The political consequences of large fiscal adjustments

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Conventional wisdom

- Fiscal adjustments lead to electoral defeats and therefore this is way they are postponed
- Fiscal adjustments on the spending side are socially very costly.

Conventional wisdom wrong?

- There is not evidence that larger budget deficits increase changes of reelection.

- Brender and Drazen (AER 2008) find the opposite: larger deficits are (weakly) associated with less success at the polls.

How about large fiscal adjustments?

- Many large fiscal adjustments have been followed by re-election of government which implemented them.

- Especially when the adjustment occurred early in the term (Alesina Ardagna and Trebbi IMF Staff papers 2006)

Table 1 – 10 periods with largest cumulative fiscal adjustment (cyclically adjusted variables)

| COUNTRY	YEARS	NUMBER OF YEARS	CHANGE IN CYCL. ADJ. DEFICIT (COCHDEF)	CHANGE IN CYCL. ADJ. EXPENDITURES (COCHEXP)	CHANGE IN CYCL. ADJ. REVENUES (COCHREV)	CUMULATIVE FISCAL ADJUSTMENT	FISCAL ADJUSTMENT PER YEAR	% OF FISCAL ADJ. DUE TO CUT IN EXPENDITURES	TERM	CHANGE IN IDEOLOGY
DENMARK	1983-86	4	-2.43	-0.85	1.58	-9.74	-2.43	35.03	2	0
GREECE	1990-94	5	-1.88	-0.50	1.38	-9.39	-1.88	26.38	2	1
SWEDEN	1994-2000	7	-1.20	-0.81	0.38	-8.38	-1.20	67.91	3	0
BELGIUM	1982-87	6	-1.26	-0.96	0.30	-7.57	-1.26	76.50	2	0
CANADA	1993-97	5	-1.36	-1.25	0.11	-6.80	-1.36	91.80	1	0
UNITED KINGDOM	1994-99	6	-1.12	-0.66	0.47	-6.72	-1.12	58.45	1	1
FINLAND	1993-98	6	-1.04	-0.81	0.23	-6.23	-1.04	78.13	2	1
PORTUGAL	1982-84	3	-1.89	-1.14	0.75	-5.67	-1.89	60.16	2	2
ITALY	1990-93	4	-1.24	0.13	1.36	-4.95	-1.24	-10.21	2	1
IRELAND	1986-89	4	-1.21	-1.54	-0.33	-4.82	-1.21	127.50	2	1

Source: Authors' calculations on OECD Economic Outlook Database no.84 and DPI 2009.

Figure 1 – Frequency in cabinet changes and fiscal adjustments

Legend:
- All adjustments
- Fiscal expansions
- Small adjustments
- Large adjustments
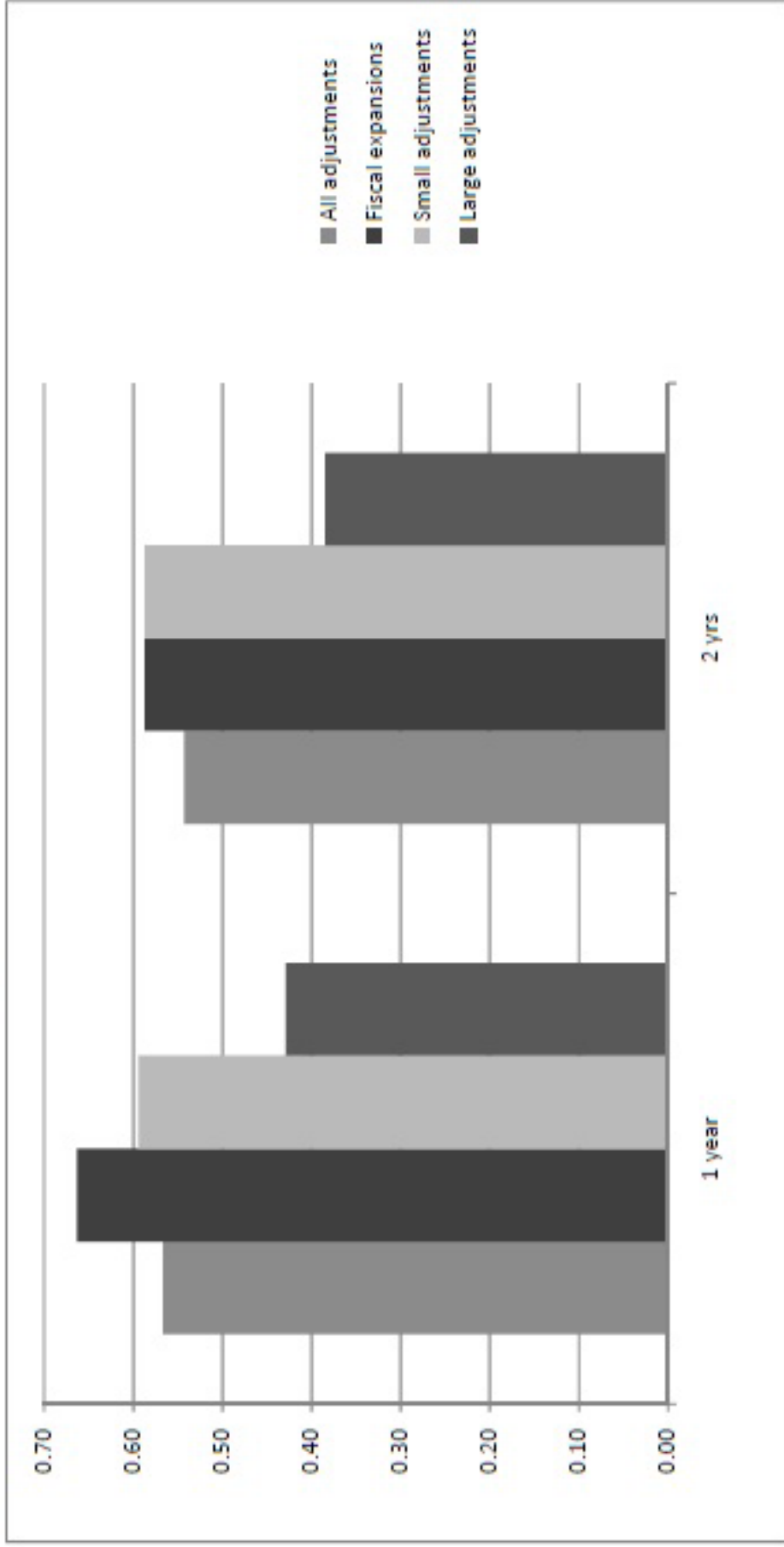
Source: Authors' calculations on OECD Economic Outlook Database no.84 and DPI 2009.

