additional factors have been given attention in assessing the likelihood of success such as the (EU) fiscal framework and political factors such as the role of political leadership, the timing of consolidations with respect to elections, and the composition of governments.

There are several reasons why the literature on successful fiscal consolidations is that ambiguous. First, the studies use different samples with regard to data vintages and sources,[1] which in turn might be based on different methods for cyclical adjustment; they differ with respect to time spans covered and, of course, include different sets of countries. Second, the methodological approaches for analysing successful consolidations comprise *case studies* focusing on a small number of countries; *descriptive studies* summarizing characteristics of a larger number of countries; and *cross-countr*y studies or *panel regressions* testing econometrically for the determinants of successful adjustments. The third and most important reason for the heterogeneous findings, however, is the lack of a commonly agreed (quantitative) definition, both for the term "consolidation" and for the term "successful consolidation". As neatly summarized by the European Commission (p. 175), "A definition of successful consolidation involves at least three different elements: (i) a measure of fiscal consolidation, (ii) a reference period over which a given size of consolidation is implemented, and (iii) a criterion discriminating between success and failure". In the absence of a consensus, authors will choose definitions that will fit their given research questions.

3 Research focus of the papers

The research of Wurzel *et al.* and Leigh *et al.* focuses on very similar questions, namely (1) on identifying the main determinants that affect fiscal consolidations with respect to its start, size and durability; and (2) on identifying properties of successful fiscal consolidations as compared to unsuccessful ones. In addition Leigh *et al.*'s paper also deals with effects of consolidations on macroeconomic variables in a simulation exercise.

However, the authors address these questions using different underlying definitions of successful consolidations and different empirical methods (compare also Table 1). To obtain their results, both papers use data for the 24 OECD member states from the 1970s to 2005 and 2006 respectively. While Wurzel *et al.* rely on

[1] Different data bases such as AMECO or OECD use different methods for cyclical adjustment, on which most of the recent literature is based.

Table 1

Comparison Leigh-Wurzel

	Leigh *et al.*	**Wurzel *et al.***
Sample	24 OECD countries 1978-2005	24 OECD countries 1972-2006
Method	Comparative Statistics Econometrics	Country Case Studies Comparative Statistics Econometrics
Definition of Consolidation	ΔCAPB > 1 percentage point of potential GDP in 1 year or 2 consecutive years (at least 0.5pp in first year) terminated if ΔCAPB < –0.3% of GDP	*Country Studies:* *ΔCAPB > 1 percentage point of potential GDP in 1 year* *Econometrics:* 3 year average of fiscal stance, measured by CAPB
Definition of Success	Primary Balance large enough to stabilize debt/GDP during the period and the two following years	*Country Studies:* Very successful: debt/GDP 5 percentage points lower after 3 years Moderate Success: debt/GDP at least stabilizes after 3 years *Econometrics:* no definition

Source: Leigh *et al.* and Wurzel *et al.*

cross-country descriptive statistics of the 24 countries, correlation analysis and econometric methods (linear regression, probit), Leigh *et al.* investigate consolidation experiences in individual countries applying correlation analysis and a multivariate panel regression. Wurzel *et al.* define a fiscal consolidation as a period in which the cyclically adjusted primary balance (CAPB) improves by at least 1 percentage point of potential GDP in one year or in two consecutive years with at least ½ percentage point improvement in the first year. A consolidation continues as long as the CAPB improves; a deterioration of <0.3 percentage points is accepted if offset the following year. Leigh *et al.*'s definition of a fiscal consolidation is quite similar for the country case studies, where a consolidation is defined as an improvement in the CAPB by at least 1 percentage point of potential GDP; however, for the correlation analysis and econometric estimations no formal definition for consolidation periods is set but just the average fiscal policy stance over three years, as measured by the CAPB, is correlated with explanatory variables.

According to Wurzel *et al.* a successful fiscal consolidation is characterized by a primary balance that is large enough to stabilize the debt-to-GDP ratio during the consolidation period and the two following years. Leigh *et al.* consider a fiscal adjustment a success if three years after the consolidation, the debt to GDP ratio is at

least 5 percentage points below the pre-consolidation ratio; a consolidation is moderately successful if the debt-to-GDP ratio is at least stabilized. However, no formal definition of success is applied for the econometric estimation.

As already observed in the existing literature, due to the arbitrariness of the different definitions applied, the periods identified as successful fiscal episodes in the two studies vary considerably, even though data sources and time spans covered are quite similar.

4 Results

Leigh *et al.*'s empirical assessment shows that (1) the size of lagged debt is positively associated with subsequent fiscal effort; *i.e.* high initial debt-to-GDP ratios that are considered unsustainable can prompt consolidations. (2) Supportive domestic (& international) growth environment facilitate maintaining tight fiscal policies. (3) Cuts in current expenditure deliver more sustained fiscal consolidations than revenue increases. (4) Higher government stability and higher institutional quality are associated with more successful consolidations. (5) However, there seems to be no significant role for the output gap, inflation and real interest rate in determining the likelihood of consolidations or their success.

