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SPENDING BEYOND OUR MEANS

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The federal government's deficit will reach $1.4 trillion this year—a whopping 10 percent of Gross Domestic Product (GDP)—and the total federal debt stands at almost $14 trillion.[1] That's $40,000 for every citizen of the United States. The U.S. fiscal picture is shaping up to be a category 3 hurricane of red ink. Unless Congress takes action immediately to reduce the deficit, the deficit will inflict devastating damage on our economy.

SPENDING MORE THAN WE TAKE IN

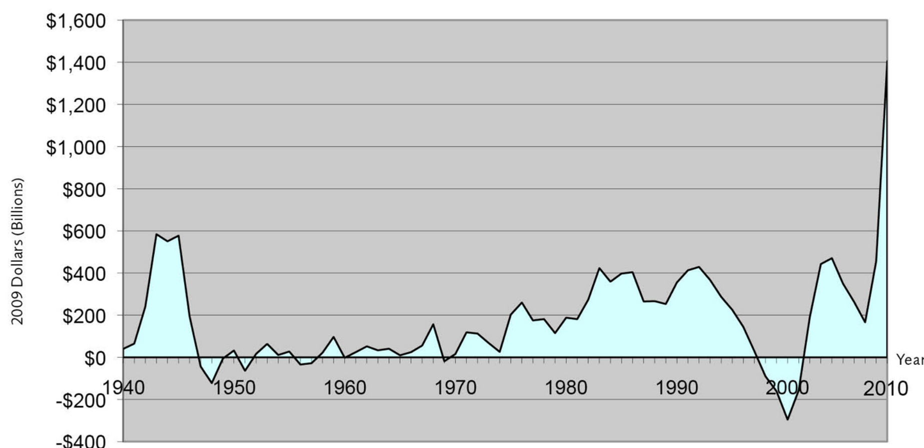
The reason we are facing a financial hurricane is simple: we spend more than we take in. Nobel Laureate James Buchanan and his colleague Richard Wagner describe the situation this way: To get their jobs, politicians always promise not to raise taxes. To keep their jobs, they direct money back home to their districts and constituents, which means that most politicians favor increased spending over spending reductions.[2] If they are unconstrained, then, policy makers will always tend to increase spending while avoiding the pain of raising taxes. This behavior leads to systematic deficits.

Figure 1 shows the record for annual federal budget deficits and surpluses from 1940 to the 2010 estimate. The chart shows deficits above the line and surpluses below it. It is easy to see the brief periods of surplus because there are so few of them.

Figure 1 also shows how quickly the U.S. government erased the massive deficits caused by World War II. After that time, though, the deficit grows larger and larger until the turn of the century brings a brief period of surpluses. Since then, with wars, financial collapse, and bailouts taking their toll, the deficit machine has been operating in overdrive.

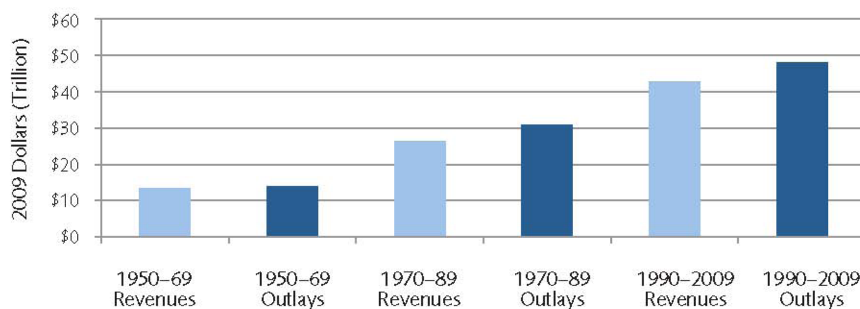
What is the origin of these deficits? Are they the result of lower revenues or higher expenditures? Figure 2, which reports real revenues and outlays for three 19-year periods (1950–1969,

FIGURE 1: FEDERAL DEFICIT, 1940–2010 (ESTIMATE), BILLIONS OF 2009 DOLLARS



Source: Author's calculations based on OMB, Budget of the United States Government, Fiscal Year 2011 *(Washington, DC: U.S. Government Printing Office, February 1, 2010), table 1.3, http://www.whitehouse.gov/omb/budget/historicals.*

FIGURE 2: FEDERAL REVENUES AND OUTLAYS, 19-YEAR INCREMENTS, 1950–2009



Source: Author's calculations based on OMB, Budget of the United States Government, Fiscal Year 2011 *(Washington, DC: GPO, February 1, 2010), table 1.3, http://www.whitehouse.gov/omb/budget/historicals.*

1970–1989, and 1990–2009), answers these questions. In the first period, there is a small deficit gap in which outlays exceed receipts. During the second and third periods, this gap continues to expand. This expansion indicates a structural deficit in the political process that does not seem to go away. Revenues are growing, but government spending continues to outstrip those increased revenues. The federal government is taking in more money, but it continues to spend more than it takes in.

THE COST OF DEFICITS

The fact that the federal government spends more that it takes in is just the beginning of the deficit story. Most of the post-1970 government spending has been allocated to providing services and products that people consume quickly—health care, food, housing, and retirement benefits—as opposed to supporting traditional investments in infrastructure that yield benefits over many years, such as better transportation systems, improved waterways, water quality-control systems, defense, and research and development.

