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CONGRESSIONAL TESTIMONY

Statement of

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"The Fiscal and Economic Effects of Austerity"

Introduction

My name is Salim Furth. I am Senior Policy Analyst in Macroeconomics in the Center for Data Analysis at The Heritage Foundation. I thank Chairman Patty Murray, Ranking Member Jeff Sessions, and the rest of the committee for the opportunity to testify today on the fiscal and economic effects of austerity. The views I express in this testimony are my own and should not be construed as representing any official position of The Heritage Foundation.

My testimony focuses on the following points:

- Tax increases are harmful to the economy and the debt;
- Spending cuts can improve both the budget and the economy;
- Structural reforms can permanently improve economic performance; and
- To date, "austerity" in Europe has consisted mainly of tax increases.

Three Distinct Approaches

Austerity is an overly broad term of economic opprobrium; its effects depend on its contents. The U.S. should pursue targeted spending cuts and structural reform, but eschew further tax increases.

Lower government spending has little immediate effect on the private economy, but can bring debt under control and promote investment and subsequent growth. Reductions in spending lower the odds of future tax increases and future inflation. Historically, successful fiscal consolidations are associated with spending cuts.

Higher tax rates slow the economy immediately and depress future growth.[1] Revenue gains are mediocre, as lower investment, attenuated work effort, and inefficient tax-avoidance depress receipts. In addition, economic harm done by the tax increase automatically increases government expenditures on unemployment insurance and poverty programs.

Structural reform of social transfer programs and regulatory regimes can substantially increase long-run growth. Among developed economies, which share the same technology and similar cultures and political systems, the extent of the government's intrusion into private lives is a primary candidate for explaining output differences.[2,3] In the U.S. for the next few decades, structural reform means balancing obligations to retiring baby boomers against competing claims on scarce productive workers. Without reforms that ease and reward productive activity, labor force participation will remain low and the fiscal burden will be staggering.

The U.S. should enact wise and permanent structural reforms, including effective marginal tax rate cuts to the poor, sustainable reform to Social Security and Medicare, and curtailment of destructive government agencies.

Has Austerity Occurred?

"Austerity" is often a term of obfuscation. Estonia, for instance, is often considered a poster child for austerity despite its 14 percent rise in government consumption and 22 percent rise in transfer payments (items like Social Security and unemployment insurance) since 2007.[4] Germany likewise grew government 11 percent over the crisis years. At the same time, both countries have raised taxes enough to keep their budgets close to balance. Meanwhile, Ireland allowed its tax revenue to fall and shifted government expenditure from government consumption (-7.5 percent) to transfer payments (+20 percent). Spain has a lower revenue rate, higher government consumption, and higher transfers than it

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[1] Karel Mertens and Morton Ravn, "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States," *American Economic Review,* June 2013 (forthcoming).

[2] Giuseppe Fiori, Giuseppe Nicoletti, Stefano Scarpetta and Fabio Schiantarelli, "Employment Effects of Product and Labour Market Reforms: Are There Synergies?" *The Economic Journal* 122, February 2012.

[3] Edward C. Prescott, "Why Do Americans Work So Much More Than Europeans?" *Federal Reserve Bank of Minneapolis Quarterly Review* 28(1), July 2004.

[4] Author's calculations based on OECD Statistics and OECD Economic Outlook #93.

did in 2007. Yet all these countries are routinely lumped as "austere," with the emphasis usually placed on the rare spending cuts.

Much less austerity has occurred globally than is commonly reported, and U.S. policies have expanded, not contracted, deficits in the past several years. We are a long way from austerity.

Fiscal Consolidations and the Historical Record

Fiscal consolidation denotes a policy change designed to shrink deficits – and it may include both spending cuts and tax increases. Twenty years of research have found that consolidation plans in which spending cuts preponderate are more effective and more conducive to growth than tax increases. In the Appendix, I present an extensive record of empirical academic research showing that spending cuts have great potential for good and tax increases great potential for harm.

Investigating the optimal mix of spending cuts and tax increases, Biggs, Hassett, and Jensen find "strong evidence" that expenditure-based consolidations are more successful than tax-based expenditures.[5] They conclude that when fiscal consolidation is needed, it should be at least 85 percent spending cuts. They also find that composition matters: successful consolidations feature large cuts to transfer programs. This confirms the basic economic result that disincentives to work will reduce economic activity.