Figure 2 - Frequency in changes of cabinet ideology and fiscal adjustments

Legend:
- All adjustments
- Fiscal expansions
- Small adjustments
- Large adjustments
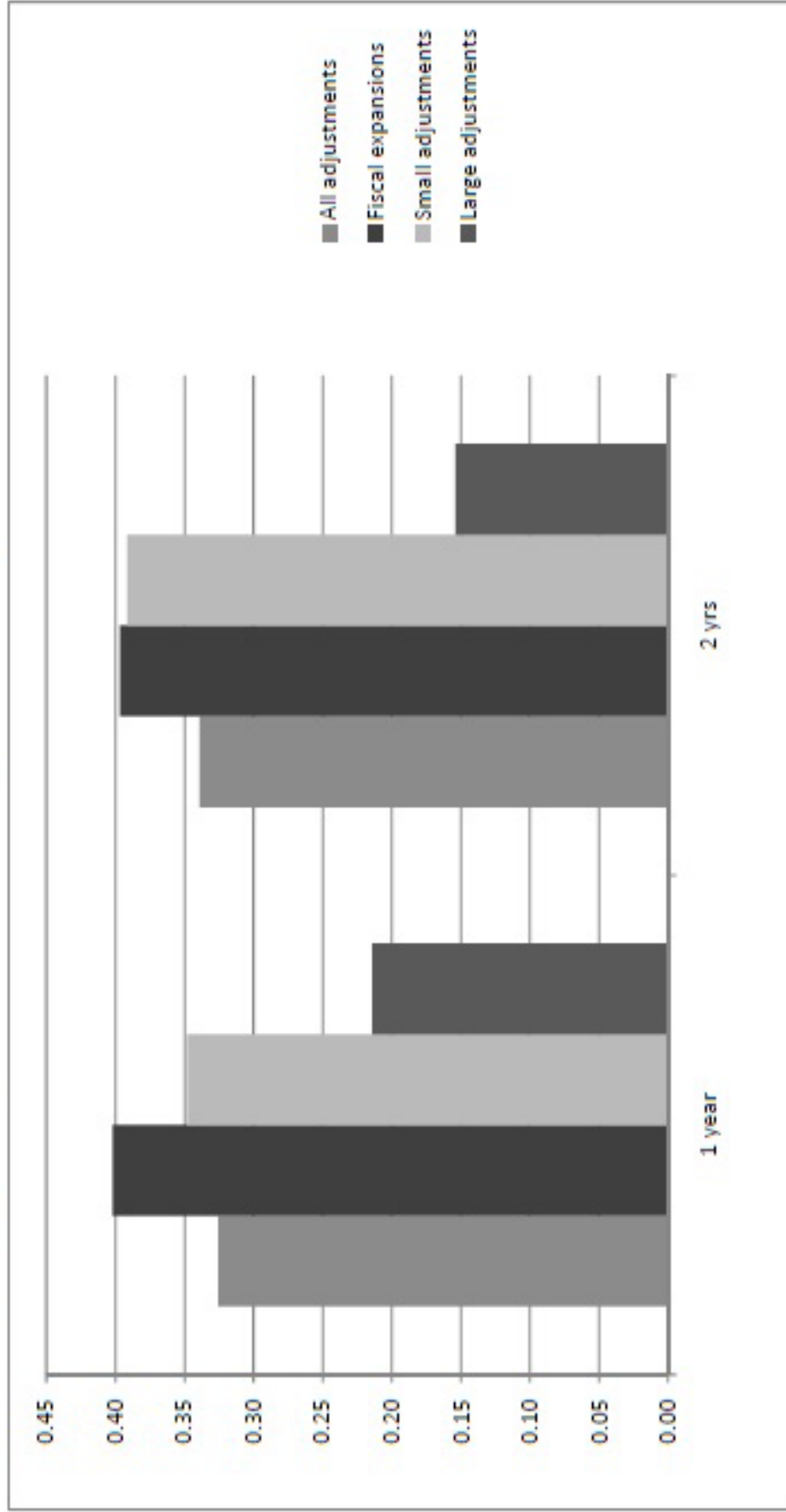
Source: Authors' calculations on OECD Economic Outlook Database no.84 and DPI 2009.

