Austerity: Spending Cut Or Tax Increase?

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John Maynard Keynes, the father of macroeconomics, said that "*The boom, not the slump, is the right time for austerity at the Treasury"*. In plain terms, austerity means cutting down expenditures. In economic jargon, austerity is a policy of by and large living within your means. Going into details, austerity implies reducing government deficits and stabilizing government debt, by cutting government expenditure or increasing revenues primarily through taxes – by curbing tax evasion or by increasing taxes.

The jury is still out on whether or not to choose austerity as a policy in difficult times. The proponents of the austerity policy, such as the International Monetary Fund (IMF) prefer that countries do not accumulate excessive debt and live by and large within their means. On the other hand, those against adopting austerity, argue that cutting down expenditures will starve the economy of the resources required for the development. Similarly raising taxes will make several firms unviable and thus reduce employment and welfare.

Despite the controversy, austerity has been chosen, most of the time, as a policy to manage the high fiscal deficit and high debt burden. For example, during the global financial crisis, *austerity* was the rubric used to define the expenditure-reducing policies at the cost of domestic; social and infrastructural needs.

Austerity, as mentioned earlier, means reducing expenditures or increasing taxes. With the annual budget close by, the discussion on austerity will hype again. This backdrop raises some essential questions. First, does austerity always contracts (slow-down) the economy? Second, if it is inevitable, then what type of austerity should be chosen – reduce expenditures or raise tax revenues? What type of austerity maybe adopted in the upcoming budget?

Austerity may not always contract the economy rather the economy may expand if the cut in public expenditure is followed by reasonable growth in private consumption, private investment, and net exports. Few notable examples of the enjoying expansionary austerity are Ireland, Austria and Denmark, Canada, Spain, and Sweden in the 1980s and 1990s. More recently, the United Kingdom and Ireland did a better job in economic growth despite cutting back on the banking sector's spending. The point is that countries with strong institutions and credible policymaking can generate required expansionary responses.

If austerity is inevitable, then what type of austerity is preferable? Should it be tax-increasing austerity, expenditure-reducing austerity, or both? To answer, we have to figure out which kind of austerity is a lesser evil. PIDE's research, along with others, shows that expenditure-based austerity is less costly than tax-based austerity. We argue that tax-based austerity negatively hits private capital investment. Therefore, it has a longer negative effect in terms of size and time period.

We calculate, along with some guidance from the literature of economics, the *multipliers* – a multiplier, in macroeconomics, is a numerical number showing how large a change in income will result from each change in policy variables like government expenditure or taxes. We establish that there is a considerable difference between the expenditure-based austerity plan and the tax-based austerity plan.

Our research suggests that a one pc reduction in government expenditure is associated with the 0.50 percentage point reduction in GDP. On the other hand, a one pc reduction in fiscal deficit, through increase in tax revenues is associated with around 5 pc loss of GDP growth, and the consequent recession that lasts for several years. This shows that tax-based austerity hurts more as compared to expenditure-based austerity. Moreover over research also tells that a cut in development expenditures causes greater loss to GDP relative to a cut in current expenditures.

In nutshell, if we must pursue austerity then expenditure-based austerity is preferable over tax-based austerity but still, all donor-preferred stabilization programs that have guided our policy have been based on tax increases. We and the IMF need to rethink our stabilization approach. Tax increases for the last three decades have been arbitrary and distortionary, and too frequent. This could be one of the reasons for the declining trend observed in long-run growth and productivity.