

# *Liberty Brief*

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## **Austerity: A Theoretical Analysis** *by Sven R. Larson, Ph.D.*

### **EXECUTIVE SUMMARY**

Governments all around the world, from Argentina to Greece to the United States, are struggling with dangerously large budget deficits. It is tempting for legislators to resort to panic-style, across-the-board spending cuts to quickly reduce the deficit. In some cases where such spending cuts are taking place, lawmakers add tax increases, hoping to shorten the time it takes to balance the budget. The problem with this combination of spending cuts and tax increases - often referred to as austerity - is that it does enough harm to the economy to drastically shrink, or even eliminate, any initial reduction in the budget deficit. This Liberty Brief explains the macroeconomics behind austerity and why austerity is the wrong path to a balanced budget.

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*Sven R. Larson is a research fellow with Wyoming Liberty Group. He is the author of two public policy books and numerous articles and research papers about health reform, the welfare state, government spending, taxes, the practice of economic freedom and related topics. He has sat for numerous TV interviews and appears regularly on radio. He has worked for several free-market think tanks and also taught economics at colleges in three different countries. Larson holds a Ph.D. in social sciences with a major in economics.*



## INTRODUCTION

There is a lot of talk these days about “austerity.” Europe is under heavy pressure from austerity policies imposed by the European Union, the European Central Bank and the International Monetary Fund. In Greece, austerity has set the course of the day for a good three years now. However, the problems that austerity was supposed to solve – a large budget deficit and an across-the-economy lack of growth – have persisted.

This raises the question: has Greece been wavering in its commitment to austerity, or is the problem related to the policy principle itself?

This paper analyzes the theory behind austerity policies. Starting with a definition, the paper outlines the consequences of austerity policies and ends with a suggestion as to the precise nature of what Greece has done wrong.

### I. CAUSES AND CONSEQUENCES

#### A. Defining Austerity

Austerity is the combination of harmful spending cuts and tax increases. This combination drains the private sector of resources without increasing economic activity. As a result of the negative effects on the private sector, austerity policies actually perpetuate the budget deficits they are supposed to eliminate.

A key to why austerity is harmful for the economy is the difference between harmful spending cuts and productive cuts. The difference between the two is captured by two cri-

teria:

1. The structural criterion. All spending cuts withhold resources from the economy that government otherwise would have recirculated into the economy one way or another. Productive spending cuts are designed in such a way that they *remove permanently* a government spending promise. A harmful cut keeps the spending promise – a cash entitlement or the provision of a service – in place but shrinks the amount of money that each eligible citizen will receive. A productive cut combines the termination of spending with reforms that allow the private sector to permanently replace government as the provider of a service or an entitlement. Dependents on government are given a transition out of government dependency, either into self-sufficiency or dependency on a private solution. By contrast, harmful spending cuts maintain government’s spending promise in kind but not in quantity, thus preventing the private sector from replacing government as the provider of the service or entitlement in question.
2. The tax cut criterion. Harmful spending cuts are combined with either constant or higher taxes. This means that government increases its drainage on the private sector: it gives less back while collecting the same or higher taxes. By contrast, productive spending cuts come in combination with tax cuts aimed at a net reduction of what government takes from the private sector. The produc-

**Austerity is the combination of harmful spending cuts and tax increases.**

tive spending cut thus opens for private provision of an in-kind service or a cash entitlement both in terms of withdrawn government spending and presence in a market, and in terms of leaving enough money in the private sector to replace government funding.

It takes more time to implement productive spending cuts than harmful cuts. The reason is that it takes some time for the private sector to put alternatives on the market. This is an essential fact that we will return to as we discuss remedies for austerity. As for the effect on the rest of the economy, the productive cuts do not depress the private sector. If anything, they stimulate activity because they open areas previously covered by government for innovation and investments.

Harmful spending cuts, by contrast, inflict harm on the private sector. By draining the private sector for resources they depress private economic activity and, if put to work in a recession, can escalate a recession into a depression. That is currently happening in some parts of Europe. It does not help that harmful cuts often are combined with higher taxes.

**Appendix 1** presents a formal analysis of the effects of austerity. This section develops a less formal, more policy oriented analysis.

### **B. The Extended Rahn Curve**

To assess the negative effects of austerity we need to gauge the success or failure of government policies against an economic performance variable. There are several to choose from; the most commonly used are GDP growth, unemployment (or job creation) and real wage growth. Among these, GDP growth is the most universal: it is the measurement of the entire economy, and includes the bases for job creation and real wage growth. It is therefore the best variable for

basic policy analysis.

Our analysis focuses on two policy variables: government spending and government tax revenues. Both of these variables affect government's share of GDP; in fact, the very purpose of austerity policy is to change government's GDP share. Therefore, it makes sense to contrast changes in government share of GDP to the performance of the economy, i.e., GDP growth.

The relationship between GDP growth and the size of government is sometimes referred to as the Rahn curve.<sup>1</sup> In a strictly theoretical context the Rahn curve is typically presented as an upside-down U: the notion is that when government is very small, its expansion makes a positive contribution to the economy. The rationale behind this is that when government protects life, liberty and property – and provides infrastructure – it builds a safe framework for the productive sector to operate.

At a certain point the positive influence of government fades away and it becomes instead a burden on the economy. This would be where government starts redistributing income and wealth between private citizens (see **Figure 1**).

There is one problem with this theoretical Rahn curve: evidence bias. There is plenty of empirical evidence for the downslope of the curve,<sup>2</sup> but no evidence of a positive influence of government on GDP growth.

There are two possible explanations for this evidence bias. First, it is entirely possible that government simply does not make a positive contribution to the economy. This does not necessarily mean that government at any size is superfluous or outright harmful. Assuming that the smallest possible government is the minimal state as defined by Robert

