MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

RESEARCH SUMMARY

THE NEW BALANCED APPROACH: Spending Cuts and Policy Reforms to Increase Competitiveness

Alberto Alesina, Professor, Harvard University
Veronique de Rugy, Senior Research Fellow, Mercatus Center

Opponents of proposals to rein in government spending and set a course for fiscal responsibility claim that austerity has failed in other countries. Often they point to the United Kingdom's failure to balance its budget and jumpstart economic growth after it implemented a series of so-called austerity measures beginning in 2010.

However, there is a growing consensus that successful fiscal adjustment is possible when mostly based on spending cuts and accompanied by policies that increase competitiveness.

A new study expands on previous research that examined why there was an 80 percent failure rate in over 100 different attempts to reduce the debt-to-GDP ratio in all developed countries over the past 30 years. According to the new study, two things mattered for the successful 20 percent—a focus on spending cuts and policy reforms that increase competiveness. These structural policy changes include liberalization of markets for labor and markets for goods and services, readjustments of public sector size and pay, and public pension reform.

Harvard University economist Alberto Alesina and the Mercatus Center at George Mason University's Veronique de Rugy examine why spending-based fiscal adjustments are not only more likely to reduce debt-to-GDP ratio than tax based ones, but also less likely to trigger a recession.

They use the cases of successful adjustments in Germany and Sweden in contrast with the recent unsuccessful adjustment attempt in the United Kingdom to explain why successful packages are complex, multiyear affairs. With most countries focused on short-term goals, those that pursue real austerity and measures to increase competitiveness will end up with better results over the long term.

SUMMARY

Germany

Germany has largely been buffered from the recession that many of the European Union countries are undergoing. Much of the credit goes to the fiscal adjustment program it implemented between 2004 and 2007. This program included

- reduced income tax rates to implement a stimulus (part of a series of supply-side oriented reforms between 1999 and 2005, including a wide-ranging overhaul of the income tax system meant to boost potential growth that didn't have much effect until 2004);
- structural reforms addressed rigidity in the labor market;

- pension reforms to address demographic pressures, such as an increase in retirement age, elimination of early retirement clauses, and tighter rules for calculating imputed pension contributions;
- large expenditure cuts in fringe benefits in public administration;
- serious reductions in subsidies for specific industries, such as residential construction, coal mining, and agriculture.

Sweden

The Swedish economy is estimated at growing at a rate of 5.6 percent currently. Sweden undertook fiscal reform that focused on cutting spending and taxes, including

- a reduction in welfare spending;
- a permanent reduction in taxes, including a 20-point reduction in the top marginal income tax rate;
- an aggressive monetary policy followed by strong export revenues and firm domestic demand.

The United Kingdom

The United Kingdom is poised to return to recession and just lost its AAA credit rating. Its debt-to-GDP ratio is deteriorating, jumping to 70.7 percent in December 2012 from 63.4 percent in December 2011. The British fiscal adjustment consisted of implementing tax increases with minimal spending cuts—a package that would group it with 80 percent of the failed attempts at fiscal adjustments.

- The plan called for £3 in government spending for every £1 in new tax revenue for the duration of the fiscal adjustment. Deficit reduction of £40 billion in the 2010–11 budget cycle was achieved by cutting £1 in spending and raising £3 in tax revenue (the opposite of the announced plan).
- These tax increases included the VAT increasing from 17.5 percent to 20 percent; a new 50 percent tax bracket on incomes of £150K, which will drop to 45 percent in April 2013; a massive increase in air passenger duty fees; a temporary payroll tax of 50 percent on bonuses of £25K (now expired); a capital gains tax hike from the minimum rate of 10 percent to a new flat rate of 28 percent; a 13 percent levy on banks; a 7 percent stamp duty on property sales higher than £2 million; and an even higher tax hike on properties bought through nonnatural persons.
- The rate of growth of spending has slowed, but government spending grew to absorb 49 percent of GDP last year, up from 48.6 percent of GDP in 2011.

The United States

While there are no simple answers for the United States, successful fiscal adjustment is possible when it is mostly based on spending cuts and accompanied by policies that increase competitiveness. Such adjustments tend to be complex, multiyear efforts.

- Data from 21 OECD countries from 1970 to 2010 show that successful fiscal adjustments on average reduced debt-to-GDP ratio by 0.19 percentage points of GDP in a given year, while the economy grew by 3.47 percentage points in total.
- Injury to lower-income earners or the poor can be mitigated by improving the way welfare programs are targeted and by scaling back programs, such as Medicare, that use taxes raised, in part, from the middle class to give public services right back to the middle class.

- Cutting subsidies going to businesses—often large, well-established and politically-connected firms—can generate substantial savings.

It is critical to understand the need to address present and future debt crises by adopting sound fiscal measures independent of the short-term impact on growth. We should pursue fiscal reform and competitiveness measures not for quick economic-growth payoff but because it may help avoid future fiscal crises by keeping the economy structurally sound.

CONTACT

Robin Bowen, Associate Director of Outreach
(703) 993-8582, rbowen5@gmu.edu
Mercatus Center
3351 Fairfax Drive, 4th Floor, Arlington, VA 22201
www.mercatus.org

ABOUT THE AUTHORS

Alberto Alesina, born in Italy in 1957, is the Nathaniel Ropes professor of political economy at Harvard University. He served as chairman of Harvard's department of economics from 2003–2006. He is also a member of the National Bureau of Economic Research, the Center for Economic Policy Research, the American Academy of Arts and Sciences, and the Econometric Society. Alesina is a leader in the field of political economics and has published extensively in all major academic journals in economics. He was a coeditor of the *Quarterly Journal of Economics* for eight years and an associate editor of many other academic journals. His two most recent books are *The Future of Europe: Reform or Decline*, published by MIT Press, and *Fighting Poverty in the US and Europe: A World of Difference*, published by Oxford University Press. He obtained his PhD from Harvard in 1986.

Veronique de Rugy is a senior research fellow at the Mercatus Center at George Mason University. Her popular weekly charts, published by the Mercatus Center, address economic issues ranging from lessons on creating sustainable economic growth to the implications of government tax and fiscal policies. She has testified numerous times in front of Congress on the effects of fiscal stimulus, debt and deficits, and regulation on the economy. De Rugy writes regular columns for *Reason* magazine and the *Washington Examiner* and blogs about economics at National Review Online's *The Corner* and at *Big Government*. She received her PhD in economics from the University of Paris 1 Pantheon-Sorbonne and did post-doctorate work on tax revolt at George Mason University.

ABOUT THE MERCATUS CENTER

The Mercatus Center at George Mason University is the world's premier university source for market-oriented ideas—bridging the gap between academic ideas and real-world problems.

A university-based research center, Mercatus advances knowledge about how markets work to improve people's lives by training graduate students, conducting research, and applying economics to offer solutions to society's most pressing problems.

Our mission is to generate knowledge and understanding of the institutions that affect the freedom to prosper and to find sustainable solutions that overcome the barriers preventing individuals from living free, prosperous, and peaceful lives.

Founded in 1980, the Mercatus Center is located on George Mason University's Arlington campus.

www.mercatus.org