

# Testimony to the Ways and Means Committee on the Effects of Spending and Deficits on Job Growth

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Chairman Camp, Ranking Member Levin and members of the committee: Thank you for giving me the opportunity to speak to you today.

In my five minutes, I would like to cover three issues. First, as is becoming well-accepted, the current spending pattern is unsustainable. Second, the problem was created by policy and can be remedied by changing policy. But raising taxes in an attempt to meet spending is not the right solution to the problem. Third, if the spending picture is not altered, economic growth will suffer, and with it, employment, wages, and the standard of living of the typical American.

It is becoming common knowledge that the US budget deficit is a threat to our long run economic survival. Most concerns are over the effect of the budget deficit on growing debt and the consequence of that debt on the ability of the US to borrow. As our debt gets large relative to GDP, we will eventually have to service this debt out of tax revenues and offsets in other spending, both of which will place significant burdens on the fiscal situation. More important will be the effect on the private economy as high levels of government borrowing raise interest rates and stifle business investment. A well-known study by Reinhart and Rogoff suggest that as debt-to-gdp ratios get above 90%, growth rates fall significantly. By one estimate, economic growth would be about 1½% at a 90% debt-to-gdp ratio, and about 3½% at levels of debt-to-gdp below 30%. Given the President's budget and forecast deficit if enacted, our debt-to-gdp ratio will be over 70% by this time next year.<sup>1</sup>

Although the discussion is usually put in terms of the deficit, focusing on the deficit can lead to the wrong policy choices. Historically (over a thirty year period of 1979-2008), the ratio of federal spending-to-GDP has been 20.8%, while the ratio of receipts-to-GDP has been 18.3%, resulting in an average deficit of 2½%. Chart 1 shows this. The horizontal dotted lines show the long run averages of spending-to-GDP and receipts-to-GDP, at 20.8% and 18.3%, respectively.

The deficit is the difference between expenditures and revenues, but it is not only the difference that matters. It is one thing to have a 2½% deficit when spending is 20.5% of GDP and quite another to have a 2½% deficit when spending is 25% of GDP. In the first case, taxes would equal 18% of GDP. In the second, taxes would equal 22.5% of GDP. The economic literature has documented that it is not only high debt ratios that impede growth. It has also been demonstrated by a number of authors that higher taxation impedes growth. If spending is high,

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<sup>1</sup>The relevant debt is publicly held debt, not that which includes that issued by one US government entity and held by another US government entity.

taxes must also be high to control the deficit.<sup>2</sup> Although estimates vary, the conclusion is that the adverse effect of taxation on growth is significant.

Policy is primarily responsible for the large deficits that are projected to be sustained into the near and distant future. Although it is true that tax receipts fall during recessions, as economic activity rebounds, so too does revenue. As the recovery continues, we can expect to return to tax levels that equal about 18% of GDP. The spending side is different. It is controlled by government policy and the President's projections move our post-recession spending ratios up considerably from our historic norm of 20.8%. The long run numbers that he presents are frightening, as Chart 1 shows. While in the past, there are ups and downs in spending and receipt ratios, the President's projections for the future show an expanding gap between expenses and receipts. This implies that the deficit and debt will rise in the future, perhaps to crisis levels.

The President does not propose to raise taxes by an amount large enough to bring the deficit down to historic levels, nor do I believe that he should. Doing so would deprive Americans of even more of their own wealth and would be bad for the economy. So what is the alternative?

I believe that we should take immediate action to retrace our footsteps. The current ratios of government outlays-to-GDP were surpassed only during World War II. The outlay-to-GDP ratio averaged 20.1% between 2005 and 2008 and the 1979-2008 thirty-year average was 20.8%, well below the 24.4% that we averaged over the past two years. Part of the spending increase over the past two years reflects an attempt to stimulate the economy through increased government spending. We can debate the effectiveness of that stimulus, but let us focus on the future, not the past. The President forecasts this year's ratio to be 25.3% and next years to be 23.6%.<sup>3</sup> Both numbers are too high and sustained spending at these levels will lead to significant debt and lower growth.