Biggs, Hassett, and Jensen also emphasize the particular situation of the U.S.: with the coming retirement surge, the U.S. has a longer-term need for fiscal consolidation than most of the historical examples. Both historical experience and the exigencies of the present urge us to adopt structural reforms that diminish dependency on transfer payments.

A famous series of papers during the 1990s identified the counterintuitive "expansionary fiscal consolidations."[6] Seven such episodes occurred during the 1980s, in Belgium, Canada, Denmark, Ireland, Italy, Portugal, and Sweden: the cyclically adjusted deficit fell substantially, but private consumption and investment continued to grow.[7] Since then, several more episodes of "expansionary consolidation" have burnished the record of spending-based deficit reduction.

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[5] Andrew G. Biggs, Kevin A. Hassett, and Matthew Jensen, "A Guide for Deficit Reduction in the United States Based on Historical Consolidations That Worked," American Enterprise Institute *Economic Policy Working Paper* 2010-04, December 2010.

[6] Francesco Giavazzi and Marco Pagano, "Can Severe Fiscal Adjustments Be Expansionary?" in *NBER Macroeconomics Annual 1990*, Olivier Blanchard and Stanley Fischer, eds., 1990.

Alberto Alesina and Roberto Perotti, "Reducing Budget Deficits," *Swedish Economic Policy Review*, III, 1996.

[7] Roberto Perotti, "Fiscal Policy in Good Times and Bad," *The Quarterly Journal of Economics* 114, 1999.

Alesina and Perotti send “a rather clear message to the policy maker: any fiscal adjustment hoping to be successful, cannot avoid dealing with cuts in the welfare state and in government wages and employment.”[8]

Although expansionary fiscal consolidations are the exception, they are not unthinkable. Success stories most often occurred in environments where debt had risen far and fast and future growth had become uncertain. While spending cuts and structural reform are no guarantee of expansion for the present U.S., such “austerity” would improve our chances of strong, sustained growth.

The Developed World Since 2007

With a plethora of evidence, all of it militating against tax increases as a means of fiscal consolidation, one might imagine that today’s policymakers have avoided such means. But in fact the opposite has occurred: harmful, tax-based “austerity” has been adopted by at least half of Europe.[9] Spending cuts have been rare outside Europe’s crisis countries, and transfer payments have risen in every country I examined.

As early as 2007, the OECD could state plainly that “[f]iscal consolidation is required in most OECD countries.”[10] While it is undoubtedly true that the boom years of the 2000s were a better time to initiate fiscal consolidation, those who did not take the opportunity had less flexibility to respond to the 2008 financial crisis and ensuing depression.[11] Those who protest that we should wait until the economy is strong to reform entitlements should recall that such opportunities came – and went – often in the last two decades.

What Austerity?

At present, only three OECD countries are running a cyclically adjusted budget surplus. That is, most current policies would lead to deficits during “normal times.”

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[8] Alberto Alesina and Roberto Perotti, “Fiscal expansions and fiscal adjustments in OECD countries,” NBER *Discussion Paper* Series No. 754, 1995.

[9] Revenue/GDP has risen in 13 of 23 European countries in my sample. Throughout the following discussion, I have a sample of 27 or 28 OECD countries, depending on data availability. I excluded Luxembourg as a special case, and Chile, Mexico, and Turkey as emerging markets. Canada, Korea, New Zealand, Norway, and the Slovak Republic lack data for certain metrics. All data are from OECD Statistics and OECD Economic Outlook, 2013 (1).

