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Fiscal Consolidation Strategy: Phased vs. Direct, Which is Better?

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Abstract: *This research aims to examine the impact of fiscal consolidation on the US economy. Since COVID-19 caused the government to cut expenditures due to higher health and business incentive expenditures, fiscal consolidation is required. The analysis is divided into three parts. First, we assume that the decrease in government expenditure is accomplished in the first year. Second, we suppose that government expenditure is progressively reduced, by 0.25% in the first year, 0.50% in the second year, 0.75% in the third year, and 1% in the fourth year. The last scenario predicts that the rest of the globe will follow fiscal consolidation. Following the investigation, we can conclude that fiscal consolidation has a significant long-term influence on the economy. Even while real GDP is declining in the near term, reductions in government expenditure may enhance real GDP in the long run. Based on the comparison of the first and second scenarios, we can conclude that gradual fiscal consolidation is preferable since real GDP does not fall immediately in the first year. Furthermore, we know that the impact of fiscal consolidation in the third scenario is not as favourable as in the first and second scenarios regarding real GDP. As a result, we may assume that the fiscal consolidation policy will be less successful if other nations follow it.*

Keywords: Fiscal Consolidation; G-Cubed; CGE Model; Fiscal Policy

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INTRODUCTION

The coronavirus (COVID-19) pandemic, which began in 2020, made various countries increase their spending, especially on health spending and business incentives affected by COVID-19 (Bresser-Pereira, 2020). This fact has increased government debt in multiple countries and even in unsafe conditions. Prudent debt management is needed to prevent the detrimental impact of high public debt on economic development. Governments that continue to borrow must balance new debt with high-quality public investment to boost the nation's physical and/or human capital. Strengthening budgeting structures and procedures may reduce fiscal risk (Makin & Layton, 2021).

Legislation and other economic solutions to boost the economy and protect individuals from COVID-19 expanded the US deficit. In April 2020, Trump authorised Paycheck Protection. $484 million will fund small business loans, healthcare, and COVID-19 testing. Recently, jobless benefits were extended, and payroll taxes were postponed (International Monetary Fund, 2021). In addition, by 2030, government debt might reach 160% of GDP (International Monetary Fund, 2020b). Romer (2012) argued that these ongoing and sizable budget deficits might be problematic because, if they last too long and are too high, they may slow down growth. Therefore, the US government must decrease its fiscal deficit to sustain long-term economic growth.

This adjustment in fiscal policy has sparked a two-part discussion. One is budgetary consolidation's influence on tightening economies and the global economy. How much and how soon to tighten, and what the ramifications could be, are also debated. Many experts say that too much austerity now would push the global economy back into recession and perhaps cause another financial catastrophe since bank and family balance sheets are not entirely rebuilt (McKibbin & Stoeckel, 2012). This paper examines fiscal consolidation's effect on the US economy. There are three scenarios in this study. First, a permanent 1% reduction in government spending will

be completed in the first year. Second, a gradual decrease in government spending, 0.25% in the first year, 0.50% in the second year, 0.75% in the third year, and 1% in the fourth year. The last scenario assumes that a permanent 1% reduction in government spending which will be completed in the first year, is also followed by countries in the rest of the world. This paper uses the G-Cubed model to simulate the three scenarios.

The hottest discussion about fiscal consolidation is whether budgetary consolidation is needed or not. Government deficits may affect long-term economic growth negatively. Society must save more or borrow from abroad since private sector funding will be cut (Rivlin & Sawhill, 2004). People decrease present spending to save or future consumption to repay debt. Fiscal deficits have the potential to restrict domestic investment and raise the current account deficit (Zhang, 2022). The ongoing deficit may have an impact on people perceptions and trust, creating a negative feedback loop between the budget deficit, financial industry, and the real economy (Rubin et al., 2004).

Some researchers contend that fiscal consolidation is unnecessary, especially in the US, given the US's present success. An increase in government expenditure to stimulate growth should be paid by taxing externalities more (Van de Water, 2017). The IMF argues similarly. According to the IMF, the COVID-19 causes budget imbalances in many nations, and deficit reduction could help sustaining debt and decrease the current account deficit. Savings from the private sector should balance the fiscal packages for 2020, while the US current account deficit should remain constant. The US should utilize its fiscal flexibility to expand infrastructure investment and consolidate its finances to lower its debt-to-GDP ratio (International Monetary Fund, 2020a).