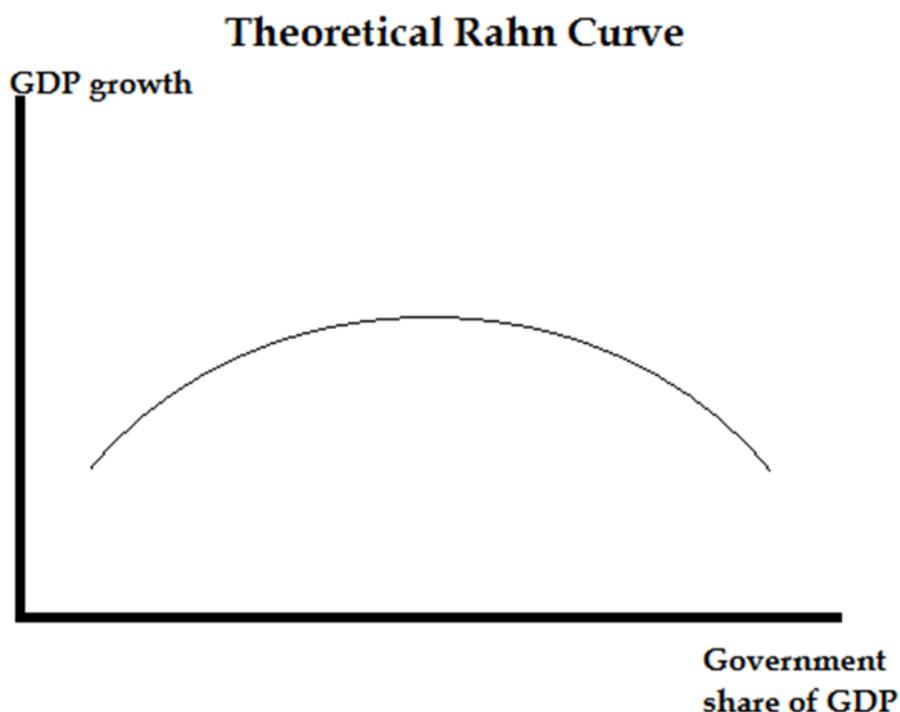
Nozick,<sup>3</sup> the government needed for those functions would be so small that it does not register in statistical studies of the size of government.

Secondly, even if government does have a positive effect on the economy during the upbound phase of the Rahn curve, it is entirely possible that there simply are no governments small enough to fall within that seg-

the peak point of the theoretical curve, i.e., where government is not depressing GDP growth.

The assumption is that this point is equivalent to a minimal state, an assumption that could be interpreted as saying that Nozick's minimal state is superfluous: the economy could do just fine without it. However, this would be a rush to conclusion: a more rea-

Figure 1



ment. The lack of empirical evidence of a positive correlation between government size and GDP growth could simply be explained by the fact that all governments that can be included in a credible empirical study are so big that they all fall within the downbound segment on the Rahn curve.

Whichever explanation is the correct one, it is reasonable to assume for our purposes that the first phase of the Rahn curve does not exist. This means that we start our analysis at

sonable explanation is that the minimal state is a *sine qua non* for a free economy. Without the minimal state the free economy cannot exist, and therefore we can have neither economic freedom nor prosperity.

In short: without the minimal state and its protection of life, liberty and property there would be no GDP to measure.

On the other hand, once government starts

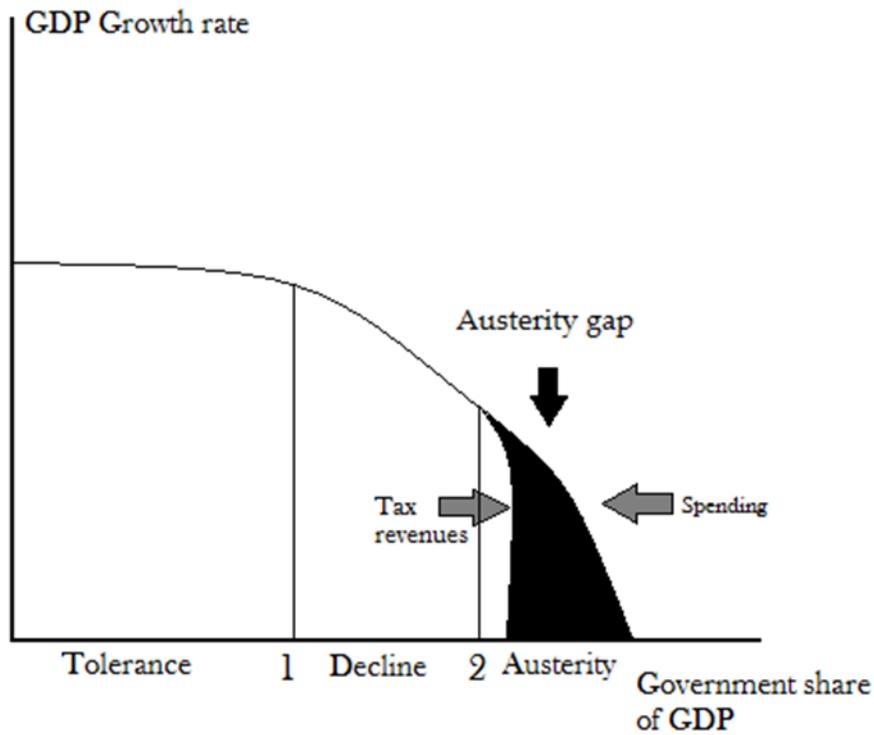
growing beyond the minimal state it intrudes on private-sector economic activity and slowly but steadily starts depressing GDP growth. This gives us an accelerating downslope which, in turn, we will divide into three phases, Tolerance, Decline and Austerity. The phases are divided by two breaking points (see Figure 2).

es are negatively influenced by the growing presence of government, but the expansions and reorganizations still happen.

If, during this phase, a critic of the welfare state suggests that the growth in government will have negative effects on the economy, he will generally be considered to be wrong. Politicians who want to continue to

Figure 2

### Extended Rahn Curve



#### C. The Tolerance Phase and the First Breaking Point

The tolerance phase is the phase of government growth where the productive sector of the economy can cope with, and adjust to, increasingly stifling regulations, taxes and government spending programs. It pays a price, but because the coping mechanisms are internal to the private sector, they are not obviously visible. Decisions by corporate executives to expand or reorganize business-

grow government take the relative lack of negative effects on GDP growth (and thus other economic performance indicators) as a sign that the welfare state can indeed co-exist with a free-market system.

Once government grows to a certain size it is no longer possible for the productive sector to adapt and neutralize the negative impact of government. The burden of taxes, market-distorting spending and associated regula-

tions becomes too heavy for private businesses to carry. GDP growth suffers noticeably.

This is where the economy hits the first breaking point. The first sign is a weaker ability to recover from a recession. The recovery takes longer and average growth after the recovery is slower than it was before the recession.

This warning sign is usually ignored by politicians and economists. The reason is not primarily that they are ideologically biased in favor of the welfare state. More likely, the reason is that modern economists do not work with quantitative instruments that are structural in nature: it is difficult to simulate the structure of the economy at the same level of rigor as can be done, e.g., with the business cycle. To use well-established economics terminology, the structure of the economy is a stock, or a constant factor comparable to a factory building, while economic activity measured through a business cycle is a flow, comparable to the manufacturing that takes place in a factory. Changes to the stock are considered too rare to offer obvious, statistically significant material for economic models.

As a result, the economics profession tends to shy away from pursuing structural explanations to changes in economic activity. This is likely a major reason why economists have not yet acknowledged the long-term downward shift in GDP growth in countries with expanded, mature welfare states.

#### **D. The Decline Phase and the Second Breaking Point**

The economies of Europe's welfare states continued to grow for the most part of the 20<sup>th</sup> century. During the '70s and '80s they passed the first breaking point and economic growth slowed down notably. This happened when government had grown to consume approximately 40 percent of GDP. One important consequence is a decline in the tax base (and tax revenues) compared to what the welfare state "needs."

