Backgrounder

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Tax Rate Reductions Strengthen the Economy, But Excessive Government Spending Threatens Long-Run Performance

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The American economy is strong. Per capita economic output is at record levels, the unemployment rate is low, and national wealth is climbing. Indeed, the U.S. economy is the envy of the developed world.

America's economy is doing comparatively well in large part because the burden of government is small, especially compared to the burden of the public sector in high-tax welfare states like France and Germany. The 2003 tax rate reductions further enhanced America's competitive advantage by reducing the tax penalty on work, investment, and entrepreneurship.

Lower tax rates certainly help to boost economic performance, but many other government policies also influence decisions to engage in productive behavior. In areas such as trade policy, regulatory policy, labor policy, and monetary policy, there have not been any dramatic changes since 2000. This is good because politicians have not moved policy in the wrong direction, but it is bad because much could be done to reduce the burden of government.

On a less optimistic note, the Bush Administration has presided over a major expansion in the size of government. This hurts growth because political forces rather than economic choices determine the allocation of an increasing share of the economy's labor and capital. The threat is especially pronounced in the long run because of the expected growth of entitlement programs.

State of the Economy

Key statistics paint a generally positive picture of the U.S. economy. All of the important measures of pros-

Talking Points

- The American economy is strong. Per capita economic output is at record levels, the unemployment rate is low, and national wealth is climbing. Indeed, the U.S. economy is the envy of the developed world.
- Per capita disposable income has climbed significantly since 2001. Americans enjoy significantly higher living standards than Europeans, and the gap has grown since 2003.
- The value of financial assets in America is nearly $40 trillion, up sharply from $31.6 trillion in 2001.
- The 2003 tax rate reductions enhanced America's competitive advantage by reducing the tax penalty on work, investment, and entrepreneurship.
- Regrettably, the Bush Administration has presided over a major expansion in the size of government, which hurts America's growth since political forces rather than economic choices determine the allocation of an increasing share of the economy's labor and capital.

This paper, in its entirety, can be found at:
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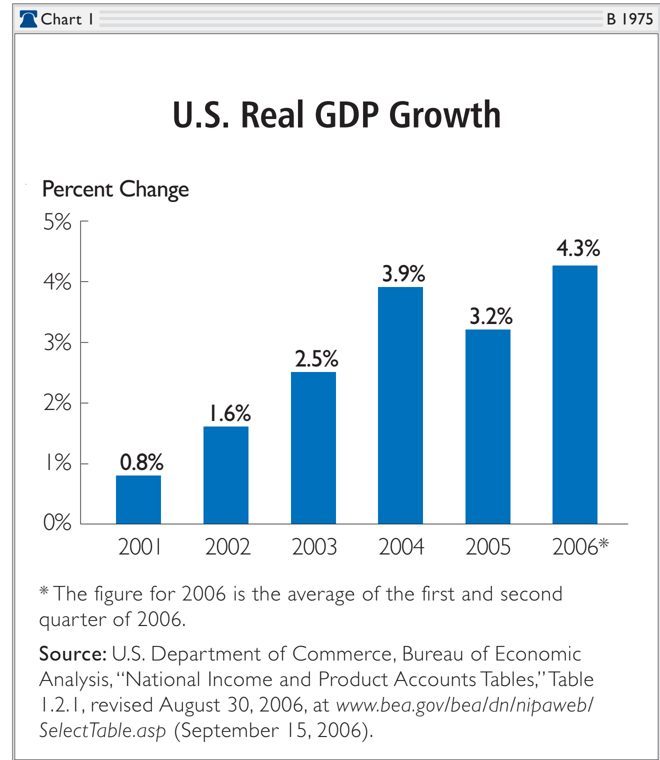
perity (e.g., national economic output, employment and unemployment, income, investment, and wealth) indicate strong economic growth. While many factors determine economic performance, the numbers suggest that the 2003 tax rate reductions were successful in helping the economy become even stronger. America's position is especially remarkable when one considers the lackluster performance of other industrialized nations.

Gross Domestic Product. Gross domestic product (GDP) grew slowly early in the decade, presumably because of the collapse of the stock market bubble and the ripple effects of the 9/11 terrorist attacks. In recent years, however, GDP growth has been quite impressive. The 2003 tax rate reductions played an important role by reducing the marginal tax rates on work, investment, and entrepreneurship. (See Charts 1 and 2.)

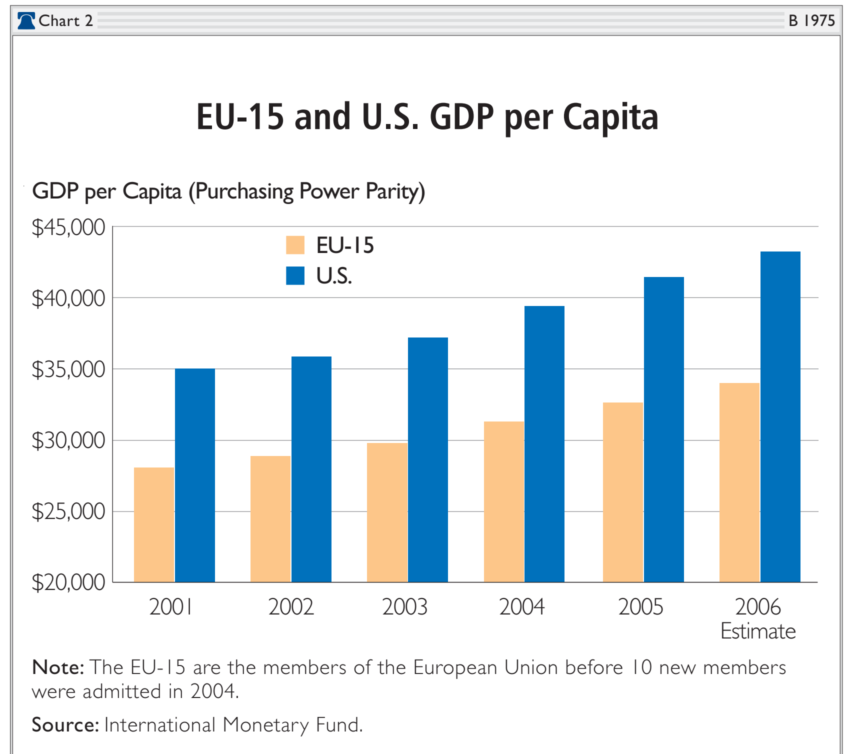
Employment. During the early part of the decade, total employment actually dropped. However, beginning in 2003, employment began to rise dramatically, around the time that the tax rate reductions were enacted. The unemployment rate is now down to 4.7 percent. (See Chart 3.) As of August 2006, 144.6 million Americans were employed—an all-time high. Moreover, the percentage of working-age Americans with jobs is much larger than the equivalent measure for Western Europe. (See Chart 4.)

Disposable Income. The statistic that probably matters most for most people is disposable income. Per capita disposable income has climbed significantly since 2001. (See Chart 5.) Americans enjoy significantly higher living standards than Europeans enjoy, and the gap presumably has grown since 2003,[1] given higher U.S. growth. (See Chart 6.)



* The figure for 2006 is the average of the first and second quarter of 2006.

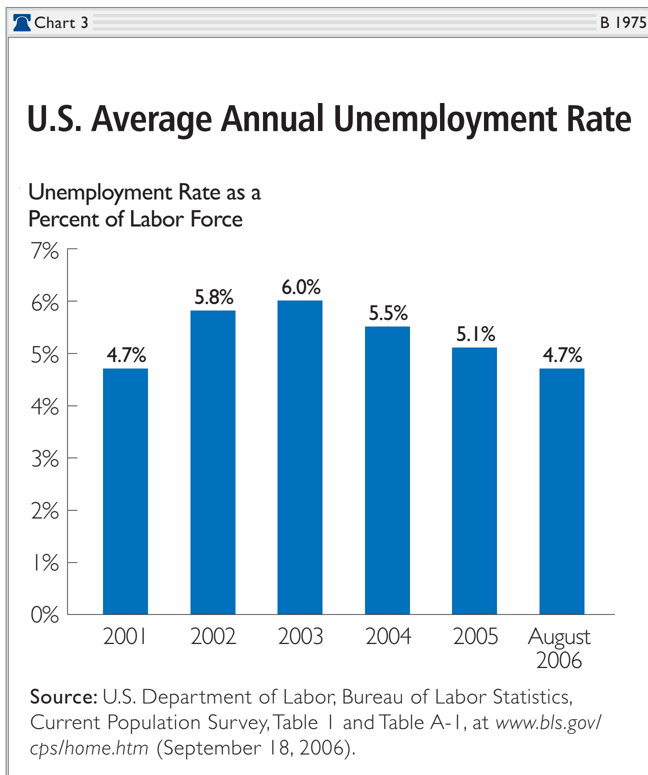
Source: U.S. Department of Commerce, Bureau of Economic Analysis, "National Income and Product Accounts Tables," Table 1.2.1, revised August 30, 2006, at *www.bea.gov/bea/dn/nipaweb/SelectTable.asp* (September 15, 2006).



Note: The EU-15 are the members of the European Union before 10 new members were admitted in 2004.

Source: International Monetary Fund.

