NATIONAL CENTER FOR POLICY ANALYSIS

Which Federal Policies Help or Hurt Economic Growth?[1]

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In the last several years Washington has experimented with larger economic interventions than ever before — yet, year after year, the economy merely trudges along. The recovery from the 2008-2009 recession has been unusually weak. All agree that something is seriously wrong, but theories as to what the problem might be range from one extreme to another.

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One side argues that we must do much more of what has failed. The opposite view is that we should reverse direction. Though politicians do not want to hear what history can tell us about how to break out of the malaise, the solution, found in a careful analysis of economic history, is amazingly simple.

In order to stimulate economic growth, the federal government should stabilize the dollar, freeze and reduce its spending, cut tax rates, and let the markets set interest rates freely.

The Relationship between Economic Growth, Public Budget Deficit and Gold Prices. Since its lowest point in the second quarter of 2009, real gross domestic product (GDP) has been growing at a far slower rate than previous cyclical recoveries: 1.75 percent per year through the first quarter of 2012. This has happened either despite or as a result of energetic deficit spending. Figure I compares GDP growth with federal debt over this period.[2]

Figure I shows debt held by the public, which excludes U.S. Treasury obligations held by other federal institutions (expressed in nominal dollars). Currently, public debt is growing three times faster than the economy. During a recession, public debt often grows while the economy shrinks, but it highly unusual for debt to grow faster than the economy in the third or fourth year of recovery.

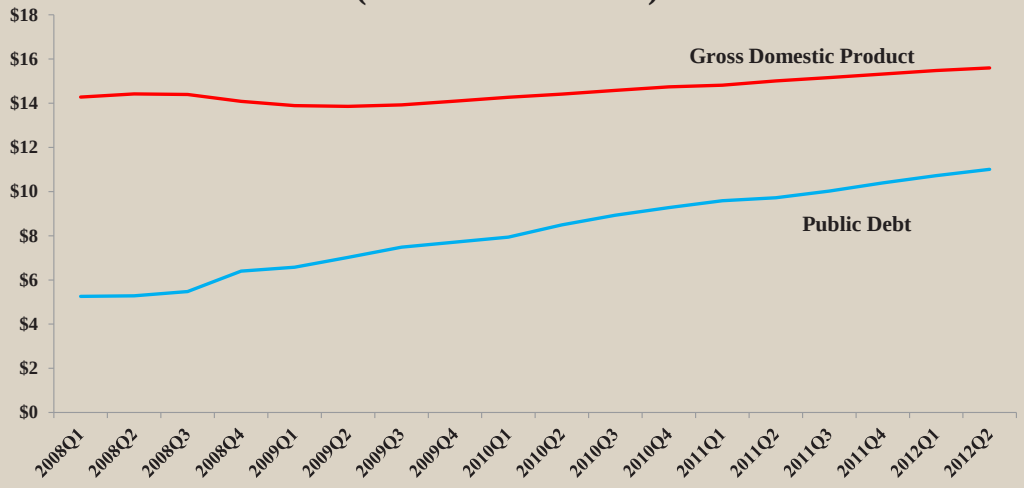
Is the growth of public debt good or bad for the economy? Table I divides U.S. history since 1810 into 20 consecutive decades, with the decades that included the Civil War and World Wars I and II in a separate category.[3] The table reveals a clear inverse relationship between federal borrowing and economic growth from decade to decade.

Federal tax revenue automatically parallels low economic growth, and that in turn implies more government debt. In theory, a budget deficit

Figure I

Growth of Public Debt and Gross Domestic Product

(in trillions of dollars)



Source: Monthly Statement of the Public Debit of the United States, U.S. Treasury. Available at www.treasurydirect.gov. Also, quarterly estimates of nominal gross domestic product, converted to a seasonally adjusted annual rate, Bureau of Economic Analysis.

can result from either excessive spending or insufficient tax revenue, or both. To determine what the case is, it is necessary to separate the spending side of the budget from the revenue side, then determine the extent to which federal spending grows faster or slower than the economy.