During the decline phase the welfare state has a systemic, negative influence on the economy. However, as is evident from the continued growth of government in Europe's welfare states during the last quarter of the 20<sup>th</sup> century, it is unlikely that legislators responsible for economic policy recognize the systemic cause of this growth decline.

Due to this oversight on behalf of responsible politicians, government continues to expand. As the decline phase continues it becomes increasingly difficult to continue the growth and politicians, instead of relieving the burden of the productive sector, resort to policy measures aimed to preserve the welfare state. These measures will be marginal compared to regular policies. There will be occasional tax increases, minor reforms to entitlements and marginal adjustments to government administration. The general course of government policies will not change; spending programs remain largely as they are, generally accompanied by the same structure and levels of taxes.

**Once government grows to a certain size it is no longer possible for the productive sector to adapt and neutralize the negative impact of government.**

**Austerity's initial effect is improvement in the government budget as tax revenues remain constant.**

Small adjustments to entitlement spending, and marginal changes to government administration, initially have little effect on the services and entitlements that government provides. Generally, this is the phase where government is made to operate more efficiently. The public does not notice many of the cost-cutting measures that agencies and administrations put to work. Public satisfaction with government – and by implication the welfare state – stays largely intact. To legislators who implement such measures, this is an indication that government, as it exists, fulfills an economically justifiable role in the economy.

There was a growing interest in growth-promoting policy among politicians and economists during the 1970s and '80s. This interest was especially strong in countries whose welfare states were in the decline phase. Labor-market oriented research led to reforms of labor markets, income taxes and even the education system in many European countries. It is not until recently that such research has attracted attention in the United States, tentatively because U.S. growth did not slow down to European levels until in the last decade.

During the decline phase government is able to balance its budget or keep its deficits within manageable proportions. However, once GDP growth has slowed down enough, and thus increased the GDP share of government high enough, the growth in tax revenues can no longer keep up with the needs of government. As a result, growth-promoting policies

will no longer “do the trick” – in European countries and in American states, periods of deficits exceed periods of a balanced budget. The economy hits the second breaking point.

The U.S. federal government is somewhat of an anomaly here, but the excessive deficits under the Obama administration can be signs that the U.S. government is now reaching this second breaking point. If so, we are on the threshold of the same austerity policies as Europe has experienced in waves since at least the mid-1980s.

It is important to keep in mind that the tolerance and decline phases do not necessarily cover only a few years. Different economies have different resiliency. A large, diversified economy such as America's will be able to prevail in the tolerance phase longer than a small economy such as, for example, Greece. In a similar fashion, an economy that relies heavily on exports, such as Sweden's, can remain in the decline phase for quite some time; the exports industry feeds the economy from markets that are independent of the austerity policies being put in place domestically.

Despite these individual differences, the underlying macroeconomic mechanisms that bring an economy through one phase and into the next are universal.

### **E. The Austerity Phase**

When an economy passes the second breaking point there is a clear shift in fiscal policy. Budget balancing will take precedence over other economic issues, and the bigger the deficit, the more panic-oriented are the attempts

at closing the gap. In practice this means that legislators resort to the kind of spending cuts we earlier classified as harmful.

Harmful spending cuts drain the private sector of resources, thus causing a net reduction of economic activity. But that does not happen instantly. The initial effect is an improvement in the government budget as tax revenues remain constant. However, as soon as the reduced spending takes effect, total economic activity is reduced. This results in more unemployment claims and more people filing for income-eligible welfare. Government spending increases again, though amid a lower level of economic activity.

The net effect of harmful spending cuts is a downward adjustment of economic growth and a maintained or increased government share of GDP. In terms of the extended Rahn curve, this means a continuation of the curve into the austerity phase. In other words, the economy reacts to the harmful cut by neutralizing the effect of the cut.

The other leg of an austerity strategy, namely a tax increase, also comes with a similarly neutralizing effect. A tax increase initially increases tax revenues, thus improving the government budget. But as the well-established Laffer curve explains,<sup>4</sup> there comes a peak where the positive effect on government revenues from the tax increase is reversed and government starts losing money as more businesses buckle under the pressure from taxes.

If the tax increases are big enough the net result will be that tax revenues actually shrink. If the number of taxpayers is reduced as a result of the tax increase, the total collection of revenue as share of GDP will actually fall. When we combine this with the net expansionary effect on government spending from the spending cuts, we are faced with the paradox that:

- A cut in government spending leads to increased government spending; and
- An increase in taxes leads to a reduction in tax revenues.

Since the purpose of the austerity strategy was to close a budget gap, the conclusion is that the austerity policy is entirely counter-productive.

If the austerity policies are repeated, the economy is put on a trajectory of perpetual budget deficits. The harder the government tries to close the gap by means of austerity, the larger the gap will grow. In addition to the persistent budget deficit, the economy also pays the price in form of ever lower growth rates.

Technically, the Rahn curve plunges toward the horizontal axis, but in the form of a loosely shaped cone rather than one line. (See **Figure 2.**) Government spending as share of GDP increases while tax revenues as share of GDP decreases.

**Appendix 2** provides a formal explanation of the austerity paradox.

One important, prevailing effect of austerity policies is that the composi-

**There comes a peak where the positive effect on government revenues from the tax increase is reversed and government starts losing money as more businesses buckle under the pressure from taxes.**

tion of government spending is changed. The deeper into the austerity phase we get, the more of government spending will be concentrated to entitlement programs. There are two reasons for this: first, as economic growth slows down average incomes drop, relatively, thus making more people eligible for entitlements; secondly, it is politically easier to terminate non-entitlement spending than entitlements, which makes non-entitlement spending an easier target when government chooses its austerity-driven spending cuts.

This gradual shift in the composition of government spending explains why the government share of GDP actually increases as a result of austerity policies. Entitlement programs are open to everyone who is eligible, and there is no cap on how many eligible persons are allowed in to a program. The longer austerity policies go on, the more people will be pushed into entitlement eligibility – and entitlement dependency.

This shift in the composition of government spending is reinforced by the efforts of austerity-minded politicians to raise taxes. Higher taxes lead to less activity in the private sector and thereby to both higher unemployment and lower overall earnings. Therefore, the tax-hike side of austerity policies helps push government spending in the direction of entitlements.

One often overlooked effect of this shift in government spending is that it, by itself, drives down GDP growth. When government produces services, paid for with taxes, it makes a positive (meaning higher-than-zero) contribution toward GDP. When government cuts down on, or stops providing, services it removes resources from the economy that otherwise would have contributed toward GDP.

If the spending cuts that remove these resources were part of a strategy to replace government as the service provider with the private sector, the net effect would be higher GDP growth. The private sector is better suited to pay for, produce and allocate education, health care and virtually every other service that is provided by government in traditional welfare states. But a reduction of government spending without reforms to pave the way for private provision of corresponding services causes a net reduction of GDP growth.

