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America's Austerity: It's the Tax Increases

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U.S. policymakers pursued deficit reduction (also called "fiscal consolidation" or "austerity") twice in 2013. As economists have shown in dozens of papers, how a country goes about reducing deficits matters a lot in determining the economic impact of the deficit reduction. As Alberto Alesina of Harvard, Daniel Leigh of the International Monetary Fund, and Kevin Hassett of the American Enterprise Institute all argued at The Heritage Foundation's symposium last month, deficit reduction based on tax increases can cause deep and immediate economic losses.[1]

The U.S. implemented both tax increases and spending cuts in 2013, but the tax increases were two to four times larger. Taking into account that the tax increases were larger and that tax increases have larger economic effects, we can safely conclude that any "austerity"-induced slowdown is due primarily to tax increases. Neither the basic historical facts nor the economic research on the topic give support to the idea that sequestration is the villain in 2013's poor economic growth.

Austerity in 2013. Several tax increases took effect in January 2013: new Obamacare taxes, the expiration of the payroll tax, and "fiscal cliff" tax increases. During the fiscal year (which ended on September 30), those together increased taxes by $188 billion.[2]

The spending cuts (i.e., sequestration) took effect in March 2013. Sequestration reduced fiscal year (FY) 2013 budget authority by $85 billion, but only $42 billion of the cuts took effect during FY 2013.[3] When considering the economic effects of spending cuts, there are good arguments for considering either the budget authority or the outlay; I report budget authority.[4]

In addition to immediate economic costs, deficit reduction has benefits, most of which are felt in the long term. When deficit reduction is undertaken through spending cuts, it frees up human resources and capital for private-sector growth. Though the transition is not immediate, the costs of spending cuts are relatively brief and mild, and the benefits remain in the long term.

In addition, successful deficit reduction lowers the ratio of debt to gross domestic product (GDP), keeping interest payments down and allowing stronger economic growth.[5] For the U.S., deficit reduction should be a major priority over the next 10 years: The retirement of the baby-boom generation will add to the government's costs and shrink the tax base.

Short-Term Compositional Effects. How different would economic performance be in the short run if sequestration had been replaced with tax increases? Table 1 shows the effects over the first two years according to four scholarly assessments.[6] For reference, the table also reports my own estimate based on the most recent period of deficit reduction in Europe and the U.S., although it has a somewhat different definition than the other estimates.

The costs are large, ranging from $57 billion in output and 320,000 jobs to $240 billion and 1.3 million jobs.

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TABLE 1

Effects of Converting Sequestration Authority to $85 Billion of Tax Increases

Assessment	Output Difference (billions)	Job Creation Difference
Blanchard and Perotti	–$57	–320,000
Guajardo, Leigh, Pescatori	–$73	–410,000
Furth	–$120	–670,000
Alesina, Favero, Giavazzi	–$140	–810,000
Mountford and Uhlig	–$240	–1,300,000

Note: Figures are calculated from two-year multipliers. Furth estimate is based on three-year contemporaneous multiplier. Employment calculations based on Okun's Law coefficients from Ball, Leigh, and Loungani.
Source: See footnote 6.

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TABLE 2

Effects of Converting 2013 Tax Increases to $188 Billion in Spending Cuts

Assessment	Output Difference (billions)	Job Creation Difference
Blanchard and Perotti	$130	700,000
Guajardo, Leigh, Pescatori	$160	900,000
Furth	$260	1,500,000
Alesina, Favero, Giavazzi	$320	1,800,000
Mountford and Uhlig	$520	2,900,000

Note: Figures are calculated from two-year multipliers. Furth estimate is based on three-year contemporaneous multiplier. Employment calculations based on Okun's Law coefficients from Ball, Leigh, and Loungani.
Source: See footnote 6.

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Conversely, what if the payroll, Obamacare, and fiscal cliff tax increases had been replaced with immediate spending cuts in the same amount? Table 2 shows that there would be significantly higher output and job creation. And what we know about longer-term growth tells us that the gains would be even greater over time.

Table 2 shows that reducing the deficit by $188 billion using spending cuts instead of tax increases would have generated from $130 billion to $520

