Economic Inequality and the Size of Government Expenditure Shocks: An Empirical Exercise

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Abstract

Empirical literature explains the heterogeneity of fiscal multiplier estimates through the analysis of various cyclical and structural determinants of economies, with economic inequality, as one of the key structural characteristics, receiving relatively little attention so far. In this study, using a wide sample of countries and applying the vector autoregression methodology, we first estimated fiscal multipliers and the impact of fiscal stimuli on the dynamics of the price level. The findings indicate that the estimated fiscal multipliers are mostly positive, and fiscal stimuli tend to produce an inflationary effect. Subsequently, we examined the variability in the size of fiscal multipliers in relation to various indicators of income and wealth inequality. The key findings of this study reveal that as economic inequality increases, particularly in the context of income disparities, the size of fiscal multipliers also rises. This insight is particularly important for policymakers in designing appropriate fiscal measures in an evolving macroeconomic environment.

Introduction

Changing economic conditions have destabilized the institutional framework within which economic policy operates. Traditional approaches by monetary and fiscal policymakers have increasingly failed to ensure appropriate cyclical adjustments and stable economic growth. The experience of the debt crisis, accompanied by deflationary pressures and economic stagnation, followed by a sharp surge in inflation, has forced both monetary and fiscal policies to reconsider their strategies and adopt less conventional instruments. As a result, fiscal policy has regained prominence in its stabilizing role. This shift has been underpinned in academic literature by renewed discussions on the functioning of the fiscal multiplier mechanism, supported by updated estimates of fiscal multipliers. These estimates have revealed significant heterogeneity in multiplier values, prompting a focus on identifying the determinants contributing to this variability.

In recent years the empirical literature has extensively reported on the phenomenon of the variability in the magnitude of fiscal multipliers. The research work (e.g., Auerbach & Gorodnichenko, 2011; Ilzetzki et al., 2013; Koh, 2017) has been focused on examining both cyclical (business cycles) as well as structural factors (indebtedness, openness, and development) of government spending multipliers. One of the unexplored areas that continues to persist is the role of economic inequality as a determinant of the size of the fiscal multiplier. The current scientific literature primarily centers on examining various connections between economic growth and inequality (e.g., Moll et al., 2022) or the effects of economic policy actions on inequality, such as assessing the impact of fiscal contractions (e.g., Agnello & Sousa, 2012) or low-interest rate policies (e.g., Chen & Li, 2023) on income inequality. To date, the research by Brinca et al. (2016) is the only one that has identified a positive correlation between wealth inequality and the magnitude of fiscal multipliers. Later, Brinca et al. (2021) delved into a Eurozone fiscal consolidation episode and linked higher income inequality with a more severe recessionary impact of the applied austerity measures. In contrast, Auerbach et al. (2021) introduced a theoretical model suggesting that higher income inequality leads to smaller fiscal multipliers.

The aforementioned studies currently provide the sole insight into the understanding of the relationship between economic inequality and the magnitude of fiscal multipliers. To the best of our knowledge, this phenomenon has not been comprehensively investigated to the extent, form, and focus that we present in this article. Therefore, based on a new and extensive quarterly dataset using a vector autoregression (VAR) model, we initially estimate the size of fiscal multipliers for 47 countries and the associated effects of increased government spending on price level dynamics. Subsequently, we assess the impact of a large number of income and wealth inequality indicators on the magnitude of fiscal multipliers.

The remainder of the article is structured as follows: Section 2 offers a concise review of the literature, Section 3 introduces the model and describes the data used, Section 4 presents the results, and Section 5 concludes the article.

Literature Review

This chapter reviews key findings on how country-specific characteristics influence the size of fiscal multipliers. Blanchard and Perotti (2002) and Perotti (2004) laid the foundation for studying fiscal policy using vector autoregression methods. Their research highlighted positive government spending multipliers and negative tax multipliers in the U.S., with Perotti (2004) noting diminishing fiscal stimulus effects after 1980 in developed economies. Subsequent studies, including Giordano et al. (2007) and Burriel et al. (2019), affirmed the significant impact of discretionary fiscal policy on output in developed countries.

Further research underscored the importance of business cycle phases and structural factors. Auerbach and Gorodnichenko (2010, 2011) found higher multipliers during recessions, though Ramey and Zubairy (2014) observed no significant differences. Later empirical literature showed that structural characteristics also matter. Ilzetzki et al. (2013) found larger multipliers in developed, closed economies and smaller or negative multipliers in high-debt countries, while Hory (2016) linked multipliers to factors like unemployment and financial development. Koh (2017) noted larger multipliers during crises and in low-debt nations but challenged the idea that openness consistently reduces multipliers. Lastly, the global financial crisis emphasized the role of discretionary fiscal measures as monetary policy constraints increased (Auerbach & Gorodnichenko, 2017).

Brinca et al. (2016) provided key insights into the impact of wealth inequality on fiscal multipliers, using a VAR approach to show a positive correlation between the wealth Gini coefficient and multiplier size. Wealth inequality accounted for about 20% of variability in multiplier size, explained by three channels: fewer liquidity-constrained households lower marginal consumption, reduced precautionary savings among less-constrained households, and lower real interest rates reducing the fiscal stimulus's value. Later, Brinca et al. (2021) examined Eurozone fiscal consolidation, finding that higher income inequality intensified the recessionary effects of austerity measures.

