

Background

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The Economic Role of Government: Focus on Stability, Not Spending

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Abstract: *Is there a role for government in the economy? Yes, says Heritage analyst Karen Campbell—but the government must focus on maintaining economic stability. Fiscal responsibility is an important part of that stability. Government debt can quickly become a burden on the economy and weaken its foundations. Sound macroeconomic policies enhance the credibility of the government and strengthen the political institutions. This credibility is vital for economic stability and Americans' long-term investment decisions that allow the U.S. economy to flourish.*

In order to restore economic stability, policymakers must focus on restoring the institutional role of governing. Government can provide a stable environment for economic growth when it can be depended upon to maintain the stability of the currency, enforce and defend property rights, and provide oversight that assures private citizens that their transaction partners in the marketplace are held accountable.¹ This will allow market participants to begin putting their resources back to work in the areas where they are most beneficial.²

After decades of lecturing developing countries on how to emerge from economic crisis and stimulate economic growth through sound government policies, U.S. policymakers and some economists are throwing out all their advice during the first major crisis test. This is particularly true when it comes to advice on accumulating more and more debt.

Talking Points

- Government should contribute to the economic growth of a nation and provide the best entrepreneurial opportunities to its citizens.
- Economic downturns can provide an opportunity to reassess processes and undertake reforms that make better use of resources, for example, by eliminating unnecessary compliance costs that no longer aid transparency, and adapting rules and procedures to the new realities in technology and individual lifestyles.
- Policymakers must recognize that accumulating debt also accumulates risk by increasing the claims on yet unrealized future income.
- Creditors believe that the U.S. will be able to produce enough GDP in the future to pay back the debt with interest. But as the debt becomes a larger percent of GDP, the ability to pay back bond holders and sustain the current population becomes increasingly difficult.

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President Barack Obama's fiscal responsibility summit³ last February indicated that he understands the urgent need for fiscal discipline. But Congress's recent enactment of the American Recovery and Reinvestment Act and the President's proposed budget makes the goals of a sustainable budget and addressing the nation's longer-term fiscal priorities, such as entitlement liabilities, even more elusive. The Congressional Budget Office's

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recent "Budget and Economic Outlook" estimated the 2009 budget deficit to be \$1.6 trillion.⁴ The Administration's recently released mid-session review from the Office of Management and Budget estimates that over the next 10 years the accumulated deficits will total \$9 trillion.⁵ This means that the debt held by the public will be a staggering 77 percent of GDP in 2019. If the debt level continues to grow faster than the economy, the U.S. will find that it owes more than it makes.

Government spending and government deficits automatically increase during economic downturns

due to more demands on social-safety-net provisions and falling tax revenues. Such spending can have a stabilizing effect on the economy because it happens automatically rather than through legislative acts, and the money is spent at times it is needed most. Borrowing and spending to stimulate the economy using legislative discretion is much more difficult to time for the right moment, and is thus much riskier. The funds are often not spent until long after the downturn has taken place, and can prolong the downturn by crowding out productive investment and spending that would have otherwise occurred.⁶

Economic downturns, while painful, do afford an opportunity to root out waste and inefficient spending both in the public and private sectors. This is because the opportunity cost of making fundamental reforms is lower during downturns.⁷ This opportunity to reassess processes and undertake reforms that make better use of resources should not be wasted.

Deficits Matter

As with all of economic life, there are trade-offs. Government deficits have both positive and negative effects. Debt is a powerful tool that can magnify gains, but its leveraging power is dangerous because it also magnifies losses. Debt should be used to finance income-producing assets that will be used to

