Who Pays for Austerity? The Design and Distributional Effects of Fiscal Consolidation in the European Union

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Introduction

- Why is this interesting?
  - Income inequality and a focus on factors that governments can control
  - Bringing distributional issues to the fore in economic policy debates
- What else will I demonstrate?
  - The benefits of international comparisons
  - The value that microsimulation methods can add to the analysis of micro-data
- What are the challenges?
  - Not one crisis but several
  - Which countries and what time period?

Credits

- I am drawing heavily on joint work with colleagues

- Avram, S., F. Figari, C. Leventi, H. Levy, J. Navicke, M. Matsaganis, E. Militaru, A. Paulus, O. Rastrigina and H. Sutherland, 2013, “The distributional effects of fiscal consolidation in nine EU countries”, *EUROMOD Working Paper EM2/13.* www.iser.essex.ac.uk/publications/working-papers/euromod/em2-13

- Work in progress with Francecso Figari and Alari Paulus

Motivation

- Fiscal consolidation measures have an impact on the income distribution. Why does this matter?
  - Inequality, and any driver of growth in it, matters in its own right
  - Prospects for macroeconomic recovery are affected by the composition of fiscal adjustment and/or who is being squeezed
  - Political acceptability and effectiveness

- Our focus is on austerity policy decisions and particularly fiscal measures which have a direct and quantifiable effect on the distribution of income.
  - “Discretionary” policy effects
  - Not “automatic” stabiliser effects

Motivation

- The fiscal consolidation literature is mainly macro-oriented and often overlooks the distributional effects

  "The crucial question, however, remains the impact of fiscal consolidations on the distribution of disposable income. On this, there is very little information, because very rarely does the timing of income-distribution surveys allow an analysis of its evolution before and after a fiscal consolidation, and because there are well-known difficulties in assessing the impact of the various budget items on income distribution" (Perotti, AER, 1996)

Summary of the approach

- Based on a microsimulation approach (EUROMOD), we provide *ex ante* estimates of the distributional impact of fiscal consolidation measures implemented in 9 EU countries since the start of the "Great Recession" and up to mid-2012
- Estonia (EE), Greece (EL), Spain (ES), Italy (IT), Latvia (LV), Lithuania (LT), Portugal (PT), Romania (RO) and the UK
- Focus on measures with a direct impact on income distribution
  - Public wages, public pensions, cash benefits, direct taxes, social insurance contributions (SICs)
  - VAT
- Microsimulation allows us to
  - Update micro data to the most recent period
  - Distinguish discretionary from automatic policy effects
- Data: 2008 EU-SILC micro-data (FRS 2009/10 in UK)
  - Market incomes adjusted to 2012 levels

A little about EUROMOD

- Tax-benefit microsimulation models deal with income, re-calculating income components (taxes and benefits) for households from micro-datasets under different assumptions
- EUROMOD is special
  - Many (27) countries in a common framework
  - Open access (subject to permission to use EU-SILC microdata)
- Highly flexible and transparent
- Effects of policy changes on income (+ effects of other changes on impact of policy)
  - First round budgetary, distributional and incentive effects
  - Cross country comparisons, EU-level analysis, “policy swaps”
- Coordinated, maintained and developed at University of Essex in partnership with 27 national teams
  - In Luxembourg: CEPS/INSTEAD

Methodological points

- Emphasis on consistent cross-country analysis
- Counterfactual scenario: How would tax-benefit systems have evolved by now (2012) without fiscal consolidation?
  - Pre-austerity policies indexed using national rules/conventions
  - Compare with actual 2012 systems
- Period considered: up to mid-2012
  - Not changes announced for the future (e.g. UK)
- What counts as an austerity measure?
  - Programme “packages” where they exist
  - Fiscal measures aimed to cut the public deficit or limit its growth
  - Exclude measures part of other policy agendas, rolling back of stimulus measures and expired measures

