Testimony before the Joint Economic Committee

Regarding Fiscal Consolidations

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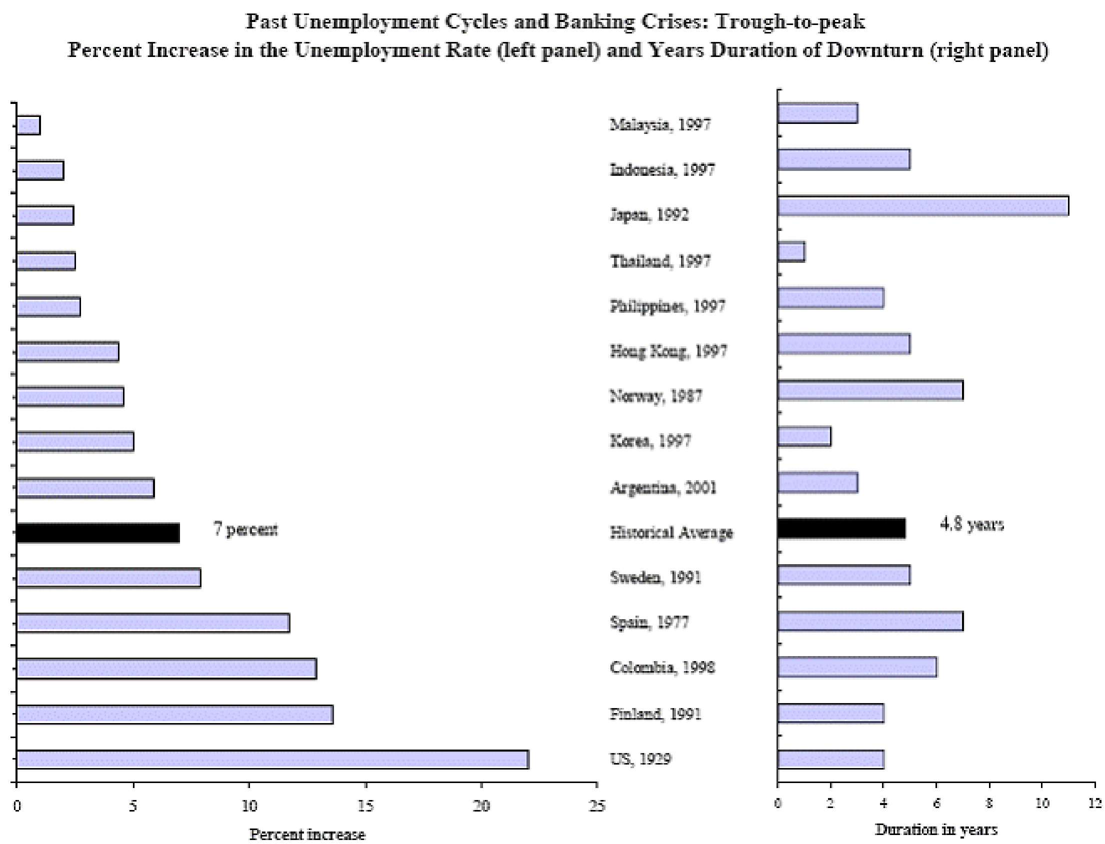
As we gather today, the third anniversary of the collapse of Lehman Brothers approaches. Even after all of that time, the U.S. economy continues to disappoint, and the U.S. labor market has hardly made any progress at all. The latest economic data suggests that growth has moderated considerably, while inflation is picking up, and fears of stagflation, not seen since the 1970s, are renewed.

The sorry state of the current economy is the predictable result of a serious policy error that appears to have been motivated by a fundamental misunderstanding of the economic challenges we face as a nation.

Those challenges should have been clear. Economists Carmen Reinhart and Kenneth Rogoff have studied the history of financial crises and found that they inevitably create lengthy periods of slow economic growth. As can be seen in Figure 1, which is taken from their study, the typical duration of the employment downturn after a financial crisis is 4.8 years.[1] Another study found that economic growth rates tend to be lower for as much as a decade after the crisis.[2]

Figure 1:




[1] Reinhart and Rogoff (2009)
[2] Reinhart and Reinhart (2010)

Given that such a lengthy period of slow growth is the challenge, it was a mistake to address it with short term Keynesian stimulus. Here is why.

While there is debate about the size of the multiplier effects of a Keynesian stimulus, let us assume, for the sake of argument, that they are substantial. Even then, the effect of the stimulus is to increase GDP when the higher spending is present, reduce GDP in an approximately equal and opposite manner when it is removed, and then reduce GDP again when taxes are raised to pay for the endeavor. The key observation is that the total effect is negative. The near term positive effect on growth is paid for in the long run with two hangovers.