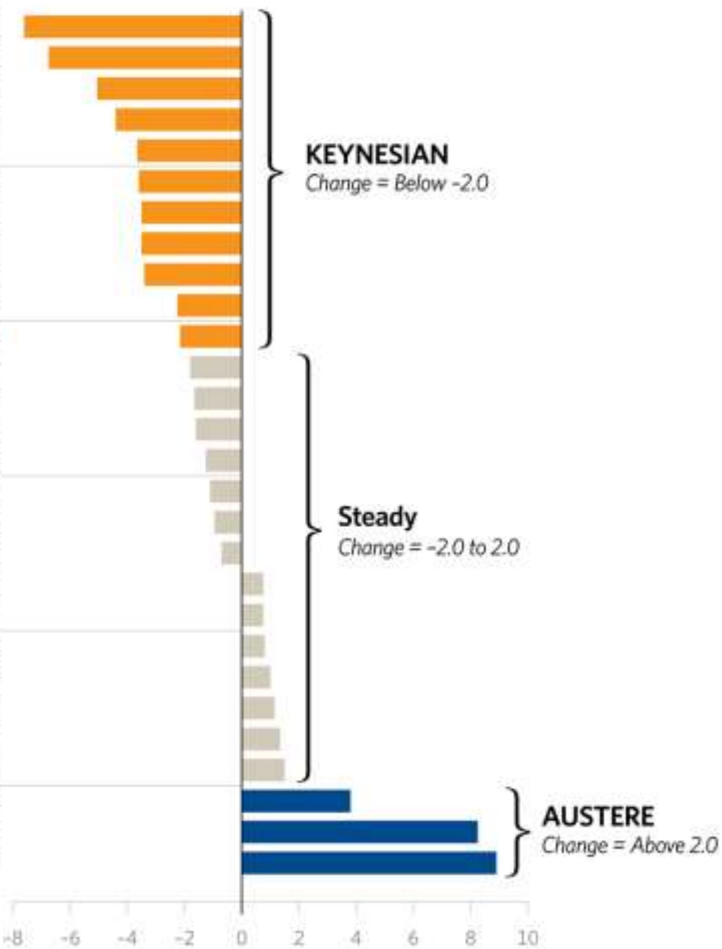
[10] Stéphanie Guichard, Mike Kennedy, Eckhard Wurzel, and Christophe André, “What Promotes Fiscal Consolidation: OECD Country Experiences,” OECD Economics Department *Working Papers*, 2007.

[11] Alesina and Ardagna record that the Netherlands, Sweden, and Switzerland initiated successful consolidations around 2004, while Germany, Norway, and Portugal initiated unsuccessful consolidations. Alberto Alesina and Silvia Ardagna, “The design of fiscal adjustments,” NBER Working Paper No. 18423, 2012.

CHART 1

Few Governments Have Enacted Real Austerity

	CYCLICALLY ADJUSTED SURPLUS OR DEFICIT AS % GDP 2006 and 2007	2012 and 2013	Change
Japan	-2.30	-9.90	-7.60
New Zealand	4.20	-2.55	-6.75
Spain	0.55	-4.50	-5.05
Finland	3.05	-1.35	-4.40
Canada	0.80	-2.85	-3.65
Australia	1.45	-2.15	-3.60
Iceland	3.30	-0.20	-3.50
Israel	-2.30	-5.80	-3.50
Denmark	2.60	-0.80	-3.40
Ireland	-1.70	-3.95	-2.25
United States	**-3.65**	**-5.80**	**-2.15**
Netherlands	-0.20	-2.00	-1.80
Belgium	-0.95	-2.60	-1.65
United Kingdom	-4.10	-5.70	-1.60
Korea	3.85	2.60	-1.25
Sweden	1.00	-0.10	-1.10
Slovenia	-2.80	-3.75	-0.95
Poland	-2.90	-3.60	-0.70
Germany	-1.05	-0.30	0.75
Switzerland	0.35	1.10	0.75
Austria	-2.35	-1.55	0.80
Czech Republic	-3.40	-2.40	1.00
France	-3.95	-2.80	1.15
Portugal	-4.20	-2.85	1.35
Estonia	-0.85	0.65	1.50
Italy	-3.95	-0.15	3.80
Hungary	-9.40	-1.15	8.25
Greece	-9.60	-0.70	8.90



Source: OECD.

Just ten OECD countries have tightened their cyclically adjusted deficits since 2006–2007. Chart 1 illustrates the paucity of fiscal tightening. Despite major crises, even Ireland, Iceland, and Spain have increased their cyclically adjusted deficits. Where recent tightening has been reported, such as in the U.K., it is largely due to winding down even larger deficits created during the recession years.

The U.S. is no exception. In 2006–2007, the U.S. was running a large cyclically adjusted deficit, almost 4 percent of GDP. It has since broadened to almost 6 percent of GDP, not including the lower tax receipts and higher spending associated with the weak economy. Without policy action, deficits will remain unsustainably large indefinitely.

Government consumption, reported in Table 1, rose in 20 OECD countries. Likewise, government consumption's share of GDP rose in 20 countries. The U.S., France, and Germany each increased spending by at least 7 percent. The U.K. was the only country to cut government (by 1.3 percent) without being forced by a major crisis. But the U.K. counteracted the cut with a much larger increase in transfer payments. The rest of the countries on the left side of Chart 2 have decreased government consumption only because they are considered a default risk.

