Challenges to U.S. Economic Recovery: Federal and State Spending

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before the Senate Committee on the Budget

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Mr. Chairman and members of the committee, thank you for inviting me to testify today regarding challenges to U.S. economic recovery. My comments will focus on the challenge of controlling federal and state government spending in coming years.

Advantages of Federal Spending Cuts

The growth in federal spending over the past decade has been extraordinary. As a share of gross domestic product, spending soared from 18.2 percent in President Clinton's last fiscal year of 2001 to 24.7 percent by fiscal 2011. The causes of this government expansion include the costs of overseas wars, expanded entitlement programs, growing spending on domestic programs such as education, and recent stimulus spending.

Two years after passage of the $800 billion stimulus, that package appears to have been a very expensive failure. Note that the total Keynesian stimulus in recent years included deficit spending of $459 billion in FY2008, $1.4 trillion in FY2009, $1.3 trillion in FY2010, and $1.5 trillion in FY2011. Despite all that deficit spending, the unemployment rate remains stuck above nine percent and this recovery is sluggish compared to prior recoveries.

Whether or not stimulus spending can goose the economy in the short-run, there is no doubt that it comes at the expense of future living standards because of the build-up of debt. Harvard's Robert Barro has calculated that the future damage caused by the 2009 stimulus bill substantially outweighed any short-term benefits it may have had.[1] Thus, to start getting federal spending under control, we first need to abandon the Keynesian approach to budget policy.

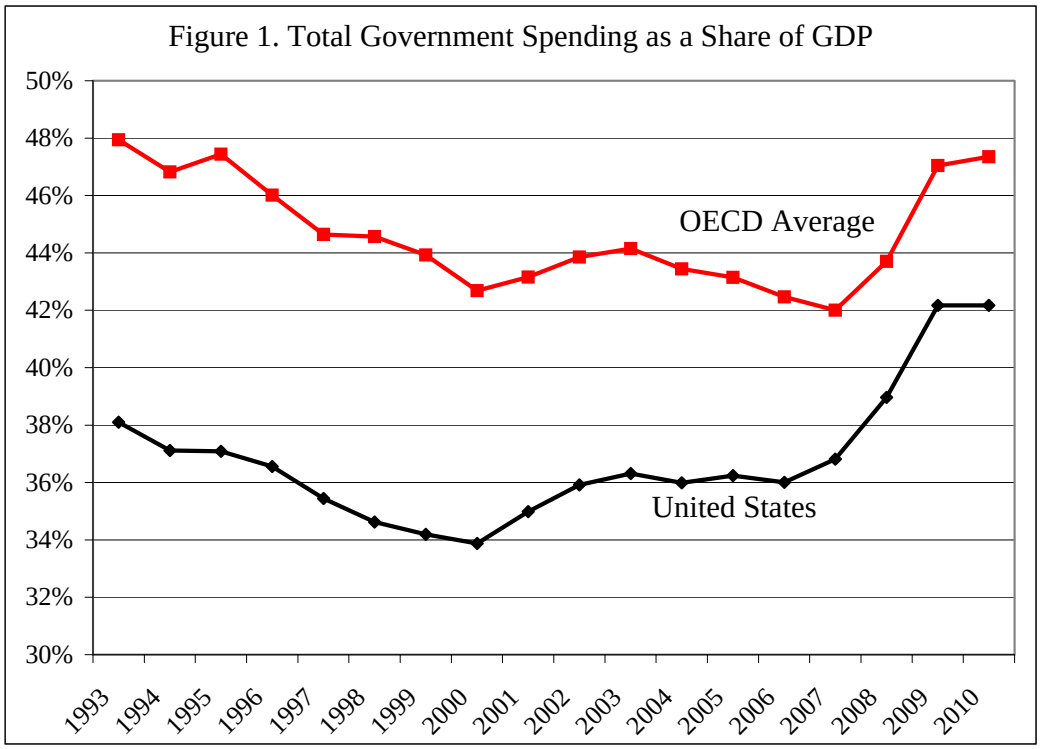
Policymakers need to change their focus from short-term fiscal manipulations to long-term spending control. In the long-run, higher government spending reduces economic growth because it transfers resources from the more productive private sector to the less productive government sector. Those transfers impose distortions or "deadweight losses" on the economy, which are further costs of government spending.

In his State of the Union address, President Obama promoted new government "investment" spending, but given that American governments already consume more than

40 percent of the nation's GDP, it is extremely unlikely that the government could find new projects with sufficiently high returns to make them worthwhile.