Such a policy might be defensible if the economy were in a typical post-war recession, which can be expected to last a bit less than a year, and be followed by a recovery with sharply higher growth. In such a case, adding a percent or two of growth during the recession might well be worth having three percent growth instead of five percent growth in the recovery. But in the lengthy, slow-growth slog out of financial crisis, the hangovers arrive before growth has lifted off. Indeed, Keynesian stimulus in this circumstance will inevitably run the risk of tossing the economy back into recession even if one adopts the view that it is "effective."

What's worse, the reliance on stimulus can easily become addictive. As each stimulus wears off, the economy inches perilously closer to recession and then calls for another stimulus emerge. But at some point, and I believe we are close to that point, the process threatens our solvency.

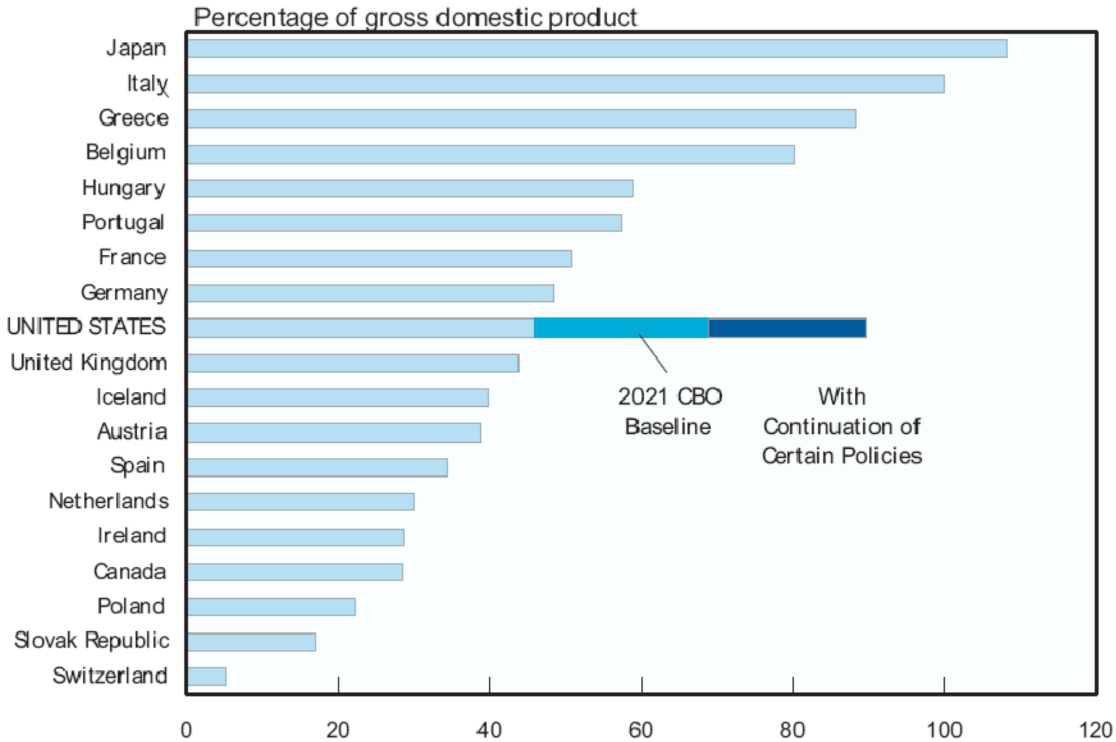
The U.S. public debt to GDP has risen from 53 percent in 2009 to 69 percent in 2011 (as reported by the CBO). The deficit under current law assumptions will total approximately $7 trillion over the next ten years, and debt to GDP will reach nearly 77 percent by 2021.

However, the current law forecast does not include the continuation of certain policies such as adjustments to the alternative minimum tax and maintaining current Medicare physician payment rates, which have become expected conventions. Nor does it account for possible extension of the Bush tax cuts beyond 2013.

CBO Director, Doug Elmendorf remarked in February "If those policies were extended permanently, deficits over the coming decade would average about 6 percent of GDP and would cumulate to nearly $12 trillion. Debt held by the public in 2021 would rise to almost 100 percent of GDP, the highest level since 1946."[3] From the director's chart, Figure 2 below, such a scenario would put the U.S. at roughly the same share of debt as Greece in 2009.[4]

[3] Congressional Budget Office Director's Blog, February 25, 2011
[4] Elmendorf presentation to the National Economists Club, February 24, 2011

Figure 2: Debt Burden Across Countries in 2009




Notes: For the United States, debt held by the public net of financial assets. For other countries, general government debt net of financial liabilities as reported by the Organisation for Economic Co-operation and Development (OECD).