TABLE 1

Changes in GDP, Government Spending, and Revenue, 2007–2012

		GROWTH IN GOVERNMENT SPENDING			
	GDP Growth	Government Consumption Growth	Transfers Growth	Change in Revenue Rate (share of GDP)	Actual 2012 Surplus or Deficit (% of GDP)
Eurozone					
Austria	3.0%	8.8%	11%	1.76%	-2.51%
Belgium	2.1%	14.5%	19%	3.33%	-4.08%
Czech Republic	1.4%	0.1%	10%	-2.41%	-4.15%
Estonia	-5.0%	13.9%	22%	4.48%	-0.28%
Finland	-2.8%	11.9%	19%	1.31%	-2.32%
France	0.5%	7.2%	12%	2.06%	-4.97%
Germany	3.5%	10.9%	6%	0.83%	0.16%
Greece	-22.4%	-20.6%	0%	4.55%	-10.05%
Ireland	-6.2%	-7.5%	20%	-4.05%	-7.38%
Italy	-7.1%	-3.4%	7%	2.18%	-3.06%
Netherlands	-0.3%	9.6%	14%	-0.11%	-3.99%
Portugal	-5.8%	-14.4%	12%	-0.36%	-6.60%
Slovak Republic	10.0%	9.8%	22%	-0.06%	-4.32%
Slovenia	-5.4%	7.7%	11%	0.60%	-3.72%
Spain	-4.3%	1.8%	19%	-6.31%	-10.94%
European Union, Non-Eurozone					
Denmark	-4.4%	11.1%	16%	3.25%	-4.51%
Hungary	-4.9%	-4.7%	0%	4.26%	-2.13%
Iceland	-5.3%	-1.2%	21%	-4.82%	-3.21%
Poland	16.7%	17.0%	18%	-1.54%	-4.00%
Sweden	5.1%	8.2%	7%	-4.48%	-0.72%
United Kingdom	-2.0%	-1.3%	12%	-0.72%	-5.90%
Others					
Australia*	13.0%	13.7%	17%	-2.11%	-4.16%
Israel*	17.6%	9.0%	14%	-5.47%	-4.12%
Japan*	-0.8%	5.4%	16%	-1.90%	-8.53%
Norway	3.2%	18.1%	17%	2.52%	15.60%
Switzerland*	6.1%	13.7%	17%	3.02%	0.56%
United States*	2.8%	7.2%	22%	-3.02%	-9.96%
Median	0.0%	8.2%	16%	-0.06%	-4.08%

* Incomplete OECD data for 2012 at the time of writing, so 2011 data was used where necessary.
Note: GDP, Government Consumption, and Transfers Growth are calculated as log differences.

Source: OECD.

Sacred Cows and Third Rails

Transfer payments – government benefits like Social Security, Medicare, unemployment insurance, or food stamps – have not diminished anywhere. The median OECD country grew transfer payments by 16 percent and devoted 2.9 percent more of GDP to transfers in 2012 than in 2007. Some of that growth is obviously the automatic stabilizers of recession, and some is due to aging. What is remarkable in the data is the absence of austerity.

Even countries undergoing severe crises or "austerity" programs failed to control the growth of transfer programs. In Spain transfers are up 19 percent, in Ireland 20 percent, in the U.K. 12 percent, and in Estonia 22 percent. Table 1 shows that only five countries reported less than 10 percent transfer growth.

The U.S. has grown transfer payments 22 percent, and transfers consume 2.9 percent more of GDP now than in 2007. This growth includes disincentives to work for those with low income, including food stamps and Social Security Disability Insurance expanded far beyond their original intent. Removing these economic disincentives would result in economic growth, higher tax receipts, lower government spending.

Recall that the empirical evidence emphasizes the importance of cutting transfer payments to achieving expansionary fiscal consolidation. Instead, OECD countries are spending more on transfers and will require steeper, more painful fiscal adjustments in the future.

Taxes Go Up

Despite a Keynesian approach to spending, many governments have raised taxes to cut the deficits they built up with all the new spending. It's a textbook error.[12]

Writing in 2010, Broadbent and Daly noted disapprovingly that "none of the existing sets of fiscal plans in the major economies… qualifies as 'expenditure-based' and 'significant'… Where there are significant corrections planned [in the U.S. and the U.K.] these are driven not by cuts in current spending but (predominantly) by lower investment or higher taxes."[13]

In measuring tax increases, I use a very tight definition: has a country increased its tax receipts as a share of GDP? This "revenue rate" will normally fall in recessions and rise in booms, so one expects to see revenue rates down somewhat across the board in the absence of policy changes.

