Accepted Manuscript

Fiscal consolidation and its cross-country effects

Apostolis Philippopoulos, Petros Varthalitis, Vanghelis Vassilatos

PII: S0165-1889(17)30157-4
DOI: 10.1016/j.jedc.2017.07.007
Reference: DYNCON 3458

To appear in: *Journal of Economic Dynamics & Control*

Received date: 8 July 2016
Revised date: 19 July 2017
Accepted date: 20 July 2017

Please cite this article as: Apostolis Philippopoulos, Petros Varthalitis, Vanghelis Vassilatos, Fiscal consolidation and its cross-country effects, *Journal of Economic Dynamics & Control* (2017), doi: 10.1016/j.jedc.2017.07.007

Fiscal consolidation and its cross-country effects*

Apostolis Philippopoulos †
(Athens University of Economics and Business, and CESifo)

Petros Varthalitis
(Economic and Social Research Institute, and Trinity College Dublin)

Vanghelis Vassilatos
(Athens University of Economics and Business)

July 31, 2017

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

*We thank the coeditor, James Bullard, and two anonymous referees for many constructive comments. We thank Konstantinos Angelopoulos, Fabrice Collard, Harris Dellas, George Economides, Saqib Jafarey, Jim Malley, Dimitris Papageorgiou, Evi Pappa, Lefteris Roubanis and Elias Tzavalis for discussions. We thank Johannes Pfeifer for help with Dynare when this paper started. We have benefited from comments by seminar participants at the University of Bern, CESifo in Munich, University of Zurich, City University in London and the Athens University of Economics and Business. Any errors are ours. Petros Varthalitis clarifies that the views expressed here may differ from those of ESRI.

†Corresponding author: Apostolis Philippopoulos, Department of Economics, Athens University of Economics and Business, Athens 10434, Greece. tel:+30-210-8203357. email: aphil@aueb.gr