The Damaging Rise in Federal Spending and Debt

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

before the Joint Economic Committee

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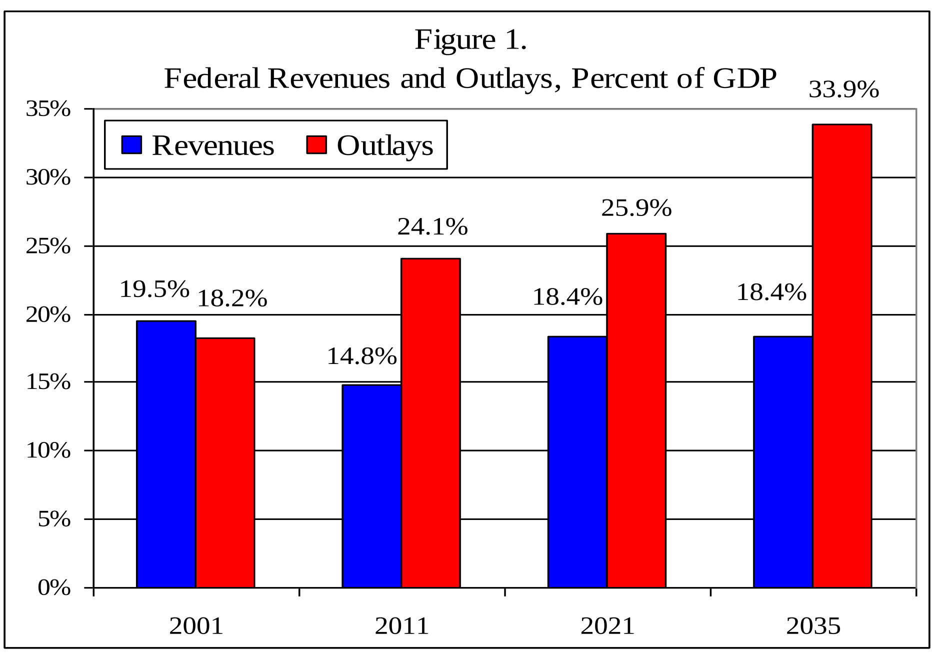
Mr. Chairman and members of the committee, thank you for inviting me to testify today. My comments will examine the likely damage to the economy if federal spending and debt keep spiraling upward.

Rising Spending and Debt

Federal spending and debt have soared over the past decade. As a share of gross domestic product, spending grew from 18 percent in 2001 to 24 percent in 2011, while federal debt held by the public jumped from 33 percent to 67 percent. The causes of this expansion include the costs of wars, growing entitlement programs, rising spending on discretionary programs, and the 2009 economic stimulus bill.

Projections from the Congressional Budget Office show that without reforms spending and debt will keep on rising for decades to come.[1] Under the CBO's "alternative fiscal scenario," spending will grow to about 34 percent of GDP by 2035, as shown in Figure 1, and federal debt held by the public will increase to at least 187 percent of GDP.



Hopefully, we will never reach anywhere near those levels of spending and debt. Going down that path would surely trigger major financial crises, as the ongoing debt problems in Europe illustrate. It is also very unlikely that Americans would support such a huge expansion of the government. The results of the 2010 elections suggest that the public has already started to revolt against excessive federal spending and debt.

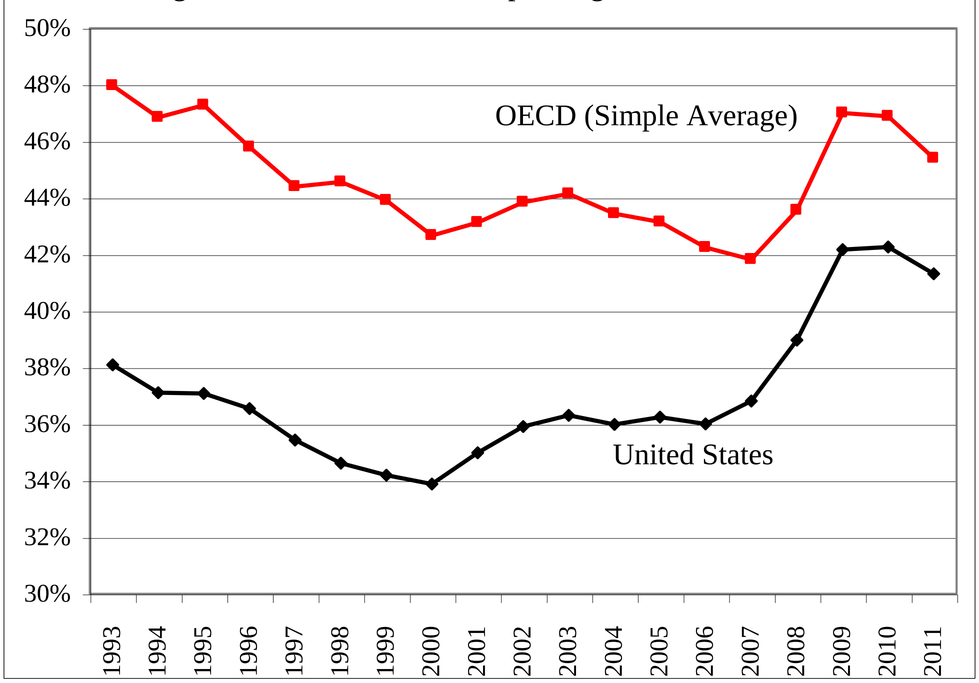
Some policymakers are calling for a "balanced" package of spending cuts and tax increases to reduce federal deficits. But CBO projections show that the long-term debt problem is not a balanced one—it is caused by historic increases in spending, not shortages of revenues. Revenues have fallen in recent years due to the poor economy, but when growth returns, revenues are expected to rise to the normal level of about 18 percent of GDP—even with all current tax cuts in place. It is spending that is expected to far exceed normal levels in the future, and thus spending is behind the huge increases in debt that are projected.

America Has a High-Spending and High-Debt Government

Some analysts say that America can afford to increase taxes and spending because it is a uniquely small-government country. Alas, that is no longer the case. Data from the Organization for Economic Cooperation and Development (OECD) show that federal, state, and local government spending in the United States this year is a huge 41 percent of GDP.[2]

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 fallen to just 4 percentage points. A few high-income nations—such as Australia—now have smaller governments and much lower government debt than the United States.

Figure 2. Total Government Spending as a Share of GDP

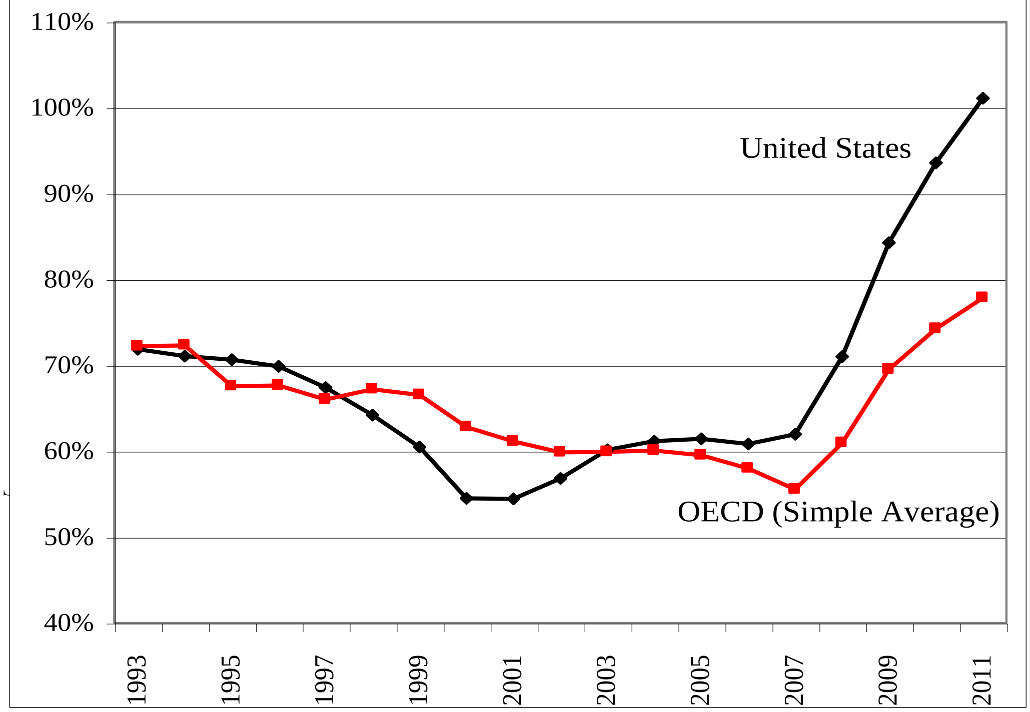


Source: OECD Economic Outlook Database, September 2011, Annex Table 25.

Historically, America's strong growth and high living standards were built on our relatively smaller government. The ongoing surge in federal spending is undoing this competitive advantage we had enjoyed in the world economy. CBO projections show that without reforms federal spending will rise by about 10 percentage points of GDP by 2035. If that happens, spending by American governments will be more than half of GDP by that year. That would doom young people to unbearable levels of taxation and a stagnant economy with fewer opportunities.

American government debt has also soared to abnormally high levels. Figure 3 shows OECD data for gross government debt as a share of GDP.[3] (The data include debt for federal, state, and local governments). In 2011, gross government debt is 101 percent of GDP in the United States, substantially above the OECD average of 78 percent.[4]

Figure 3. Gross Government Debt as a Share of GDP



Source: OECD Economic Outlook Database, September 2011, Annex Table 32.

Harmful Effects of Deficit Spending

Federal deficit spending has exploded. Even with the recent passage of the Budget Control Act, the deficit is still expected to about $1 trillion next year. The damage caused by this spending includes:

1. Transferring resources from higher-valued private activities to lower-valued government activities. With government spending already at 41 percent of GDP, new spending will likely have a negative return, which will reduce output.

2. Creating pressure to increase taxes in the future, which would reduce growth. Higher taxes impose “deadweight losses” on the economy of at least $1 for every $2 of added revenues, as discussed below.
3. Increasing federal debt, which creates economic uncertainty and a higher risk of financial crises, as Europe’s woes illustrate. Research indicates that economic growth tends to fall as debt rises above about 90 percent of GDP, as discussed below.

Economists in the Keynesian tradition dispute the first point. They believe that the demand-side “stimulus” benefits of spending are so important that they outweigh the problems of microeconomic distortions and misallocations caused by federal programs. However, it is very difficult to see any economic boost from the huge deficit spending of recent years.

The total Keynesian stimulus in recent years includes not only the 2009 stimulus package of more than $800 billion, but the total amount of federal deficit spending. We’ve had deficit spending of $459 billion in fiscal 2008, $1.4 trillion in fiscal 2009, $1.3 trillion in fiscal 2010, and $1.3 trillion in fiscal 2011. Despite that huge supposed stimulus, U.S. unemployment remains at high levels and the current recovery has been the slowest since World War II.[5]

The Obama administration claimed that there are large “multiplier” benefits of federal spending, but the recent spending spree seems to have mainly just suppressed private-sector activities.[6] Stanford University’s 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.[7] Any “sugar high” to the economy from spending increases was apparently small and short-lived. Harvard University’s Robert Barro estimates that any small multiplier benefits that the stimulus bill may have had is greatly outweighed by the future damage caused by higher taxes and debt.[8]

John Taylor recently testified that deficit-spending stimulus actions “have not only been ineffective, they have lowered investment and consumption demand by increasing concerns about the federal debt, another financial crisis, threats of inflation or deflation, higher taxes, or simply more interventions. Most businesses have plenty of cash to invest and create jobs. They're sitting on it because of these concerns.”[9]

As federal debt grows larger, the problems caused by fiscal uncertainty will get magnified. The CBO notes that “growing federal debt also would increase the probability of a sudden fiscal crisis, during which investors would lose confidence in the government’s ability to manage its budget and the government would thereby lose its ability to borrow at affordable rates. Such a crisis would . . . probably have a very significant negative impact on the country.”[10]

Research by economists Kenneth Rogoff and Carmen Reinhart found that government debt burdens above 90 percent of GDP are associated with lower economic growth.[11] After examining data on dozens of countries, they concluded that “high debt is associated with slower growth; a relationship which is robust across advanced and emerging markets.” [12] High debt can also be associated with inflation crises, “financial repression,” and other problems. Furthermore, high public and private debt acts as a “contagion amplifier” in the globalized economy.

A new paper by economists at the Bank for International Settlements (BIS) similarly found that when government debt in OECD countries rises above a threshold of about 85 percent of GDP, economic growth is slower.[13] As debt rises, borrowers become increasingly sensitive to changes in interest rates and other shocks. "Higher nominal debt raises real volatility, increases financial fragility, and reduces average growth," the authors note.[14]

The BIS economists conclude that countries should build a "fiscal buffer" by keeping its debt well below the danger threshold. They note that without major reforms, debt-to-GDP levels will soar in coming decades in most advanced economies due to population aging. Thus, one more reason for the United States to cut its spending and debt is to help it weather future financial crises spilling over from countries that are in even worse shape than we are.

Baseline Projections Are Optimistic

In support of building a large "fiscal buffer," policymakers should recognize that both short-term and long-term CBO projections are optimistic in various ways. Perhaps the future will include some positive budget surprises, but the big risk factors seem to be on the negative side.

In CBO's baseline, federal deficits fall substantially over the coming decade, partly due to changes under the recent Budget Control Act. However, spending will be higher than projected if:

- Policymakers lift caps in the Budget Control Act.
- Policymakers launch new spending programs or respond to unforeseen crises or wars.
- Higher interest rates push up interest costs, which is a risk that gets magnified as federal debt grows larger.
- A major recession causes large cost increases in programs sensitive to economic cycles, such as unemployment insurance.
- Policymakers respond to another recession with costly new "stimulus" plans. The persistence of Keynesian policy ideas in Washington is an important risk to the outlook for federal debt.

There are likely to be negative shocks in coming years that we don't foresee. Consider that in its January 2008 budget outlook, CBO projected that U.S. economic growth would slow in 2008 but then rebound fairly strongly in subsequent years.[15] CBO discussed the risk of a recession, but didn't foresee the calamity that was already starting. The upshot is that policymakers should take a conservative approach and build a "fiscal buffer" with large spending cuts now before another recession causes the deficit to soar again.

CBO's long-range projections—such as the "alternative fiscal scenario" (AFS) shown in Figure 1—are also optimistic. In its basic projections, CBO does not factor in the negative effects of rising spending, debt, or taxes on GDP after 2021, but it does do that in a separate analysis.[16] If spending actually followed the course shown in Figure 1, CBO estimates that GDP in 2035 would be up to 10 percent less than shown in the AFS, and

GNP would be up to 18 percent less. In turn, spending-to-GDP and debt-to-GDP ratios would be worse than usually shown in long-range budget charts.

Under the AFS, rising deficit spending could reduce American incomes. The CBO finds that real GNP per capita could stop growing in the late 2020s, and then start falling after that. In a historic reversal, future generations of Americans would become successively poorer.

The way to ensure our continued prosperity is to cut federal spending and reduce debt. In a 2010 analysis, the CBO compared the high-spending AFS with Rep. Paul Ryan's "Roadmap" plan.[17] The Ryan plan would restrain federal spending to roughly current levels for the next few decades, and then start reducing it. By the late 2020s, GNP per capita under the Ryan plan would begin rising above the flat and then falling levels under the AFS. By the late 2050s, GNP per capita would be 70 percent higher under the Ryan plan than under the AFS.[18]

Rising Spending Reduces Growth

Let's take a look at how federal spending damages the economy over the long-run. Federal spending is financed by extracting 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 project are taken away from building other products in the economy. The $10 billion rail project creates government-connected jobs, but it also kills $10 billion worth of private activities.

