# Report on Master Thesis

**Institute of Economic Studies, Faculty of Social Sciences, Charles University**

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| **Student:** | **Jaroslav Máca** |
| **Advisor:** | **PhDr. Jaromír Baxa, Ph.D.** |
| **Title of the thesis:** | **Expansionary Fiscal Consolidation Revisited: Evidence from the Over-Indebted Europe** |

## *OVERALL ASSESSMENT*

### Short summary

The thesis analyses empirically the effects of fiscal consolidations in a sample of 28 EU countries from 2004 to 2019. It provides some evidence that the consolidations may have a positive effect on GDP growth after 7 years, which is interpreted as a sign of their expansionary features. According to the thesis, this holds especially for tax-based consolidations, which runs against the conventional wisdom. The author also analyses the differences in the impact of fiscal consolidations among countries with pegged and flexible exchange rates.

### Contribution

The author contributed to the empirical literature on the impacts of fiscal consolidations, which is so far inconclusive as regards Keynesian vs. non-Keynesian features. He demonstrates that the empirical results depend on the chosen methodology and appropriate use of control variables. As part of the research, the author has updated the existing databases on fiscal consolidations in Europe, which is in itself a relevant contribution.

### Methods

The method preferred by the author is based on a narrative approach to identifying fiscal consolidation events. He then uses these to estimate impulse response functions of key macroeconomic variables, relying on the local projection method. As a robustness check, the author compares the estimates with a more common approach based on the fiscal impulse measure derived from the cyclically adjusted budget balance. He also compares estimated with and without control variables.

Overall, I consider the chosen methodology as legitimate. However, the justification of its use in the thesis is very brief. In particular, the author claims that the narrative approach “is thought to be free of any potential endogeneity”, referring to the paper by Romer and Romer (2010). Nevertheless, when commenting on his results, the author repeatedly acknowledges that fiscal consolidations are often enforced by harsh macroeconomic circumstances, loss of market confidence, etc. It is thus questionable to what extent they can be regarded as purely exogenous events. This may have an impact in the estimated IRFs, i.e. some of the macro dynamics that are ascribed to the fiscal consolidations may actually be related to the circumstanced that have forced the governments to consolidate. For example, Figure 5.4 suggest that government bond yields go up in the first years after fiscal consolidations. This is counter-intuitive, as credible fiscal consolidations should reduce the risk premium and lower the expected supply of government bonds, thus leading to their lower yields. It suggests some reverse causality, i.e. governments are forced to consolidate if there is a confidence crisis and sovereign risk premium goes up. And reverse causality is associated with the endogeneity issue. The author could comment more on this aspect at the defense.

At the same time, if I understand it correctly, the estimated IRFs (see Figure 5.1.) are on GDP growth, not levels. The fact that GDP growth tends to be statistically significantly be higher after 7 years from the consolidation may be just a “pay-back” of the significantly lower GDP growth rates in the first two years, with the economic activity first contracting, but later on returning to its potential level. This is consistent with the conventional idea that aggregate demand shocks affect output only in the short-to-medium-term, and not in the long run. In other words, the results presented by the author may not be a sign of non-Keynesian feature of fiscal consolidations. At the defense, the authors should also address this issue.

Another potential weakness is the chosen “0-1” classification of fiscal consolidations into tax-based vs. spending-based. It may actually be the case that the most successful and credible fiscal consolidations are designed as a mix of tax-based and expenditure-based measures, as such they may split the burden of adjustment more evenly over the whole society, and be thus politically more sustainable. But his intermediate category is not considered in the analysis.

**Literature**

The literature survey is extensive, covering empirical papers at least from 2002 to 2023. I very much appreciate the summary table provided on page 16. Section 2.1 probably goes too much into the history of economic thought, starting even with ancient Indian thinkers, but this is a minor remark.

**Manuscript form**

The manuscript form is overall fine. The thesis has a logical structure, is written in very good English and is overall easy to read.

One minor remark concerns the rich Figures with robustness checks provided in the Appendix. The font size of the figure names is so small that it is impossible to read in a printed version of the thesis. In the electronic version, one needs to zoom to roughly 250% of the standard size to be able to read it, which is impractical.

**Overall evaluation and suggested questions for the discussion during the defense**

The thesis is overall very good, bringing interesting and thought-provoking empirical results. I have no doubt that it required significant effort from the student to achieve these. I recommend it for defense with an A grade (at the borderline with B, i.e. the final grade should reflect also the debate at the defense).

The results of the Turnitin analysis do not indicate significant text similarity with other available sources. The thesis is an original work by the student.

Suggested questions for defence:

1) Clarify why you believe that the narrative approach may “be free of any potential endogeneity”. Are you not concerned that some of your estimated IRFs (e.g. an increase in government bond yields after fiscal consolidation) reflect reverse causality?
2) Is it possible that higher GDP growth after 7 years from the consolidation is just a “pay-back” of the significantly lower GDP growth rates in the first two years, with the economic activity first contracting, but later on returning to its potential level? If this is the case, is it possible to call this “expansionary fiscal consolidation”?
3) Don’t you think that good and credible fiscal consolidation may be composed of a mix of tax-based and expenditure-based measures? Could introducing a third category of “balanced consolidation plans” significantly alter your empirical results?
4) You find out that inflation declines 3-4 years after fiscal consolidations. The effect is even larger, and longer-lasting, in countries with floating exchange rates, and thus autonomous

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monetary policies. Does it imply that central banks react to announced fiscal policy plans too late, and are not able to offset their impact on inflation even in the medium term? Why do you think that central banks cut the interest rates only 3 years after fiscal consolidations (see Figure 5.14.), while in principle they should incorporate them in a forward-looking manner?

***SUMMARY OF POINTS AWARDED*** *(for details, see below):*

| **CATEGORY** | | **POINTS** |
|---|---|---|
| *Contribution* | *(max. 30 points)* | 28 |
| *Methods* | *(max. 30 points)* | 25 |
| *Literature* | *(max. 20 points)* | 19 |
| *Manuscript Form* | *(max. 20 points)* | 19 |
| **TOTAL POINTS** | *(max. 100 points)* | **91** |
| **GRADE** | **(A – B – C – D – E – F)** | **A** |

***NAME OF THE REFEREE: Doc. Mgr. Tomáš Holub, PhD.***

***DATE OF EVALUATION: 29 May 2024***

*Signed digitally by T. Holub*

***Referee Signature***