It is possible to get back to historic levels in a relatively rapid fashion without slowing the current recovery. This would require that we cut spending significantly in the next couple of years. In addition, I believe we should institute a rule that constrains the growth in spending. In a piece published in the Wall Street Journal about six months ago, I proposed an "inflation-minus-one rule" that would limit the growth in expenditures in any given year to the recent inflation rate, minus one percentage point. Because GDP generally grows considerably faster than this rate, over time, the ratio of spending to GDP would fall. My calculations suggest that, coupled with the initial cuts, we could return to the size of government that prevailed throughout most of our recent history within about four years. Continued restraint would allow us to balance

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<sup>2</sup>Some examples: Barro (1991) finds that growth is inversely related to the share of government consumption in GDP. Hansson and Henrekson (1994), find that government total outlays have negative effects on productivity. Waldman (1999) find that taxing personal income is negatively related to growth and the more progressive tax structures are associated with lower economic growth. Prescott (2002) argues that the difference in taxation between the US and France explains much of the difference between the two countries' growth rates. Bergh and Karlsson (2010) find that government size robustly correlates negatively with growth.

<sup>3</sup>Economic Report of the President, 2011, Table B-79.

the budget at historic receipts-to-GDP ratios within the decade.

With the unemployment rate still close to 9%, job creation is obviously a primary focus. In the short run, increased employment comes with economic growth, as chart 2 shows. The two series, employment growth and GDP growth, move in tandem. History has shown us that the economy rarely creates jobs in the absence of economic growth. But over the longer run, the main effect of economic growth is on wages, which has a direct impact on the typical American's standard of living. The link requires two steps.

First, GDP growth is usually linked to productivity growth, as chart 3 shows. The one-year-moving-average of GDP and labor productivity are shown to move parallel with one another. When we have good periods of GDP growth, we usually have good periods of productivity growth. To enjoy high productivity growth over a sustained period, rapid economic growth is necessary.

Second, both theory and experience imply that wage growth comes with productivity growth. Chart 4 shows the four-year moving average of productivity growth and wage growth. In periods during which productivity grows rapidly, wages also grow rapidly. When productivity falters, so too do wages.

In the labor market, it is important to bear in mind one final point. Even during deep recessions, a tremendous amount of hiring occurs. At the worst part of the recession, there were still around 4 million hires per month,<sup>4</sup> which means that about 35% of the labor force turned over in a year. Churn is an important feature of our labor market and most hiring is for the purpose of replacement, not expansion. Anything that restricts labor mobility is likely to result in increased unemployment. Europe's severance pay requirements are a case in point. The restrictions placed on employers to separate workers have backfired. Employers are reluctant to hire when they know that they cannot layoff during downturns. To ensure that hiring increases to the levels that prevailed at the peak, it is important that we make sure that our labor market remains flexible.

Let me conclude. We can best deal with our labor market problems by ensuring that we have a pro-growth economic environment. Perhaps the largest threat to long term growth is the recent high level of government spending, which will result in high deficits or will require that we raise taxes substantially. Either course impedes economic growth. The high level of spending can be reversed. If we adopt the appropriate policy, we can look forward to economic growth, low unemployment and rising wages.

Thank you and I welcome your questions.

