Joint Economic Committee Republicans
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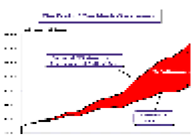
America's Prosperous Future: Limited Government

Introduction

The conventional wisdom in Washington is that Americans will need to sacrifice to balance the budget. However, fiscal discipline does not equal economic hardship. The Republican plan to balance the budget by reducing spending and cutting taxes is a recipe for expanded economic growth. By expanding economic growth, every American will have greater opportunities to succeed and prosper.

Economic growth is the answer to many ills of society. Faster economic growth will allow companies to better compensate workers, government to more rapidly balance the budget, and citizens to more easily provide for healthy families and cleaner neighborhoods. However, increased economic growth requires a change in the Washington mind set. Too many in government are satisfied with economic growth in the range of 2 percent a year. Historically, we have been able to do much better. Real GDP grew 3.7 percent between 1946 and 1973. The Reagan expansion restored economic growth to this historic level. However, under the Clinton Administration, we are lowering the bar.

 Click here to see Figure.

The Reagan expansion was boosted by tax cuts. The post-war expansion also was accompanied by low taxes and low government spending. Government cannot control every factor responsible for economic growth; however, government can take two very important steps that will revive economic growth; **reduce spending and cut taxes.**

Reduce Spending

To restore economic growth, it is important to reduce government spending. Recently, the Joint Economic Committee (JEC) released a report written by two academic economists, Lowell Gallaway and Richard Vedder.[1] They carefully studied U.S. history to examine the relationship between government spending and economic growth. They concluded that at current spending levels the last dollar government spends reduces private sector GDP by $1.38. In other words, the economy experiences a net loss of 0.38 cents. From their analysis, it follows that in 1994, if the federal government were to reduce its spending by four percentage points, economic growth would have increased to 5.4 percent.[2]

Figure 1 demonstrates the potential loss from excessive federal spending over the last 30 years. This output loss is expressed as the difference between actual GDP growth and the GDP growth that would have occurred with federal government spending at its optimal level.

Government spending reduces GDP growth for two reasons. The first is that government spending is inefficient. Economic efficiency requires good information, flexibility, and responsibility. Governments spend money based upon political calculations, not necessarily economic calculations. Special interest groups have an incentive to give biased information to political decision makers, as evidenced by the legions of lobbyists. Responsibility is divided as decision-making is shared by Congress, the President, and bureaucrats in the Administration. Political allocation of resources reduces economic well-being by interfering with private markets' efficient allocation of resources.

The second reason for the negative aspects of government spending is its effect to bid up the price of resources. The purpose of markets is to provide price signals to entrepreneurs. They use these signals to evaluate projects to determine if these projects are profitable. If projects are profitable, entrepreneurs will hire workers and purchase capital to realize their profits. The effect of government spending is to raise the cost of resources. These higher costs will make many entrepreneurial projects unprofitable and reduce private-sector activity.

A final irony of excessive government spending is that it works perversely to lower government revenues, by slowing economic growth. By balancing the budget through spending restraint, we allow future generations to enjoy more government services. If Congress would have restrained spending throughout the 70s and 80s, we would have $10 billion more to spend for government services while maintaining a balanced budget.[3] Clearly, if Congress and the President are concerned with the economic well-being of America's children, they will reduce the size of government.

Cut Taxes

The Republicans in Congress have presented a budget of historic significance. For the first time in recent memory, Congress proposes to balance the budget and cut taxes at the same time. Finally, a majority of legislators recognize that Washington demands too much of the resources and time of ordinary, working Americans. The tax cut proposed by the Republicans is specifically targeted to strengthen families and spur investment and economic growth.

All taxes reduce economic growth. People seek to avoid taxes. The actions they take to avoid taxes means that they will reduce income-producing activities. They will work fewer hours, invest less, or hide income if the costs of taxation are too high. Economists have studied the burden of taxation and have estimated that every dollar raised from taxes reduces income from 17 to 56 cents.[4]

The evidence of the benefits of lower taxes can be seen in three tax cutting periods in the 20th century. In the 1920s, taxes were cut three times in direct response to economic slowdowns. The result of the tax cuts was an improved economy[5]. From 1920 to 1929, the economy grew 4.3 percent. In the 20th century, only one other decade rivaled the rapid growth rate of the 1920s, the 1960s. President Kennedy pushed for a tax cut in 1963. Soon after the tax cut, employment rose and the economy expanded. The third important tax cut in the 20th century was enacted under President Ronald Reagan. The result of the Reagan tax cut was a prolonged economic expansion following the disastrous consequences of the high-inflation, low-growth Carter years.

The Reagan expansion, while impressive, was hampered by the failure of Congress to restrain spending. Government spending as a percent of GDP was highest in the 1980s.

The current expansion is hobbled by the tax hikes that the Democratic Congress, along with Presidents Bush and Clinton, enacted. If the economy of the 90s is to match the economic growth record of the 80s, the economy will have to grow a full percentage point faster than projections.[6]

Conclusion

The Republicans are trying to restore prosperity to the American economy. The way is simple, but is blocked by an Administration, and members of Congress, who seek to preserve the status quo of excessive government spending and high taxes. The idea of reducing spending and cutting taxes is not based upon some masochistic obsession with sacrifice. Real spending cuts and real tax cuts can return America to the path of prosperity and strong economic growth.

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Endnotes:

1. Gallaway, Lowell and Vedder, Richard. 1995. The Impact of the Welfare State on the American Economy.

2. Gallaway and Vedder find that the optimal level of federal government spending is 17.57 percent. ibid.

3. This assumes that government spends the optimal 17.57 percent and economic output is at the potential output in Figure 1.

4. Ballard, Charles L.; Shoven, John B. and Whalley, John. 1985. "General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States." American Economic Review. 75 (1): 128-138.

5. JEC Staff Study. 1982. The Mellon and Kennedy Tax Cuts: A Review and Analysis.

6. From 1980 to 1989, a period which included two recessions from high-inflation, the economy grew 2.5 percent. The economy grew at a much better 3.7 percent after the Reagan tax cuts took effect. The economy must grow 3.3 percent a year in the 1990-1999 period to match the level of the 80s. The CBO projects the economy to grow 2.3 percent per year.