The Facts About Spending Cuts, the Debt, and the GDP

Separating economic myths from economic truths

Veronique de Rugy | July 29, 2011

Editor's Note: Reason columnist and Mercatus Center economist Veronique de Rugy appears weekly on Bloomberg TV to separate economic fact from economic myth.

Raising the debt limit might put off a downgrade disaster in August, but that still isn't enough—as Standard & Poor's recent warning made clear. Perhaps the most important shot not heard around the world was S&P's *other* admonition: Namely, that the U.S. bond rating will be downgraded in three months, if not sooner, unless we do something about government spending. Beyond raising the debt limit, S&P laid out clear criteria for avoiding a downgrade: 1) reduce the debt by about $4 trillion; 2) agree to a credible plan within three months; and 3) guarantee that this newfound fiscal discipline will actually stick.

If S&P isn't bluffing, then lawmakers should get serious about reducing the debt-to-GDP ratio, and they should do it quickly. But how do we achieve such a task?

Myth 1: *You cannot reduce the deficit to an appropriate level without also raising taxes.*

Fact 1: *Spending cuts are the most effective way to reduce the debt-to-GDP ratio.*

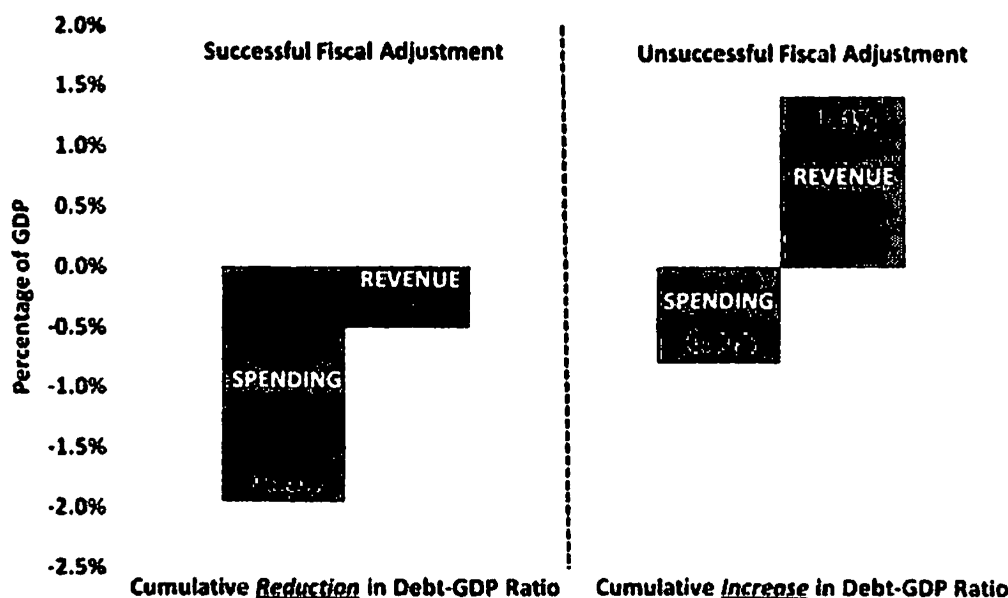
We are not the first nation to struggle with a dangerous debt-to-GDP ratio, and thankfully, the academic world has already produced great insights into what can be done to reduce this ratio without hurting the economy.

Take the work of Harvard's Alberto Alesina and Silvia Ardagna. They examined 107 efforts to reduce the debt in 21 OECD nations between 1970–2007. Their findings suggest that tax cuts are more expansionary than spending increases in the cases of a fiscal stimulus. Also, they found that spending cuts are a more effective way to reduce the debt-to-GDP ratio:

> For fiscal adjustments we show that spending cuts are much more effective than tax increases in stabilizing the debt and avoiding economic downturns. In fact, we uncover several episodes in which spending cuts adopted to reduce deficits have been associated with economic expansions rather than recessions. We also investigate which components of taxes and spending affect the economy more in these large episodes and we try to uncover channels running through private consumption and/or investment.

As you can see in this chart, in cases of successful fiscal adjustments—defined by the cumulative reduction in debt-to-GDP ratio three years after fiscal adjustment greater than 4.5 percentage points—spending as a share of GDP fell by about 2 percentage points while revenue also fell by half a percentage point (left bars). On the other hand, unsuccessful fiscal adjustment packages—cumulative increases in debt-to-GDP ratio—were made of smaller spending reductions (only 0.8 percentage-point reduction) and large revenue increases (right bars).