We divide this paper into four sections. First, we describe the literature review about fiscal consolidation. Second, we will discuss the effect of fiscal consolidation on the US economy using the three scenarios. Finally, this paper will be closed with the conclusion.

METHODOLOGY

This research is macroeconomics research using simulation method. The G-Cubed application is used in this simulation. In the G-cubed model used in this paper, energy and non-energy sectors are separated, and the globe is split into US and non-US groups. As the US is considered half of the global economy, its fiscal policies will undoubtedly affect the world. The G-cubed model combines macroeconomics, econometrics, and international trade theory (McKibbin & Wilcoxen, 2013). There are three essential elements in the G-Cubed model.

First, flows and stocks are clearly considered, where fiscal deficits lead to government debt buildup, investment leads to capital accumulation, and current account deficits increase foreign demand against home output (McKibbin & Tan, 2009). Second, families make decisions based on their future prediction, and enterprises are not always optimum in the short term. Financial capital may instantly move to where the best predicted returns are, unlike physical capital (McKibbin & Wilcoxen, 2013). Last, this model implements global accounting identities (McKibbin & Stoeckel, 2012). For example, a current account deficit on domestic production must be offset by future trade surpluses. Then, the government's budgetary deficit must be offset by future income. These properties make it trustworthy for evaluating macroeconomic policy concerns.

RESULTS

I run the G-Cubed model with 3 scenarios: 1% permanent reduction in government spending completed in the first year, 1% permanent reduction in government spending completed gradually, and the US and global demand shocks of 1% budget deficit cuts permanently. The results are as below:

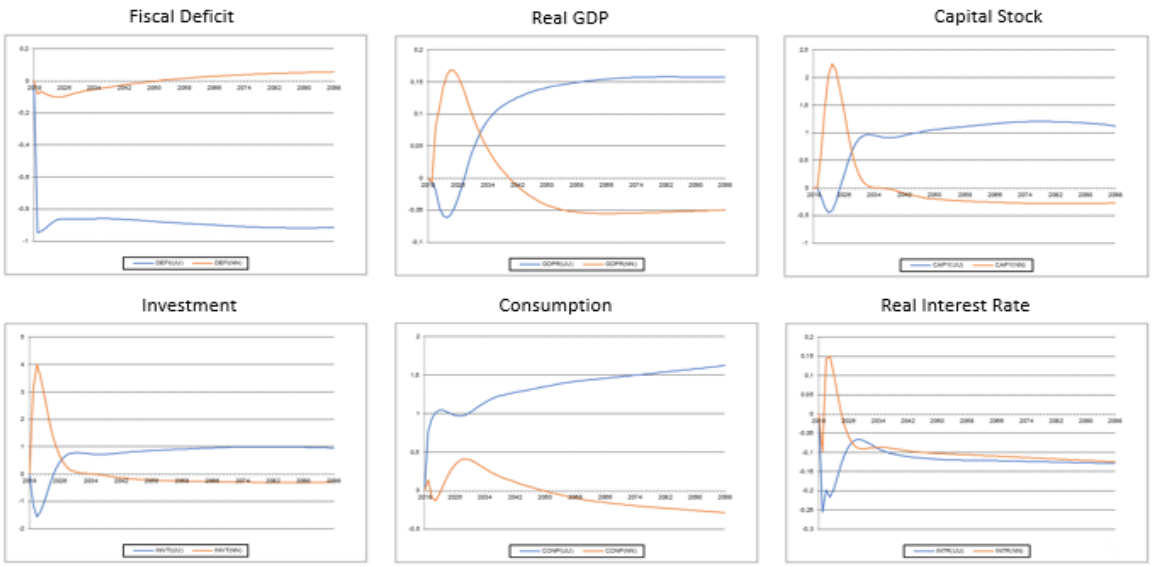

Figure 1. Simulation of Scenario 1 (Source: Author Estimation)

