Endogenous fiscal consolidations: Testing three mechanisms

Draft paper for the 10th ADC, CEU 20-21 April, 2015

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First draft - Do not circulate

Abstract

Why is there such variation in austerity despite the common shock of the Great Recession and the coordinated turn to austerity in 2010? To explore this puzzle, I suggest to study the UK and France as (al)most similar cases in a historical perspective. Despite their similarities, their diverging strategies are counterintuitive especially in the light of comparable partisan orientation, fiscal institutions, economic structure that, according to the existing literature, should have led to comparable outcomes. I explain this divergence with three endogenous mechanisms: inequality, linkages of social groups with the budget and political coalitions. Through these three mechanisms, past consolidations redistribute political power among social groups and thus influence future fiscal consolidations. Evidence suggests that if austerity at time t increases inequality significantly, social groups will be less prone to increase taxation at time $t+1$ and will thus put the burden of adjustment on spending cuts. Likewise, linkages with the budget suggest that social groups paying earmarked taxes will oppose spending cuts and thus force the adjustment on the tax side of the budget. Finally, variation in the center of gravity of political coalitions constrain political parties and bias fiscal policies during austerity. Taken together, these mechanisms indicate that through second round effects austerity reshapes the distribution of future policies.

Keywords: austerity, endogeneity, inequality, linkages, social coalitions
Classification: political economy, comparative politics
Wordcount: 8,201

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