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The Promise of Fiscal Consolidation: How Cutting Spending Can Help to Return America to Prosperity

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KEY TAKEAWAYS

Two-trillion-dollar annual deficits over the next decade will force Congress to either cut spending or raise taxes, or risk fiscal collapse.

Tax increases have historically failed to fix fiscal imbalances; instead, tax increases have led to deep and prolonged recessions.

Fiscal adjustments driven by spending cuts can have a pro-growth effect, restoring public confidence that taxes will remain low in the future.

The U.S. fiscal gap—the difference between revenues and expenditures—is a systemic problem driven by sustained growth in mandatory spending since the early 1970s.[1] The current health and economic crisis will only serve to accelerate trends that have been baked into U.S. fiscal policy for decades. Following unsustainable budgets, fiscal adjustments driven by spending cuts can help to restore public confidence in the government's fiscal capacity and reassure taxpayers and investors that revenues will not have to increase to cover current spending. Compromise plans that do not fix systemic expenditure growth, and instead try to raise taxes to balance budgets, have historically failed to fix budgets or revive faltering economies.

If left unaddressed, the U.S. fiscal gap could precipitate an international crisis of confidence among buyers of U.S. government securities that will force

Congress to cut spending growth, increase taxes, or both. However, international financial markets will likely give the U.S. Congress a continued license to run up larger and even more unsustainable debts for some time. The sustainability of the U.S. debt depends on the continued functioning of U.S. political institutions, the belief that those institutions can regain control of annual deficit growth at some point in the future, and the ability of the U.S. economy to return to a reasonable growth path.

Each of these factors is increasingly under pressure. In July 2020, Fitch Ratings, one of the three main global credit-rating agencies, lowered the outlook for the U.S. credit rating from stable to negative, citing "ongoing deterioration in the U.S. public finances and the absence of a credible fiscal consolidation plan."[2] To stave off fiscal crisis, investors must continue to believe that the U.S. political and economic systems remain strong enough to collect enough taxes to service the accumulated debts.

How Congress and state governments respond to current budget pressures will affect the future prosperity of American workers and the probability of ruinous fiscal collapse. Delaying sustainable budget reforms—by doing nothing or responding with higher taxes—will make the pandemic-induced recession worse and will ensure a longer and more drawn-out economic recovery. Delayed fiscal action will eventually force a debt crisis at an unknown point in the future. In the meantime, the cost and uncertainty of an impending crisis and resulting fiscal adjustment will simmer under the surface for years or decades, dragging down potential growth. The costs of high debt-to-GDP (gross domestic product) ratios are well documented and have already reduced U.S. growth.[3] Future increases in public debt will further shrink business investment, reducing productivity, wages, and economic output.[4]

The pandemic recession and an unprecedented congressional fiscal response must now be paired with expenditure reforms that reduce the growth rate of systemically flawed health, welfare, and retirement programs that are driving the U.S. budget crisis. Fiscal adjustments that reduce expenditures are most successful at returning countries to economic growth while also lowering debt-to-GDP ratios. Expenditure-based reforms can restore confidence in government fiscal capacity and stimulate investments that boost productivity, wages, and economic output.

Current Fiscal Landscape

America's fiscal mismanagement is not a new phenomenon. Before the coronavirus pandemic and resulting economic recession, the Congressional

Budget Office (CBO) projected a $1 trillion gap between federal revenues and expenditures in 2020. Over the following decade, federal spending was projected to grow faster than the economy and faster than revenue growth.[5] At the end of the decade, annual spending growth was projected to consume 41 percent of annual GDP growth and would consume more than 30 percent of GDP growth on average over the decade. In the next 30 years, the U.S. debt-to-GDP ratio was projected to reach 180 percent, up from 79 percent in 2019.[6] By every measure, the pre-pandemic budget was unsustainable.

Pandemic spending and the 2020 economic recession will further increase the unsustainability of the U.S. budget. In the first half of 2020, Congress authorized an unbudgeted $2.4 trillion in deficit spending.[7] Trillions more in additional federal expenditures are still likely as Congress considers the next fiscal response to the coronavirus.

