The impact of fiscal consolidations on the functional components of government expenditures

Vítor Castro

Faculty of Economics, University of Coimbra, Portugal
Economic Policies Research Unit (NIPE), Portugal

ARTICLE INFO

JEL classification:
E62
H50
Keywords:
Government expenditures
Functional components
Fiscal consolidations
European Union

ABSTRACT

This paper analyses how the functional components and sub-components of government expenditures are affected by fiscal consolidations. A fixed-effects estimator is employed over a panel of 15 European Union countries during the period 1990–2012. The results show that spending on public services increases during fiscal consolidations, while spending on defence, public order, health, education and social protection is significantly cut. A more disaggregated analysis proves that fiscal consolidations are harmful for important social expenditures, in particular, for those related to citizens’ safety, health assistance, social protection and investment in human capital. This evidence is even stronger in a particular group of countries, known in the literature as PIIGS. Hence, fiscal consolidations can have important implications on the living standards of the more economically vulnerable citizens.

1. Introduction

The consolidation efforts observed in several countries have motivated academics to analyse the characteristics and the empirical determinants of fiscal consolidation programmes. The rising of public deficits and debts in the aftermath of the recent Great Recession have revived the interest on this issue.

The funds transferred by fiscal authorities to rescue the banking sector and the discretionary measures adopted by several European Union (EU) governments, in particular, to boost the economic activity, led to considerable fiscal deficits and pushed government debts to historically high levels. This forced EU countries to abandon those expansionary fiscal policies and to implement austerity programmes. The Greek crisis boosted this process, as countries wanted to convince the markets that they were in a better position. Hence, several consolidations and austerity packages started to be implemented.

While EU institutions emphasize the importance of fiscal consolidations as a requirement for sustainable growth, the US consider that they may hurt short-term growth and longer adjustment periods should be allowed. Assessing the trade-off between consolidation of public finances and economic growth is fundamental for the formulation of effective policies. Several studies look at this relation and try to identify the determinants, impact, timing and the length of fiscal consolidations (Alesina et al., 2008; Alesina and Ardagna, 2010; Barrios et al., 2010; Cimadomo et al., 2010; Sanz, 2011; Cimadomo, 2012; Agnello et al., 2013, 2015, 2016; Ball et al., 2013; Bi et al., 2013; Afonso and Jalles, 2014; Anderson et al. 2014; Agnello and Sousa, 2014; Caffo and Cellini, 2014; Cugnasca and Rother, 2015; Afonso and Jalles, 2016). Others take into account the kind of consolidation to show that successful consolidations are primarily based on spending cuts rather than increasing taxes (Alesina and Perotti, 1995, 1997, 1998; McDermott and Wescott, 1996; Buti and Sapir, 1998; Forni et al., 2010; Afonso and Jalles 2012; Erceg and Linde, 2013; Heylen et al., 2013, among others).

However, as far as we are concerned, no study on fiscal consolidations looks at their impact on the functional components of public expenditure. Sanz (2011) explores the relationship between the components of government expenditure and the government size, but he does not account for fiscal consolidation spells. A few other papers have also looked at those components but from a political perspective (see, for instance, Potrafke, 2010; Katsimi and Sarantides, 2012; Enkelman and Leibrecht, 2013; Morozumi et al., 2014; Castro and Martins, 2016a, 2016b). They analyse whether and how electoral motives, government ideology and political support affect the components of public expenditures, but they are silent regarding the role of fiscal consolidations.

* The author acknowledges the helpful comments and suggestions from the editor and two anonymous referees. The author also wishes to thank the financial support provided by the Portuguese Foundation for Science and Technology under the research grant SFRH/BSAB/113580/2015 (partially funded by COMPETE, QREN and FEDER). This paper was written while the author was visiting the Faculty of Economics, University of Cambridge, UK. He is grateful for the facilities provided by this University to develop his research.

☆ Correspondence address: Faculty of Economics, University of Coimbra, Av. Días da Silva 165, 3004-512 Coimbra, Portugal.

E-mail address: vcastro@fe.uc.pt.

http://dx.doi.org/10.1016/j.econmod.2016.09.027
Received 13 July 2016; Received in revised form 21 September 2016; Accepted 30 September 2016
0264-9993/ © 2016 Elsevier B.V. All rights reserved.
The knowledge of how fiscal consolidations affect spending on education, health, social protection, public services, among others, is of the most importance for an adequate design of fiscal consolidation programmes. Knowing their impact on those components allows fiscal authorities to take action to mitigate the negative economic and social effects of fiscal consolidations and to avoid the deterioration of the well-being of the more vulnerable citizens. If the adjustments rely essentially on expenditure cuts in education, health or social protection, for example, – to reduce the public deficit and debt quickly – the middle and lower classes in a society will feel the pinch more intensively than richer citizens. This can lead to higher income inequalities (Agnello and Sousa, 2014), social and political instability (Agnello et al., 2014b) and human development (Agnello et al., 2015b).

This analysis represents an important step forward relatively to the previous literature, as it allows us to identify and understand which items inside the components of public expenditure are being more significantly affected by the fiscal consolidation processes and, as so, infer about the social consequences for the most vulnerable citizens.

A fixed-effects estimator is used in the empirical analysis and the results show that spending on public services increases during fiscal consolidations, while spending on defence, public order, health, education and social protection is significantly cut. A more disaggregated analysis proves that fiscal consolidations are harmful for important social public expenditures, undermining citizens’ safety, health assistance, investment in human capital and social protection. Public services are likely to be increased due to a rise in public debt transactions observed during periods of fiscal consolidation. All this evidence has proved to be stronger in a particular group of countries, here called PIIGS.