In contrast, Auerbach et al. (2021) proposed that higher income inequality reduces fiscal multipliers, as poorer

households' constrained demand and wealthier households' low spending propensities dampen the multiplier effect. They referenced Miranda-Pinto et al. (2023), who linked inequality to fiscal stimulus's impact on credit markets. Their findings suggested high inequality might ease credit conditions, potentially leading to larger multipliers, though empirical evidence was mixed.

The broader link between inequality and fiscal policy has been explored by others. Heimberger (2020) found that fiscal austerity worsens income inequality, with disposable income Gini coefficients rising significantly after fiscal adjustments, particularly during crises and under spending cuts. Similarly, Furceri et al. (2022) showed that a 1% GDP cut in government spending increases income inequality by 1 percentage point.

While structural and cyclical determinants of fiscal multipliers are well-studied, the role of inequality remains underexplored. Wealth inequality's effects were directly analyzed by Brinca et al. (2016), and income inequality was indirectly assessed in fiscal consolidation contexts by Brinca et al. (2021), with further theoretical contributions from Auerbach et al. (2021).

Model and Data

To gauge the impact of government spending multipliers, we employed the analytical approach outlined by Blanchard and Perotti (2002). This methodology was further extended by Perotti (2004) and tailored for the examination of fiscal policy measures. Assume a basic model encompassing three variables: the natural logarithm of real government consumption (g_t), the natural logarithm of real GDP (y_t), and the natural logarithm of the price level (p_t). The vector of endogenous variables can be written as X_t and the vector of residuals in reduced form as U_t. The ensuing reduced VAR structure can be expressed as:

$$X_t = A(L)X_{t-1} + U_t \quad (1)$$

where $X_t = [g_t, y_t, p_t]'$ and $U_t = \left[u_t^g, u_t^y, u_t^p\right]'$, L is the lag operator, and $A(L)$ is the polynomial of the corresponding degree. The reduced form of residuals of the variable g_t, i.e. u_t^g, can be interpreted as a shock.

Based on the so-called AB model (Lütkepohl 2005), we wrote a system of equations in the matrix form represented by the following equation:

$$AU_t = BE_t \quad (2)$$

where U_t is the vector of the VAR residuals and $E_t = \left[e_t^g, e_t^y, e_t^p\right]'$ is a vector of structural shocks or innovations. We can define matrices A and B. The equation (2) is written in the form:

$$\begin{bmatrix} 1 & 0 & 0 \\ -\alpha_g^y & 1 & 0 \\ -\alpha_g^p & -\alpha_y^p & 1 \end{bmatrix} \begin{bmatrix} u_t^g \\ u_t^y \\ u_t^p \end{bmatrix} = \begin{bmatrix} \beta_g^g & 0 & 0 \\ 0 & \beta_y^y & 0 \\ 0 & 0 & \beta_p^p \end{bmatrix} \begin{bmatrix} e_t^g \\ e_t^y \\ e_t^p \end{bmatrix}. \quad (3)$$

To achieve the identification of the system, we necessitate a total of $\left(2k^2 - \frac{1}{2}k[k+1]\right)$ restrictions where k stands for the number of endogenous variables which is 3 within our context.

The ordering of the variables delineates the causal interrelations among them. Concomitantly, alterations in government spending prompt immediate reactions in both real GDP and the price level. Simultaneously, government spending exhibits no concurrent response to changes in output and price level within the identical timeframe. Moreover, the price level exerts no contemporaneous influence on output. This system attains precise identification due to its adherence to a fitting set of constraints (12 restrictions). Based on the results derived from the VAR model, the impulse response function evaluates the dynamic patterns and magnitudes of individual component reactions to government spending shocks.

To scrutinize the associations between the magnitude of government spending multipliers and distinct country attributes, the following specification was applied:

$$FM_i = \beta_0 + \beta_1 X_i + e_i \quad (4)$$

where FM_i is the government spending multiplier of a country i, β_0 is a constant term, β_1 is slope regression coefficient, X_i is a country-specific characteristic of a country i, and e_i represents residuals.

The VAR model in our study comprises real government spending, real GDP, and GDP deflator. All variables have quarterly frequency and cover the period between 1995 and 2021 for 47 countries. Data for government consumption, GDP, and price levels are collected from the International Financial Statistics database (IMF, 2023). Additional variables are collected to examine the role of countries' characteristics. Thus, we employed the income Gini index as a measure of income inequality (World Bank, 2023) and top 10%, top 20%, lower 10%, and lower 20% income shares as income distribution measures (World Bank, 2023). Regarding wealth

