Discussion of "Fiscal Austerity Measures: Spending Cuts vs. Tax Increases" by

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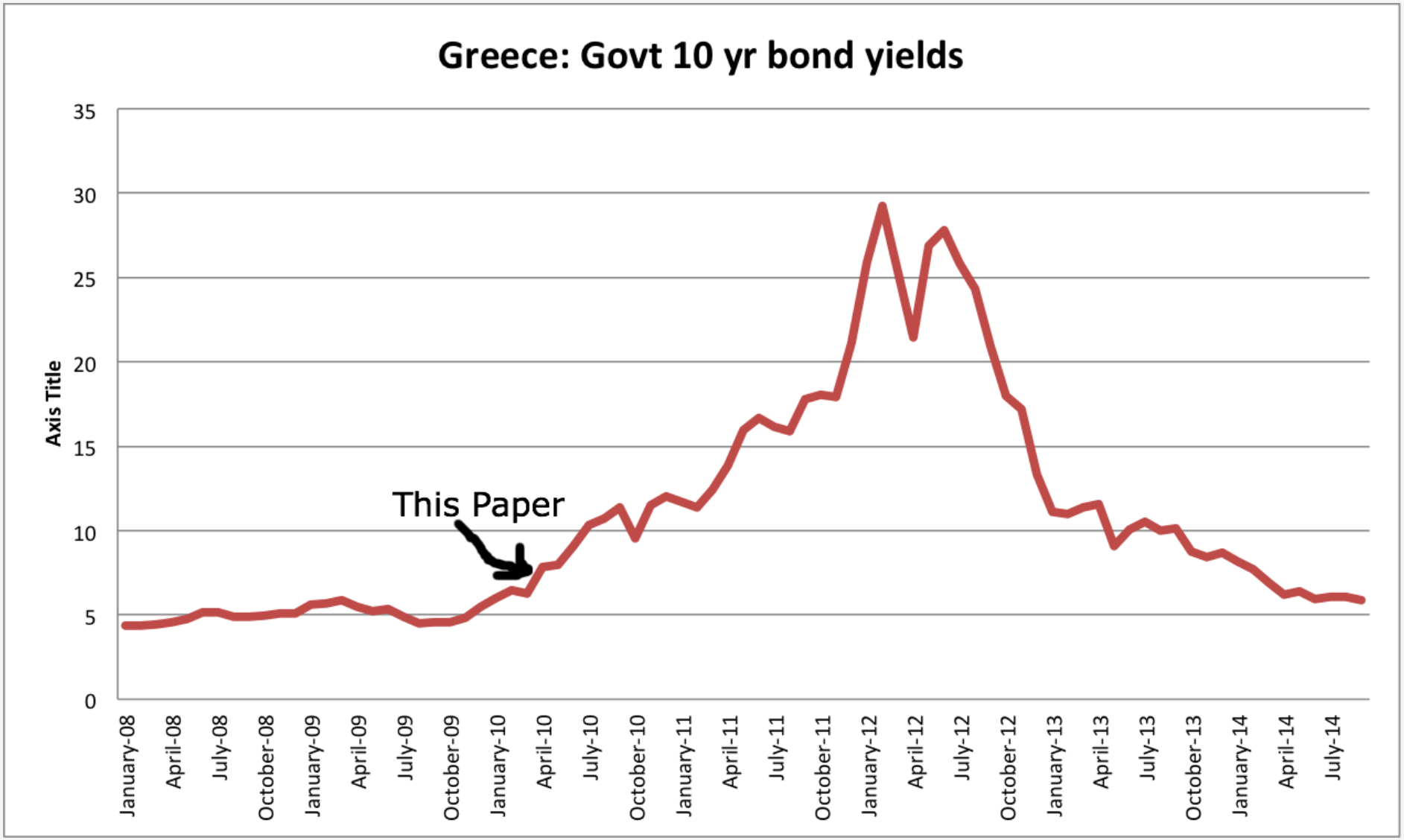
Overview

- Three main results:
  - A country with high level of external indebtness (Greece) is very sensitive to external shocks
  - It is welfare improving to reduce the debt to GDP ratio over time
  - Cuts in gov't spending are more damaging to GDP than tax increases in the short run (vs. Alesina etal. 2012)
- Nice and easy to read paper. Some of the results are a little of a black box, however.

