

The Stimulus Bill and Government Spending

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before the House Committee on Oversight and Government Reform,

Subcommittee on Regulatory Affairs, Stimulus Oversight, and Government Spending

February 16, 2011

Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding government spending and the 2009 stimulus bill. My comments will focus on the need to control federal spending, but I will also discuss state government budgets, as the states were major recipients of stimulus funding.

Short-Run “Sugar High” and Long-Run Damage

Federal spending has soared over the past decade. As a share of gross domestic product, spending grew from 18.2 percent in fiscal 2001 to 24.7 percent by fiscal 2011. The causes of this expansion include the costs of overseas wars, growing entitlement programs, rising spending on domestic programs such as education, and the 2009 stimulus bill.

Two years after passage of the \$821 billion stimulus package, it appears to have been a very expensive failure of Keynesian fiscal policy.¹ Note that the total Keynesian stimulus in recent years included deficit spending of \$459 billion in FY2008, \$1.4 trillion in FY2009, \$1.3 trillion in FY2010, and \$1.5 trillion in FY2011. Despite all that deficit spending, U.S. unemployment remains stuck at high levels and the recovery is sluggish compared to prior recoveries.

Economists debate how much of a “sugar high” increased government spending can provide to the economy in the short-run. Obama administration economists think that the Keynesian “multipliers” from spending are large, but many macroeconomists think that they are small because added government spending mainly just displaces private-sector activities.²

In the long-run, there is little doubt that additional government spending reduces our standard of living because of the build-up of debt. Future taxpayers will bear the burden of the \$821 billion stimulus plus hundreds of billions of dollars in related interest costs. Harvard’s Robert Barro has calculated that the future damage caused by the 2009 stimulus bill substantially outweighed any short-term benefits it may have had.³

Keynesian fiscal policy, which has dominated Washington in recent years, has pushed the nation closer to a financial and economic disaster in the years ahead. Keynesianism is an

economic dead-end, and it should be abandoned. Policymakers should change their focus from short-term fiscal manipulations to long-term spending control.

Long-Run Costs of Government Spending

The federal government will spend \$3.7 trillion this year financed by a huge extraction of resources from current and future taxpayers. That extraction comes at a large cost. The resources consumed by the government cannot be used to produce goods in the private sector. For example, the engineers working on a \$1 billion government high-speed rail scheme are precluded from building goods to satisfy real consumer needs in the marketplace. Policymakers tout the jobs created by the \$1 billion of spending, but they usually overlook the \$1 billion of private activities that are displaced.

