

- Empirical analysis of fiscal adjustments (deficit reduction).
- OECD countries from 1960 – 19905.
- Fiscal adjustments usually thought to (1) be contractionary (short run) (2) be a political liability (unpopular).
- Study (1) economic consequences of fiscal adjustments and (2) politics of fiscal adjustment.
- Main results: (1) FA are not always contractionary and their composition matters quite a lot; (2) governments are not punished for reducing deficits, and their popularity does not decrease, and the composition of FA also matters for survival of government.

- **Definitions:**

FA: primary deficit to GDP falls by at least 1.5 percentage points.

"Successful": in the following three years def-to-GDP ratio is on average at least 2 pp than in the first year of FA; or after three years def-to-GDP is at least 5 pp less than in first year.

- *Composition matters:* In successful adjustments  $\frac{2}{3}$  of deficit reduction comes from spending cuts, while in unsuccessful one only  $\frac{1}{3}$  is on the spending side. The rest is on tax increase.

Spending: spending cuts in successful ones come from nonwage gov consumption and subsidies. In unsucc. is more about public investment.

Taxes: Unsucc. rely heavily on increases in taxes on labor (unions!). Succ: indirect taxes and taxes on business.

- *Economic Consequences:*

(1) Rate of growth (relative to G7) increases with succ., decreases with unsucc. Unemp falls etc. AND rate of growth before succ is lower and before unsucc.

(2) Investment and consumption boom

(3) Currency depreciation preceding adjustment (in both, but more in succ)

(4) Unit labor costs decrease during succ, increase during unsucc. Profit share in income increase in succ, decline in unsucc.

- *Political effects of composition*

Expectations effect: welfare cuts are more permanent, they may have strong positive wealth and expectations effects, because they single permanent reductions in the level of taxes.

Political credibility: cut spending on welfare and wages enjoys increases credibility and may have stronger effects on **interest rates**.

- So why are unsuccessful adjustments implemented?

Ideology: no, not impact on frequency of loose and tight episodes. And probability of success is same for left-wing right-wing parties.

Prob of success is lower for centrist (coalition) governments → effect of fragmented decision process on the timing of stabilizations.

Increases in deficit weakly but positively correlated with changes in government.

Higher prob of survival for adjustment on the spending side.