Pandemic spending could, in theory, be a one-time expenditure, increasing the stock of national debt, but not accelerating the growth rate of the structural deficit. On the other hand, the pandemic could also increase both the level and growth rate of the debt. Temporary programs could become semi-permanent as they are continually extended. Congress is also likely to prevent future budgeted tax increases and spending reforms from kicking in automatically. Extended slow or negative economic growth will also decrease revenues and increase outlays from countercyclical safety-net programs, such as Medicaid, unemployment insurance, and the Supplemental Nutrition Assistance Program.

If Congress follows current law by allowing scheduled tax increases to take effect in 2026 and does not pass another economic relief bill, the pandemic is projected to add $4.4 trillion to the primary deficit, which is partly offset by lower projected interest costs.[8] In the optimistic CBO current law projections, spending and revenues continue to diverge over the next decade. The Committee for a Responsible Federal Budget projects, under the likely scenario that Congress passes additional emergency legislation and keeps taxes from increasing, that the deficit will average more than $2 trillion a year and continue to expand over the following decade.[9]

By every metric, deficit and expenditure growth were unsustainable pre-crisis and will be even more precarious following the pandemic's fiscal response. Deficits and debt cannot grow faster than the economy over the long run.[10] Systemic deficit growth eventually forces policymakers either to cut spending or to raise taxes. Debt accumulation and currency devaluation are only viable as short-term solutions.[11]

Because the U.S. has uniquely low average taxes compared to its economic peers,[12] it is possible for Congress to increase taxes over the short term.[13] However, additional tax revenue alone cannot make the U.S. budget sustainable; the problem is driven by expenditure growth. Furthermore, tax increases have historically resulted in additional spending of greater value than the revenue raised.[14] Nevertheless, the upper bound for politically viable tax increases is likely former Vice President Joe Biden's proposal to raise $3.8 trillion in additional revenue, increasing taxes by about 8 percent over the next decade. This upper-bound proposal would still need to be paired with expenditure cuts to stabilize pre-pandemic U.S. debt at 150 percent of GDP.[15] Things have only gotten worse. Post-pandemic, a 20 percent increase in taxes would only finance half of the projected increase in future spending, by one estimate.[16]

Even as the economy begins to rebound, the additional spending may not subside. Many policymakers wrongly believe that economic crises are best met with large "stimulus" programs, whereby additional government spending can help jump-start the economy. In a previous Heritage Foundation *Backgrounder*, this author reviews the evidence on how past stimulus programs failed to jump-start economic recovery—and likely made economic recovery more difficult.[17] Individuals and businesses react to new government programs by scaling back their private spending, and shifting—rather than expanding—production, canceling out any theoretical benefits of additional government expenditures. The fiscal stimulus programs currently being considered will likely have one lasting legacy: larger government debt and an increasingly uncertain budgetary future.

The same economic theory that recommends increased government expenditures to revive an ailing economy often keeps policymakers from seriously considering reforming and reducing outlays following economic and budgetary crisis. However, the following sections review a robust economics literature that shows how conventional wisdom is misguided. Governments facing the choice of raising taxes or cutting spending should cut spending to minimize economic hardship and ensure a more robust recovery.

Restoring Confidence with Spending Reductions

Properly implemented fiscal adjustments driven by spending cuts do not have to be contractionary, as predicted by many mainstream economic models. Implemented correctly, expenditure-based fiscal adjustments can be pro-growth in the short run and long run. Reducing government spending can restore confidence in the government's fiscal capacity and reassure taxpayers and investors that revenues will not have to increase to cover current unfunded expenditures.[18]

In their 2019 book *Austerity: When It Works and When It Doesn't,* Alberto Alesina, Carlo Favero, and Francesco Giavazzi, summarize more than a decade of research on how countries address fiscal crises, outline case studies, and present an empirical investigation of 16 countries over three decades, comprising 184 distinct austerity plans.[19] Their research separates austerity plans into two groups: those that primarily rely on spending cuts, and those that primarily rely on tax increases. The results are strikingly consistent. The authors conclude: "Tax-based plans lead to deep and prolonged recessions, lasting several years. Expenditure-based plans on average exhaust their very mild recessionary effect within two years after a plan is introduced."[20] The expenditure-based plans in their sample often still include significant tax increases that are simply smaller than the expenditure cuts. It is likely that expenditure-only plans would perform even better on the margin of economic growth.[21]

Economic recovery and sustained economic growth depend on consumers and investors feeling secure in their knowledge of the future. As Alesina and his co-authors note, "A successful fiscal consolidation removes uncertainty and stimulates demand by making consumers, and especially investors, more optimistic about the future."[22] The difference in output effects from tax-based and expenditure-based fiscal consolidations depends mainly on the different responses of private investment. Cutting expenditures signals that governments are more committed to sustainable budgeting and thus reduces future uncertainty that can discourage economic activity.