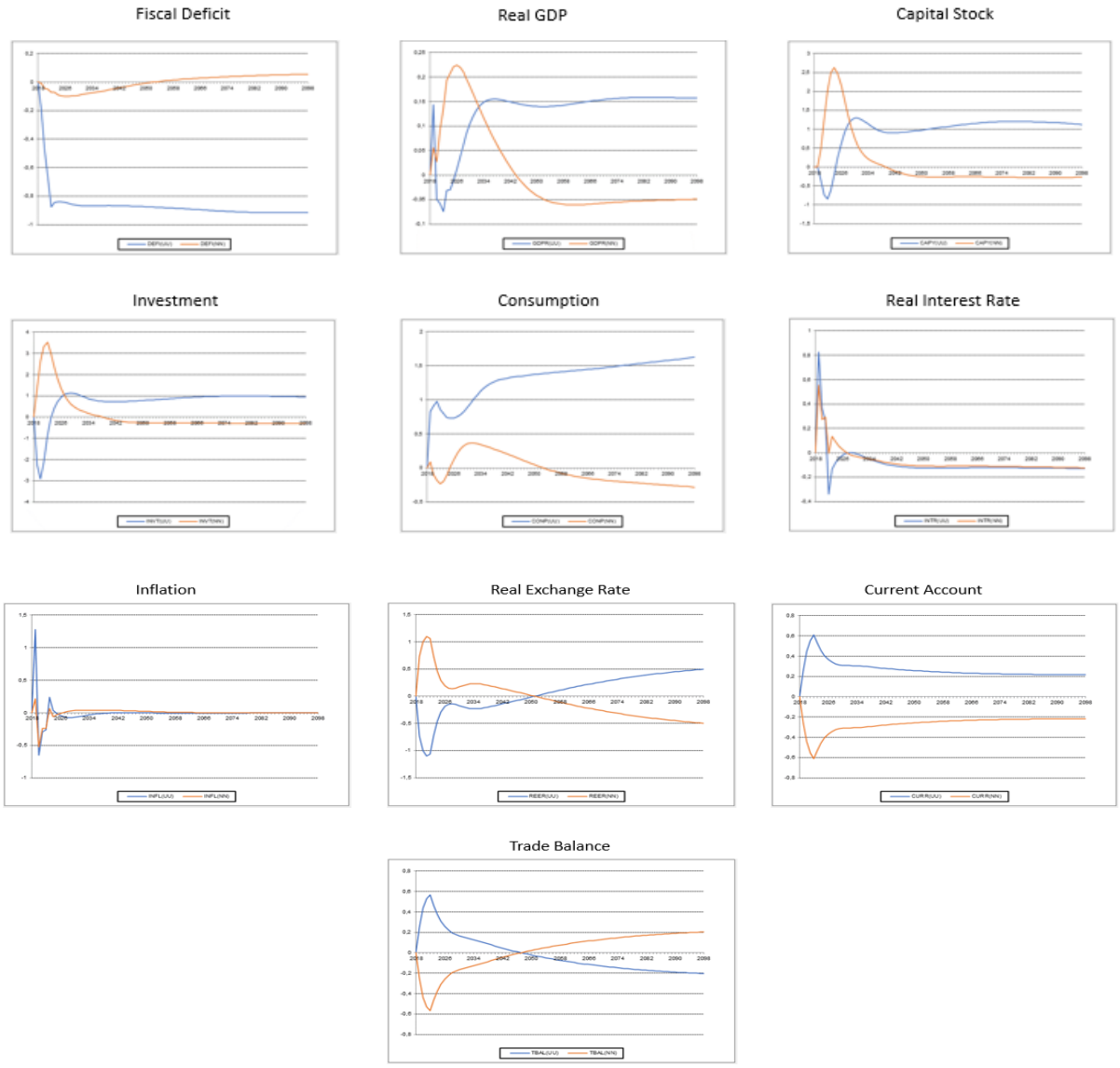

Figure 2. Simulation of Scenario 2 (Source: Author Estimation)