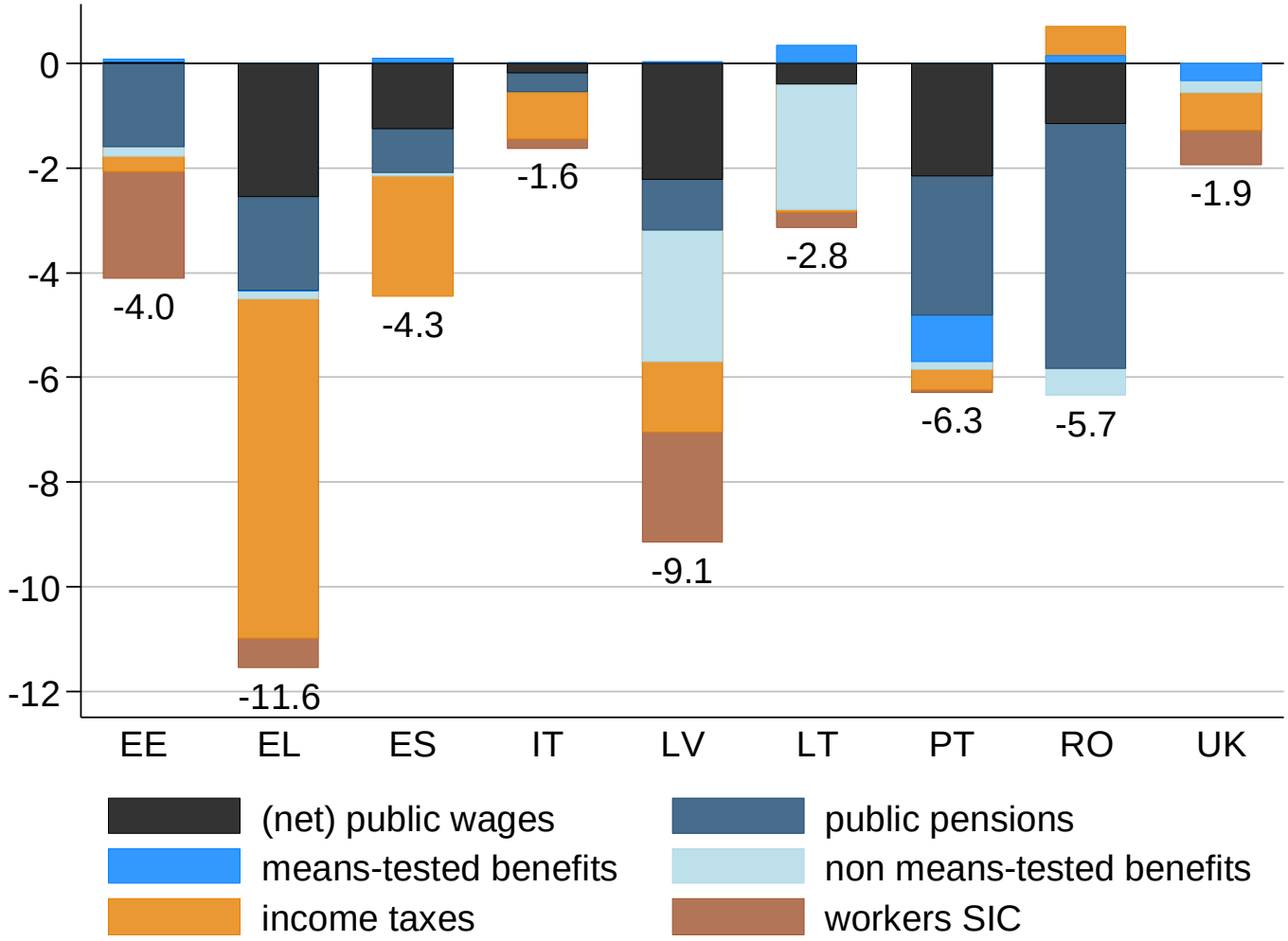
Types of fiscal consolidation measure: summary

	EE	EL	ES	IT	LV	LT	PT	RO	UK
Cuts in **benefits or public pensions** (or freezing)	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Increased **income taxes** and/or reduced tax concessions	Yes	Yes	Yes	Yes	Yes	No	Yes	No	Yes
Increased worker **social insurance contributions** (SICs)	Yes	Yes	No	Yes	Yes	No	Yes	No	Yes
Public sector **pay cuts** (or freezing)	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	(No?)
Increased **property taxes**	No	Yes	(Yes)	Yes	(Yes)	(Yes)	(Yes)	(Yes)	No
Increased standard rate of **VAT**	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

