

The Economic Effects of a Fiscal Consolidation Strategy

John B. Taylor¹

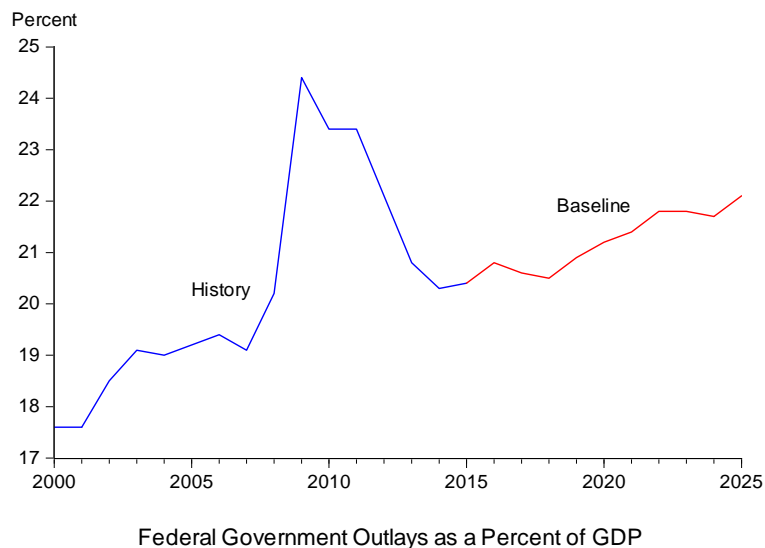
Testimony Before the
Committee on the Budget
U.S. House of Representatives

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Chairman Price, Ranking Member Van Hollen, members of the Committee, thank you for inviting me to testify at this hearing on “Why Congress Must Balance the Budget.”

I would like to focus my remarks on the economic effects of a fiscal consolidation strategy—such as the one in the FY2016 Budget Resolution Conference Report—that aims to gradually and credibly bring the federal budget from deficit into balance over a number of years.

A good place to start is with the recent history and the future outlook for U.S. federal government outlays as a percentage of GDP as shown in this chart.

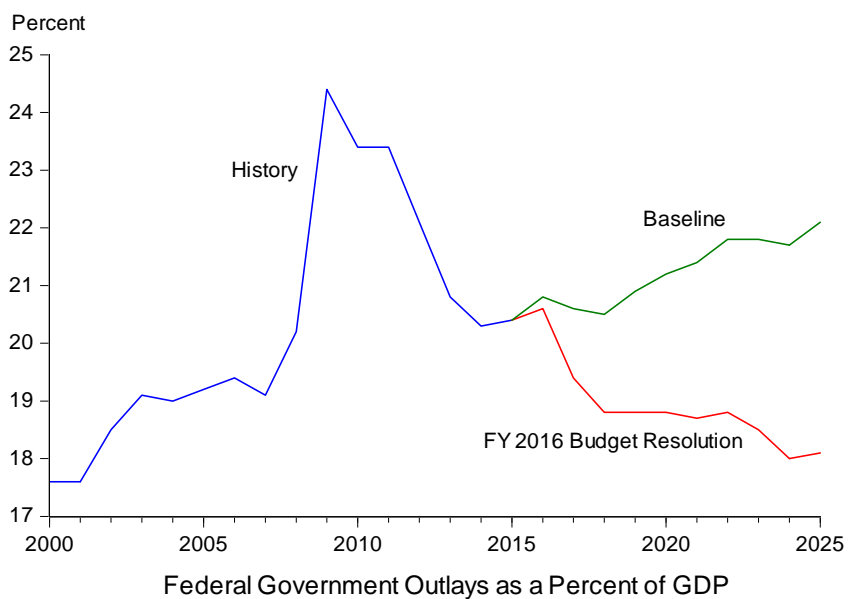


Government outlays include both government transfers and government purchases of goods and services. The history line in the chart shows the increase in outlays as a percentage of GDP since 2000. The baseline in the chart shows the outlook for spending under current policies over the next decade according to the Congressional Budget Office’s most recent baseline. The history and the outlook together show an ongoing increase in spending as a share of GDP interrupted by a bulge associated with the financial crisis and great recession. With federal spending growing more rapidly than GDP, spending in the year 2025 as a share of GDP under current law is projected to be 4.5 percentage points above the 2000 level.

¹ Mary and Robert Raymond Professor of Economics at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford’s Hoover Institution

Such a sustained increase in spending would require higher tax rates in order to keep the deficit down and prevent the debt from rising to economically dangerous levels. The CBO projects that under current law the federal debt rises to 78 percent of GDP by 2025 and 103 percent by 2040. Under the CBO’s alternative fiscal scenario, the federal debt would exceed 100 percent of GDP by 2030 and 200 percent by 2050.² Higher tax rates reduce incentives to save and investment to the detriment of economic growth and all the benefits that economic growth delivers.

Hence, there is a need for a fiscal consolidation strategy in which spending grows at a slower rate than GDP for a while, thereby reducing spending as a percentage of GDP, as does the FY2016 Budget Resolution shown in this chart.