Policymakers should reject the idea that added spending is good and beneficial for the economy. It isn't. In recent decades, the federal government has expanded into hundreds of areas that would be better left to state and local governments, businesses, charities, and individuals. That expansion is sucking the life out of the private economy and creating a top-down bureaucratic society. Cutting federal spending would also enhance personal freedoms by dispersing power from Washington.

Policymakers shouldn't think of spending cuts as a necessary evil needed to reduce debt. Rather, the government's fiscal mess is an opportunity to make reforms, such as privatization, that would spur growth. After all, the United States is no longer a small-government nation, as revealed by data from the Organization for Economic Cooperation and Development.[2] The OECD calculates that total federal, state, and local government spending in the United States in 2010 was 42 percent. For many years, America had about a 10 percentage point government size advantage compared to the OECD average, but that advantage has now shrunk to just 5 percentage points, as shown in Figure 1.



Source: OECD Economic Outlook Database, Annex Table 25.

Historically, America's robust economic growth and high living standards were built on our relatively smaller government than Europe and elsewhere. But if we continue down the current high-spending path, we will become just another sluggish welfare state. Projections by the Congressional Budget Office under its "alternative fiscal scenario," show that federal spending will climb by another 11 percentage points of GDP by 2035 unless we

make major reforms.[3] Such a spending expansion would doom young people to unbearable levels of taxation and an economy with few opportunities and little innovation.

We need major federal spending cuts. We should cut entitlements, domestic spending, and defense. The president's fiscal commission had lots of good spending cut ideas, and so do plans by various thinktanks and members of Congress. I've proposed cuts to balance the federal budget by 2020 at www.downsizinggovernment.org. And I've suggested that Congress cap the annual growth in total federal outlays to help force ongoing efforts to find savings.[4]

Some economists argue that spending cuts would hurt the economy. But consider a real-world experiment of substantial budget-cutting—the Canadian reforms of the 1990s.[5] In the early 1990s, overspending had pushed the size of the Canadian government to 53 percent of GDP, and government debt was soaring. The center-left Liberal government then reversed course and began cutting spending in 1995. Over two years, they chopped 10 percent from total federal spending—equivalent to Congress cutting spending about $370 billion in two years. Then the government held spending at roughly the lower level for another three years.

As spending was cut, the Canadian economy did not stagnate—it boomed. Indeed, it boomed for the next 15 years until it was hit by the recent U.S.-caused recession.[6] Canadian government spending has fallen by more than 10 percentage points of GDP and the federal budget was balanced 10 years in a row.[7] At the same time, the government spurred growth with pro-market reforms such as free trade, corporate tax cuts, and privatization. The Canadian model of sharp spending cuts and microeconomic reforms to boost growth is an excellent model for U.S. policymakers to follow.

Current State Budget Woes

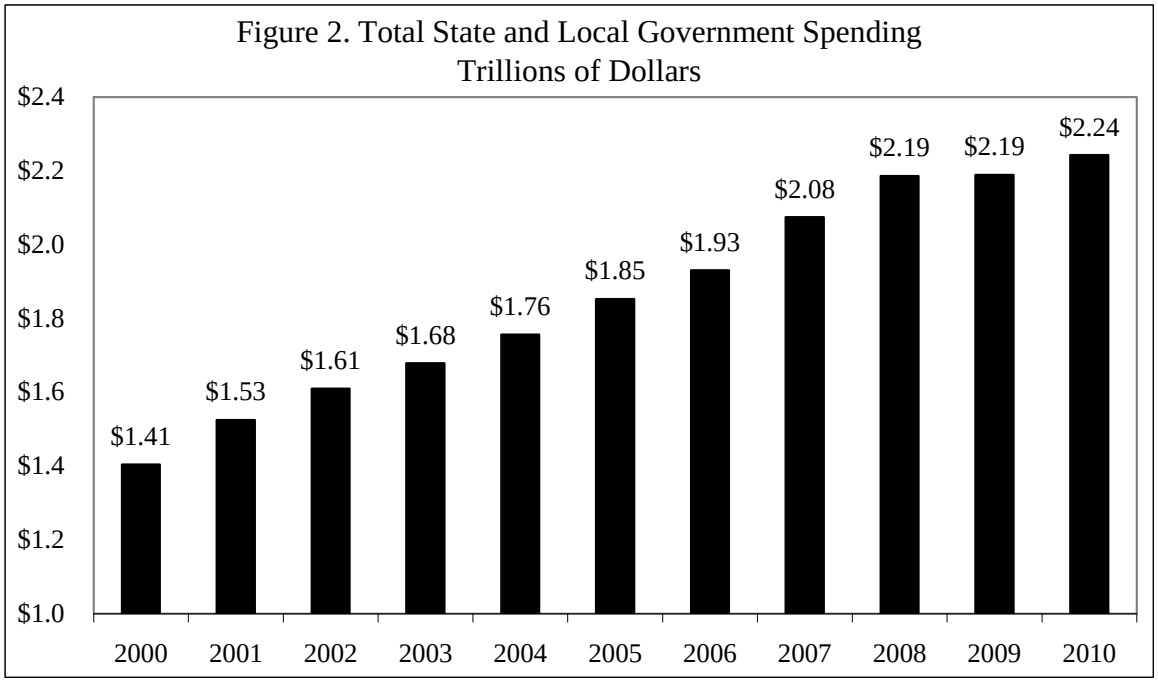
In recent years, we've been deluged with news stories claiming that state governments are radically slashing their budgets and state tax revenues are plummeting. Those concerns led to state bail-out funding in the 2009 stimulus bill, and it is behind continued calls for added state aid.

