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SPINTAN – Policy Brief No. 7

Fiscal consolidation and income distribution*

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SUMMARY

Objectives of the research

Public policies have effects on growth in the long run, but also on the distribution of current resources in the short run. This study tries to shed light on the distributional effects of recent fiscal consolidation policies, as implemented in some European countries, mainly through in-kind public transfers.

Scientific approach / methodology

The study uses standard methods in distributional analysis over an extended household income definition. This extended income is obtained by imputing, at household level in EU-SILC records, the value of public services provided in-kind by the public sector.

New knowledge and/or European added value

The methodology allow us to measure, quantitatively, the impact of public policies –social transfers, direct taxes and in-kind transfers– on the initial distribution of market income, which is mainly determined by the labour market, since the main component is labour income.

Hence, it takes an income generating process perspective for distributional analysis that goes from the initial income generated in the market, to the final extended income enjoyed by households and individuals.

Key messages for policy-makers, businesses, trade unions and civil society actors

Experiences in terms of the depth of the recession and the policies implemented to deal with it vary greatly across EU countries. In fact no single pattern emerges within Europe. In some countries, like Spain, inequality has increased substantially and is now at record

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levels. In others, like Poland or the Netherlands, inequality in disposable incomes actually fell during the crisis years.

In any case, in-kind public transfers are highly redistributive, also during the crisis despite fiscal consolidation policies.

Objectives of the research

Public policies have effects on growth in the long run, but also on the distribution of current resources in the short run. This study looks at the distribution of income in 16 EU countries during the recent global financial and economic crisis, and the subsequent period of fiscal consolidation. Experiences in terms of the depth of the recession and the policies implemented to deal with it vary greatly across EU countries. We illustrate this diversity, and show how the crisis has accentuated the differences among EU countries, both in income levels and inequality.

The effects of the public sector on household income distribution have traditionally been measured through the effects of money transfers and taxes, but in developed economies in-kind transfers are of increasing importance. In our context, the analysis of in-kind transfers –mainly education and health– from a distributional perspective is of paramount importance, since fiscal consolidation programmes have led to a reduction in public expenditure in these services in many countries.

Scientific approach / methodology

In order to look at the effects of public policies on income distribution we consider the income generating process: from market income to extended disposable income, passing through gross income –market income plus social monetary transfers– and disposable income –gross income minus direct taxes–.

While the process of going from market income to disposable income is straightforward, and all the information needed is available in the EU-SILC, the process of going from disposable income to extended income, including the value of public services in household income, is not.

For this exercise, aggregate estimates for each country and year of different public services are required. The services considered are education, health, social housing, early childhood education care and elderly care.

Valuation of these services are imputed at household level into EU-SILC records using different criteria, related to the usage by individuals –if an actual consumption approach to imputation is used– or personal characteristics of the individuals –if an insurance value approach to imputation is used–.

Eventually standard distributional tools and indexes are used.

New knowledge and European added value

Even if the study focuses on the redistribution effects of fiscal consolidation policies, mainly related to the provision of in-kind public services, looking at the role of cash transfers and indirect taxes puts the redistributive impact of in-kind public services into context. Old-age pensions are by far the public intervention with the largest redistributive effect. This is a general fact for all countries, although there are significant differences among countries.

The rest of social cash transfers have the second most important redistributive effect, whereas as a general rule, direct taxes do not have a great redistributive impact. This ranking, however, does not take into account in-kind public services. When they are taken into account in-kind public services are second in importance of the redistributive effect.

Broadening income to account for in-kind benefits from the public sector increases household disposable income by as much as 30% on average in 2003, and a little less in 2012, 27%, as a consequence of fiscal consolidation policies implemented in some but not all countries. Because countries differ in their implementation of public services, this impact varies between almost 40% in the Nordic countries like Sweden or Denmark and a little more than 20% in other countries such as Germany or Greece.

Extending income to account for in-kind benefits has a considerable impact on inequality and poverty. On average, inequality, measured by the Gini index, fell by 6.6 percentage points in 2003 and slightly less, 5.7 percentage points, in 2012, which amounts to a reduction in inequality of about one fifth.

Key messages for policy-makers, businesses, trade unions and civil society actors

The prime aim of public services, like education and health, is not redistribution, but the provision of a decent life for all citizens. They do, however, have important redistribution effects. This happened even during the crisis years for countries where consolidations policies have been stronger.

The reason is simple. Market income has fallen by more than the value of these public services, so they have been supporting families, which otherwise would have been worse off.

This is by no means to say that the fiscal adjustment programmes have been a success in overall distributional terms. In some countries, the scale of the reduction in income levels is large, especially for people at the bottom of the distribution.

SPINTAN – Smart public intangibles

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