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Austerity, inequality and politics

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ABSTRACT

We analyze the effect of budget consolidation on income inequality in 17 OECD countries while controlling for political and ideological differences. We find that the impact of fiscal adjustments on the Gini coefficient does not depend on the political party in power, but on the type of government. Austerity measures by coalition governments significantly reduce income inequality when compared with single party and minority governments, even when they are successful or expenditure based. While coalition governments are less successful in reducing structural budget deficits, they perform much better in terms of addressing distributional concerns.

1. Introduction

Rising income inequality in advanced economies in recent years has led to public debates and has renewed the interest of academic researchers in the causes and consequences of this ongoing trend. In addition, the Great Recession has led to widespread economic, political and social costs.[1] The resulting surge in government debt in advanced countries raised fears about fiscal sustainability and forced many European governments into unprecedented fiscal adjustments due to rapidly rising government bond yields. The necessity, timing, size and scope of these expenditure cuts and tax increases remain controversial and have led to concerns about their distributional effects.

High or rising income inequality may matter for a variety of reasons. Inequality potentially reduces social mobility and social cohesion. Intergenerational earnings mobility tends to be low when income inequality is high. It may thus become increasingly more difficult for highly skilled young people to climb the social ladder. Inequality also poses political challenges as social unrest and political instability may increase, while physical and mental health decline (OECD, 2011; Wilkinson and Pickett, 2009).

Against this background, the consequences of austerity measures on unemployment levels, poverty rates and income inequality are of general interest. Fiscal reforms that are implemented in order to reduce uncertainty and regain competitiveness may be associated with efficiency gains. However, these gains are likely to require time to materialize while there may be substantial costs in the short run. There may thus be a trade-off between short run costs such as increased inequality, unemployment and lower growth

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[1] Costs include a decline in output and disposable income, an increase in unemployment, poverty and suicide rates, social unrest (protests and strikes), discontent, political instability or a decline in trust in institutions. See also Altindag and Mocan (2010), Dao and Loungani (2010), Jenkins et al. (2011) or Schaltegger and Weder (2013).

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and medium to long-term benefits in the form of fiscal sustainability, political stability and higher economic growth. Whether inequality increases or decreases in the medium term evidently depends on how the costs and benefits of such reforms are distributed among citizens.

This paper provides an empirical analysis of the effects of fiscal adjustments on income inequality depending on the political environment for a sample of 17 OECD countries during the period from 1978 to 2009. The paper contributes to the empirical literature by taking into account different aspects of the political economy. Related research from Agnello and Sousa (2012), Ball et al. (2013) and Woo et al. (2013) indicates that fiscal austerity increases income inequality. However, it remains unknown whether this result depends on the political party or the type of government in power. We do not find any significant differences between left-wing, centrist and right-wing governments. However, fiscal adjustments by coalition governments are associated with significantly lower levels of inequality than those implemented by single party or minority governments. This result also holds when austerity measures are expenditure based and when they are successful in reducing debt levels.

Thus, the trade-off between austerity and inequality is shaped by the accompanying political regime. While coalition governments tend to be associated with high government spending and fiscal deficits because they are more inclined to yield to various interest groups, they also appear to be better equipped in dealing with distributional concerns. Because multiparty governments tend to spread the costs of their spending decisions among all coalition members, the same seems to hold when they are forced to cut the budget deficit. Since coalition governments are formed by different parties, the costs of negotiation are higher and this helps to explain why they are less successful than single party and minority governments in reducing government debt. However, having to take account of various interests also appears to produce more favorable outcomes in terms of income inequality.

The paper is structured as follows. In Section 2, we provide a short review of the empirical literature on the interplay of fiscal policy, political factors and income inequality. Section 3 describes our model and presents the corresponding estimates and some extensions and robustness checks. Section 4 concludes.

2. Review of the empirical literature

The relationship between fiscal policy and income inequality has received considerable attention in recent years. This interest has increased further after the Great Recession and the fiscal adjustment programs that were implemented in its aftermath. Tax and benefit policies are generally found to exhibit a strong effect on disposable household income. But government policies have become less effective in reducing inequality over time because social benefits and top income tax rates were cut (Immervoll and Richardson, 2011; Bastagli et al., 2012).

Previous empirical work regarding the effects of fiscal adjustments on poverty and inequality includes Smeeding (2000), Mulas-Granados (2005), Agnello and Sousa (2012), Ball et al. (2013) and Woo et al. (2013). They all find that austerity measures are associated with a significant increase in poverty and income inequality. Rawdanowicz et al. (2013) analyze ten episodes of large fiscal adjustments in OECD countries and find that the Gini coefficient increased in only five cases. They argue that a full assessment of the effects of fiscal consolidation packages would have to include dynamic measures such as an analysis of the life-time income distribution, the equality of opportunity, as well as interactions with other policies.

Kaplanoglou et al. (2013) find that more targeted social transfers, higher public expenditure on training and social housing as well as lower VAT rates on basic necessities increase the probability of reducing deficits and debt levels substantially. The findings of Mulas-Granados (2005) point to a considerable trade-off between economic growth and equality. Expenditure based adjustments are less harmful for growth, but are associated with a less equal income distribution, whereas the reverse applies for revenue based adjustments. He thus concludes that different strategies of fiscal adjustments lead to different economic consequences in the short run.

In the context of political economy, several studies have highlighted that both government ideology and the type of government affect fiscal policy outcomes. For example, Mulas-Granados (2003) analyzes fiscal policy strategies in EU countries between 1970 and 2000 and concludes that government ideology and political fragmentation significantly affect fiscal policy strategies.[2] In the 1990s, government ideology was the strongest determinant of the composition of the budget. When implementing austerity measures, left-wing governments chose to increase direct taxes in order to maintain the government wage bill and public investment. On the expenditure side, they cut subsidies, consumption and social transfers. Tavares (2004) also finds that left-wing governments tend to reduce the budget deficit by raising taxes, whereas right-wing governments frequently rely on spending cuts. Fiscal adjustments are more persistent if left-wing governments cut expenditure and if right-wing governments increase taxes. He argues that, by implementing fiscal adjustments that are against the interests of their constituencies, governments can signal commitment and credibility.

In the political-economy literature, coalition governments tend to favor high government spending. The theoretical argument is based on the public budget as a fiscal commons that will be overused by the interplay of interest groups (Weingast et al., 1981). A single party government is accountable for its policy decisions and hence has an incentive to keep interest group influences in

[2] Schaltegger and Feld (2009a) show that fiscal federalism as a special case of government fragmentation supports consolidation strategies of government in the case of Swiss cantons. Baskaran (2013) shows that government fragmentation in the case of large cabinets is also of importance for the German Länder — even though the effect is rather small. Hallerberg et al. (2007) point to the importance of budgetary institutions for the working of fiscal rules and budget procedures in EU countries on public finances.