1. For example, ensuring that voluntary transactions made on the basis of false claims will be prosecuted is a deterrent for those who might falsify claims. Knowing that this is a deterrent gives innocent parties the needed assurance to make voluntary transactions without having to write costly contingent contracts for every transaction.
2. Robert Barro, *Determinants of Economic Growth: A Cross-Country Empirical Study* (Cambridge, Mass.: MIT Press, 1998).
3. The summit was convened at the White House on February 23, 2009.
4. "The Budget and Economic Outlook: An Update," Congressional Budget Office, August 2009, at <http://cbo.gov/ftpdocs/105xx/doc10521/08-25-BudgetUpdate.pdf> (September 9, 2009).
5. "Mid-Session Review: Budget of the U.S. Government, Fiscal Year 2010," Office of Management and Budget, August 25, 2009, at http://www.whitehouse.gov/omb/assets/fy2010_msr/10msr.pdf (September 9, 2009).
6. If the money is borrowed from individuals or nations outside the U.S., this merely changes the channel through which the effects occur (for example, through exchange rates versus interest rates, etc.). There is an argument that during recessions the money borrowed was being hoarded and, therefore, the government-borrowed money carries no or very low opportunity cost. However, a lender's willingness to lend to a government during a recession does incur an opportunity cost represented by the interest payment. Further, this interest payment and the borrowed funds represent a lost opportunity for future Americans who must pay back the principle and interest instead of using those funds to invest or spend elsewhere.
7. The opportunity cost of disrupting and reforming a system during good economic times when a system is functioning well is lost value that the system produces. However, in an economic downturn, when systems have been disrupted, the value that system produces is lower, and thus the opportunity cost of reforming the system and creating a better, more efficient process is also lower.

pay back the debt. Using debt financing to pay for consumption or unproductive assets can lead to a sinkhole as the outflow of interest and principle payments becomes larger than the inflow of income. In the case of small budget deficits, the positive effects most likely outweigh the negative effects, for example, of increased risk and interest rates. As the deficit grows, the negative effects of adding to the nation's debt start to overwhelm any positive effects.

Large deficits can contribute to price instability. If the government finances the deficit by printing money, it can lead to inflation through depreciation of the currency, which makes foreign goods more expensive. This puts increasing pressure on the domestic price level by raising the price of imports. If the government issues debt, competition with businesses and other individuals for investment dollars results, increasing the cost of borrowing to finance productive investments in the private sector.

Given a stable foundation, private individuals can invest and produce the vibrant standard of living that meet the changing needs and wants of society.

A weak fiscal position can weaken government's ability to provide security for property rights. Being overleveraged makes it that much more difficult to borrow in the face of a security crisis or other unforeseen catastrophe. The government can also lose its role as a credible governing body (overseer) of markets when it becomes an active participant in the markets.⁸ Careful arms-length oversight will also

promote clarity, so that reliable information about goods and services is available to those buying and selling in the market, allowing good price signals to come out of the market system. This minimizes distortions and enables people to make the best possible decisions about how to spend their budgets.

The Global Economy: Makes Sound Institutions More Critical

In economies that compete globally, the government's creditability is even more crucial. This creditability is dependent on the fiscal responsibility of the government.⁹ The International Monetary Fund (IMF) has long advocated fiscal restraint to establish credit for emerging economies. The established credit of the U.S. is largely due to the strength of its financial institutions. The U.S. should not abuse its greater fiscal flexibility in terms of its debt, but instead should work to maintain the credit of the U.S. government.¹⁰

Preserving the credibility of the United States abroad is not only a diplomatic exercise. Large fiscal deficits in developed economies not only crowd out investment in the private sector, they compete with the debt issued by emerging economies. When many developed economies issue debt simultaneously, the cost and availability of funding for developing economies increases and limits the ability of developing countries to raise much-needed external funding as they work toward economic development.¹¹ Sound fiscal policy and a credible commitment to deficit reduction will help keep the United States a world leader and good citizen of the global economy.¹²

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8. "Crony capitalism" has plagued both developing and developed economies. Japan's government connection with private banks is a recent, oft-cited example.
 9. Although in developed and established economies fiscal responsibility in terms of the government deficit may become less of a factor in its "credit rating" than for an emerging economy, there is a tipping point for which the deficit, even in an advanced economy, becomes a catalyst for a loss of confidence. One proximate measure of this confidence is the market for insurance contracts in the event of a U.S. Treasury default. Greg Ip reported on January 11, 2009, in *The Washington Post*, "We're Borrowing Like Mad. Can the U.S. Pay it Back?", that: "Last week, markets pegged the probability of a U.S. default at 6 percent over the next 10 years, compared with just 1 percent a year ago." See <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/09/AR2009010902325.html> (September 9, 2009).
 10. There is some anecdotal evidence that the then-proposed spending stimulus had a negative effect on international investors. In South Korea, for example, confidence in U.S. Treasuries began to wane. Evan Ramstad, "Bearish View in Korea," *The Wall Street Journal*, January 20, 2009, at http://online.wsj.com/article/SB123237117098594719.html?mod=dist_smartbrief (September 9, 2009).

