

The distributional effects of fiscal consolidation in 9 EU countries

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Motivation

- The economic crisis and the fiscal consolidation measures have an **impact on income distribution**:
 - 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
 - political acceptability
- Governments may not be able to control extent to which economies are hit by crisis or how this affects households; but they can control how austerity measures are distributed.
- Our focus is on austerity policy decisions and particularly fiscal measures which have a direct and quantifiable effect on the distribution of income.



Motivation

- Fiscal consolidation literature is mainly macro-oriented and often overlooking 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 what we do

- 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)
 - “Sharp instruments” relative to other consolidation measures
 - VAT
- Data: 2008 EU-SILC data (FRS 2009/10 in UK)
 - Market incomes adjusted to 2012 levels



Methodological issues

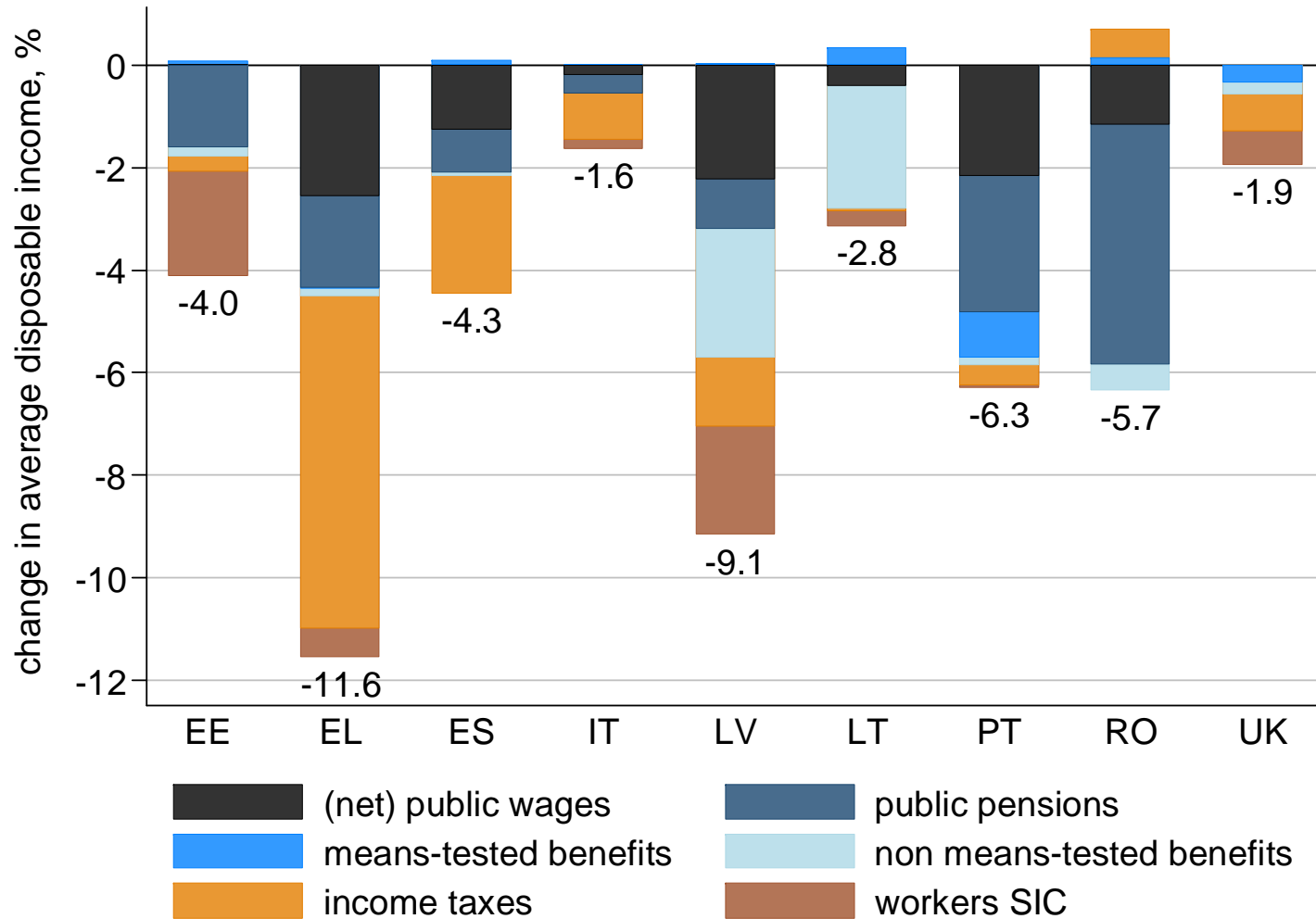
- Emphasis on consistent cross-country analysis
- Counterfactual: **How would tax-benefit systems have evolved by now (2012) without fiscal consolidation?**
 - Pre-FC policies indexed using national rules/conventions
 - Compare with actual 2012 systems
- Period: **all fiscal consolidation implemented up to mid-2012**
 - Not changes announced for the future (e.g. UK)
- Measures of fiscal consolidation
 - 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**

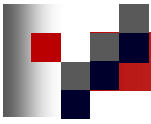


Simulation details

	Austerity period	Indexation conventions used in the construction of 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.

