

## **Comment on Alesina, Perotti and Tavares**

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This is an fitting paper to mark the Brookings Panel's celebration of the elimination of the U.S. budget deficit. BPEA has had not a few papers analyzing the effects of budget deficits on the U.S. economy.<sup>1</sup> Now the deficit is finally a thing of the past, and discussion has turned to the best way to utilize the surplus. Controversy remains, of course, about the contribution to closing the fiscal gap of the economic initiatives taken by the first Clinton Administration and the 103rd Congress, versus the unusually persistent economic expansion that has dominated the 1990s, and which may have occurred for largely independent reasons including some emanating from a building four blocks due west of the White House. According to the Administration's estimates, only \$102 billion of the \$280 billion decline in the budget deficit between 1992 and 1998 is due to the improvement in the economy, while the rest is due to fiscal policy changes.<sup>2</sup> The question is whether those supposedly autonomous changes, welfare reform for example, are really independent of the cycle -- or whether they will be rolled back when the next recession hits and the states will again appear

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<sup>1</sup>Economic historians will remember Nancy H. Teeters, "Outlook for Federal Fiscal Policy," BPEA 2 (1972), pp.467-477; George L. Perry, "Policy Options for 1974," BPEA 1, (1975), pp.222-235; Benjamin Friedman, "Crowding Out or Crowding In? Economic Consequences of Financing Government Deficits," BPEA 3 (1978), pp.593-641; R. Glenn Hubbard and Kenneth L. Judd, "Liquidity Constraints, Fiscal Policy, and Consumption," BPEA 1 (1986), pp.1-50.

<sup>2</sup> Fiscal Year 1999 Federal Budget, Analytical Perspectives Volume, Table 1-5, p.12.

on the federal doorstep pleading for help with their welfare programs. All this will continue to be debated, of course, more intensely as the electoral season approaches. Alesina, Perotti and Tavares do us a service by reminding us that the variability in cross-country data can be quite useful for answering such questions.

This is also an appropriate paper with which to celebrate the contributions to the literature on fiscal policy made previously by the authors. It is standard nowadays to distinguish fiscal contractions from fiscal consolidations and to give credence to the idea that reductions in budget deficits can be expansionary under certain circumstances. For this insight we have the authors and their collaborators to thank.

Their point is that reductions in budget deficits can be expansionary, even in the short run, if those reductions are large, enduring and take the form of spending cuts on transfer payments and public-sector salaries in particular. This type of deficit reduction can have a large positive effect on consumer confidence and investment spending. Denmark and Ireland in the 1980s are early instances where this is said to have been the case, and subsequent work, extended and consolidated here, suggests that this result carries over to a larger sample of countries.

The obvious objection is on grounds of simultaneity bias. By the authors' argument, deficit reductions -- or, more precisely, certain kinds of deficit reductions -- raise the rate of economic growth. But we also know that faster growth favorably affects the deficit. A standard academic game is to take a supposed instance of an expansionary fiscal contraction and argue that the economy was in fact stimulated by some omitted variable that raised output and induced the observed fall in the budget deficit. For Denmark and Ireland in the 1980s, for

example, analysts argue that fiscal consolidation occurred in the period of the soaring U.S. dollar; the favorable competitiveness effects of these countries' depreciating real exchange rates therefore swamped the negative output effects of the contractionary fiscal impulse. The authors are aware of the problem, which they attempt to solve by cyclically adjusting the deficit. But the one thing we know about cyclical adjustments is that we don't know how to do them. We don't know whether business cycles are symmetric. We don't know whether they are alike. We don't know the size of the unit-root component.

Note also that while the authors correct the deficit (as well as total primary expenditures and total revenues) for the cycle, Table 2.3, where changes in the composition of expenditure are compared between sustained and transitory ("successful" and "unsuccessful") fiscal adjustments, relies on cyclically uncorrected figures. During sustained adjustments, most of the spending reduction, according to this table, comes out of transfers. But it is precisely this subcategory of public spending that is likely to be particularly sensitive to the cycle. An alternative interpretation is therefore that when there is a sustained acceleration in growth for reasons having little to do with fiscal policy, much of the induced reduction in the deficit takes the form of a fall in government transfers. Convincing remaining skeptical readers will thus require sensitivity analysis using alternative cyclical corrections and correcting for the cycle not just total expenditures but also its components.

Indeed, there are economic as well as statistical reasons to question whether the balance of tax increases and spending cuts and the composition of the latter are in fact the dominant determinants of whether deficit reduction is expansionary or contractionary. An alternative hypothesis is that the macroeconomic effects hinge rather on initial conditions. The

effect of fiscal consolidation on consumer confidence and consumer spending is likely to resemble the effect of speed on the peace of mind of the passengers of a moving car. If the car is hurtling out toward a brick wall, stepping on the brakes will increase the passengers' confidence. If fiscal policy is on an unsustainable trajectory, in other words, with explosive growth in the ratio of debt to GNP, then stepping on the budgetary brakes will increase confidence, encourage consumer spending, and stimulate investment, because households and firms believe that adjustment now obviates the need for more painful and costly adjustment later. But if the car is creeping down an empty highway, the passengers will begin to wonder whether they are ever going to reach their destination. If the driver then steps on the brakes, his passengers will throw up their hands in despair. Spending cuts or tax increases when there is no problem of fiscal sustainability, in other words, and are more likely to elicit the standard textbook response.