This article is organized as follows. Section 2 presents a brief review of the relevant literature. Section 3 describes the data and presents the econometric model. The main results are presented and discussed in Section 4 and Section 5 concludes.

2. Literature review

The studies on fiscal consolidations have concentrated the attention on the factors that influence their implementation. The state of public finances and the economic conditions have been regarded in the literature as the most important conditionings of fiscal consolidations (Perotti, 1999; Giavazzi et al., 2000; Blanchard and Perotti, 2002; Alesina et al., 2008; Barrios et al., 2010; Agnello et al., 2013, 2014a; Anderson et al., 2014; Afonso and Jalles, 2016).

Fiscal consolidations are usually implemented when the stance of governments is weak, frequently related to large public debts; the domestic economy is not always thriving as expected and ends up being negatively affected by the austerity measures in the short-term. In the long-run, the economy tends to recover, but in some cases/countries and under certain conditions it may take quite a long time (Anderson et al., 2014).

Blanchard and Perotti (2002) show that positive government spending shocks increase output and private consumption and have a crowding-out effect over private investment, while positive tax shocks have a negative effect on output and private spending. On the contrary, Afonso and Jalles (2014) show that during consolidations, lower government consumption increases private consumption. This effect is higher for countries with lower debt levels, implying that more successful consolidations might be associated with reduced crowding-out effects. Nevertheless, this debate is far from reaching an agreement, as some recent studies have shown that several countries are now facing uncertainty about the effects of fiscal measures on the economic activity (Cimadomo, 2012; Cimadomo et al., 2012; Anderson et al., 2014), as well as regarding the duration of such adjustment programs (Agnello et al., 2013).

Other studies focus on the impact of fiscal consolidations on income distribution. Coenen et al. (2008) argue that depending on the fiscal instrument used, fiscal consolidations may have pronounced distributional effects. Furceri et al. (2015) show that fiscal consolidations increase income inequality and lower wage income shares in the short and medium-term. Agnello and Sousa (2014) also uncover a significant widening of the income gap during episodes of fiscal consolidation. Moreover, Mulas-Granados (2005) finds that successful fiscal consolidations are associated with higher income inequality, while Afonso and Jalles (2012) show that the stance of the cyclically adjusted primary balance and the duration of the consolidations can contribute to their success.

The timing, size, and composition of the austerity measures are other important factors that can affect a fiscal consolidation, its likelihood of success and duration (von Hagen and Strauch, 2001; von Hagen et al., 2002; Agnello et al., 2013; Agnello et al., 2015a; Agnello et al., 2016). In terms of timing, gradual consolidations are considered to be more successful than quick adjustments. However, Barrios et al. (2010) show that when public debt is very high and the economy is not growing, quick measures might be the best option. In the same line, von Hagen et al. (2002) also notice that when a fiscal consolidation lasts for a long period of time it can be affected by fatigue and the consolidation process might be reversed. Giavazzi and Pagano (1996) and von Hagen and Strauch (2001) put the emphasis on the size of the fiscal consolidations, which can indicate the extent of the governments’ commitment to achieve long-term sustainability in public debt. In addition, Molnár (2012) notices that large consolidations need multiple instruments for the consolidation to succeed.

Regarding the composition, Alesina and Perotti (1995, 1997, 1998), McDermott and Wescott (1996), Buti and Sapir (1998), Forni et al. (2010), Erceg and Linde (2013) and Heylen et al. (2013) show that spending-driven fiscal consolidation programs have better conditions to be successful than fiscal adjustments that rely essentially on tax increases and cuts in investment. Agnello et al. (2015b) provide additional evidence that spending-driven consolidations are shorter than tax-driven consolidations and that the size of the consolidation program does not significantly affect the duration of fiscal consolidations. Moreover, Molnár (2012) shows that spending-driven adjustments are more likely to stabilise public debt than revenue-driven ones. In this context, the business cycle literature corroborates the idea that tax-cuts are more effective in stimulating the economic activity than higher government spending, but the importance of tax cuts versus higher government spending has been in debate among policymakers and economists for a long time (see, among others, Garcia and Henin, 1999; Mountford and Uhlig, 2009; Jha et al., 2014; Hur et al., 2014).

However, as far as we are concerned, no study on fiscal consolidations looks at their impact on the functional components of public expenditure. Sanz (2011) explores the relationship between components of government expenditure and government size in 25 developed countries and shows that fiscal discipline affects public spending composition. However, he does not identify fiscal consolidation spells; he only accounts for changes in the size of the government. That is not a suitable approach to understand how the components of public expenditure behave during fiscal consolidations. As the size of the government is measured by dividing total government spending by GDP, it accounts for effects from the level of total government spending and the economic cycle. Hence, we cannot learn much on the actual effect of fiscal consolidations.

Other few papers that look at the behaviour of the functional components of public expenditure take a political perspective. Potrafke (2010) finds that incumbents increase the growth of public health expenditures in election years, while Enkelman and Leibrecht (2013) conclude that election cycles are mainly found in the new democracies of Eastern Europe and in categories such as social welfare, general public services, environmental protection and infrastructures. More recently, Castro and Martins (2016a, 2016b) found political opportunism mainly in health, education, social welfare and general public...
دریافت فوری
متن کامل مقاله

امکان دانلود نسخه تمام متن مقالات انگلیسی
امکان دانلود نسخه ترجمه شده مقالات
پذیرش سفارش ترجمه تخصصی
امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
امکان دانلود رایگان ۲ صفحه اول هر مقاله
امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
دانلود فوری مقاله پس از پرداخت آنلاین
پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات