Testimony on Vermont State Budget, Deficits, and Borrowing

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Thank you for the opportunity to provide testimony on the state's proposed budget. I am a professor of economics at the University of Vermont, there since 1995. My expertise is as a macroeconomist. I have analyzed and provided input to a number of organizations, including the World Bank and United Nations, during past economic crises—the Asian Financial Crisis and the Great Recession. I have particularly focused on issues of government financing that promote greater economic resilience in response to an economic crisis. Although I am not able to testify in person, I felt compelled to submit testify today to share what we as economists have from the economic crises of the last 3 decades, so that they can be applied to budgetary decisions in Vermont. One of the lessons learned is about the negative impact of budget cuts during a crisis, or austerity, on long-run growth and the state's fiscal position. It is that issue I would like to focus your attention on.

To address the budget woes caused by the harm COVID-19 has done to Vermont's economy, policymakers should be guided by up-to-date economic theory and experience. Budget cuts have been proven to be a misguided and harmful response to the type of economic crisis we find ourselves in.

Rather, there are evidence-based alternatives to budget cuts, grounded in lessons economists have learned from past economic crises. In the 1930s, for example, state governments' efforts to balance their budgets nullified the expansionary policy of the federal government, prolonging the recovery from the Great Depression. Further, the Great Recession of 2008 demonstrated that if austerity measures (cuts to government spending) are adopted too soon, the recovery will be delayed for years, contributing to deterioration of our human capital, resiliency, and small business viability, which will result in long-term damage to our economy and our social fabric.

This evidence has influenced even conservative institutions like the International Monetary Fund to proclaim that cutting spending during a crisis is bad economics. In fact, the evidence indicates that deficit spending (that is, funding spending gaps by borrowing) is the best way to fight the pandemic and economic destruction it has thus far caused. This perspective, based on research of the impacts of fiscal policy in recent crises, stands in contrast to the advice offered to the legislators from some state officials. There is no mainstream economist (including Noble Laureate Joseph Stiglitz) that I know that would support budget cuts for Vermont, given our current conditions. This may differ from advice you have received, for example, from State Treasurer Pearce. Economists' approach to these issues differs because our lens extends beyond strictly finance to encompass the broader effects on the economy of budget cuts vs. borrowing. Cuts have negative economic effects that can outweigh any financial benefits. Yes, there is a cost to borrowing but a full understanding of its impact must also account for the social and economic benefits, beyond financial accounting. I elaborate on this below.

Why is austerity a bad idea right now? Budget cuts reduce spending by definition. This leads businesses and families to cut their consumption and investment, further lowering their spending. This is especially true if the state government cuts personnel (wages and salaries), which seems an inevitable effect of cuts. Businesses cannot survive without customers, and so businesses respond by laying off more workers. This "multiplier" effect means that precipitous cuts in government spending in response to budget gaps due to COVID further depress employment, incomes and, as a result, tax revenue. The result is the opposite of what was intended—a deterioration, not improvement, in the state's budget position. We should be clear—there is no other savior on the horizon. The economy is in an "induced coma." The effect of cuts is less economic activity, higher unemployment and business survival prospects, leading to a worsening of the budget gap. Those are only the short-run negative efforts of budget cuts at a time like this.

The long-run effects, especially of untargeted cuts, are worse. Take, for example, the effect on children's development. Brain neuroscience research shows that everyday hardships have a substantially bigger impact on the poor than the wealthy, and that in children, they cause neurobiological changes that can have long-term negative effects on self-regulation and learning, emotional control, memory and language. This is just one example of how austerity today raises costs in the future, in this case, of social services for kids who have faced deprivation. The costs of cuts clearly outweigh any hypothesized benefits.

Although Vermont has a history of being economically frugal, now is the time to find innovative ways to fund the budget gap. We are one of just a few states that do not require a balanced budget, providing us space to creatively respond to this crisis. Vermont has reserves of about 14% of expenditures, among the highest in the country apart from resource-rich states like North Dakota and Alaska. What can Vermont do then? It can use some of its rainy day funds.

Recent interviews with senior officials at the three largest credit rating agencies—Fitch, Moody's, and S&P Global—by the Pew Research Foundation indicate that tapping the rainy day fund can reduce the chance of a credit downgrade. This is because it is well understood that not addressing an economic crisis with budget support to businesses and households can actually lower economic activity and thus tax revenues, worsening the state's budgetary position.

The state can also borrow—and without the negative effects forecast by State Treasurer Pearce. Vermont has a credit rating of Aa1. As the state emerges from this crisis, higher employment and thus incomes will generate the tax revenue to pay down the debt—and state expenditures will fall.

Vermont can also of course generate more revenue. The 20% highest income households in Vermont received $350 million in tax breaks in 2018 alone, due to the Trump tax cuts. Temporarily clawing back some of those cuts from those who have least suffered from the economic effects of COVID to support those most harmed is an investment in Vermont's economic future. Left unaddressed, the negative effects of economic crisis on small businesses and households will do long-run harm to our economy. A solidarity tax to support those families and businesses can put Vermont on a sounder economic footing in the future.

People often assume that budget gaps are due to reckless overspending. Whatever the circumstances in other cases, this time is different. There is no profligacy. Borrowing and wisely spending those borrowed funds can avoid more layoffs and bankruptcies as well as debt build-up by households, all of which would promote a faster economic recovery than budget cuts at this time.