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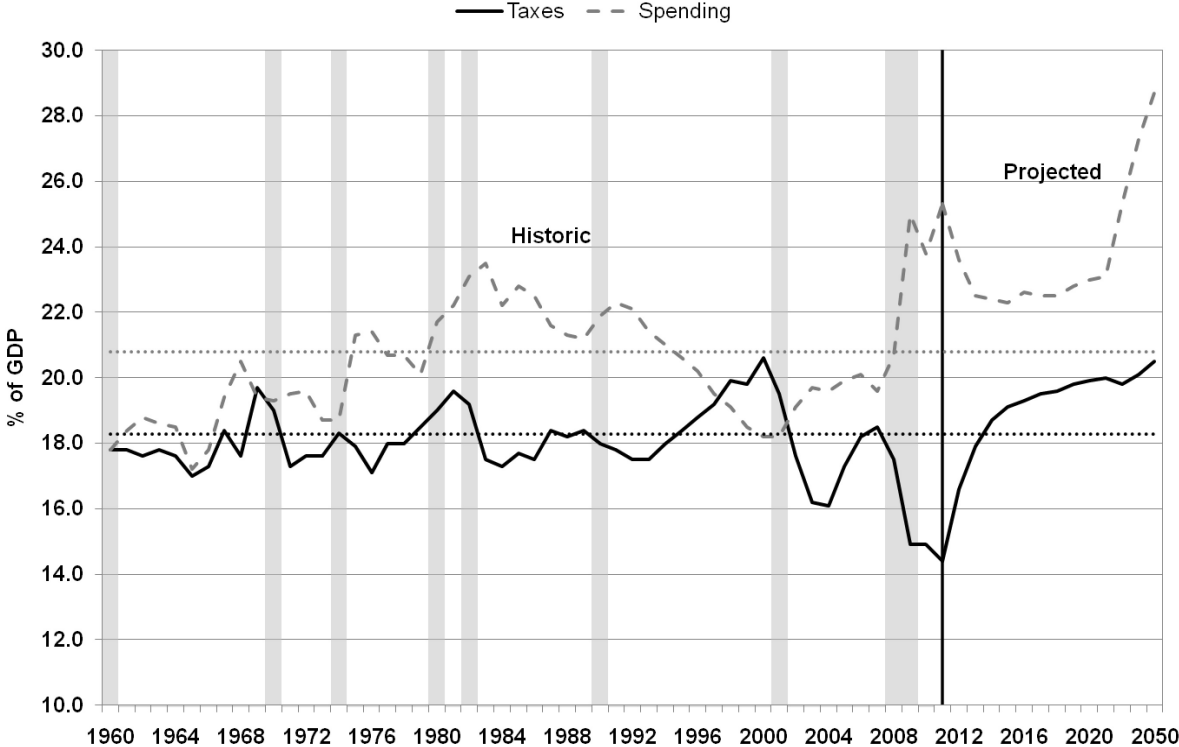
<sup>4</sup>Bureau of Labor Statistics, JOLTS data.

## References

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Charts

Chart 1. Spending and Taxes



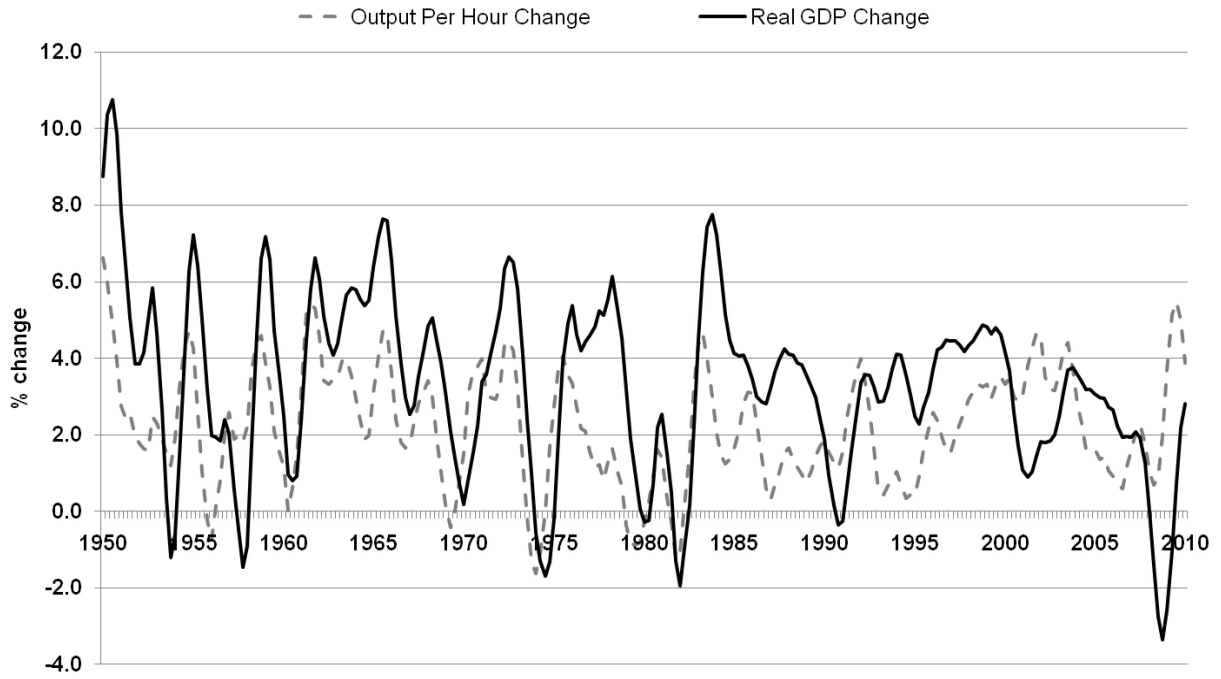
Source: Office of Management and Budget.