Fiscal Adjustments by Spending and Revenue Changes in OECD Countries, 1970 to 2007



Source: Alesina and Ardagna "Large changes in fiscal policy: taxes versus spending," 2009.
Produced by Veronique de Rugy, Mercatus Center at George Mason University

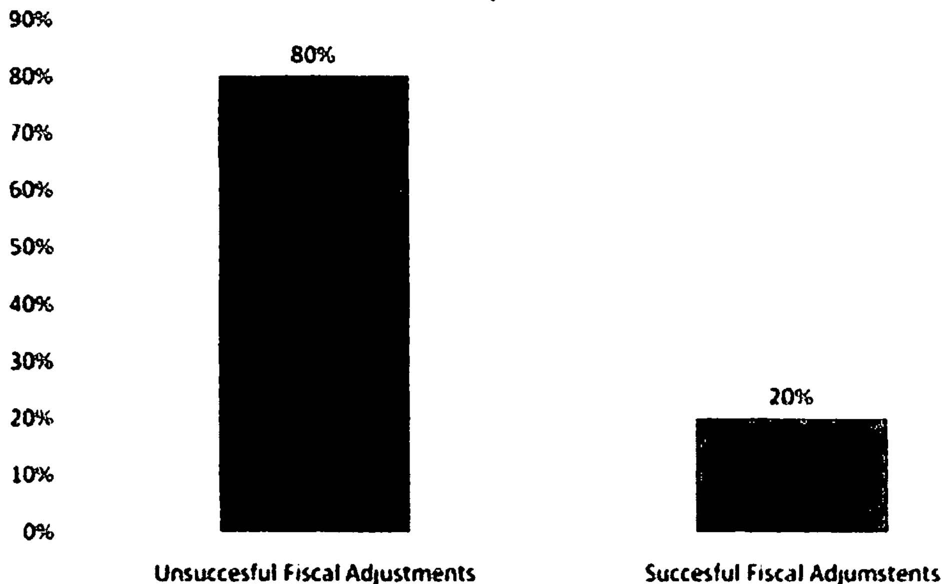
The IMF found similar results and reports that fiscal adjustment on the requisite scale of what we need today is actually not unprecedented:

> During the past three decades, there were 14 episodes in advanced economies and 26 in emerging economies when individual countries adjusted their structural primary balance by more than 7 percentage points of GDP. Several economies were also able to sustain large primary surpluses for five or more years afterwards, though the record is more mixed in this regard.

For those who are not ideologically inclined toward austerity measures, it is key to remember that this research is consistent with the work of former Obama Council of Economic Advisers chairman Christina Romer and her economist husband, David Romer, which shows that increasing taxes by 1 percent of GDP for deficit-reduction purposes leads to a 3 percent reduction in GDP. In fact, Alesina and Ardagna discuss the work of Romer and Romer starting on page five of their paper.

Myth 2: *Lawmakers facing economic catastrophe forget about politics and adopt measures that address genuine fiscal issues.*

Fact 2: *Politicians rarely put politics aside. Historically, four out of five fiscal adjustments were primarily comprised of tax increases—and were unsuccessful.*



