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Designing Federal Budget Policy to Spur Economic Growth

Presentation to the National Association for Business Economics

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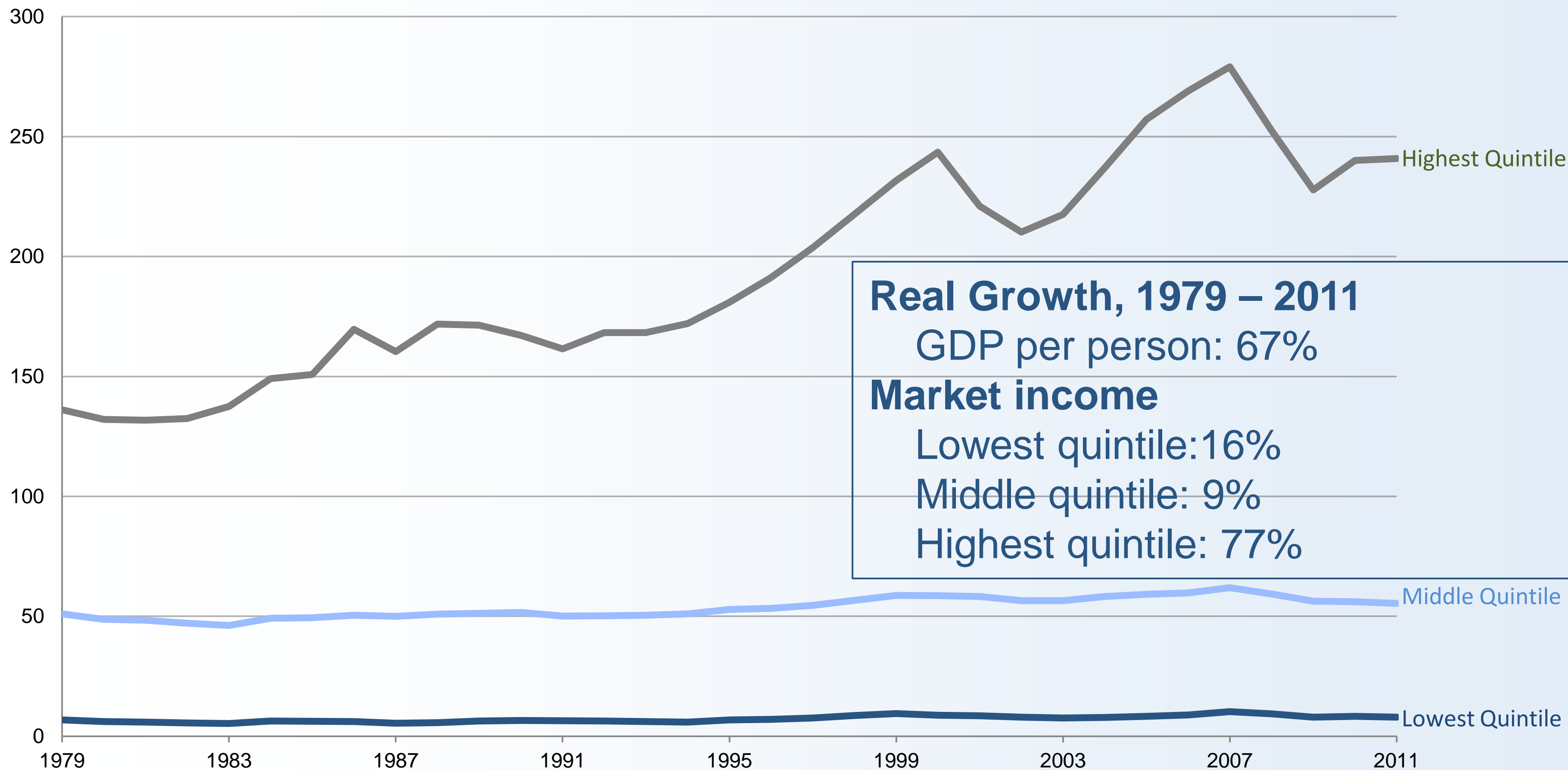
Economic growth for whom?

The traditional answer is “economic growth for the country as a whole.”

That answer stems from a view that growth in total output and income will generate growth in incomes for most people.

