Fiscal Consolidation in a Currency Union: Spending Cuts vs. Tax Hikes

Abstract

(with Jesper Lindé)

This paper uses a two country DSGE model to examine the effects of tax-based versus expenditure-based fiscal consolidation in a currency union. We find three key results. First, given limited scope for monetary accommodation, tax-based consolidation tends to have smaller adverse effects on output than expenditure-based consolidation in the near-term, though is more costly in the longer-run. Second, a large expenditure-based consolidation may be counterproductive in the near-term if the zero lower bound is binding, reflecting that output losses rise at the margin. Third, a "mixed strategy" that combines a sharp but temporary rise in taxes with gradual spending cuts may be desirable in minimizing the output costs of fiscal consolidation.