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Cutting the U.S. Budget Would Help the Economy Grow

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Abstract

As the House and Senate budget conference meets to decide the fiscal course of the United States, lawmakers should focus on reducing federal spending. Federal spending is growing rapidly and will accelerate outside the 10-year budget window. Even though tax revenues are projected to grow faster than spending over the next decade, the nation faces chronic and increasing deficits. Research finds that high spending, high debt, and tax increases are harming economic growth and prosperity. Putting the budget on a path to balance with spending cuts would spur economic growth by reducing uncertainty and freeing up resources for investment and job creation. As the European crisis demonstrates, the option of making gradual changes will expire, and Americans and the U.S. economy will suffer a self-inflicted wound from unavoidable austerity measures if lawmakers continue to procrastinate the inevitable.

> *Austerity is the result of countries' democratic decisions to wait until the last minute before acting, under the pressure of the markets, mainly by raising taxes rather than implementing long-waited reforms.*
>
> —Lorenzo Bini Smaghi, former member of the executive board of the European Central Bank.[1]

Key Points

- The House and Senate budget conference provides an important opportunity to improve the U.S. fiscal and economic outlook, while avoiding the consequences of a European-style spending and debt crisis.
- If lawmakers neglect entitlement reform and further spending reductions, growing spending and high debt will significantly depress U.S. economic growth.
- Lawmakers should feel emboldened to enforce sequestration-level spending and slow the growth in entitlement spending, providing certainty over the U.S. fiscal course.
- Research shows that when governments cut spending, private investment surges.
- Additional government spending today harms economic growth in the long term, while budget cuts today would enable the economy to grow much faster tomorrow, making Americans better off.

This paper, in its entirety, can be found at **http://report.heritage.org/bg2864**

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Members of the Senate and the House of Representatives have convened the first budget conference in four years. With the deadline of December 13 for the conference report, lawmakers have little time to agree on a budget plan for fiscal year 2014 and beyond, and yet so much depends on their succeeding.

Excessive federal spending and high debt slow economic growth. Despite a broad consensus that the U.S. fiscal path is unsustainable without significant reductions in spending—especially in the growing spending on entitlements—many policymakers are hesitant to embrace large-scale budget cuts for fear of slowing the economy. This fear is misplaced because significant budget cuts today would enable stronger economic growth tomorrow. If lawmakers neglect entitlement reform and further spending reductions, growing spending and high debt will significantly depress U.S. economic growth.

The Budget Situation

Federal spending is taking an increasing share of the productive resources in the economy. At well above one-fifth of gross domestic product (GDP), federal spending is too high, and chronic deficits are quickly driving publicly held debt above three-fourths of GDP.

The federal government has used borrowing to finance much of the spending growth over the past two decades. For the past four years, low tax revenues due to the recession and temporary government spending measures—such as the stimulus, the Troubled Asset Relief Program (TARP), and assistance programs—have resulted in consecutive trillion-dollar annual deficits.

Despite expiration of these temporary spending measures, sequestration, and a surge in revenues, annual deficits remain staggeringly high at $700 billion for fiscal year 2013 and will surge beyond $1 trillion before the end of the decade.[2] Growing federal spending, especially on health care and retirement entitlements, will drive deficits and debt to even higher levels after 2023. Tax revenues are quickly growing to beyond their historical average of about 18 percent of GDP. With the $3.2 trillion in tax increases over the decade enacted under President Barack Obama, tax revenues are now growing faster than spending, but not enough to curb the growth in deficits and debt.[3]

Spending will remain well above the historical average of 20.2 percent in the near term and will dramatically surge after the end of the decade as entitlement programs, including the Medicaid expansion and health care subsidies in the Affordable Care Act (Obamacare), overwhelm the federal budget.

Sequestration

Much of the budget conference debate is focused on undoing sequestration, a 2.5 percent reduction of projected spending over 10 years that went into effect on March 1, 2013. This demonstrates the extent to which policymakers are willing to drag their feet on even moderate spending reductions.

