

IS AUSTERITY THE ANSWER TO EUROPE'S CRISIS?

Veronique de Rugy

Austerity is a term used to describe debt-reduction policies, but it can mean radically different things. For some people, austerity means adopting a debt-reduction package dominated by tax increases. For others, it means adopting a package made mainly of spending restraint—including reforms of social programs. The lack of a distinction between the two meanings of the word—and hence, the distinction between two different debt-reduction policies—is unfortunate and could also explain the confusion over what is happening in Europe.

In this debate there are two important questions to keep in mind. The first question asks, Which of the two types of austerity measures successfully reduces the debt-to-GDP ratio? The second asks, What is the impact of austerity measures on economic growth?

Which of the Two Types of Austerity Measures Successfully Reduces Debt to GDP?

The United States is not the first nation to struggle with a worrisome debt-to-GDP ratio. Fortunately, the academic world has already produced great insights into what can be done to help the problem without hurting the economy. Take Harvard University economists Alberto Alesina and Silvia Ardagna. In an October 2009

Cato Journal, Vol. 33, No. 2 (Spring/Summer 2013). Copyright © Cato Institute. All rights reserved.

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working paper published by the National Bureau of Economic Research, the duo look at 107 efforts to reduce debt in 21 OECD nations between 1970 and 2007. Several countries were successful, among them Austria in 2005, Finland in 2005, and Sweden from 1997 to 2004. Spending cuts, the scholars found, are more effective than tax increases in reducing the ratio of debt to GDP. With successful fiscal adjustments, spending as a share of GDP fell by an average of 2 percentage points while revenue fell by half a percentage point. Unsuccessful fiscal-adjustment packages involved smaller spending reductions (only about eight-tenths of a percentage point, on average) and large revenue increases.

Following and building on the work of Alesina and Ardagna (2009), American Enterprise Institute economists Andrew Biggs, Kevin Hassett, and Matthew Jensen published a working paper in December 2010 covering more than 100 instances in which countries took steps to address their budget gaps. They identify successful consolidations as those in which the ratio of debt to potential GDP three years following the first year of the consolidation declined by at least 4.5 percentage points. Their conclusion: “Countries that addressed their budget shortfalls through reduced spending burdens were far more likely to reduce their debt than countries whose budget-balancing strategies depended upon higher taxes.” What’s more, “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 extremely mainstream. My colleague at the Mercatus Center Matt Mitchell has done a review of the academic literature on this issue and he finds of the 22 papers published that looked at this question all of them find that the most promising way to shrink the debt is to restrain spending so it shrinks relative to economic output and not to increase taxes (Mitchell 2011).

But there are other factors worth mentioning when talking about successful fiscal adjustments. Looking at 66 instances of fiscal adjustments in Canada, France, the United States, Japan, Germany, and Italy, the authors of the IMF book called *Chipping Away at Our Debt*, find that ambitious plans tend to produce more adjustments than modest ones (Mauro 2011). They also find also that such plans aren’t associated with more frequent changes in government (in other words, politicians who adopt ambitious fiscal adjustment plans

aren't penalized by voters). However, the book does stress the fact that public support is a key factor to achieving successful fiscal adjustment.

Interestingly, successful fiscal adjustments are rooted in reform of social programs and reduce the size and pay of the government work force. Germany provides a good example in that regard. Economists Christina Breuer, Jan Gottschalk, and Anna Ivanova (2011), have looked at the four major fiscal adjustments the country adopted in the last 40 years. Let's focus on the last one (2004–07), which is particularly interesting since it was challenging, ambitious, successful, and probably responsible for Germany's ability to sustain the financial crisis better than most countries.¹

First, the country implemented a stimulus by reduction of income tax rates. This reduction was part of a series of supply-side-oriented reforms implemented from 1999 to 2005—including a wide-ranging overhaul of the income tax system meant to boost potential growth that didn't have much effect until 2004. In addition, significant structural reforms to tackle the rigidity in the labor market as well as demographic pressure on the pension system were put in place. These two factors were connected and perceived as a response to an aging population. These reforms included “an increase in the statutory retirement age, the elimination of early retirement clauses, and tighter rules for calculating imputed pension contributions.” Finally, Germany adopted large expenditure cuts in the fringe benefits in public administration (no more Christmas-related extra payments) and also serious reductions in subsidies for specific industries (residential construction, coal mining, and agriculture). In the “lessons learned” section of IMF book, the authors attribute the success of this fiscal adjustment (unlike the previous one) in large part to the structural reforms.

The bottom line is that successfully reducing a debt-to-GDP ratio is possible. The bad news, however, is that even (or especially) in a time of crisis, lawmakers are driven more by politics than by good public policy. Countries in fiscal trouble generally got there through years of catering to pro-spending constituencies, be they senior citizens or the military-industrial complex, and their fiscal adjustments

¹The previous three fiscal adjustments (1976–79, 1982–85, and 1992–95) are also worth looking at.

tend to make too many of these same mistakes. As a result, failed fiscal consolidations are more the rule than the exception. Eighty percent of the adjustments that Biggs, Hassett, and Jensen studied were failures.

What Is the Impact of Budget Restraint on Growth?

There is little debate about the idea that reductions in the burden of spending have positive impact on GDP in the long run. By contrast, the question about whether, in the short term, budget cuts shrink or grow GDP is far from being settled. However, a few lessons have emerged.