Sensitivity to External Interest Rate Shocks

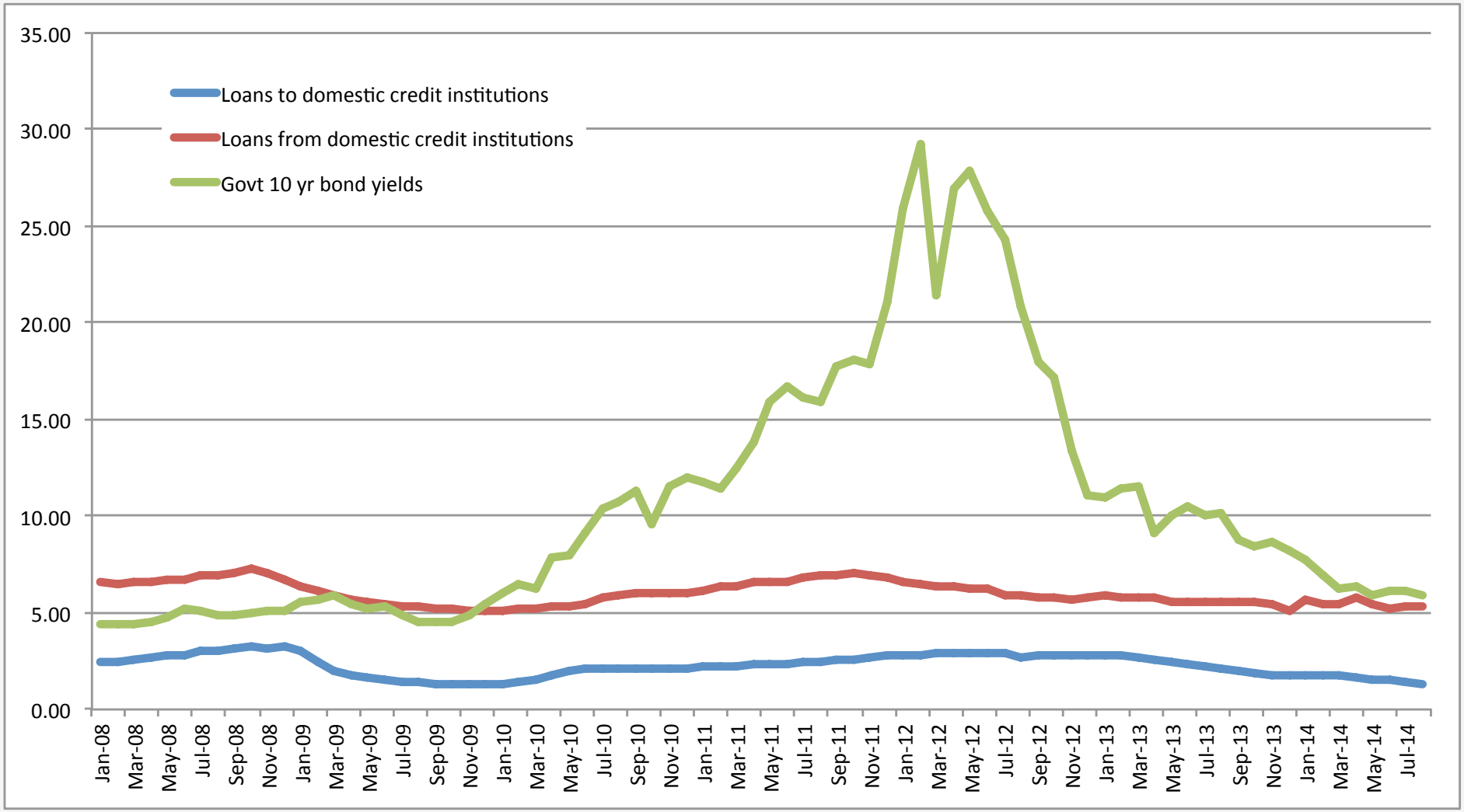


Source: Bank of Greece

Sensitivity to External Interest Rate Shocks

- Increase in interest rates:
  - Portfolio adjustment: MPK has to increase: decrease in capital stock and GDP
  - Substitution effect: Increase in savings (decrease in current account)
  - $r \nearrow \rightarrow S \nearrow$ and $K_P \searrow$, $Y' \searrow$,
  - Overall, negative wealth effect (b/c CA deficit initially?)
- Questions:
  - Alternative explanation to an increase in savings / decrease in CA: income effect: future looks worse than today
  - $TFP' \searrow \rightarrow S \nearrow$ and $K_P \searrow$, $Y' \searrow$. Plus $r_{GOVT} \nearrow$ implies negative wealth effect.
  - The explanation in the paper relies on the fact that *all* borrowers and savers face an increase in the interest rate: is that consistent with data?
  - How to interpret higher r_{GOVT} without introducing risk explicitly?

Sensitivity to External Shocks



Source: Bank of Greece

Policy Reforms

- Two aspects:
  - intertemporal dimension (decrease debt over time?)
  - spending cuts vs tax increases
- Intertemporal dimension
  - A standard Ramsey optimal tax problem: Smooth labor taxes over time. In the absence of spending or TFP shocks, constant debt to GDP ratio over time.
  - Here the answer is very different. It is better for taxes to go up and then down. Why?
  - My guess is, that it is all driven by the decrease in r in response to lower B/Y. It would be nice to see what happens if the interest rate channel is shut down.
  - General argument for driving debt to 0? $\underline{B} > 0$?

Spending Cuts vs Tax Increases