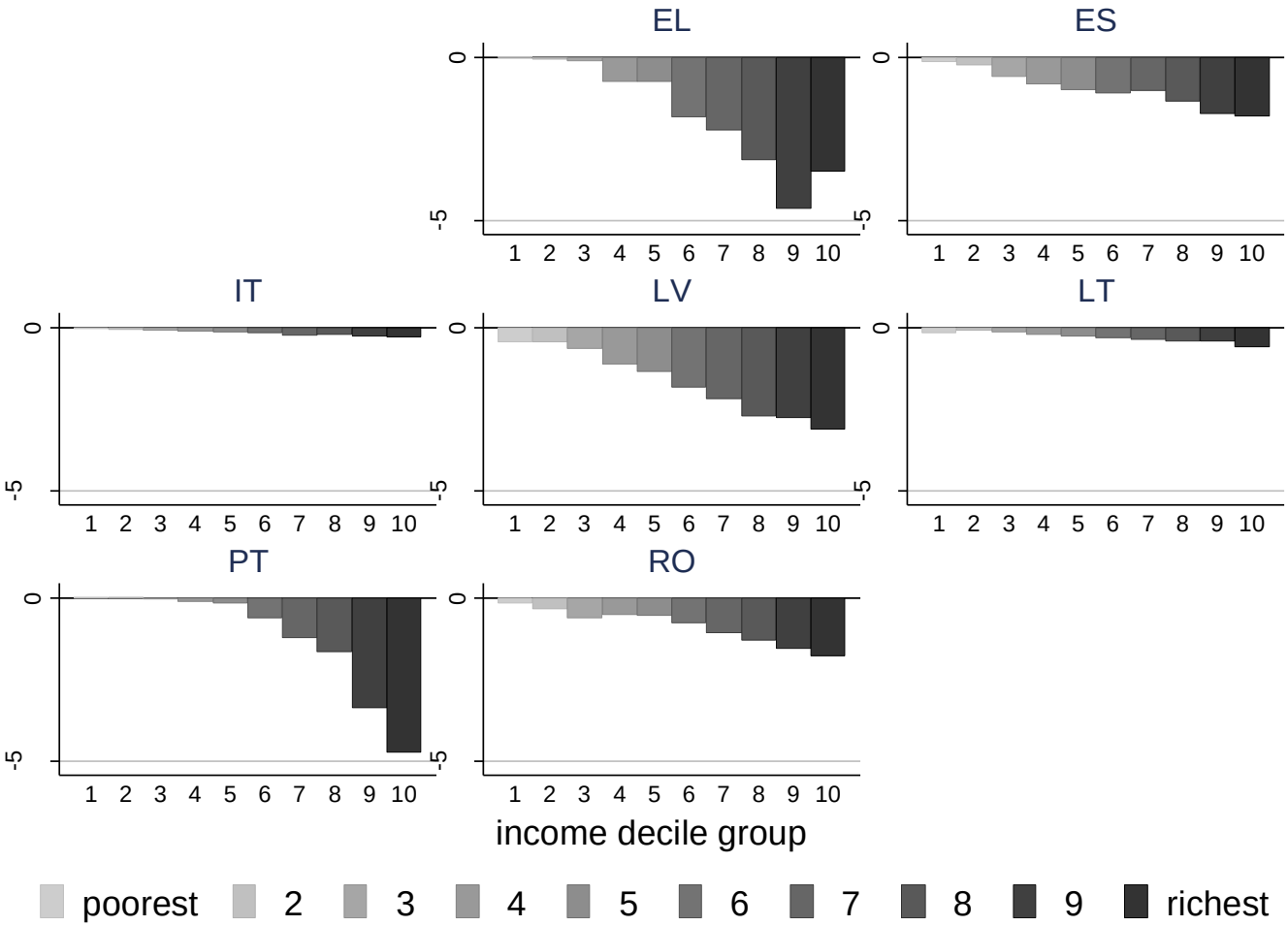
Simulation details

	Austerity period	Indexation conventions used in the construction of "business as usual" counterfactuals
Estonia	2009-11	None except pensions (CPI+earnings) and some benefit ceilings (earnings)
Greece	2010-12	None
Spain	2010-12	None except pensions (CPI)
Italy	2011-12	Pensions and benefits indexed mainly by prices; no indexation of income tax thresholds
Latvia	2009-12	None except pensions and some small disability benefits (CPI since 2009)
Lithuania	2009-12	None
Portugal	2009-12	Most components by CPI
Romania	2010-12	None except pensions (CPI+earnings)
UK	2009-12	Most components by prices; some by earnings.

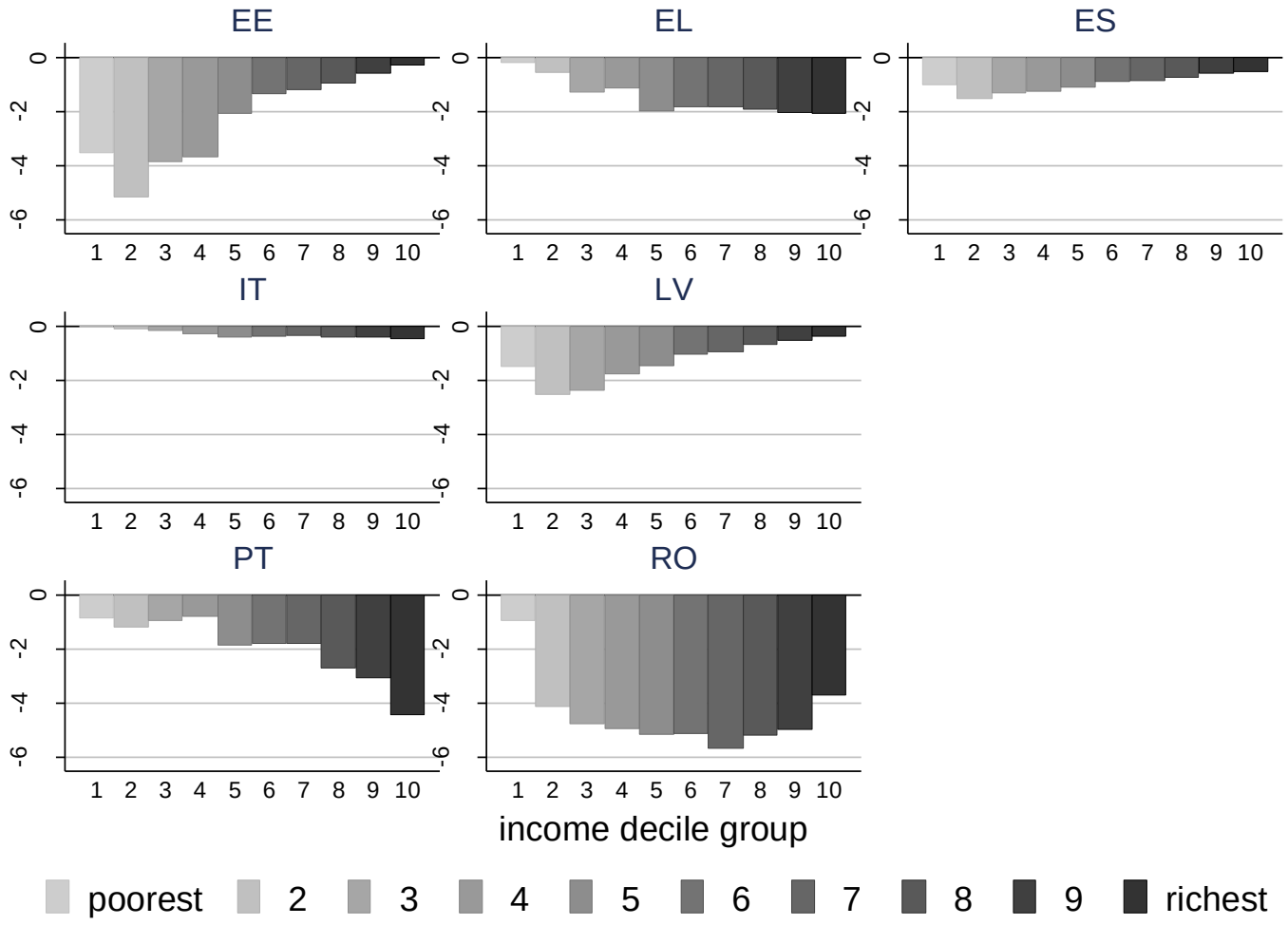
Aggregate change in household disposable income by income component %