First, Alesina and Ardagna's work shows that tax cuts are more expansionary than spending increases in the case of a fiscal stimulus. This is consistent with the work of former Obama Council of Economic Advisers chairman Christina Romer and her economist husband, David Romer (2010). They show, for instance, that increasing taxes by 1 percent of GDP for deficit-reduction purposes leads to a 3 percent reduction in GDP.

Second, fiscal adjustment achieved through spending cuts rather than tax increases are less recessionary than those achieved through tax increases. For instance, in a recent blog post at EconLog, George Mason University economist Garrett Jones (2012) summarized the findings of an IMF paper that studied 173 fiscal consolidations in rich countries and found "that nations that mostly raised taxes suffered about twice as much as nations that mostly cut spending."

A new paper called "The Design of Fiscal Adjustments," by Alesina and Ardagna (2012) confirms this finding. Building on their previous work, they provide even more evidence that fiscal consolidations based mostly on the spending side result in smaller recessions or none at all, when compared to tax-based adjustments. Additionally, they find that private investment tends to react more positively to spending-based adjustments. Thus, they argue that spending cuts are more sustainable and effective in reducing debt and raising economic growth.

Jones (2012) also noted that one possible explanation for these results is the role played by the central banks during the fiscal adjustment period. He writes, "Central banks play nice when governments cut spending, loosening up monetary policy. They're not as nice when governments raise taxes."

Other economists have also noted that spending-based fiscal adjustment accompanied by the “right polices” (easy monetary policy, liberalization of goods and labor markets, and other structural reforms) tend to be less recessionary or even have a positive impact on growth.

Now it is important to note that real austerity measures are important independently of their short-term impact on growth. In fact, austerity measures should be pursued, not because we hope for a quick economic-growth payoff, but because they are desirable from a structural standpoint and they may—even though it is hard to test—help avoid future fiscal crises. With that in mind, we can take a look at what European governments have done.

A Look at European Governments’ Austerity

For several years now, European governments have tried versions of austerity in hopes of reviving the continent’s flailing economies. But not only have their efforts failed, we’re now told, they have actually made things far worse.

According to one naysayer, former Obama administration chief economic advisor Larry Summers (2012), austerity efforts are “counterproductive” to growth. In a recent Bloomberg TV interview, Nobel laureate and economist Paul Krugman said, “I wish I’d been wrong for the sake of the world” about his prediction that “Austerians” pushing for fiscal retrenchment would destroy Europe.

There are three basic problems with this growing anti-austerity backlash. First, almost no nation is actually cutting spending. In most cases, policymakers are merely squabbling over whether to restrain how fast it is growing. Second, the “cuts” have been relatively small compared to the size of the problem and meaningful structural reforms were seldom implemented. Third, to the extent declining European countries pursued austerity, it has mainly been through large tax increases. If the economies of Spain, France, Britain, and other European nations are suffering, it’s not because of “savage” spending cuts. It’s because small make-believe spending cuts are overwhelmed by tax increases.

Consider Britain, where supposed austerity measures represent a “stunning failure of policy.” If you recall, the original austerity plan announced by Chancellor George Osborne would have cut £3 in

government spending for every £1 in new tax revenue over the course of the fiscal adjustment. But what was announced did not come to pass yet. A look at the data reveals that so far some £40 billion was shaved from the deficit during the 2010–11 budget cycle by raising £3 of new tax revenue for every £1 in cuts—exactly the reverse of what was promised. There is no reason to expect the trend to be reversed in 2013.

What's more, the work of economist Anthony Evans (2012) shows that the UK has, at best, slowed down the growth of spending, but it has not really cut overall spending. In other words, spending cuts in the UK can't be blamed for the weak growth path the country is on. On the other hand, tax increases can. Here is a partial list: a VAT hike from 17.5 percent to 20 percent (probably the main culprit of the UK's current problems); a new 50 percent tax bracket on incomes over £150,000, which will drop to 45 percent later this year; an increase in air-passenger duty to 8 percent; a "temporary" payroll tax of 50 percent on bonuses over £25,000 (which has now expired); a capital-gains tax hike that takes the minimum rate from 10 percent to a new flat rate of 28 percent; a 0.13 percent levy on banks;² an increase to 7 percent in the stamp duty on the sale of properties worth more than £2 million; and an even steeper tax hike on properties bought through "non-natural persons."³

The bottom line is that the UK, like most other European governments, has implemented private-sector austerity (i.e., tax hikes) without public-sector austerity (i.e., spending cuts or spending restraint). The failure of "austerity" shouldn't surprise anyone since as Alesina and others have found, these are the type of fiscal adjustments that tend to fail at reducing the debt-to-GDP ratio.

As Europe sinks deeper into recession, government officials might want to remember that lesson. They must start actually cutting spending and reforming their bloated governments.

²HM Revenue & Customs, "Bank Levy: 2013 Rate Change," http://www.hm-treasury.gov.uk/d/bank_levy_rates_from_1_January_2013.pdf.

³For more details, check "United Kingdom: Budget 2012 Announced with Important Changes for Individuals," *Totally Expat*, March 23, 2012, <http://totallyexpat.com/news/united-kingdom-budget-2012-announced-important-individuals/>.

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