1. "Austerity, Spending, and Growth: A Symposium," The Heritage Foundation, October 25, 2013, http://www.heritage.org/events/2013/10/debt-symposium.
2. Curtis S. Dubay and Romina Boccia, "Tax Revenue Rose Five Times Faster Than Spending Fell in 2013," The Heritage Foundation, The Foundry, October 31, 2013, http://blog.heritage.org/2013/10/31/tax-revenue-rose-five-times-faster-than-spending-fell-in-2013/.
3. Romina Boccia, "Sequestration: Much Larger Spending Cuts Needed to Balance the Budget," The Heritage Foundation, The Foundry, March 1, 2013, http://blog.heritage.org/2013/03/01/sequestration-much-larger-spending-cuts-needed-to-balance-the-budget/.
4. Economic effects of announced spending cuts could take place immediately—in anticipation of the cuts—or gradually, as fewer checks go out for government expenses.
5. See Salim Furth, "High Debt Is a Real Drag," Heritage Foundation *Issue Brief* No. 3859, February 22, 2013, http://www.heritage.org/research/reports/2013/02/how-a-high-national-debt-impacts-the-economy.
6. Olivier Blanchard and Roberto Perotti, "An Empirical Characterization of the Dynamic Effects of Changes in Government Spending and Taxes on Output," *Quarterly Journal of Economics*, Vol. 117, No. 4 (2002), pp. 1344, 1347, http://qje.oxfordjournals.org/content/117/4/1329.abstract (accessed November 5, 2013); Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "Expansionary Austerity: New International Evidence," International Monetary Fund *Working Paper* 11/158, July 2011, p. 25, http://www.imf.org/external/pubs/ft/wp/2011/wp11158.pdf (accessed November 5, 2013); and Salim Furth, "Growth Effects of Taxation and Spending," in Salim Furth, ed., *Europe's Fiscal Crisis Revealed: In-Depth Analysis of Spending, Austerity, and Growth*, Heritage Foundation *Working Paper* 10-13, October 23, 2013, http://www.heritage.org/research/reports/2013/10/europes-fiscal-crisis-revealed-indepth-analysis-of-spending-austerity-and-growth. Author's estimate from Table 2 in Alesina, Favero, and Giavazzi. Note that the multipliers are estimated based on plans that feature both taxes and spending; my usage applies the multipliers loosely outside the original context. Alberto Alesina, Carlo Favero, and Francesco Giavazzi, "The Output Effect of Fiscal Consolidations," *Working Paper*, October 2013, http://didattica.unibocconi.it/mypage/upload/48751_20131010_030430_THEOUTPUTOFFISCALCONSOLIDATIONSOCTOBER2013.PDF (accessed November 5, 2013); Andrew Mountford and Harald Uhlig, "What Are the Effects of Fiscal Policy Shocks?," *Journal of Applied Econometrics*, No. 24 (2009), pp. 983–984, http://onlinelibrary.wiley.com/doi/10.1002/jae.1079/abstract (accessed November 13, 2013); and Laurence M. Ball, Daniel Leigh, and Prakash Loungani, "Okun's Law: Fit at Fifty?," National Bureau of Economic Research *Working Paper* No. 18688, January 2013, http://www.nber.org/papers/w18668 (accessed November 13, 2013).

billion more in GDP by the end of 2014 and added between 700,000 and 2.9 million jobs. By comparison, employment rose by 1.3 million in FY 2013 and 2.8 million in FY 2012.

The range of estimate is large, but the question is not whether tax increases are more costly than spending cuts; it is *how much* more costly they are.

Defenses of Higher Spending. Those who favor higher taxes and spending look for a variety of creative deviations from straightforward economics in order to justify their preferred policies.

One argument is that "hysteresis"—the decay of skills and opportunities among the long-term unemployed—is severe right now, so the short-term costs of spending cuts will be magnified by interacting with hysteresis. Those who sincerely think hysteresis is the biggest economic problem today should be arguing loudest against tax increases, given the evidence that the short-term costs of tax increases are even larger than the short-term costs of spending cuts, and should also oppose Obamacare on the grounds that it increases the fixed cost of hiring workers.

Another argument is that taxes should be raised on specific groups that "can afford" to pay. But this slippery form of redistributionism does not have any bearing on the economic impact of a tax. In fact, the literature shows that deficit reductions based on spending cuts outperform tax increases most prominently in investment.[7] Economies with spending cuts invest more than economies with tax increases. Those who can "afford" to pay taxes can also afford to save and invest. Higher investment raises wages and creates jobs. Redistributionism does not help economic growth.

A third objection is that sequestration was not the best way to cut government spending. That is certainly true, and funding should be shifted from the least effective government functions to the most effective. But that is always true: Government spends too much on boondoggles all the time. Trading poorly designed sequestration cuts for elimination of useless programs and reforms that help put Social Security, Medicaid, and Medicare on a permanently sustainable trajectory would be welcome. And the need to improve government efficiency in no way diminishes the economic evidence that tax increases are vastly more harmful than spending cuts.

Tax Increases to Blame. The Obama tax increases are the clearest answer to the question of why economic growth has been sluggish. Those who argue that sequestration is to blame for the poor economic performance of 2013 are ignoring tax increases that are two to four times as large and a broad research consensus that the short-term costs of tax increases far outweigh the short-term costs of spending cuts. Researchers agree that tax increases are much more harmful to growth and job creation than spending cuts. The negative impact of President Obama's tax increases is made worse by the simple fact that the tax increases are much larger than the spending cuts.

Policymakers can allow higher growth and more jobs without adding to the deficit by replacing taxes with spending cuts. Brian Lucking and Daniel Wilson of the San Francisco Fed show that taxes will continue to rise rapidly in 2014 if Congress does not act and that "nine-tenths of [the] excess fiscal drag [through 2015] comes from tax revenue rising faster than normal.... [F]actors underlying this 'supercyclical' rise [include] higher income tax rates for high-income households, the recent expiration of temporary Social Security payroll tax cuts, and new taxes associated with the Obama Administration's health-care legislation."[8]

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7. Maria Gabriella Briotta, "Economic Reactions to Public Finance Consolidation: A Survey of the Literature," European Central Bank *Occasional Paper Series* No. 38, October 2005, http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp38.pdf (accessed November 13, 2013); and Alberto Alesina, Carlo Favero, and Francesco Giavazzi, "The Output Effect of Fiscal Consolidations," National Bureau of Economic Research *Working Paper* No. 18336, August 2012, http://www.nber.org/papers/w18336 (accessed November 13, 2013).

8. Brian Lucking and Daniel Wilson, "Fiscal Headwinds: Is the Other Shoe About to Drop?," Federal Reserve Bank of San Francisco *Economic Letter* 2013-16, June 3, 2013, http://www.frbsf.org/economic-research/publications/economic-letter/2013/june/fiscal-headwinds-federal-budget-policy/ (accessed November 13, 2013).