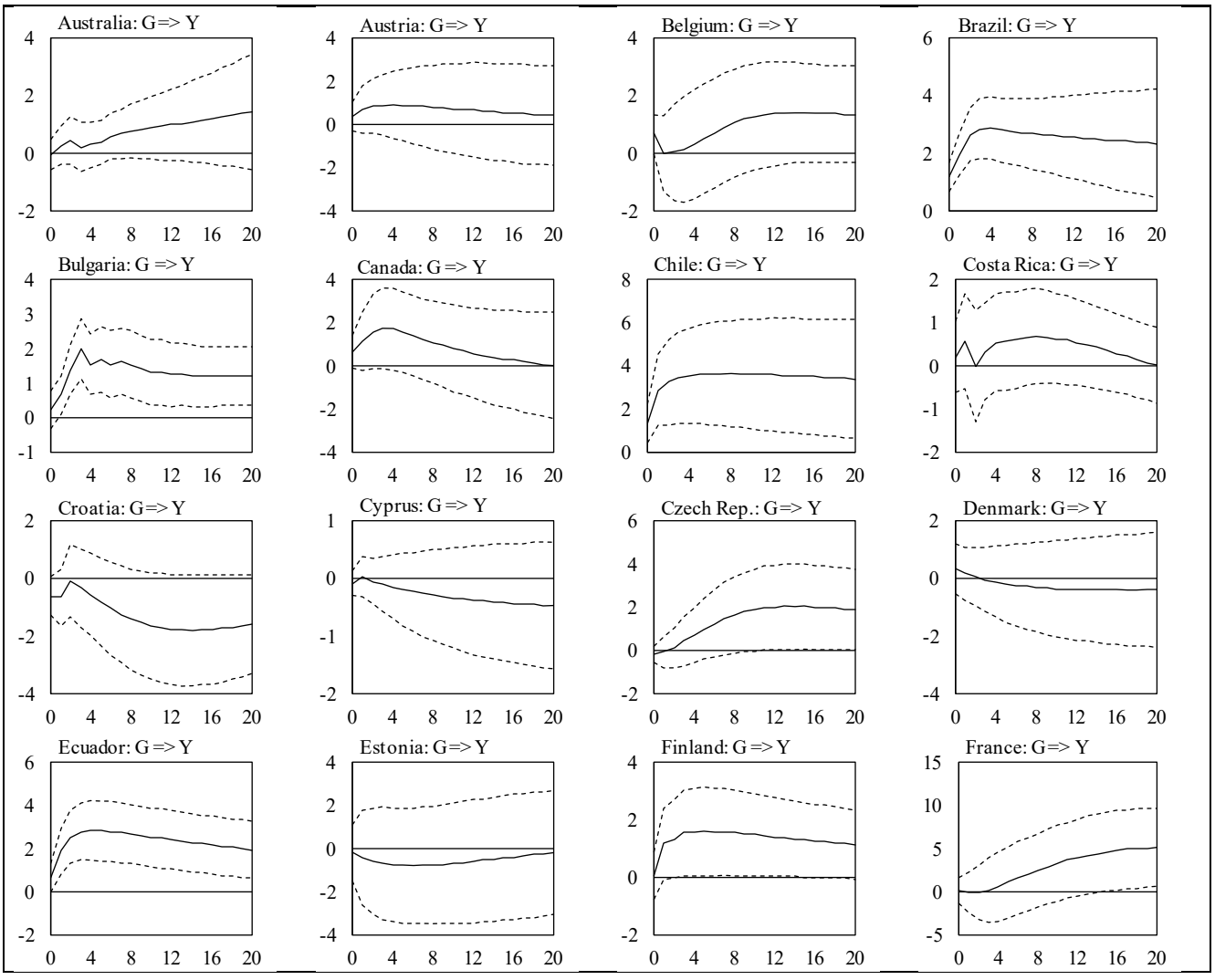
inequality, the data set from Credit Suisse Bank (2023) was utilized. The average value of a specific indicator is determined based on available data. In the case of the wealth Gini, the median value is also included.

Estimation Results

The estimates of fiscal multipliers (Table 1) reveal that first, fiscal multipliers are predominantly positive across the forecast horizon for 31 countries, predominantly negative for 9 countries, and partially positive for 7 countries. Second, in the case of 25 countries, the value of multipliers is greater than one for at least part of the forecasting horizon. Third, in the case of 24 countries, the multiplier estimates are statistically significant. Furthermore, our analysis suggests the inflationary side effects of applying fiscal stimulus. Specifically, the estimates show (Table 2) that, in the case of 32 out of 47 countries, increased government spending causes inflationary pressures. In additional 13 countries, the price level response is at least partially positive. Only in two countries do the price dynamics indicate downward pressures. The price response is statistically significant in 83% of the countries of our sample.