The Danger of the “Kitchen Sink” Approach

Many believe there is a danger of doing too little. In fact, the danger probably lies in trying to do too many different things in the hope that one of them will restore economic growth. By doing too much there is a greater chance that policy effects will offset one another (for example, providing a tax cut on investments that gives people an incentive to invest, while increasing government investment that raises the cost of investing).

The investment ambitions, while admirable, can be achieved in a decentralized way if the government once again focuses on its supportive role of providing a solid economic foundation. Given a stable foundation, private individuals can invest and produce the vibrant standard of living that meet the changing needs and wants of society.¹³

Institutional Management

Government institutions must be managed well to guard their credibility in providing a just system of laws and enforcement. This can be starkly evident in less-developed countries but is no less true for developed countries.

For a developed economy, well-run government institutions are no less important. Effective govern-

ment institutions ensure that those employed in the public sector are doing their jobs effectively, with the goal of *supporting* the private sector, not competing against it. Rather than borrowing more money and creating new programs and layers of bureaucracy,¹⁴ this Administration and Congress should:

1. Focus on the election campaign promise of streamlining agencies;
2. Exercise restraint in rushed deficit spending projects with no risk-return evaluation;
3. Focus on financial regulatory reform;
4. Reform the tax code; and
5. Signal a commitment to trade rather than protectionism.

The first two points demonstrate a commitment to fiscal responsibility and give an opportunity to review the purposes of agencies in light of current needs and changing technology. This will help to increase the level of accountability in both the private and public sectors, as evaluations shine the light on how operations have been conducted. Demonstrating fiscal responsibility also signals a commitment to supporting the U.S. currency,¹⁵ which will reassure America’s trading partners.

The third point will help restore credibility to U.S. financial institutions. It is well past time to

11. For a discussion of some issues related to developing countries as well as how thresholds play a role, see M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei, “Financial Globalization: A Reappraisal,” International Monetary Fund *Working Paper* No. WP/06/189, August 2006. Also see “Swimming Against The Tide: How Developing Countries Are Coping With the Global Crisis,” Background Paper prepared by World Bank Staff for the G20 Finance Ministers and Central Bank Governors Meeting, Horsham, United Kingdom, on March 13–14, 2009, at <http://siteresources.worldbank.org/NEWS/Resources/swimmingagainstthetide-march2009.pdf> (September 9, 2009).
12. Nobel laureate Paul Krugman made a similar comparison with underdeveloped economies in arguing for deficit restraint in 2004: “If this kind of fecklessness [high deficits] goes on, investors will eventually conclude that America has turned into a third world country, and start to treat it like one.” “Rubin Gets Shriek,” *The New York Times*, January 6, 2004, at <http://query.nytimes.com/gst/fullpage.html?res=9E00EFD81231F935A35752C0A9629C8B63&sec=&spn=&pagewanted=2> (September 9, 2009).
13. William J. Baumol, Robert E. Litan and Carl J. Schramm, *Good Capitalism, Bad Capitalism, and the Economics of Growth and Prosperity* (New Haven, Conn.: Yale University Press, May 2007).
14. For relationships between economic freedom and growth and the way country rankings can change both positively and negatively due to government policies, see Terry Miller and Kim R. Holmes, *2009 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2009).
15. Large deficits can increase the political incentive to depreciate the currency in order to “pay” for the debt. Recent warnings from China, a large holder of U.S. currency, give some anecdotal evidence of this concern. See Andrew Batson, “China Takes Aim at Dollar,” *The Wall Street Journal*, March 24, 2009, at <http://online.wsj.com/article/SB123780272456212885.html> (September 9, 2009).

modernize this country's financial regulatory system so that it can meet the challenges of today rather than reflect the structure of a market that no longer exists. The new system should be flexible and encourage the kind of innovation that has helped to provide low-cost financial services to millions of consumers, while also providing the credit that is so necessary for economic growth. It is important that the recent stabilization in the financial sector and other legislative agendas do not change the priority of this reform effort.