As GDP growth slows down, again, there is a move of more people from self-sufficiency into dependency on government-provided entitlements.

#### **F. Greece: A Case in Point**

In the late 1980s Denmark went through a period of austerity policies. An election put an end to it as voters elected a new government that wanted to break the vicious circle of austerity. Their traditional demand-stimulating policies gave temporary relief and created a period of several years of sustained economic growth. However, the causes of the fiscal problems that led to austerity were left in place, which has now put Denmark on a track toward another round of austerity.

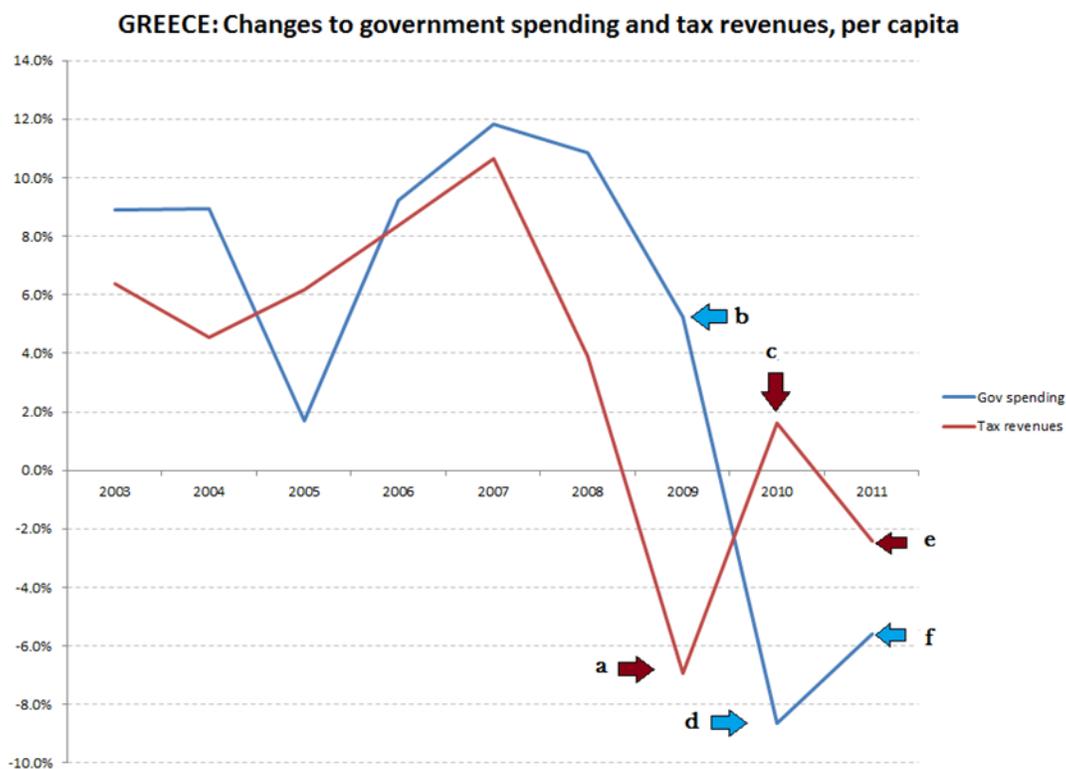
Sweden experienced a period of deep austerity in the mid-1990s. Thanks to a change in monetary policy that led to a 40-percent depreciation of the Swedish currency vs. the U.S. dollar, exports started growing dramatically during the period when austerity was implemented. The result was a dichotomization of the Swedish economy between a depressed domestic sector and a thriving export industry. (Sweden was one of the first countries in Europe where gross exports surpassed private consumption as the largest GDP component.) Tax revenues from the ex-

port industry provided sufficient remedy to ease the austerity pressure and bring the country's slide into the austerity phase to a crawl (see **Figure 3**).

Germany experienced a period of austerity-style policies in the 2000s, but the policies were terminated before they had any lasting, detrimental effects on the economy.

- again (c),
- while per-capita government spending is shrinking (d).
- However, the consequences of these measures show up in 2011, when tax collections are down (e),
- and the downward trend in dependency on government entitlements is replaced by an increase (f).

**Figure 3**



Today, Greece is the country that is most notoriously associated with austerity. As Figure 4 shows, recent events make the Greek economy well suited to illustrate the effects of austerity policies:

- In 2009 the Greek government enacts tax increases (a),
- and spending cuts (b).
- These measures have the desired effect: by 2010 per-capita tax revenues increase

All things equal, the two lines will cross again in 2012: government spending per capita will once again increase while tax revenues per capita will continue to decline.

**II. REMEDIES**

Once an economy enters the austerity phase, legislators will be faced with a very limited set of remedial options. To date, there is no example of a modern welfare-state economy that has pulled out of an austerity phase by

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inherent policy measures. On rare occasions countries have been able to stall the downward austerity trend, but the common factor has always been an exogenous rebound in tax revenues. The example of Sweden in the 1990s is a case in point: exports surged for a number of years after a dramatic depreciation of the currency. Tax revenues from the booming exports industry allowed government to put its austerity policies on hold.

The first option under austerity is to terminate entitlement programs immediately. The only way to motivate such a policy is to rely on a completely static approach to economics. Even if the strategy would combine over-night spending cuts with over-night tax cuts, there is only a very limited likelihood that the strategy would yield strong GDP growth and a balanced government budget. The main problem, from a strictly economic viewpoint, is that the tax cuts and the spending cuts may not target overlapping constituencies. Families in low income brackets who receive entitlements as supplements to their income tend to be net takers from government, while taxpayers in higher income brackets tend to be net contributors. Since low-income families have a higher propensity to consume than high-income families, the short-term result would be a decline in consumer spending. The effect is a decline in economic activity instead of the sought-after expansion.

Another strictly economic reason why this strategy would fail is that overnight tax cuts would flood the economic system with liquidity at a time when demand for liquidity is

low. It is well established that consumers, regardless of income, respond slowly to an increase in disposable income. (The Permanent Income Hypothesis as well as life-cycle theories rest on solid empirical ground.) Furthermore, consumers are even more unlikely to increase spending in a recession. The effect of a large, sudden tax cut is therefore a significant rise in savings. This means a build-up of cash reserves in banks as high-income earners increase their savings balances, a depression of interest rates and a reinforcement of a phenomenon called "the liquidity trap." discussed next.

The second option under austerity is to use monetary policy to stimulate economic activity. Popularly known as "printing money," this option would replace higher taxes with a monetization of government debt as a means to pay for entitlements. So long as this happens in a recession and there is no dramatic expansion in entitlements, there is practically no inflation risk associated printing money. The association between expanding money supply and inflation is based on pop-culture misunderstandings of economics that fail to recognize the need for a transmissions mechanism between more money and prices. That transmissions mechanism is only present when the economy is expanding or government is radically growing its entitlement programs. In the austerity phase, neither is the case.