Table 1

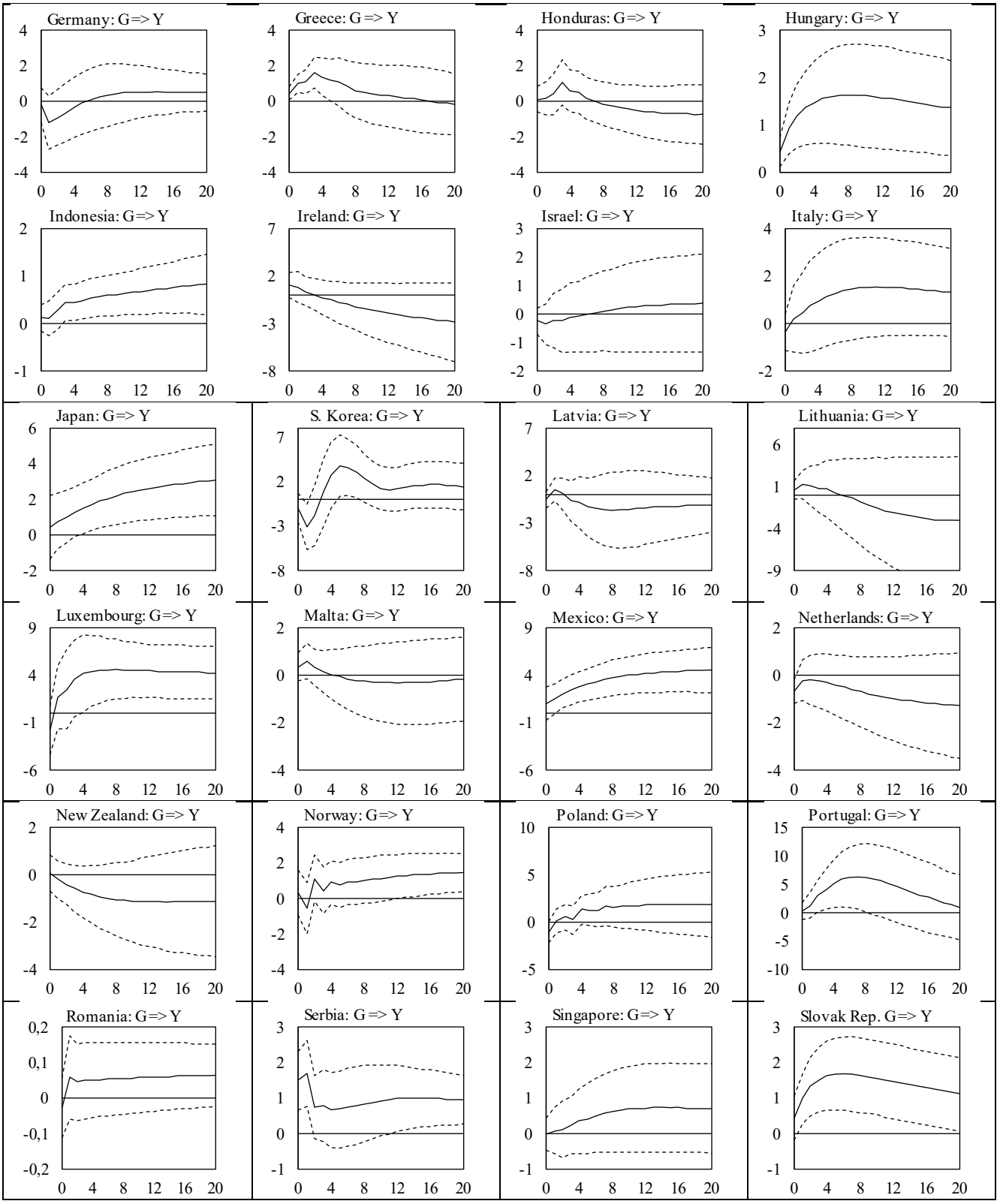
Government spending multipliers by countries



Notes: The solid line represents the output effect of a positive shock in government spending, with a magnitude of 1% of GDP. The dashed lines represent the upper and lower limits of the 90% confidence band.

Continuation of Table 1

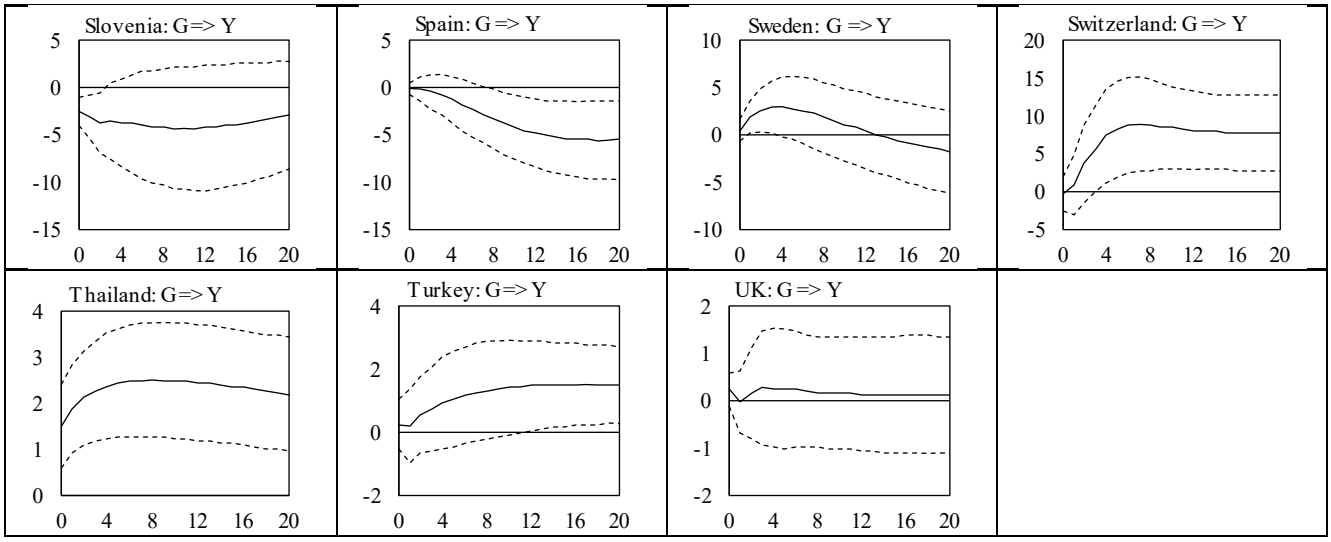
Government spending multipliers by countries



