Statement of

Daniel Mitchell,
Senior Fellow,
Cato Institute

before the Senate Budget Committee,

Economic Stimulus: Budget Policy for a Strong Economy Over the Short- and Long-Term

January 30, 2008

Mr. Chairman, Members of the Committee, thank you for the opportunity to testify. My name is Dan Mitchell. I am a Senior Fellow at the Cato Institute. The views I'll be expressing today are my own.

Government policy can have a large impact on economic performance. With regards to fiscal policy in particular, the aggregate levels of taxation and spending matter. Relative changes in the aggregate levels of taxation and spending also influence growth.

Equally important, the composition of taxes and spending matter. Some types of taxation cause more economic damage, per dollar raised, than others because they lead to a bigger deadweight loss. There are similar differences on the spending side of the fiscal ledger. Some types of spending are believed to enhance economic performance by creating an environment that is conducive to work, saving, investment, risk-taking, and entrepreneurship. Other types of spending are thought to hinder economic growth by, among other things, misallocating resources that could be used more efficiently if left in the productive sector of the economy.

Economists do a poor job of predicting future economic performance, and I have no desire to add to the profession's embarrassment by offering my own guess about whether the economy is heading into a recession. For purposes of this testimony, though, let us assume that a downturn exists. Can fiscal policy help ward off a downturn, or at least alleviate its impact?

The most realistic answer is no. While fiscal policy is very important, as discussed above, it is much more likely to have an impact on long-run growth than it is to affect short-run economic performance. And to the extent that fiscal policy can affect short-run economic performance, it is because good long-term policy also yields positive – albeit small – short-run results.

For all intents and purposes, today's stimulus debate is a new chapter in a long-running controversy about Keynesian economics. Based on the work of John Maynard Keynes, the theory asserts that government should borrow money and then inject it into an economy, causing additional consumer spending. Supposedly, this consumer spending

means more demand for goods and services, which will cause more people to be employed to produce those goods and services.

There are several reasons to be skeptical about Keynesian stimulus. The key shortcoming is that it only looks at one-half of the equation. If the government sends a check to Person A, that person may run out and spend the money. And if the government spends money on Program B, that may result in an immediate outlay. But this type of analysis overlooks the fact that the government first has to borrow the money from Person C. In other words, any money in the pocket of Person A or any money spent on Program B is necessarily offset by less money in the pocket of Person C. There is no increase in the amount of income in the economy – unless the government monetizes the debt, and even that doesn't work since inflation simply reduces the value of existing money.

Some Keynesians admit that the money given to Person A or spent on Program B results in less money in the hands of Person C, but they then argue that the goal is to transfer money from people who are more likely to save and give it to people who are more likely to consume. Indeed, this is why there often is a focus on redistributing the money to those with less income. In theory, poor people will rush out and spend the money right away.

Once again, though, the theory ignores the real-world economy. When Person C saves money, those funds don't disappear. Through the process of financial intermediation, the funds are allocated to borrowers. Those borrowers either use the money to purchase consumptions goods or investment goods. In other words, government borrowing to finance so-called stimulus programs merely "crowds out" private sector borrowing and private sector spending. There is no increase in economy-wide spending.

To summarize, Keynesian stimulus plans do not work because they do nothing to increase national income. All that happens is that existing national income gets redistributed from one person to another. Another key point to understand is that consumer spending is a consequence of economic growth, not the cause of economic growth.

There are a number of academic studies showing that Keynesian stimulus is not effective, but real-world examples are probably more persuasive. There have been several episodes of Keynesian "pump priming," and there is little evidence that these attempts have been successful. Beginning with the surge of deficit spending during the Great Depression, continuing through to the rebates of the 1970s, and most recently with the rebates of 2001, Keynesian stimulus packages have not succeeded.

The 2001 episode is particularly instructive. The bulk of the 2001 tax cut – at least the part that took effect right away – was Keynesian-style rebates and child credits. These provisions put money in people's pockets, but, as explained above, redistributing national income is not the same as increasing national income. As such, the economy's growth was relatively anemic after the 2001 tax cut was adopted.

