Insight

Repairing a Fiscal Hole: How and Why Spending Cuts Trump Tax Increases

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The United States is not the first country to find itself in a fiscal crisis; history is replete with countries, states, and cities that have spent well beyond their means and found it necessary to retrench—or else. There are myriad ways to combine tax and spending changes to achieve a sensible budget, and in the past 40 years it seems nearly every combination has been attempted by some government somewhere. A very relevant question is what can we learn from the experiences of others that have tried to close a gaping budget gap?

Research tells us that spending cuts trump tax increases when countries attempt to close enormous budget deficits. A recent study[1] that examines the outcomes of 21 countries with 109 years of "fiscal consolidation" finds that *the countries that achieved the best results in extricating themselves from a fiscal crisis relied overwhelmingly on spending reductions rather than tax increases to do so—with cuts outweighing tax increases by a factor of five or six to one in the countries.*

Spending Increases Do Not Stimulate the Economy

An argument offered by many for delaying—or simply refusing to consider—any spending cuts is that doing so is liable to push the economy back into a recession. However, believing that maintaining or increasing government spending is beneficial for economic growth assumes a level of ignorance on the part of households that defies economic reality.

Most Americans realize that annual deficits exceeding $1 trillion cannot continue forever. Many fear that the path towards reducing these deficits leads to higher taxes and in anticipation they set more money aside. Thus, any increase in aggregate demand brought about by higher government spending is mitigated by lower personal spending. Indeed, savings rates jumped up in the wake of the Great Recession and the immense deficits that accompanied them not merely because profligate US households felt an obligation to reduce spending but in part because they knew to expect higher taxes in the near future.

A wealth of economic research tells us that tax increases reduce economic growth. For instance, a 2007 paper[2] by former Council of Economic Advisers head Christina Romer and her husband, David Romer, estimated that a one percent tax increase depresses economic growth by three percentage points. Andrew Mountford and Harald Uhlig[3] found in 2008 that both tax increases and spending increases harm economic growth, but that tax reductions—even if temporarily financed with deficits—can bring about an increase in GDP. Alberto Alesina, in a 2010 study,[4] shows that government spending does not increase private spending, but rather provides a purely ephemeral—and relatively weak—jolt to economic growth with a countervailing negative impact in the longer run, as the increase in the deficit dampens spending in the long run. In an economy where the recession began over 3 years ago and ended over 18 months ago, it makes sense to focus on the long run.

But Spending Decreases Often *Do* Stimulate the Economy

Reducing government spending sends two complementary signals to the economy: First, that the government is serious about getting its budget under control, which lets consumers, investors, and businesses know that the government is much less likely to crowd out private sector activities in the future.

Secondly, spending cuts suggest that taxes are much less likely to be raised in the future. Lower future tax rates can act as a spur to economic activity today, since people know that they'll be operating in a more profitable environment in the future.

As a result, government spending cuts can usher in periods of stronger economic growth.

Sustained Economic Growth is Crucial to Revenue Growth

The two periods of highest tax revenue growth in the Postwar economy occurred from 2004-2007—when revenue went up by almost 50 percent—and from 1996-2000, when revenues went up nearly as rapidly. Tax *rates* did not go up in either period; these two jumps in tax revenue came in the midst of a sustained period of economic growth. The link between economic growth and revenue growth may seem self-evident but the two do not necessarily move in lockstep; revenue growth lags economic growth but then eventually catches up—with a vengeance. The reason is simple: as an expansion continues more and more people participate in the labor market, turning recipients of government programs into taxpayers.

This is another reason why reducing the budget gap via tax increases is so harmful. The short-term revenue gain is counterbalanced with reduced economic growth, both today and in the future. That's not to say that higher tax rates completely foreclose economic growth—plenty of Western European countries have managed middling growth in the midst of tax rates well above our own—but the reduction in growth we would see from significant tax increases would push the revenue surge further into the future and possibly beyond the realm of the current expansion, meaning it would not happen at all.

Back from the Edge

An important study[5] recently published by Alberto Alesina and Silvio Ardagna examined the fates of 21 countries that tackled severe budget deficits and lived to tell about it. The link that connects the economies that succeeded in turning around their budget—and their economy—is that they emphasized spending reductions over tax cuts.

Their approach is simple: Using OECD data, they examine over 100 episodes where a country undertook a "fiscal adjustment" that exceeded 1.5 percent of GDP, and declare that adjustment a success if the ratio of government debt to GDP falls by more than 4.5 percentage points three years after the initial fiscal adjustment.

They discovered that in the successful adjustments, spending falls by an average of two percent of GDP and, somewhat surprisingly, tax revenues also fall, by an average of 0.5 percent of GDP. Of the two percentage point reduction in spending, nearly half of it comes from a reduction in transfer payments.

In the unsuccessful adjustments, spending does not fall; instead, these governments attack the deficit by increasing taxes, which ultimately negates any economic growth. Indeed, in unsuccessful adjustments, transfer payments actually *increase* by 0.4 percent of GDP.

From this analysis they derived a rough rule of thumb that adjustments have to be 85 to 90 percent spending reductions to have any chance of working. And more specifically, most of the reductions need to come from government payroll and transfer payments.

Case Studies

To get a better feel for the successful strategies we briefly discuss three different governments that faced steep and seemingly intractable budget deficits and made politically difficult decisions to reduce those deficits—one that succeeded (Canada) and two that recently followed in its footsteps, with the results still to be determined.