Printing money to fight austerity is very likely to be entirely ineffective for a reason other than inflation. The reason has to do with the phenome-

non mentioned briefly earlier, known in the economics literature as the liquidity trap. When money supply expands at a given level of money demand, interest rates fall as the bank system tries to sell the newly available liquidity to prospective borrowers. While lower interest rates generally enable stronger GDP growth, two conditions must be met for this to happen. First, there must be enough credit-worthy borrowers to take new debt; the average credit rating of individuals and businesses is lower in a recession than in a strong growth period. Secondly, businesses and individuals who qualify for new loans must have an outlook on their personal financial future that is strong enough to encourage them to borrow. This is also unlikely to be the case in a recession.

When the central bank prints money in a recession, the end result is more than likely that it will add liquidity to an economy that is already saturated with liquidity and thus unable to put more money to work. Hence the liquidity trap.

The third policy option under austerity is Keynesian deficit stimulus. Contrary to what mis-educated opinions of Austrian economists tend to stipulate, Keynes did not develop his theory of deficit spending for regular recessions. Keynes was a depression economist, explaining how an economy can pull out of a situation where the private sector is unequivocally depressed and unable as well as unwilling to take the risk of spending more money. This is a unique situation that does not occur in the regular business cycle but has been misused

by politicians in search of a scholarly motivation to grow government.

The key to understanding the Keynesian anti-depression strategy is to understand the role of effective demand in the economy. The core of Keynes's macroeconomic theory is that the actual spending taking place in an economy will determine the short-to-medium course of key performance variables, GDP growth being one of them. Referring to actual spending as effective demand, Keynes explained that an economy with stagnant or falling effective demand will either go in to a recession or be stuck in a recession.

Effective demand comes from either of four categories of economic agents: consumers, private investors, government or foreign buyers (exports). In a normal recession private effective demand in the form of consumption, investments and exports will balance each other out through the course of a business cycle. When households lose confidence in the economy, some businesses see opportunities and increase investments, thus providing new effective demand to an otherwise stagnant economy. By contrast, a fall in business investments tends to be countered by exports or a rebound in consumer confidence.

In a normal recession there is no need for government to intervene. In fact, government intervention in a regular business cycle is almost always going to distort the allocation and reduce the performance of the economy. The case for a Keynesian intervention comes when the economy continues its downward trend in a recession:

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when the limited pessimism of a recession becomes economy-wide, the private sector is in a sustained state of universal pessimism. The effect of such pessimism is a universal resistance to increasing effective demand. By definition, the economy is in a depression.

Government is the only agent in the economy that can take deliberate action to provide more effective demand. To once again correct a pop-culture misunderstanding of Keynesian economics, it is important to point out that government does not need to spend money to provide more effective demand in the economy. It also has the option to cut taxes.

One of the key features of the economic policy that constitutes austerity is, again, tax increases. In order to reverse the downward trend of higher taxes, growing government and weaker growth, government could therefore reverse its tax policy. By simply declining to raise taxes government would remove one of its two measures that negatively influences the economy; if it stops raising taxes but continues to try to cut spending, it will not add any effective demand. All that it will accomplish is to slow down the drainage of effective demand that drives the economy downward. Tax cuts, on the other hand, put more resources back into the economy.

We could combine tax cuts with spending cuts, preferably productive cuts as defined earlier. However, productive spending cuts take comparatively long time to implement – they are ineffective when as recovery

measures when an economy is in a deep recession or a depression. Such reforms are highly effective in preventing an economy from falling into the austerity phase in the first place, but once we enter the downward spiral of panic-driven, harmful spending cuts, tax increases and declining private-sector activity we no longer have any room for productive, long-term oriented, structural spending cuts.

One alternative is to combine tax cuts with harmful, across-the-board spending cuts. These cuts reduce government's presence in the economy without providing a replacement plan for the private sector. Tax cuts do let the private sector keep more of its resources, a measure that counters some of the negative effects of harmful cuts.

However, the combination is haphazard in the sense that those affected by the spending cuts are not necessarily the ones benefiting from the tax cuts. Even though this combination would be a broader form of withdrawal of government from the economy than if the harmful cuts were combined with tax increases, the net effect on the economy is not going to be much better than stand-alone tax cuts.

In a situation where austerity policies have brought the economy into, or on the verge of, a depression it is critical that every policy measure has maximum effect. A better strategy than across-the-board budget cuts is to freeze spending, cut taxes on a broad scale and wait with spending cuts until confidence and optimism has returned to the private sector.

One measure that does not cost anything is deregulation. There are, essentially, two types of regulations. The first kind is the misguidedly benevolent regulation, which is designed based on a false notion that government can improve the functioning of a market by telling private businesses and their customers how to interact with one another. Regulations on the automobile market belong to this category. The second kind is purposely designed to stifle private business (it is reasonable to count the Dodd-Frank banking regulations to this category).

Regulations of the former kind often win support from legislators who consider themselves friends of the free-market economy, while they are less inclined to support legislation of the latter kind. The problem is that it is difficult to distinguish the economic effects of these two kinds of regulations: the economics literature is generally inconclusive with reference to the motive behind regulations, which indicates that regulations are bad regardless of why they are put in place.

It is difficult to provide any general analytical advice on how to deregulate an economy in the midst of a depression. The reason is that a depression is such an extreme economic environment that standard economic models for the most part do not apply. Furthermore, every economy has a different regulatory system and even in the United States regulations vary from industry to industry, state to state. It is also important to remember that regulations, while costly and stifling to operations and investments in business, do not cause a de-

pression in themselves. Therefore, they can be helpful in pulling the economy out of a recession but not as a stand-alone measure.

When the private sector generally has a positive outlook on the future, it is more willing to take risks and more willing to invest in new industries and sectors of the economy. This is also a good time to initiate productive spending cuts. These are, again, cuts that structurally replace government with private-sector solutions to, e.g., health care, education, retirement and welfare. The more affluent the private sector is, the more resources there will be available for investments in, e.g., private education as an alternative to public education; private, charity-based welfare as opposed to government-provided welfare; and privately funded, owned and operated health care.

Such structural reforms are necessary if we want to prevent the economy from entering the downward slope into the austerity phase in the first place. The cause of the problems that eventually bring us into austerity is to be found in the welfare state. So long as the welfare state remains, it will sooner or later put us on a track to austerity *by its own inherent mechanisms*.

#### **A. Fiscal Re-Routing: A Remedy Tailored for America**

A perfect storm of budget cuts is descending on Washington, DC. It is increasingly likely that Congress will have to start its new session in January 2013 with drastic budget cuts. If they do not get to any other cuts, there are the ones dictated by the

**Deregulation can be helpful in pulling the economy out of a recession, but not as a stand-alone measure.**

2011 sequestration plan.<sup>5</sup> While the sequestration-derived plan is limited to less than one percent of federal spending, it is a safe bet that if there is a change to those spending-cut plans, it will be in the form of more cuts, not less.

