RESEARCH INSIGHTS

Do Changes in the Composition of Public Spending Affect the Macroeconomic Consequences of Fiscal Adjustments?

- **While fiscal consolidations tend to be contractionary, the size of the output fall depends on the composition of spending cuts.**
- **A fiscal consolidation of 1 percent of GDP that is implemented by reducing public investment rather than public consumption reduces output by 0.7 percent within three years.**
- **In contrast, safeguarding public investment from budget cuts vis-à-vis public consumption can neutralize the contractionary effects of fiscal adjustments on impact, and can even spur output growth over the medium term.**

CONTEXT

When countries decide to slash budget deficits, governments typically cut public investment relatively more than public consumption, as capital expenditure cuts are more politically palatable than cutting sensitive items such as public wages. However, given that the multiplier of capital expenditure is typically larger than that of public consumption according to estimates available in the literature, then it may be beneficial to protect, or even to expand public investment during fiscal adjustments to reduce the output costs. Thus, assessing the role of public spending composition during fiscal adjustments is key to evaluate how fiscal policy changes affect macroeconomic outcomes, and to inform policy discussions on optimal fiscal consolidation design.

PROJECT

This paper is part of a broader research agenda on the macroeconomics of public investment at the Inter-American Development Bank. It follows up on previous studies showing how public investment reacts to the business cycle, and the role of fiscal rule design in protecting public investment during fiscal consolidations. It also builds upon an extensive academic and policy literature showing how spending composition affects the size of fiscal multipliers.

This paper shows that output responses to fiscal adjustments depend on changes in the composition of public expenditures, or more specifically, on the mix between public investment and public consumption cuts during fiscal consolidations.

The analysis exploits heterogeneity in the behavior of both spending components and distinguishes fiscal adjustment episodes of public investment protection and penalization in order to estimate their impacts on economic activity. The empirical exercises are undertaken using a sample of 26 advanced and 44 developing countries during 1980-2019.

RESULTS

While fiscal consolidations are on average contractionary, the size of the output fall depends on the behavior of public investment vis-à-vis public consumption during the fiscal adjustment. Over time, differences increase between fiscal adjustments based on cutting public consumption and those based on public investment.

When public investment is penalized relative to public consumption—i.e., the share of capital outlays in public expenditures decreases—a consolidation of 1 percent of GDP reduces output by 0.7 percent within three years of that fiscal shock. In contrast, safeguarding public investment from budget cuts vis-à-vis public consumption can neutralize the contractionary effects of fiscal adjustments on impact, and it can even spur output growth over the medium term.

The difference between these responses is driven by private investment, which remains subdued when public investment loses ground relative to public consumption and experiences a strong recovery when the public investment share in total spending is protected during a fiscal consolidation.

These findings suggest that positive crowding-in effects of public investment on private investment are a key mechanism to explain variation in the output responses of different fiscal adjustment plans.

Key Concept

FISCAL CONSOLIDATION

A policy move to reduce the fiscal deficit by increasing revenues, cutting government spending (including public investment and consumption), or both.

POLICY IMPLICATIONS

Even before the coronavirus pandemic, there was growing concern in policy and academic circles about the secular decline in public investment shares across industrial and developing countries. The pandemic has resulted in a further marked deterioration of fiscal accounts around the world as countries responded to its unprecedented challenges with expansionary fiscal policies.

As the pandemic recedes, however, many countries will have to design fiscal consolidation plans to restore debt sustainability. While fiscal adjustments may be inevitable, expenditure policy can dampen the negative economic effects of consolidation plans by protecting specific expenditure items.

The optimal design of fiscal adjustment packages is thus likely to call for the protection of public investment from large budget cuts, particularly given low pre-existing levels in many emerging markets. Safeguarding the public investment to public consumption expenditure ratio may prove enough to avoid deep and prolonged contractionary effects of austerity, and it may even generate expansionary benefits over the medium term.