Canada

In the early 1990s Canada faced a budget situation that closely resembles the current U.S. budget predicament. Spending was over 22 percent of GDP, the government had been running a deficit exceeding 4 percent of GDP for over a decade, and government debt was approaching 100 percent of GDP. The newly-installed Liberal government decided to use its election mandate to force through a budget that aggressively reduced the deficit.

It began by instituting sharp across-the-board reductions in spending and then subsequently imposing a five year expenditure freeze. When the five year plan expired i
t passed a debt repayment plan that outlined future spending and created a contingency fund to be used to pay down debt in years when the government ran a surplus. Virtually every single department experienced a budget cut and by 1997 government spending was lower than at any other time since 1951. Four years after the budget plan began the government achieved a surplus, aided in part by the dramatic decline in interest rates brought about by renewed confidence in the government's plans. About 85 percent of the deficit reductions were achieved by budget reductions.

Besides balancing the budget the government also pursued other systemic improvements in the economy. It fixed its dysfunctional unemployment insurance system and at the same time slashed the myriad business subsidies that had arisen during the government of Pierre Trudeau. It also divested itself of several government-run businesses.

Ireland

The global financial crisis took an especially large toll on the economy of Ireland. Before the 2008-2009 financial crisis Ireland ran a budget surplus and had public debt equal to 25 percent of GDP. But, in 2009 the country's budget deficit was 11.7 percent of GDP, with public debt at 65 percent of GDP.

Ireland has since taken drastic measures with the goal of reducing the deficit below 3 percent of GDP by 2014. In 2009 it passed a plethora of budget cuts—and a few tax increases—that helped reduce the annual deficit by almost five percent of GDP. Further budget cuts in 2010 saved another 2.5 percent of GDP, with the government embarked on a fundamental reform of its tax code and public pension system. The country's austere post-crisis budgets helped to reduce its borrowing costs.

The bulk of the savings came from reducing public sector payroll as well as entitlements. The deflationary pressure of these actions precipitated a necessary reduction in labor costs, which helped to make Ireland's export sector more competitive.

Puerto Rico

Perhaps the best example for how an economy can adopt a pro-growth budget reform can be found within the United States. The Great Recession began earlier, was more severe, and lasted longer on the island of Puerto Rico than in the rest of the country, with unemployment topping out above 17 percent in early 2010. While the NBER officially declared the recession over in the mainland US by the summer of 2009, Puerto Rico's economy remained stagnant eighteen months later, more than four years after its economy first contracted.

The recession devastated the government's finances: the annual deficit exceeded 50 percent of GDP from 2006-2009, leading ratings agencies to push its bond grade to junk status.

In 2009 Puerto Ricans elected a conservative, Luis Fortuño, to be governor, and he quickly implemented aggressive reforms to rectify the government budget deficit. In his first year his government reduced the public sector payroll by nearly 20 percent and closed the woefully underfunded public pension system to new employees, instituting a 401(k) system for them. The government also came up with innovative ways to dramatically reduce sales tax evasion while reforming the corporate tax system, reducing top tax rates at both the personal and the corporate level. In addition, Puerto Rico chose to reform its outdated unemployment-insurance system to allow laid-off workers to use their UI compensation to pay for education or retraining while also removing the disincentives for work inherent in its structure.

The government also managed to increase infrastructure investment by leasing the airport and the major tollways to private investors, generating billions of needed dollars along the way.

The result of this shock therapy has been a budget that is nearly balanced, a bond rating well north of its former "junk" status, and an economy that is showing signs of life. The fact that Governor Fortuño managed these drastic reforms without a major loss in popularity suggests that getting a government's budget under control is not automatically politically unpopular.

The Rx for the US Budget: Cut Spending

The evidence belies the argument that a fragile U.S. economy precludes spending cuts. Government spending should always be judged on its own merits and not as to whether the economy can withstand its diminution: the research shows that a smaller government footprint ultimately hastens economic growth.

With government spending well beyond historic norms and debt nearing 100 percent of GDP, few would dispute the pressing need to address our deficit. The path to fiscal solvency is clear: Government needs to reduce spending in all areas of the budget as soon as possible.

[1] Biggs, Andrew G.; Hassett, Kevin A. & Matthew Jensen. (2010) A Guide for Deficit Reduction in the United States Based on Historical Consolidations that Worked. AEI Economic Policy Working Paper 2010-04. <http://www.aei.org/docLib/20101227-Econ-WP-2010-04.pdf>

[2] Romer, Christina D. & David H. Romer. (2007) The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks. University of California Berkeley. <http://www.econ.berkeley.edu/~cromer/RomerDraft307.pdf>

[3] Mountford, Andrew & Harald Uhlig. (2008) What are the Effects of Fiscal Policy Shocks? National Bureau of Economic Research. NBER Working Paper 14551. <http://www.nber.org/papers/w14551.pdf>

[4] Alesina, Alberto. (2010) Fiscal Adjustments: Lessons from Recent History. Prepared for Ecofin meeting in Madrid, April 2010. <http://www.economics.harvard.edu/faculty/alesina/files/Fiscal%2BAdjustments_lessons.pdf>

[5] Alesina, Alberto & Ardagna (2010) Large Changes in Fiscal Policy: Taxes Versus Spending. *Tax Policy and the Economy vol. 24.* <http://www.economics.harvard.edu/faculty/alesina/files/Large%2Bchanges%2Bin%2Bfiscal%2Bpolicy_October_2009