The 2003 tax cut, by contrast, was focused on "supply-side" provisions, including lower marginal tax rates on dividends, lower marginal tax rates on capital gains, and – by accelerating the income tax rate reductions scheduled for 2004 and 2006 – lower marginal tax rates on work and entrepreneurship. It is no coincidence that the economy performed much better after the 2003 tax cut than it did after the 2001 tax cut. That's because the 2003 tax rate reductions improved incentives to earn additional income by lowering tax rates on productive behavior.

To be sure, there are many factors that influence economic performance, so it is always appropriate to use caution when trying to interpret the impact of various policies. For instance, the economy's weakness during the 1930s presumably should not be blamed on the Keynesian policies. Expanding the size of government surely did not help growth, but bad monetary policy, protectionism, high tax rates, and regulatory intervention all played a role in hindering a recovery.

Policies That Work

If Keynesian stimulus does not work, what other fiscal policy options are available? In part, the answer is that there are no automatic fiscal policy solutions to an economic downturn – particularly when the economy's weakness is the result of non-fiscal factors such as poor monetary policy.

Good changes in fiscal policy help an economy grow faster, to be sure, but the short-run effect is not very large. Imagine, for instance, if the internal revenue code was replaced by a flat tax – much as nations ranging from Iceland to Mongolia have done. Moreover, imagine if that flat tax changes the economy's annual inflation-adjusted growth rate from 2.2 percent to 2.6 percent. In the short run, this does not have a big impact on living standards. Even after 10 years, the slight increase in the rate of annual growth does not translate into a big jump in national income. Indeed, it is only about 4 percent higher than it would have been.

But in the long run, the relatively small change in the rate of growth has a big impact on living standards. Because of compounding, changes that seem trivial become very large. After 100 years, an economy that grows 2.6 percent annually instead of 2.2 percent annually will have about 50 percent more income.

The lesson of the story is that policy makers should concentrate on reforms that will improve the economy's long-run performance. With regards to fiscal policy, that means less government spending, not more government spending. That means permanently lower tax rates, not gimmicky temporary tax rebates.

Are Deficits Good or Bad?

For years, some people have been arguing that deficits are terrible because they supposedly boost interest rates, and thus reduce capital formation. This is the so-called Rubinomics school of thought, though 1950s-era Republicans made the same arguments. Now, many people – sometimes the same people – are saying we need higher deficits to stimulate the economy.

So which is it? Are deficits good or bad? In reality, deficits are the least important fiscal policy variable.

If budget surpluses were a path to economic nirvana, nations such as Sweden would be role models. Instead, largely because taxes and spending consume more than half of that nation's output, Swedes have much lower living standards than Americans.

Likewise, if deficits were the key to prosperity, Japan should have been an economic powerhouse after 1990. Deficits skyrocketed and debt exploded, often because of explicitly Keynesian stimulus programs, but the economy remained mired in a long stagnation.

In third-world nations where debt is financed by printing money, deficits matter. In the United States, with a $14 trillion economy and government borrowing and debt at historically low levels, deficits qua deficits are largely irrelevant.

Deficits don't drive the economy. Indeed, it is the other way around. If the economy is strong, deficits tend to fall because tax revenues rise and people are not clamoring for government programs. And if the economy is weak, deficits rise because taxpayers have less taxable income and people are more likely to want money from the government.

In other words, what matters is the size of government and the structure of the tax system. If government is too big, diverting too many resources from the productive sector, growth will suffer. If the tax system is too punitive, discouraging work, saving, and investment with high marginal tax rates, growth will suffer. Whether or not total spending is more than total revenue, or vice-versa, is a secondary issue.

Conclusion

To conclude, Keynesian economics is bad theory. It's even worse in practice. It didn't work in the 1930s, and it didn't work in the 1970s. It didn't work earlier this decade. And it hasn't worked in other nations, such as Japan, that have tried to spend their way to prosperity. Thank you for this opportunity to testify. I will be happy to answer any questions.