



# Joint Economic Committee

## Republicans

Senator Sam Brownback *Ranking Member*  
Representative Kevin Brady *Senior House Republican*

## Republican Staff Commentary

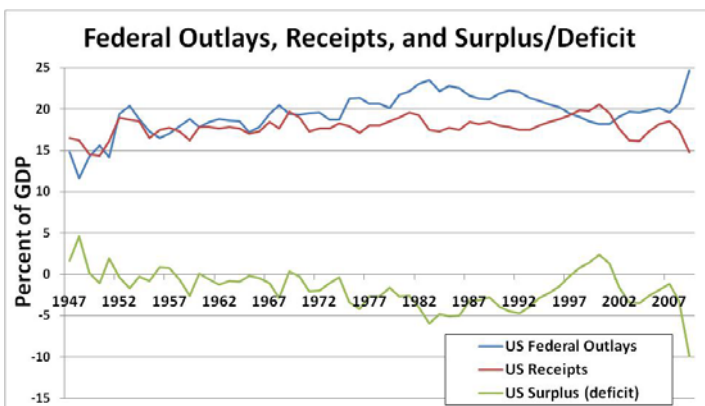
### Less Spending + Lower Taxes = More Jobs, Higher Growth

September 16, 2010

#### Unsustainable Fiscal Course

The U.S. Government is on an unsustainable fiscal course. During fiscal year (FY) 2009, the federal budget deficit was \$1.368 trillion, equal to 9.4 percent of Gross Domestic Product (GDP). At the end of FY2009, gross federal debt (a.k.a. public debt) had grown to \$11.876 trillion, equal to 83.4 percent of GDP, while publicly held federal debt had increased to \$7.545 trillion, equal to 53.0 percent of GDP.<sup>1</sup>

Based on President Obama's *Budget of the United States Government, Fiscal Year 2011*, both the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) project large federal budget deficits during the current fiscal year and for each of the next 10 fiscal years. By the end of FY 2020, the OMB projects that gross federal debt will be \$25.777 trillion, equal to 107.1 percent of GDP, while publicly held federal debt will be \$18.573 trillion, equal to 77.2 percent of GDP.<sup>2</sup> Alternatively, the CBO projects that publicly held federal debt will be \$20.294 trillion, equal to 90.0 percent of GDP, at the end of FY 2020.<sup>3</sup>



A cursory review of these projections proves that higher outlays are the primary cause of persistent federal budget deficits and accumulating federal debt. After World War II (FY1947 to FY2008), federal outlays averaged 19.5 percent of GDP, while federal receipts averaged 17.8 percent of GDP.<sup>4</sup> Over the next ten fiscal years, the CBO projects that federal outlays will average 24.1 percent of GDP, 4.6 percentage points—a 24 percent increase—above the post-war average, while federal receipts will average 18.9 percent, only 1.1 percentage points—a 6 percent increase—above the post-war average.<sup>5</sup>

Measuring federal debt to GDP provides a comparative picture of the unsettling path of government finances relative to the country's economic activity as a whole. The increasing gap between government spending and government's ability to pay encapsulates the unsustainable course government has already embarked upon. When measuring debt to government's ability to pay, the government's fiscal course is more treacherous than Greece's, with U.S. publicly held debt to revenue of 358.1 percent for 2009.<sup>6</sup> As government will only ever obtain a fraction of GDP through taxation, this far gloomier measure identifies how exceedingly limited government's ability to pay for the public debt is. So long as outlays continue to exceed receipts, this ratio will continue to widen.

- In other developed countries, fiscal consolidations based on reducing government outlays have been far more successful in reducing government budget deficits and stabilizing government debt than fiscal consolidations based on tax increases.
- Contrary to the predictions of Keynesian economists and their macroeconomic models, fiscal consolidations based on reducing government outlays did not cause deep and sustained economic slowdowns. Instead, the expectations for higher after-tax income in the future boosted private consumption and investment, increasing real GDP growth over time.
- Fiscal consolidations based on reducing government outlays were politically sustainable because they boosted long-term real GDP growth.

Conceptually, economists divide government budget deficits into two categories: temporary and structural. Temporary budget deficits are due to the adverse economic effects of sporadic events such as a recession, major natural disaster, or war that cause a short-term spike in outlays or a short-term drop in tax receipts. Temporary budget deficits disappear once the adverse economic effects of an atypical event dissipate. Therefore, temporary budget deficits do not generally have significant adverse economic effects.

In contrast, structural budget deficits are due to a long-term excess of government outlays over tax receipts. Structural budget deficits persist unless spending and tax policies are changed. Unlike temporary budget deficits, empirical studies have found that structural budget deficits have significant adverse economic effects.

In May 2010, the CBO estimated that the portion of future federal budget deficits that result solely from the economic downturn—the cyclical element—will peak at a projected \$403 billion, equal to 2.5 percent of GDP, by FY 2011 and then decline rapidly to a projected \$29 billion, equal to 0.2 percent of GDP, in FY 2014.<sup>7</sup> Thus, most of the federal budget deficits over the next 10 fiscal years are structural. As such, policymakers should be very concerned that large federal budget deficits throughout the next decade will have significant adverse effects on the U.S. economy.

### **Bad Fiscal Habit**

In all too many countries, excessive government budget deficits and government debt accumulation have become a bad fiscal habit. Justification for this bad habit can be attributed to John Maynard Keynes (1883-1946) and the Keynesian economists that his work influenced. Keynes advocated countercyclical fiscal policy: during a recession when the unemployment rate is high and aggregate demand is slack, Keynes argued for boosting government outlays through budget deficits to stimulate aggregate demand and create jobs. Keynesian theory was the intellectual rationale for enacting the *American Recovery and Reinvestment Act of 2009* (ARRA).

During booms, however, Keynes advocated that governments run budget surpluses and reduce government debt as a percent of GDP. During the post-war era, policymakers both here and abroad have generally accepted Keynes' advice during recessions, but have largely ignored it once expansions were underway.

In the absence of constitutional restraints on the level of, or increase in, government outlays, taxes, budget deficits, or debt, public choice economists have found that the “concentrated benefits-dispersed cost” paradox—whereby significant benefits can be granted to a relatively small group by spreading relatively insignificant costs across a large population—creates a bias in policymaking toward higher government outlays financed through budget deficits. The current and potential recipients of government outlays have a far greater incentive to lobby policymakers to create or expand programs than taxpayers at large have to lobby against them. At the same time, taxpayers tend to resist tax increases. Without countervailing economic or political forces, the size of government outlays, budget deficits, and debt as a percent of GDP tend to grow over time.

### **Big Government Reduces Economic Growth**

Persistent large government budget deficits and excessive government debt are economically detrimental. As early as November 2009, the IMF expressed concern about the recent increase in government debt in the United States and other developed countries due to stimulus programs. The IMF stressed the need for an orderly withdrawal of stimulus spending:

*Fiscal deficits and government debt levels both affect interest rates. Stabilizing debt at post-crisis levels would imply higher interest rates (perhaps by 2 percentage points). ... This underscores the need for governments to announce credible exit strategies now, even if it is premature to begin exiting from fiscal support.<sup>8</sup>*

Empirical studies have found that excessive government outlays, taxes, budget deficits, and debt accumulation adversely affect economic growth. Regardless of whether government size is measured as outlays or tax receipts as a percent of GDP, Bergh and Henrekson (2010) found that an increase in government size by 10 percentage points of GDP slows the annual rate of real GDP growth by 0.5 to 1 percentage points.<sup>9</sup> Moreover, research on U.S. states found a correlation between high state government debt-to-state GDP ratios and slow rates of state real GDP growth.<sup>10</sup>

In a paper presented at the American Economic Association, Reinhart and Rogoff (2009) examined the link between government debt and economic growth rates over the last two centuries. Reinhart and Rogoff examine over 3,700 annual observations covering a wide range of political systems, institutions, exchange rate arrangements, and historical circumstances. Countries with gross government debt-to-GDP ratios greater than 90 percent grew much more slowly. For advanced countries, the average annual real GDP growth rate was about 2 percentage points lower in countries with government debt-to-GDP ratios greater than 90 percent than in countries with ratios less than 30 percent.<sup>11</sup> This finding is relevant for U.S. policymakers because the federal gross government debt-to-GDP ratio is rapidly approaching the 90 percent threshold for reduced real GDP growth.

### **Why Economic Growth Suffers**

Big government adversely affects economic growth in several ways.

First, structural government budget deficits boost the demand for loanable funds in financial markets relative to the supply. The increased demand for loanable funds tends to drive up real interest rates. Higher real interest rates also tend to increase domestic saving and inflows of foreign investment, but because the demand effects are significantly larger than the supply effects, real interest rates remain higher. In turn, higher real interest rates “crowd out” some private consumption and investment that would have otherwise occurred. At the margin, lower private investment limits the growth in the stock of private productive assets. In turn, a smaller stock of private productive assets than what would have otherwise existed lowers the real GDP growth rate in future years.

Laubach (2007) estimated the impact of federal budget deficits and federal debt on long-term interest rates. Laubach found that a one percentage point rise in the expected federal debt-to-GDP ratio in five years boosted five-year forward yields on ten-year Treasury notes by three to four basis points. Laubach also found that a sustained one percentage point increase in the federal budget deficit-to-GDP ratio increased the five-year forward yield on 10-year Treasury notes by about 25 basis points.<sup>12</sup> Likewise, Furceri and Mourougane (2010) found that a deficit-financed increase in government consumption and investment crowds out both private consumption and investment through higher government bond yields.<sup>13</sup>

Second, most federal outlays are for programs that are unlikely to enhance economic growth. For example, government transfer payments may encourage workers at the margin to leave the workforce or retire. To the extent that transfer payments encourage workers to shift away from market activities, this would have a negative effect on real GDP growth. Bergh and Henrekson (2010) found that higher taxes necessary to pay for transfers had the effect of encouraging workers to avoid taxable activities and engage in more do-it-yourself and non-taxed activities.<sup>14</sup>

Third, while federal outlays for infrastructure, science, and technology may yield net economic benefits, these programs constitute only 4.15 percent (\$147.6 billion) of federal outlays in FY 2010.<sup>15</sup> However, the CBO (1998) found that even these expenditures were “unlikely to have a perceptible effect on economic growth.”<sup>16</sup>

## How Fiscal Consolidation Occurs Matters

While there is a growing consensus that a major fiscal consolidation must occur in the United States, there remains considerable disagreement over whether the fiscal consolidation should occur primarily through (1) increasing taxes to bring tax receipts in line with projected outlays, or (2) restraining spending to bring outlays in line with projected tax receipts. There is also disagreement over *when* the fiscal consolidation should occur.

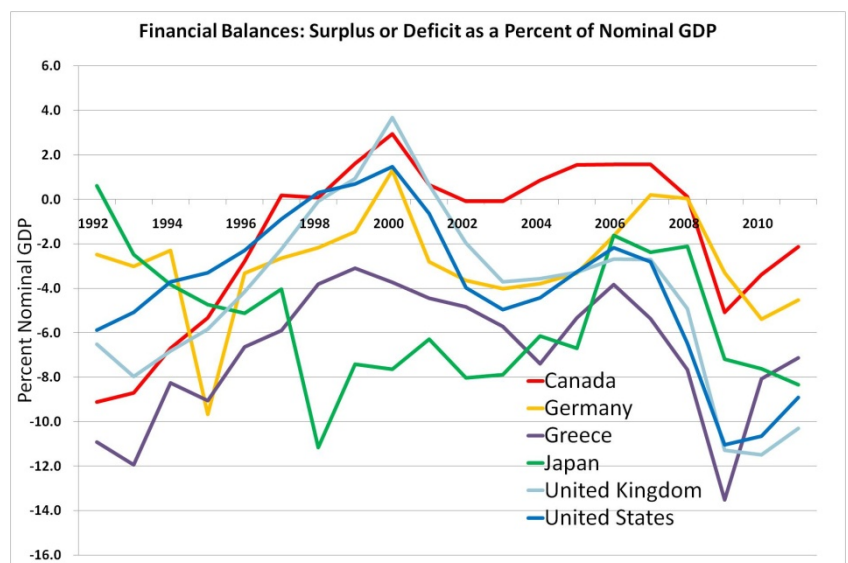
These conflicting views were on display in the G20 summit meeting in Toronto, Ontario, Canada (June 26-27, 2010). German Chancellor Angela Merkel argued that credit market and economic conditions had improved sufficiently to move forward with deficit reduction and stimulus exit strategies. In contrast, President Obama held that significant budget deficit reductions were premature. Without success, Obama pressed other G-20 leaders to increase government spending. In a statement on June 27, 2010, G-20 leaders pledged to halve government budget deficit-to-GDP ratios by 2013 and stabilize government debt-to-GDP ratios by 2016, but the G-20 leaders agreed to let each G-20 country move at its own pace.<sup>17</sup>

A growing body of empirical research suggests that fiscal consolidation through spending restraint is more likely to improve a government's fiscal position than fiscal consolidation through tax increases. Contrary to the predictions of Keynesian economists and their macroeconomic models, fiscal consolidations based on reducing government outlays did not cause deep and sustained economic slowdowns. Rather, government spending reductions caused households and firms to no longer expect future tax increases to service government debt. The change in expectations caused households and firms to boost their current consumption and investment. The expectations-related boost in private consumption and investment more than offset any loss in government consumption and investment from government outlay reductions, resulting in increased real GDP growth. Moreover, fiscal consolidations based on government outlay reductions have proven less politically difficult than many public choice economists previously thought.