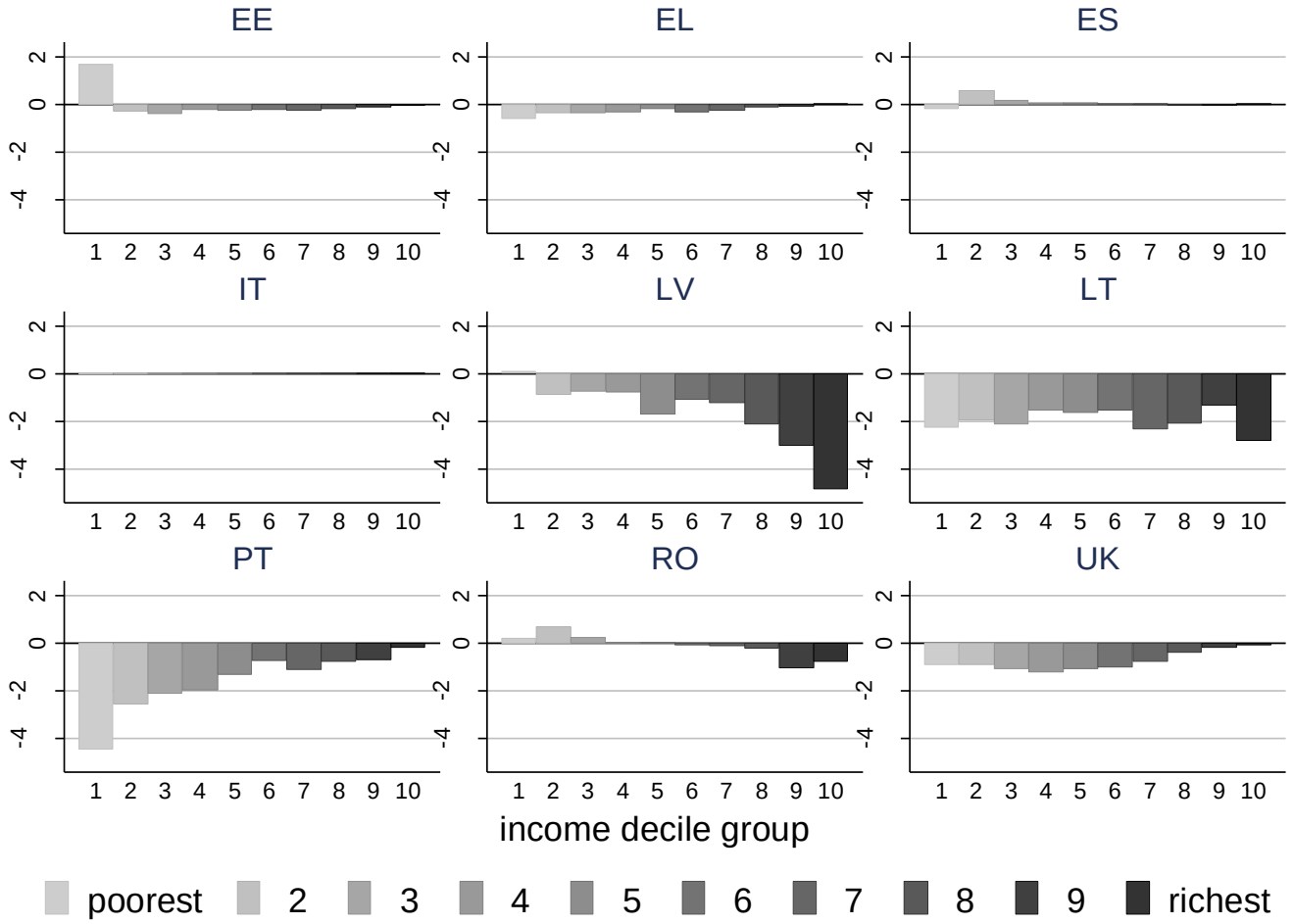
% change in household disposable income due to public sector pay cuts (net)



