Statement before the United States House of Representatives

Committee on Ways and Means

Hearing on Impediments to Job Creation

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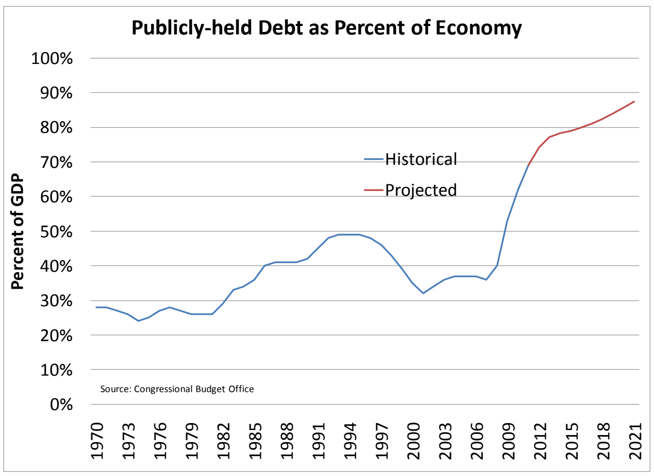
Chairman Camp, Ranking Member Levin and Members of the Committee. Thank you for offering me the opportunity to testify with regard to federal deficits and debt and how they might be resolved with the minimum impact on job creation in the economy.

My name is Andrew Biggs and I am a resident scholar at the American Enterprise Institute. The views I express today are my own and do not represent those of AEI or any other institution.

Hemingway wrote that people go bankrupt in two ways: gradually, and then suddenly. We are well into the gradually phase. The suddenly phase could come sooner than we imagine if financial markets conclude that America's elected officials lack the will to bring its finances into order.



Economists Carmen Reinhart and Kenneth Rogoff have found that debt even at current levels reduces average economic growth rates by around 1 percentage point, a result that over time would have a massive impact upon employment and the American standard of living.[1] Making matters worse, the Congressional Budget Office forecasts that publicly-held debt – already at its highest level since the aftermath of World War Two – will rise to 87 percent of GDP by 2021 under the President's budget proposal.

Addressing deficits and debt is a truly daunting task. The CBO projects that over the next 25 years alone the federal government faces a "fiscal gap" of 4.8 percent of GDP.[2] Bridging that fiscal gap would require an immediate and permanent 23 percent increase in all federal tax revenues or an equivalent reduction in federal outlays. Delaying action only makes the gap larger.

This fiscal gap is *not* the result of Americans paying too little taxes. Indeed, the CBO forecasts that tax revenues over the next 25 years will equal 20.7 percent of GDP, 15 percent *above* the average since 1970.[3] Rather, the gap arises through sharply rising federal outlays, principally on the Social Security, Medicare and Medicaid programs.

To resolve this gap, the federal government must undergo a significant fiscal consolidation, which is defined as "a policy aimed at reducing government deficits and debt accumulation."[4] Without a fiscal consolidation, a debt or currency crisis is inevitable.

The history of financial crises is one of surprises. No one can know when market participants will decide that enough is enough. Accordingly, the United States may have only one chance to choose correctly. That is why it is important to understand what approaches have and have not worked in the past.

Over the past several decades many developed countries have undertaken fiscal consolidations. Some have succeeded and others failed, both in causing lasting reductions in debt and in generating positive impacts on economic growth.

What has separated the successes from the failures? To help answer this question, in a recent article with my AEI colleagues Kevin Hassett and Matthew Jensen, we reviewed the extensive existing literature on fiscal consolidations as well as conducted our own data analysis.[5]

Successful and unsuccessful fiscal consolidations

Our approach extends a method that is widely used by economists in academia and nongovernmental organizations such as the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF).

Using a large dataset covering over 20 OECD countries and spanning nearly four decades, we first isolated over 100 instances in which countries took steps to address their budget gaps. Some of these fiscal consolidations were principally spending-based while others relied more on taxes.

We returned to these countries several years later to see which fiscal consolidations had succeeded in significantly reducing debt and which had failed. Our baseline standard for success is that a fiscal consolidation must reduce the ratio of debt to GDP by 4.5 percentage points over a three year period.[6] We then analyzed how successful fiscal consolidations differed from unsuccessful ones.

Our findings are striking: countries that addressed their budget shortfalls through reduced spending were far more likely to reduce their debt than countries whose budget-balancing strategies depended upon higher taxes.