1. International data are available only through 2003.



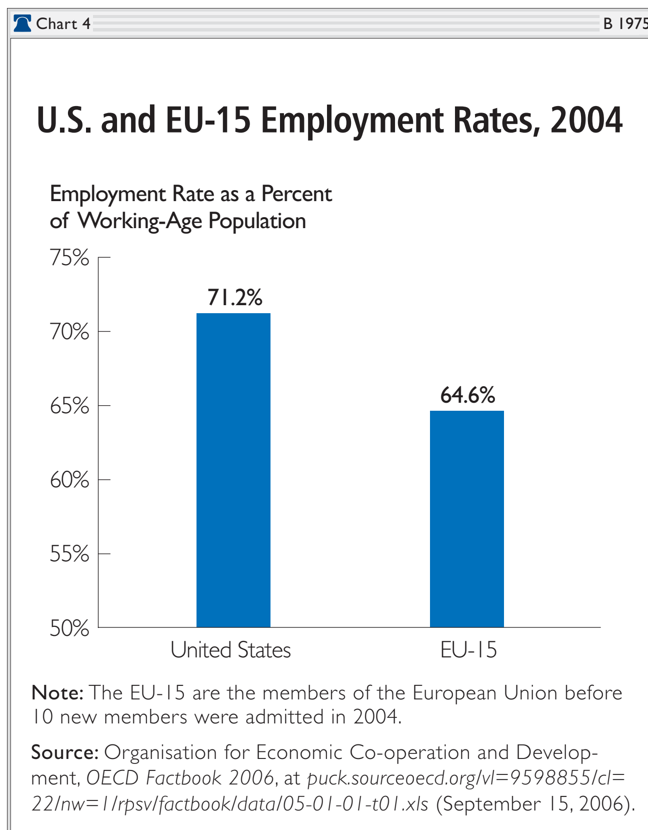
Source: U.S. Department of Labor, Bureau of Labor Statistics, Current Population Survey, Table 1 and Table A-1, at *www.bls.gov/cps/home.htm* (September 18, 2006).

Investment. Investment is a key driver of future economic performance. Between 2001 and 2005, gross investment rose by 17 percent, and net investment rose by 13 percent. (See Chart 7.) Investment was relatively sluggish for the first few years of the decade but has grown rapidly since enactment of the lower tax rates on dividends and capital gains.

Wealth. The value of financial assets in America is nearly $40 trillion, up sharply from $31.6 trillion in 2001. Like disposable income, wealth is an important measure of people's well-being. Wealth did drop in 2002 but began a dramatic climb in 2003. (See Chart 8.)

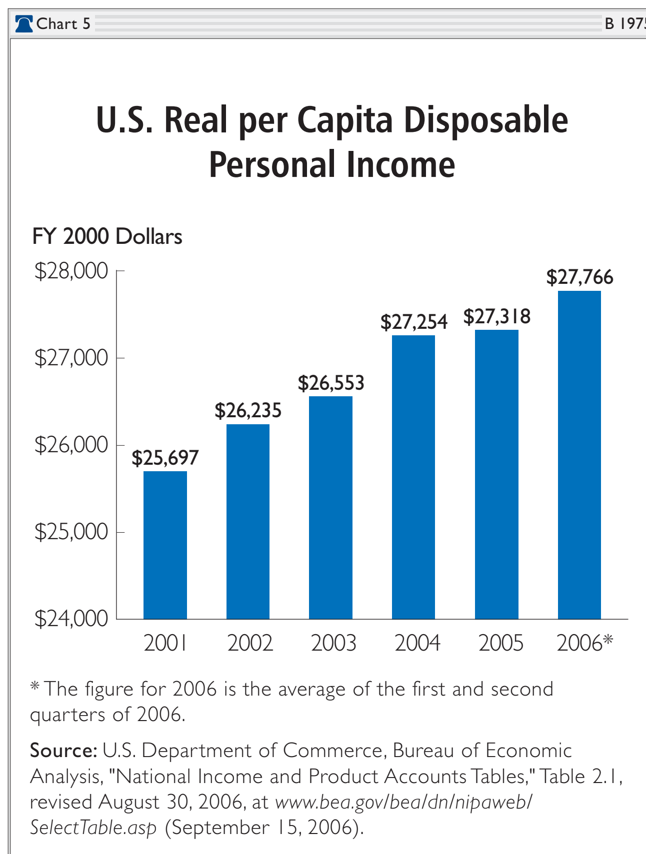
Government Policy and Economic Performance

Government should create and maintain conditions and institutions that facilitate economic growth. Upholding the rule of law and protecting property rights, for instance, will produce an envi-



