Discussion
of Perotti. The "Austerity Myth": Gain Without Pain?

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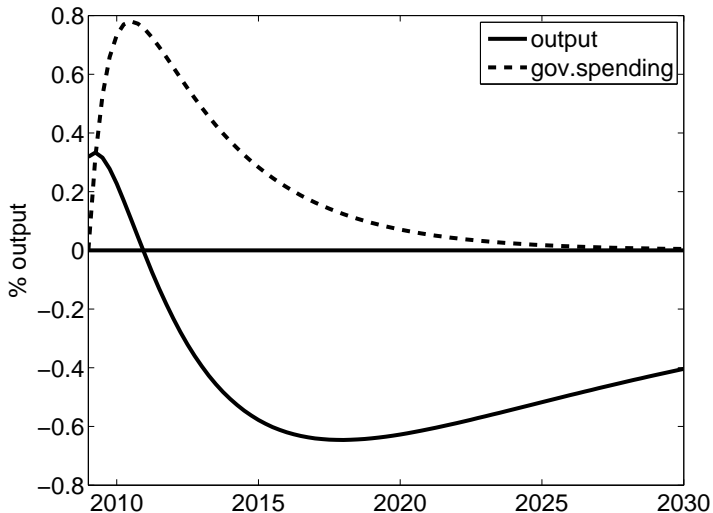Department of Economics
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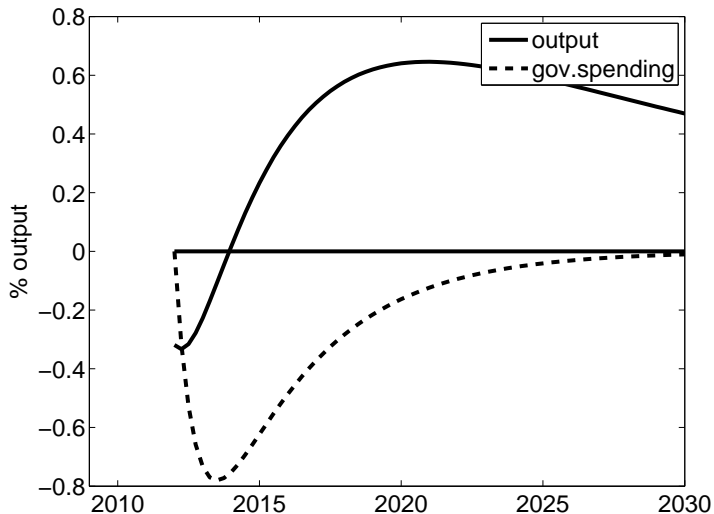
June 23, 2011

Outline

Questions and Answers

- Questions.
  - ▶ What is the effect of fiscal consolidation?
  - ▶ Increase taxes or cut spending?
- Answers

Fiscal Stimulus in 2009 ...

Source: Uhlig, AER 2010

... and Fiscal Consolidation in 2012

Source: Uhlig, AER 2010, "flipped"
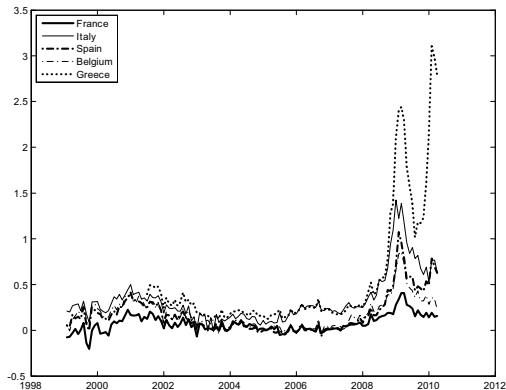
Default premia in Europe

Figure 2: 10-year sovereign spreads against Germany, selected countries.

Source: Borgy-Laubach-Mesonnier-Renne (2011)

Perotti

- Question: is fiscal consolidation per spending cuts expansionary **in the short run**?
- Perotti: Attacks IMF Oct 2010 "Economic Outlook" analysis.
- IMF: replace statistical with "action-based" analysis.
- Perotti: IMF got econometrics wrong
- Perottie: Details matter! Case studies show
  - IMF neglected important data.
  - Narrative is more complicated: wage restraints, exchange rates.
  - There were less of a spending cut than IMF claims.

Perotti: therefore: it's complicated.

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Discussions

- Discussion (Uhlig)
- of a Discussion (Perotti)
- of a Discussion (IMF)
- of a Discussion (Alesina-Ardagna 2010)
- of a previous literature (Alesina, Ardagna, Giavazzi, Pagano, Perotti)

Spending Cuts: expansionary in the **short run**?

- No (Uhlig)
- It's complicated (Perotti)
- No (IMF)
- Yes (Alesina-Ardagna 2010)
- Yes (Alesina, Ardagna, Giavazzi, Pagano, Perotti)

Of course: it depends.

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Econometrics

$$\Delta s = \alpha \Delta y + \epsilon_s \tag{1}$$
$$\Delta y = -0.25\Delta y - 2.5\epsilon_s + \epsilon_y \tag{2}$$

- Δs: gov surplus, Δy: output change, ϵ_s: policy change, ϵ_y: bus cycle shock. $\alpha > 0.25$: automatic stabilizer.
- Data on: Δs, Δy. **Challenge:** it is hard estimate ϵ_s-coeff. in (2), due to "second round" effects.
- Note though: suppose $\alpha = 0.5$, $\epsilon_s = 1$, $\epsilon_y = 0$. Then, $\Delta y = 2$ per (2) and $\Delta_s = 0$ per (1). Is that really a policy change?
- Perhaps the question is wrong.

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Case studies

- Correcting the data: useful. Replicable?
  - ▶ p. 23: "IMF does not count the contribution of a tax amnesty that netted 1.7 percent of GDP in 1988".
  - ▶ p. 32: "I estimate ... a cumulative improvement in the discretionary balance by 4.4 percent of GDP"
- Reporting the facts: useful.
- Causal interpretation?
  - ▶ p. 19: "However, the price of this policy of devaluations and realignments was high interest rates and a large differential vis à vis Germany"
  - ▶ p. 28: "in Denmark the expansion that occurred at the time of the consolidation was driven by domestic demand; in Ireland, for a long time it was driven mostly by exports".
- World trends? Retrenchment of welfare state in early 80's.
- Finland: transition from semi-socialism? Nokia?
- Benchmark? Sample of countries?
- Journalism versus Science.

Conclusions

- Which question? Short run?
- Governments should do what governments must do.
- Spending restraints are wise, certainly in the long run.
- Case studies need scientific discipline.