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Assessing fiscal episodes

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ABSTRACT

In an OCDE panel, for the period 1970–2010, we assess the effects of fiscal consolidation episodes, with four different definitions. Our results reveal that lower final government consumption increases private consumption in three out of the four approaches, when a fiscal consolidation occurs, and the debt ratio is above the cross-country average. The magnitude of these coefficients is higher for countries with lower debt levels, implying more successful consolidations associated with reduced crowding-out effects. There is some evidence of non-Keynesian effects for both private consumption and private investment, and the effects of social transfers on private investment tend to be negative, both in the short and long run. In a financial crisis, such effects are also more prone to happen. Finally, raising long-term interest rates reduces per capita private investment.

1. Introduction

The 2008–2009 economic and financial crises brought again into the limelight the question of fiscal episodes and the importance of the so-called expansionary fiscal consolidations. Indeed, while several institutions and economists argued for the importance of fiscal stimuli in the context of the crisis, the case for fiscal retrenchment, which via expectations, promotes more private demand and growth, surfaced again in the discussion in the aftermath of the crisis. Therefore, in this paper we revisit the debate of the non-Keynesian effects of fiscal policy, and assess notably expansionary fiscal consolidation episodes in the context of OECD countries, via private consumption and private investment.

In view of the somewhat ad-hoc set-up that is usually available in the existing studies, we contribute to the literature by cross-checking several methods that have been used to determine the existence of fiscal episodes, in order to confer some robustness to the analysis. Consequently, on the one hand, we use several more established approaches to determine fiscal episodes, based on changes of the cyclically adjusted primary balance, proposed and applied by Giavazzi and Pagano (1996), Alesina and Ardagna (1998), and Afonso (2010). On the other hand, and as an additional comparison, we also use the fiscal episodes identified on the basis of a so-called policy action-based approach proposed by the IMF (2010).

Specifically, we assess in a panel framework, for the period 1970–2010, whether a usually expected positive response of private consumption and private investment to a fiscal expansion is reversed. Such event can arise if, for instance, consumers and investors might anticipate future difficulties stemming from fiscal expansions and a decrease in permanent income and in private consumption may occur. Moreover, if agents actually expect benefits from the implementation of a credible fiscal retrenchment, such reverse effect may indeed take place.

In a nutshell, our results show that lower final government consumption would increase private consumption in the short run, when there is a fiscal consolidation, and the debt ratio is above the cross-country average. The magnitude of these coefficients is higher for countries with lower debt levels, translating a more successful consolidation programme associated with reduced crowding-out effects. Regarding private investment, in general, our estimations deliver weaker but similar results to the ones reported for private consumption, with social transfers having a negative impact on private investment, both in the short and long run. The three approaches that determine the fiscal episodes on the basis of the cyclically adjusted primary balance tend to produce closer results than the so-called policy-based action method. In any case, empirical evidence seems to support the existence of non-Keynesian effects affecting both private consumption and private investment (which is further adversed in the presence of financial crises). Finally, raising long-term interest rates reduces per capita private investment.

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Table 1
Fiscal Episodes (FE), based on the change in the primary cyclically adjusted budget balance and on the so-called policy action-based approach.

