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Fiscal consolidation and its cross-country effects*

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Abstract

We build a new Keynesian DSGE model consisting of two heterogeneous countries in a monetary union. We study how public debt consolidation in a country with high debt (like Italy) affects welfare in a country with solid public finances (like Germany). Our results show that debt consolidation in the high-debt country benefits the country with solid public finances over all time horizons, while, in Italy, debt consolidation is productive in the medium and long term. All this is with optimized feedback policy rules. On the other hand, fiscal consolidation hurts both countries and all the time, if it is implemented in an ad hoc way, like an increase in taxes. The least distorting fiscal mix from the point of view of both countries is the one which, during the early phase of pain, Italy cuts public consumption spending to address its debt problem and, at the same time, reduces income tax rates, while, once its debt has been reduced in the later phase, it uses the fiscal space to further cut income taxes.

Keywords: Debt consolidation, country spillovers, feedback policy rules, new Keynesian.

JEL classification: E6, F3, H6

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