But that view has been wrong in the past few decades: The rising tide has *not* lifted most people’s boats very much.


Real Average Market Income for Households
Thousands of 2011 dollars
300
250
200
150
100
50
0
1979
1983
1987
1991
1995
1999
2003
2007
2011
Highest Quintile
Middle Quintile
Lowest Quintile
Real Growth, 1979 – 2011
GDP per person: 67%
Market income
Lowest quintile:16%
Middle quintile: 9%
Highest quintile: 77%
Source: CBO

Economic growth for whom?

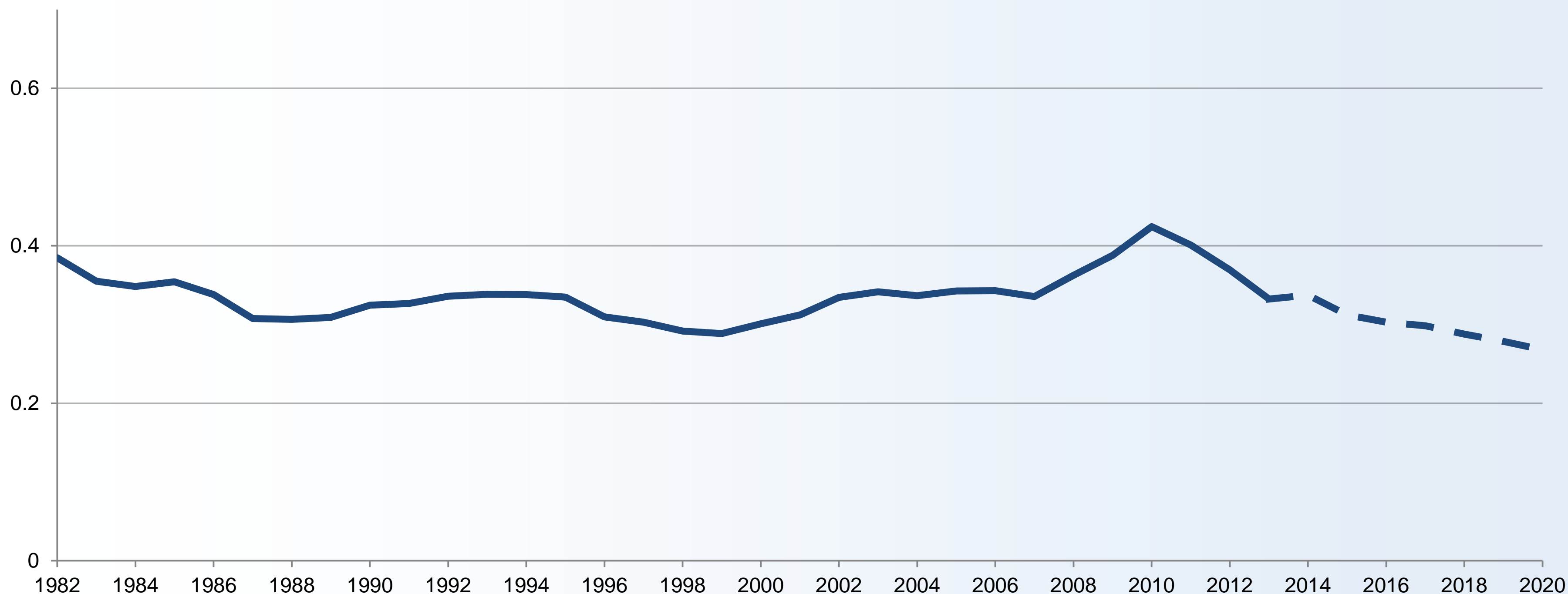
The market incomes of people across most of the income distribution have benefited very little from the growth of total output and income in the past few decades.

Given that pattern, my value judgment is that we should focus on designing fiscal policy to spur income growth for lower- and middle-income people.

A five-part agenda for federal budget policy to spur income growth

1. Maintain federal investment as a share of GDP
2. Reform the tax code to increase the efficiency of business investment
3. Encourage innovation
4. Reduce federal debt relative to GDP, but only slowly
5. Reduce uncertainty about future budget policy

1. Maintain federal investment as a share of GDP



1. Maintain federal investment as a share of GDP

Under current caps on discretionary spending, federal nondefense investment in infrastructure, education and training, and research and development soon will be smaller relative to GDP than at any time in at least 50 years.