### Chart 2. Employment Growth and Real GDP Growth



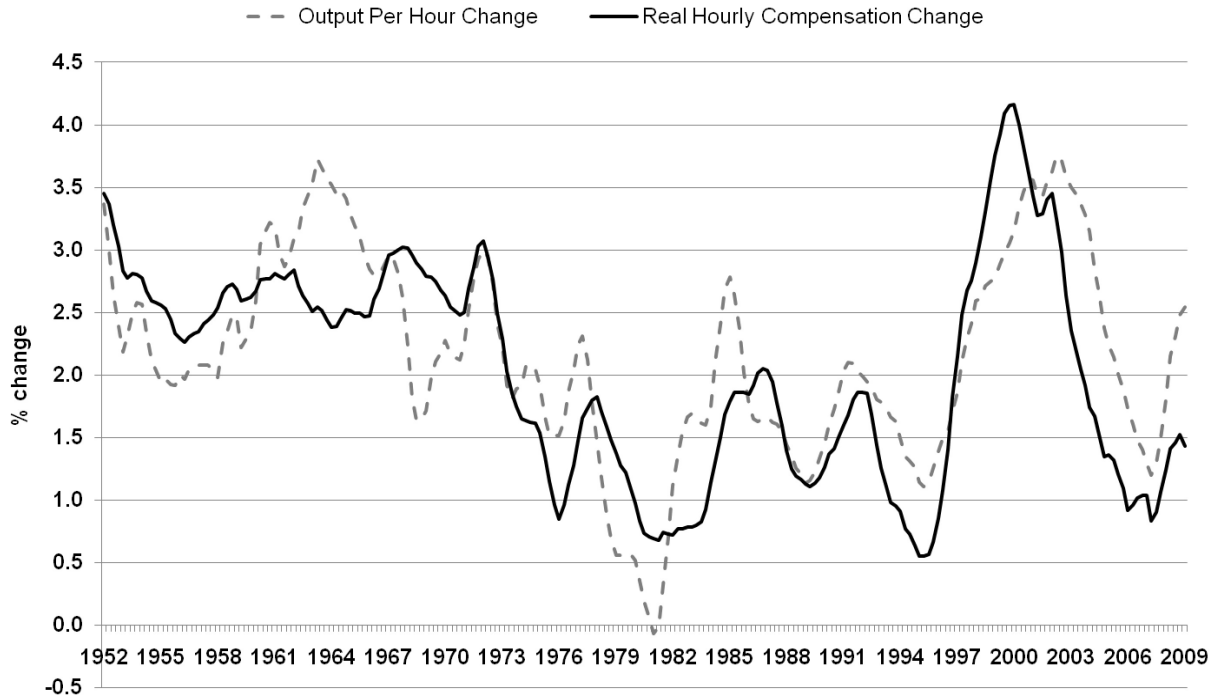
Source: Economic Report of the President 2011.

**Chart 3. Productivity Growth and Real GDP Growth  
1-year Moving Average**



Note: Data are from 1950Q1 to 2010Q4.  
Source: Bureau of Labor Statistics.

**Chart 4. Productivity Growth and Real Wage Growth  
4-year Moving Average**



Note: Data are from 1950Q1 to 2010Q4.  
Source: Bureau of Labor Statistics.