When Congress and the President negotiated over increasing the debt ceiling in the summer of 2011, they agreed to raise the debt limit in three installments for a total increase of $2.1 trillion. To offset this increase, they enacted caps to limit the growth in discretionary spending to save $917 billion over 10 years. To achieve at least $1.2 trillion in additional spending reductions, Congress established a "super committee" to identify specific cuts. Sequestration, an idea originally proposed by the Obama Administration,[4] was intended as a mechanism to force cuts by threatening automatic spending cuts if the super committee failed, which it ultimately did.[5]

1. Lorenzo Bini Smaghi, "Reform Denial Poses Bigger Threat to Italy Than Austerity," *Financial Times*, The A-list blog, March 5, 2013, http://blogs.ft.com/the-a-list/2013/03/05/reform-denial-poses-a-bigger-threat-to-italy-than-austerity/ (accessed March 6, 2013; subscription required).
2. Romina Boccia, Alison Acosta Fraser, and Emily Goff, "Federal Spending by the Numbers 2013," Heritage Foundation *Special Report* No. 140, August 20, 2013, http://www.heritage.org/research/reports/2013/08/federal-spending-by-the-numbers-2013.
3. Curtis Dubay and Romina Boccia, "Tax Revenue Rose Five Times Faster Than Spending Fell in 2013," The Heritage Foundation, The Foundry, October 31, 2013, http://blog.heritage.org/2013/10/31/tax-revenue-rose-five-times-faster-than-spending-fell-in-2013/.
4. Bob Woodward, "Obama's Sequester Deal-Changer," *The Washington Post*, February 22, 2013, http://www.washingtonpost.com/opinions/bob-woodward-obamas-sequester-deal-changer/2013/02/22/c0b65b5e-7ce1-11e2-9a75-dab0201670da_story.html (accessed April 1, 2013).
5. Alison Fraser, ed., "Federal Spending by the Numbers 2012," Heritage Foundation *Special Report* No. 121, October 16, 2012, http://www.heritage.org/research/reports/2012/10/federal-spending-by-the-numbers-2012.

These automatic spending reductions demonstrate Washington dysfunction. Rather than deliberately identifying waste and inappropriate federal spending, the President and Congress relinquished their responsibility to govern to a blunt instrument that barely even slows the growth in total federal spending. Even with sequestration, nominal federal spending is projected to grow by 69 percent in 10 years. Lawmakers should deliberately budget within sequestration spending levels and do much more to slow the explosion in spending and debt.

High Stakes

Academic research shows that economic growth slows significantly at high levels of public debt. The Congressional Budget Office (CBO) estimates in its alternative fiscal scenario that publicly held debt will rise to 87 percent within the decade, assuming only moderate increases in net interest costs.[6] According to the CBO, "Such a large amount of federal debt will reduce the nation's output and income below what would occur if the debt was smaller, and it raises the risk of a fiscal crisis (in which the government would lose the ability to borrow money at affordable interest rates)."[7]

Spending on interest on the debt is already the sixth-largest budget item at today's historically low interest rates, and interest payments are projected to double in only five years. If interest rates rise higher or sooner, U.S. federal debt will reach economically damaging levels even faster.

Academic research by a number of economists finds that countries with high debt levels experience lower economic growth. Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff found that debt levels between 90 percent and 120 percent of GDP correlate with slower growth of 1.2 percentage points.[8] Similarly, Manmohan S. Kumar and Jaejoon Woo report that advanced economies with high levels of debt grew 1.3 percentage points slower annually than their low-debt (below 30 percent) counterparts. Kumar and Woo additionally emphasize that the negative effects of debt increase as debt grows from 30 percent to 90 percent.[9] Finally, Stephen Cecchetti, Madhusudan Mohanty, and Fabrizio Zampolli identified 84 percent of GDP as the point at which high debt becomes most harmful.[10] The U.S. is on track to exceed this level before the end of the decade.

Slower growth directly affects American families. As Heritage Foundation economist Salim Furth calculated, a decade of debt drag would reduce the income of the typical American family by $11,000.[11] Moreover, lower growth means fewer available jobs and fewer opportunities for Americans to improve their economic circumstances.[12]