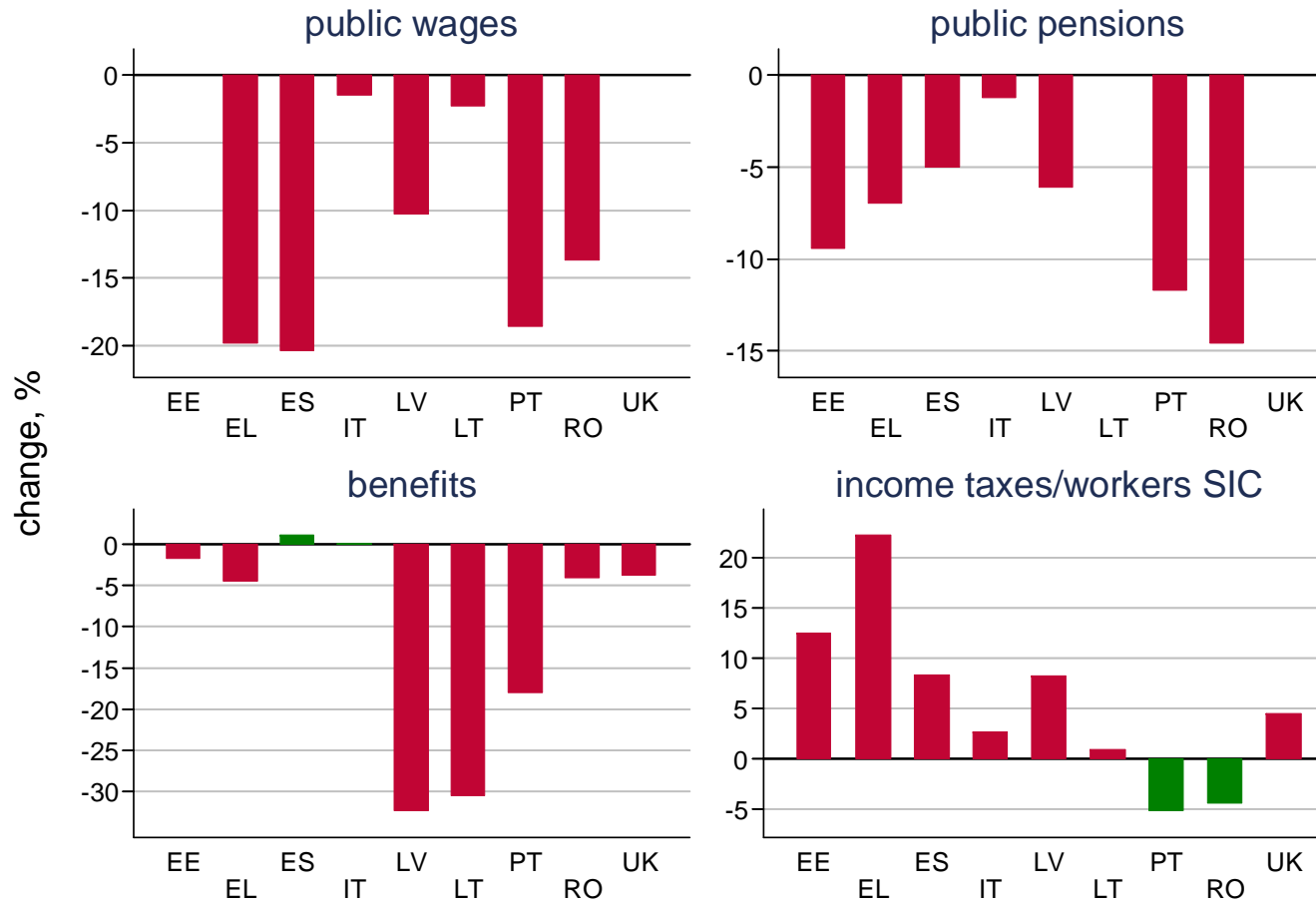
Aggregate change in household disposable income by income component %





