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Fiscal Consolidation – When to Do it

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August 2013

Center for Economics & Public Policy | University of California, Irvine

Downloadable copy available online

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Fiscal Consolidation – When to Do it

Fiscal consolidation – a policy aimed at reducing government deficits – can be viewed as an investment. A country's welfare declines in the period in which fiscal consolidation is financed (through increased taxes or reduced spending), and increases in future periods due to the consequent reduction in debt. If fiscal consolidation is an investment, the question then arises of when to make the investment. The main point of this paper is that, though a policy may be beneficial, under many conditions the decision of whether to adopt the policy should be delayed. Considerations for timing are:

- Changes in costs or benefits of the policy over time
- Obtaining information in the future that may change the decision
- Influencing beliefs of the public about the wisdom of the policy
- The effect of immediate or delayed decisions on reputation
- Bargaining about the distribution of benefits

Changes in costs over time

An investment is more attractive in periods when the costs of doing so are low. The cost of deficit reduction can consist of reduced output in the periods when taxes are increased or spending is reduced. Data suggest that increases in taxes or reductions in spending will cause larger drops in output when a country is in recession. Therefore, fiscal consolidation might be best delayed when a country is in a recession, and pursued with vigor when the country has high employment and growth.

Obtaining information in the future that may change the decision

Delaying the decision of whether to adopt a policy of fiscal consolidation may be advantageous when the following three conditions are satisfied:

- The costs incurred by adopting the policy cannot later be reversed.
- The decision maker is uncertain about future economic conditions, but will learn about them next period. For example, the government is unsure how financial markets will react to the size of the government debt next year.
- A policy not adopted now can be adopted later.

For illustration, consider a proposed policy, say a tax increase, that reduces the deficit. In the current period it costs $100 and in the next period it will generate benefits of either $80 or $140, each with equal probability. If the policy is immediately adopted, there is a 50% chance that the net benefit will be -$20 (a benefit of $80 minus taxes of $100) and a 50% chance that the net benefit will be $40 (a benefit of $140 minus taxes of $100). The expected, or average, payoff is therefore 1/2(-100+80) + 1/2(-100+140) = 10. If, however, the decision can be postponed for one period, the benefits become known with certainty. Therefore, if the benefits turn out to be only $80, the policy will be rejected. If the benefits turn out to be $140, the policy will be adopted for a net benefit of $40. With postponement there is a 50% chance that the net benefit will be 0, and a 50% chance that the net benefit will be 40. The expected payoff is therefore 20. In this example (though not in all), a government should choose to postpone the decision.

Influencing beliefs of the public about the wisdom of the policy

The public's belief about the ability of an official, or the wisdom of the policies he adopts, can also affect the effectiveness of policy. For example, if the public believes that a policy of fiscal consolidation will reduce future debt, and so reduce future interest rates, then investors will be willing to lend money at lower interest rates, thereby reducing the government's costs in reducing the deficit. In addition, if the public believes that a quickly-adopted policy is obviously correct, the policy will in turn be successful.

The effect of immediate or delayed decisions on reputation

Policy makers who care not only about the country's welfare, but also about their own reputations, have different considerations about the timing of policy. Recall that delay could be warranted if the politician is not fully informed in the current period, but may learn about economic conditions later on. The public, however, may believe that some government officials are more capable than others, with a capable one not having to wait to learn about economic conditions. Under these circumstances an official may want to indicate that he is a capable type, and so take action immediately, even if he is not fully informed. In other words, an official may take an action too soon with the goal of increasing his reputation.

Bargaining about the distribution of benefits

Delay may also occur when different parties all favor fiscal consolidation, but disagree about who should bear the costs or reap the benefits. A political party may veto a beneficial policy today, in the hope that later it will have greater power, and so be able to adopt a policy that benefits it even more.

Policy Implications

The main point in this study is that, though a policy of fiscal consolidation may be good, it should not necessarily be immediately adopted. Considerations for the timing of adoption can be broadly divided into two groups: those which a benevolent government might do, and those which arise from selfish or political motives. The first group consists of the first three points discussed in this study: accounting for differences in costs now and in the future, considering the value from obtaining information in the future, and influencing beliefs of the public about the wisdom of the policy.

The second group consists of the last two points discussed in this study: the effect of timing on reputation, and political bargaining about the distribution of benefits. Decisions motivated by these considerations can hurt the country.

The first group of arguments, in particular, makes the point that even when it is clear that fiscal consolidation will be necessary, delays in implementing the consolidation are not necessarily a sign of "dysfunctional" or "paralyzed" government. Economic analysis points to reasons why, in some circumstances, "kicking the can down the road" can be better policy.