Ironically, President Obama recognized that fiscal consolidations based on spending restraint could be economically beneficial in the *Economic Report of the President* (2010):

*Policies that provide gradually but permanent and growing deficit reduction have another potential advantage. By improving the outlook for the long-term performance of the economy, they [governments] can improve business and consumer confidence today. As a result, deficit-improving policies whose effects are felt mainly in the future can actually boost the economy in the short run. There is considerable evidence that such "expansionary fiscal contractions" are not just a theoretical possibility (see, for example, Giavazzi and Pagano (1990); Alesina and Perotti (1997); Romer and Romer (forthcoming)).<sup>18</sup>*

Alesina and Ardagna (2009, revised 2010) examined the effects of fiscal policies in OECD member-countries from 1970 to 2007. Alesina and Ardagna found that high government outlays relative to GDP slow real GDP growth. "[C]ontrolling for initial conditions, a one percentage point higher increase in the current spending to GDP ratio is associated with a 0.75 percentage



point lower growth”.<sup>19</sup> Alesina and Ardagna found that fiscal stimuli based upon tax cuts are more likely to increase real GDP growth than those based on spending increases. Alesina and Ardagna found that fiscal consolidations based on spending cuts without tax increases are more likely to reduce both government deficit-to-GDP and government debt-to-GDP ratios than those based upon tax increases. In addition, Alesina and Ardagna found that fiscal consolidations on the spending side are less likely to create recessions than those on the tax side.

Broadbent (2010) reviewed every major fiscal consolidation in OECD member-countries since 1975. He found that fiscal consolidations that focused on government outlay reductions have been far more successful than those that are tax-driven.<sup>20</sup> In the 1980s and 1990s, a large number of OECD member-countries engaged in fiscal consolidation programs to reduce government budget deficit-to-GDP and government debt-to-GDP ratios. Instead of deep and sustained economic slowdowns, these member-countries experienced relatively fast economic recoveries through growth in private sector consumption and investment.

Giavazzi and Pagano (1990) were first to identify this unexpected phenomenon and referred to it as the perverse effects of fiscal policy. They found that while a cut in government spending reduces aggregate demand over the short term, it also changes expectations, leading households and firms to anticipate a permanent increase in their future income due to lower taxes (or at least the avoidance of future tax increases). In turn, this expectations effect increases private sector consumption and investment.<sup>21</sup> Ironically, the perverse fiscal effect may also explain why President Obama’s ARRA fiscal stimulus package has not been successful. Major new laws such as health care, cap and trade, and ever expanding government spending with huge government deficits as far as the eye can see have the effect of conditioning people’s expectations to higher taxes and hence lower incomes in the future. As a consequence, this expectations effect decreases private sector consumption by households and investment by firms.

When examining the difference between consumption and investment effects, Alesina, et al. (2002) found that changes in private investment explain a greater share of the boost in real GDP growth after large fiscal consolidations than changes in private consumption.<sup>22</sup> Alesina et al. also found a number of supply side effects from government spending cuts. For example, they found that a reduction by one percentage point in the primary spending-to-GDP ratio leads to an increase in private investment by 0.16 percentage points of GDP in the same period, a cumulative increase of 0.50 percentage points of GDP after two years, and a cumulative increase of 0.80 percentage points of GDP after five years. They also found a strong growth effect for spending cuts obtained by reducing government employment costs: the response to a cut in the government’s wage bill by one percentage point of GDP caused an increase in investment of 0.51 percentage points of GDP in the same period, a cumulative increase by 1.83 percentage points after two years, and a cumulative increase of 2.77 percentage points after five years. They also found that tax reductions increase private investment, but to a lesser degree than spending reductions.

A crucial consideration for many policymakers has been their fear that government outlay cuts will be unpopular. However, Broadbent (2010) found that fiscal consolidation based on spending reductions can actually benefit policymakers.<sup>23</sup> Broadbent cites Canada, Ireland, and Sweden as examples of newly elected governments that were able to make these changes without suffering politically.