Table I also shows that deficit spending is conducive to depreciation in the value of the dollar in terms of gold. The faster the debt grows relative to the economy, the more the dollar price of gold rises, in time driving up prices throughout the economy. Deficit spending does not stimulate economic growth, but does stimulate inflation.

Federal Spending Crowds Out Private Spending. Table II displays calculations similar to those in Table I, but classifies decades according to whether federal spending relative to GDP increased or decreased.[4] The inverse correlation between debt and the economy shown in Table I is not merely a result of the tie between GDP and federal revenue. Over time, the faster government spending increases relative to the economy, the more slowly the economy grows.

There is also substantial evidence pointing to an inverse relationship between what is erroneously called stimulative fiscal policy and the economy's performance. Purchases of goods and services by the private sector, and by the public sector, add up to total GDP. Figure II shows years in which the government's share of GDP changed, grouped according to the size of the increase or decline, and the average response

Table I

Federal Deficits and Economic Growth (decadal averages, 1810 to 2010)

Decades in which the budget deficit was:	Federal Borrowing as a percentage of GNP	Annualized Real GDP Growth	Annualized Change in the Price of Gold
In Surplus (Six Decades)	0.6%	4.90%	0%
Less than 1% of GNP in Deficit (Six Decades)	-0.4%	4%	-0.1%
More than 1% of GNP in Deficit during Peace Time (Six Decades)	-3.6%	3.2%	7.7%
More than 1% of GNP in Deficit during Wartime (Six Decades)	-5.9%	3.7%	0.5%

Note: Gross national product for 2010 is estimated from second and third quarter output data. Through 1850 the budget balance is for calendar years; thereafter for June-end fiscal years.

Sources: National debt outstanding as of year-end (1790-1842) and as of June 30 (1843-2009) (U.S. Treasury at www.treasurydirect.gov) and calendar-year gross national product. Thomas S. Berry, *Estimated Annual Variations in Gross National Product, 1789 to 1909*, (Richmond: Bostwick Press, 1968) republished in Brian R. Mitchell, *International Historical Statistics: The Americas and Australasia* (London and Basingstoke: Macmillan Press, 1983), Appendix K1, page 887; and Office of Business Economics/Bureau of Economic Analysis, together with calendar-year averages of the dollar price of gold (Jastram and Leyland/*Metals Week/Wall Street Journal*).[5]

in the private sector's share for each group.[6] Figure II reveals that there is an inverse relationship between them: Excessive public spending "crowds out" spending by the private sector.

The correlation is not only clear, but linear and proportionate. The difference in the private component of output shown in the left-hand and right-hand bars is 51.8 percentage points of GDP. The corresponding difference in the public component of output is 75.2 percentage points of GDP. This implies that the average dollar spent by government results in about two-thirds of a dollar of reduced private sector spending. This calculation is conservative because it does not include a further inverse relationship between government purchases and private purchases one or more years in the future.

Table II

Percentage Changes in Federal Spending and Economic Growth (decadal averages, 1810 to 2010)