Large fiscal imbalances can create economic uncertainty for investors and consumers. "Investors seem to prefer expenditure cuts, probably because they anticipate a future decline, or at least no increase in taxation. Thus they invest more."[23] Cutting taxes is not always necessary to activate a supply-side response resulting in additional economic activity. Merely removing the threat of future tax increases by constraining spending can boost private investment and consumption. However, by prioritizing growth over deficit reduction, Sven Larson explains in his book *Industrial Poverty*, that as governments spend less, strategic tax cuts can simultaneously return additional purchasing power to the private sector, further boosting growth and ultimately making deficit reduction easier as the economy accelerates more quickly.[24]

Simulating a pro-growth fiscal consolidation plan, John Cogan, Daniel Heil, and John Taylor illustrate how holding down projected expenditure growth can boost short-term and long-term GDP growth. By holding federal expenditures at the pre-pandemic level of about 20 percent of GDP, the authors show that the spending restraint can prevent large future tax increases. They estimate that in the first two years, the expenditure-based consolidation boosts the real GDP growth rate by 10 percent. "Over the longer-term, GDP increases by about 3.7 percent after 25 years. This is equivalent to a 7 percent increase in the economy's real growth rate."[25] The model assumes that people are forward-looking and that they know that, absent reform, taxes will rise significantly in the future. Therefore, after the expenditure cuts are implemented, the anticipation of tax cuts (relative to the no-reform baseline) leads "to an immediate growth of consumption and output and avoids any decrease in economic activity."[26]

Tax Increases Kill Economic Recovery

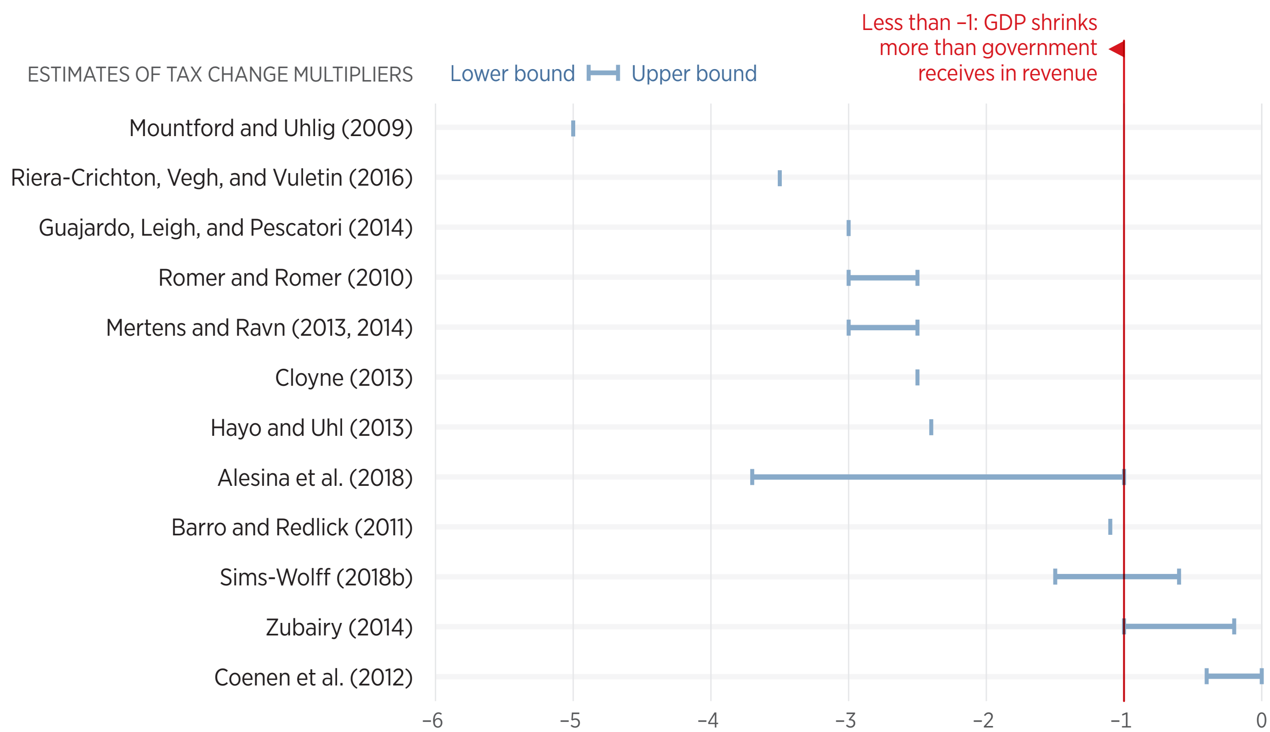
Raising taxes as a strategy to balance budgets or pay for new spending is less successful and more damaging to economic growth than cutting spending. The economic cost of tax increases is high and confirmed by a wide range of economic estimates.