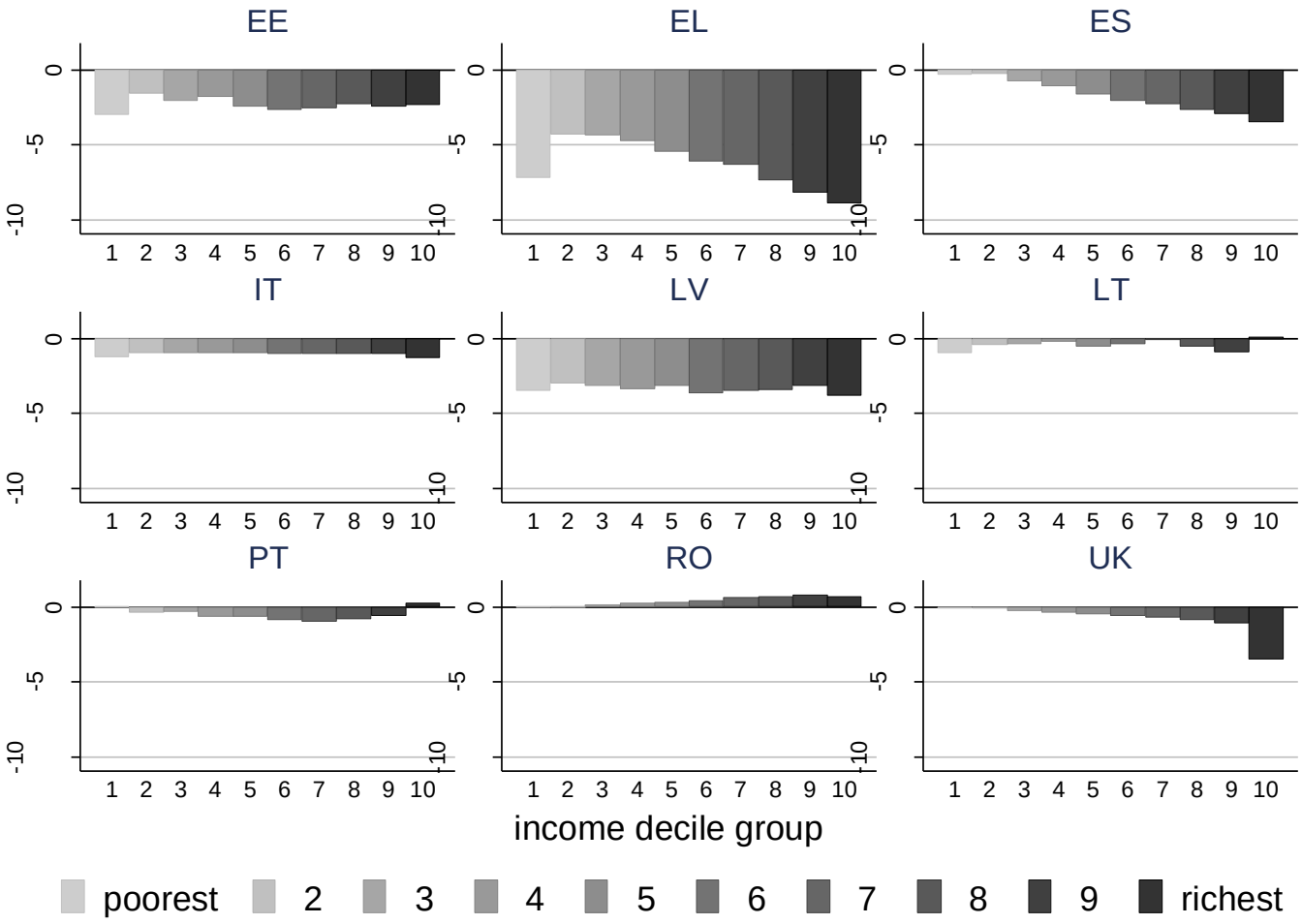
% change in household disposable income due to cuts in public pensions



