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Austerity and the path of least resistance: how fiscal consolidations crowd out long-term investments

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ABSTRACT

What policies do government prioritize when they implement austerity? I argue that governments choose the path of least resistance when they engage in fiscal consolidations. Positive policy feedback protects programmes from retrenchment when they cover large segments of the population. In contrast, policies involving discounting short-term benefits for long-term gains are more exposed to austerity as they are subject to an intertemporal trade-off. Using a compositional dependent variable analysis in 17 OECD countries from 1980 to 2014, I show that austerity, measured with the narrative approach to fiscal consolidations, is associated with a decrease in the proportion of public investment in research and development and gross fixed capital formation and an increase in health care and pensions' proportion of budgets. The budget shares of human capital investments in education, childcare and active labour

market policies and of compensatory transfer-based labour market insurance are resilient to austerity.

KEYWORDS:

Austerity fiscal consolidations health care infrastructures long-term investments welfare states

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Notes

1 Fiscal consolidations can involve tax increases, but this article focuses on spending cuts.

2 One could argue that R&D expenditures are similar to human capital investment since they aim to foster knowledge accumulation. However, they differ in many ways that make them closer to physical capital investments. R&D is not proximate to most citizens (they involve transfers to few people in high tech firms and in higher education institutions). Like physical capital investment, R&D is collectively owned once patents

expire, in contrast to human capital investment which is privately owned, making it closer to a public good. It is also a discretionary spending, like physical capital investment and in contrast to human capital investments that are closer to entitlements. In any case, R&D remains a small proportion of the two types of investment and removing R&D from the analysis does not change the main results as shown in appendix Figure A7.

3 The countries are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, Portugal, Spain, Sweden, United Kingdom and the USA.

4 Using the Philips-Perron and LLC test.

5 Using the PSS bounds, Engle-Granger and Westerlund tests

6 Theoretically, the effect of consolidation on budgets should be immediate, it is thus better to use the partial adjustment model than the dead start model (a lagged the value of each covariate). Results from the dead start model are similar.

Additional information

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