In a 10-year review of new research following the financial crisis, Valerie Ramey reports tax multipliers from researchers using different models, techniques, data, and time periods. The tax multiplier is the ratio of the change in output (GDP) over the tax increase.[27] A tax multiplier of –1 means that for every dollar of new revenue collected from increasing taxes, GDP shrinks by the same amount. Tax multipliers are always negative because taxes remove resources from the private sector. Chart 1 shows Ramey's sampling of tax change multipliers based on aggregate data. A majority of the estimates show that tax increases reduce GDP by two or three times the increase in revenue. The economic costs of tax increases are often larger than the revenue raised because taxes change incentives, making working and investing less attractive.

The types of taxes used to bring in more revenue can also intensify the economic cost of revenue increases significantly. Results from the public finance literature clearly show that business and investment taxes (taxes on capital income) are the most economically destructive compared to sales taxes and wage taxes (taxes on consumption and labor).[28] In the context of fiscal adjustments, new taxes on investment creates a double hit to economic growth by first increasing the after-tax cost of expanding business operations, and then, by increasing uncertainty about future fiscal policy by not credibly fixing the expenditure-based drivers of budgetary imbalances.

CHART 1

Tax Hikes Shrink Economy Two to Three Times More than Revenue Raised



NOTE: Estimates use aggregate data, no state dependence.
SOURCE: Valerie A. Ramey, "Ten Years after the Financial Crisis: What Have We Learned from the Renaissance in Fiscal Research?" *Journal of Economic Perspectives*, Vol. 33, No. 2 (Spring 2019), p. 105, https://pubs.aeaweb.org/doi/pdf/10.1257/jep.33.2.89 (accessed August 17, 2020).

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Because tax increases have steep economic costs, they are less effective at reducing deficits. Alesina and his co-authors conclude that tax-based fiscal adjustments are "self-defeating: they slow down the economy and do not reduce the debt ratio."[29] Relying on taxes to close the fiscal gap can create a cycle of tax increases that slow down growth, which adds pressure to expenditure growth by increasing the use of countercyclical anti-poverty programs, which then requires still higher taxes to avoid a debt crisis. Additional evidence outside fiscal crises also shows that new taxes are followed by increases in spending, making deficits larger, not smaller.[30]

A Framework for U.S. Fiscal Consolidation

The current pandemic-related spending will likely not trigger an immediate fiscal crisis for the federal government. However, current unplanned spending *will* move up the date and increase the near-term likelihood of a U.S. fiscal crisis if no action is taken. Left unchecked, underlying pre-COVID budget pressures will continue their demographic-fueled march toward budget deficits more than 50 percent larger than revenues. Many state and municipal budgets face similar pressures as pension and health care costs consume an ever-growing portion of current-year expenditures.[31]

Successfully implementing a large-scale fiscal adjustment is politically difficult, and the failure rate is high. More than 80 percent of austerity plans fail to meaningfully reduce debt-to-GDP levels.[32] As reviewed above, those plans that rely primarily on spending cuts are more likely to succeed. In a review of fiscal adjustments, Andrew Biggs, Kevin Hassett, and Matthew Jensen conclude: "To facilitate success in future consolidations, our results and the previous literature indicate that a suitable low-end target for the expenditure share is around 85 percent of the total fiscal consolidation."[33]