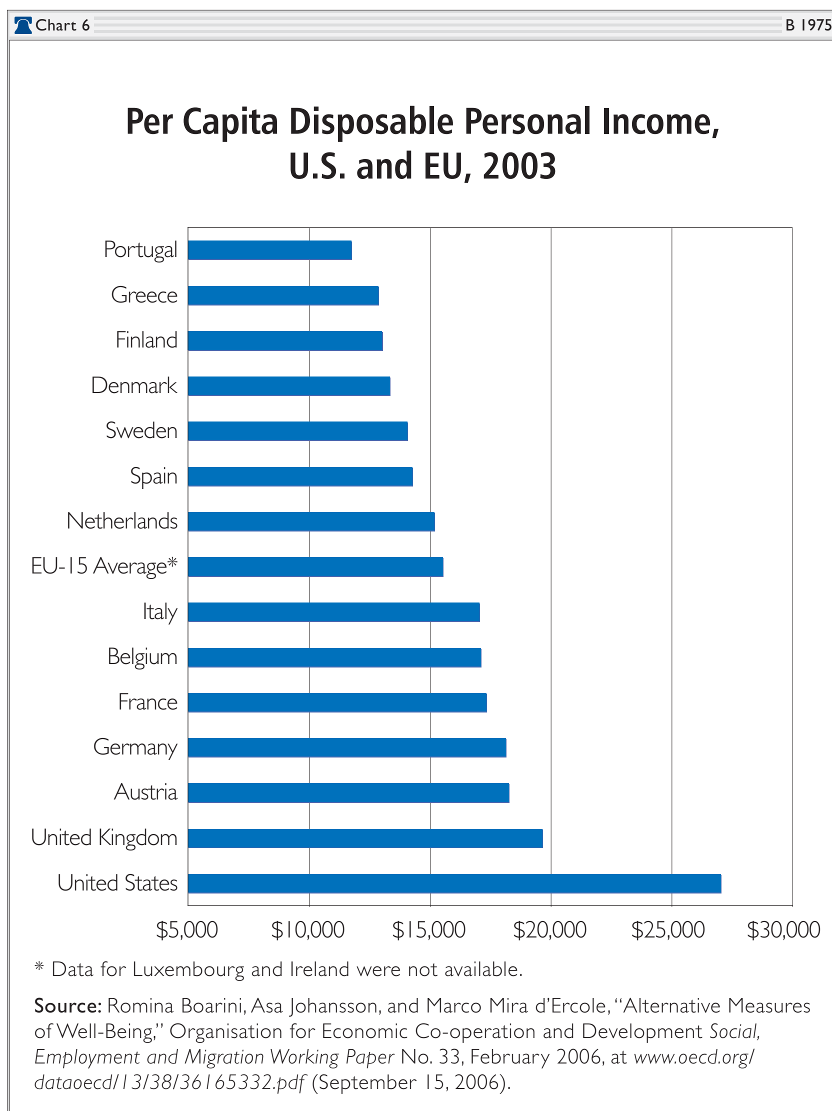
Note: The EU-15 are the members of the European Union before 10 new members were admitted in 2004.

Source: Organisation for Economic Co-operation and Development, *OECD Factbook 2006*, at *puck.sourceoecd.org/vl=9598855/cl=22/nw=1/rpsv/factbook/data/05-01-01-t01.xls* (September 15, 2006).



* The figure for 2006 is the average of the first and second quarters of 2006.

Source: U.S. Department of Commerce, Bureau of Economic Analysis, "National Income and Product Accounts Tables," Table 2.1, revised August 30, 2006, at *www.bea.gov/bea/dn/nipaweb/SelectTable.asp* (September 15, 2006).



* Data for Luxembourg and Ireland were not available.

Source: Romina Boarini, Asa Johansson, and Marco Mira d'Ercole, "Alternative Measures of Well-Being," Organisation for Economic Co-operation and Development *Social, Employment and Migration Working Paper* No. 33, February 2006, at *www.oecd.org/dataoecd/13/38/36165332.pdf* (September 15, 2006).

ronment that is conducive to wealth creation and productive activity.

However, government today is much larger in size and scope than the limited public sector envisaged by America's Founders. This larger government imposes a heavy cost on economic performance. Government spending generally results in the misallocation of labor and capital because political factors guide how those resources are used. The damage is compounded by the high tax rates used to finance the bulk of the spending. Regulations further inhibit growth by raising the cost of engaging in productive behavior.

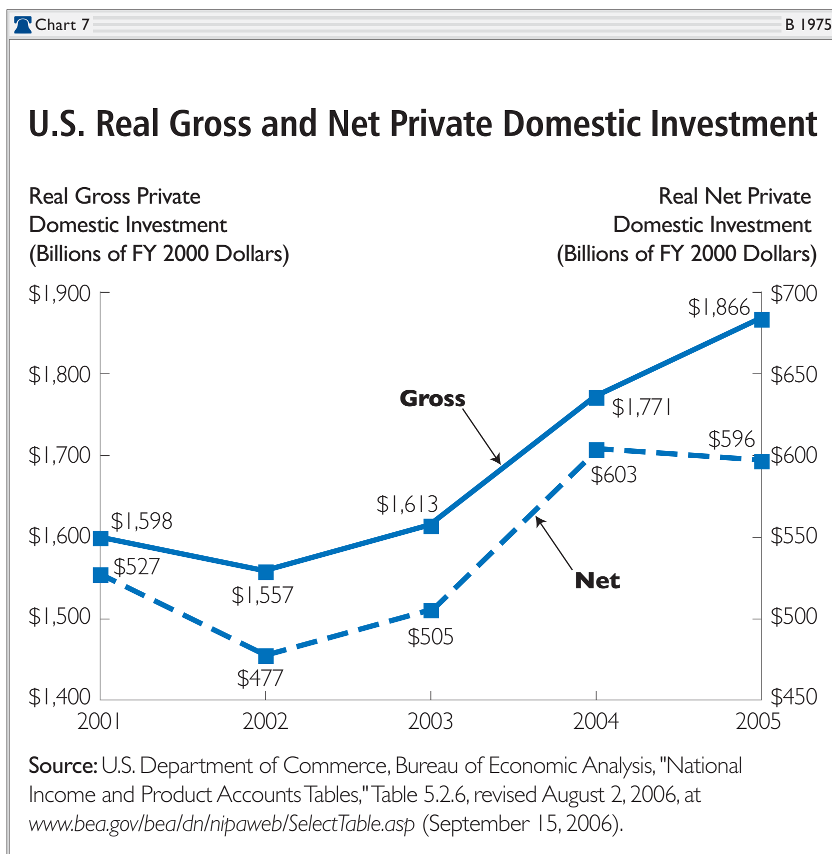
This is why talk about government policies to "grow the economy" is somewhat misleading. Government is not the generator of economic growth and wealth creation. Instead, it is often an obstacle to productive activity. This is why policymakers should focus on reducing or removing the barriers created and imposed by excessive government.