Country	IMF	FE1		FE2		FE3	
	Contractions	Expansions	Contractions	Expansions	Contractions	Expansions	Contractions
Australia	1980, 1985–88, 1994–99	2009	1987–88	1975, 2009	1987–88	2009	1987–88
Austria		1976, 2004	1997	1976, 2004	1984, 1997, 2001, 2005	2004	1984, 1997, 2001, 2005
Belgium	1982–84, 1987, 1990, 1992–99	1981, 2005, 2009	1982–87	1981, 2005, 2009	1982–85, 1993, 2006	1981, 2005, 2009	1982–85
Canada	1980–1999	1975, 1977–78, 2002, 2009	1987, 1996–98	1977, 2001–02, 2009	1981, 1986–87, 1996–97	1975, 2009	1987, 1996–97
Denmark	1983–86, 1995	1975–76, 1982, 1991, 2010	1983–87	1975–76, 1982, 1990–91, 1994, 2009–10	1983–86	1975–76, 1982, 1991, 2010	1983–86
Finland	1984, 1988, 1992–2000, 2006–07	1979–80, 1991–93, 2010	1976–77, 1997–98, 2000–01	1978–79, 1987, 1991–92, 2009–10	1976–77, 1981, 1984, 1988, 1996–97, 2000–01	1978–79, 1987, 1991–92, 2010	1976–77, 1996–97, 2000–01
France	1984, 1986–89, 1991, 1995–98, 2000, 2006–07	2009–10		2009–10		2009–10	
Germany	1982–89, 1992–2000, 2003–07	1975, 1991, 2001–03		1975, 1990–91, 2001–02		1975, 1990–91, 2001–02	
Greece		1981–85, 1989–90, 2008–09	1991–92, 1994, 1996–99, 2006, 2010	1981–82, 1985, 1989–90, 2008–09	1982, 1986, 1991–92, 1996–98, 2005–06, 2010	1981–82, 1985, 1990, 2008–09	1991,1994, 1996–97, 2006, 2010
Ireland	1982–88, 2009	1975, 1979, 2001–03, 2007–09	1976–77, 1983–86, 1988–89, 2010	1974–75, 1978–79, 1995, 2001–02, 2007–09	1976–77, 1983–84, 1988, 2010	1974–75, 1978–79, 2001–02, 2007–09	1976–77, 1983–84, 1988, 2010
Italy	1992–98, 2004–07	2001	1977, 1982–83, 1992–94	1981, 2001	1977, 1982–83, 1992–93	1981, 2001	1977, 1982–83, 1992–93
Japan	1997, 2003–07	1993–95, 1998 2009–10	1998–2000, 2005–07	1975, 1994–95, 1998, 2009–10	1998–99, 2005–06	1993–94, 1998, 2009–10	1999–00, 2006–07
Netherlands		2002, 2010	1991, 1993	2001–02, 2009–10	1991, 1993	2002, 2009–10	1991
Portugal	1983, 2000–03, 2005–07	1978–80, 2005, 2009–10	1977, 1983–84, 1986	1978–79, 1985, 1990, 1993, 2005, 2009–10	1977, 1983–84, 1986, 1988, 1992, 1995,2006	1978–79, 1993, 2005, 2009–10	1977, 1983–84, 1986, 1988, 1992
Spain	1983–89, 1992–98	2008–10	1987	2008–09	1986, 1987, 2010	2008–09	1987
Sweden	1983–84, 1986, 1992–97, 2007	1974, 1979–80, 1991–94, 2002–03	1984, 1987, 1996–99	1974, 1979, 1991–93, 2002–03, 2010	1976, 1983–84, 1987, 1996–97	1974, 1979, 1991–93, 2002	1984, 1987, 1996–97
United Kingdom	1981–82, 1994–99	1972–75, 1992–94, 2001–04, 2009–10	1981–82, 1997–2000	1972–73, 1990, 1992–93, 2001–02, 2009–2010	1981, 1997–98, 2000	1972–73, 1992–93, 2001–03, 2009–10	1981, 1997–98
United States	1980–81, 1985–86, 1988, 1990–91, 1993–94, 2000	2001–02, 2007–10		2001–02, 2007–08		1974, 2001–02, 2007–08	
Years with episodes	172	95	73	95	79	78	59
Average duration (years)	3.8	2.0	2.1	1.6	1.5	1.6	1.6

Notes: all measures computed by the authors, except the IMF one.
FE1 — measure used by Giavazzi and Pagano (1996): the cumulative change in the primary cyclically adjusted budget balance is at least 5, 4, 3 percentage points of GDP in respectively 4, 3 or 2 years, or 3 percentage points in one year.
FE2 — measure used by Alesina and Ardagna (1998): the change in the primary cyclically adjusted budget balance is at least 2 percentage points of GDP in one year or at least 1.5 percentage points on average in the last two years.
FE3 — measure based on Afonso (2010): a fiscal episode occurs when either the change in the primary cyclically adjusted balance is at least one and a half times the standard deviation (from the full panel sample) in one year, or when the change in the primary cyclically adjusted balance is at least one standard deviation on average in the last two years.
IMF — measure computed by the IMF (2010), so-called policy action-based approach to account for consolidation episodes.