Extent of changes by income component %

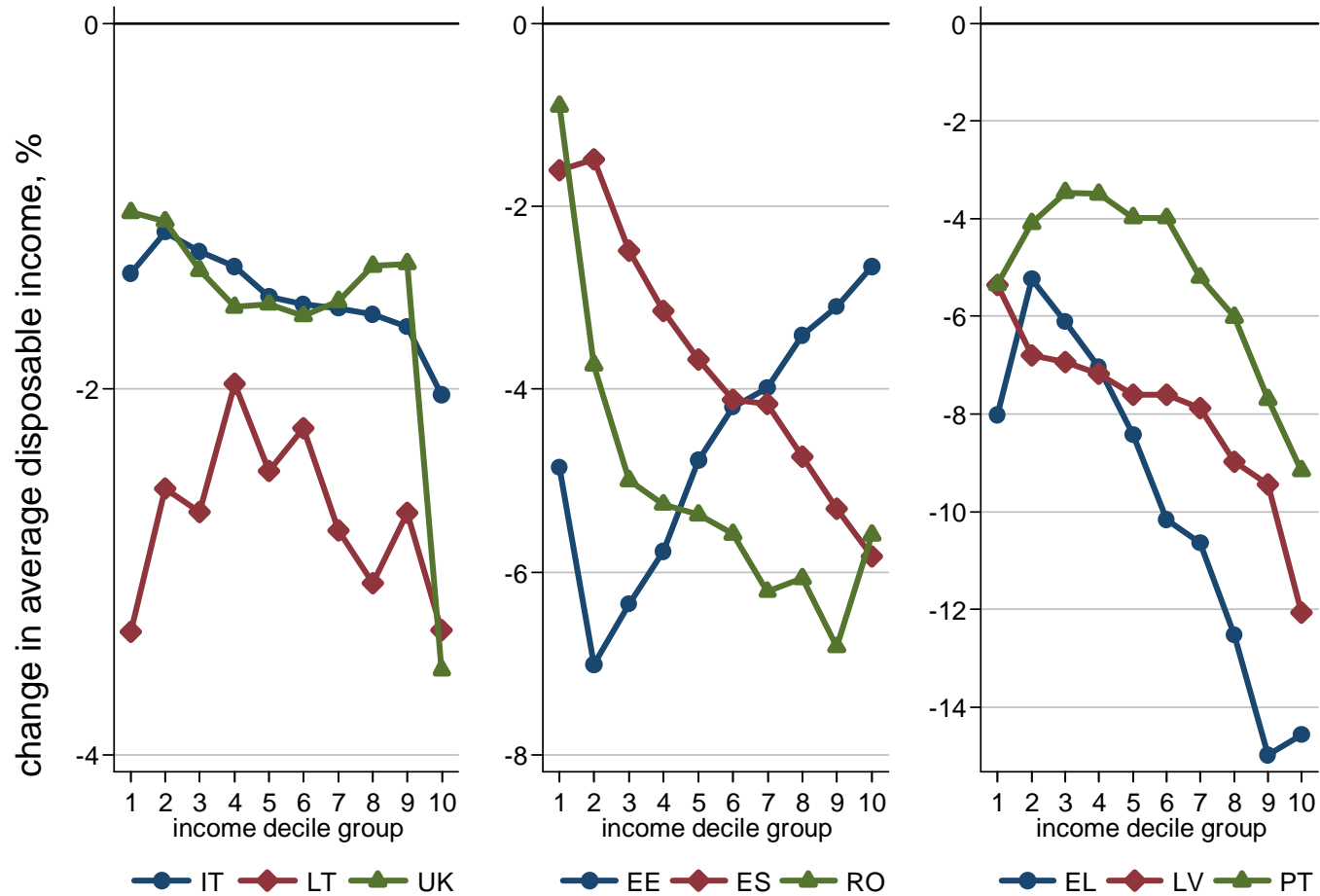
Interval for grid lines: 5pp



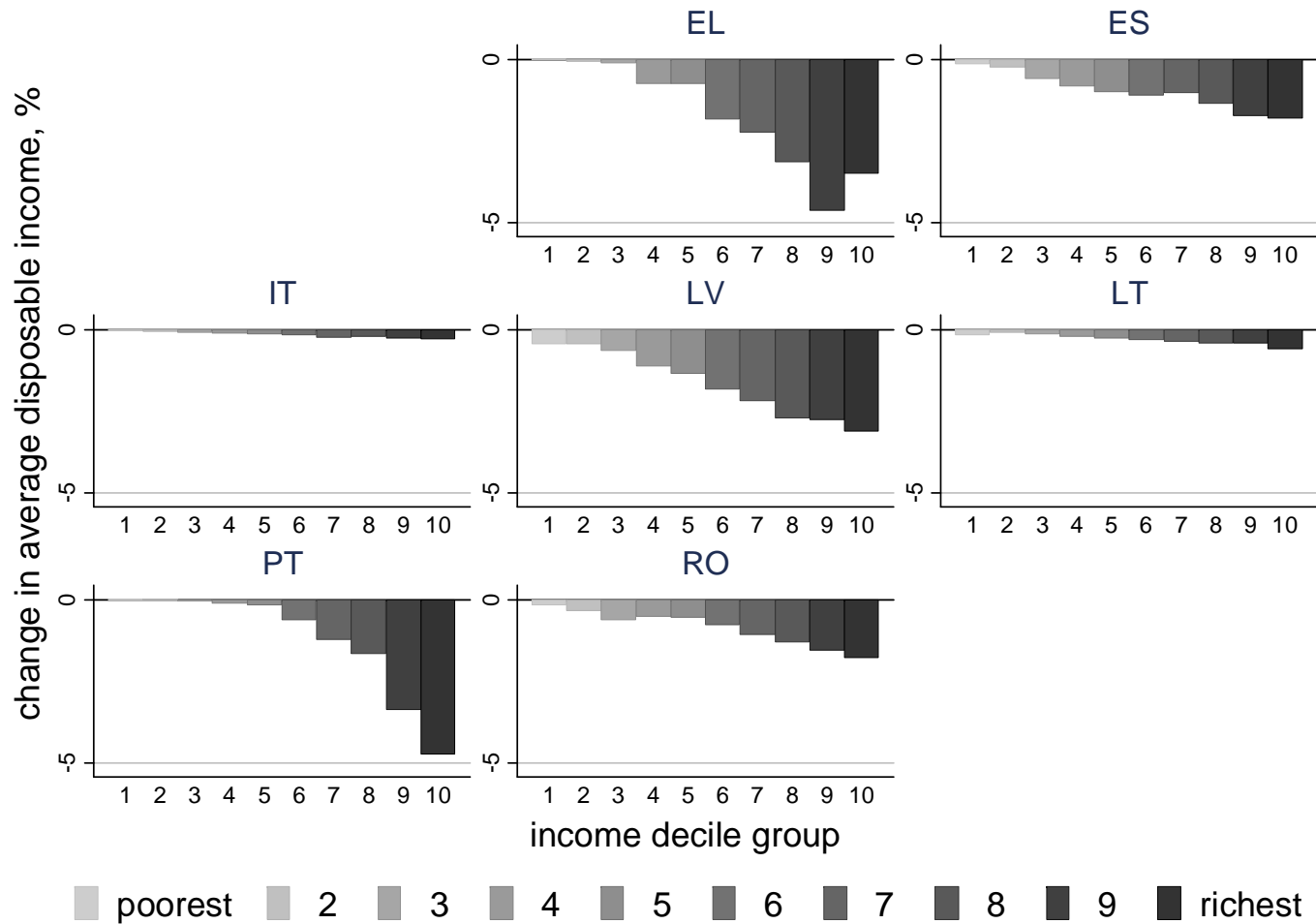
Note: results for taxes and benefits also include effects due to the changes in public wages.

