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Can successful fiscal adjustments only be achieved by spending cuts?

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ABSTRACT

We re-examine the conventional view that to be successful, fiscal adjustments should rely on spending cuts and not on tax increases. We apply the Bai-Perron structural break filter to identify fiscal adjustments and their successfulness in 20 OECD countries. Our results suggest that the composition of fiscal adjustments is not related to their success. Furthermore, we find that political-economy variables considered are not robustly related to successful fiscal adjustments with one exception: the probability of a successful fiscal adjustment increases if left-wing governments rely on spending cuts and right-wing governments rely on tax increases.

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1. Introduction

Fiscal policies in several countries across the world have become unsustainable. Therefore, fiscal policy adjustments are inevitable to reduce government indebtedness. An important issue is how policymakers should get their fiscal house in order. According to Broadbent and Daly (2010, p. 6), "[t]he consensus within the academic literature is that successful corrections of severe fiscal imbalances share two essential features: they are decisive and they focus on cutting expenditure." Likewise, Alesina and de Rugy (2013, p. 8) argue that "evidence suggests that the types of fiscal adjustment packages that are most likely to reduce debt are those that are heavily weighted toward spending reductions and not tax increases."[1]

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[1] The work by Alesina and his co-authors even made it into influential textbooks. For instance, Romer (2012) refers to it. Also in policy-oriented publications several references to this research can be found. For instance, in the IMF's World Economic Outlook, October 2010 the work is described as "extremely influential in the debate regarding the consequences of fiscal adjustment".

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It is important to point out that, to the best of our knowledge, this 'consensus' is not based on strong theoretical reasoning but on empirical evidence. Several authors conclude that successful fiscal policy adjustments rely on expenditure cuts rather than increased revenues (cf. Alesina and Perotti, 1995; McDermott and Wescott, 1996; Alesina and Ardagna, 1998, 2010; Alesina et al., 1998; von Hagen et al., 2001, 2002; Broadbent and Daly, 2010; Biggs et al., 2010; Hernandez de Cos and Moral-Benito, 2012; Afonso and Jalles, 2012).[2] Most papers in this line of research start by identifying a fiscal adjustment, mostly on the basis of changes in the cyclically adjusted (primary) budget balance, and then examine how successful and non-successful adjustments differ from each other. Success is generally defined in terms of the lasting effect the adjustment program has on reducing the government debt-to-GDP ratio and/or the budget deficit-to-GDP ratio.

As politicians are in charge of fiscal policy, the literature has paid some attention to the political economy of fiscal adjustments. In their seminal paper, Alesina and Perotti (1995, p. 236) summarize their main findings as follows: "Coalition governments are as likely as other governments to try very tight fiscal policies. However, they seem to be unable to carry out the types of expenditure cut that are needed to make adjustment long lasting. As a result, their success rate is drastically lower than that of both minority and single-party governments. Left- and right-wing governments are just about equally likely to carry out successful adjustments. Closeness to elections does not influence the likelihood of strong adjustments, or their success rates."

We re-examine the evidence that successful fiscal adjustments are characterized by spending cuts and that certain political-economy factors do (or do not) matter. Our paper makes the following contributions to the literature.[3] First, following Wiese (2014), we apply the Bai and Perron (1998, 2003) structural break filter to identify fiscal adjustments and their success. To be more precise: We apply the Bai-Perron (BP) approach to the cyclically adjusted budget balance as share of GDP to identify fiscal adjustments. In addition, we apply the BP approach to the growth rate of the government debt-to-GDP ratio to identify whether a fiscal policy adjustment has been successful. This approach is more objective than approaches used in this line of literature so far. Adjustments are generally defined in the literature as a discretionary (i.e. cyclically adjusted) and significant decline in the general government's budget balance. Significant in this case does not refer to statistical significance, but rather whether the change in the cyclically adjusted (primary) budget balance exceeds some (subjectively selected) threshold. Likewise, previous studies identify successful adjustments based on the lasting effect the adjustment program has on reducing the government debt-to-GDP ratio and/or the budget deficit-to-GDP ratio. So, these filters are based on a 'one-size-fits-all' principle and they do not take into account that the budgetary processes in some countries may lead to a much more volatile budget balance than those in other countries. A filter that does not take volatility into account is prone to identify fiscal adjustments that are the result of the budgetary institutions in place (or other factors driving fiscal policy volatility), rather than deliberate attempts of politicians to improve the budget balance. The identification of fiscal adjustments and their success should be related to the variability of the budgetary process in a country. Previous studies failed to do that and it is important to examine how this affects results for robustness reasons.

Our second contribution is that we show that just comparing the composition of successful and non-successful fiscal adjustments (as older studies in this line of literature did) leads to biased results. We provide random-effects probit model estimates for the probability that a fiscal adjustment is successful, conditional on the presence of a fiscal adjustment. Some previous studies that provide empirical estimates of the drivers of successful fiscal adjustments (e.g. Ardagna, 2004; Schaltegger and Feld, 2009) compare successful adjustments with unsuccessful adjustments and periods of no fiscal adjustment. Instead, our estimates are only based on successful and unsuccessful fiscal adjustments. Our justification is best explained using a simple metaphor: when a doctor wants to evaluate the effectiveness of a medicine in comparison to a placebo, (s)he will allocate the medicine and the placebo only to people having the disease and not to people without a diagnosis. Our results do not suggest that successful fiscal adjustments rely more on spending cuts than on tax increases.

Third, although some previous studies on the determinants of successful fiscal adjustments have considered some political-economy determinants of successful fiscal adjustments, they did not consider a wide range of potentially important political-economy factors. We consider several political-economy variables that have been suggested by studies focusing on the determinants of fiscal policy outcomes and fiscal adjustments (see section 4 for more details). Our results do not suggest that political-economy variables are robustly related to successful fiscal adjustments, with one exception. In line with the findings of Tavares (2004), we find some evidence that the probability of a successful fiscal adjustment increases when left-wing governments rely on spending cuts and right-wing governments rely on tax increases.

The paper that comes closest to our work is Holden and Larsson Midthjell (2013). These authors redo the analysis of Alesina and Ardagna (2010) using a measure of changes in fiscal policy designed to avoid reverse causality. Our study differs with respect to the methodology to identify (successful) fiscal adjustments and the inclusion of political-economy determinants of successful fiscal adjustments.

[2] Even though the quotes of Broadbent and Daly (2010) and Alesina and de Rugy (2013) would suggest otherwise, there are dissenting views. For instance, Heylen and Everaert (2000) reject the hypothesis that to succeed, consolidation should rely on cutting the government wage bill. Their evidence is based on a model explaining the growth of government debt in 39 fiscal consolidation periods. Similarly, Ardagna (2004) and Holden and Larsson Midthjell (2013) find no indication that it matters for the success of the adjustment whether it is achieved via spending cuts or tax increases. Focusing on medium-term adjustments, Baldacci et al. (2012) conclude that when adjustment needs are large, fiscal adjustments that rely on revenue-enhancing measures are more likely to accelerate debt consolidation than those based on expenditure-based cuts only.

[3] We do not address the argument that expenditure-based fiscal adjustments may be less contractionary than usually thought or even be expansionary (see Alesina et al. (1998), Ardagna (2004), IMF (2010), Alesina et al. (2015a), Guajardo et al. (2014) and Alesina and de Rugy (2013) for further discussion). Likewise, we do not address the issue of (the consequences of) fiscal austerity (see, for instance, Alesina et al., 2015b; Beetsma et al., 2015; Eichengreen and Panizza, 2016 and references cited therein).