Instead, thirteen OECD countries have increased their revenue rates. Of these, only Greece, Italy, and Hungary faced crises severe enough that they raised taxes and cut government consumption – classic

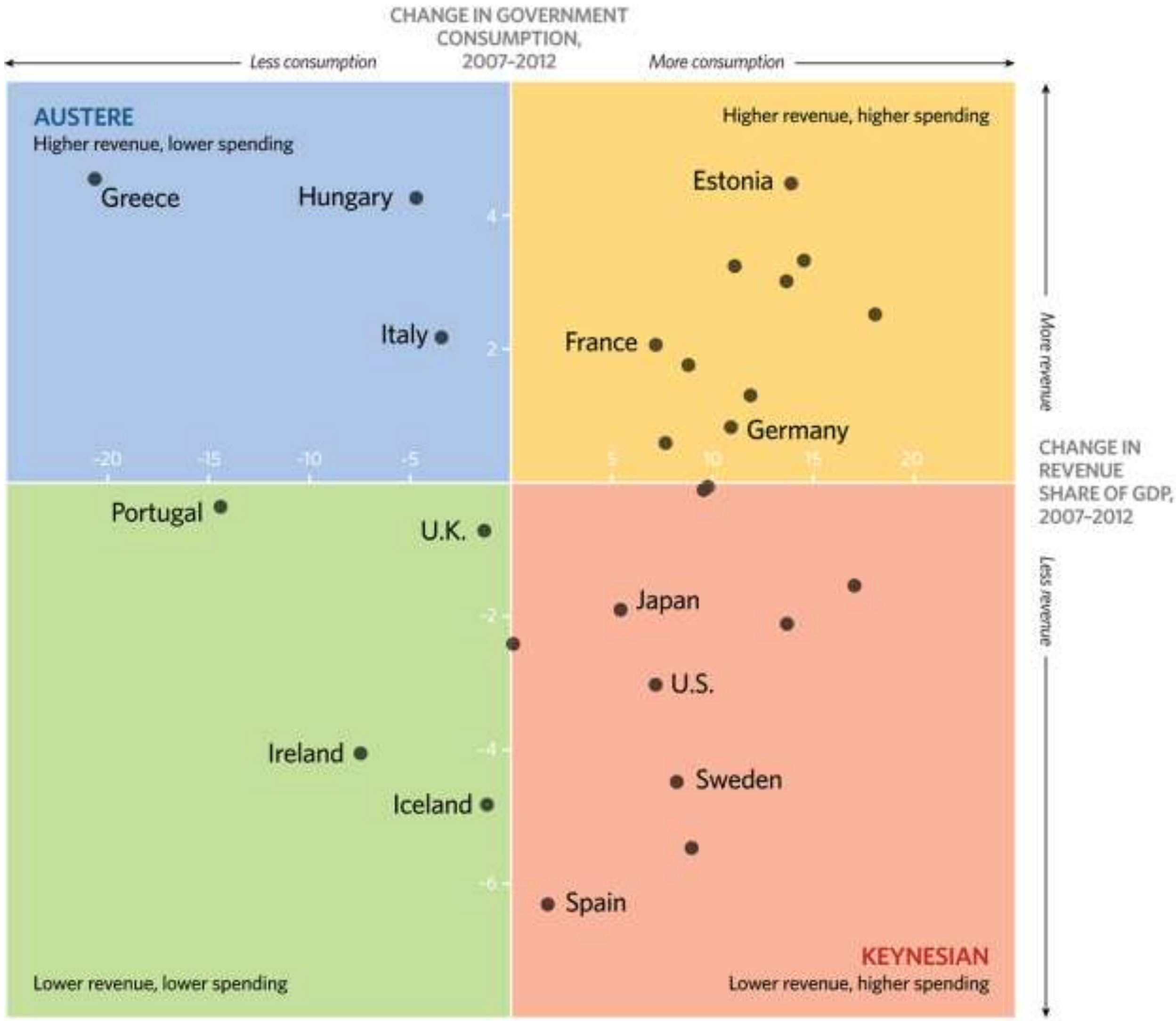
[12] Recall Alesina and Perotti, "Fiscal expansions and fiscal adjustments in OECD countries."