Table 2 - Probit coefficients (full sample)

VARIABLES	(1) IDEOCH	(2) IDEOCH	(3) IDEOCH	(4) IDEOCH	(5) IDEOCH
CHDEF[1]	0.0058 (0.052)				
COCHDEF[2]		-0.0064 (0.058)			
TOTCHDEF[3]			0.1069 (0.067)		
CHEXP[4]				-0.0176 (0.062)	
CHREV[5]					-0.0250 (0.062)
DGDP	-0.0003 (0.040)	0.0002 (0.042)	-0.0776* (0.047)	-0.0084 (0.043)	-0.0047 (0.041)
DUNR	0.0081* (0.005)	0.0076 (0.005)	-0.0001 (0.005)	0.0083* (0.005)	0.0079* (0.004)
INFL	0.0395*** (0.014)	0.0478*** (0.014)	0.0409*** (0.014)	0.0393*** (0.013)	0.0405*** (0.014)
DURAT	0.3318*** (0.059)	0.3406*** (0.060)	0.3361*** (0.059)	0.3324*** (0.059)	0.3291*** (0.059)
COAL	0.1652 (0.152)	0.1193 (0.155)	0.1407 (0.154)	0.1608 (0.152)	0.1643 (0.152)
MAJ	-0.0111 (0.180)	-0.0601 (0.184)	-0.0775 (0.182)	-0.0114 (0.180)	-0.0149 (0.181)
Constant	-2.2523*** (0.255)	-2.2690*** (0.265)	-2.0274*** (0.261)	-2.2252*** (0.263)	-2.2327*** (0.258)
Log-likelihood	-218.62	-209.73	-216.98	-218.77	-218.54
Observations	612	590	612	613	612

Source: see data Appendix at the end of the paper.
Standard errors in parentheses: *** p<0.01, ** p<0.05, * p<0.1.

1. Change in public deficit: percentage point change in the ratio of public deficit to GDP.
2. Change in the primary deficit (CHDEF), corrected for the cycle.
3. Average change in deficit during tenure: average percentage point change in the deficit over the years that the current cabinet has been in power, up to the current year.
4. Change in public expenditures: percentage point change in the ratio of primary expenditures to GDP.
5. Change in public revenues: percentage point change in the ratio of public revenues to GDP.

When TOTCHDEF is used, given variables are replaced by dTOTGDP, dTOTUNR and TOTINFL. The coefficients on DGDP, DUNR and INFL are the coefficients on these variables.

Reverse causality

- Do government get reelected despite having done fiscal adjustments?

- Only "strong government" can do them?

- Hard to test: no clear cut evidence

So?

- Political constraints do not come only from elections
- Pressure groups, lobbies.
- War of attrition model (Alesina and Drazen AER 1990)
- Concentrated benefits diffuse costs (Buchanan and Tullock)

Social costs of fiscal adjustments

- We don't know enough.
- Much depends on the efficiency of the welfare state.

Expensive but ineffective welfare systems

per cent of households at risk of poverty *before* and *after* social transfers (2003)

	before	after
Sweden	29	11
Finland	28	11
Holland	22	12
Denmark	32	12

	before	after
Germany	24	16
France	26	12
Belgium	29	16
Italy	22	19
Spain	22	19
Greece	24	21
U.K.	26	18

Source: Eurostat

	Transfers to families (% disposable income)	Percent to poorest quintile
Germany	**26,9**	**20,2**
France	**30,1**	**19,6**
Sweden	**32,2**	**25,8**
USA	**7,4**	**25,5**
UK	**16,6**	**33,7**
Spain	**21,0**	**16,0**
Italy	**28,0**	**11,7**
Greece	**21,7**	**12,6**
Turkey	**1,9**	**8,5**

Fonte: Peter Whiteford, 2006

Examples

- Government wages
- Pensions
- Physical infrastructures
- Taxes

Conclusions

- Don't always believe in conventional wisdom