Source: Biggs, A. and Hasset, K. and Jensen, M. (2010). American Enterprise Institute
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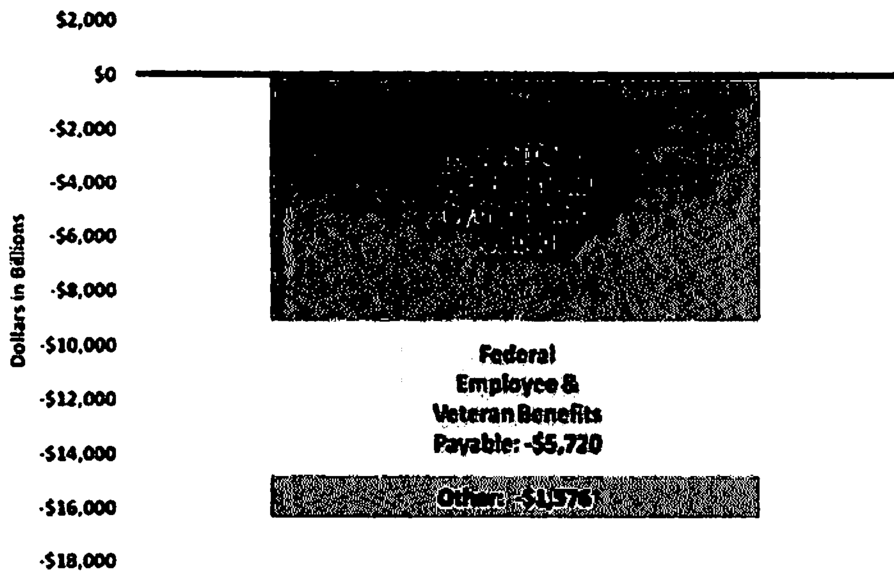
Following and building on Alesina and Ardagna's work, a new paper by Andrew Biggs, Kevin Hassett, and Matthew Jensen of the American Enterprise Institute studies fiscal adjustments covering over 100 instances in which countries took steps to address their budget gaps. Their results are consistent with those of the Harvard economists; expenditure cuts outweigh revenue increases in successful consolidations. Moreover, their work shows that even in a time of crisis (or especially in a time of crisis), lawmakers tend to adopt policies for the sake of politics. Countries in fiscal trouble generally got there through years of catering to interest groups and pro-spending constituencies (on both sides of the political aisle), and their fiscal adjustments tend to make too many of the same mistakes.

As a result, failed fiscal consolidations are the rule rather than the exception. Indeed, 80 percent of the fiscal adjustments Biggs, Hassett, and Jensen studied were failures. The United States cannot afford to follow this pattern.

Myth 3: *We have had higher debt-to-GDP ratios before so we shouldn't worry now.*

Fact 3: *We should worry. The debt-to-GDP ratio actually underestimates the size of the government's real liabilities.*



As government debt and deficits have swollen, we often look to the past for guidance. From that point of view, history appears to be reassuring, since several advanced countries have had debt-to-GDP ratios much higher than the one we have now. The United States after World War II had a public debt/GDP ratio of roughly 110 percent, while Britain's was 250 percent. In fact, the UK's national debt has averaged almost 100 percent of GDP since its creation in 1693. France's public debt was about 280 percent of GDP at the end of World War II. And yet neither of these countries defaulted. So why should we worry?

Two main reasons: First, while our debt is big now, it's only going to get bigger in the coming years. This year, the debt held by the public is $9.7 trillion, which is roughly 69 percent of GDP. According to the Congressional Budget Office, it will reach 200 percent in 2037--if the economy doesn't collapse first (which it likely will). These projections aren't surprising considering that the president's budget doubles the debt held by the public from $9 trillion today to $18 trillion in 2021.

Second, the debt-to-GDP ratio actually underestimates the scale of our debt problem. Here is why:

1. *Intragovernmental debt*. This $4.6 trillion of debt is money that the federal government owes to its various trust funds. In other words, it's a liability to the government but an asset to the trust funds, so in accounting term it's zeroed out. However, over time the programs will redeem the IOUs as they need the money to fund benefits. As that happens, the intragovernmental debt decreases but debt held by the public increases. Eventually, this $4.6 trillion will be converted into public debt.

2. *Unaccounted liabilities.* There exists a broad range of liabilities that are debt, yet are not captured in the debt-to-GDP ratio. To take one example, the Financial Statement of the United States values the government's civil-service pension liabilities (that is, the contractual claims on government accumulated to date by civil servants) at $5.7 trillion. That amount is not captured by the debt-to-GDP ratio. A share of this $5.7 trillion will be paid for by IOUs included in the intragovernmental debt, which we know will be converted into public debt. In addition, the unfunded share of this liability will have to be paid for with more debt, which isn't accounted for in the debt/GDP metric. The Financial Statement of the United States shows another $1.5 trillion of such liabilities, including payments due to government-sponsored enterprises.

3. *Unfunded liabilities.* There is a balance of $39 trillion in unfunded liabilities over 75 years for programs such as Social Security and Medicare.

While we can't add all these numbers up because it would be the equivalent of comparing oranges to apples (some of these numbers represent the net present value of beneficiaries' future claims on the government), considering them in context still helps to illustrate why the debt-to-GDP ratio underestimates how much present and future debt has been accumulated over the years. Hopefully, this also helps illustrate why the current debt-ceiling debate shouldn't just focus on Treasury's ability to pay our bills today, but must focus on our overall debt problem.

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