The fourth, reform of the tax code, should focus on simplification, transparency of the tax burden, broadening the base, and lowering overall rates. Reducing the layers and complexity of the tax code frees up resources that citizens can put to more productive use. The Tax Foundation estimated that in 2005, individuals and non-profits spent six billion hours complying with the federal tax code.¹⁶ This amounts to an additional 22 cents per dollar of tax collected—which means that American citizens paid \$1.22 for every \$1 that the government received in tax revenue.

Simplifying the tax code and streamlining the collection process would allow taxpayers to save this time and money, effectively giving them more disposable income. Increased disposable income can help people build wealth. Wealth is built by investing in assets. With house prices no longer rapidly appreciating, more productive asset investments might be in infrastructure, energy, health technology, and other assets of the future.

Reducing marginal tax rates on income both at the corporate and individual levels increases the benefits that individuals and corporations receive

Economic growth generates higher tax revenues that support the governing institutions.

from using their scarce resources to earn that income. This increased incentive to use resources productively creates greater economic growth. As the economy grows, more investments can be made, which in turn create more opportunities for growth, employment, and higher standards of living. Furthermore, economic growth generates higher tax revenues that support the governing institutions. This positive feedback effect is in fact a main motivation for many countries to undertake fundamental tax reforms.

Fifth, trade protectionism requires economic controls either in the form of subsidies (explicit or implicit), tariffs, or quotas. Import substitution policies have long been discredited by development economists.¹⁷ Becoming more closed off to the global economy weakens an economy, forcing it to spend its resources on providing goods and services it could buy cheaper elsewhere and forgoing production of goods and services it could sell abroad at a higher price than at home. This ultimately raises costs on everyone and stifles economic growth.

These five recommendations are in fact the prescriptions the IMF, the World Bank, and developed countries have been giving developing and emerging economies for a long time.¹⁸ This is because sound macroeconomic policies enhance the credibility of the government and strengthen the political institution.¹⁹ This credibility is vital for the economic stability that is necessary for making long-term investment decisions.²⁰

16. Scott A. Hodge, J. Scott Moody, and Wendy P. Warcholik, "The Rising Cost of Complying with the Federal Income Tax," *The Tax Foundation Special Report* No. 138, January 10, 2006.

17. Dani Rodrik, "Understanding Economic Policy Reform," *Journal of Economic Literature*, Vol. 34, No. 1 (March 1996), pp. 9–41. Note: Import substitution is a policy that pursues development of domestic production capacity of a currently imported good by protecting the domestic producers of that good and thereby shielding them from the competitive pressure of the import.

18. Edward L. Glaeser, "Abandoning the Pillars of Sound Policy," *The Boston Globe*, April 4, 2009, at http://www.boston.com/bostonglobe/editorial_opinion/oped/articles/2009/04/04/abandoning_the_pillars_of_sound_policy/?rss_id=Boston+Globe+---+Editorial%2FOp-ed+pages (September 9, 2009).

19. Amartya Kumar Sen, *Development as Freedom* (New York: Oxford University Press, 1999).

Conclusion

Citizens receive value from the government's role of making and enforcing laws that give the citizens the opportunity to freely pursue opportunities. The fact that the U.S. is a developed economy does not mean that the government does not need to take reform measures. The Administration and Congress should not waste this opportunity to ensure that 21st-century U.S. government institutions continue to provide a stable environment for individuals to freely pursue wealth-growing investments.

Having an orderly governing body allows private citizens to make long-term investment decisions

about their personal resources. A credible governing body contributes to the economic growth of a nation and provides the best opportunity to accomplish its national investment and growth goals through the entrepreneurial spirit of all its citizens. Making fundamental changes to the rules and agencies that have become outdated and opaque will provide economic stability and give potential entrepreneurs the confidence to work toward meeting the ever-changing needs of society.

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20. For a formal analysis and discussion on the role of the political institution in creating an environment for a functioning market order, and the negative investment and development effects if this institution loses credibility by being seen as susceptible to capture by powerful constituent groups, see László Bruszt, "Market Making as State Making: Constitutions and Economic Development in Post-Communist Eastern Europe," *Constitutional Political Economy*, Vol. 13, No. 1 (March 2002).