% change in household disposable income due to cuts in non pension cash benefits

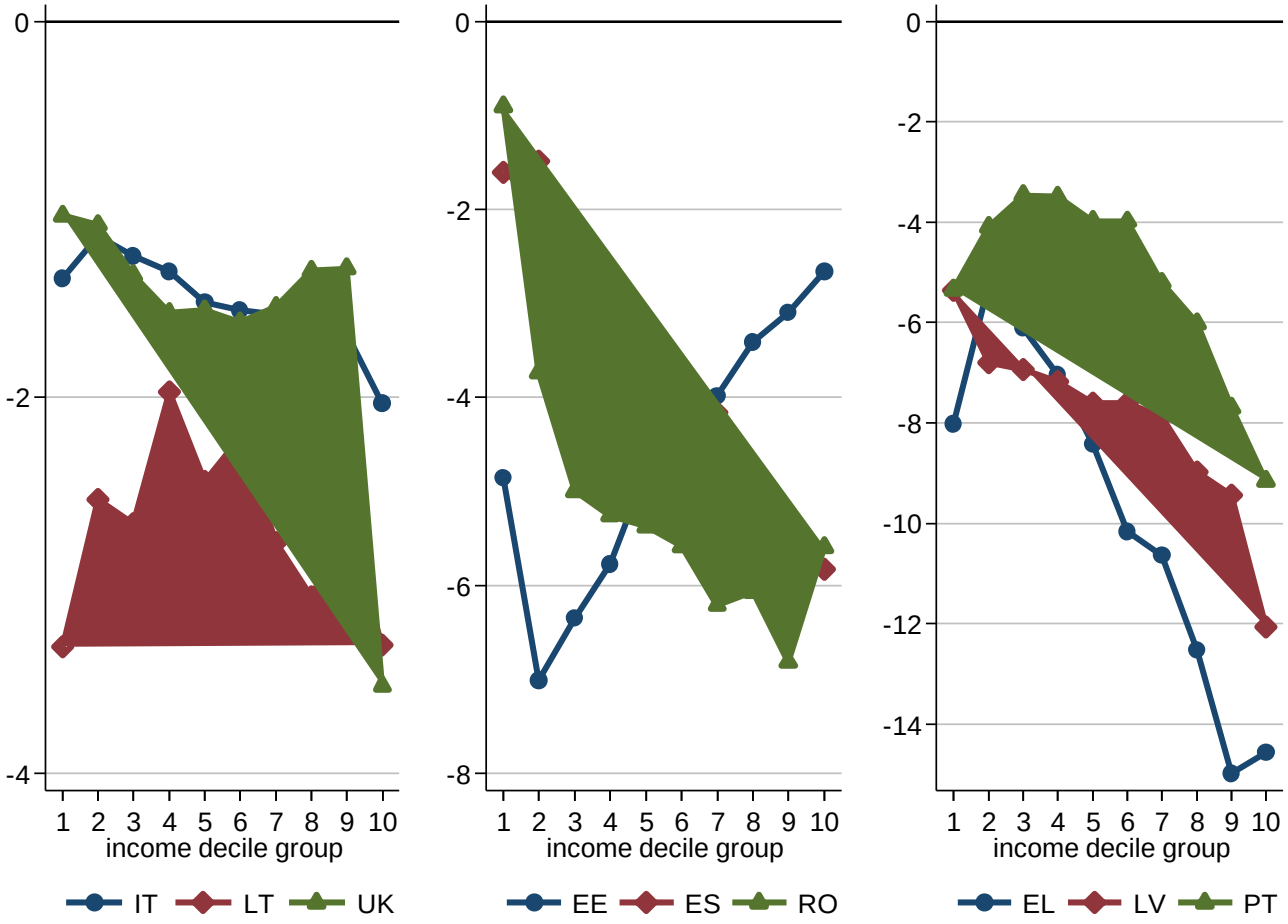


% change in household disposable income due to increases in income tax and worker SIC



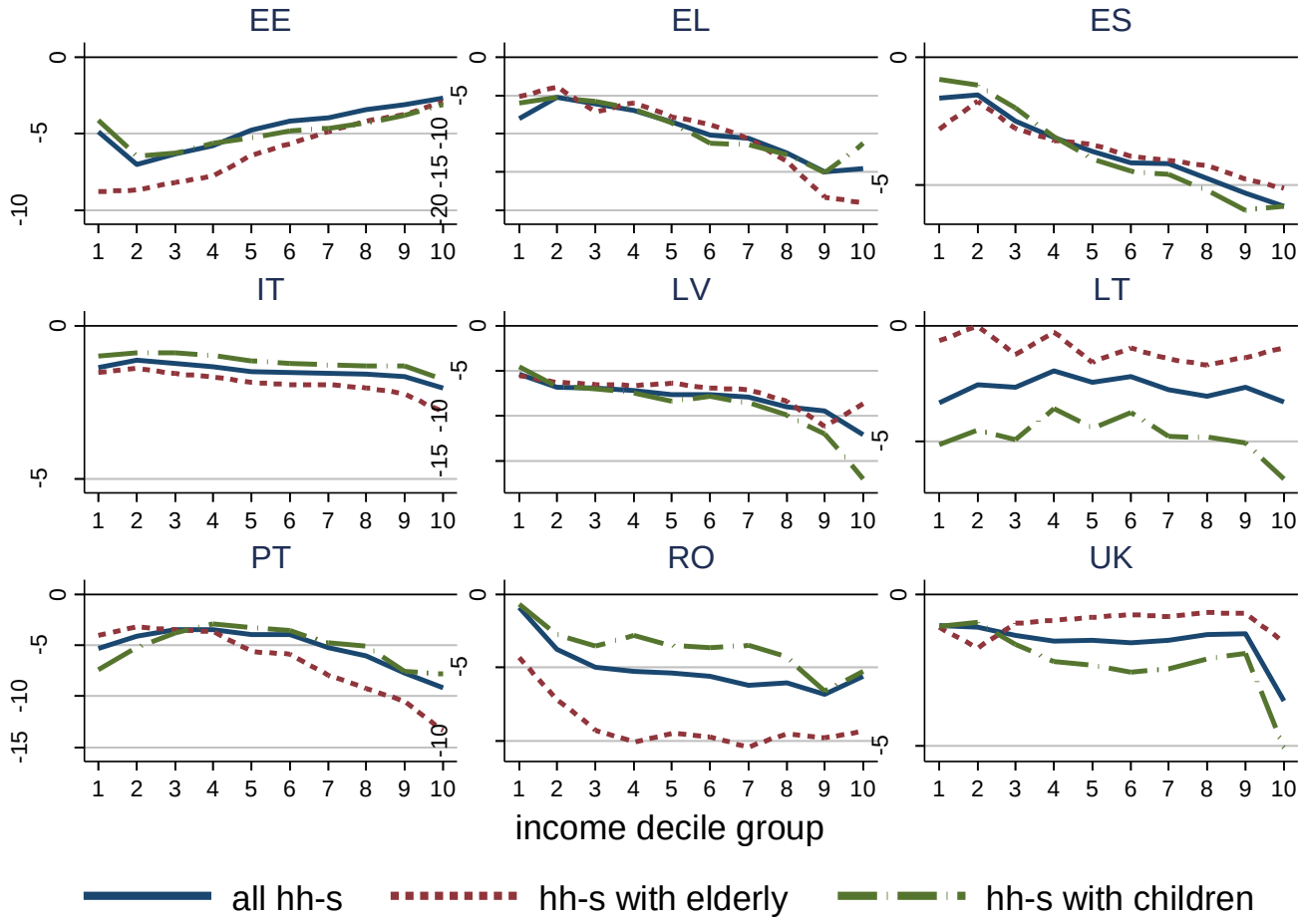
% change in household disposable income by income decile group