The reality is that overall state and local government spending has not been slashed. Certainly, governments have had to tighten their belts during the recession, but that is entirely reasonable as families and businesses have had to do the same. Furthermore, recent belt-tightening came after years of robust state spending growth.

Data from the National Association of State Budget Officers (NASBO) show that state general fund spending rose 47 percent between FY2000 and FY2008.[8] Spending then fell 11 percent during FY2009 and FY2010, but spending is now growing again and NASBO expects a 5 percent increase in FY2011.

However, state general fund spending is only part of a broader state budget picture. Figure 2 shows that total state and local government spending rose 55 percent between 2000 to

2008, based on U.S. Bureau of Economic Analysis data.[9] State and local spending leveled out in 2009 at $2.19 trillion, and then it started rising again. In 2010, it was up 2 percent. As a share of GDP, total state and local spending increased over the last decade—from 14.1 percent in 2000 to 15.3 percent in 2010. Thus, despite two recessions during the past decade, state and local spending now consumes a larger share of the U.S. economy.



Source: Bureau of Economic Analysis, National Income and Product Accounts, Table 3.3. Calendar years.

While states have had to trim their general funds, the overall state and local budget situation is not as dire as news reports have suggested. It's true that a number of states, such as California, have dug themselves into deep fiscal holes. But overall state revenues and spending are rising again as the economy expands.

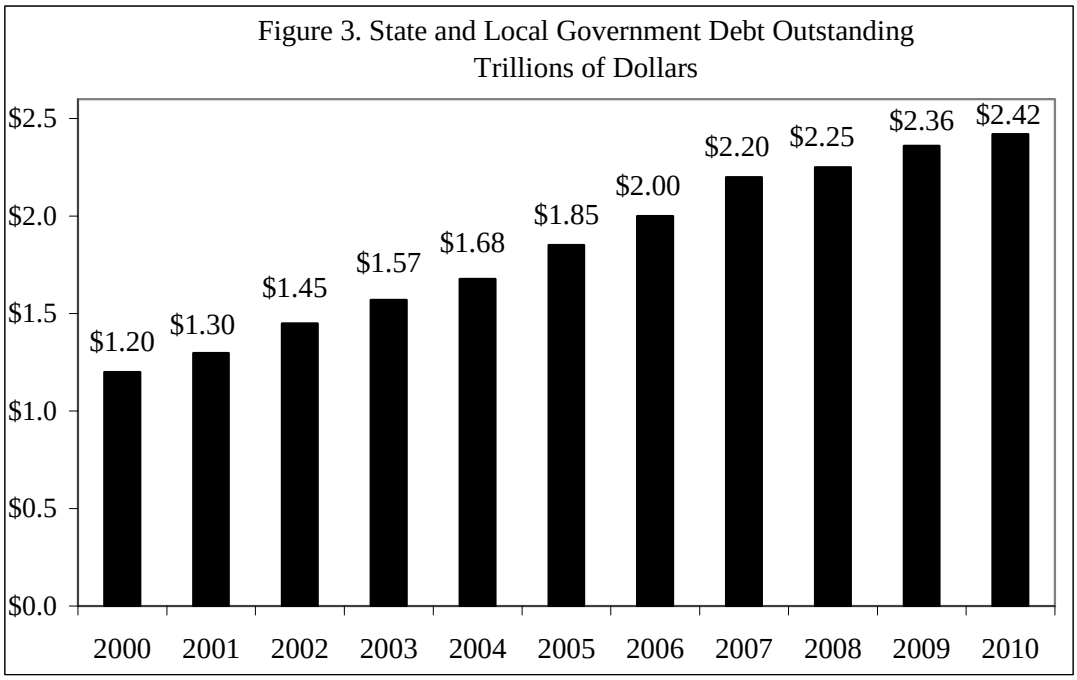
Some pundits are pointing to large "budget gap" figures to suggest that most states are still in a fiscal crisis. The Center on Budget and Policy Priorities, for example, claims that states currently face a $125 billion budget gap.[10] But that is a speculative number, not hard data. If a state expects revenues and spending to rise 7 percent, but then a new forecast shows revenues rising only 3 percent, the state is said to have a 4 percent "gap" or "shortfall." But spending is still rising by 3 percent, which is not a crisis. Budget gap estimates are partly artifacts of faulty economic forecasting and an inability of states to respond flexibly to changing circumstances.