- Cuts in public spending are worse than tax increases in the short run. Results reversed in the long run.
- Driving forces: partially productive government investment, plus a decline in r in the long run.
- Partially productive G:
  - $G \searrow \rightarrow$ $TFP \searrow$ $H_P \searrow$ and $K_P \searrow$,
  - $G \searrow \rightarrow$ wealth $\nearrow$, $H_P \searrow$
- Unproductive G:
  - $G \searrow \rightarrow$ wealth $\nearrow\nearrow$, $H_P \searrow\searrow$
- The effect on TFP dominates?
- The effects are reversed in the long run, due to decrease in r.

Spending Cuts vs Tax Increases

- How unproductive is government investment here?

$$MP_{KP} = r + \delta = 0.14$$
$$MP_{KG} = \alpha_1 \eta \frac{Y}{K_G} = \alpha_1 \eta \delta \frac{Y}{I_G} = 0.09 * 0.42 * 0.1 * \frac{1}{0.05} = 0.075$$

  About in the middle.

- How about labor?

- Empirical evidence on this?

Other comments

Risk Premium

- The estimated risk premium function is

$$r^{risk} = \beta_0 + \beta_1 \left(\frac{B}{Y}\right) + \beta_2 \left(\frac{B}{Y}\right)^2$$

where $\beta_0 = 0.2437$, $\beta_1 = -0.00538$, $\beta_2 = 3E - 05$.

- Decreasing in $\frac{B}{Y}$ (for reasonable values). Typo?

Other comments

Capital-Output Ratio

- The model is calibrated to capital-output ratio of 1.5. Seems very low. Does that include public capital too?
- Moreover: from the calibration

$$r = MP_{KP} - \delta$$
$$r = \alpha_2 \frac{Y}{K_P} - \delta$$
$$0.04 = 0.35 \frac{Y}{K_P} - 0.1$$

yields $\frac{K_P}{Y} = 2.5$!

- If public capital is included, then $\frac{K_P + K_G}{Y} = 3$, even higher. ??

Conclusions

- Enjoyed reading the paper! Raises some questions of first order importance.
- Focusing on the main mechanisms (and ignoring other ones) would help to sharpen the message