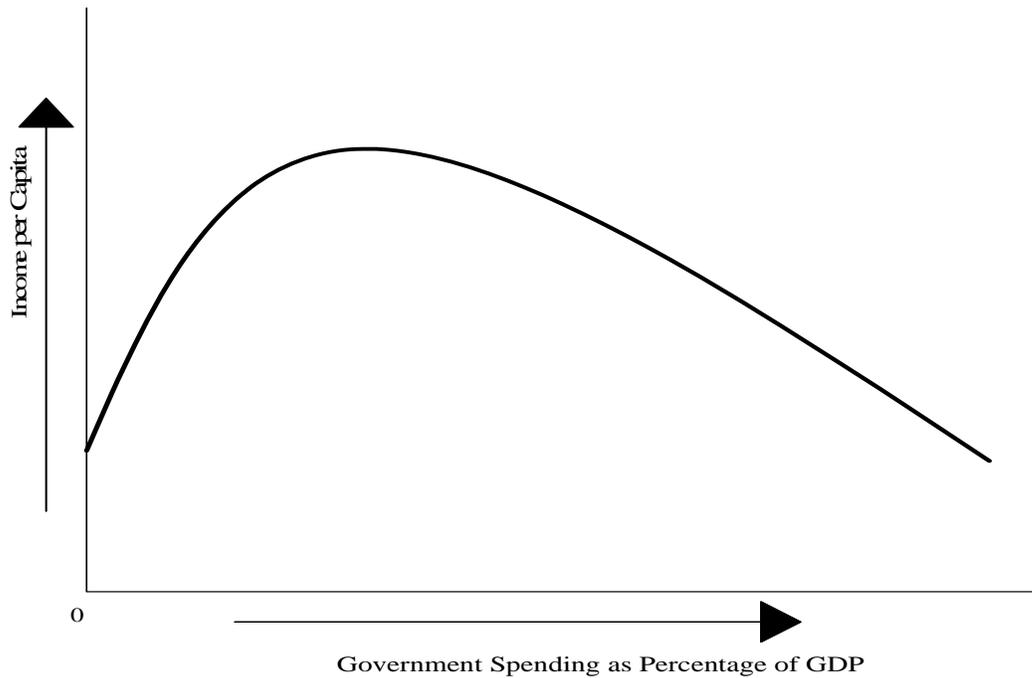
The private sector would actually lose more than \$1 billion in this example. That is because government spending and taxing creates “deadweight losses,” which are costs caused by distortions to working, investment, entrepreneurship, and other productive activities. Economists provide a range of estimates for the size of deadweight losses. The CBO says that “typical estimates of the economic cost of a dollar of tax revenue range from 20 cents to 60 cents over and above the revenue raised.”⁴ Economist Martin Feldstein concludes that “the deadweight burden caused by incremental taxation ... 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.”⁵ Thus, a \$1 billion high-speed rail scheme would cost the private economy \$2 billion or more.

When it intervenes in markets, the government uses a “leaky bucket” because of the damage it causes on both the tax and spending sides. Economist 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.”⁶

The larger the government grows, the leakier the bucket becomes because tax distortions rise rapidly as tax rates rise and spending is allocated to activities with ever lower returns.⁷ Figure 1 illustrates the consequences of the government’s leaky bucket. On the left-hand side of the figure, tax rates are low and the government initially delivers important public goods such as crime reduction and the enforcement of contracts. Those activities create high rate of returns, so per-capita incomes initially rise as the government grows.

As government expands further, however, it engages in less and less productive activities. The marginal return from government spending falls and then turns negative. On the right-hand side of the figure, average incomes fall as the government expands. Government in the United States is almost certainly on the right-hand side of this figure—it has expanded far beyond the optimal point that maximizes the nation’s well-being. For evidence, see www.downsizinggovernment.org, which catalogs the ongoing failures of many federal government agencies.

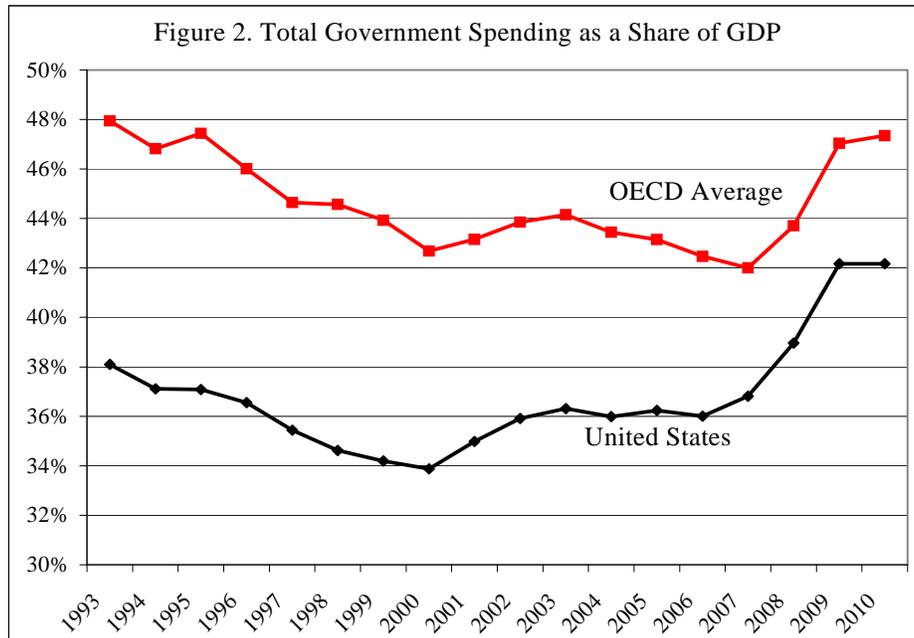
Figure 1. The Size of the Government and Average Incomes



