ECFIN Workshop "Fiscal Rules in Europe: Design and Enforcement''

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Highlights

- Despite - or because of - growth deceleration, the **need for fiscal prudence**, is relevant in the current policy junction.
- Much caution is needed when interpreting **negative yield-growth gaps as a permit for higher deficits**.
- Empirical work supports the claim that: **austerity is not the “kiss of death"** for governments who adopt these policies.
- Expenditure based austerity measures are likely to substantially reduce the cost of consolidation in the EU as compared to tax based ones.
- However, the paper goes **a bit too far** in prescribing expenditure-based austerity measures.
- Some issues regarding the **“narrative approach” and sample selection**.

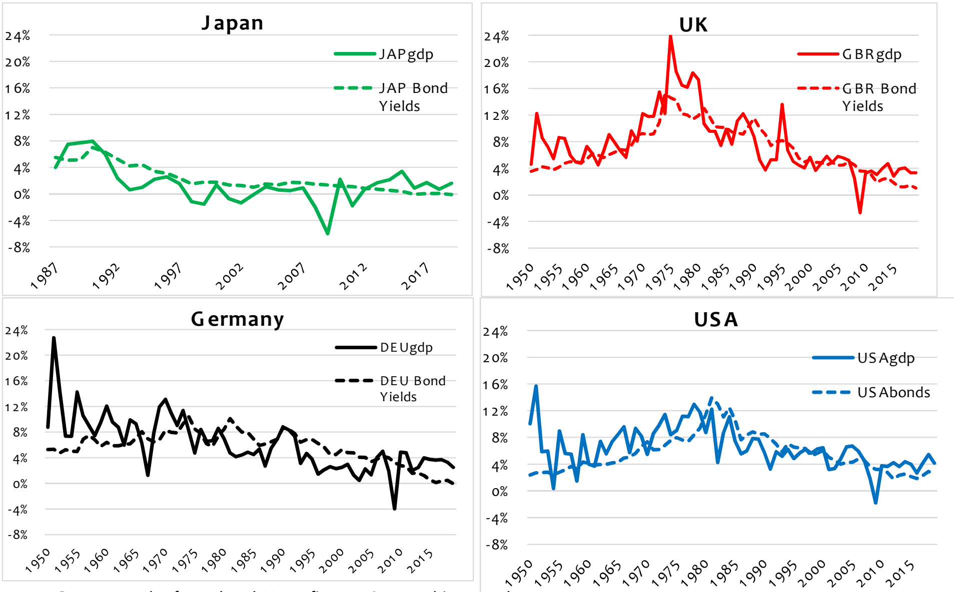
The Current Policy Question

- The current discussion of fiscal policy modifications is closely tied to two topics:
  1. The **decelerating growth environment** in the advanced economies;
  2. **Low long-term interest rates**, in many cases even negative.
- There is a lively debate regarding the source of low growth:
  1. A predominantly cyclical development?
  2. Secular stagnation – e.g., demographics, China?
- Accurate diagnosis is critical for the policy prescription.

Why and Where Prudence is Needed?