Wurzel *et al.* find that (1) low initial cyclically adjusted primary balances (CAPB), *i.e.* a weak initial situation, and high interest rates are important for prompting fiscal adjustments as well as for boosting their size and duration. (2) The initial economic situation, measured as the output gap, affects the size and the intensity of the adjustment. (3) A fiscal adjustment started under a weak economic environment had a higher likelihood of success in the sense of reaching debt sustainability. (4) Cuts in current expenditure are associated with larger consolidations, and if these cuts mostly affect social spending they increase the chances for success. (5) Elections play a role in initiating a consolidation, and fiscal rules with embedded expenditure targets are found to be associated with larger and longer adjustments and higher success rates.

The conclusion drawn from these two papers is that current expenditure cuts, in particular cuts of social spending, are more supportive for fiscal consolidations and for their success than revenue increases. Furthermore, some kind of rule or institutional indicator, such as the time of election or government composition etc., matters for fiscal adjustments. However, there seems to be no consensus on the importance of macroeconomic conditions (output gap), interest rates, initial debt levels or the size of the CAPB for (successful) fiscal consolidations. These findings confirm "conventional wisdom" that expenditure cuts are imperative for successful consolidations, but hardly resolve the inconclusiveness of the existing literature on the other aspects determining consolidations.

Furthermore, even though both papers use cyclically adjusted primary balances, when defining the characteristics of a consolidation, "good" cyclically adjusted data is not necessarily available for all revenue and expenditure categories.[2] Hence, with respect to the specific role of growth, the criticism stated by McDermott and Westcott already in 1996 (p. 741), seems to remain valid: "Given the interactions between economic growth and changes in public debt ratios, it is difficult to distinguish between the contribution of good growth to successful consolidations and the effect of successful consolidations in boosting demand and growth".

5 Some comments and suggestions for further work

Leigh *et al.* identify the determinants of successful fiscal consolidations based solely on case studies on fiscal reforms in 14 countries which have generally been classified as successful. The insight provided by the analysis of individual countries is very interesting as it goes beyond the existing literature with respect to the importance of structural reforms, the mobilization of popular support and the adjustment at subnational levels. However, in order to properly identify the determinants that separate successful from unsuccessful consolidations, the authors should also analyse episodes of unsuccessful fiscal consolidations. This would enable the authors to assess if there is indeed a difference between successful and unsuccessful consolidations other than related to GDP growth. Of particular interest is whether different policy measures have been taken during successful and unsuccessful consolidation periods, with a view to advising policy makers accordingly.

The focus of Wurzel *et al.*'s paper is mostly on what factors affect different aspects of fiscal consolidations; for example which determinants have prompted fiscal adjustments, affect its size, duration and intensity. Less focus is given on which factors are imperative for the success of a consolidation with respect to stabilizing and reducing the debt-to-GDP ratio.

According to the estimation results it seems that several factors that are important for the start, duration, intensity and size of an adjustment are irrelevant for the success of the consolidation with respect to stabilising debt and vice versa. Given these facts, one could conclude that a consolidation's size, duration and intensity are not linked to its success. If this is a valid conclusion should the focus not be redirected and expanded towards identifying the determinants of successful consolidations? After all,the ultimate goal for policy makers should be to increase the sustainability of public finances by reducing the debt-to-GDP ratio rather than just knowing what determines start, size, and duration of a fiscal consolidation.

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[2] Wurzel (2007) p. 8: "…for expenditure items where cyclically-adjusted variables are not available the non-adjusted ones (both for the numerator and the denominator) were used".

To get deeper insights into the determinants of successful fiscal consolidations it might be interesting to further break down expenditure cuts according to functional classification. Applying the literature of the quality of public finances and growth one could try to assess what a cut in certain expenditure categories during consolidations generally classified as successful might imply for future growth and growth potential, respectively.

Furthermore, it could be interesting to assess the impact of one-off measures and so-called creative accounting measures on consolidations and their success – given the very short-term-oriented definitions for successful consolidations; in particular whether the findings on successful consolidations still hold if one-off effects are taken into account. Moreover, knowledge on one-off measures used for consolidations is important for assessing the future scope for successful fiscal adjustments, as some one-off measures increasing the likelihood of success might cease to be an option, e.g. privatizations.

Last but not least, future research should take into account the importance of exchange rate and interest rate policies for successful consolidations. As exchange rate depreciations or devaluations and country-specific interest rate adjustments increasing competitiveness are not available as policy instruments any longer in Economic and Monetary Union (EMU), consolidating successfully might prove harder (Lambertini and Tavares, 2005) within EMU.

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