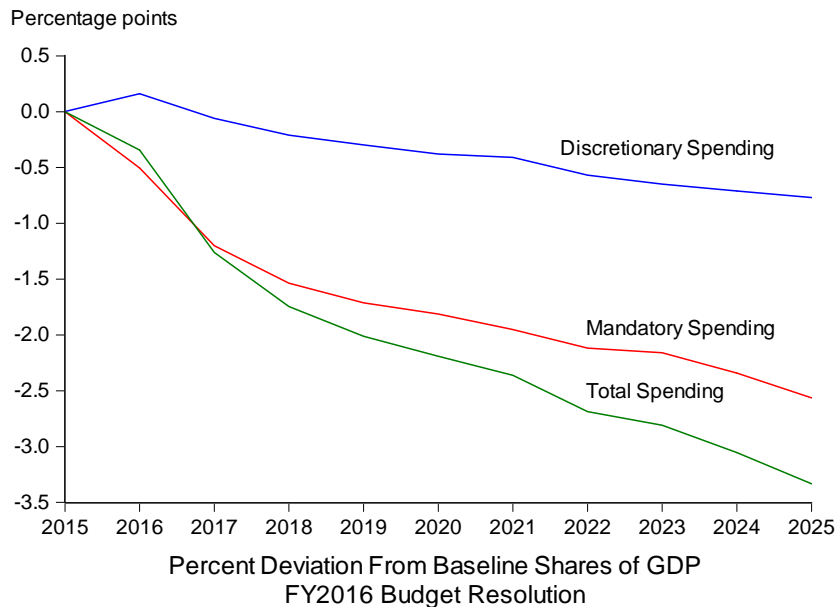


Observe that this strategy brings spending as a share of GDP in 2025 to a level above the level that existed in the year 2000. According to the CBO’s current baseline, tax revenues as a share of GDP will be 18.3 percent of GDP in 2025 under current law. The consolidation strategy in the FY2016 Budget Resolution maintains this level of revenues—though with a tax reform assumed—and has spending at 18.2 percent of GDP. It would thereby effectively balance the budget.

The impact of this budget strategy on the economy in both the short run and the long run depends on how much of the spending adjustment pertains to government purchases of goods and services and how much pertains to transfer payments. Because the growth of future spending is mainly due to the rapid growth of future entitlement spending, any sensible fiscal consolidation strategy will have proportionately more adjustment in transfers than in government purchases.

² “The 2015 Long-Term Budget Outlook Analysis” Congressional Budget Office June 16, 2015

This is true of the strategy in the FY2016 Budget Resolution as shown in the next chart. This chart gives percentage deviations from the baseline shares of GDP for mandatory spending (mainly transfers), discretionary spending (mainly purchases), and total non-interest spending. Recall that the baseline total spending share is growing during this period.



Note that the change in government purchases (discretionary spending) compared to baseline is relatively small and gradual. In fact, there is a small increase in the short run. The change in transfers (mandatory spending) is larger, but also spread out pretty evenly over the ten year consolidation period.

In order to estimate the impact of such a strategy on economic growth over the short term and the long term, one needs a structural macroeconomic model that takes into account incentive effects and expectations of households and firms, as well as short-term price-wage rigidities and other economic frictions or adjustment costs. In research with John Cogan, Volker Wieland, and Maik Wolters, I have used a structural model of the economy that incorporates these essential features.³

We ran simulations of such a model to estimate the impact of a fiscal consolidation strategy very similar to the FY 2016 Budget Resolution, so the impact should be similar.⁴ The

³ John F. Cogan, John. B. Taylor, Volker Wieland, and Maik Wolters (2013), “Fiscal Consolidation Strategy”, *Journal of Economic Dynamics and Control*, 37(2): 404-421. See also John B. Taylor, “Using Hybrid Macro-Econometric Models to Design and Evaluate Fiscal Consolidation Strategies,” Econometric Society Meetings, January 2015 for a review of how the models have been improving over time.

⁴ John F. Cogan, John. B. Taylor, Volker Wieland, and Maik Wolters (2013), “Fiscal Consolidation Strategy: An Update for the Budget Reform Proposal of March 2013,” Stanford Institute for Economic Policy Research, Discussion Paper 12-033

phase-in of the FY2016 plan is quite similar to the strategy in the simulations, but it has less reduction in purchases relative to the baseline in the very short run (actually it has an increase) and more reduction in the longer run. The phase-in of transfers also has less reduction in the short run (first five years) and more in the long run. These differences are likely to make the short run impact of the FY2016 Budget Resolution on real GDP more positive than the model simulations.

Because the FY2016 budget consolidation path for spending is lower than the baseline path, it could allow either lower tax revenues and/or lower levels of government debt compared with the baseline. In fact, the FY2016 Resolution keeps tax revenues close to the baseline for the first 10 years and uses the funds released from reduced federal spending to reduce the debt to GDP ratio relative to the baseline.⁵ This corresponds to one of the scenarios⁶ in our model simulations in which tax reductions relative to baseline are postponed for 10 years. After that 10 year period the tax revenues and tax rates are reduced relative to the large increases that would have been necessary to keep the debt to GDP ratio from rising.

The model simulations show that the impact on real GDP would be positive in both the short run and the long run.⁷ Real GDP increases throughout the simulation, with the benefits rising over time. Even in the short-run, the consolidation of government finances is found to boost economic activity in the private sector sufficiently to overcome the reduction in government spending. Consumption and output increase at the start of the program with further increases later on. Investment rises by only a little in the short run, but by more in the longer run.

The economic rationale for these positive results is straightforward: With a gradually phased-in and credible budget plan, households can take into account future reductions in government spending and higher expected future incomes. Businesses will also be able to adjust. Given a reduction in tax rates in later years compared with likely tax increases, they would also face more favorable conditions for production, investment and work effort. Of course to reap all these positive benefits, it is essential that the plan be credible.

⁵ As stated earlier, however, the FY2016 budget resolution assumes some tax reform with lower tax rates and a broader base. The model simulation discussed here do not include the added economic benefit of that type of reform

⁶ Called the “consolidation scenario”

⁷ The CBO also finds increases in GDP and income in the long run, but a small reduction in 2016-2018. See “Budgetary and Economic Outcomes Under Paths for Federal Revenues and Noninterest Spending Specified by Chairman Price,” March 2015