## **Conclusion**

Fiscal consolidations based on restraining government spending have been far more successful in reducing government budget deficits and stabilizing government debt than fiscal consolidations based on tax increases. Contrary to the predictions of Keynesian economists and their macroeconomic models, fiscal consolidations based on reducing government outlays have not caused deep and sustained economic slowdowns. Instead, consolidations based on reducing government outlays increased expectations for future after-tax income, boosting private consumption and investment and real GDP growth over time. Moreover, fiscal consolidations

based on reducing government outlays were politically sustainable because they boosted long-term real GDP growth.

Gordon Brady and Robert O'Quinn

---

<sup>1</sup> Office of Management and Budget and Haver Analytics.

<sup>2</sup> Office of Management and Budget and Haver Analytics.

<sup>3</sup> Congressional Budget Office and Haver Analytics.

<sup>4</sup> Office of Management and Budget and Haver Analytics. Calculations by authors.

<sup>5</sup> Congressional Budget Office and Haver Analytics. Calculations by authors.

<sup>6</sup> Marès, A., "Ask Not *Whether* Governments Will Default, but *How*," Sovereign Subjects, Morgan Stanley Research, p. 3, August 25, 2010.

<sup>7</sup> Table 1, The Effects of Automatic Stabilizers on the Federal Budget, Congressional Budget Office. May 2010.

<http://www.cbo.gov/ftpdocs/114xx/doc11471/05-27-AutomaticStabilizers.pdf>

<sup>8</sup> *The State of Public Finances Cross-Country Fiscal Monitor: November 2009*, Fiscal Affairs, International Monetary Fund, IMF Staff Position Note, SPN/09/25,

p. 6. <http://www.imf.org/external/pubs/ft/spn/2009/spn0925.pdf>.

<sup>9</sup> Bergh, A. and Henrekson, M., *Government Size and Implications for Economic Growth*. American Enterprise Institute, Washington, D.C., June 2010.

<sup>10</sup> Yandle, B., *Everyman's Deficit: A Result of Decades of Spending beyond Our Means*. Mercatus Center, (July 2010).

<sup>11</sup> Reinhart, C. and Rogoff, K., "Growth in a Time of Debt," NBER Working Paper No. 15639. December 2009.

<sup>12</sup> Laubach, T., "New Evidence on the Interest Rate Effects of Budget Deficits and Debt." *Finance and Economics Discussion Series*, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, DC. 2003-12; Revised May 2007. Also published under same title by the *Journal of the European Economic Association* 7, no. 4: 858-85. 2009.

<sup>13</sup> Furceri, D. and Mourougane, A. "The effects of fiscal policy on output: A DSGE analysis," OECD, ECO/WKP (2010) 26

<sup>14</sup> Bergh, A. and Henrekson, M., *Government Size and Implications for Economic Growth*, American Enterprise Institute, Washington, D.C., June 2010.

<sup>15</sup> Chapter 4, *National Science Foundation Report* (2010). <http://www.nsf.gov/statistics/seind10/c4/c4s4.htm#s1>

<sup>16</sup> The economic effects of federal spending on infrastructure and other investments. June 1998 <http://www.cbo.gov/doc.cfm?index=601&type=0>

<sup>17</sup> Bloomberg.com, June 27, 2010.

<sup>18</sup> *Economic Report of the President* (2010) p. 150. Romer and Romer, which was listed as forthcoming is in the ERP, now published as Romer, Christina D. and Romer, David H. "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks"

*American Economic Review* 100 (June 2010): 763-801. Found at: <http://www.aeaweb.org/articles.php?doi=10.1257/aer.100.3.763>.

<sup>19</sup> Alesina, A. and Ardagna, S., *Large Changes in Fiscal Policy: Taxes Versus Spending* (National Bureau of Economic Research, Working Paper No. 15438, 2009, revised 2010).

<sup>20</sup> Broadbent, D., *Limiting the fall-out from fiscal adjustment*, *Global Economics Paper No. 195*, Goldman Sachs, April 14, 2010.

<sup>21</sup> Giavazzi, F. and Pagano, M., (1990): "Can severe fiscal contractions be expansionary? Tales of two small European countries." In: Blanchard, O. and Fischer, S (eds.): *NBER Macroeconomics Annual*, MIT Press, Cambridge, MA.

<sup>22</sup> Alesina, A., Ardagna, S., Perotti, R., and Schiantarel, F., "Fiscal Policy, Profits, and Investment." *American Economic Review*, Vol. 92, No. 3 (June 2002), pgs. 571-589.

<sup>23</sup> Broadbent, D. (2010) at 21.