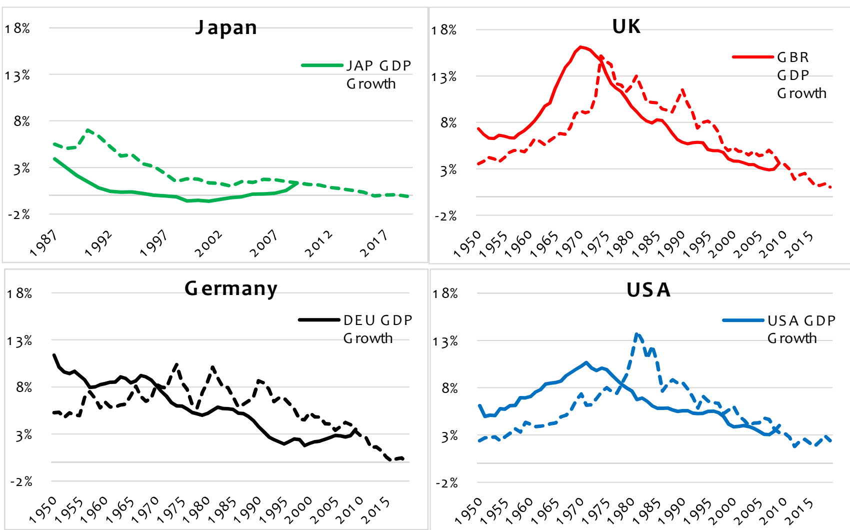
- Much of the current policy discussion is about **using fiscal policy to support growth**, rather than about austerity. In 2019, the average deficit of the 17 Euro countries was 0.8% of GDP, and they had a primary surplus.
- Cyclical deceleration calls for a Keynesian expansion. **The paper is silent about expansions**, as policy effects may be different when they are temporary and expansionary.
- **In secular stagnation, fiscal policy needs to be tightened** in the long run to preserve fiscal sustainability. But, **investment** in infrastructure, human capital and structural reforms **may support long-term growth** and revive private investment.
- the paper's advice is relevant because this calls for austerity measures to **pay for the additional growth-enhancing measures,** and since government size in the Euro area is similar to 20 years ago.
- Negative yield-growth gaps should be treated very cautiously as a justification for higher deficits.

Nominal Yield to Maturity on 10Y Government Bonds and Nominal GDP Growth



Source: Bank of Israel and Macrofinance & Macrohistory Lab

A Different Angel: Nominal Yield on 10Y Government Bonds and Average Nominal GDP Growth in the Following 10 Years



Source: Bank of Israel and Microfinance & Macro history Lab

Electoral Effects of Fiscal Prudence

- Several (not too many) papers have examined the effects of fiscal prudence on voters and reelection prospects of leaders.
- Brender and Drazen (AER, 2008) find that in advanced economies **governments that reduce deficits during their term, substantially increase their reelection chances**. [NLK examples]
- They also find that voters do not systematically prefer expenditure based consolidations to revenue based ones.

The Narrative Approach

- Tavares (JPubE, 2004) shows that revenue-based consolidations are more effective for right-wing cabinets, while expenditure-based ones work for left-wing cabinets ("It takes a Nixon to go to China").
- This raises the question of the political characteristics of the different types of consolidations: Is it really the composition, or is it **signaling commitment**? Accordingly, isn't it too simplistic to **assume that politicians tell the truth**? In Israel's case, the characterization of legislation is clearly manipulative. What are the potential biases?
- Does ideology and/or political concerns affect how leaders **frame** their policies?
- In the current paper, most austerity measures are on the expenditure side. **Does that mean that governments already know the model**? Or is it a reflection of politicians' choice how to frame different policies (expenditure cuts need justification, tax hikes are more easily "sold" as driven by cyclical needs)
- Romer and Romer found many tax cuts in their narrative database and much fewer significant tax increases.

Some Classification issues

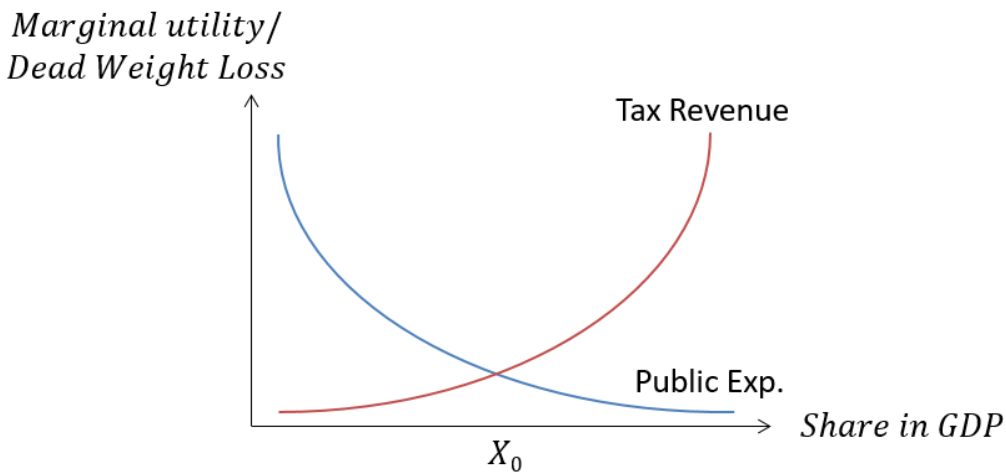
- Among the country-years before expenditure based austerities Public expenditure was 49% of GDP, in Tax based ones 44%.