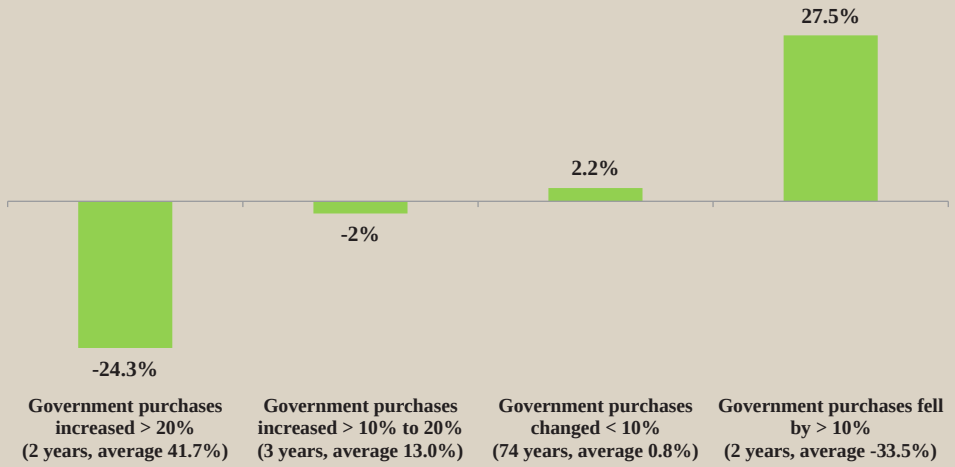
Averages for	Average net percentage change in outlays relative to GDP	Annualized growth of real GDP
Decades of Major War (1860-1870, 1910-20, 1940-50)	4.0%	3.8%
Peacetime decades in which outlays as a percentage of GDP rose > 5% (2 decades)	5.6%	2.2%
Peacetime decades in which outlays as a percentage of GDP rose < 5% (6 decades)	1.5%	3.6%
Peacetime decades in which outlays as a percentage of GDP declined (6 decades)	-1.6%	3.9%

Sources: Calendar-year totals of nominal GDP and real GDP at constant 1996 prices, Richard Sutch, *Historical Statistics of the United States*, millennial edition, Bureau of Economic Analysis; fiscal-year totals of federal government outlays, *Annual Report of the Secretary of the Treasury*, *Economic Report of the President*; and the highest marginal income tax bracket by calendar year, John Joseph Wallis, *Historical Statistics of the United States, Millennial Edition*, and National Taxpayers Union.

Crowding out also takes place in the labor market. Advocates of government intervention argue the government can at least partially solve the unemployment problem by adding to its own payrolls. Figure III shows the average net change in total employment in and following years government employment increased or diminished.

Figure II

Average Annual Changes in Private and Government Purchases as Percentages of Gross Domestic Product



Note: Calendar-year totals of purchases of goods and services by the private sector and federal, state and local governments, corrected for inflation using the GDP implicit price deflator.

Source: Author's calculations.

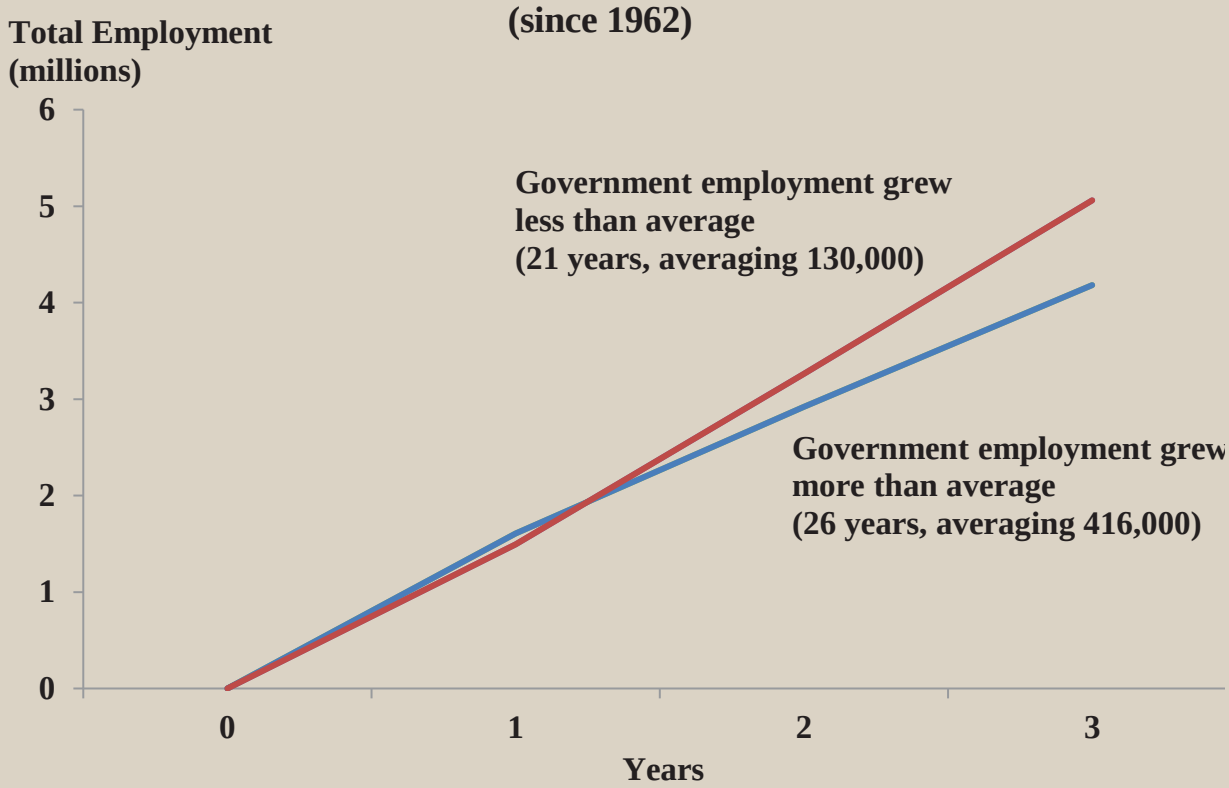
In the average year since 1962, government employment increased by 273,000. Total employment increased slightly more in years government payrolls went up more than usual than it did in years government payrolls went up less than usual. But the net gain is unimpressive:

- For every additional government worker, roughly half a private worker disappears, leading to a net gain

Figure III

Cumulative Increase in Total Employment Compared to Government Employment

(since 1962)



Note: Cumulative increase in total employment during and following years in which government employment changed.

Sources: Calendar-year average of civilian employment, Household Survey, Bureau of Labor Statistics; government employment, Establishment Survey, Bureau of Labor Statistics.

of only half a worker.

- Over a three-year period, every government employee added results in a reduction in total employment of more than three workers!

Far from helping to solve the unemployment problem, government hiring reduces the ability of the private sector to create jobs to such an extent that total employment is actually reduced. This result seems counterintuitive and puzzling until one remembers that neither the government nor the private sector can hire a worker unless they commit resources and capital to make sure that worker is productive. The resources and capital used by the government must originate in the private sector and, of course, have to be appropriated by taxation or borrowing.

If it takes three times as much capital to fund a productive government job as it does to fund an equally productive private job, each government job created could very well subtract three or four private jobs. This is more than a mere crowding out of private economic activity; it is a waste of scarce resources.

Among economists, even simple "crowding out" is a contentious subject. Few pay much attention to the concept, and many deny it occurs. But with reference to pre-Keynesian times, the economy can sensibly be viewed as a finite system in which resources,

spending or jobs cannot be created out of nowhere. They can be created in one part of the system only at the expense of other parts. The economy does not grow because something is added to it, but as a result of more efficient use of resources, better management decisions by its participants, or simply greater vitality. And nothing depletes vitality more than uncertainty or fear.

Figure IV is a simplified way to illustrate the nature of a classical economy, identifying the four major ways in which its size, prosperity or performance can be measured.[7] These four economic measures are: output of goods and services, the inputs of labor, capital and other resources required to generate this output, the income obtained by the owners of these resources when they are hired by producers, and spending by the receivers of this income. In a perfect accounting system they would all be equal.