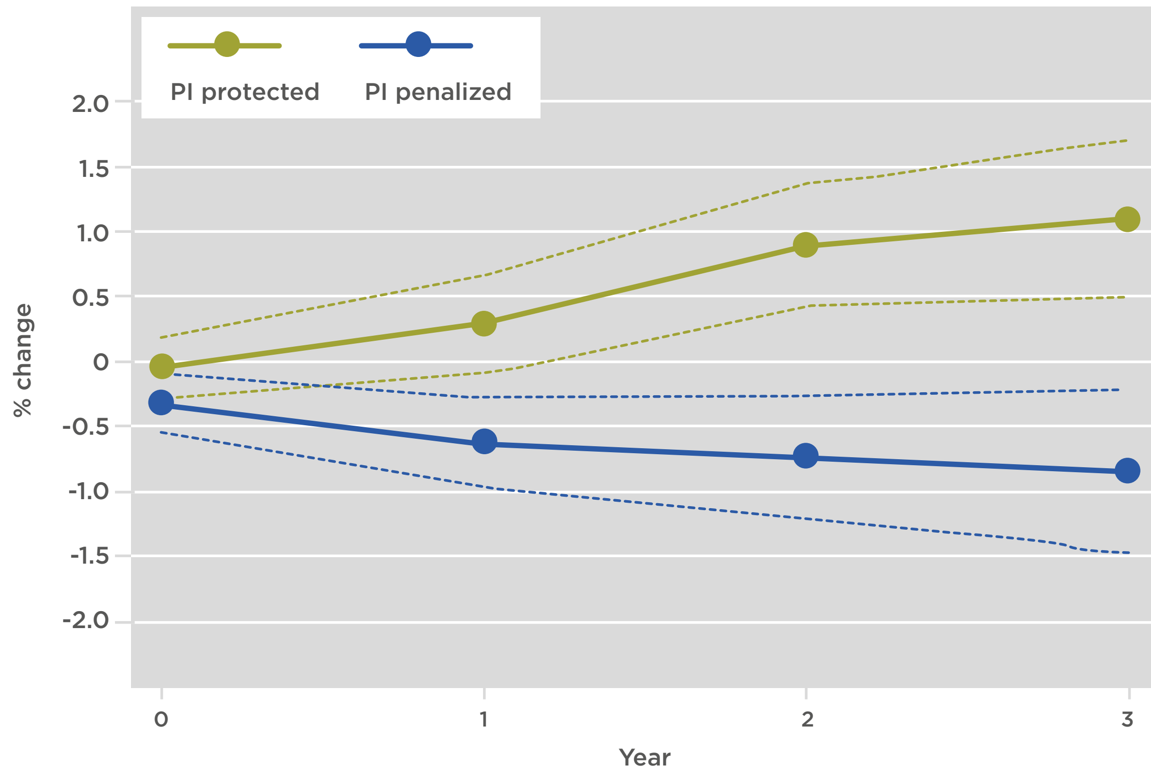
However, the protection of public investment is not automatic. Thus, countries could consider strengthening institutional mechanisms designed to safeguard productive public investment from budget cuts, including the introduction of fiscal rules with an emphasis on spending composition issues, and implementation of medium-term fiscal frameworks to assure predictable capital spending levels over time.

Key Concept

FISCAL MULTIPLIER

The change in real GDP caused by a one-unit increase in a fiscal variable.

Figure 1. Response of GDP to a Fiscal Consolidation



Source: Ardanaz et al. 2021.
Note: Year = 0 denotes the year of a fiscal consolidation. PI protected (penalized) denotes a situation in which a positive (negative) change in the public investment to public consumption ratio is observed as a result of fiscal adjustment. Dotted lines indicate 90 percent confidence interval.

IDB RESEARCH ON FISCAL CONSOLIDATIONS

This is a joint research project between the Research Department and the Fiscal Management Division of the IDB, in collaboration with researchers from the Economics Department of Universidad Nacional de la Plata in Argentina.

FULL STUDY

Ardanaz, Martín, Eduardo A. Cavallo, Alejandro Izquierdo, and Jorge Puig. 2021. "The Output Effects of Fiscal Consolidations: Does Spending Composition Matter?"

DEPARTMENT OF RESEARCH AND CHIEF ECONOMIST

The Department of Research and Chief Economist generates new ideas to enrich the knowledge base that supports the policy agenda of the Inter-American Development Bank (IDB) and its member countries for achieving sustainable and equitable development in the region. To maximize the impact of its research, the Research Department carries out activities that serve as inputs to other IDB departments, governments, the academic community and public opinion in the region.