Notes: The solid line represents the output effect of a positive shock in government spending, with a magnitude of 1% of GDP. The dashed lines represent the upper and lower limits of the 90% confidence band.

Continuation of Table 1

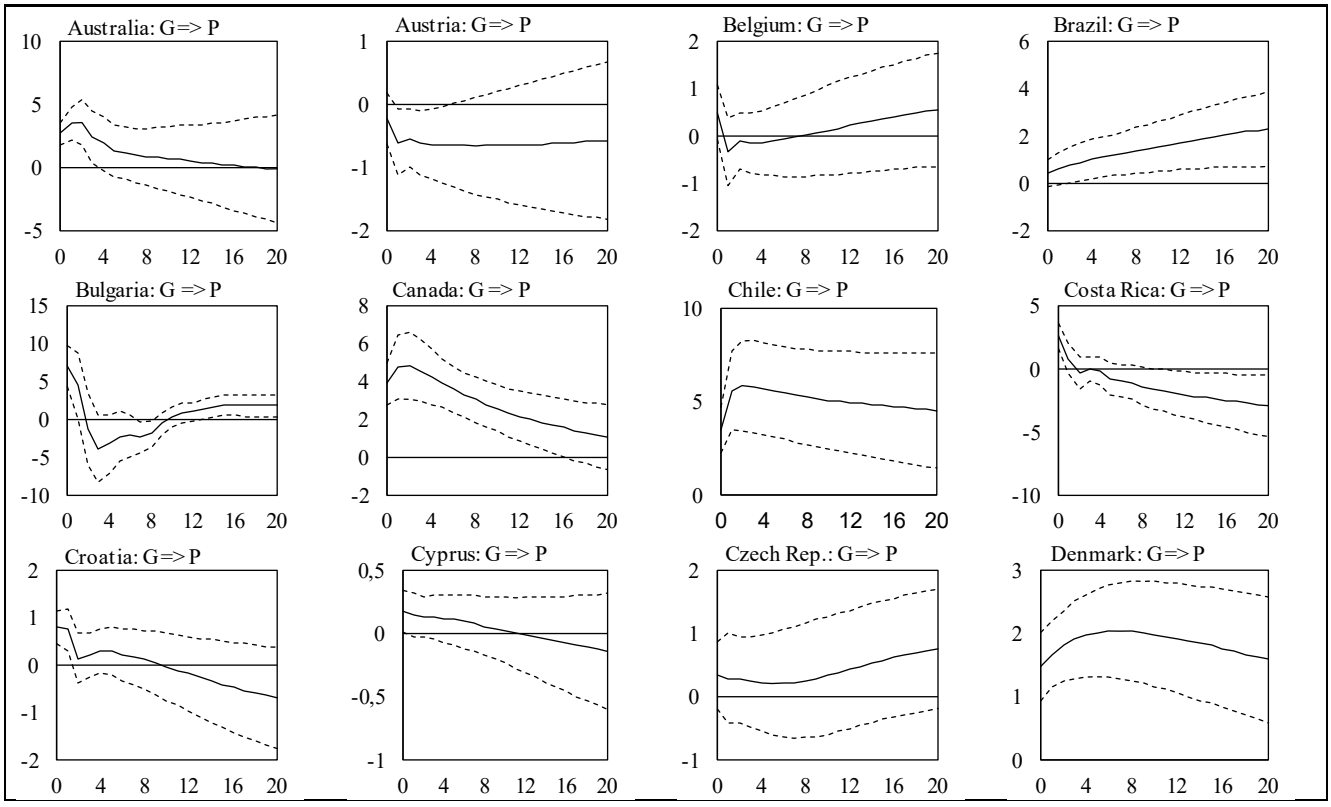
Government spending multipliers by countries



Notes: The solid line represents the output effect of a positive shock in government spending, with a magnitude of 1% of GDP. The dashed lines represent the upper and lower limits of the 90% confidence band.