Change in household disposable income by income decile group %

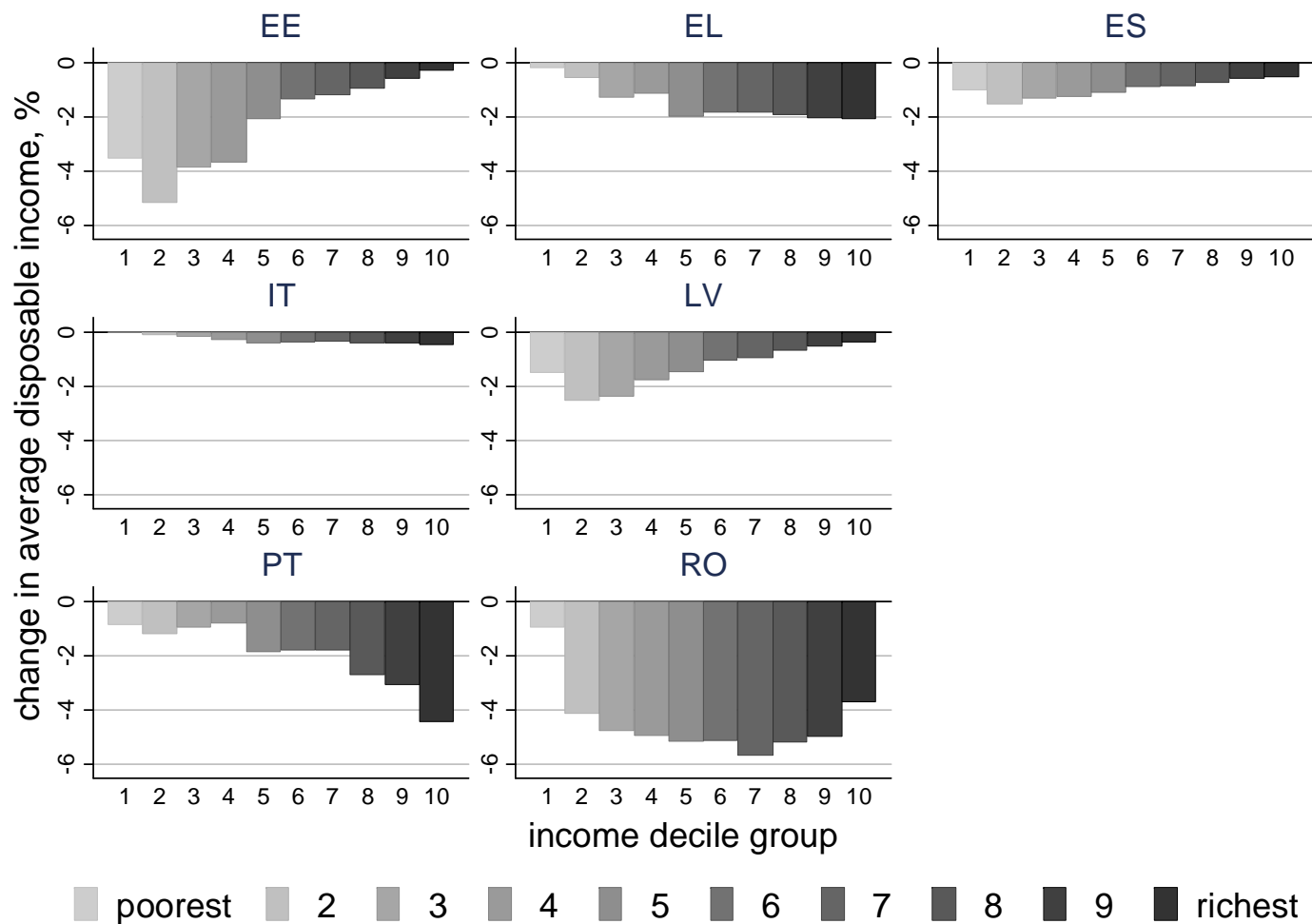
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% change in household disposable income due to public sector pay cuts