Mixing small tax increases with larger expenditure cuts can meet the goals of deficit reduction, but they do not necessarily also facilitate economic growth. To maximize the economic benefits of fiscal consolidations, policymakers should rely entirely on expenditure reforms. Providing a counterfactual to the late 1990s Swedish fiscal adjustment, Larson concludes that "a spending cuts–only austerity package, one-third of the size of the actual package…would have reduced the budget deficit to the same extent as the actual austerity package did, but with" higher employment and higher consumer spending.[34] Tax increases can erode the positive impact of spending reforms by removing additional private resources that would otherwise be able to more fully compensate for declining government activity.

The type of expenditure reductions is also an essential component. Reforms must be made to programs that are the source of unsustainable growth. The Heritage Foundation's Paul Winfree estimates that less than 2 percent of federal spending accounts drive the long-run U.S. budget crises. However, these accounts are "equivalent to 60 percent of gross spending over the next 10 years, with spending on government-funded health care programs contributing the largest component to fiscal unsustainability."[35] Biggs, Hassett, and Jensen and a similar OECD study conclude that the largest share of spending cuts should be comprised of social transfer programs to increase the chances of successful fiscal reform.[36] Social transfer programs, such as Social Security, Medicare, Medicaid, and state-level retirement benefits, are the biggest drivers of fiscal unsustainability at every level of government across the U.S.

Austerity is often forced by an actual fiscal crisis of spiraling interest costs, plummeting revenues, or a combination of the two. The probability that the U.S. will face this sort of abrupt budgetary crisis in the near term increased due to the coronavirus pandemic, but a simmering crisis of economic malaise is still the more likely medium-term outcome.[37] The politically easy, short-term budgetary patch could include letting taxes automatically increase in 2026 when the tax cuts of the 2017 Tax Cuts and Jobs Act expire, and further increase taxes on investment and high-income Americans to ensure that revenue growth remains elevated. These tax increases will further hamper economic growth and the economic recovery. Tax increases will not remove, but merely prolong, the economic uncertainty of how Congress will ultimately react to the systemic fiscal imbalances of uncontrolled spending growth when the fiscal crisis does arise. Whether through increased debt or higher taxes, delaying expenditure reforms will be economically costly.

Addressing budget imbalances is politically challenging, and effective budget reform that primarily cuts expenditures and makes the most significant reductions to direct benefit programs is more challenging still. The irony is that fiscal adjustments that rely mainly on spending cuts are more successful at boosting the economy and reducing debt levels, precisely because it is more politically difficult.[38] Bold plans that address the key drivers of deficits signal a serious political commitment to sustainable budgeting.[39] Attempts to balance the budget through a combination of roughly equal tax increases and spending cuts send the opposite signal, such as President Barack Obama's National Commission on Fiscal Responsibility and Reform, which produced the Simpson–Bowles plan.[40] By trying to make up for irresponsible spending by increasing taxes, lawmakers signal that they are not yet serious enough to address the problem head-on.

Concluding Recommendations for the U.S.

In order to facilitate a robust American economic recovery and ensure that rising government debt does not lead to fiscal crisis, lawmakers, should:

- **Avoid additional stimulus spending.** Governments are not able to tax and spend their way to prosperity. Additional stimulus spending will simply worsen America's budget imbalances without the benefits of the promised economic boost.

- **Reduce the growth rate of spending through entitlement reform.** Just a few systemically flawed programs are driving the U.S. budget crisis. The only credible way to address long-run fiscal imbalances is to reform health, welfare, and retirement programs.

- **Prevent taxes from increasing in 2026 and beyond.** Congress and state legislatures will face immense budget pressures in the coming years. Seemingly easy fixes that allow the 2017 tax cuts to expire or proposals to increase taxes elsewhere will not fix systemic budget imbalances and will further stunt economic recovery.

Following unsustainable budgets, fiscal adjustments driven by spending cuts can be pro-growth, helping to return economies back to health. Tepid half-measures that do not fix systemic expenditure growth, and instead try to increase taxes to balance budgets, have historically failed to fix fiscal imbalances or revive economies. Cutting spending restores confidence in the government's fiscal capacity and reassures Americans that future taxes will not have to increase to cover current expenditures.

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Endnotes

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