How Policymakers Have Helped Growth. Tax policy is the only area in which policymakers have significantly reduced barriers to economic growth in recent years, although movement in the right direction has been haphazard. Lower taxes can help the economy in two ways.

First, lower taxes can promote growth indirectly by making it more difficult for politicians to spend money. As explained in the next section, however, this "starve the beast" approach has not been very successful in recent years.

Second, tax cuts can promote growth if policymakers reduce marginal tax rates on productive behavior. The 2003 tax cut was very successful in this regard, reducing tax rates on working, saving, and investing. Key provisions included:

1. Immediately implementing the lower income tax rates that were approved in 2001 but were not scheduled to take effect until 2004 and 2006. This dropped the top tax rate from 38.6 percent to 35 percent and reduced other tax rates by similar amounts.
2. Reducing the double taxation of dividends from a maximum of 38.6 percent to 15 percent. This provision significantly reduced the tax penalty on new investment and lowered the tax code's bias in favor of debt-financed investment over equity-financed investment.
3. Reducing the double taxation of capital gains from a maximum of 20 percent to 15 percent.



Like the dividend provision, this reduced the tax penalty on new investment and lowered the tax code's bias in favor of debt-financed investment.

By creating a 15 percent rate for both dividends and capital gains, the 2003 tax law also eliminated a tax bias favoring retained profits (which produce capital gains) over distributed profits (dividends). This helps to ensure that economic factors rather than tax differences guide the allocation of profits.

The 2001 tax package, by contrast, was poorly designed. Almost all of the tax cuts that took effect immediately—such as the rebate, the expanded child tax credit, and the 10 percent tax bracket—had little or no impact on incentives to work, save, and invest. Marginal tax rates were reduced by 1 percentage point (0.5 percentage point in 2001 and 0.5 percentage point in 2002), but the bulk of the marginal tax rate reductions were postponed until 2004 and 2006, and the repeal of the death tax was deferred until 2010.

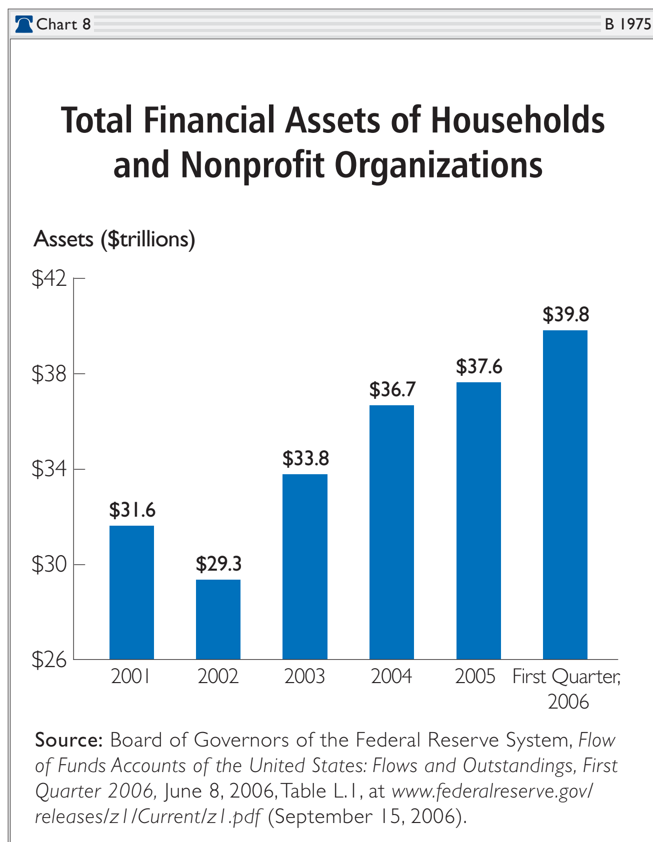
This is one of the reasons why the economy underperformed in 2001 and 2002. Not only was there an economic downturn that began in the final year of the Clinton Administration, but the tax cuts enacted in 2001 did not substantially increase incentives to engage in productive behavior. However, the "supply-side" tax rate reductions of 2003 did lower marginal tax rates, leading to much faster economic growth and much higher levels of job creation.

