Reducing Deficits by Cutting Spending

Statement of Chris Edwards, Director of Tax Policy Studies, Cato Institute,

before the Senate Finance Committee

July 26, 2011

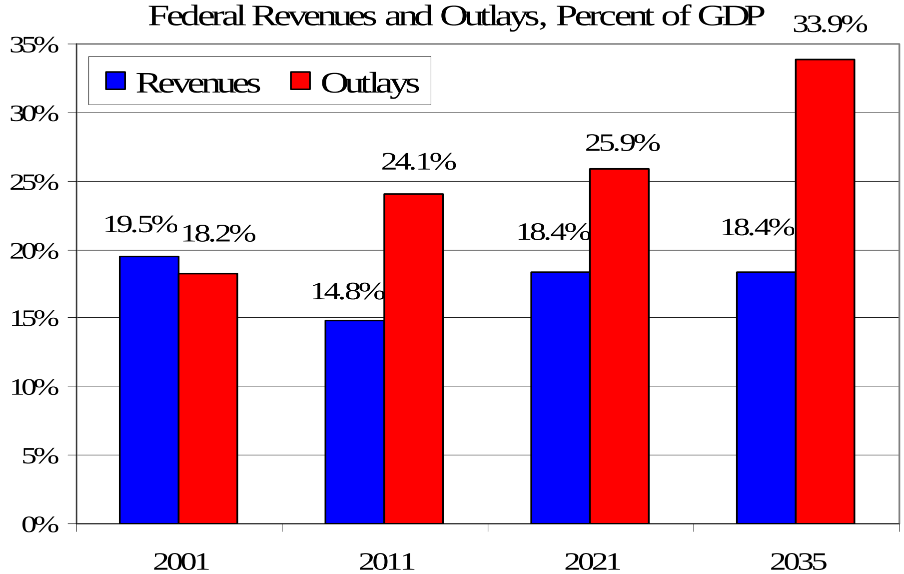
Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding federal deficit reduction. My comments will examine current budget trends and the advantages of major spending cuts.

Current Budget Trends

Federal spending has soared over the past decade. As a share of gross domestic product, spending grew from 18.2 percent in fiscal 2001 to 24.1 percent by fiscal 2011. The causes of this expansion include the costs of wars, growing entitlement programs, rising spending on discretionary programs, and the 2009 economic stimulus bill.

Recent projections from the Congressional Budget Office show that without reforms spending will keep on rising for decades to come.[1] Under the CBO's "alternative fiscal scenario," spending will be 25.9 percent of GDP by 2021 and 33.9 percent of GDP by 2035, as shown in Figure 1. Thus, the federal government is on course to consume an 86 percent greater share of the economy by 2035 than it did a decade ago (33.9 percent vs. 18.2 percent).

Figure 1.
Federal Revenues and Outlays, Percent of GDP



Some policymakers believe that our main fiscal problem is rising debt, and they are calling for a "balanced" package of spending cuts and tax increases. But CBO projections show that the long-term debt problem is not a balanced one—it is caused by historic increases in spending, not shortages of revenues. Excessive spending is the underlying cause of the government's long-run fiscal problems.

The last time the federal budget was balanced was under President Clinton's last budget in fiscal 2001. Policymakers restrained spending to 18.2 percent of GDP that year, and revenues were abnormally high at 19.5 percent of GDP, mainly due to the strong economy. For example, capital gains realizations were soaring, which caused capital gains tax revenues to hit 1 percent of GDP in fiscal 2001.[2]

A decade later in fiscal 2011, revenues are down by 4.7 percentage points of GDP, while spending is up by 5.9 percentage points of GDP. However, revenues are down only temporarily due to the poor economy. Capital gains tax revenues, for example, are expected to be just 0.3 percent of GDP this year.[3] When the economy fully recovers, revenues are expected to rise to at least the long-term normal level of about 18 percent of GDP.[4]

Some people say that the main problem is that the Bush tax cuts of 2001 and 2003 are draining the Treasury. But with the Bush tax cuts in place, federal revenues were 18.2 percent of GDP in fiscal 2006 and 18.5 percent in fiscal 2007. Certainly, the Bush tax cuts of 2001 and 2003 reduced federal revenues, but CBO scoring shows that they roughly just reversed out the federal tax increases of 1990 and 1993.[5]

Note that even with the Bush cuts, the top federal personal income tax rate of 35 percent is higher than the 28 percent rate achieved by bipartisan agreement in the late 1980s. With state-level taxes included, the top U.S. personal rate today is 42 percent, which is the same as the average among Organization of Economic Cooperation and Development countries.[6] In my view, the Bush tax rate cuts on ordinary income, dividends, and capital gains simply brought the United States into better competitive alignment with other advanced economies.[7]

Looking ahead, the CBO projects that with current income tax cuts in place and AMT relief extended, revenues will rise to 18.4 percent of GDP by 2021, or a bit above the normal level of recent decades. For 2035, the CBO simply fixes revenues at the same 18.4 percent, but their discussion indicates that "real bracket creep" would actually keep pushing up revenues as a share of GDP beyond 2021.

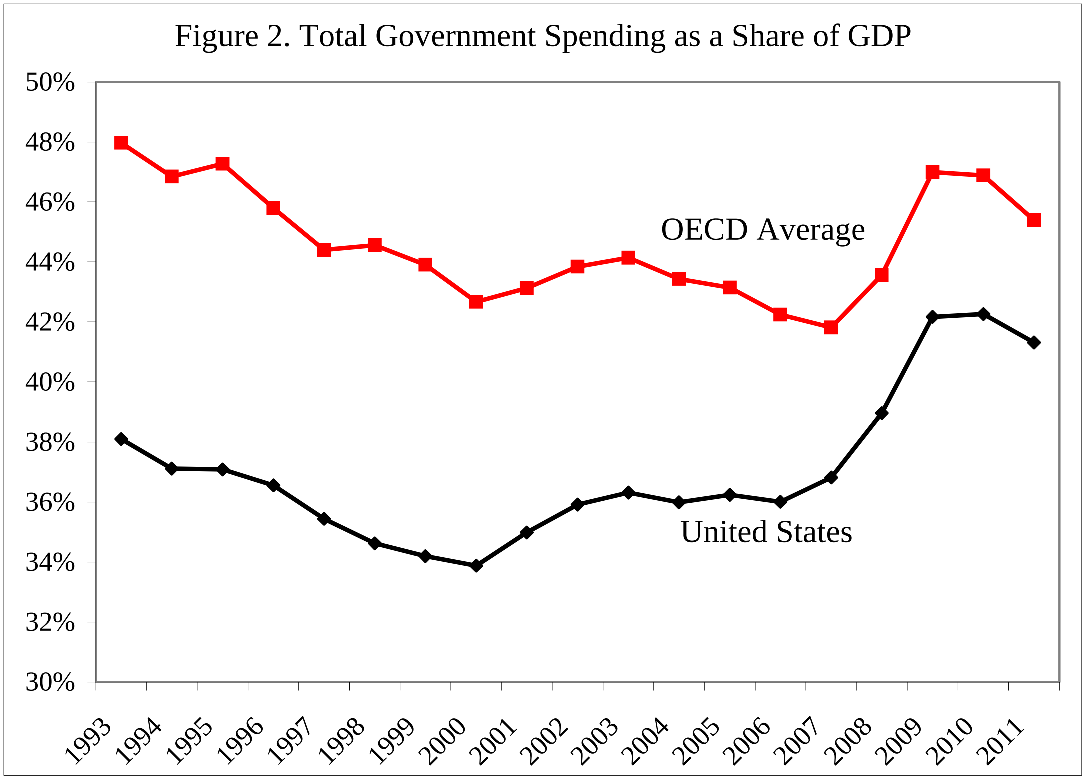
America Has Become a Big-Government Nation

To recap, CBO projections reveal no shortage of federal revenues in coming years. Instead, they show federal spending—which is already abnormally high—rising to unprecedented peacetime levels and the government accumulating massive debt as a result.

The United States used to be a relatively small-government country, but that is no longer the case. OECD data show that total federal, state, and local government spending in the United States in 2011 is a huge 41 percent of GDP.[8]

Figure 2 shows that government in the United States used to be about 10 percentage points of GDP smaller than the average government in the OECD. But that size advantage has now fallen to less than 5 percentage points. A number of high-income nations—such as Australia—now have smaller governments than does the United States.

Historically, America's strong growth and high living standards were built on our relatively smaller government. The ongoing surge in federal spending threatens to undo this competitive advantage that we have enjoyed in the world economy. The CBO's new projections show that federal spending will rise by about 10 percentage points of GDP by 2035. If that happens, American governments will be consuming more than half of everything produced in the nation by that year. That would doom young people to unbearable levels of taxation and a stagnant economy with fewer opportunities.



Source: OECD Economic Outlook Database, May 2011, Annex Table 25.

Government Spending Harms the Economy

There is some talk in Washington about further spending measures to try and stimulate the flagging economy. Yet now more than two years after passage of the $821 billion stimulus package in 2009, it seems pretty clear that that effort was a very expensive Keynesian policy failure.[9]

Note that the total Keynesian stimulus of recent years has been much larger than just the 2009 stimulus bill. In Keynesian theory, the total amount of deficit spending is the amount of demand-side stimulus. We've had deficit spending of $459 billion in fiscal 2008, $1.4 trillion in fiscal 2009, $1.3 trillion in fiscal 2010, and $1.4 trillion in fiscal 2011.

Yet despite that enormous deficit-spending stimulus, U.S. unemployment remains stuck at high levels and the recovery is very sluggish compared to prior recoveries. Indeed, the current recovery is the slowest since World War II by various measures.[10] Economists Robert Gordon of Northwestern University and Robert Hall of Stanford University recently concluded that it has indeed been the worst recovery.[11]

Obama administration economists had claimed that the Keynesian "multipliers" from government spending are large, meaning that spending would give a big boost to GDP. But other macroeconomists have found that Keynesian multipliers are actually quite small, meaning that added government spending mainly just displaces private-sector activities.[12] Stanford University Professor John Taylor took a detailed look at GDP data over recent years, and he found little evidence of any benefits from the 2009 stimulus bill.[13] Any "sugar high" to the economy from recent increases in government spending was apparently very small and short-lived.

The reality is that Washington is very poor at trying to micromanagement short-term economic performance. Its failed stimulus actions of recent years have just put the nation further into debt, which has harmed our long-term prosperity. Harvard University's Robert Barro calculated that any short term benefit that the 2009 stimulus bill may have provided from small spending multipliers is greatly outweighed by the future damage caused by higher taxes and debt.[14]

Let's take a look at how federal spending damages the economy over the long-run. Federal spending is financed by the extraction of resources from current and future taxpayers. The resources consumed by the government cannot be used to produce goods in the private marketplace. For example, the engineers needed to build a $10 billion government high-speed rail line are taken away from building other products in the economy. The $10 billion rail line creates government-connected jobs, but it also kills at least $10 billion worth of private jobs.

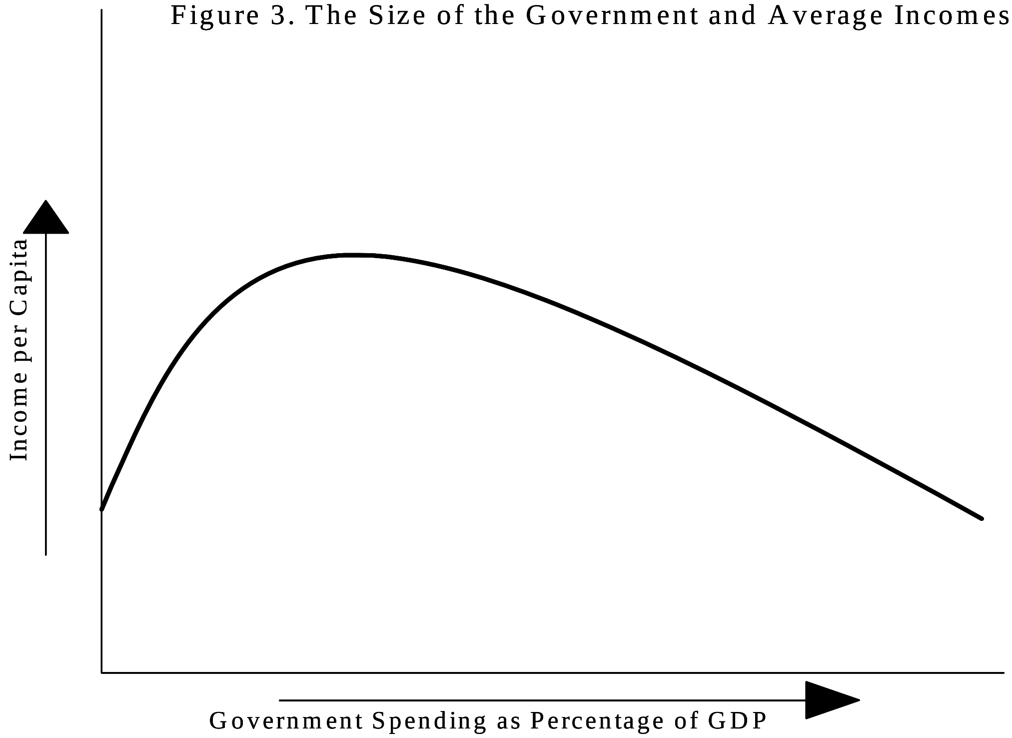
Indeed, the private sector would actually lose more than $10 billion in this example. That is because government spending and taxing creates "deadweight losses," which result from distortions to working, investment, and other activities. The CBO says that deadweight loss estimates "range from 20 cents to 60 cents over and above the revenue raised."[15] Harvard University's Martin Feldstein thinks that deadweight losses "may exceed one dollar per dollar of revenue raised, making the cost of incremental governmental spending more than two dollars for each dollar of government spending."[16] Thus, a $10 billion high-speed rail line would cost the private economy $20 billion or more.