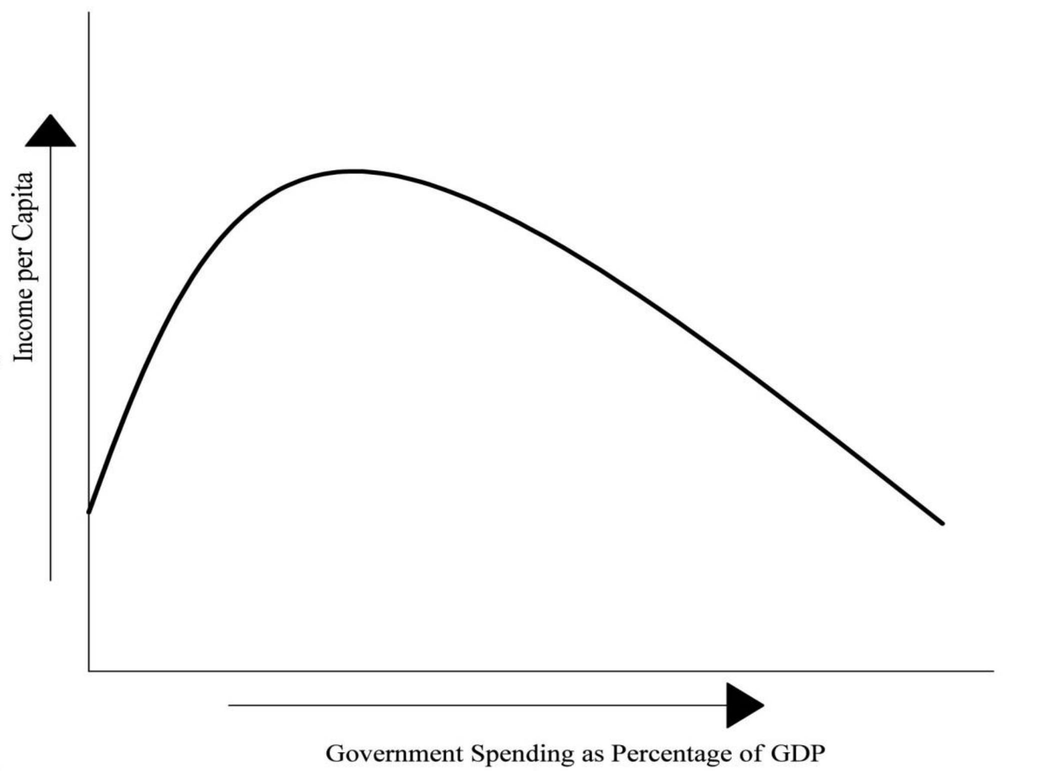
Indeed, the private sector would actually lose more than $10 billion in this example. That is because government spending and taxing creates "deadweight losses," which result from distortions to working, investment, and other activities. The CBO says that deadweight loss estimates "range from 20 cents to 60 cents over and above the revenue raised."[19] 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."[20] 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. Stanford University's 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."[21] Texas A&M University's 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."[22]

The larger the government grows, the leakier the bucket becomes. On the revenue side, tax distortions rise rapidly as marginal tax rates rise.[23] On the spending side, funding is allocated to activities with ever lower returns as the government expands. Figure 4 illustrates the consequences of the leaky bucket. On the left-hand side, tax rates are low and the government delivers useful public goods such as crime reduction. Those activities create high returns, so per-capita income initially rises 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 income falls as the government expands. Government in the United States—at 41 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.[24] That would place us substantially to the right in Figure 4, and it suggests that major federal spending cuts would boost incomes over time.

Figure 4. The Size of the Government and Average Incomes



Conclusions

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 and deficits are cut, the United States is headed for economic ruin as growth falls and rising debt threatens further financial crises.

Policymakers should turn their full attention 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 essays on Cato's website www.DownsizingGovernment.org describe many federal programs that produce low or negative returns. Programs often create economic distortions, damage the environment, restrict individual freedom, or have high levels of fraud and abuse.

I've proposed a plan to cut spending on entitlements, defense, and discretionary spending over 10 years to balance the budget.[25] Spending reforms should aim to revive constitutional federalism and reverse the expansion of the federal government into areas better left to state and local governments, businesses, charities, and individuals.