[13] Ben Broadbent and Kevin Daly, "Limiting the Fall-Out from Fiscal Adjustment," *Goldman Sachs Global Economics Paper* No. 195, April 2010, p.5.

austerity, in the upper left corner of Chart 2.[14] The other ten have raised taxes along with government consumption and transfers. Instead of funding deficit reduction, the new taxes fund larger government.

CHART 2

Most Governments Have Increased Spending Since 2007



Source: OECD.

Outside of Europe, Keynesian policies are more common. The U.S., Japan, Israel, and Australia[15] have lowered revenue rates while increasing government spending. The U.S. and Japan are running unsustainably large deficits and have very high debt-to-GDP ratios.

[14] Not coincidentally, these three also experienced some of the lowest increases in transfer payments, clearly reflecting reforms to the transfer systems.

[15] The only four non-European countries in the relevant sample.

How Will the Economy Go Forward?

Meanwhile, there is pressure in the U.S. to raise taxes while preserving the temporary spending surge associated with the recession and stimulus. As decades of evidence indicate, raising taxes without cutting spending has a poor record of containing debt and a worse record of returning the economy to growth.

A better path is to accept that short-term stimulus has been tried – on a spectacular scale – and failed, and move on to preparing the country for stability and growth through the retirement boom of the 2020s by cutting spending and controlling the growth of transfers.

Sequestered?

The 2013 budget sequestration was poorly designed policy. However, its artlessness does not outweigh the fact that it is a step in the right direction. Pier Carlo Padoan, Chief Economist of the OECD, emphasized in a speech last week that the U.S. should make the spending cuts of the sequester less harmful by incorporating them into a credible, permanent fiscal consolidation.[16]

Since taking effect in March, sequestration has had no discernible impact on growth or employment numbers, nor on financial markets. Where sequestration policies are particularly perverse, straightforward legislation can improve the content of policies while remaining revenue neutral. There are many places in the federal budget where small savings can be found at little cost.[17] In fixing sequestration, policymakers should restore government investment at the expense of the wage bill and transfer payment growth.

Stimulated?

Temporary deficit spending – optimistically called stimulus – is designed to move economic activity from the future to the present. It can effectively do so when there is slack labor and capital, but the question remains whether there is a large welfare benefit to shifting forward tomorrow's GDP. By running large deficits each of the last five years, the U.S. has engaged in an enormous stimulus program.

Some have argued that the $640 billion of stimulus from the federal deficit in 2013 is not enough, and the amount should be increased. DeLong and Summers show that when the negative effects of a recession have permanent drag on the economy (i.e., unit root hysteresis), deficit spending can be self-financing under certain conditions and assumptions.[18] Their paper is valuable in that it reminds the

[16] Pier Carlo Padoan, "Presentation of the May 2013 OECD Economic Outlook," May 29, 2013, http://www.oecd.org/about/secretary-general/presentation-of-the-may-2013-oecd-economic-outlook.htm (accessed May 30, 2013).

[17] See, for example, Patrick Louis Knudsen, "$150 Billion in Spending Cuts to Offset Defense Sequestration," Heritage Foundation *Backgrounder* No. 2744, November 15, 2012, http://www.heritage.org/research/reports/2012/11/150-billion-in-spending-cuts-to-offset-defense-sequestration.

[18] For example, see J. Bradford DeLong and Lawrence H. Summers, "Fiscal Policy in a Depressed Economy," *Brookings Papers on Economic Activity*, Spring 2012.

economics profession of how little is known about the existence or size of hysteresis, and how much long-run gains or losses can outweigh short-run considerations.

But DeLong and Summers' model could easily be rewritten to instead feature coefficients from the literature on debt drag, which would show that under certain conditions, spending cuts are self-financing.[19] Better yet, DeLong and Summers' model could incorporate the permanent productivity gains from structural reforms, such as the labor market reforms championed by the OECD.[20] There is substantially more empirical evidence that debt drag is a problem and structural reform is a solution than there is about hysteresis, although more research may ultimately shed light on the latter.

A more likely scenario is that money spent today will not pay for itself, and will have to be cut from government spending tomorrow. Deficit spending for hopeful stimulus today could easily mean cuts to Social Security and Medicare in the 2020s, or a lack of public and private investment as interest payments crowd out valuable government functions and raise hurdle rates over the next few decades.

