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Budget Cuts Would Not Harm the Economy

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The Congressional Budget Office projects that the federal budget deficit will exceed three-quarters of $1 trillion in 2013. The U.S. economy continues to badly underperform, leaving millions of Americans out of work, depressing wage gains, and restricting opportunities. Despite a broad consensus favoring deficit reduction, some worry that reducing the budget deficit too rapidly might further weaken the recovery. These concerns are misplaced.

Steady, sustained deficit reduction would not hamper the recovery and may well provide modest near-term support for growth by whittling away at the debilitating uncertainty restraining growth. President Obama and Congress should work toward cutting spending in 2013 as part of a credible plan to balance the budget in 10 years in full confidence that the economy would benefit thereby.

This paper, in its entirety, can be found at **http://report.heritage.org/ib3851**

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Deficit Spending Does Not Spur Growth. As the economy slid into recession in 2008, first President Bush and then President Obama resorted to massive deficit spending to sustain and then stimulate the economy. It failed on a bipartisan basis.

It failed not because the spending surge and tax relief were poorly designed—and not because the resulting deficits were too small for the task—but because it could not work: The essential theory behind the stimulus was fundamentally flawed, a form of fiscal alchemy.

Basic Keynesian theory holds that the economy is underperforming because total demand is too low. Government spending contributes to total demand while taxes subtract from demand. Thus, the theory proceeds, by increasing government spending and reducing taxes fiscal policy can boost total demand and thus push the economy toward full employment. It is simple arithmetic, proponents argue.

Of course, were it truly so simple, there would be no reason to stop at deficits pushing the economy toward full employment; one could increase deficits sufficiently to attain full employment fairly quickly.

The theory fails because it relies on the unstated fantasy government can magically create demand out of thin air. In fact, government must borrow to finance deficits, and all borrowing subtracts from the funds that would otherwise be available and used in the private sector for private investment or private consumption. While budget deficits most certainly increase demand, the borrowing necessary to finance those deficits must dollar-for-dollar reduce demand. The net effect is more government debt but not more total demand and certainly not more jobs.

Those seeking to sustain the theory sometimes point to the possibility of importing more saving from abroad, thus avoiding the reduction in domestic private demand that must otherwise follow from the increase in government borrowing. To be sure, a net increase in imports of foreign saving likely financed some of the recent increase in budget deficits. However, it is also true the balance of payments must balance everywhere and always. As government borrowing rises and net inflows of foreign savings rise, so too must the net trade deficit—either U.S. exports must decline or U.S. imports must rise. In either event, once again total demand is unaffected though the composition of demand changes.[1]

After the Obama stimulus in 2009 failed to spur the economy, Congress and President Obama tried again with a payroll tax rate cut in 2010 intended to increase employment indirectly by increasing total demand and to increase the demand for workers directly by lowering employers' costs. The policy failed on both counts.

The policy failed to spur employment indirectly for the reasons described above: While government net demand rose, government borrowing also rose, reducing private demand or increasing the trade deficit dollar-for-dollar. However, the payroll tax cut also failed to increase employment because policymakers ignored the reality of who pays the payroll tax. Employees, not employers, pay the tax, so cutting the payroll tax raised the return to work. This was fine for those working, but it left undisturbed employers' costs. The net effect, then, ironically, was to increase the supply of workers in an environment of high unemployment.

Deficit Reduction Does Not Harm Growth. Just as deficit spending failed to spur the economy, cutting spending and reducing the budget deficit would generally not slow the economy in the near term. It may even provide a modest short-term lift while improving the economy's performance in future years.

In the near term, reducing government spending means leaving more of the nation's saving available for private use. In short, government's contribution to demand falls while private demand rises. The added benefit to the economy comes from the reduction in uncertainty associated with slowing the growth in federal debt. As many now acknowledge, a main cause of the slow recovery in recent years is an oppressive uncertainty surrounding the effects of Washington policies.

Smaller deficits mean less uncertainty, which means a somewhat stronger economy in the near term. In the longer run, less deficit spending means more capital available for private investment to increase future productivity and future wages.

Shock and Awe vs. Steady and Consistent. Reducing government budget deficits generally means a stronger economy in the long run with little or no near-term ill-effects. The exception occurs when spending shifts quickly and in large amounts. The enormity of government spending means it plays a substantial role in the economy. Thus, rapid and unexpected reductions in spending can affect the economy like any other major shock, such as a rapid increase in the price of oil. Economic arrangements predicated on certain expectations about government spending are upended, rendering plans obsolete and inflicting losses on those affected.

This effect was apparent in the data on gross domestic product (GDP) for the fourth quarter of 2012. The preliminary data included a rapid drop in federal spending on national security. Apparently, and wisely, the Defense Department prepared for the substantial cuts to 2013 defense spending in case sequestration is allowed to take effect. These cuts threaten national security, and they cause enormous management problems for the Pentagon. They also mean a shock to the economy and so naturally there is a negative economic consequence.

However, the reduction in defense spending was not per se a cause of the reduction in overall GDP growth; the cause was the *unexpected* sharp reduction in spending, and this effect is fleeting because the economy will quickly adjust to the new level of spending.

Looking Across the Pond. Many nations across Europe are cutting spending and raising taxes while watching unemployment soar. Is this in store for the United States if the federal government aggressively cuts spending?

The answer is no. While the shock effect from spending reductions may be greater largely because European economies suffer from less flexible labor markets, Europe's current economic malaise is only tangentially related to fiscal policy, and that through Europe's proclivity for raising taxes on productive activity.[2]

The true sources of Europe's current difficulties are regulatory and monetary, and so there are no lessons for a more austere U.S. fiscal policy to be drawn from Europe aside from the folly of raising taxes. On the contrary, like the U.S., many countries in Europe have increased their public debt to dangerous levels, and so while austerity poses at most a minor shock-effect problem for economic growth today, failure to rein in deficits and debt would pose an enormous threat to Europe's economy once today's issues are resolved.

Diminish Uncertainty: Follow the Path to Balance. Projected federal budget deficits pose a dire

1. See Brian M. Reidl, "Why Government Spending Does Not Stimulate Economic Growth: Answering the Critics," Heritage Foundation *Backgrounder* No. 2354, January 5, 2010, http://www.heritage.org/research/reports/2010/01/why-government-spending-does-not-stimulate-economic-growth-answering-the-critics.
2. See J. D. Foster, "Is Austerity Crushing Europe?," The Heritage Foundation, *The Foundry*, May 17, 2012, http://blog.heritage.org/2012/05/17/is-austerity-crushing-europe/.

threat to America's future. President Obama and Congress should settle on a firm path to balancing the federal budget within the next 10 years and then get to work reforming federal programs and cutting spending in 2013 to follow that path. Doing so would have a modest, positive effect on the economy in the near term as another Washington-sourced uncertainty hanging over the economy diminishes, while a stronger foundation is built for America's future growth.

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