- Transfer payments were 18% and 15% respectively.

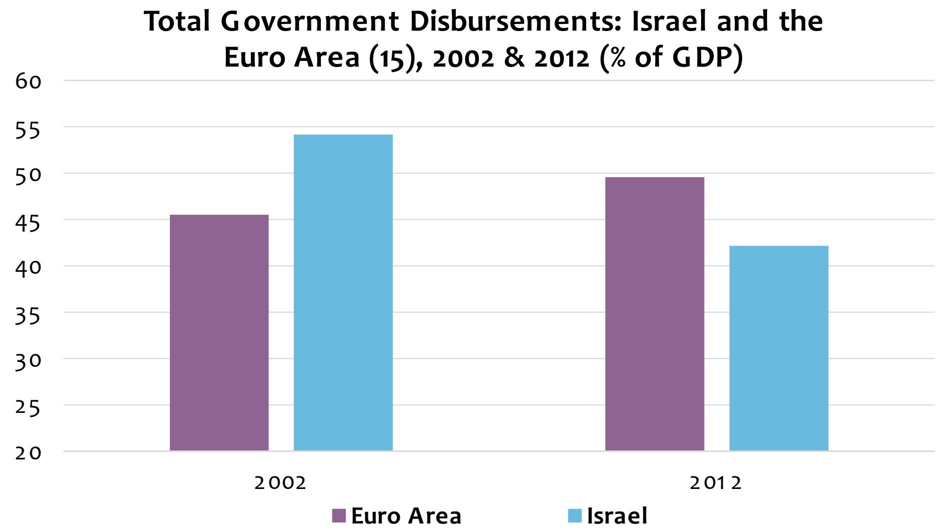
- **In 30% of the country-years classified as expenditure based austerity, public expenditure actually increased as % of GDP**. In another 12% there were significant expenditure expansions at the same time as the "narrative" expenditure cuts.

- Among the large (at least 1% of GDP) "narrative" austerity measures years, 58% were years with other expenditure expansions of the magnitude noted above.

Is it Always preferable to cut Expenditures?



Two Israeli Consolidations: The Size of Government Should Matter for Policy Mix



Government Size Effects on Policy Mix

- Israel's 2003 consolidation was a textbook austerity, according to the current paper.
- In fact, the APT (Brookings, 1998) and Giavazzi and Pagano (1990) papers were frequently cited during the program's design.
- Given the starting point, the program did not only succeed, but the cut in expenditure was sustained.
- In 2012, with a small government and low tax burden, the government pushed for further tax reductions and tried to consolidate with expenditure cuts. It backfired, resulting in a social protest and, eventually, a surging structural deficit.

If You Want to go North don’t Head South

- Growth may respond better to expenditure cuts, especially when the government is large (Gunter et al., 2018), but the social welfare function may suggest a different optimal level of expenditure than the one that maximizes growth.
- The normative point is not the scope of the discussion here.
- But, if social preferences are for a larger government, is it still optimal to consolidate by cutting expenditure to below the desired level, just to see it rising again, rather than “paying for it” with taxes.
- Should **expenditure always be cut**, or should policy be recalibrated after the consolidation?

Thank You