Structural Reform

There is no substitute for private sector economic growth. Although government can easily boost its own portion of GDP, it can only indirectly and imprecisely have a positive impact on private consumption and private investment, which are the cornerstones of material well-being present and future. The most proven, fiscally sound, and long-lasting policy changes to help achieve growth are structural reforms.[21]

Angel Gurría, Secretary-General of the OECD, laid out a mandate for structural change:[22]

> We have done the number crunching: we have simulated the effects of structural reforms on potential output across the OECD area through 2060. Our analysis shows that moving to best practice across a number of policy areas – product and labour market regulations, and education, just to name a few – would raise per capita incomes by some 20% in the median

[19] For a summary of the debt drag literature, see Salim Furth, "High Debt Is a Real Drag," Heritage Foundation *Issue Brief* No. 3859, February 22, 2013, http://www.heritage.org/research/reports/2013/02/how-a-high-national-debt-impacts-the-economy.

[20] Pier Carlo Padoan, "Presentation of the May 2013 OECD Economic Outlook."

[21] See, among many, Alan Krueger and Jorn-Steffan Pischke, "Observations and Conjectures on the U.S. Employment Miracle," NBER *Working Paper* No. 6146, 1997; Clifford Winston, "Economic Deregulation: Days of Reckoning for Microeconomists," *Journal of Economic Literature* 31(3), 1993; Edward P. Lazear, "Job Security Provisions and Employment," *Quarterly Journal of Economics* 105(3), 1990; Andrea Bassanini and Romain Duval, "The determinants of unemployment across OECD countries: Reassessing the role of policies and institutions," *OECD Economic Studies* 42(1), 2006; John Williamson, "What Washington Means by Policy Reform," in *Latin American Adjustment: How Much Has Happened?* John Williamson, ed., 1990;

[22] Angel Gurría, "Presentation of the May 2013 OECD Economic Outlook", prepared remarks, May 29, 2013, http://www.oecd.org/about/secretary-general/presentation-of-the-may-2013-oecd-economic-outlook.htm (accessed May 30, 2013).

> OECD country. This is huge! And those gains would be even higher for those countries that are now furthest from best practice. So our call continues to be: “go structural”. It is good for growth and prosperity, and it is good for the public finances.

The U.S. is better situated in terms of product and labor market regulations than the crisis countries of Southern Europe, but improvements could raise U.S. labor participation substantially.

Fiscal structural reforms can be distinguished from merely cutting spending by two criteria:

(1) A systematic or ongoing form of spending is cut, and
(2) Incentives for economic activity are improved by the reform.

Structural reform in the U.S. could lower the effective marginal tax rates[23] facing low-income workers by cutting some of the benefits which eviscerate the reward to work. Structural reform could shut down subsidies to farmers, favored energy companies, and big-ticket colleges. Structural reform could undo Social Security Disability Insurance’s growth into a catch-all welfare program.[24] Structural reform could shrink government agencies primarily involved in economically destructive activities, such as the Commerce Department and the EPA. Structural reform could include an end to favorable tax treatment for mortgage interest and employer perks from health insurance to parking.

Structural reform shifts the government’s role in society away from replacing private economic activity and toward protecting individual liberty.

This testimony makes no pretense of evaluating or recommending a specific set of structural reforms. But in the context of the difficult choices of “austerity” or debt drag, cutting deficits and promoting growth through structural reform offers the best way forward.

[23] Elaine Maag, C. Eugene Steuerle, Ritadhi Chakravarti, and Caleb Quakenbush, “How Marginal Tax Rates Affect Families at Various Levels of Poverty,” *National Tax Journal* 65(4), December 2012.

[24] David H. Autor and Mark G. Duggan. "The Growth In The Social Security Disability Rolls: A Fiscal Crisis Unfolding," *Journal of Economic Perspectives* 20, 2006.

Stefan Staubli, “The impact of stricter criteria for disability insurance on labor force participation,” *Journal of Public Economics* 95(9–10), October 2011.

APPENDIX: Empirical Evidence that Spending Cuts Are Better than Tax Increases.

The discovery of expansionary fiscal consolidations led researchers to study the variety of fiscal consolidations and their average effects. Alesina's extensive research program has anchored this literature for twenty years, but he is by no means alone in his investigations.