From a principled viewpoint there are two ways that Congress as well as the President can reduce spending: reactively or proactively. The reactive strategy means defensive budget cuts and tax increases – austerity. By contrast, under the proactive strategy Congress would make reforms that permanently eliminate cost-driving spending programs.

State governments can also choose between reactive and proactive approaches to their budgets. Most states have very limited deficit problems, but their budgets are nevertheless under stress. Tax revenues are below what they have forecasted and planned for, and the outlook is uncertain if not outright pessimistic. When the federal government offered stimulus funds the states were quick to accept the money and took it as a replacement for lost in-state revenues.

As the stimulus bill is phased out and the flow of federal funds returns to “normal,” states are feeling yet another revenue squeeze: their in-state revenue streams are not picking up because of the persistent recession, and the federal government does not seem willing to make the stimulus funds permanent.

It is tempting for states to respond with reactive austerity measures. They can put such policies to work fast, and the superficial result seems to be a quick, accurate fix for a budget that has run into the red. A closer look, though, shows that austerity never delivers the lasting results that politicians want: on the contrary, once a government resorts to reactive austerity, it will actually aggravate

the problems it is trying to solve.<sup>6</sup>

Proactive reform measures, by contrast, aim to permanently remove the causes of government budget deficits. These causes are embedded in the entitlement programs that make up about two thirds of federal spending, and more than that of state spending.

The mere suggestion that we reform away entitlement programs and permanently replace them with private solutions is radical enough to fall on deaf ears, even among conservatives, but it is nevertheless the only alternative to reactive austerity. The cost of an entitlement program is determined not by what taxpayers can afford, but by the entitlement parameters that politicians have put into the design of the program. These parameters will raise the cost of the program:

- independently of how the economy performs; health care is an example; or
- in direct opposite to the performance of the economy; examples are welfare and food stamps.

In either case the programs will lead to a budget deficit in recessions. The longer the recession, the bigger the deficit. Furthermore, welfare states suffer from a long-term trend of longer deficits and shorter periods of surpluses. The reason is in the mix of the two kinds of entitlement programs: the cost of health care, for example, increases faster than taxpayers’ incomes, on average, which raises the long-term unaffordability of health care. At the same time, welfare programs balance deficits with surpluses over time – at best. As a result there is no program in place that counter-balances the long-term deficit effect of government-provided health care.

Education tends to suffer from a similar long-term cost push as health care does. To accommodate the gradual cost-push in many

entitlement systems, state legislatures tend to adopt baseline budgeting, i.e., a cost increase that is built in to the budget. Habitually, legislators mark up spending by a certain rate each year, typically 6-7 percent.

The baseline increase in spending exceeds the growth in state GDP in most states. In California, perhaps the best known example, state spending increased 1.3 percentage points faster than state GDP for a good quarter century (before the latest recession began in 2008). This means that states have to add money to their budgets each year. They have

In 2009 Congress recognized this when it passed the American Recovery and Reinvestment Act, a.k.a., the stimulus bill. While sold politically as a way to spend money on “shovel-ready” jobs, the real content of the bill was a massive budget bailout of our state governments. The federal funds share of state spending increased dramatically: in 2009 states got \$552 billion through the Federal Aid to States (FAS) program, a 17-percent rise over 2008. In 2010 the federal government sent \$630 billion to the states, up 14 percent over 2009.

**Table 1: Federal Aid to States share of total spending, 2011; \$ millions; NASBO estimates**

SC	50.0%	NC	34.4%	MT	38.6%	KS	26.2%
MS	48.4%	NY	33.7%	NM	38.5%	WA	26.1%
OK	45.5%	NE	32.9%	KY	38.2%	OH	23.9%
TN	45.1%	IA	32.8%	TX	38.0%	VA	23.2%
MI	44.8%	CO	31.0%	RI	37.2%	AK	22.8%
SD	44.2%	MD	30.5%	ME	36.7%	HI	22.8%
AL	43.5%	UT	29.6%	GA	36.3%	DE	22.0%
PA	42.8%	MN	29.5%	ND	36.2%	WY	21.6%
ID	42.8%	NV	28.9%	AZ	35.9%	WV	21.6%
MO	41.6%	IL	28.8%	NH	35.7%	CT	12.3%
LA	41.1%	WI	28.6%	FL	35.5%	MA	7.2%
CA	40.2%	IN	39.2%	NJ	28.0%		
AR	34.6%	VT	38.6%	OR	27.9%		

historically relied on two methods: increases in taxes and fees, or an inflow of more money from the federal government.

Tax increases are, for the most part, off the table. There is a deep reluctance toward spending cuts, and those cuts that do happen tend to be temporary, across-the-board cuts that do not change the driving forces behind government spending. As a result, when state politicians look for measures to save their budgets they are left with only one option: federal funds.

These funds pay for everything under the sun – the FAS program is like a welfare state Wal-Mart. It pays for Medicaid, No Child Left Behind (or Raise to the Top), Title I Education Funds, TANF, WIC, Food Stamps (or SNAP), Low Income Home Energy Assistance, and a long list of other spending items. (While not every single FAS dollar goes toward entitlements, the welfare state constitutes about 80 percent of the program.)

As mentioned, the so called stimulus bill aggravated states’ dependency on the federal

government. As a total share of state spending, Federal Aid to States climbed from 26 percent in 2008 to 36 percent in 2011. The share varies dramatically; however, a total of 12 states get more than 40 cents of their total spending from the FAS program (see **Table 1**).

A major problem with the FAS program is that it slowly but relentlessly erodes state independence. While the United States formally remains a federation, the FAS program is making us look more and more like a unitary nation state, run from the top down, not the ground up. The ARRA Stimulus Bill has, in all likelihood, permanently worsened the situation, even though it was supposed to provide a temporary infusion of cash.

Already in 2011, the National Governors Association asked Congress not to terminate the funds, as that would cause problems in state budgets.<sup>7</sup> Over the past year there have been numerous examples of states lamenting the prospect of losing the temporary extra money. Just a few examples:<sup>8</sup>

- In July 2011, Massachusetts governor Deval Patrick went into panic mode over the prospect of losing even a small share of federal funds, as a result of a temporary shutdown of the federal government;
- Texas Governor Rick Perry accepted a 23.5 percent increase in federal funding every year from 2007 to 2010;
- In April 2011, California legislators were faced with small cuts in federal funds, but were obviously unable to prioritize between school spending and fire and rescue services, as the distribution of cuts was dictated by the federal government;
- In March 2011, Kansas Governor Sam

Brownback learned that even if you try to cut state spending, the federal government can force you not to do it, so long as they send cash your way;

- During the 2011 budget negotiations with the state legislature, Mississippi Governor Haley Barbour tried to use temporary education-designated stimulus funds to meet the state's permanent education spending obligations;
- In one of the most bizarre cases of surrendering state sovereignty, Missouri state Senator Kurt Schaeffer, a Republican, demanded during the 2011 legislative session that the Show-Me state spend every dollar of federal funds it gets, regardless of the long-term consequences for the state – because if they sent the money back to the federal government it would just give it to someone else to spend...