The typical unsuccessful fiscal consolidation consisted of 53 percent tax increases and 47 percent spending cuts. By contrast, the typical successful fiscal consolidation consisted of 85 percent spending cuts. These results are consistent with a large body of peer-reviewed research.[7]

A fiscal consolidation can fail either because the government subsequently backtracked or because poor economic performance caused GDP to decline, thereby raising the debt/GDP ratio. Expenditure-based consolidations have strengths in both areas. Most have included structural changes to make spending programs more sustainable, while (as discussed below) spending reductions appear to be more conducive to positive economic performance. In either case, spending-based consolidations are more likely to "stick" and reduce debt over the longer term.

Consistent with other studies, we found that successful fiscal consolidations focused spending cuts in two areas: social transfers, largely meaning entitlements in the American context, and the government wage bill, which means the size and pay of the public sector workforce. For instance, one 1996 IMF study concluded that "fiscal consolidation that concentrates on the expenditure side, and especially on transfers and government wages, is more likely to succeed in reducing the public debt ratio than tax-based consolidation."[8] Other studies concur.[9]

Fiscal consolidations and economic growth

A fiscal consolidation will be easier to pass legislatively and more likely to succeed if it contributes to rather than detracts from economic growth, particularly if reforms must be undertaken at a time when the economy is already weak.

For that reason, the economics literature has asked whether a successful fiscal consolidation can improve or at the least be neutral with regard to short-term economic growth. Traditional Keynesian economics generally says no: if government withdraws funds from the economy, either by increasing taxes or by reducing outlays, lower demand would at least temporarily reduce economic output.[10]

However, many economists now agree that these negative Keynesian effects can be partially or fully offset if a large and credible fiscal consolidation generates confidence that more disruptive steps have been avoided down the road.[11] Individuals, businesses or markets may quickly become more willing to spend, to invest or to lend if short-term steps avert a long-term crisis.[12]

Generating confidence and credibility is one reason reductions in transfer spending and government wages appear to be important. As the OECD noted, "governments more committed to achieving fiscal sustainability may also be more likely to reform politically sensitive areas. As a by-product of doing so, they may at the same time bolster the credibility of the consolidation strategy, thereby improving its chances of success."[13]

But not all fiscal consolidations spur growth. Harvard economists Sylvia Ardagna and Alberto Alesina found that only around one-quarter of fiscal consolidations coincided with an increase in economic growth. Again, there was a stark difference between fiscal consolidations associated with increased growth and those that were neutral or negative with regard to growth. Ardagna and Alesina conclude that "the expansionary episodes of fiscal adjustments are mostly characterized by spending cuts," finding that fiscal consolidations that increased economic growth on average were composed of 85 percent spending cuts and 15 percent tax increases. Fiscal consolidations that did not spur growth were composed on average of 63 percent tax increases and 37 percent spending reductions.

The finding that successful fiscal consolidations may spur growth is not without controversy. A recent IMF study has countered that most fiscal consolidations will not increase short-term growth, causing a debate between economists that has not yet been settled.[14] But it is important to stress what this disagreement is *not* about.

First, this controversy is not about whether spending-based fiscal consolidations are more likely to succeed than tax-based consolidations. Even using the IMF study's methods, spending-based consolidations are more likely to reduce deficits and debt than tax-based consolidations.[15]

Second, the IMF study does not dispute that spending-based fiscal consolidations generate superior short-term economic outcomes than tax-based consolidations. The IMF concluded that three years following a spending-based consolidation:

- GDP would be around 1.4 percentage points larger than under a tax-based consolidation, a difference in today's terms of around $200 billion. A spending-based consolidation would have a small and statistically insignificant negative impact on growth, while a tax-based consolidation would significantly reduce output. The GDP gap between spending and tax-based consolidations would be even larger when spending cuts are focused on transfer programs and/or when revenue increases are based upon indirect taxes, such as sales taxes or a VAT.

- Unemployment would be around 0.5 percentage points lower than under a tax-based consolidation, equal in today's terms to around 615,000 jobs.

The IMF study found that gains in GDP and reductions in interest rates would take place over the longer-term as well.

While an economic debate continues, both approaches agree that expenditure-based fiscal consolidations are superior to tax-based consolidations when it comes to boosting the economy. And both approaches agree that spending-based consolidations are more likely to reduce debt than tax-based consolidations.