Interval for grid lines: 2pp

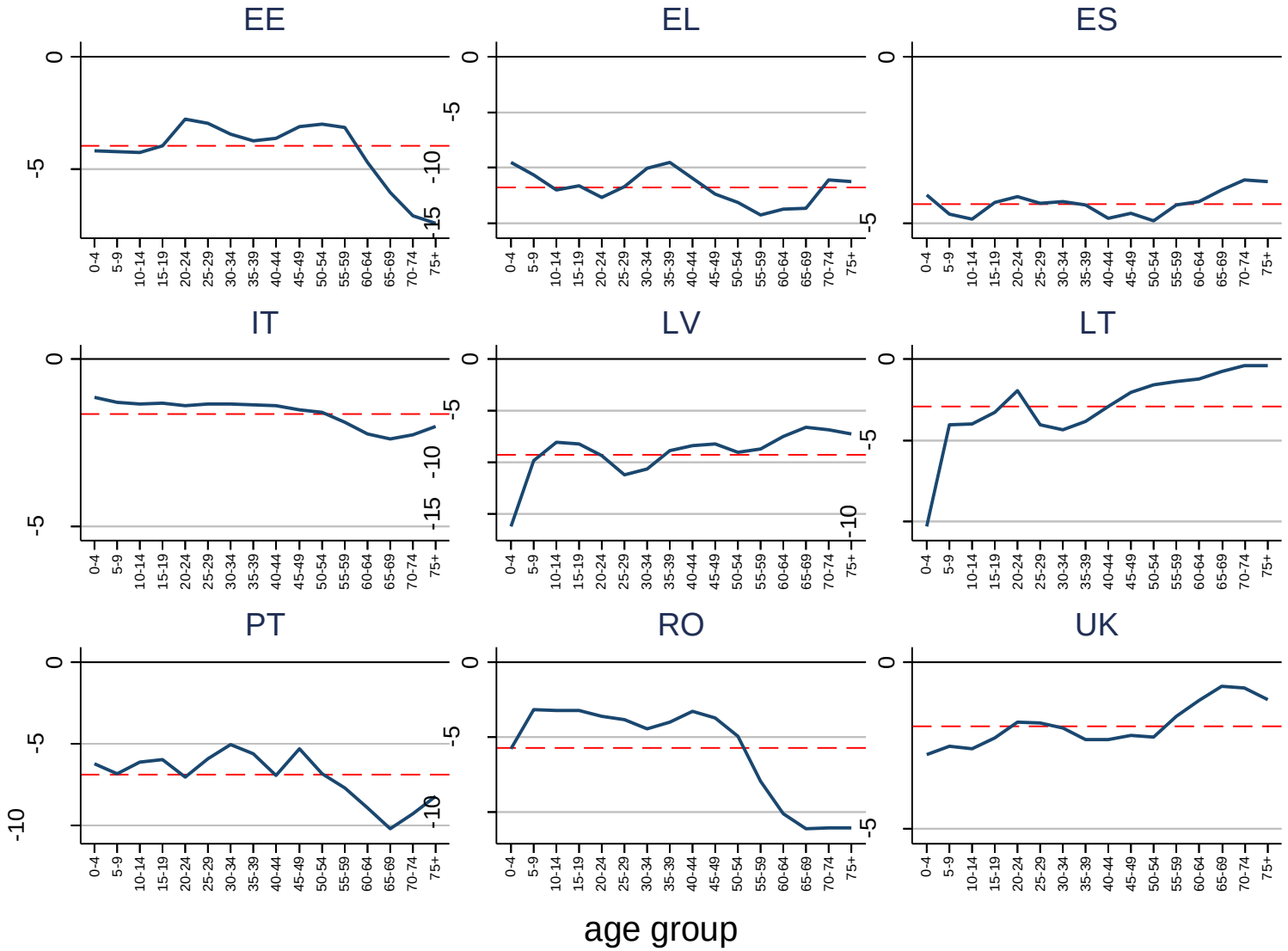


Change in household disposable income by income decile group & household type %

Interval for grid lines: 5pp

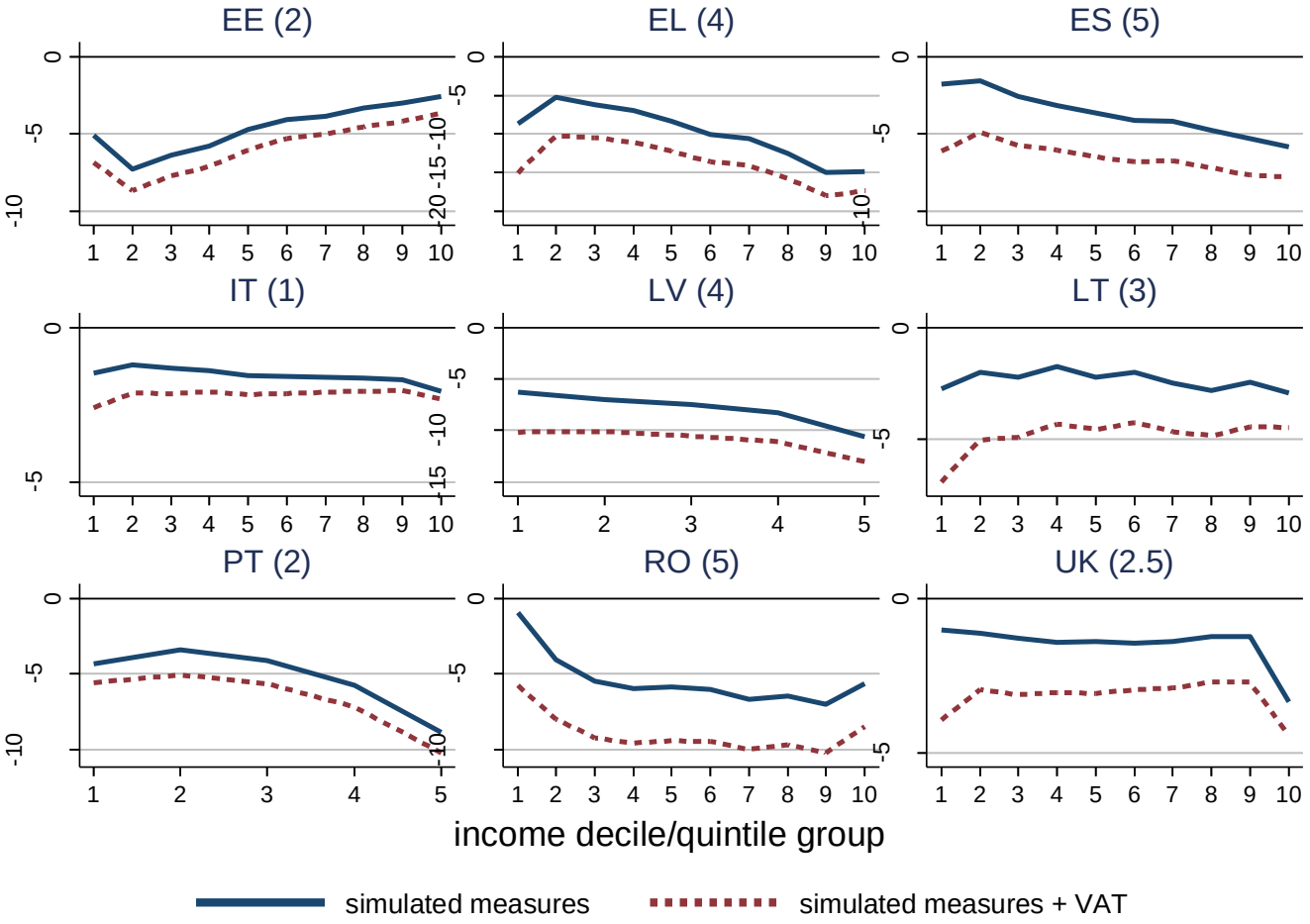


Change in household disposable income by age group %



What differences do VAT increases make?

Interval for grid lines: 5ppt. ppt increase in standard rate of VAT shown in brackets



Summary

- Distributional implications of government choices about fiscal consolidation: effects on income up to mid 2012

Progressive	**Greece** – though large even for bottom decile group **Spain** – low income pensioners lose more **Italy** – flat with VAT **Latvia** – top decile group & children lose more **Romania** – pensioners lose more **UK** – top decile group & children lose more
Inverted U-shape	**Lithuania** – children lose more, regressive with VAT **Portugal** – low income children lose more
Regressive	**Estonia** – especially for pensioners

Compared with the previous year (2011) …

(Callan et al., 2011) 5 countries in common

- **UK**: policies -- and hence distributional effect -- very similar
- **Greece:** many additional changes, the effect is larger and still progressive although less so than in 2011.
- **Spain**: the effect in 2011 was flat, progressive in 2012.
- **Estonia:** the effect is very different due to the expiry of some policies and the continuing reductions in pensions in real terms: now regressive in 2012 rather than flat.
- **Portugal**: the regressive picture in 2011 was transformed into an inverse U-shape because of the addition of some progressive policies (public sector wage and pension cuts) to the earlier regressive package (cuts in minimum income).

Compared with this year (2013)?

- Work in progress…