The government uses a "leaky bucket" when it tries to help the economy. Former Council of Economics Advisors Chairman, Michael Boskin, explains: "The cost to the economy of each additional tax dollar is about $1.40 to $1.50. Now that tax dollar … is put into a bucket. Some of it leaks out in overhead, waste, and so on. In a well-managed program, the government may spend 80 or 90 cents of that dollar on achieving its goals. Inefficient programs would be much lower, $.30 or $.40 on the dollar."[17] Texas A&M Professor Edgar Browning comes to similar conclusions about the magnitude of the government's leaky bucket: "It costs taxpayers $3 to provide a benefit worth $1 to recipients."[18]

The larger the government grows, the leakier the bucket becomes. On the revenue side, tax distortions rise rapidly as marginal tax rates rise.[19] On the spending side, funding is allocated to activities with ever lower returns as the government expands. Figure 3 illustrates the consequences of the leaky bucket. On the left-hand side, tax rates are low and the government initially delivers useful public goods such as crime reduction. Those activities create high returns, so per-capita incomes initially rise as the government grows.

As the government expands further, it engages in less productive activities. The marginal return from government spending falls and then turns negative. On the right-hand side of the figure, average incomes fall as the government expands. Government in the United States—at more than 40 percent of GDP—is almost certainly on the right-hand side of this figure. In a 2008 book on federal fiscal policy, Professor Browning concludes that today's welfare state reduces GDP—or average U.S. incomes—by about 25 percent.[20] That would place us substantially to the right in Figure 3, and it suggests that major federal spending cuts would increase U.S. incomes over time.

Figure 3. The Size of the Government and Average Incomes



Cutting Federal Spending

Federal spending is soaring, and government debt is piling up at more than a trillion dollars a year. Official projections show rivers of red ink for years to come unless policymakers enact major budget reforms. Unless spending is cut, the United States is headed for economic ruin. I've proposed a detailed plan at www.DownsizingGovernment.org to cut spending on entitlements, defense, and discretionary spending over 10 years to balance the budget.[21]

The essays on this Cato website provide evidence that many federal programs produce very low or negative returns. Many programs—such as Medicare and the EITC—have high levels of fraud and improper payments. Other programs create economic distortions, damage the environment, or restrict individual freedom.

The federal government has expanded into hundreds of areas that would be better left to state and local governments, businesses, charities, and individuals. Reviving constitutional federalism is one important way to help reduce federal spending and debt. Cutting federal spending would also enhance civil liberties and improve democratic governance by dispersing power from Washington.

Conclusions

In recent years, policymakers have put great time and effort into trying to manipulate the short-run economy. These efforts have been very unsuccessful, and the government is much further in debt as a result.

Instead, policymakers should turn their full attentions to long-run spending reforms. They should begin terminating the many unneeded and damaging federal programs that draw resources out of the private sector and sap the economy's strength. The Cato Institute has documented the reasons why we should terminate many federal programs and agencies at www.DownsizingGovernment.org.