Policymakers should think about these realities when they are presented with new ideas for spending. For example, in his State of the Union address, President Obama promoted new government “investment” spending. But given how much the government already spends and the large distortions created by the tax system at the margin, it is extremely unlikely that the government could find new projects with sufficiently high returns to make them worthwhile.

The sad reality is that United States is no longer a small-government nation, as revealed by data from the Organization for Economic Cooperation and Development.⁸ The OECD calculates that total federal, state, and local government spending in the United States in 2010 was 42 percent. For many years, America had about a 10 percentage point government size advantage compared to the OECD average, but that advantage has now shrunk to just 5 percentage points, as shown in Figure 2.

Historically, America’s robust economic growth and high living standards were built on our relatively smaller government than Europe and elsewhere. But if we continue down the current high-spending path, we will become just another sluggish welfare state. Projections by the Congressional Budget Office under its “alternative fiscal scenario,” show that federal spending will climb by another 11 percentage points of GDP by 2035 unless we make major reforms.⁹ Such a spending expansion would doom young people to unbearable levels of taxation and an economy with few opportunities and little innovation.



Source: OECD Economic Outlook Database, Annex Table 25.

We need major federal spending cuts. We should cut entitlements, domestic spending, and defense. I've proposed cuts at www.downsizinggovernment.org to balance the federal budget by 2020. And I've suggested that Congress cap the annual growth in total federal outlays to help force ongoing efforts to cut costs.¹⁰

Some economists argue that spending cuts would hurt the economy, but the Canadian reforms of the 1990s show that the opposite is true.¹¹ In the early 1990s, overspending had pushed the size of government in Canada to more than 50 percent of GDP and debt was soaring. But the federal government reversed course and chopped 10 percent from total spending in two years—equivalent to Congress cutting spending by \$370 billion. The government held spending at roughly the lower level for a few more years, and overall government spending in Canada fell by 10 percentage points of GDP.¹²

As spending was cut, the Canadian economy boomed for 15 years until it was hit by the recent U.S.-caused recession.¹³ As spending came down, the Canadian government helped spur economic growth with pro-market reforms such as free trade, corporate tax cuts, and privatization. The Canadian model of spending cuts and microeconomic reforms to boost growth would be an excellent model for U.S. policymakers to follow.