Alesina and Perotti showed that when deficits expand, it is usually due to spending increases, and when deficits shrink, it is usually due to tax increases. Spending cuts are the exception, but they are the only way that countries have closed budget deficits without harm to the economy. They argue that "fiscal adjustment cannot have long-lasting effects unless it tackles two expenditures – government employment and social programs – often regarded as untouchable by policymakers and their advisors."[25]

OECD economists found that spending-based deficit reduction was more effective at lowering the debt-to-GDP ratio. The spending cuts were most effective when they were based on rules, enforced over time, and maintained transparency.[26] An OECD model of fiscal adjustment found that cutting spending at the margin can yield "surprisingly large income gains compared with the alternative of raising taxes."[27]

Ardagna looked simultaneously at the growth and debt consequences of fiscal consolidation,[28] and found that the composition of the adjustment determines whether economic growth follows. Fiscal adjustments featuring cuts to the government wage bill led to higher subsequent growth.[29]

Alesina, Perotti, and Tavares document 23 years with successful consolidations in which deficit reduction came 66 percent from spending cuts. On the other side, there were 49 years of unsuccessful deficit reduction, with just 27 percent from spending cuts. The spending cuts in unsuccessful consolidations occurred mostly to government investment and left government wages and transfer payments untouched.[30]

IMF economists noted that "consolidation is more painful when it relies primarily on tax [increases]", is more painful for Euro members, and is more painful if the central bank does not or cannot

[25] Alesina and Perotti, "Fiscal expansions and fiscal adjustments in OECD countries."

[26] Guichard, Kennedy, Wurzel, and André, "What Promotes Fiscal Consolidation: OECD Country Experiences" 553, 2007.

[27] Boris Cournède and Frédéric Gonand, "Restoring Fiscal Sustainability in the Euro Area: Raise Taxes or Curb Spending?" OECD Economics Department *Working Papers* 520, 2006.

[28] This is an important distinction. Papers that track the evolution of (debt/GDP) may conflate differing effects.

[29] Silvia Ardagna, "Fiscal Stabilizations: When Do They Work and Why," *European Economic Review* 48(5), 2004.

[30] Alberto Alesina, Roberto Perotti, José Tavares, "The Political Economy of Fiscal Adjustments," in *Brookings Papers on Economic Activity*, Vol. 1998(1), Maurice Obstfeld and Barry Eichengreen eds., 1998.

accommodate the budget cut.[31] Lambertini and Tavares found that spending cuts contributed more to the effectiveness of fiscal consolidations than tax increases.[32]

Von Hagen, Halite, and Starch looked at the factors that determine the length and success of fiscal consolidations. They found that consistency in approach is valuable, and that consolidations based on cuts to "politically sensitive items… such as transfers, subsidies, and government wages" are more likely to persist long enough to be effective.[33] There is a payoff to political courage.

Alesina and Ardagna advanced and extended the previous literature with recent data. They confirmed the previous findings: tax-based fiscal consolidations usually fail, and lead – on average – to a recession. Using two datasets, their model estimates that a 1 percentage point drop in government spending has mild positive effects on growth or no effect on growth, and that a 1 point increase in taxes has either mild or severe negative effects on growth.[34]

McDermott and Wescott of the IMF confirmed Alesina and Perotti's key findings: cutting transfers and government wages is the key to successful and expansionary fiscal consolidation. They detail one case of expansionary austerity: New Zealand slashed government spending in the teeth of a 1991 recession and emerged with high growth, low unemployment, and a slim debt-to-GDP ratio.[35] Recent data yielded more examples of "expansionary fiscal consolidation," including Canada, Finland, Sweden, and the U.K. in the 1990s and Denmark, the Netherlands, and Switzerland in the 2000s.[36]

Alesina, Favero, and Giavazzi[37] have responded to the political debate of the last few years by formalizing their definitions and working with new data made available by Devries, Guajardo, Leigh, and Pescatori.[38] Focusing on multi-year plans and treating planned and surprise fiscal changes differently, Alesina et al. again confirmed that tax-based consolidations are more costly in terms of output losses.

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[31] Daniel Leigh, Pete Devries, Charles Freedman, Jaime Guajardo, Douglas Laxton, and Andrea Pescatori, "Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," International Monetary Fund *World Economic Outlook: Recovery, Risk and Rebalancing*, 2010.

[32] Luisa Lambertini and José A. Tavares, "Exchange Rates and Fiscal Adjustments: Evidence from the OECD and Implications for the EMU," *Contributions to Macroeconomics* 5(1), 2005.

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