How Policymakers Have Hindered Growth. Policymakers have dramatically expanded the size and scope of federal spending. Federal spending is projected to increase by 9 percent in 2006 alone—the largest yearly jump since 1990. These spending increases hurt the economy by distorting the allocation of jobs and capital.[2]

This is not just a one-year phenomenon. Total federal spending has skyrocketed 45 percent since President George W. Bush took office in 2001. Adjusted for inflation, spending has jumped by 27 percent in just five years—more than twice as much as real spending grew during the eight years of the Clinton Administration. Measured on an annual basis, inflation-adjusted spending during the Bush years has increased more than three times as fast as it did during the Clinton years. Indeed, spending as a percentage of GDP has grown more under George W. Bush than it has under any other President since Franklin D. Roosevelt.[3]

Outlays for mandatory programs (the so-called entitlements) account for 53 percent of the $820 billion spending increase since 2001. The three

2. All budgetary calculations in this section are based on data from the Office of Management and Budget (OMB) unless otherwise noted.



Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Flows and Outstandings, First Quarter 2006,* June 8, 2006, Table L.1, at *www.federalreserve.gov/releases/z1/Current/z1.pdf* (September 15, 2006).

major entitlements—Medicare, Medicaid, and Social Security—currently consume nearly half of all federal spending and will take a growing bite in each successive year as the baby boomers retire. In just a few decades, overall federal spending will reach levels higher than current spending levels in France and Germany if entitlement spending is left on autopilot.

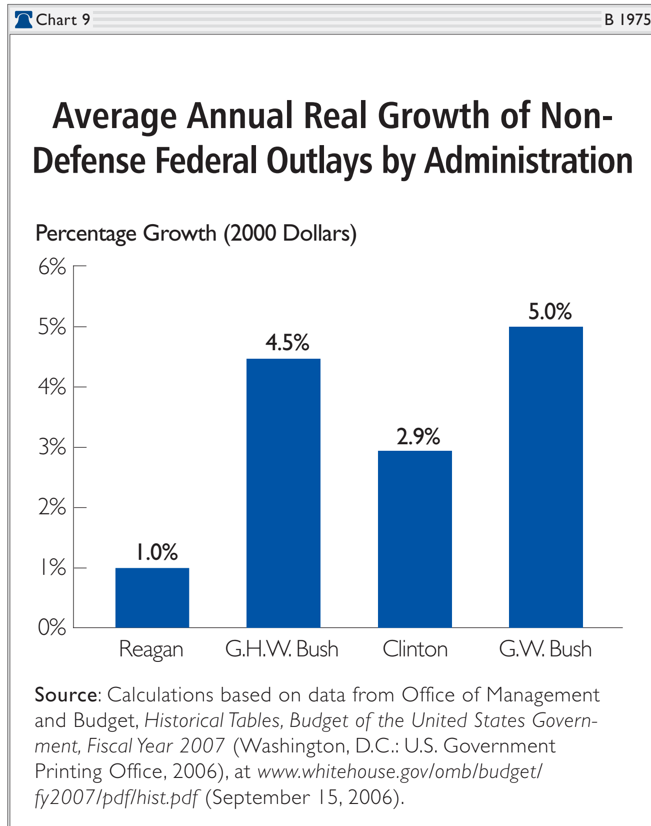
Discretionary spending—the portion of the budget that is appropriated annually by lawmakers—has surged 59 percent since 2001, up from $649 billion in 2001 to more than $1 trillion in 2006. A 77 percent increase in defense spending after 9/11 has largely contributed to the rapid growth in overall discretionary spending under the Bush Administration, although non-defense discretionary spending has also jumped by 44 percent in the same period and is now at record levels in both nominal and inflation-adjusted dollars.[4]

Non-defense spending is responsible for the vast majority of overall spending increases. From 2001 through 2006, federal outlays in nominal terms grew by $820 billion, of which $584 billion (71 percent) went to spending unrelated to defense, including a 2002 farm bill, a 2003 Medicare drug bill, and the 2001 No Child Left Behind Act. The largest domestic spending increases have occurred in education spending (up 137 percent), international spending (up 111 percent), and health research and regulation outlays (up 78 percent).[5]

Even after adjusting for inflation, the record of the Bush Administration is discouraging. Total inflation-adjusted non-defense spending has climbed by 5 percent annually, significantly faster than it grew under Bill Clinton and nearly five times faster than it grew under Ronald Reagan. (See Chart 9.)