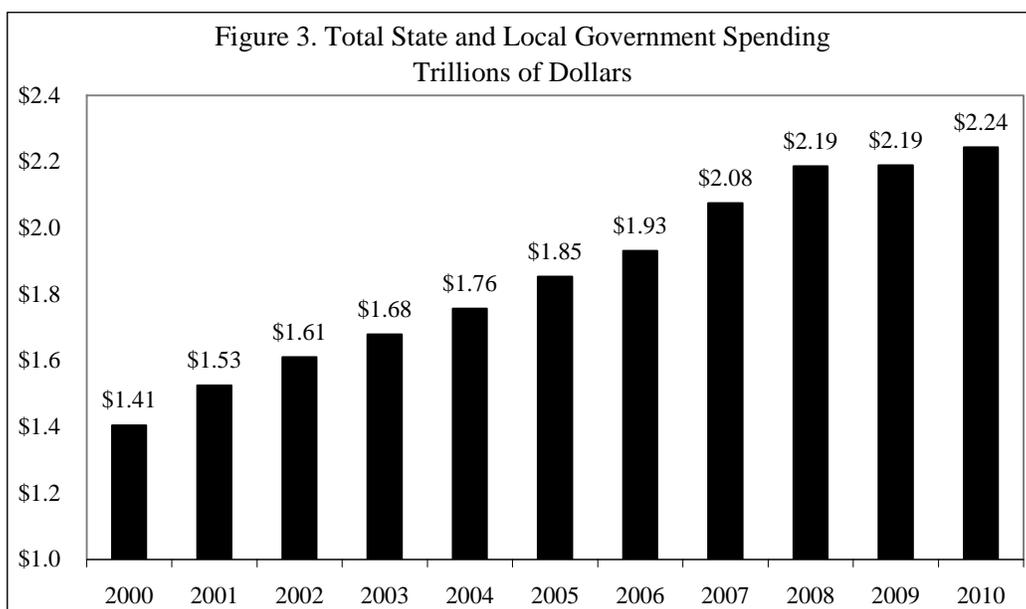
In sum, policymakers should reject the idea that added spending is good and beneficial for the economy. It isn't. In recent decades, the federal government has expanded into hundreds of areas that would be better left to state and local governments, businesses, charities, and individuals. That expansion is sucking the life out of the private economy and creating a top-down bureaucratic society. Cutting federal spending would spur economic growth and enhance personal freedom by dispersing excessive power from Washington.

Aid to the States Should be Cut, Not Increased

The 2009 stimulus bill included substantial aid to state and local governments. The view was that the states were hard hit by the recession and they needed emergency federal help. In recent years, news stories have suggested that state budgets have been radically slashed in devastating ways.

The reality is different. Overall state and local government spending has not been slashed. Most states did have to tighten their belts during the recession, but that is entirely reasonable as families and businesses had to do the same. Furthermore, recent belt-tightening came after years of robust state spending growth.

Figure 3 shows that total state and local government spending rose 55 percent between 2000 to 2008, based on Bureau of Economic Analysis data.¹⁴ State and local spending leveled out in 2009, and then it started growing again in 2010. It is true that a number of states, such as California, have dug themselves into deep fiscal holes, but overall state revenues and spending are now rising again as the economy expands. As a share of GDP, total state and local spending increased over the last decade—from 14.1 percent in 2000 to 15.3 percent in 2010, according to the BEA.



Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 3.3. Calendar years.

Looking ahead, Congress should repeal any remaining stimulus funding to help reduce the federal deficit. Then Congress should start cutting the entire aid-to-state system, which costs federal taxpayers about \$650 billion a year. The system is hugely bureaucratic, stifles state policy diversity, and encourages overspending by every level of government.¹⁵

Some groups are pointing to large “budget gap” figures to suggest that the states have a short-term fiscal crisis. The Center on Budget and Policy Priorities, for example, claims

that the states face a \$125 billion budget gap, even though tax revenues are growing.¹⁶ But such “gaps” are speculative numbers, not hard data. If a state expects revenues and spending to rise 7 percent, but then a new forecast shows revenues rising only 3 percent, the state is said to have a 4 percent “gap” or “shortfall.” But spending is still rising by 3 percent, which is not a crisis. Budget gap estimates are partly artifacts of faulty economic forecasting and an inability of states to respond flexibly to changing circumstances.

The real state budget crisis is not these short-term gaps, but the longer-term problem of soaring debt and unfunded obligations in state retirement plans. State and local bond debt more than doubled over the last decade from \$1.20 trillion to \$2.42 trillion, according to the Federal Reserve Board.¹⁷ Unfunded obligations in state and local defined benefit pension plans are more than \$3 trillion when realistic accounting methods are used.¹⁸ The states also have huge funding gaps in their retirement health plans of at least \$1.4 trillion.¹⁹

Defined benefit pension plans have become a unique luxury of the public sector. DB plans are available to 84 percent of state and local workers, but to just 21 percent of private workers.²⁰ Furthermore, public sector plans are generally more generous than the remaining private-sector plans.²¹ The good news is that a number of states are starting to tackle the high costs of these government employee benefits.