In addition, Congress should create budget restraint mechanisms to encourage policymakers to make spending tradeoffs. In their recent testimonies to the Senate Finance Committee, former Senator Phil Gramm and former Comptroller General David Walker proposed mechanisms to target and control deficits. However, it would be better for new budget mechanisms to target spending, not deficits. A simple mechanism would be to impose a cap of three percent on the annual growth in total federal outlays. Even that modest restraint would be enough to balance the budget in a little over a decade.[22]

Some policymakers worry that spending cuts would hurt the economy, but other high-income nations have cut spending with very positive economic results. In the mid-1990s, for example, Canada faced a debt crisis caused by runaway government spending—similar to our current situation. But the Canadian government changed course and slashed total spending 10 percent in just two years and then held it roughly flat for another three years.[23]

Total Canadian government spending was cut by more than 10 percentage points of GDP over a decade. The Canadian economy did not sink into a recession as Keynesian economists might fear, but instead was launched on a 15-year economic boom. A recent Joint Economic Committee report summarizes other international examples of spending cuts coinciding with strong economic growth.[24] In sum, cutting federal spending is the right policy to strengthen U.S. growth over both the short-term and longer-term horizons.

Thank you for holding these important hearings.

Chris Edwards
Director of Tax Policy Studies
Editor of www.DownsizingGovernment.org
Cato Institute
202-789-5252

cedwards@cato.org

[1] Congressional Budget Office, "CBO's 2011 Long-Term Budget Outlook," June 2011.
[2] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2010 to 2020," January 2010, p. 85.
[3] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2011 to 2021," January 2011, p. 93.
[4] Historical revenue data is available at www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/hist01z2.xls.
[5] CBO scores for the first five years of the various tax changes are shown at www.cato-at-liberty.org/how-big-were-the-bush-tax-cuts.
[6] OECD data is available at www.oecd.org/ctp/taxdatabase.
[7] Virtually all OECD nations provide special treatment to reduce the taxation of dividends and capital gains. For example, numerous countries have tax rates of zero on long-term capital gains. See Chris Edwards and Daniel Mitchell, *Global Tax Revolution* (Washington: Cato Institute, 2008).
[8] Organization for Economic Cooperation and Development, "Economic Outlook Database," May 2011, Annex Table 25, www.oecd.org/dataoecd/5/51/2483816.xls.
[9] The "stimulus" bill was the American Recovery and Reinvestment Act of 2009. For an updated estimate of the bill's cost, see Congressional Budget Office, "The Budget and Economic Outlook," January 2011, p. 13.
[10] Joint Economic Committee, "Uncharted Depths: Welcome to Barack Obama's 'Recover Bummer,'" Republican Staff, June 23, 2011.
[11] Quoted in www.cato-at-liberty.org/biggest-keynesian-stimulus-slowest-recovery.
[12] See, for example, Robert J. Barro, "Government Spending Is No Free Lunch," *Wall Street Journal*, January 22, 2009; John F. Cogan and John B. Taylor, "The Obama Stimulus Impact? Zero," *Wall Street Journal*, December 9, 2010; John H. Cochrane, "Fiscal Stimulus, Fiscal Inflation, or Fiscal Fallacies," University of Chicago Booth School of Business, February 27, 2009.
[13] Dr. John Taylor, Testimony to House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, February 16, 2011.
[14] Robert J. Barro, "The Stimulus Evidence One Year Later," *Wall Street Journal*, February 23, 2010.
[15] Congressional Budget Office, "Budget Options," February 2001, p. 381.
[16] Martin Feldstein, "How Big Should Government Be?" *National Tax Journal*, vol. 50, no. 2, June 1997, pp. 197-213.
[17] Michael Boskin, "A Framework for the Tax Reform Debate," in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution, 1996), p. 14.
[18] Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 179.
[19] Deadweight losses rise more than proportionally as tax rates rise.
[20] See Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 188.
[21] www.DownsizingGovernment.org/balanced-budget-plan.
[22] www.cato-at-liberty.org/federal-budget-cap-at-3.

[23] See www.cato-at-liberty.org/cutting-government-the-canadian-way and www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.
[24] Joint Economic Committee, "Spend Less, Owe Less, Grow the Economy," Republican Staff, March 15, 2011.