The Adverse Impact of Excessive Government Spending. Considerable research shows a negative relationship between high levels of government spending and economic performance.[6] Some of this research is based on cross-country comparisons, which generally show that nations with large welfare states—such as France and Germany—suffer from economic stagnation and high unemploy-

3. Brian M. Riedl, "Observations on Budget Estimates from the Mid-Session Review," Heritage Foundation *WebMemo* No. 1149, July 11, 2006, at *www.heritage.org/research/budget/upload/wm_1149.pdf.*
4. It is important to note that defense increases have largely restored spending to a level consistent with recent history, given that defense spending was diminished dramatically in the 1990s following the end of the Cold War. However, at $440 billion, inflation-adjusted defense spending has quickly surpassed historical levels—and is now $112 billion, or 34 percent above the $328 billion 45-year inflation-adjusted historical average. Non-defense discretionary spending has exceeded its 45-year inflation-adjusted historical average by an even greater margin—$166 billion, or 66 percent higher—even though its growth since 2001 has not been as rapid as the growth in defense spending. The increase in the defense budget is due primarily to the unusual circumstance of the current war on terrorism. Nevertheless, wasteful elements clearly exist within the defense budget and need to be examined just as all other budget items are examined.
5. Brian M. Riedl, "Federal Spending: By the Numbers," Heritage Foundation *WebMemo* No. 989, February 6, 2006, at *www.heritage.org/research/budget/wm989.cfm.*



Source: Calculations based on data from Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2007* (Washington, D.C.: U.S. Government Printing Office, 2006), at *www.whitehouse.gov/omb/budget/fy2007/pdf/hist.pdf* (September 15, 2006).

ment. Other scholars look at historical data and find that nations—such as Sweden—grew rapidly when the burden of government was small but began to stagnate when the welfare state expanded. Regardless of how it is measured, a bigger public sector means less economic growth because, as a director of the Congressional Budget Office has testified, government spending "diverts productive resources from private consumption or investment to government use."[7]

Academic research has consistently found that when government is too large, it hinders economic performance. A recent paper from the European Central Bank (ECB) found that "there is illustrative evidence of a negative relationship between rising public expenditure and economic growth."[8] Another ECB study reported "a strong correlation between total spending increases and growth declines" and noted, "No study has found a positive relationship between growth and aggregate expenditure."[9] Instead, overwhelming evidence points to a negative relationship. A study from the International Monetary Fund (IMF), for example, concludes that "government size has a negative impact on growth.... [D]ecreasing the government size by 5 percentage points, all other things being equal, would raise GDP growth by ¼ percentage point."[10]

Since 2001, the burden of government spending has increased by 2 percentage points of GDP.[11] These studies and many others with similar findings suggest that this spending increase is hindering economic performance. Small reductions in the rate of growth may make only a slight difference in

6. For more information, including a review of the academic literature, see Daniel J. Mitchell, Ph.D., "The Impact of Government Spending on Economic Growth," Heritage Foundation *Backgrounder* No. 1831, March 15, 2005, at *www.heritage.org/Research/Budget/bg1831.cfm*.

7. Douglas Holtz-Eakin, "The Economic Costs of Long-Term Federal Obligations," testimony before the Committee on the Budget, U.S. Senate, February 16, 2005, at *www.cbo.gov/showdoc.cfm?index=6094&sequence=0* (September 18, 2006).

8. Antonio Afonso, Ludger Schuknecht, and Vito Tanzi, "Public Sector Efficiency: Evidence for New EU Member States and Emerging Markets," European Central Bank *Working Paper* No 581, January 2006, p. 29, at *www.ecb.int/pub/pdf/scpwps/ecbwp581.pdf* (September 18, 2006).

9. Antonio Afonso, Werner Ebert, Ludger Schuknecht, and Michael Thone, "Quality of Public Finances and Growth," European Central Bank *Working Paper* No. 438, February 2005, pp. 22 and 23, at *www.ecb.int/pub/pdf/scpwps/ecbwp438.pdf* (September 18, 2006).

10. International Monetary Fund, "Austria: Selected Issues," *Country Report* No. 04/237, August 2004, at *www.imf.org/external/pubs/ft/scr/2004/cr04237.pdf* (September 18, 2006).

11. Federal spending consumes slightly more than 20 percent of U.S. GDP. State and local government spending consumes more than 11 percent of GDP. For more information, see Office of Management and Budget, *Historical Tables, Budget of the United States Government, Fiscal Year 2007* (Washington, D.C.: U.S. Government Printing Office, 2006), pp. 312–313, Table 15.3, at *www.whitehouse.gov/omb/budget/fy2007/pdf/hist.pdf* (September 18, 2006).

the short run. For instance, the IMF study implies that recent spending increases since 2001 have reduced annual growth by 0.1 percent. However, the cumulative effect of even minor differences in growth can have a significant long-run impact on living standards. Indeed, if annual growth is 0.1 percent slower—e.g., 2.0 percent instead of 2.1 percent—total economic output after 30 years would be significantly lower, akin to a reduction in economic output today of $2,740 per household.[12]

The Net Impact. Economic policy in recent years can be described as two steps forward, one step back. The lower tax rates on productive behavior have improved economic performance by reducing the tax code's penalties against work, saving, and investment. The economic benefits of lower tax rates have been partially offset, however, by government spending increases that cause a less efficient allocation of the nation's labor and capital.

