

This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Europe and the Euro

Volume Author/Editor: Alberto Alesina and Francesco Giavazzi, editors

Volume Publisher: The University of Chicago Press

Volume ISBN: 0-226-01283-2

Volume URL: <http://www.nber.org/books/ales08-1>

Conference Dates: October 17-18, 2008

Publication Date: February 2010

Chapter Title: Comment on "The Euro and Fiscal Policy"

Chapter Author: Roberto Perotti

Chapter URL: <http://www.nber.org/chapters/c11657>

Chapter pages in book: (324- 325)

- . 2005. Fiscal rules and fiscal performance in the EU and Japan. CEPR Discussion Paper no. 5330.
- Wyplosz, C. 2005. Fiscal policy: Institutions versus rules. *National Institute Economic Review* 191 (January): 70–84.

Comment Roberto Perotti

This is an interesting and well-written chapter that presents a useful overview of fiscal policy issues and some interesting results. In these comments I will focus on what I regard as the two most important empirical questions studied in the chapter: (a) is fiscal policy more or less countercyclical in Europe than in the United States? and (b) has the euro plus the Growth and Stability Pact induced a more procyclical (less countercyclical) behavior of fiscal policy in European Monetary Union (EMU) countries?

On the first issue, the answer of the chapter is clear, and confirms both existing empirical results and common wisdom on the difference between Europe and the United States: “discretionary” fiscal policy seems more countercyclical in the United States, “automatic stabilizers” more countercyclical in Europe. The authors present convincing empirical evidence on this effect, and support it with equally convincing robustness analysis. I do not have much to add on this point.

On the second issue, obviously it is hard to base any conclusion on less than ten years of data, but even leaving this problem aside, I think the verdict is still open, and hard to reach. As the authors point out in section 8.4, following the discussion at the conference, the problem is well illustrated by a comparison of figures 8.3 and 8.6: while discretionary fiscal policy in the euro area seems procyclical if evaluated against the output gap, it appears countercyclical if evaluated against the growth rate of gross domestic product (GDP).

Note that this issue in turn involves two fundamentally different underlying issues. The first is, what is the appropriate variable to cyclically adjust the budget? Suppose that a certain expenditure item changes automatically, by law, in response to the output gap; then the appropriate variable to cyclically adjust this expenditure item is the output gap. Similarly, the appropriate variable is output growth if by law an expenditure or revenue item moves with the change in the level of output. In reality, things are even more complex, because the reference level for cyclical adjustment (potential output or last year’s output) is not defined by law.

But even assuming we have taken a stance on the appropriate reference

level of output in doing the cyclical adjustment, this is different from the question: “to what variable do policymakers react when setting discretionary fiscal policy?” Here I would surmise that the reasons for using the output gap in monetary policy reaction functions are more compelling than in fiscal policy reactions functions. Monetary authorities understand and use the concept of output gap; fiscal policymakers (therefore including congressmen when voting on the budget) typically do not know, do not understand, and do not use the concept of output gap; they react to GDP growth.

A second explanation for the results on the cyclical behavior of discretionary fiscal policy (and at the same time an illustration of the perils of drawing inference from 8 data points) is ideology and fatigue. Comparing figures 8.3 and 8.4, it is clear that the results are heavily influenced by two years. The euro area result in figure 8.3 depends heavily on 2000 and 2001, two good years in terms of gap, when, however, many governments relaxed their discretionary fiscal policy following several years of budget cuts enacted to qualify for the EMU. Conversely, the U.S. results are heavily influenced by 2001 and 2002, two years of low output gap in the United States, when taxes were cut and spending increased, due in part to the ideology of the new administration and in part to exogenous foreign policy events.