Thus, by focusing on large budget cuts, persistent budget cuts, and transfer- and public-wage-bill-dominated budget cuts, the authors miss the principal determinant of whether those cuts are expansionary or contractionary, namely, the initial conditions and in particular whether fiscal policy is on a sustainable or an unsustainable course. One would expect budget cuts of the same size, persistence and composition to have very different effects depending on the initial debt-to-GNP ratio, the growth rate of the economy, and the real interest rate. I have already mentioned why the evidence from Ireland and Denmark in the 1980s is difficult to interpret, but for those who believe that their fiscal consolidations were expansionary, it is precisely the fact that these countries' ratios of debt to GDP were exploding that lends credence to the argument.

Putting these points together gives us a diagram like Figure 1, with the change in GNP on the horizontal axis and the change in the deficit on the vertical axis. The downward sloping curve is the response of the deficit to growth; I label it the revenue effect (although there may also be some induced reduction in deficit spending with growth due to lower outlays on, inter alia, unemployment compensation). The other curve, which slopes up but bends back when deficits reach sufficiently high levels, represents the direct effect of changes in deficit spending on changes in GNP. I label this the multiplier effect with the understanding that the multiplier can be positive or negative. We thus have a “Keynesian range” of small deficits, and an “anti-Keynesian range” of large deficits. As drawn, there are two equilibria, and only the low-deficit equilibrium is stable. If revenues respond to output with a lag and the economy is always on the multiplier curve, then a small perturbation in the neighborhood of the low-deficit equilibrium will have only a small output effect, but an equally small perturbation in the neighborhood of the high deficit equilibrium can have a very large output effect. What matters, accordingly, is not just the composition, size or persistence of the budget cut, but the initial conditions.

Indeed, there is reason to think that whether deficits reduced by spending cuts have more favorable output effects than deficits reduced by tax increases will also depend on initial conditions. To be sure, in Northern Europe, where the initial condition is a bloated public sector, there is good reason to believe that a fiscal consolidation that emphasizes spending cuts will have favorable output effects. But in Russia, to take an extreme counterexample, the initial condition is deficits due to tax avoidance and unsatisfactory revenue performance generally. There, fiscal consolidation achieved through greater tax effort is likely to be more

sustainable than consolidation attempted by further cuts in the social safety net. Most countries lie between these extremes, but precisely where is not clear. Where, for example, do we put Italy?

Note that Table 3.1, in which the authors analyze the correlation between “successful” and “unsuccessful” adjustments and initial conditions (in the form of the level and cumulated change in the public debt ratio), is consistent with this emphasis. It shows that governments are more likely to implement sustained (“successful”) fiscal consolidations when initial conditions are poor. Since the authors show elsewhere in the paper that “successful” adjustments are more likely to be expansionary, there is reason to infer that fiscal adjustments undertaken when initial conditions are poor have the most positive macroeconomic effects, although this point is not analyzed explicitly. Nor do the authors take the final critical step of asking whether the mix of tax increases and spending cuts and the composition of the latter still significantly shape the macroeconomic response even after controlling for those initial conditions.

I found especially interesting the authors’ new results on the political consequences of fiscal adjustments. They find that looser fiscal policies do not increase a government’s chances of political survival, and that cuts in the public-sector wage bill and transfer payments do not increase the chances of government collapse. These striking results pose a paradox: if fiscal consolidation is rewarded, or if at least governments are not penalized for it, why then are they so reluctant to undertake it? The authors’ interpretation is that transfer recipients and public employees, spending on whom must be cut if the fiscal consolidation is to be sustainable, comprise a formidable blocking coalition.

The zero coefficient on the deficit on which this conclusion hinges is an example of the Frankel recipe for successful empirical work, “The secret of empirical work,” in his words, “is to define your hypothesis so that failure to find significant results can be interpreted as support.”<sup>3</sup> In particular, I worry that the zero coefficient on which the authors place such emphasis is a product of multicollinearity. According to the authors’ own arguments, minority coalition governments will find it difficult to engineer sustained reductions in deficit spending because they are unable to form the kind of encompassing coalitions needed for agreement on sacrifices all around. But we also know from the electoral politics literature that political fragmentation -- good proxies for which are coalition status, the number of parties in the coalition, and majority or minority status in the parliament -- is the most robust predictor in the literature of expected government tenure. Since these variables affect cabinet changes directly, but also affect the change in the deficit, the effect of the latter on cabinet changes is likely to be difficult to pin down.

Hence, I am more impressed by the regressions in which the authors attempt to distinguish the effects on political popularity and government survival of large deficit cuts and of fiscal consolidations that mainly take the form of spending cuts. Again, however, the troubling fact is that most of the relevant coefficients are insignificantly different from zero. In any case, if one believes that it is not the magnitude or the composition of the change in the deficit but rather the initial conditions that are important, it is not entirely clear what to make of these results.

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<sup>3</sup>Cited by Paul Krugman on p.406 of “Are Currency Crises Self-Fulfilling?” *NBER Macroeconomics Annual*, pp.345-378.

Reverse causality is an issue here as well, and the authors go to considerable lengths to address it. They look at the timing of changes in government and fiscal policy, experiment with instruments, and focus on a subset of exogenously-imposed changes in fiscal stance associated with the requirements of the Maastricht Treaty, asking whether the response to these is any different. Let me comment on the last of these. Assume that fiscal consolidation really does reduce government popularity but ordinary least squares regressions fail to pick this up because unusually popular governments use their surplus political capital to reduce deficits. Because Maastricht-mandated reductions are exogenous (ignoring Pogo's problem, "I have met the signatories of the Maastricht Treaty, and they are us"), reverse causality is less of a problem, and we should expect a negative effect of deficit reduction. But achieving Maastricht-mandated deficit reduction means not just a different fiscal position but also the reward of qualifying for monetary union, which one presumes will have a positive effect on popular support for the government, especially in countries like Italy where deficit reduction is a pressing issue. Given this unique payoff structure, it is not surprising that the authors again fail to find a negative impact of deficit cuts on government popularity.