

Welfare Consequences of Fiscal Consolidation Plans: The Role of Publicly Provided Goods

This paper analyzes the welfare effects caused by fiscal consolidation plans carried out through a cut in government expenditure in a heterogeneous agent with incomplete markets model. The contribution of this study is twofold: first, it proposes a novel approach to model public expenditure consumption by households that generates a consumption distribution that matches the data. Second, it analyses the distributional welfare consequences in the short and long run of public debt deleverage considering front-loaded and back-loaded consolidations. The results show that there are welfare gains in the long run associated with consolidation through expenditure retrenchments, but they are offset by the magnitude of the short term welfare losses. Regarding distributional welfare effects, households in the lowest income quintiles are the ones that benefit the most in the long term, but also those who suffer the most during the consolidation.