That is not forward-looking, growth-oriented budget policy. Cutting federal investments will reduce total output and income relative to what they would otherwise be.

In particular, reducing federal investment in education and training will reduce the incomes of lower- and middle-income people relative to what they would otherwise be.

1. Maintain federal investment as a share of GDP

We should raise the caps on nondefense discretionary spending substantially, in order to maintain overall federal investment as a share of GDP.

We should work to increase the return on federal investments. For example, we should increase the role of careful cost-benefit analysis in deciding which specific investments to undertake.

There is a growing body of evidence that certain health-care benefits, housing subsidies, education subsidies, and other means-tested benefits raise future incomes of some young people. We should protect those investments as well.

2. Reform the tax code to increase the efficiency of business investment

Increasing the *amount* of business investment through tax reform would be difficult to achieve while still collecting sufficient tax revenue and not increasing burden on people of modest means.

If one relaxed the condition of revenue neutrality, then it would be easier to reduce the marginal tax rate on capital. However, the increase in federal borrowing would diminish economic growth.

If one shifted the tax burden toward people of modest means, then it would be easier to reduce the marginal tax rate on capital. However, people of modest means might well be worse off, even after accounting for the effects of additional capital.

2. Reform the tax code to increase the efficiency of business investment

The current tax code distorts businesses' decisions regarding asset types, industries, organizational forms, and geographic locations.

Reducing those distortions would boost future incomes.

We should enact revenue-neutral and distribution-neutral tax reform that increases the efficiency of business investment.

3. Encourage innovation

Policies that are not primarily budget policies:

- Increase immigration of high-skilled people.
- Improve the patent system.

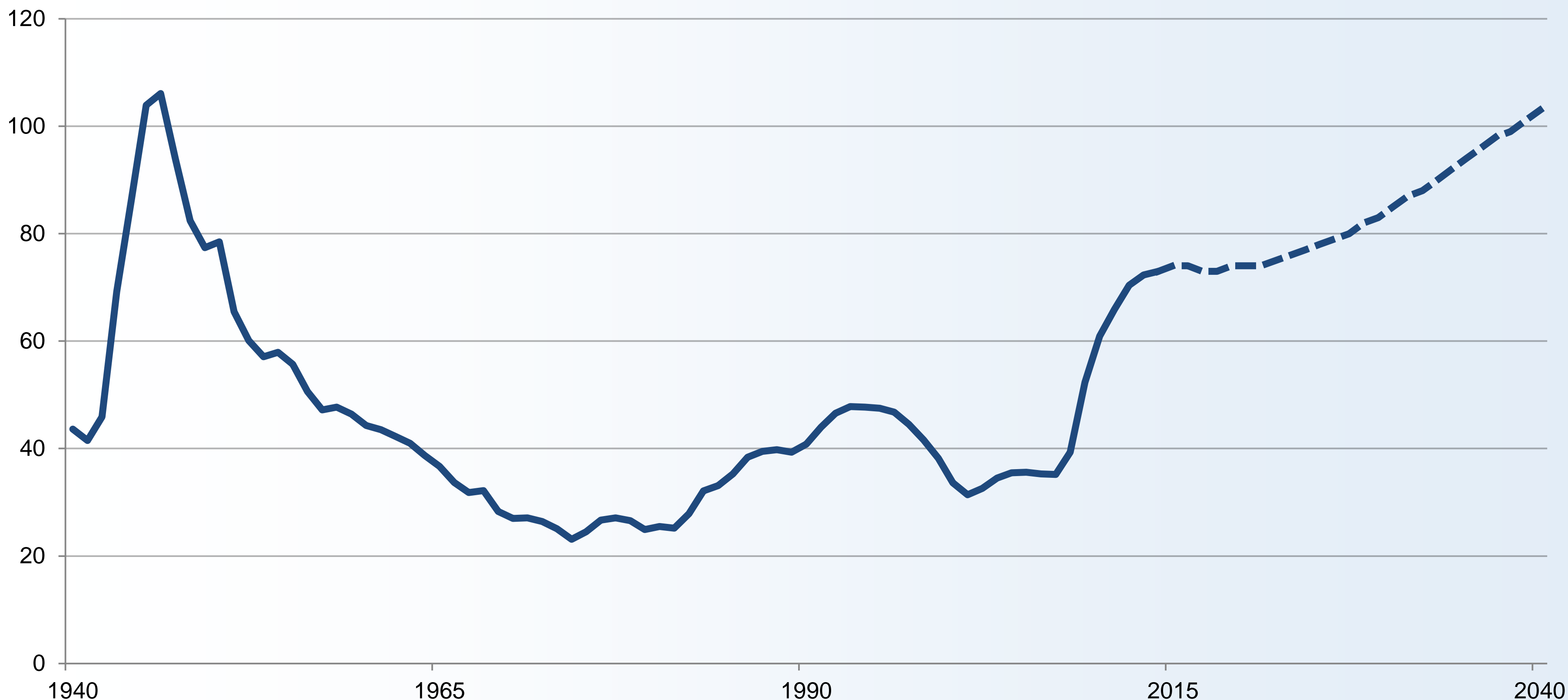
Budget policies:

- Provide robust funding for research.
- Provide strong support for education in science, technology, engineering, and mathematics—or STEM.

4. Reduce federal debt relative to GDP, but only slowly

Federal debt as a percentage of GDP is currently very high by historical standards, and it probably will be much higher in a few decades without significant policy changes.

4. Reduce federal debt relative to GDP, but only slowly



Source: CBO, 2015

4. Reduce federal debt relative to GDP, but only slowly

Economics does not offer a straightforward guide to the optimal amount of federal debt. In my assessment, the prudent approach is to reduce the debt-to-GDP ratio gradually over the next few decades rather than letting it increase.

That approach would, in the long run:

- allow for additional investment in private capital, which would raise future incomes.
- give policymakers flexibility to respond to unexpected events, such as financial crises, recessions, and international threats.

4. Reduce federal debt relative to GDP, but only slowly

A further decline in the deficit in the next few years would hurt the economic expansion—just as the rapid drop in the deficit in the past few years slowed the recovery by lowering output, investment, employment, and wages relative to what they would have been otherwise.

Therefore, we should *not* reduce federal debt quickly.

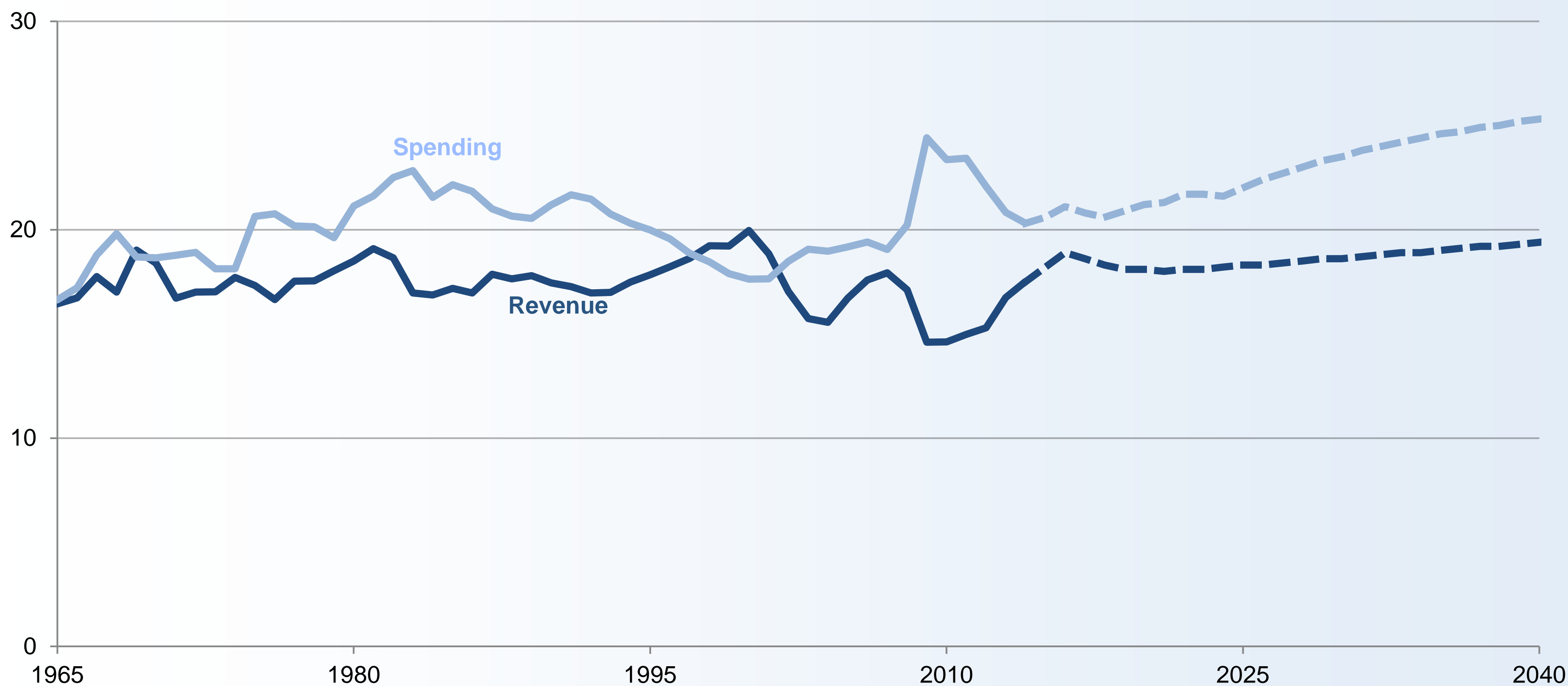
A rush to "normalize" fiscal policy has been the biggest policy error during the economic recovery