Paul Krugman recently penned a column focusing on CBPP data showing that even conservative Texas has a budget gap as large as California's at up to $25 billion.[11] I was surprised by this, so I looked into it. The latest figures from the Texas state comptroller show general fund revenues at $35.4 billion in FY2010, and a projected $37.0 billion in FY2011 and $37.9 billion in FY2012.[12] Texas revenues are certainly sluggish, but it's not

clear where the giant budget gap comes from. Indeed, if the state could simply hold spending flat for a while, there would be no gap or shortfall.

The Real State Budget Crisis

The real state budget crisis is not short-term budget gaps, but the longer-term problem of soaring debt and unfunded obligations in state and local retirement programs. Figure 3 shows that there has been a large increase in state and local government bond debt over the past decade. While state and local debt was fairly stable during the 1990s, it has more than doubled during the last decade from $1.20 trillion to $2.42 trillion, according to the Federal Reserve Board.[13]



Source: Federal Reserve, Flow of Funds Accounts, Table D.3..

In addition to rising bond debt, state and local governments face huge unfunded costs in their pension and retiree health plans. Defined benefit pension plans have become a unique luxury of the public sector. In 2009, they were available to 84 percent of state and local workers, but to just 21 percent of private workers.[14] Furthermore, public sector plans are generally more generous than the remaining private-sector plans.[15] Recent news articles have highlighted the excesses of public-sector pensions in many cities and states.[16]

Official estimates show that state and local pension plans are underfunded (or overpromised) by about $1 trillion.[17] However, official estimates typically understate the poor shape of pension plans because they rely on optimistic assumptions to value future liabilities. Using more realistic assumptions, a study by Robert Novy-Marx and Joshua Rauh found that state and local pensions have an enormous funding gap of $3.2 trillion.[18]

State and local governments also have large funding gaps in their employee retirement health plans, which likely total more than $1.4 trillion.[19] The combination of funding gaps in state and local pension and health plans amounts to roughly $40,000 for every household in the United States. That is the amount that taxpayers will be on the hook for over future years unless policymakers start cutting excessive benefit levels.

However, an important caveat with regard to debt and unfunded obligations is that the 50 states are in quite different fiscal positions. With respect to bond debt, some states borrow very little, while other states are heavily indebted. A report by Moody's shows that state-level debt varies from more than 8 percent of state GDP in Hawaii and Massachusetts to near zero in Iowa, Wyoming, and Nebraska.[20] Interestingly, those states with smaller union shares in their public sectors have lower per-capita debt loads.[21]

Large differences between the states are also evident in pension funding gaps.[22] Economist Andrew Biggs calculates that the median ratio of pension obligations-to-GDP is 27 percent, but that ratio varies from a low of 11 percent in Nebraska to a high of 49 percent in Ohio.[23]

State policy also varies widely with respect to public sector unionization, which affects state fiscal policy. While some states, such as New York, have more than two-thirds of their state-local workforces unionized, there are about a dozen states that do not allow public sector unionism at all.[24] Virginia, for example, bans collective bargaining in the public sector. Looking ahead, unionization is important because state policymakers need the flexibility to deal with all the fiscal challenges that they face. Unions often resist efforts to cut costs in state and local governments. Optimally, the states would follow Virginia's example and ban collective bargaining in the public sector.