Conclusions

Whether to address the fiscal gap through tax increases or spending cuts is not merely a philosophical preference for large or small government. Rather, a large body of research analyzing historical data indicates that fiscal consolidations focused on reducing spending are far more likely to reduce debt and enhance the economy than tax-based consolidations.

Where do current budget blueprints stand? While different baselines produce different results, the recommendations from the President's Fiscal Commission and the Bipartisan Policy Center's Debt Reduction Task Force appear to be 50 to 55 percent expenditure reductions in the near term, rising somewhat over time. While these plans have much that is commendable, in the historical context the expenditure shares of these proposals are on the low end of what is likely to succeed.

We are not living in ordinary times and so the ordinary ways of making policy decisions no longer apply. The normal way of doing things has simply been to argue over the rate at which government outlays increase. The "new normal," so to speak, will be deciding how much to cut. The answer, according to historical data and a long record of academic research, is that to succeed most of our fiscal retrenchment should take place on the expenditure side.

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[1] Reinhart and Rogoff (2010). Note that Reinhart and Rogoff's calculations are based upon *gross* public debt, which in the case of the U.S. would include intergovernmental debt held in the Social Security and other trust funds. By this measure, U.S. debt is already above the 90 percent of GDP level that Reinhart and Rogoff find leads to adverse economic outcomes.

[2] Over 50 years the gap rises to 6.9 percent of GDP and over 75 years to 8.7 percent of GDP. Congressional Budget Office (2010).

[3] CBO's alternate baseline projects average revenues of 20.7 percent of GDP over the next 25 years, versus an average of 18 percent of GDP from 1970 through 2010.

[4] OECD. "Glossary of Statistical Terms."

[5] Biggs, Hassett and Jensen (2010).

[6] We also generated calculations using different standards for what constitutes success, which tended to reinforce the findings reported here.

[7] For reference, Alesina and Perotti (1996) report that successful consolidations were 64 percent expenditure cuts and 37 percent revenue increases. Unsuccessful consolidations were 34 percent expenditure cuts and 66 percent revenue increases. Alesina and Ardagna (1998) report that successful consolidations were 62 percent expenditure cuts and 38 percent revenue increases. Unsuccessful consolidations were -79 percent expenditure cuts and 178 percent revenue increases. Alesina and Ardagna (2009) report that successful consolidations were 135 percent expenditure cuts and -35 percent revenue increases. Unsuccessful consolidations were 34 percent expenditure cuts and 66 percent revenue increases. Von Hagen and Strauch (2001) report that successful consolidations were 52 percent expenditure cuts and 48 percent revenue increases. Unsuccessful consolidations were 12 percent expenditure cuts and 88 percent revenue increases. Zaghini (1999) reports that successful consolidations were 77 percent expenditure cuts and 23 percent revenue increases. Unsuccessful consolidations were 2 percent expenditure cuts and 98 percent revenue increases. McDermott and Wescott (1996) found that expenditure based consolidations have a 41 percent chance of success; whereas revenue based consolidations have a 16 percent chance of success.

[8] McDermott and Wescott (1996).

[9] Columbia University economist Roberto Perotti concluded, "the more persistent adjustments are the ones that reduce the deficit mainly by cutting two specific types of outlays: social expenditure and the wage component of government consumption. Adjustments that do not last, by contrast, rely primarily on labor-tax increases and on capital-spending cuts." See Perotti (1995). A 2007 IMF study found that "Reduction in [the government] wage bill and social security spending (including social transfers, health care, and unemployment benefits) made an important contribution to fiscal adjustment in a number of cases. Such cuts were usually facilitated by structural reforms aimed at improving the efficiency of public services provision and the incentive structure of insurance schemes. In contrast, tax increases and capital expenditure cuts were accompanied by structural changes in only a few instances." See Kumar, Leigh, and Plekhanov (2007).

[10] This would be the case in the Keynesian view unless a fiscal consolidation allowed for more accommodative monetary policy, which Leigh, et al (2010) find is the case when the consolidation is expenditure-based.

[11] Perotti (1999). Ardagna and Alesina (2009).

[12] Blanchard (1990).

[13] OECD (2007).

[14] Leigh, et al (2010). Alesina (2010) responds to this study.

[15] This was one of the findings of Biggs, Hassett and Jensen (2010).