Table 2

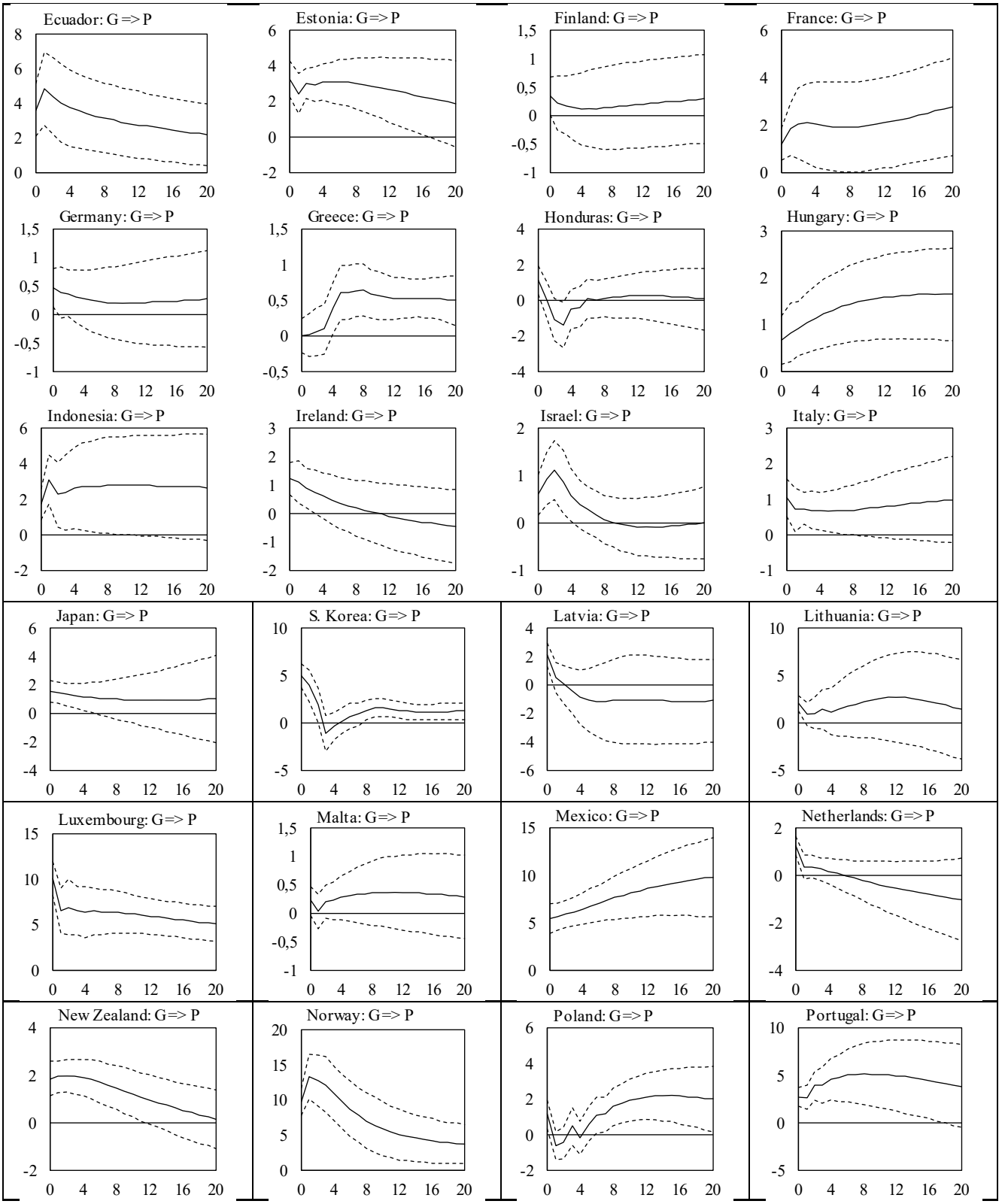
Response of price level to a positive shock in government spending



Notes: The solid line represents the response of price level to a positive shock in government spending, with a magnitude of 1% of GDP. The dashed lines represent the upper and lower limits of the 90% confidence band.