6. Congressional Budget Office, "How Different Future Interest Rates Would Affect Budget Deficits," March 27, 2013, http://www.cbo.gov/publication/44024 (accessed on April 3, 2013).
7. Congressional Budget Office, "Macroeconomic Effects of Alternative Budgetary Paths," February 5, 2013, http://www.cbo.gov/publication/43769 (accessed on April 3, 2013).
8. Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, "Public Debt Overhangs: Advanced-Economy Episodes Since 1800," *Journal of Economic Perspectives*, Vol. 26, No. 3 (Summer 2012), pp. 69–86, http://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.26.3.69 (accessed February 6, 2013). The authors analyze central government gross debt, excluding debt by states and municipalities. For most of the countries analyzed, gross debt does not include significant amounts of intragovernmental debt and is a roughly equivalent measure to debt held by the public in the U.S. In the U.S., however, gross debt includes significant amounts of intragovernmental debt such as money the government borrowed from the Social Security trust fund. For the United States, publicly held debt is the more economically relevant debt measure. A measure that combines publicly held debt with state and local debt shows the combined U.S. debt at 84 percent of GDP. See Salim Furth, "High Debt Is a Real Drag," Heritage Foundation *Issue Brief* No. 3859, February 22, 2013, http://www.heritage.org/research/reports/2013/02/how-a-high-national-debt-impacts-the-economy.
9. Manmohan S. Kumar and Jaejoon Woo, "Public Debt and Growth," International Monetary Fund *Working Paper*, July 2010, http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf (accessed November, 5 2013).
10. Stephen Cecchetti, Madhusudan Mohanty, and Fabrizio Zampolli, "The Real Effects of Debt," Bank for International Settlements *Working Paper* No. 352, September 2011, http://www.bis.org/publ/work352.pdf (accessed February 22, 2013).
11. Salim Furth, "Debt Is a Real Drag in Any Season," The Heritage Foundation, February 27, 2013, http://www.heritage.org/research/commentary/2013/2/debt-is-a-real-drag-in-any-season.
12. Romina Boccia, "How the United States' High Debt Will Weaken the Economy and Hurt Americans," Heritage Foundation *Backgrounder* No. 2768, February 12, 2013, http://www.heritage.org/research/reports/2013/02/how-the-united-states-high-debt-will-weaken-the-economy-and-hurt-americans.

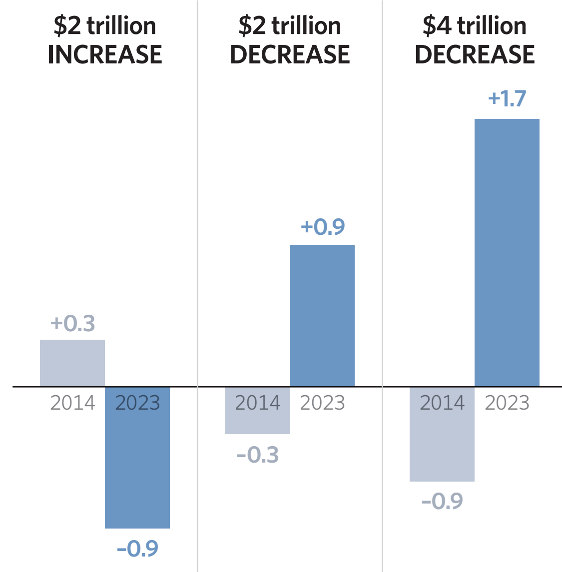
Gross National Product

National income measures such as gross national product have inherent shortcomings. Any short-term reduction in GNP partially comes through an accounting mechanism and is by itself a poor indicator of the economy's health. GNP equals the total of consumption, government spending, investment, net exports, and net factor payments. This means that government spending, even if it is wasted or depresses overall economic growth, is factored in as a positive in GNP calculations.

CHART 1

Shrinking the Deficit Boosts Long-Term Economic Growth

According to the Congressional Budget Office, reducing the deficit would significantly boost long-term gross national product (GNP). And the bigger the reduction in the deficit, the more long-term GNP would grow.



Note: Figures are the percentage difference from CBO's baseline.
Source: Congressional Budget Office, "Macroeconomic Effects of Alternative Budgetary Paths," February 5, 2013, http://www.cbo.gov/publication/43769 (accessed April 3, 2013).

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Budget Cuts Today, Economic Growth Tomorrow

Lawmakers face a choice of either confronting the nation's spending crisis head-on by reforming entitlement and other structural spending or continuing to operate with their heads in the sand, waiting for a spending and debt tsunami to wash over the nation and drown economic growth.

Research shows that reductions in government spending free resources in the economy for investment and job creation, thus spurring economic growth. For example, the CBO assessed three different deficit scenarios and their impact on the economy: a $2 trillion increase in primary deficits, a $2 trillion decrease in primary deficits, and a $4 trillion decrease in primary deficits. The CBO's results show that any short-term boost in gross national product (GNP)[13] from higher deficit spending in the short term would be more than offset by the long-term reduction in economic growth from higher interest rates and a crowding-out effect of private investment. Equally, any short-term dip in GNP from additional deficit reduction would be followed by stronger economic growth over the long term.[14]

