Summary for non-specialists
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Fiscal performance and income inequality: Are unequal societies more deficit prone? Some cross country evidence.

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Among developed and middle-income countries there is a pervasive tendency towards running persistent deficits - the so called deficit bias – and, consequently, to accumulate government debt over time. In the literature, this tendency is predominantly attributed to the 'common pool' problem: geographically dispersed spending interests competing for government resources do not internalise costs for society as a whole and hence give rise to overspending. In this paper we examine an alternative explanation of the deficit bias, namely the distribution of personal income. Although there are a number of theories that hypothesise an interplay between income inequality and fiscal performance, to our knowledge, the link has so far not been tested empirically.

Our analysis tends to corroborate the conjecture according to which income inequality makes fiscal discipline more difficult. In line with our priors, the link between income distribution and fiscal performance is not a direct one. Rather, interactions with political factors are at play. The first type of interaction relates to the political orientation and focus of governments. Inequality tends to weigh on public finances only when governments from the left of the political spectrum, which generally care more about equity issues, also represent special interests, conceivably those who benefit from deficit-financed redistribution. This finding is consistent with theoretical models according to which governments supported by a majority of poor and liquidity constrained voters will tend to run deficits. The second type of interaction is more straightforward and intuitive. It implies that income inequality will tend to lead to a deterioration of the budget balance when governments face political instability that puts their position at risk. The third, and somewhat less transparent, channel through which inequality seems to impinge on fiscal performance works in combination with economic

growth: a higher degree of income inequality is associated with a muted impact of economic growth on the budget. One way to read this result is that political pressure to spend additional revenues accruing from growth mounts as the distribution of income becomes more uneven.

Our findings support observations and policy conclusions that are relevant especially in the aftermath of the post-2007 global financial and economic crisis. In particular, when planning fiscal adjustment packages, inattention with respect to the distribution of income could trade off unfavourably and even backfire giving rise to mounting political pressure for higher redistributive spending. Hence, in order to safeguard the sustainability of public finances or fiscal adjustment packages it may be worth keeping an eye on the distributional effects of alternative policy paths.