- Policy changes are no longer about austerity in some countries (Baltic states)
- For the UK the effects start to be much larger and more regressive
- Greece: an additional austerity package
- Probably more to come in the other S. European countries

Summary of main points

- Scale of changes differs across countries
  - Remembering this is about direct effects on household income only
- Distributional effects depends on
  - Chosen policy mix
  - Position in the income distributions of those affected
- Mostly progressive; VAT reduces progressivity
- Distributional picture can change year-to-year (EE, PT)
- For the UK – the main story is still to come.....

Final reflections… and more work to be done

- Cuts in services may be just as important, and fall heavily on particular groups (gendered effects…)
- The window in time matters
- Other countries? Ireland: Keane et al (2013)
- Aim has been to measure the discretionary policy effect – but also need to put this in the context of changes in the income distribution generally
  - Reductions in market income due to the crisis
  - "Automatic" policy effects
  - (Behavioural reactions; other changes since the latest micro-data)
- "Nowcasting"
  - Country studies in Jenkins et al (2013)
  - Greece: Matsaganis and Leventi (2013)
  - 8 EU countries using EUROMOD: Navicke et al (2013)

Thank you!

Acknowledgements and further information

- The process of extending and updating EUROMOD is financially supported by the Directorate General for Employment, Social Affairs and Inclusion (DG-EMPL) of the European Commission.

- EUROMOD is made generally available for academic and not-for-profit use. Contact euromod@essex.ac.uk
- For more information see www.iser.essex.ac.uk/euromod

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