Government spending changes the composition of total demand, such as by increasing consumption at the expense of investment. Poorly targeted deficit spending would boost GNP in the short term, but leave less available for productive investments in the future. Deficit spending shifts economic resources from the future to the present, leaving younger generations with a larger tax burden and fewer resources to invest. In reverse, lower government spending frees economic resources for investment in the private sector, which improves consumer wealth. In sum, additional government spending today harms

13. "Unlike the more commonly cited GDP, GNP excludes foreigners' earnings on investments in the domestic economy but includes U.S. residents' earnings overseas; changes in GNP are therefore a better measure of the effects of policies on U.S. residents' income than are changes in GDP." Congressional Budget Office, "Macroeconomic Effects of Alternative Budgetary Paths," p. 3.
14. The CBO uses a common Solow-type model to consider how different deficit scenarios affect output and income based on changes to the nation's capital stock and labor wages.

economic growth in the long term, while budget cuts today would enable the economy to grow much faster tomorrow.

The CBO scenario does not specify how deficit reduction would be accomplished—whether through entitlement reforms or by raising taxes. However, the mechanism is important. If the President and Congress raised taxes further, they would reduce the incentives to work, save, and invest, consequently lowering economic growth. Higher taxes would also mean that fewer resources would be available in the economy to build businesses and hire workers. Balancing the budget with a massive tax increase rather than by limiting spending is a recipe for economic stagnation. The long-term health of the economy depends less on a balanced budget than on limiting the size and scope of the government.

An in-depth Heritage Foundation report reveals lessons from Europe's exercise in austerity. The authors reached the overwhelming conclusion that the method of austerity matters: Increasing taxes was more damaging to the economy and less effective in reducing deficits than spending cuts. Moreover, reducing spending brings the added benefit of stronger economic growth over time.[15]

In a paper that analyzes the effects of fiscal policy on investment in 18 member countries for the Organisation for Economic Co-operation and Development, Alberto Alesina and other economists found that higher government spending is associated with less business investment. However, when governments cut spending, private investment surges.[16] More recent research by Alesina and others concluded that a mild dip in GDP from spending reductions is a temporary effect that quickly gives way to growth. As Salim Furth summarized the research, "Alesina, Favero, and Giavazzi's results imply that the void left by decreased government spending is filled within a year by increased investment and consumption, and the economy continues growing."[17]

Another factor warranting further research consideration is that large deficit spending depresses growth by increasing uncertainty over a country's future fiscal health. Major U.S. credit rating agencies continue to stress the need for additional deficit reduction over the long term. Moody's recently emphasized that the U.S. economy "has demonstrated a degree of resilience to major reductions in the growth of government spending."[18] Lawmakers should feel emboldened to enforce sequestration-level spending and slow the growth in entitlement spending, thereby providing certainty on the U.S. fiscal course.

Much Larger Spending Cuts Needed

Despite the hype about sequestration, federal spending will grow rapidly over the next decade and will accelerate beyond the 10-year budget window. In addition to enforcing sequestration, lawmakers should reform entitlement and other structural spending to rein in spending and debt now and not wait until a debt crisis forces severe austerity measures on Americans.

Putting the budget on a path to balance with spending cuts would spur economic growth by reducing uncertainty and by freeing up resources for investment and job creation. As the European crisis demonstrates, the option to make gradual changes will expire, and Americans and the U.S. economy will suffer a self-inflicted wound from unavoidable austerity measures if lawmakers continue to procrastinate the inevitable.

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15. Salim Furth, ed., "Europe's Fiscal Crisis Revealed: In-Depth Analysis of Spending, Austerity, and Growth," Heritage Foundation *Working Paper* No. 10–13, October 24, 2013, http://www.heritage.org/research/reports/2013/10/europes-fiscal-crisis-revealed-indepth-analysis-of-spending-austerity-and-growth.
16. Alberto Alesina et al., "Fiscal Policy, Profits, And Investment," National Bureau of Economic Research *Working Paper* No. 7207, July 1999, http://www.nber.org/papers/w7207 (accessed February 4, 2013).
17. Salim Furth, "Research Review: Spending Cuts Are Better Than Tax Increases," Heritage Foundation *Issue Brief* No. 3868, March 5, 2013, http://www.heritage.org/research/reports/2013/03/spending-cuts-are-better-than-tax-increases.
18. Moody's "Moody's Changes Outlook on US Aaa Sovereign Rating to Stable from Negative; Rating Affirmed," July 18, 2013, https://www.moodys.com/research/Moodys-changes-outlook-on-US-Aaa-sovereign-rating-to-stable--PR_277667 (accessed November 7, 2013).