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Whelan, K. 2010. "The Enduring Influence of Ireland's 1987 Adjustment." *Irish Economy* blog. http://www.irisheconomy.ie/index.php/2010/08/20/the-enduring -influence-of-irelands-1987-adjustment/.

Comment   Philip R. Lane

This excellent chapter revisits the influential "expansionary fiscal contraction" (EFC) hypothesis. The EFC hypothesis highlights that there are non-linearities in fiscal dynamics, with the impact of fiscal austerity sharply differing between fiscally-stable and fiscally-unstable economies. If fiscal austerity signals to investors that the debt level will stabilize or even decline over time, it may be associated with a decline in sovereign default risk and a reduction in interest rates. For countries with a flexible exchange rate, it may also signal a reduction in inflation and the expected rate of devaluation, so that it further reduces nominal interest rates through this channel. If fiscal austerity reduces the expected future tax burden on workers/households and investors, it can also boost the real economy by raising the expected post-tax return to working and investing.

It is notoriously difficult to test the EFC hypothesis. The number of cases of sustained fiscal austerity is relatively small and many factors influence macroeconomic outcomes, so there is a limited value to econometric studies. Rather, Perotti's chapter provides a careful treatment of a number of important case studies and this approach is highly informative.

The author provides a useful feedback rule for the fiscal surplus

$$(1) \qquad \Delta s = \alpha_y \Delta y + \alpha_p \Delta p + \beta_y \Delta y + \varepsilon_s,$$

where $\alpha_y > 0$ captures the operation of automatic stabilizers, $\alpha_p > 0$ allows for revenue windfalls from asset price booms, $\beta_y > 0$ reflects activist countercyclical policy interventions, and ε_s measures acyclical shifts in the fiscal position. In fact, the set of financial factors that can influence fiscal outcomes extends beyond asset prices (Benetrix and Lane 2011). Large current account deficits mean that spending levels are ahead of income levels, which boosts revenues from indirect tax sources. In related fashion, rapid credit growth can reorientate the economy from tax-poor export activity to tax-rich nontradables production (since VAT is not levied on exports) and also boost revenue from transaction taxes (stamp duties on housing purchases).

Furthermore, it should be recognized that governments follow procyclical policies in many countries. Revenue windfalls from a financial boom may prompt additional spending or tax cuts, such that $\alpha_p <= 0$ is possible. In a

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similar vein, political economy factors or cognitive problems (a failure to differentiate between cyclical upturns and improvements in trend growth) mean that output expansions may induce discretionary fiscal expansions so that $\beta_y <= 0$. Given the cross-country and cross-time heterogeneity in these coefficients, panel-type estimation will limited value in understanding the specific experiences of individual countries, which reinforces the desirability of the case-study approach developed in this chapter.

The careful treatment of the fiscal data for each country in this chapter is a salutary lesson for empirical fiscal research. It underlines the importance of differentiating between announced fiscal plans and the actual implementation, with the role of midyear fiscal adjustments especially important in understanding fiscal outcomes. Another lesson is that the multiyear nature of fiscal adjustment episodes means that it is important that the "event window" is selected appropriately, in order to fully capture the full impact of fiscal adjustment programs. Again, this provides a warning against "one size fits all" empirical approaches, since the appropriate event window may vary across different episodes. An important substantial finding from Perotti's forensic data investigation is that the contribution of revenue growth in these fiscal adjustment episodes has been understated in previous research.

In terms of the economics of fiscal austerity, Perotti points to several key issues. First, fiscal austerity was accompanied by exchange rate devaluation in several cases, which may have been an important support to output growth during these episodes (in addition, the export channel was affected by the general state of demand in trading partners). Second, there were sizable declines in nominal and real interest rates, which can be largely attributed to a decline in expected inflation. In turn, there was a virtuous cycle by which lower inflation was reinforced by wage moderation, with this process faciliated by incomes policies in various countries.

It is important to assess the lessons from these case studies from the 1980s and 1990s for the current wave of fiscal austerity programs. The author highlights that competitiveness gains are hard to achieve in the absence of nominal exchange rate flexibility, especially when wage inflation is also low in partner countries. With the exception of imposed nominal wage cuts in the public sectors of crisis-hit countries, the evidence so far points to considerable downward wage rigidities: export-led output growth is hard to engineer under these conditions, especially when growth is also anaemic in major trading partners.

Perotti points to incomes policies as a factor in wage moderation during these episodes. It would be good to know about the conditions required for incomes policies to be effective. In particular, incomes policies may be more feasible under crisis conditions than in periods of robust labor demand, if inflation is low but still substantially positive, and in environments in which a combination of fiscal austerity and wage moderation can plausibly provide direct (if partial) payoffs to the real incomes of workers through lower

interest rates (lower mortgage rates) and a stronger level for the exchange rate (lower cost of imported consumer goods).

For the euro area, a common central bank means that policy interest rates do not respond to country-specific fiscal actions. That said, the very high country spreads that have emerged during the euro crisis means that fiscal dynamics can be improved by austerity programs that successfully reduce perceived default risks. In turn, in relation to the wider economy, the sovereign risk premium influences the cost of funding for the domestic banking system, even if some larger corporates might be able to obtain international funding at a lower cost.

The analysis in this chapter also indicates that there is plenty of room for new research on several dimensions of fiscal adjustment. In relation to revenue growth, the relative contribution of tax rate increases versus the broadening of the tax base is an important topic. In terms of spending cuts, the balance across transfer programs, public consumption, and public investment should be further assessed in relation to their relative impact on short-term and long-term economic performance.

A major issue concerns the impact of banking crises on the design and execution of fiscal adjustment programs. While Perotti classifies Finland and Sweden in the 1990s as representing adjustment under flexible-rate (inflation-targeting) regimes, the banking crises suffered by these countries are central to fiscal and macroeconomic dynamics during these episodes.

While there is much to learn from previous episodes, it is important to bear in mind some key structural shifts. In particular, the levels of domestic and international financial development are far greater now than twenty years ago. The ratios of domestic credit to GDP have grown sharply (especially in the euro periphery), while the ratios of cross-border financial assets and liabilities to GDP have expanded even more rapidly. This means that balance sheet mechanisms are more powerful now than in the past, which can change the design of optimal fiscal policy. For instance, the interaction of credit constraints and high sectoral debt levels (households, firms) mean that declines in current disposable income have a disproportionate impact on private-sector default rates. In turn, if taxpayers are the ultimate underwriters of the banks, this can offset the fiscal impact of austerity measures. Especially for countries that cannot devalue, an important implication is that the realistic and optimal speed of fiscal adjustment is slower than in previous episodes.

In addition, the very large increase in cross-border financial positions means that the spillover impact of financial market stress has grown considerably. This consideration, reinforced by the synchronized timing of fiscal austerity in many countries in the current crisis, means that it is vital that a global perspective on fiscal adjustment is maintained by policymakers. Accordingly, country-by-country fiscal analysis should be supplemented by

broader research that fully incorporates the various macroeconomic and financial interdependencies across countries.

Reference

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