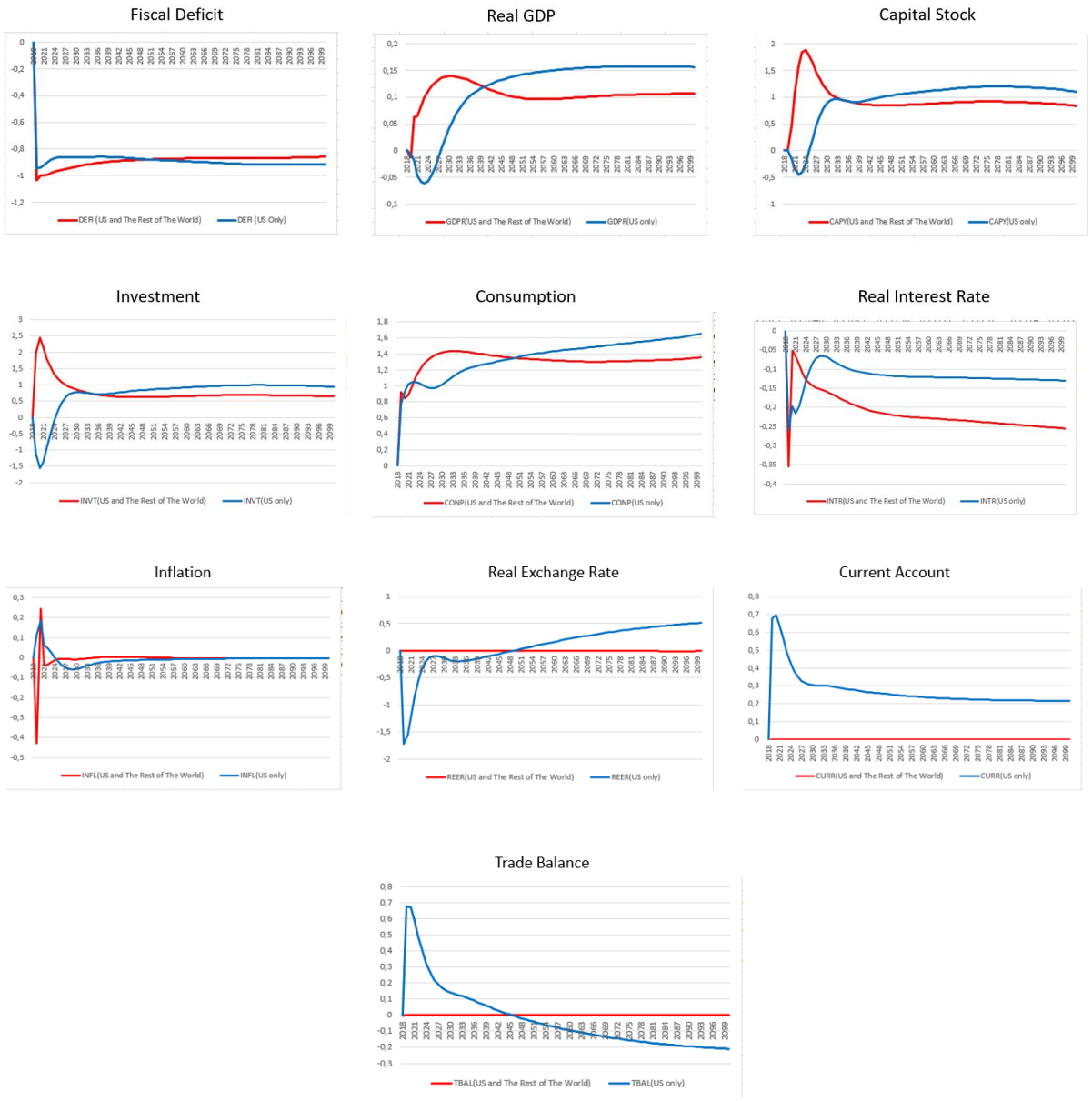

Figure 3. Simulation of Scenario 3 (Source: Author Estimation)

DISCUSSION

Scenario 1: 1% permanent reduction in government spending completed in the first year

In this section, we compare the effect of 1% permanent reduction in government spending completed in the first year on the US economy (blue curve) and the rest of the world economy (orange curve). In the instant scenario, reducing government expenditure on the economy generates an abrupt decline in US GDP. After the instant scenario is accomplished, the US economy shrinks. Then, as a cyclical adjustment, interest rates fall. Also, in the short-run, government spending cuts could reduce investment in the US. Since the US is a vast economy, reducing US interest rates also affects worldwide. Therefore, global interest rates decrease.

Next, in the long-term, real interest rate declines cause relative consumption prices to decrease over time, shifting inter-temporal consumption from the future to the present (Mansur, 2014). Thus, the long-run US consumption grows. The other effect is that the lower short and long-run interest rates reduce borrowing costs. It causes the long-run investment and capital stock to rise. However, in the short-term, a contracting US economy makes investors less interested, influencing capital outflows to the rest of the world. Therefore, the rest of the world's capital inflows improve its capital stocks and production. The increase in output leads to the rise of consumption in the rest of the world in the short term.