From a federal perspective, the thing to note is that the 50 states are in quite different fiscal positions. For example, a report by Moody’s shows that state-level debt varies from more than 8 percent of state GDP in Hawaii and Massachusetts to near zero in Iowa, Wyoming, and Nebraska.²² There are also large differences between the states in pension funding gaps.²³ Part of these fiscal differences likely stem from the wide variations in public sector unionization between the states.²⁴

The states have chosen different paths, and they are free to do so in our federal system. Over time, we can hope that the spendthrift states can learn policy lessons from the more frugal states. The important thing is that federal policymakers avoid any further bail-outs of the states because that would simply reward the mismanaged states at the expense of the others. State policymakers have the power to solve their own fiscal problems without federal intervention.

Thank you for holding these important hearings.

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- ¹ The “stimulus” bill was the American Recovery and Reinvestment Act of 2009. For an updated estimate of the bill’s cost, see Congressional Budget Office, “The Budget and Economic Outlook,” January 2011, p. 12.
- ² See, for example, 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,
- ³ Robert J. Barro, “The Stimulus Evidence One Year Later,” *Wall Street Journal*, February 23, 2010.
- ⁴ Congressional Budget Office, “Budget Options,” February 2001, p. 381.
- ⁵ Martin Feldstein, “How Big Should Government Be?” *National Tax Journal*, Volume 50, no. 2, June 1997, pp. 197-213.
- ⁶ Michael Boskin, “A Framework for the Tax Reform Debate,” in *Frontiers of Tax Reform*, ed. Michael Boskin (Stanford: Hoover Institution, 1996), p. 14.
- ⁷ Regarding taxes, deadweight losses rise more than proportionally as tax rates rise.
- ⁸ Organization for Economic Cooperation and Development, “Economic Outlook Database,” December 2010, Annex Table 25. For OECD countries, I calculated the unweighted average.
- ⁹ Congressional Budget Office, “The Long-Range Budget Outlook,” June 2010, p. 7.
- ¹⁰ See www.cato-at-liberty.org/swap-debt-limit-for-cut-and-cap.
- ¹¹ See www.cato-at-liberty.org/cutting-government-the-canadian-way and www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.
- ¹² See www.oecd.org/dataoecd/5/51/2483816.xls.
- ¹³ See www.oecd.org/dataoecd/6/27/2483806.xls.
- ¹⁴ U.S. Bureau of Economic Analysis, National Income and Product Accounts, Tables 3.3 and 6.2D.
- ¹⁵ Chris Edwards, “Federal Aid-to-State Programs Top 1,100,” Cato Institute Tax and Budget Bulletin no. 63, February 2011.
- ¹⁶ Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, “States Continue to Feel Recession’s Impact,” Center on Budget and Policy Priorities, January 21, 2011.
- ¹⁷ Federal Reserve Board, *Flow of Funds Accounts of the United States* (Washington: Federal Reserve Board of Governors, December 2010), Table D.3.
- ¹⁸ Robert Novy-Marx and Joshua D. Rauh, “The Liabilities and Risks of State-Sponsored Pension Plans,” *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.
- ¹⁹ Chris Edwards and Jagadeesh Gokhale, “Unfunded State and Local Health Costs: \$1.4 Trillion,” Cato Institute Tax and Budget Bulletin no. 40, October 2006.
- ²⁰ Chris Edwards, “Employee Compensation in State and Local Governments,” Cato Institute Tax and Budget Bulletin no. 59, January 2010.
- ²¹ Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits* (Philadelphia: The Pew Charitable Trusts, 2007), p. 11.
- ²² Moody’s Investors Service, “2010 State Debt Medians Report,” May 2010, Table 5.
- ²³ www.aei.org/docLib/2010RPOno1g.pdf.
- ²⁴ Chris Edwards, “Public Sector Unions,” Cato Institute Tax and Budget Bulletin no. 61, March 2010.

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Committee on Oversight and Government Reform
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