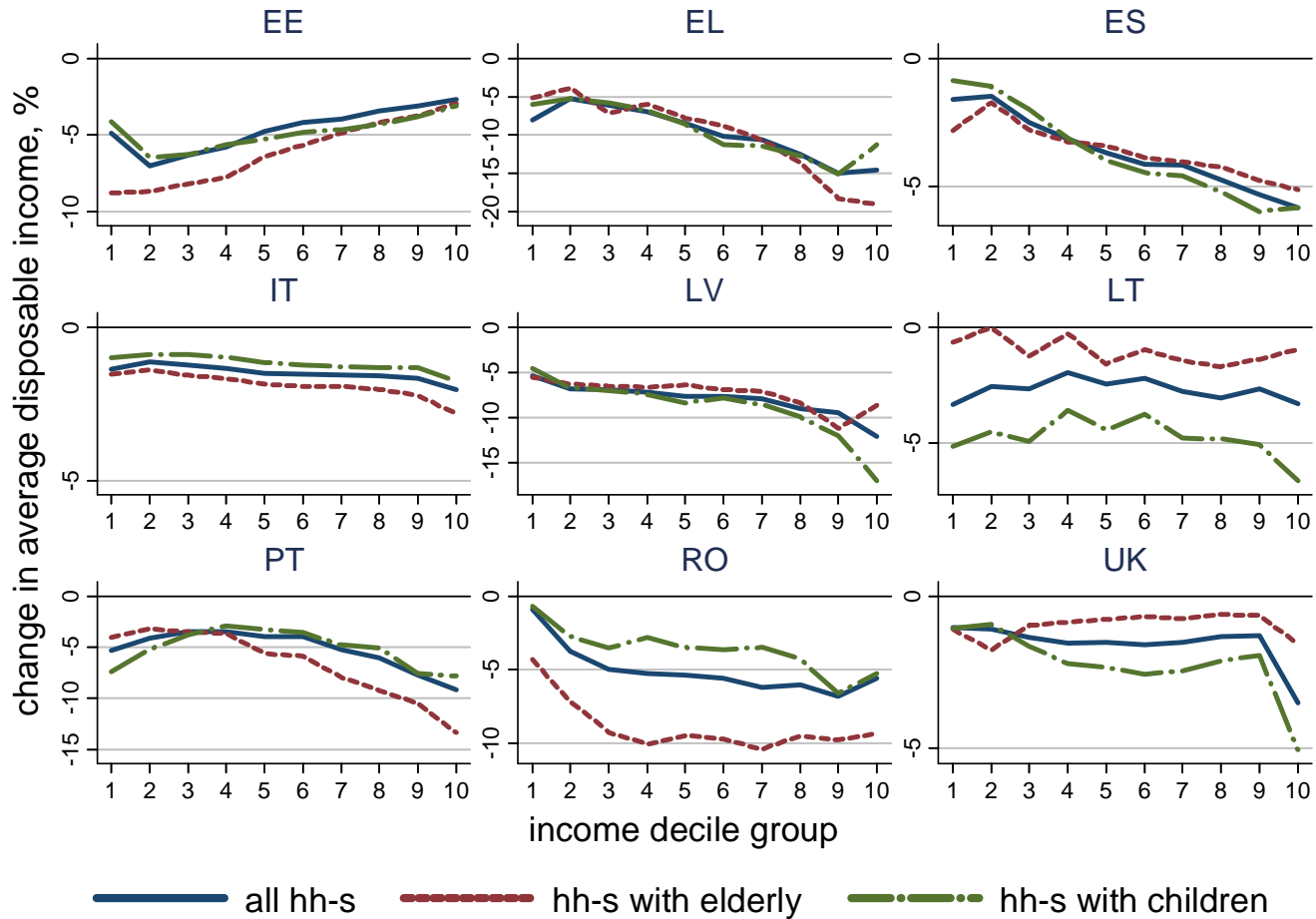


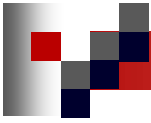
% change in household disposable income due to cuts in public pensions



