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Spending Cuts are Better than Tax Increases

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Governments regularly run fiscal deficits and periodically awake to the need to restore balance to their finances. These episodes of "fiscal correction" or "austerity" may emphasize either tax increases or spending cuts. As the United States faces an out-of-control budget deficit and trillions in unfunded promises to future retirees, the question looms large: Tax more, spend less, or do some of both?

Economists Alberto Alesina, Carlo Favero, and Francesco Giavazzi explore this question in a current working paper.[1] Specifically, they ask whether tax-based or spending-based fiscal corrections lead more rapidly to economic growth.

Fiscal Corrections Needed. The U.S. and other advanced economies are in need of fiscal correction. A paper published by the Organization for Economic Co-operation and Development (OECD) estimates that in order to reach a goal of reducing debt to 60 percent of gross domestic product (GDP) by 2025, the U.S. requires the third-largest fiscal correction of the 21 countries measured.[2]

The author, Robert Hagemann, looked at the prospects for fiscal correction in the OECD report and identified income transfers, health expenditures, government wages, and education expenditures as the largest components of government budgets. The U.S. is close to average in terms of spending on these components among OECD countries. On the revenue side, Hagemann notes the expansiveness of exemptions, credits, and deductions in the tax codes of OECD countries, especially the U.S.

In a richly descriptive paper, Alesina and Silvia Ardagna dissect fiscal corrections in 21 countries since 1970.[3] They find that half of attempted adjustments failed to lower the debt-to-GDP ratio. Spending-based adjustments were more likely to succeed and more likely to lead to economic growth; tax-based adjustments were more likely to fail in their basic purpose.

Looking at 17 advanced economies from 1978–2009, Pete Devries, Jaime Guajardo, Daniel Leigh, and Andrea Pescatori document 173 fiscal corrections.[4] For each country and year, they cite evidence on the reasons stated for the policies and the specific mix of spending cuts and tax increases in each case. In the U.S., they note five years with tax-based budget tightening between 1978 and 1986 and 10 years of spending-based correction from 1988 to 1998.

The Effect on Economic Growth. Alesina, Favero, and Giavazzi use the dataset compiled by Devries, Guajardo, Leigh, and Pescatori and quantitatively take account of multi-year fiscal plans as initially announced. Of course, governments do not always follow through on initially announced plans, and the authors also quantify deviations from the announcements. Thus, each "plan" consists of announced and unannounced policy changes across a series of years.

Alesina, Favero, and Giavazzi then categorize each plan as tax-based or spending-based. One criticism of their approach is that they use a binary approach instead of taking the specific tax-and-spending mix into account.

The authors then use data to estimate the effects of the plans on economic growth. They find that

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tax-based corrections lead to extended recessions enduring at least three years. By contrast, spending-based corrections are followed by mild recessions, with recovery following within a year.

In order to check the robustness of their result, Alesina, Favero, and Giavazzi test each country separately. They check whether tax-based corrections are more likely to be used during a recession, examine monetary policy as an additional explanation, and control for global conditions. None of these robustness checks alters their main conclusion: Spending cuts do much less damage to growth than tax increases.

Deficits and Taxes Both Diminish Investment. Examining the components of GDP, Alesina, Favero, and Giavazzi find that the difference between tax-based and spending-based corrections is driven by investment. While private consumption behaves similarly in both cases, investment falls much more in response to a tax-based correction.

Why does investment react so much differently in the two cases? According to the economic theory of crowding out, government borrowing falls in a fiscal correction, releasing more funds to be used for investment. In a tax-based correction, however, this effect is offset by the increase in taxation, which makes investment opportunities less attractive, discourages competition, and induces investors to take their money overseas.

Policy Implications. The U.S. and other economies facing a potential debt crisis need to consider carefully the relative impacts of cutting government spending or raising taxes.

If the federal government attempted to balance its budget using large tax increases, international experience suggests that an extended recession would follow. If recent recessions are any indication, a new recession would lead to large automatic and discretionary increases in government spending, which would use up the new tax revenue without dealing decisively with the deficit. That was the experience of many countries analyzed by Alesina and Ardagna: Despite higher taxes, debt-to-GDP ratios did not shrink.

A spending-based fiscal correction, on the other hand, might have mild recessionary effects, according to the authors, but would quickly give way to growth. Keep in mind that GDP is the sum of consumption, investment, government spending, and net exports. Thus, any decrease in government spending is "baked in" as a decrease in GDP, even if it has no effect on the rest of the economy. Alesina, Favero, and Giavazzi's results imply that the void left by decreased government spending is filled within a year by increased investment and consumption, and the economy continues growing.

These studies suggest that both economic growth and smaller deficits are necessary to achieve long-term budget stability in the U.S. Smaller government can achieve the latter without endangering the former.

Summary of Findings. The studies cited above find some predictable conclusions regarding the use of spending cuts and tax increases in fiscal corrections, including:

- Attempted deficit reductions, or "fiscal consolidations," have historically been undertaken as multi-year plans with mixes of spending cuts and tax increases. Different approaches have yielded different results.
- Fiscal consolidations that emphasize spending cuts are more likely to reduce debt and less likely to lead to recession.
- Fiscal consolidations that emphasize tax increases have a strong, negative effect on investment, diminishing the productive capacity of the economy.
- About half of attempted deficit reductions fail, typically those with greater tax increases and smaller spending cuts**.**

Evidence in History. Amid the ongoing debate over how to stabilize the finances of the federal government in the long run, policymakers should keep in mind that this has been done before both in the U.S. and abroad. Many years of evidence

1. 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 March 5, 2013).
2. Robert Hagemann, "Fiscal Consolidation: Part 6. What Are the Best Policy Instruments for Fiscal Consolidation?" OECD Economics Department *Working Paper* No. 937, January 2012, http://dx.doi.org/10.1787/5k9h28kd17xn-en (accessed August 31, 2012).
3. Alberto Alesina and Silvia Ardagna, "The Design of Fiscal Adjustments," Harvard University working paper, September 2012, http://www.economics.harvard.edu/faculty/alesina/files/The%2Bdesign%2Bof%2Bfiscal%2Badjustments%2BSept%2B2012.pdf (accessed March 5, 2013).
4. Pete Devries, Jaime Guajardo, Daniel Leigh, and Andrea Pescatori, "A New Action-Based Dataset of Fiscal Consolidation," International Monetary Fund *Working Paper* No. WP/11/128, June 2011, http://www.imf.org/external/pubs/ft/wp/2011/wp11128.pdf (accessed September 4, 2012).

indicate that spending-based fiscal consolidation is more effective at reducing debt and less likely to cause a recession. The last balanced budgets in the U.S. resulted from a long sequence of spending cuts from 1988 to 1998, allowing a sustained surge of economic growth. As government shrank and the risks associated with high government debt receded, innovation, private investment, and take-home wages soared. Let's try that again.

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