Continuation of Table 2

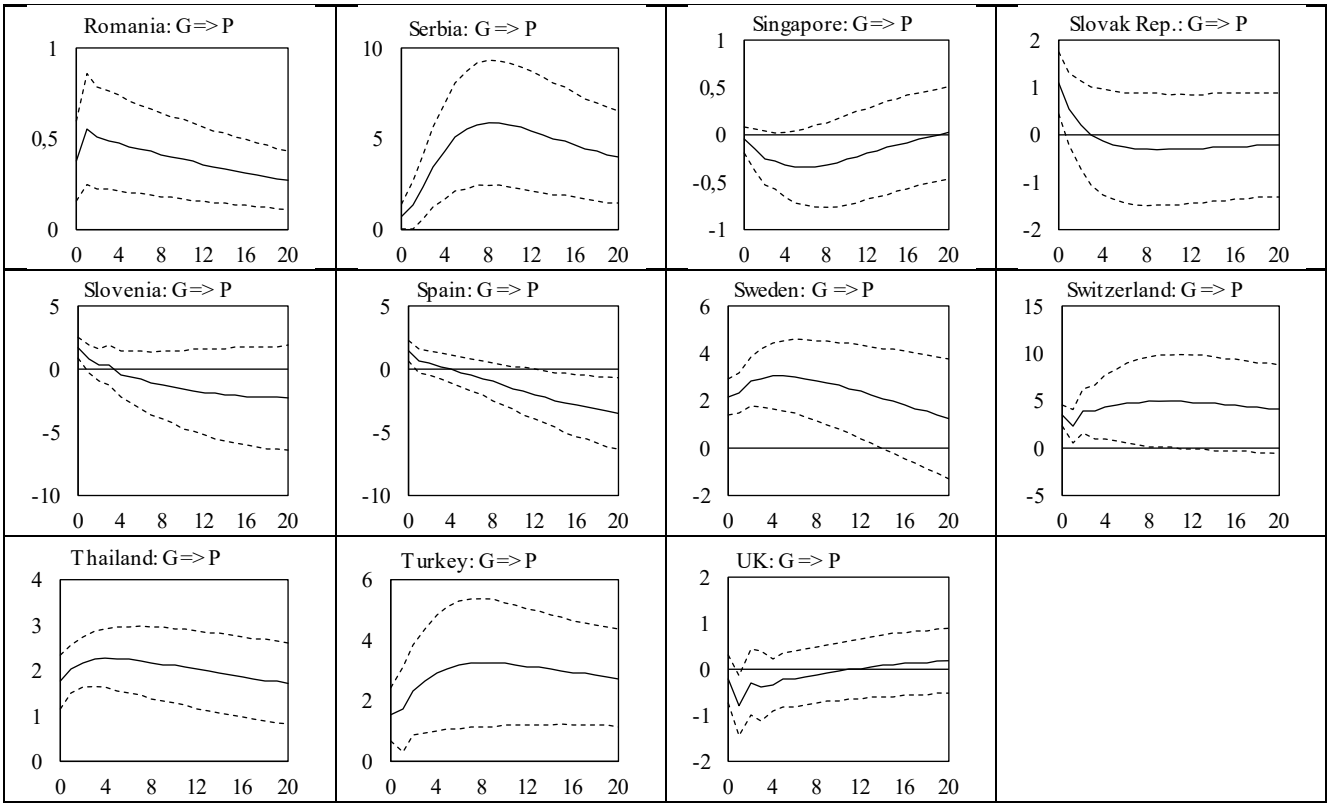
Response of price level to a positive shock in government spending



Notes: The solid line represents the response of price level to a positive shock in government spending, with a magnitude of 1% of GDP. The dashed lines represent the upper and lower limits of the 90% confidence band.

Continuation of Table 2

Response of price level to a positive shock in government spending



Notes: The solid line represents the response of price level to a positive shock in government spending, with a magnitude of 1% of GDP. The dashed lines represent the upper and lower limits of the 90% confidence band.

The estimates given in Table 3 suggest that higher income and wealth inequality tend to increase the size of the government spending multiplier, as indicated by the positive coefficients for income and wealth Gini measures and the shares held by the top income groups. Conversely, the shares held by the low-income groups tend to decrease the size of the multiplier, as indicated by the negative coefficients. The coefficient for income Gini is positive and statistically significant in all eight cases at a 10% significance level and in seven cases at a 5% significance level, suggesting that countries with greater income inequality tend to have larger government spending multipliers. In three cases, income inequality helps to explain nearly 20% of the variability of fiscal multipliers. The coefficients for the share of the top 10%- and 20%-income groups are also positive in all cases. Conversely, the coefficients for the share of lower 10%- and 20%-income groups are negative in all cases showing that countries where low-income households hold larger fraction of income tend to have smaller government spending multipliers. Coefficients for income concentration indicators are statistically significant in 88% of cases at a 10% significance level and in 72% of cases at a 5% significance level and help to explain a considerable portion of the variability of fiscal multipliers. This is especially evident by the impact multiplier and average impact and first quarter multiplier where R-squared values hover between 15% and 20%.

The coefficients for wealth Gini are positive in all cases but just marginally statistically significant in some cases, suggesting that the distribution of wealth may have a weaker effect on the size of government spending multipliers. Nevertheless, the results indicate that countries with a less equal distribution of wealth tend to exhibit larger government spending multipliers, as also observed in Brinca et al. (2016). Overall, our findings suggest that income inequality and income concentration have a significant impact on the size of government spending multipliers while wealth inequality may have a more limited impact.

Based on the results, we can infer that fiscal policy tends to be more potent in more unequal societies. This implies that fiscal stimulus can more rapidly and effectively boost economic growth during recessions. Conversely, fiscal contraction in these countries during periods of fiscal crises may exacerbate and prolong recessions. Moreover,

fiscal policy could potentially contribute to reducing economic inequality. In highly stratified societies, fiscal stimulus exhibits a greater multiplier effect, meaning that appropriately tailored and more targeted increases in public spending could enhance the incomes of relatively poorer segments of the population.

