Fiscal consolidations and distributional effects

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The context of the study was the variety of austerity packages

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enacted by a number of countries in the

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last decade or so.

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Which themselves are really a

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response to the sort of financial crisis of the late 2000s. And the policy

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enacted

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in order to try and counteract some of those

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effects. And the sort of combination of both the crisis itself and the policies was that a number of developed rich countries had a growing levels of government debt and, and eventually they wanted to try and cut this through either

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cutting government spending or

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raising tax revenues, which is what we call fiscal austerity.

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So what we're trying to do in this paper is address what forms of austerity are best and and really sort of, as the title indicates, we're really thinking about what when we're thinking about what's best is what's least bad. And the way we address it in the paper is thinking about the effects of

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fiscal austerity in two dimensions.

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So the first is thinking about the effect

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on the average economy. So thinking about sort of total aggregate levels of prosperity and income. And then the second is considering the distributional effects. And the distributional effects is sort of important for two main reasons. The first is just because economically and politically income inequality has become far more of an important issue over the last few decades. But more pertinently with respect to fiscal austerity. Austerity itself is quite a long process. It's quite hard to cut government debt to any significant degree in a in a year or two. And therefore you need austerity packages, which which are long lasting. And in a democracy, it's quite hard to have a long lasting policy. That is unpopular, you need to have that political buy in order to make sure that electorally it makes sense in

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the future. And

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this is sort of even more important when you look at the empirical evidence. Typically, the empirical literature tends to suggest that fiscal austerity hurts the poor more than it hurts the rich, at least relatively speaking. And these reasons stronger when austerity

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is based around spending

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cuts rather than tax rises. So really at the heart

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of what we're trying to do in

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this paper is trying to build a theoretical model,

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which addresses different types of fiscal austerity packages to consider, which leads to the to the least bad outcomes with respect to both the aggregate and the sort of distributional effects

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of these policies, we use, what we

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call dynamic stochastic

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general equilibrium model, which, which sort of general equilibrium part of that means

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modelling everybody in the economy

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due to some sort of

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optimization of some base motivation. So firms in this economy are looking to sort of optimise the profitability, households are

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looking to

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maximise their happiness and the importance of that component is that we can rely on when we change things in the model that the responses of these agents are going to be sort of sensible responses Given that sensible underlying motivations, the dynamic and stochastic components just mean, these, these effects can change over time. And the impact of austerity does change over time. And we we can allow some form of randomness in the model. That's, that's what stochastic means. The kind of important parts that we add to the model, all we sort of elaborate on relative to a standard model of this all is, firstly, with respect to the fiscal policy settings. So like I said, empirical literature sort of, can split between government spending versus tax rising baseball therapy, whereas we can go a little bit further and theoretical models. So our government has four different ways in which you can spend money and therefore different ways in which you can cut back spending. And importantly, those different ways interact in the economy in different

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methods and that sort of picking up

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the variation and the different things that government spends money on. Similarly, the tax raising parts of the economy, the tax regime,

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The government

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that has four

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different sort of policy tools that hasn't spoken, again, reflecting the

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different ways in which we are attacks

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in the economy. And then the other sort of key sort of addition and elaboration of this model is how we get our variation across different individuals or households in the economy. And these households are allowed to vary both with

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respect to their income, and with respect to their

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wealth. So on on one end of the spectrum, is sort of household that has full access to financial markets and uses that access completely. So they, they invest in businesses, they invest in capital to rent out to businesses, they lend money to the government, they sort of hold the government debt in that respect. They can also lend money to other households in the economy, and they can buy housing stock. And this kind of financial wealth has two impacts in the model. One is if these households experience an income shelves,

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they have the wealth

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to kind of insure themselves against these income shocks. If what reason they have lower income tomorrow, they can use some of their wealth to kind of smooth that effect out. Secondly, this financial assets allows them to gain income you gain income from your investments you gain income from, from the from the financial assets you hold.

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At the other end of the spectrum

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of households, we have households which we call hand to mouth

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and their models not to access financial

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markets tool and they just spend their income each period. So their income is mainly being derived from their employment from from from using their labour towards wages. But they also will get some some transfers from the government looking to do some some sort of income redistribution through the fiscal sector. And the way this is sort of internally consistent in the model is we say these households are too impatient to want to ever say that they don't have enough income or consumption. Who ever wants to save and if they never want to save, then no lending body He's ever going to lend to them, because they're never going to save it in order to pay back these loans. And in between these two sort of spectrums,

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sort of households with all the financial wealth and the households who just spend

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their income and don't engage with any financial markets, all households, which still spend as much money as they can experience that they're impatient. They'll pour memes First, if you like. But what they what separates them in this respect, is they own a little bit of housing, so that they don't own their house altogether. But they own a

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part of the house if you think about a sort of deposit on a mortgage, and

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they can borrow against the housing because the housing itself retains its value and acts as collateral to, to to anybody lending the money. And what this means is they get to consume their labour income, they get to consume whatever the government gives them by way of sort of transfer payments. And they also get to consume whatever they get to borrow in this market when they're borrowing and the value of the house and importantly therefore, if the value As the house goes up, they get to borrow a little bit more, they also have to repay more back in interest. But yeah, that's the sort of defining difference

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of households in this model. And what this picks

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up therefore, is we've now got differences in income. So the sort of

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those who have lots of financial wealth that will

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be a lot richer than the other two thirds of

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households. And also, we pick up

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on this inequality of wealth, which is, you know,

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inequality and wealth is always a lot more stuff

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as an inequality of income in most economies. And the sort

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of third kind of really neat element of this sort of way

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of separating households is allows the housing sector to play a role in this Columbian and what we know of sort

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of, by the financial

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crash, just over a decade ago, and just in general, sort of what happened in the housing sector is an important driver or at least an important factor

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in how the macro economy responds to different shocks or in the model. We can sort of have two key ways of changing our fiscal or Sarah experiments. So one ways we can change the composition of the physical therapy so we can change the different

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expenditure items the government can cut,

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we can change the different tax rates they can raise. The other component which we can change is the speed

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of austerity.

