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Fiscal Consolidations and Heterogeneous Expectations

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Abstract

We analyze fiscal consolidations using a New Keynesian model where agents have heterogeneous expectations and are uncertain about the composition of consolidations. We look at spending-based and tax-based consolidations and analyze their effects separately. We find that the effects of consolidations and the output multipliers are sensitive to heterogeneity in expectations before and after implementation of a specific fiscal plan. Depending on the beliefs about the type of consolidation prior to implementation, we show that heterogeneity in expectations may lead to optimism in the economy, improving thus the performance of a specific fiscal plan, or can work towards the opposite direction leading to pessimism, amplifying the contractionary effects of the consolidation. In general, we find that spending-based consolidations last longer and lead to deeper recessions when agents are boundedly rational compared to the rational expectations benchmark, while the opposite holds for tax-based consolidations.

JEL Classification: H60, D83, E32, E62, E63, H30

Keywords: Fiscal policy, uncertainty, heterogeneous expectations, bounded rationality

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[†]The views expressed do not reflect the official position of De Nederlandsche Bank or the Eurosystem.

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