To sum up, some states have been quite frugal, while others seem intent on imposing large costs on future generations. The states have chosen different paths, but they are free to do so in our federal system. Hopefully, the mismanaged states can learn lessons from the better-managed states when it comes to policies such as employee pensions. Certainly we want to avoid federal interventions that would reward the spendthrift states and penalize the frugal states, such as federal bail-outs.

However, I am also skeptical of calls for intervention in the form of a new federal bankruptcy statute for state governments. Such an intervention is not needed because the states already have the power to mend their finances without help from Washington. Supporters of a bankruptcy law are rightly concerned about preventing a future bailout of the states, but I don't see that the political incentives for a bailout would be much changed. The governor of California and other poorly managed states would still rather lobby for a federal bailout than to declare state bankruptcy. Also, I'm uneasy about the idea that the federal government would make it easier for state governments to stiff their bondholders and other creditors.

In sum, the recession has prompted the states to trim their general fund spending, but many states need to make larger reforms in coming years to reduce debt and unfunded

obligations.[25] States should cut low-value programs, such as business subsidies. They should privatize government assets, such as highways and airports, and use the proceeds to pay down state debt. They should encourage private financing for new infrastructure, as Virginia has done with the widening of the Capitol Beltway,

State and local governments should put all new workers on defined contribution retirement plans, rather than defined benefit plans. They should change the formulas on current pension plans to make them less lucrative. They should increase employee premiums for pensions and heath care plans. They should reform accounting methods for their pension plans to use lower and more realistic discount rates for future liabilities. And the states with unionized workforces should end collective bargaining to give government managers greater fiscal flexibility. State policymakers have the power to make all these reforms without federal intervention.

Thank you for holding these important hearings. I look forward to working with the committee on these issues.

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[1] Robert J. Barro, "The Stimulus Evidence One Year Later," *Wall Street Journal*, February 23, 2010.
[2] Organization for Economic Cooperation and Development, "Economic Outlook Database," December 2010, Annex Table 25, www.oecd.org/dataoecd/5/51/2483816.xls. For the OECD, I calculated the unweighted average of the countries.
[3] Congressional Budget Office, "The Long-Range Budget Outlook," June 2010, p. 7.
[4] See www.cato-at-liberty.org/swap-debt-limit-for-cut-and-cap.
[5] See www.cato-at-liberty.org/cutting-government-the-canadian-way and www.cato-at-liberty.org/canadas-spending-cuts-and-economic-growth.
[6] See www.oecd.org/dataoecd/6/27/2483806.xls.
[7] See www.oecd.org/dataoecd/5/51/2483816.xls.
[8] National Association of State Budget Officers, *The Fiscal Survey of States*, June 2010.
[9] U.S. Bureau of Economic Analysis, National Income and Product Accounts, Tables 3.3 and 6.2D.
[10] Elizabeth McNichol, Phil Oliff, and Nicholas Johnson, "States Continue to Feel Recession's Impact," Center on Budget and Policy Priorities, January 21, 2011.
[11] See www.nytimes.com/2011/01/07/opinion/07krugman.html.
[12] Texas Comptroller of Public Accounts, "Biennial Revenue Estimate: 2012-2013 Biennium," January 10, 2011, p. 35.
[13] Federal Reserve Board, *Flow of Funds Accounts of the United States* (Washington: Federal Reserve Board of Governors, December 2010), Table D.3.

[14] Chris Edwards, "Employee Compensation in State and Local Governments," Cato Institute Tax and Budget Bulletin no. 59, January 2010.
[15] Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits* (Philadelphia: The Pew Charitable Trusts, 2007), p. 11.
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[17] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.
[18] Robert Novy-Marx and Joshua D. Rauh, "The Liabilities and Risks of State-Sponsored Pension Plans," *Journal of Economic Perspectives* 23, no. 4 (2009): 191–210.
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[22] www.aei.org/docLib/2010RPOno1g.pdf.
[23] www.aei.org/docLib/2010RPOno1g.pdf.
[24] Chris Edwards, "Public Sector Unions," Cato Institute Tax and Budget Bulletin no. 61, March 2010.
[25] I discuss state fiscal reforms in www.cato.org/speeches/chrisedwards-state-fiscal.pdf.