When the economy is suffering from a shortfall in demand, and the federal funds rate is close to its lower bound, the tax increases or spending cuts that reduce budget deficits lower output, investment, employment, and wages.

The legitimate concern about federal debt has been its long-term path, not its short-term spike, so reducing the deficit as quickly as we did was a significant mistake.

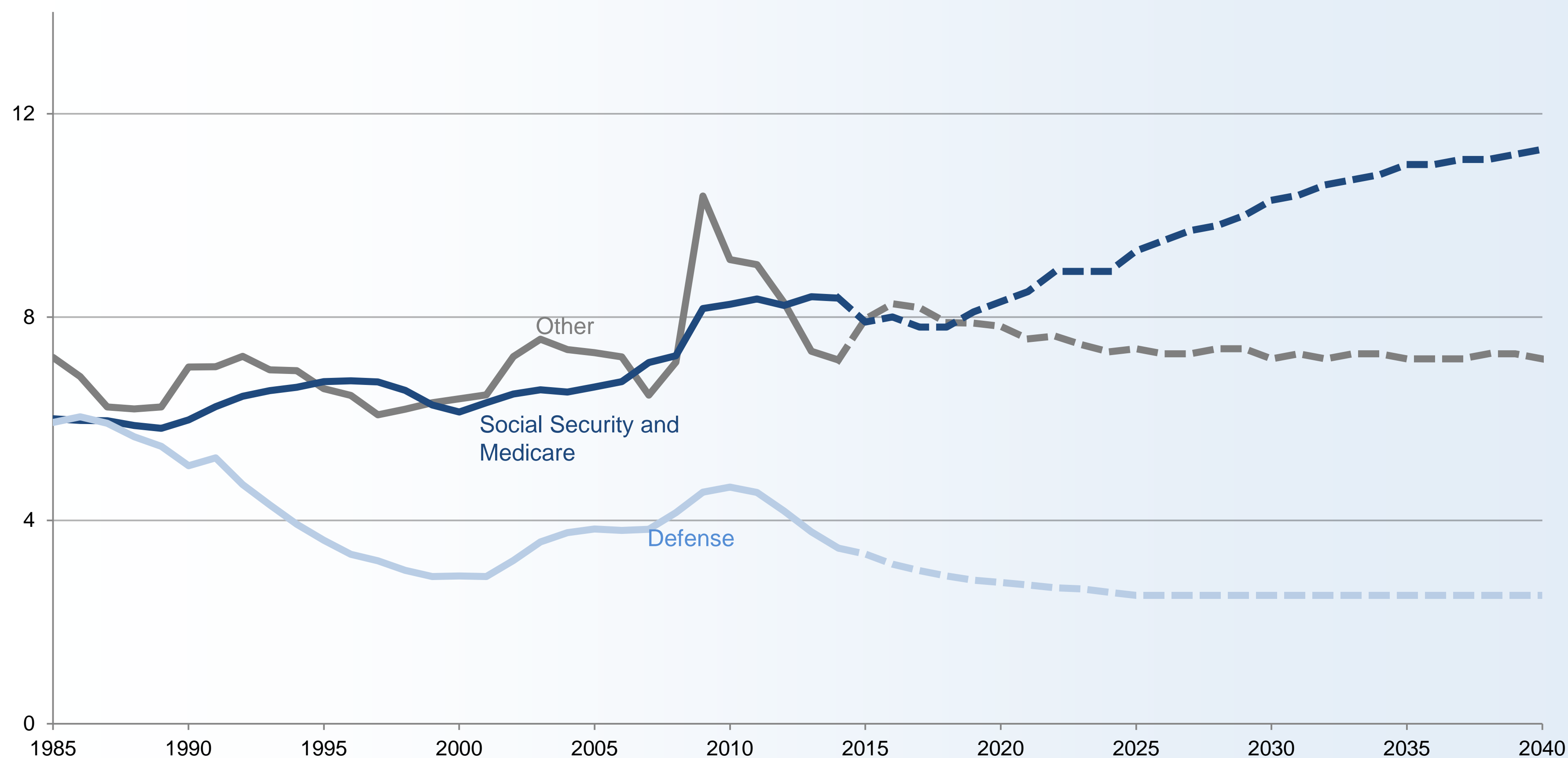
(Similarly, a rapid normalization of monetary policy would have been a significant mistake, and the Federal Reserve has wisely resisted pressure to do that.)