Table 3
Determinants of the size of government spending multiplier

$FM_i = \beta_{0,i} + \beta_{1,i}X_i + e_i$								
	Impact multiplier		*Average impact and first quarter multiplier*		*Average one-year multiplier*		*Average two-year multiplier*	
X_i	β_1	R^2	β_1	R^2	β_1	R^2	β_1	R^2
Income Gini	0.043*** (0.003)	0.176	0.055*** (0.001)	0.216	0.063*** (0.006)	0.156	0.064** (0.036)	0.094
Share of top 10% IG	0.060*** (0.003)	0.187	0.076*** (0.001)	0.232	0.089*** (0.004)	0.177	0.093** (0.024)	0.113
Share of top 20% IG	0.053*** (0.004)	0.178	0.068*** (0.001)	0.222	0.079*** (0.006)	0.166	0.081** (0.032)	0.103
Share of low 10% IG	-0.346** (0.013)	0.134	-0.428*** (0.007)	0.156	-0.444** (0.041)	0.093	-0.390 (0.175)	0.042
Share of low 20% IG	-0.166** (0.010)	0.144	-0.208*** (0.005)	0.173	-0.226** (0.024)	0.113	-0.212 (0.111)	0.058
Wealth Gini (median)	0.025 (0.101)	0.060	0.026 (0.145)	0.048	0.042* (0.073)	0.071	0.055* (0.075)	0.070
Wealth Gini (average)	0.026* (0.089)	0.064	0.027 (0.131)	0.051	0.040* (0.097)	0.061	0.050 (0.113)	0.056
$FM_i = \beta_{0,i} + \beta_{1,i}X_i + e_i$								
	First quarter multiplier		*Second quarter multiplier*		*Third quarter multiplier*		*Fourth quarter multiplier*	
X_i	β_1	R^2	β_1	R^2	β_1	R^2	β_1	R^2
Income Gini	0.067*** (0.002)	0.189	0.066** (0.012)	0.133	0.073** (0.018)	0.117	0.066* (0.069)	0.071
Share of top 10% IG	0.093*** (0.002)	0.204	0.095*** (0.008)	0.155	0.104** (0.013)	0.134	0.095* (0.054)	0.084
Share of top 20% IG	0.082*** (0.002)	0.194	0.083** (0.010)	0.143	0.091** (0.017)	0.125	0.083* (0.064)	0.077
Share of low 10% IG	-0.509** (0.014)	0.131	-0.455* (0.067)	0.076	-0.497* (0.089)	0.066	-0.412 (0.228)	0.034
Share of low 20% IG	-0.250*** (0.009)	0.148	-0.232** (0.043)	0.092	-0.258* (0.056)	0.083	-0.222 (0.159)	0.046
Wealth Gini (median)	0.026 (0.254)	0.029	0.046* (0.085)	0.067	0.052 (0.101)	0.060	0.062* (0.091)	0.064
Wealth Gini (average)	0.028 (0.237)	0.032	0.045 (0.105)	0.059	0.047 (0.150)	0.046	0.055 (0.113)	0.048

Notes: FM_i represents selected government spending multiplier of a country i, X_i represents the determinant of the size of the government spending multiplier in the country *i*. Based on regression analysis, slope coefficients with corresponding R^2 are listed; p-values are in parentheses. ***p < 0.01, **p < 0.05, *p < 0.1.

Concluding Remarks

Simultaneously with the evolving economic conditions of the past decade, the empirical literature has been gradually developing a common framework on the topic of fiscal multipliers although certain aspects still lack consensus. This article contributes new and compelling empirical evidence to this discussion by linking higher fiscal multipliers with more unequal economies in the context of income and wealth distribution. Specifically, our findings can be comprised as follows. First, estimated values of fiscal multipliers are mainly positive in 66% of the countries, mainly negative in 19% of the countries, and partially positive in 15% of the cases, with over half of the countries experiencing a fiscal multiplier value exceeding unity on at least part of the forecasting horizon. Second, the response of the price level to a positive shock in government spending is primarily inflationary. Third, our empirical evidence demonstrates that a higher level of economic inequality, especially income inequality, leads to higher values of fiscal multipliers. According to the results, fiscal policymakers should give particular attention to the parameters related to income and wealth inequality when applying various budgetary measures. Future research should be devoted to the investigation of the nature of the interest rate response to fiscal shocks in the context of income and wealth inequality, building upon the work of Miranda-Pinto et al. (2023)

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Ekonomska neenakost in velikost multiplikatorja državnih izdatkov: empirična analiza

Izvleček

Empirična literatura heterogenost ocen fiskalnih multiplikatorjev pojasnjuje z analizo različnih cikličnih in strukturnih determinant gospodarstev, pri čemer je ekonomska neenakost kot ena izmed pomembnih strukturnih karakteristik v literaturi doslej prejela razmeroma malo pozornosti. V tej študiji smo na širokem vzorcu držav z uporabo metodologije vektorske avtoregresije najprej ocenili fiskalne multiplikatorje in vpliv fiskalnih spodbud na dinamiko splošne ravni cen. Ugotovitve kažejo, da so ocenjene vrednosti fiskalnih multiplikatorjev pretežno pozitivne, prav tako pa aplikacija fiskalnih spodbud povzroča inflacijski učinek. Nato smo preučili variabilnost velikosti fiskalnih multiplikatorjev v povezavi z različnimi indikatorji dohodkovne in premoženjske neenakosti. Ključni izsledki te študije razkrivajo, da se z naraščanjem ekonomske neenakosti, zlasti v kontekstu dohodkovnih razlik, povečuje tudi velikost fiskalnih multiplikatorjev. Ta ugotovitev je pomembna zlasti za nosilce ekonomske politike pri oblikovanju ustreznih fiskalnih ukrepov v spreminjajočem se makroekonomskem okolju.

Ključne besede: fiskalni multiplikator, dohodkovna neenakost, premoženjska neenakost, VAR