% change in household disposable income by household type %

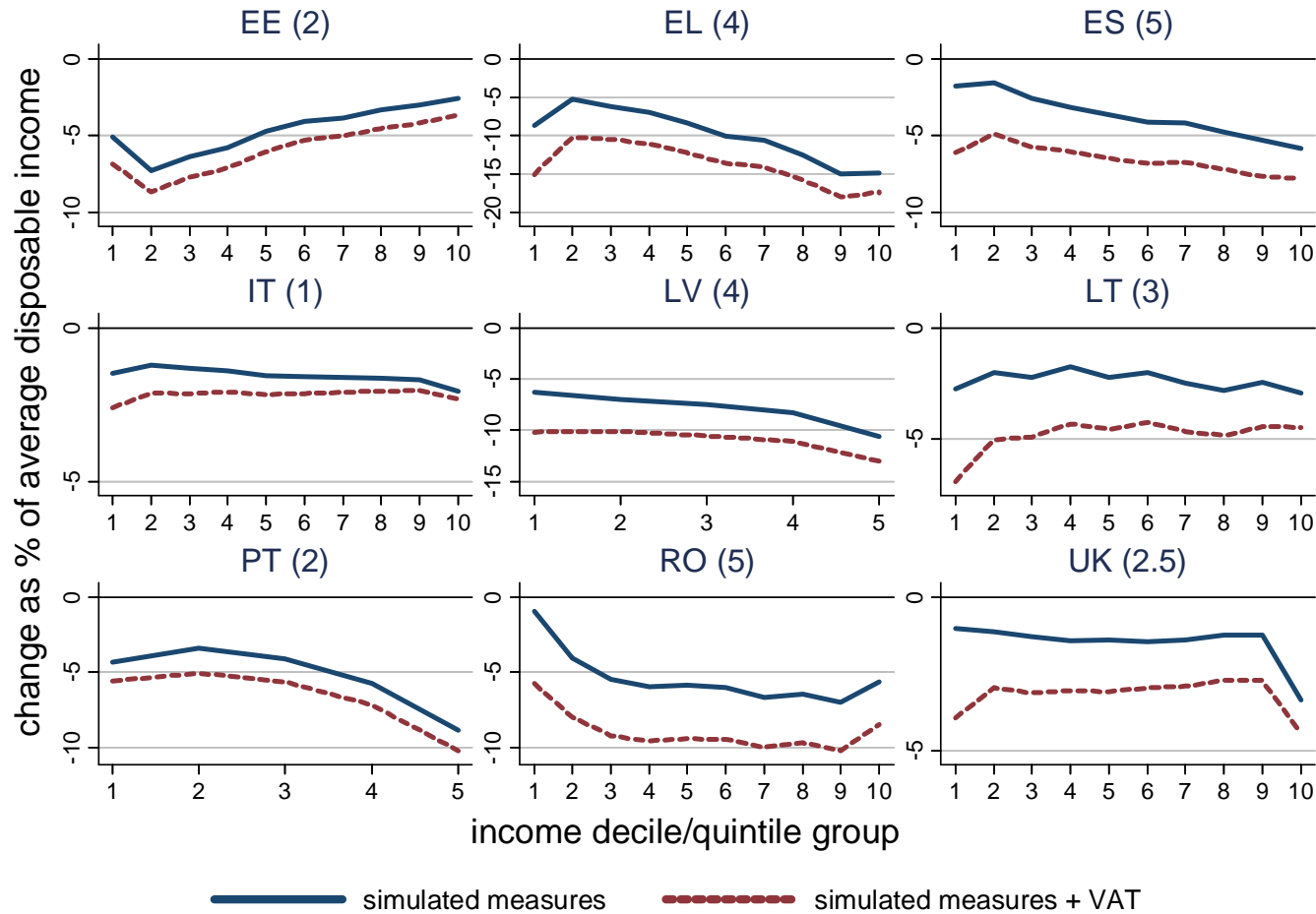
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What differences do VAT increases make?