To reduce the debt-to-GDP ratio



Source: CBO, 2015

To reduce the debt-to-GDP ratio



To reduce the debt-to-GDP ratio

My value judgment: We should try to spur income growth for lower- and middle-income people.

Restraining federal debt by cutting their benefits or raising their taxes would be counterproductive.

We should avoid significant cuts in benefits targeted at lower- or middle-income people—as well as significant across-the-board cuts in benefits, such as increasing the eligibility age for full Social Security benefits. Such cuts would significantly reduce income for people of modest means.

To reduce the debt-to-GDP ratio

Instead, we should increase means-testing of Social Security and Medicare benefits, and we should raise taxes on the affluent.

This approach does not offer a free lunch. Making Social Security and Medicare more progressive would weaken the connection between an individual’s taxes and benefits, and it would reduce incentives to work and save.

This is the best of the available alternatives for restraining federal debt without unduly burdening those Americans who have fared the worst in economic terms in recent years.

5. Reduce uncertainty about future budget policy

Uncertainty makes it more difficult for businesses to have the confidence to undertake investment and more difficult for them to know what they should invest in.

The quantitative significance of this problem generally is not clear. But unnecessary policy uncertainty is a self-inflicted wound.

In some specific cases, this is a serious problem. One clear example is climate policy.

5. Reduce uncertainty about future budget policy

Uncertainty is also created by the constant brinkmanship over critical policy actions.

Policy uncertainty hampers effective decision-making far beyond the business community.

Decision-making by the Congress is hampered by the constant brinkmanship.

5. Reduce uncertainty about future budget policy

We should reduce uncertainty about future budget policy by:

- Avoiding shutdowns and debt-ceiling threats;
- Avoiding short-term extensions of expiring policies and continuing resolutions for appropriations;
- Addressing, rather than deferring, long-term issues—such as entitlement policies, tax policies, and policies to address climate change.

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One Final Recommendation

Analysts and policymakers should not over-promise about the effects of federal budget policy on economic growth.

Demographic changes have greatly slowed the feasible pace of labor force growth and therefore the feasible pace of GDP growth.

Exaggerating what better budget policy could accomplish may seem like a harmless way to encourage action by our inertial political system. But I think there is harm to over-promising, because it increases distrust between people and their government.

Despite the limitations of federal budget policy, it can make a significant difference to growth in people's incomes over time.

Thank you