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And that is, by the very nature, we're looking at a number of different households, we're looking at a number of different macroeconomic outcomes and a number of different fiscal austerity experiments. However, the kind of underlying outcomes are, fiscal austerity is bad

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to overall economic

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activity, so it is bad for output.

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And it's also quite bad for income inequality. So in almost all our fiscal experiments, no matter what the composition, income inequality gets worse rather than getting better, it impacts the poor rather than the rich, which clearly reconciles with the empirical literature. Also, reconciling with the empirical literature is that

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government spending cuts

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tend to be worse on the poor than tax rises.

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However, that's not a universal case. There are some tax rises, which would hurt the poor more than some spending cuts, because we now have that sort of granularity in theoretical model to be able to sort of identify that. But what's really important, much more so than the composition of the fiscal austerity is the speed in which it's an activity. So faster fiscal austerity, trying to cut government debt quickly, has a much more amplified impact

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on the economy. So when these

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outcomes are worse, which is almost all the experiments,

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faster austerity will have a worse effect on

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output and proper authority will have a worse effect on income inequality.

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And that sort of effect dominates

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over the sort of compositional factors of which specific fiscal instruments were either cutting or raising. And the other sort of under sort of underlying results which are true across the sort of variety of different ways in which we get these results is that fiscal austerity is is worse.

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In environments similar to the macroeconomic

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environment of the last decade, in particular, we find in our paper that when you have this will start when the economy is already in a downturn, that tends to lead to more amplified effects of austerity. So it tends to lead to worse outcomes with respect to the aggregate economy, and worse outcomes with

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respect to income inequality, income inequality

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gets worse with austerity, when the economy is already doing quite poorly. Also, when other policies are constraints. So the last decade, monetary policy in most developing countries has been

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constrained by the sort of believe

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that interest rates can't go below zero. And when one policy is constrained, the effects of the other policies become that much more magnified. And therefore the the effects of physical therapy in this case become that much more magnified. So realistically, the kind of overwhelming results are that

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physical therapy is bad

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for the economy in general, it wasn't income inequality

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and it does so more when you Try and cut that quickly,

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or when you're cutting that,

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in thirds is an apology, which is already in the dental. Really, this paper and all economics is being honest, is a story of trade offs. So a key trade off here is between the political and the economic. Politically, we quite like quick austerity, we quite like to cut government debt in a way which is, which is nice and quick and doesn't go across election cycles. I think, in the UK, the conservative manifesto 2010 is a classic example of this. So in 2010, the conservatives sort of got elected parliament as a coalition government on the promise of enacting austerity, but their their plan was to have austerity for five years, essentially the life of a parliament, and realistically what their plan was to have austerity for four years. And then the fifth year that stopped doing austerity and make the electorate happy and get reelected. What actually happened was we had 10 years of austerity didn't have anywhere near the impact that they wanted to have. And then politically It became too much to handle it and then natural policy. So politically we'd like short, this will serve if we can have it be economically, we won't quite long and sort of long winded austerity that takes a long time to kick in.

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And that kind of trade off between the political and economic

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is interesting in itself, but particularly in a sort of period where we have quite divisive political environment. If we just focus on the kind of economic trade off, if we think of

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fiscal austerity is trying to achieve three objectives.

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So the key objective here is cutting government debt. And then the two objectives that we're sort of playing about with in the paper one is trying to sort of not have too much of a damaging effect on output or total

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level of economic activity and the other being

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the third objective being trying to have a small impact on income inequality, or even making income inequality less than or equal, making it better. You Kind of cheap to those objectives reasonably well, but it's hard to get the service. So you could have an austerity package, which does cut government debt. It doesn't affect output too much. But those are the packages which have the biggest impact on income inequality. You can have fiscal austerity, which does cut government debt and doesn't rise for income inequality could actually improve income inequality might make incomes more equal, but they tend to be those policies which are associated with the worst outcomes for output. So in this respect, you can you can always have two or three of your objectives. But there's a compromise that you have to have to compromise or pick your poison of what you're going to lose and these policies. And realistically what physical therapy needs is kind of a sort of open dialogue between sort of politicians, the government

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and individuals about how these trade

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offs are going to be navigated. I think the same set of authors, we've we've just a couple years ago called expansionary contractions and fiscal free lectures too good to be true. And in that we really sort of try and come up with scenarios where governments in fiscal policy setting framework

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can have

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the best outcomes from all their objectives

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almost like a free policy.

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And it knows if we approach the

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question in a different way, but the sort of outcomes are the same where

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it is possible in a sort of very, very unusual situation that you can have this sort of wonderful policy that

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has no trade offs

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whatsoever, but it's just very, very unlikely. And

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I think that's true of this paper as well that that physical therapy is there's going to be pain somewhere. And it's just how that pain is negotiated and compromised, which is the sort of key point that needs to be determined by by governments and people alike.

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