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 children lose more Romania – pensioners lose more UK – top decile and children lose more
Inverted U-shape	Lithuania – children lose more, regressive with VAT Portugal – low income children lose more
Regressive	Estonia – especially for pensioners

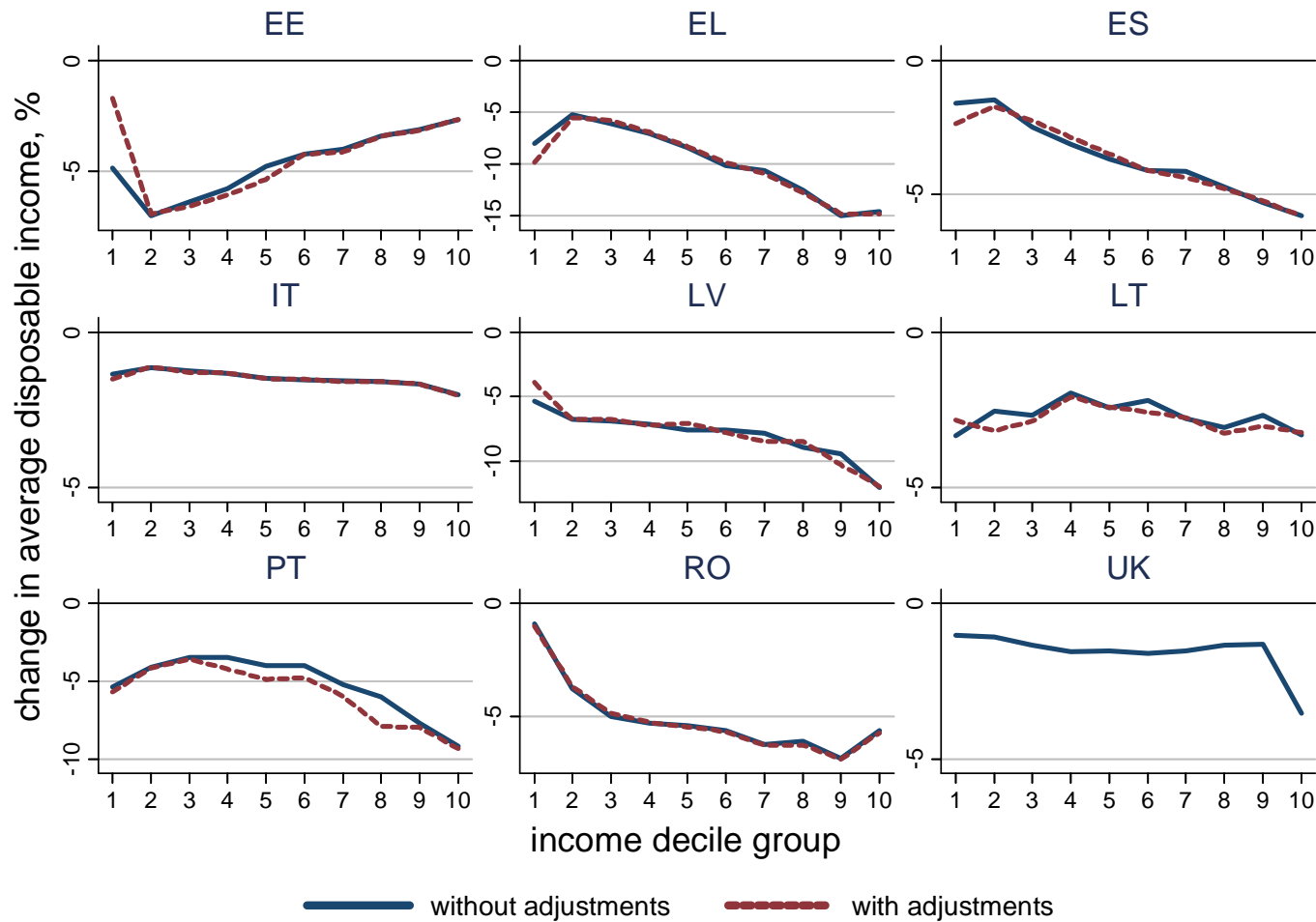


Other issues / sensitivity tests

1. Changes in labour market composition: do they make a difference to the distributional effects of the policy measures?
 - Explicit simulations of labour market transitions based on LFS 2007-11 employment by characteristics
2. Austerity in perspective: what were the effects of all tax-benefit changes 2008-12?
 - All tax-ben policy changes (no pay cuts); common time period; common indexation
3. Comparisons with a similar analysis last year: has the picture changed?
 - Common countries: Estonia, Greece, Spain, Portugal, UK