It is one thing for the government to borrow money to build assets that will make people and the economy more productive. It is quite another for it to borrow year-in and year-out to pay for food, housing, and health care. The difference, of course, relates to the fact that eventually, we taxpayers will have to pay those debts. Newly generated income and wealth make this payment possible. If more wealth is not created, then deficits and interest paid on the resulting debt will continue to increase. Taxpayers will then owe even more money, and ultimately everyone will be worse off.

When the government subsidizes the services it provides without raising taxes or cutting other programs, it does two things. One, it automatically increases the deficit. Two, it makes the price observed by consumers less than the actual cost of providing the benefit. People then naturally want more of the artificially cheap service. They become boosters for more deficit-funded subsidies.

Increased government subsidization has had a number of unfortunate effects.

- Increased government spending on subsidies means that there is less money that goes to traditional outlets such as transportation systems. Unimproved highways and traffic controls impose a high cost on commuters. The U.S. Department of Transportation reports that "the annual person-hours of delay per capita for all urbanized areas grew from 17.1 hours in 1997 to 21.8 hours in 2005."[3] The long lines of commuters travelling like snails on their way to and from work generate billions of dollars of delay costs each year. The more time commuters spend in their cars, the less time they have to spend on productive activities that would grow the economy.

- Producers of unsubsidized fuel-efficient gas engine and diesel-equipped automobiles must compete with the builders of highly subsidized hybrid or electric autos. The deficit-funded subsidies reduce demand for (or as economists would say, "crowd out") unsubsidized diesel-equipped and other fuel-efficient cars. Because of subsidies, cars that are really cheaper to produce and drive are made to look more expensive. This misallocation of scarce resources makes us all poorer.

- Government spending on social welfare appears to be eroding private support of charitable nonprofit organizations. Across 1975–1994, researchers found that a 10 percent increase in government contributions to the poor led to a 5.8 percent reduction in private charitable contributions.[4] Through time, private organizations are predicted to focus on lobbying for more federal support of the causes they support instead of finding more innovative ways to serve the poor.[5]

- Private support of the arts falls. Research shows that a one dollar increase in National Endowment for the Arts' funding is associated with an 80 cent decrease in private contributions.[6]

- Increased government borrowing associated with deficits can crowd out private investment activity, which would really create mischief in the present economy. The evidence is mixed, but economist Jeffrey Frankel found that private borrowers paid higher interest rates for their loans during the 1980s when the federal government, because of deep deficits, was hitting credit markets hard for additional cash.[7]

- With increased federal borrowing, the real-estate market might take even longer to recover. In the period from 1974 to 2007, federal deficits appear to be systematically associated with higher home-mortgage interest rates when all other factors are equal.[8]

- Finally, and of key importance, when the federal government takes in a dollar by taxation and runs it through an agency to fund a favored program, that dollar gets a "haircut" because of the cost of collecting the dollar and managing the federal programs that distribute benefits. Researchers find that it costs from $1.40 to $1.60 for the federal government to transfer one dollar.[9]

The growing deficit and government's increasing provision of historically private services are creating a society that is marginally more dedicated to consumption than to investment, looks more frequently to government to address problems, and has an increasing addiction to government money. Wealth creation suffers in such a society, as do intangible but important virtues such as creativity and compassion.

DOING SOMETHING ABOUT THE DEFICIT

The deficit problem is so serious that it was a key focus of President Obama's 2010 State of Union Address. The president called for a three-year freeze on discretionary spending other than that for national security, Medicare, Medicaid, and Social Security and told of plans to reduce the annual deficit to 3 percent of GDP by 2015.[10]

The 3 percent of GDP goal is the deficit standard for members of the European Union and is based on hard logic.[11] If economies on average grow real GDP at 3 percent a year or more, then, holding tax rates constant, a structural deficit of about 3 percent a year (interest costs included) can coexist.

> Reeling in federal spending must be the first step in taming an unruly deficit. The reason is simple: Raising taxes enough to close the gap would require a doubling of tax rates. This is far more than the taxpayers will tolerate.

In the United States, however, if the economy only grows at 3 percent and deficits are larger than that (as they are now), then one of four unpleasant things (or some combination thereof) will have to take place. We will have to: 1) cut federal programs by enough to close the gap; 2) raise taxes by the gap between

the 3 percent and the deficit growth rate; 3) print money to pay off debt, thereby generating inflation; or 4) default.

None of these choices is pleasant, but reeling in federal spending must be the first step in taming an unruly deficit. The reason is simple: Raising taxes enough to close the gap would require a doubling of tax rates. This is far more than taxpayers will tolerate. Of course, some tax increases may be feasible, but feasible increases will not be nearly enough to close the deficit gap. Printing enough additional money to do the job would also be futile as it would drive up inflation. Inflation robs savers and rewards borrowers, and continued inflation destroys incentives that support work and wealth creation. And obviously, default is not an option. The recent threats of default involving Greece, Spain, Portugal, and Italy were enough to send economic tremors across the globe. Imagine what would happen if the United States, the provider of the world's reserve currency, threatened to default.

The one remaining option is to rein in spending systematically. Doing so will require legislation that sets spending reductions in motion while imposing tough discipline on future spending increases. Taking this action will not be easy for politicians who understandably love to deliver publicly provided goods to their constituents. But if policy makers do not take real steps to constrain spending and get the house in order, the force of the resulting fiscal hurricane will put the brakes on the redistribution game. More importantly, the nation will be poorer, and our government will have failed in carrying out its basic duty: to protect the wealth of its people.

ENDNOTES

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