The capital outflows depreciate the US dollar and raise inflation, while the rest of the world's currency strengthens and lowers inflation. The depreciation of the US currency improves the US trade balance in the near term, boosting US production. Successful budget deficits must be followed by better balance of payments or

reduced private excess (Allsopp et al., 2008). The rest of the world's trade balance worsens as exports become more expensive. Private consumption in the US will rise as the increase of production and the decrease of government expenditure. Capital returns to the US while the contraction persists. All of them cause US real GDP to expand in the long term, while the rest of the world slows back to baseline or even lower than baseline.

Scenario 2: Gradually phased reduction in government spending

The results of the reduction in government spending for the phased strategy look similar to the drops completed in the first year. The most striking difference is in real GDP and real interest rate. In terms of real GDP, in the first year, when the reduction was made by 0.25%, real GDP could still grow. However, in the second year, when the reduction has reached 0.5%, real GDP starts to decline, but then it will increase again as in the first scenario. The increase in real GDP in the first year is due to a rise in consumption in the US which is higher than the decrease in government spending.

Another exciting thing is the real interest rate. Unlike the first scenario, in this scenario, the real interest rate increases in the first year. The rise in consumption in the first year and an increase in real GDP caused money demand for transactions to increase. This increase in money demand causes the real interest rate to increase (Mankiw, 2020). In the long run, the effect of direct strategy and phased strategy are similar. There is no significant difference in the economy. Thus, we could conclude that the difference of the effect between direct strategy and phased strategy is just exist in the short-run.

Scenario 3: The Global Fiscal Consolidation

This third scenario examines the impact of US and global demand shocks of 1% budget deficit cuts permanently. Positive shock transmission occurs when both nations' real GDP is affected (McKibbin & Tan, 2009). Therefore, it is apparent that fiscal deficit cuts favourably affect the US and real global GDP. Transmissions distinguish US-only fast scenarios from the global fiscal consolidation scenario findings. In the short-run, under US-only quick scenario, shock is negatively transmitted. Globally, shocks are transmitted positively. As indicated in the preceding section, reducing the government deficit would improve the balance of payments, decrease private savings, and increase private investment (Allsopp et al., 2008). If the US and the rest of the globe decrease their budget deficits equally, production and revenue would be transferred to each other.

When the US and the rest of the world cut spending, their output drops instantly. They ultimately become positive due to a relaxing financing constraint caused by a reduced government debt stock. Smaller debt stock reduced taxes due to falling bond interest. Additionally, under reasonable expectations, consumers take on reduced future taxes and enhance their consumption as human wealth accumulates. This G-cubed model's shock transmissions rely heavily on rational expectations (McKibbin & Tan, 2009).

This model's forward-looking agents know how the economy would move (Allsopp et al., 2008). Because they anticipate that production would rebound after a decline in the first year, they will boost investment, resulting in a rise in capital stock in the near run owing to higher projected rates of return. It is also due to under rational expectations, corporations are aware of the future tax implications, therefore they use a considerably lower prospective rate of interest to discount the production discouragement in the near term. In the near term, this results in a rise in investment and capital stock. They also recognise that future production will decrease, causing investment and capital stock to dip somewhat before returning to normal when output stabilises.

Moreover, according to the global fiscal consolidation scenario, productivity in both the United States and the rest of the world decreases lower in the first year before immediately increasing. Because the rest of the world's currencies gain so slowly or the US dollar depreciates so slow, there are only modest fluctuations in the trade balance, which is almost 0. Then it leads to substantially reduced swings in the inflation rate. Therefore, interest rates are firmly fixed at 0.

CONCLUSION

This paper aims to analyze the effect of fiscal consolidation on the US economy. Fiscal consolidation is needed since COVID-19 forced the government to reduce spending due to increased health and business incentive expenditure. We divide the analysis into three sections. First, we assume that the government spending reduction is completed in the first year. Second, we assume that the government decreases government spending gradually, 0.25% in the first year, 0.50% in the second year, 0.75% in the third year, and 1% in the fourth year. The final scenario assumes that the rest of the world follows the fiscal consolidation. After the analysis, we know that budgetary consolidation greatly impacts the economy in the long run. Even though the decline in real GDP is happening in the short run, the reduction of government spending could increase the real GDP in the long run. Based on the comparison between the first and second scenarios, we know that the gradual fiscal consolidation is favourable since the real GDP does not decrease directly in the first year. Additionally, in the third scenario, we know that the effect of fiscal consolidation is not as good as in the first and the second scenario in terms of real GDP. Thus, we could conclude that the fiscal consolidation strategy could be less effective if other countries follow the plan.

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