These examples illustrate a prevailing attitude among state legislators and governors that federal funds are in effect free money. This will cause enormous problems for the states as the federal government starts cutting down on the FAS allowances.

#### **B. Is the solution higher state taxes?**

In order to answer this question, let us first look at where the states would have been without the stimulus money. This will help us assess exactly how bad the situation has become just over the past couple of years – and how much effort it is going to take for states to reclaim their fiscal sovereignty.

If the states had not accepted any stimulus money, but instead kept the FAS shares of their total spending at 2008 levels, they would have spent \$235 billion less in 2010 than they actually did, and \$179 billion less in 2011. In theory, now (2012) when the stimu-

lus bill funds are supposedly over, the states are expected to revert back to a spending in that vicinity.

What does that mean, and is it at all realistic to expect them to do so?

The problem is that many states have de facto - if not openly - used the stimulus money to replace lost in-state funding for permanent programs. The aforementioned case from Mississippi is a good example. In order to

other words, almost double its taxes.

South Carolina would have to increase its in-state tax revenues by 73 percent, and Wyoming by 49 percent.

To be more specific, suppose that the states tried to recover the replacement revenues through personal individual income taxes. In the five states with a flat income tax the effects would have been as described in **Table 2**.

**Table 2**

Indiana	from today's	3.4 percent	to	5.2 percent
Massachusetts:	from	5.3 percent	to	6.5 percent
Michigan:	from	4.4 percent	to	10.3 percent
Pennsylvania:	from	3.1 percent	to	6.1 percent
Utah:	from	5.0 percent	to	8.3 percent

maintain their permanent spending they will therefore have to resort to tax increases.

To see what this would mean, let us do a thought experiment. Let us assume that states spent the same amount of money in 2010 but that instead of relying on the large infusion of stimulus money they had raised taxes on their own residents. (We are using 2010 as opposed to 2011 for this experiment because there is more detailed data available for 2010.)

Under these assumptions, states would on average have had to increase their tax revenues by 26.2 percent. Let us refer to this as the *replacement rate* for federal funds at a given spending level.

Some states would have to raise taxes to almost catastrophic levels. At the top of the list is Alaska, which would have had to increase its in-state tax revenues by 91 percent - in

These rates are calculated under entirely static assumptions. It is well known that higher taxes reduce economic activity and therefore erode the very base for the higher tax. As a result, tax increases rarely yield the extra revenues that legislators expect when they raise the taxes.

For a closer look at the effects, let us use Wyoming as an example. The Cowboy State has no personal income tax. Based on IRS data, in 2010 Wyomingites earned an estimated \$12 billion in personal, individual taxable income. According to our calculations above, the state would have needed \$1 billion to replace the stimulus money. That would work out to an eight-percent tax on taxable income.

Using a so called CGE model for the Wyoming economy, an estimation of the effects of this tax indicates a significant loss of private-sector jobs. Compared to a growth trajectory without this tax, Wyoming would lose 14-

15,000 private-sector jobs per year. This would obviously depress private-sector activity and as a result shrink the tax base in the state economy. As a result, in order to balance their budgets the state and local governments would have to cut 4,500-5,000 jobs.

The government job loss number is high compared to the loss in the private sector. The reason for this is that Wyoming has a very large government bureaucracy. In 2011 the state and local governments had 318 employees per 1,000 private-sector employees. This is by far the highest rate in the country. However, the difference between Wyoming and other states is only one of numbers, not of macroeconomic mechanics. Every state that tries to raise taxes to replace federal funds will run into the same kind of problem with losing private jobs and having to reduce the number of government employees.

If states follow the route of tax increases to replace federal funds, they will in other words raise the price on government services – that would be the tax increase – and reduce the quality of the product they give in return for that product. That would be fewer teachers, longer lines at the DMV, fewer police officers and less money for those who depend on welfare.

When our legislators deliberately raise taxes and cut spending in this way, they have put austerity to work. The end result of austerity is nowhere near what politicians think it will be. Unlike the intended goal of balancing the budget and bringing the economy back to growth, it leads to perpetual deficits and puts the private sector in a downward spiral of rising unemployment and zero or negative growth.<sup>9</sup>

## CONCLUSION

Austerity, the combination of harmful spend-

ing cuts and tax increases, drains the private sector of resources without increasing economic activity. When legislators use austerity to balance a government budget, this drainage prevents them from reaching their goal. Instead of improving the economy, austerity policies perpetuate the budget deficits and thus create new motives for more of the same policies.

Proponents of austerity tend to advocate that all spending cuts are good, but they fail to recognize the distinction between productive spending cuts and harmful spending cuts. The former remove permanently a government spending program by combining reduced spending with tax cuts and deregulations. This allows the private sector to develop alternatives to what government has monopolized.

The latter kind of spending cuts are those that reduce current levels of spending in isolation. They do not come with tax cuts or deregulations and thus leave the spending programs themselves structurally intact. As a result, the same factors that caused the initial budget deficit will eventually generate a new one.

It takes more time to implement productive spending cuts than harmful cuts. This is entirely related to the fact that the private sector needs time to develop alternatives to government. When those alternatives emerge, however, the private sector will thrive, as opposed to contract under harmful spending cuts.

Because of the longer time from decision to effect, it is crucial that a legislature that wishes to put structural cuts to work gives itself enough time to do so. It is not advisable for a legislature to wait with structural reforms until the country's credit rating has fallen to the point where interest rates are rising as a result. The United States is not there yet, but

with two credit downgrades recently time is running out.

#### ENDNOTES

<sup>1</sup> Center for Freedom and Prosperity: The Rahn Curve and the Growth-Maximizing Level of Government, June 2010: <http://freedomandprosperity.org/2010/videos/the-rahn-curve-and-the-growth-maximizing-level-of-government/>

<sup>2</sup> <http://archive.freedomandprosperity.org/Papers/rahncurve/rahncurve.pdf> and <http://danieljmitchell.wordpress.com/2012/02/09/data-in-new-world-bank-report-shows-that-large-public-sectors-reduce-economic-growth/>

<sup>3</sup> Nozick, R: Anarchy, State and Utopia, Basic Books, 1977.