Some analysts worry that spending cuts would hurt the economy, but other high-income nations have cut spending with very positive results. In the mid-1990s, for example, Canada faced a debt crisis caused by runaway spending—similar to our current situation. But the Canadian government changed course and slashed total spending 10 percent in just two years—which would be like us chopping annual spending by $360 billion in two years.[26] Total government spending in Canada 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.[27] Thus, spending cuts should not be viewed as bad tasting medicine needed only to cure our debt disease, but as an opportunity to create positive and lasting benefits to the economy and society.

Thank you for holding these important hearings.

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[1] Congressional Budget Office, "Long-Term Budget Outlook," June 2011.
[2] Organization for Economic Cooperation and Development, "Economic Outlook Database," September 2011, Annex Table 25, www.oecd.org/dataoecd/5/51/2483816.xls.
[3] Organization for Economic Cooperation and Development, "Economic Outlook Database," September 2011, Annex Table 32.
[4] This is a simple average of OECD countries. The OECD publishes a weighted average, but that figure is, of course, heavily influenced by the United States.
[5] See Joint Economic Committee, "Uncharted Depths: Welcome to Barack Obama's 'Recover Bummer,'" Republican Staff, June 23, 2011. And see the comments of economists Robert Gordon and Robert Hall at www.cato-at-liberty.org/biggest-keynesian-stimulus-slowest-recovery.
[6] See 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.

[7] John Taylor, Testimony to the House Committee on Oversight and Government Reform, Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending, February 16, 2011.
[8] Robert J. Barro, "The Stimulus Evidence One Year Later," *Wall Street Journal*, February 23, 2010.
[9] John Taylor, Testimony to the Senate Finance Committee, Subcommittee on Fiscal Responsibility and Economic Growth, September 13, 2011.
[10] Congressional Budget Office, "Long-Term Budget Outlook," June 2011, p. 22.
[11] The authors summarize their findings in Carmen Reinhart and Kenneth Rogoff, "A Decade of Debt," National Bureau of Economic Research, Working Paper 16827, February 2011.
[12] Carmen Reinhart and Kenneth Rogoff, "A Decade of Debt," National Bureau of Economic Research, Working Paper 16827, February 2011, p. 5.
[13] Stephen Cecchetti, M.S. Mohanty, and Fabrizio Zampolli, "The Real Effects of Debt," Bureau for International Settlements, September 2011.
[14] Stephen Cecchetti, M.S. Mohanty, and Fabrizio Zampolli, "The Real Effects of Debt," Bureau for International Settlements, September 2011, p. 4.
[15] Congressional Budget Office, "The Budget and Economic Outlook: Fiscal Years 2008 to 2018," January 2008, Chapter 2.
[16] See Chapter 2 in Congressional Budget Office, "Long-Term Budget Outlook," June 2011.
[17] Congressional Budget Office, Douglas Elmendorf letter to Paul Ryan, January 27, 2010, www.cbo.gov/ftpdocs/108xx/doc10851/01-27-Ryan-Roadmap-Letter.pdf.
[18] Congressional Budget Office, Douglas Elmendorf letter to Paul Ryan, January 27, 2010, p. 16.
[19] Congressional Budget Office, "Budget Options," February 2001, p. 381.
[20] Martin Feldstein, "How Big Should Government Be?" *National Tax Journal*, vol. 50, no. 2, June 1997, pp. 197-213.
[21] Michael Boskin, "A Framework for the Tax Reform Debate," in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution, 1996), p. 14.
[22] Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 179.
[23] Deadweight losses rise more than proportionally as tax rates rise.
[24] See Edgar K. Browning, *Stealing From Ourselves: How the Welfare State Robs Americans of Money and Spirit* (Westport, CT: Praeger Publishers, 2008), p. 188.
[25] www.DownsizingGovernment.org/balanced-budget-plan.
[26] See www.cato-at-liberty.org/cutting-government-the-canadian-way and see www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.
[27] Joint Economic Committee, "Spend Less, Owe Less, Grow the Economy," Republican Staff, March 15, 2011.