A Road Map for Future Prosperity

Economic growth is not a mystery. The rule of law, property rights, and sound money are necessary to create the right foundation for productive activity. Low tax rates and a limited burden of government build upon that foundation by minimizing the barriers to work, saving, and investment.

Therefore, to enhance economic performance, Congress should:

1. **Make the pro-growth portions of the Bush tax cuts permanent.** This item falls into the "first, do no harm" category. If policymakers fail to make permanent (or at least extend) key elements of the Bush tax cuts, the economy will be hit with higher tax rates on working, saving, and investing. Thus, a permanent extension of the lower tax rates on personal income, dividends, and capital gains is essential to maintaining the only significant bit of pro-growth policy enacted during the Bush years.
2. **Implement reforms to shift the Internal Revenue Code closer to a simple and fair flat tax.** Assuming that the supply-side tax rate reductions already enacted are made permanent, the next step is to implement reforms that further reduce marginal tax rates on productive behavior. Ideally, policymakers should strive to enact reforms that shift the tax code toward a flat-rate, consumption-based system such as the flat tax. A flat tax system has worked remarkably well in Hong Kong for nearly 60 years, while flat tax regimes in Eastern Europe have helped former Communist nations enjoy rapid growth.
3. **Cap the growth of federal spending.** Government is too big and is growing too fast. After falling to 18.5 percent of GDP at the end of the Clinton years, the burden of government has since jumped to 20.6 percent of economic output, and most of the additional spending is unrelated to national defense and homeland security. The federal budget should be significantly reduced, but even a modest level of spending restraint would shrink the burden of government as a share of economic output. If the Bush Administration had simply let spending grow at the same rate as it grew during the Clinton Administration, federal outlays today would consume only 16.9 percent of the economy. For those who mistakenly focus on fiscal balance rather than the size of government, this degree of fiscal discipline would have produced a $184 billion surplus.

   However, there is still hope for the future. Merely holding spending increases today to 4 percent annually—approximately the rate of inflation plus population growth—would reduce the burden of government to about 19.1 percent of GDP by 2011—1.5 percentage points below its current level.[13]
4. **Eliminate programs or devolve them to the state and local levels.** A substantial portion of the federal budget is devoted to programs and activities that should be privatized or han-

12. Calculations based on data from Office of Management and Budget, *Historical Tables*.

13. Calculations based on data from Office of Management and Budget, *Historical Tables*.

dled by state and local government. Education, health, transportation, agriculture, and housing are not proper functions of the federal government.

5. **Reform entitlements.** Programs such as Social Security and Medicare should be modernized. Changing these tax-and-transfer entitlements into systems based on private saving and personal ownership would give individuals greater control over their lives. Such reforms would also boost economic performance—in part because the distortionary impact of high payroll tax rates would be mitigated as workers were instead allowed to put monies into personal accounts and in part because changes in Medicare and Medicaid are necessary to restore market forces to the health care system.
6. **Use cost-benefit analysis to rein in regulatory excess.** Government regulation constrains people to act in certain ways. In some cases, such as seat-belt mandates, the requirements can generate benefits at low cost. In other cases, such as pollution restrictions, the requirements can generate benefits at high costs. In still other cases, such as the Sarbanes–Oxley regulations of corporate governance, the requirements impose extremely high costs with almost no benefit. Setting aside the moral issue of whether government should dictate private behavior (such as the wearing of seat belts), lawmakers and government bureaucracies could substantially reduce the economic damage of regulation if they engaged in cost-benefit analysis before imposing new regulations.

Lawmakers should also be guided by the do-no-harm principle. There are many proposals to increase the cost and burden of government. For example, increasing the minimum wage would reduce employment opportunities for low-skilled workers. Letting the tax cuts expire would discourage work, saving, and investment by imposing higher tax rates on productive activity. Expanding government intervention and regulation would hinder the efficient exploration, development, and production of new energy sources.

Conclusion

The U.S. economy has enjoyed strong growth in recent years, especially compared to the lackluster performance of other developed nations. Unemployment is low, income is high, and wealth is at record levels. Government is not the reason for the economy's growth, but policymakers can improve economic performance by reducing or eliminating barriers to productive behavior. The Bush Administration's 2003 tax cut—which lowered marginal tax rates on work, investment, and entrepreneurship—has encouraged growth and improved competitiveness.

Regrettably, the benefits of better tax policy have been undermined, especially in the long run, by excessive government spending. The Bush Administration has presided over a dramatic increase in the burden of government spending. Whether measured in nominal or inflation-adjusted dollars or as a share of GDP, federal outlays have grown at an unprecedented rate. This is harming economic growth because government spending is determined by political rather than economic motives. This results almost inevitably in a less efficient allocation of labor and capital compared to what would happen if market forces governed the use of those resources.

One of the most important lessons from the data is that economic policy matters. Comparisons between America and Europe show that a heavier burden of government is associated with weaker economic performance. It is therefore no surprise that the lower tax rates adopted in 2003 have helped to widen America's competitive advantage, but if government spending continues to climb, the U.S. runs the risk of economic stagnation.

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