That means that the painful process Greece is going through today may be around the corner for us. The day of reckoning may be even sooner if we pursue yet another deficit-financed spending binge. The good news is that there is substantial reason to believe that there is a way out of this destructive Keynesian cycle.

Over the past several decades many developed countries have undertaken fiscal adjustments in attempts to reduce high debt levels. These countries' restructurings had varying degrees of success and failure, both in reducing debt and in stimulating growth. The economics literature has focused on answering two main questions in this area: what aspects of fiscal consolidations produce lasting reductions in debt, and what aspects encourage macroeconomic expansion?

The answer to the first question is clear. Based on a review of the economics literature and analysis of 21 OECD countries, two of my colleagues and I recently found that cutting expenditures is more likely to produce a lasting reduction in debt than increasing revenues.[5] It is also typical that the more aggressively a country cuts expenditures, the more likely it is to successfully reduce debt in the long term. Averaging across a range of methodologies, the typical unsuccessful fiscal consolidation consisted of 53 percent tax increases and 47 percent spending cuts. The typical successful fiscal consolidation

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

consisted of 85 percent spending cuts.[6] In particular, cuts to social transfers and the government wage bill are more likely to reduce debt and deficits than cuts to other expenditures.

There is more debate over the second question: what aspects of fiscal consolidation encourage macroeconomic expansion? The essence of the debate hinges on the balance between two economic effects of fiscal consolidation, the expectational effect and the Keynesian effect. The *expectational* effect is the positive effect on consumption and investment that occurs when policy is put on a sustainable path. These likely surge after a consolidation because of expectations of lower future tax liabilities.

In other words, an immediate consolidation will alleviate the hoarding that accompanies fears of a larger and largely tax-driven consolidation in the future. Expenditure based consolidations would provide stronger expectational effects, because there is a better chance they are successful at reducing debt, and because higher near term taxes are hardly designed to ignite optimism in investors and consumers. The Keynesian effect reduces aggregate demand and therefore GDP growth.

The controversy is over whether the expectational effects of fiscal consolidation can completely outweigh the Keynesian effects in order to create short-term growth. There is less controversy around the view that the long-term benefits of fiscal consolidation are substantial. Two schools of thought have emerged in the debate. Harvard economist Alberto Alesina and his various coauthors argue that consolidation, especially expenditure cuts, can lead to a burst of growth starting immediately.[7] A team of IMF economists, however, identified possible methodological flaws in Alesina's studies and claim that the typical fiscal consolidation would be contractionary.[8]

It is beyond the scope of this testimony to resolve the dispute between the two corners of the literature. A fiscal consolidation optimist would believe that the Alesina work is correct, and then would expect that a large fiscal consolidation in the U.S. would lead to significant positive growth effects even in the near term.

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[6] Many papers from the peer-reviewed literature confirm these results. 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.

[7] Alesina and Ardagna (2009), Alesina and Ardagna (1998), and Alesina and Perotti (1996)

[8] Leigh, et at. (2010)

A pessimist would point to the alternative work of the IMF and argue that the growth effects are more uncertain. But it is important to note that even in this case, the IMF study points to positive growth effects if the fiscal consolidation is correctly designed.

That is, both sides of the literature find that reducing expenditures will provide a better growth outcome than increasing revenues. Although the IMF finds that a tax-based consolidation would reduce GDP by around 1.6 percentage points three years following implementation, they find that the negative effects of a spending-based consolidation would be small and statistically insignificant. That is, even in the most pessimistic corner of the fiscal consolidation literature, there is little to dissuade us from pursuing a consolidation today. Moreover, they find that spending-based consolidations that are focused primarily on transfer cuts could produce positive near-term growth effects.

The latter point is especially interesting since the authors study near-term cuts in entitlements. One might expect these to have a relatively large short-run negative effect on consumption behavior. The fact that expectational effects dominate even when entitlements are cut immediately suggests that out-of-control entitlement spending has a profoundly negative impact on forward-looking sentiment and business and consumer confidence.

This result also suggests a policy opportunity. Given the massive imbalances that exist today, it is likely that consumers have very little faith that current programs will remain in place throughout the course of their lifetimes. Accordingly, cuts to entitlements that phase in gradually over time will likely have little impact on their perceived lifetime wealth, as the benefit cuts are effectively already factored into consumer expectation. If consumers don't expect promised benefits to be paid, government can reduce promised benefits without causing today's consumption to go down.

Which means, of course, that the expectational effects of a fiscal consolidation could easily be expected to dominate and produce significant near-term growth if there are few immediate cuts to benefits but significant longer-term cuts. If, in addition, the fiscal consolidation were paired with a tax reform that broadened the tax base and reduced marginal tax rates, then a significant growth spurt would be the natural expectation to draw from the economic literature.

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