<sup>4</sup> Laffer: A: The Laffer Curve: Past, Present and Future, The Heritage Foundation, June 1, 2004: <http://www.heritage.org/research/reports/2004/06/the-laffer-curve-past-present-and-future>

<sup>5</sup> See <http://www.cbpp.org/cms/?fa=view&id=3635>

<sup>6</sup> See [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2048739](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2048739)

<sup>7</sup> See <http://www.larson4liberty.com/2011/02/governors-please-dont-cut-our-allowance.html>

<sup>8</sup> These examples are all documented at [larson4liberty.com](http://www.larson4liberty.com).

<sup>9</sup> See [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2048739](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2048739)

## APPENDIX 1

1. The formal explanation of how austerity policies reduce economic activity begins with the traditional definition of GDP from the demand side:

$$Y = C + I + G + (X - Z)$$

where  $Y$  is gross domestic product,  $C$  is private consumption,  $I$  is gross fixed capital formation (or investments),  $G$  is government spending,  $X$  is exports and  $Z$  is imports.

2. To do a comparative-static analysis we need to define in more detail how each of these variables are determined. Starting with private consumption:

$$C = C_E + b(Y - tY)$$

where  $C_E$  is subsistence consumption, or consumption financed by welfare and unemployment checks,  $b$  is the propensity to consume out of earned income and  $t$  is the average income tax rate.

3. Gross fixed capital formation, or private corporate investment, is determined by:

$$I = aY_{-1}$$

where  $a$  is the propensity to invest based on last year's GDP. This is a very simple representation of the accelerator.

4. Government spending:

$$G = G_C + G_E$$

where  $G_C$  is government consumption and  $G_E$  is spending on entitlements. It is assumed that  $G_E = C_E$  at all times.

$G_C$  is the form of government expenditure that pays for services, such as public education, and goods, such as school buses. It is customary in national accounts theory and macroeconomics to treat government investments equally to government consumption (unlike the private sector where investments are reported as a separate type of spending). Therefore, government investments are assumed to be included in  $G_C$ .

5. Exports:

$$X = xY_W$$

where  $x$  is the propensity of the world – represented by global GDP or  $Y_W$  – to buy our goods and services.

6. Imports:

$$Z = zY$$

where  $z$  is the propensity to import based on our GDP.

7. We substitute these definitions of each of the five variables in equation 1. We then add three basic quantitative assumptions that largely represent the U.S. economy: the propensity to consume,  $b$ , is 0.7 or 70 percent of the last earned dollar, net taxes; the income tax rate is 0.22 or 22 percent on the average earned dollar; and the propensity to import is 0.15, or 15 percent. This gives us the following multiplier for an increase in economic activity (represented here by private consumption):

$$\frac{dY}{dC} = \frac{1}{1-b(1-t)-z} = \frac{1}{1-0.7(1-0.22)-0.15}$$

Suppose we try to increase tax revenues by ten percent by increasing the tax rate,  $t$ , from 20 to 22 percent. The higher tax weakens the multiplier and depresses private consumption. Consumers spend less than they otherwise would have done. Due to the counter effect of a lower level of private spending, the ten-percent increase in tax revenues that politicians wanted ends up being a 4.9 percent increase.

This calculation does not take into account the loss of taxpayers as unemployment rises. If we add that factor, assuming ten percent of the lost GDP translates into increased entitlement spending, the growth in tax revenues is cut in half again, to 2.6 percent.

The neutralization of the tax increase grows with the tax rate and with the rate of government dependency. Suppose, e.g., that the initial tax rate is 40 percent, a realistic assumption for a European welfare state. Suppose also that 20 percent of the lost GDP translates into entitlement dependency, also a realistic assumption for a European welfare state. If government tries to increase its tax revenues by ten percent under these assumptions, total tax collections actually fall.

If we also adjust the propensity to import upward, as we would have to do for a European country, the result from the tax increase is a net reduction in tax revenues. Taxes as share of GDP plummet while government spending as share of GDP continues to rise, just as explained in the extended Rahn curve analysis.

## APPENDIX 2

The trajectory of government entitlement spending as created by austerity policies can be illustrated as follows:

$$G_E = \alpha \sin \left[ \left( \frac{2\pi}{t} \right) t \right] + \rho^R$$

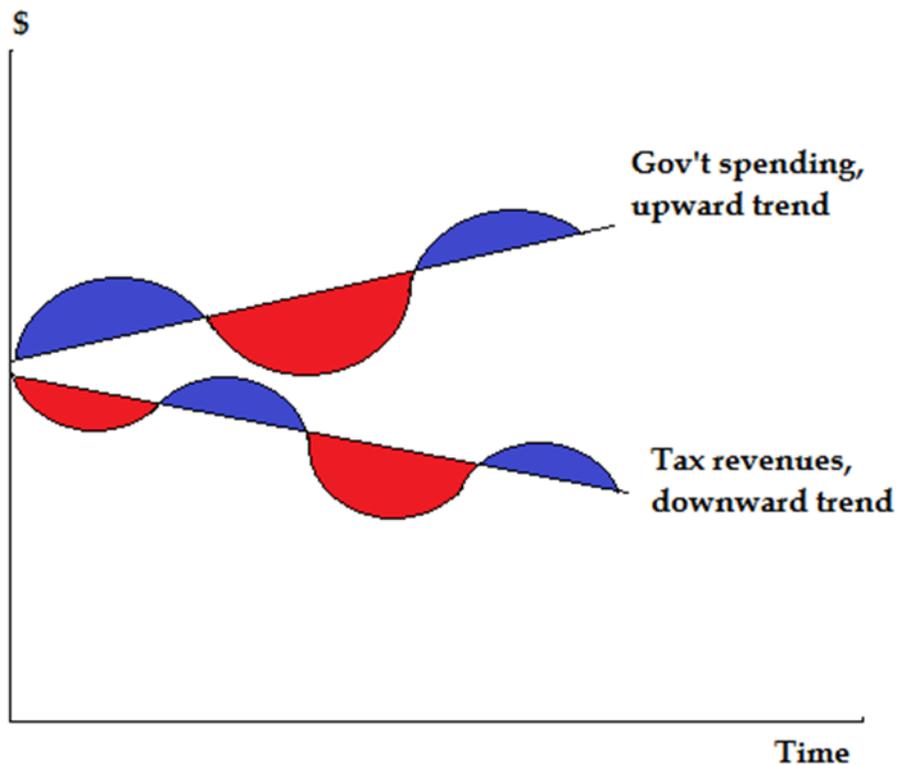
where  $R > 1$ .

In a similar fashion, the long-term trend in tax revenues is negative. Each tax increase erodes the tax base, effectively making the tax increase a self-defeating policy measure:

$$T_E = \alpha \cos \left[ \left( \frac{2\pi}{t} \right) t \right] + \rho^S$$

Here,  $S < 1$ , making the trend negative.

Over time a gap develops between entitlement spending and tax revenues. This gap is driven by the policies that try to close that very same gap: higher taxes and spending cuts. A graphic illustration would look as follows:







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