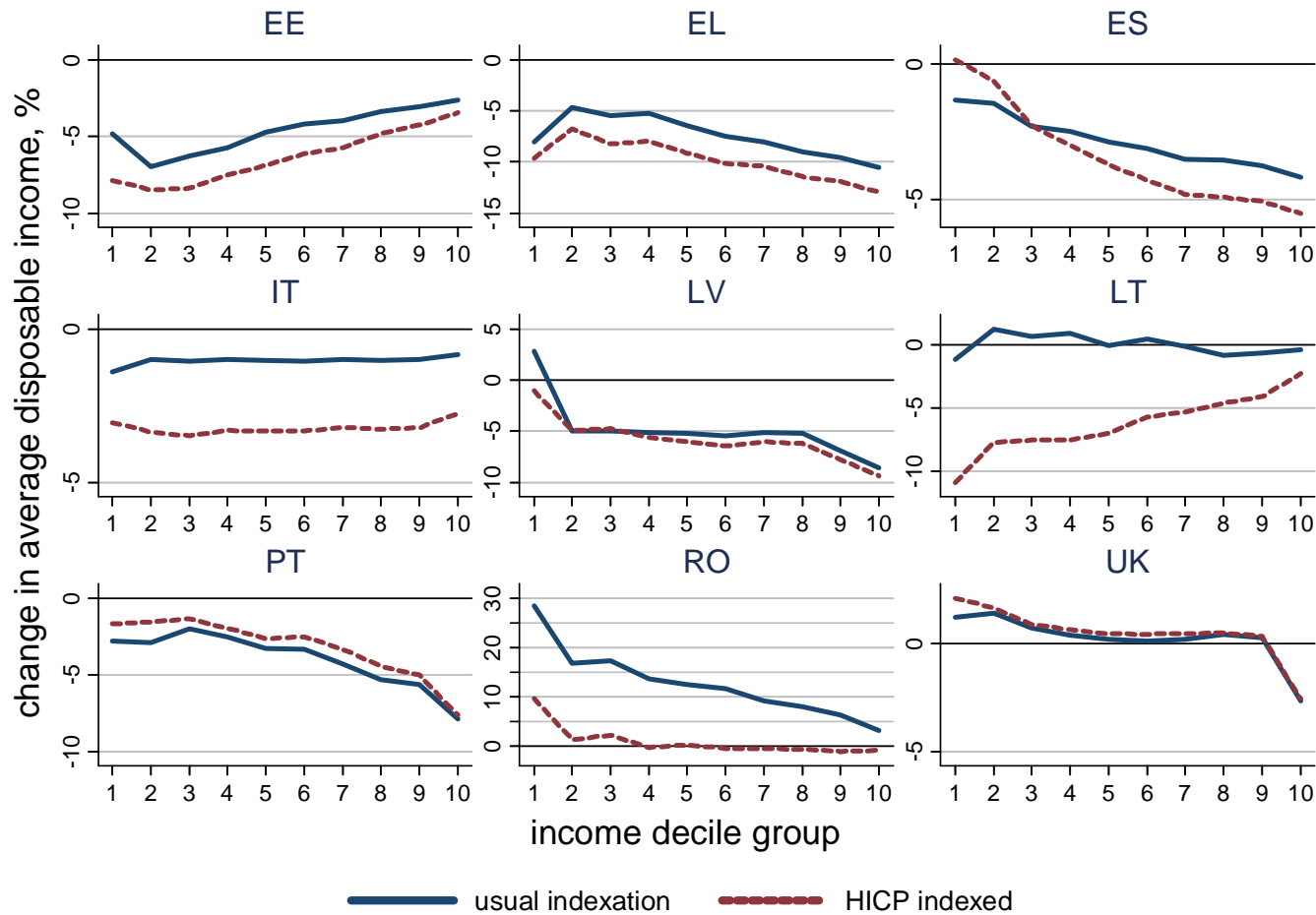
% change in household disposable income: adjustments for labour market change 2007-11

Interval for grid lines: 5pp



Fiscal consolidation in context: the effect of all tax-benefit changes 2008-2012

Interval for grid lines: 5pp





Compared with last year ...

(Callan et al., 2011)

- **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, now progressive.
- **Estonia:** the effect is very different due to the expiry of some policies and the continuing reductions in pensions in real terms: now regressive rather than flat.
- **Portugal:** the regressive picture in 2011 has been transformed to 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).



Summary of main points

- Scale of changes differs across countries
 - Remembering caveat 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)
- Distributional consequences are robust to labour market changes (as modelled)
- Fiscal drag has major distributional implications in ES, LT, RO and scale effects also in EE, EL and IT
- For the UK – the main story is still to come.....



Thank you!

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