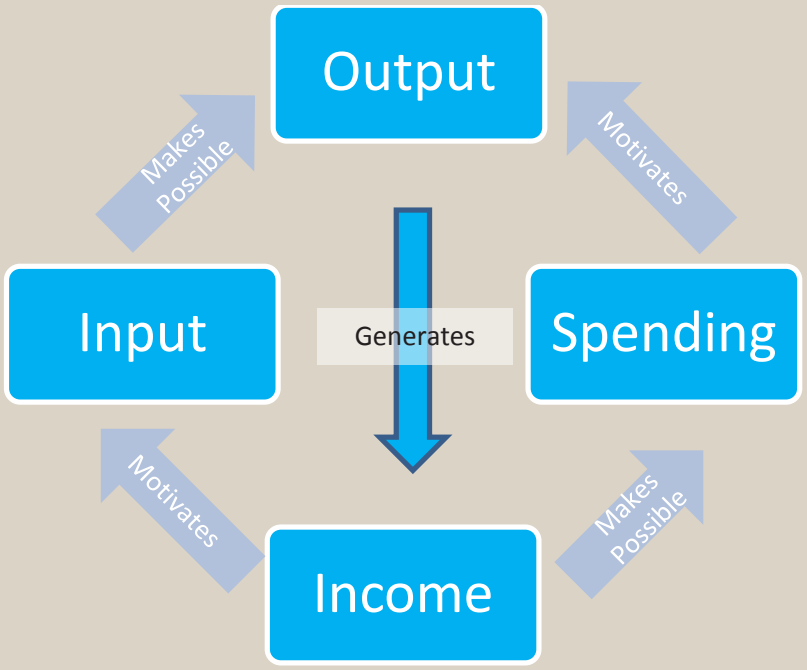
The fourfold symmetry is reminiscent of another classic tenet of economics, that supply and demand are two sides of the same coin. At this extreme level of simplicity, output, input, income and spending can be viewed, similarly, as four sides of the same square!

Relationship between the Economy and Other Macroeconomic Policies. If the federal government cannot boost output and employment either by increasing its spending or by adding directly to its payrolls, perhaps it can use tax policy to stimulate the economy.

There is an instinctive belief that stimulus from tax rate cuts must be paid for by lost tax revenue. However, the evidence contradicts this assumption. Empirically there is a tax-rate structure that maximizes revenue. Tax rates lower than the maximizing rate enlarge the tax base but generate less revenue. But tax rates higher than the maximizing rates cause the tax base to shrink so much that they cost the government more revenue than they collect. The fact that federal revenue has never surpassed 20 percent of GDP consistently suggests that tax rates in excess of 20 percent may well be revenue

Figure IV

The Mutual Equivalence of the Economy's Four Sides



Source: Author.

losers. This empirical finding is known as Hauser's Law.[8]

The sensitivity of the economy to changes in tax rates, especially top income tax rates, is also controversial. Table III shows that decades in which the top marginal income tax rate increased were decades of inferior economic growth and stock market performance.[9]

The relationship between top marginal tax rates, economic growth and stock market performance does not appear to be linear. This suggests that changes in tax rates are disruptive and that the benefit of small reductions in tax rates might be undercut by the

Table III

Economic Growth, and Percentage Changes in Stock-Market Performance and the Top Bracket of Income Tax (decade averages, 1920 to 2010)

Decades in which the top income tax bracket:	Annualized average real GNP growth	Average annualized Standard & Poor's price change	Median annualized Standard & Poor's price change
Increased more than 10 percentage points (three decades, average 47%)	2.7%	2.6%	-1.6%
Changed less than 10 percentage points (four decades, average 1%)	3.7%	4.6%	4.4%
Was cut more than 10 percentage points (three decades, average –36%)	3.6%	8.4%	10.2%

Note: Changes in all variables are comparisons between the last year of each decade and the last year of the previous decade. Gross national product, rather than gross domestic product, is used because it has a longer history.

Sources: See Figure I, together with calendar-year real gross national product (Office of Business Economics/Bureau of Economic Analysis) and calendar-year averages of the composite total-return index of stocks (University of Chicago/Ibbotson Associates/Dimensional Fund Advisors) and the price of gold bullion (Jastram and Leyland/*Metals Week/Wall Street Journal*).

Table IV

The Relationship between Money Creation and Economic Performance (10-year periods from 1918 through 2008)					
Averages for decades in which:	Annual change in bank reserves	Annual change in the monetary base	Annual change in real GDP	Annual change in large-cap stock prices	Annual change in the price of gold
World War II occurred	6.1%	12.2%	6.4%	3.1%	1.9%
Bank reserves grew faster than average (four decades)	7.5%	6.9%	2.4%	1.6%	10.7%
Bank reserves grew slower than average (four decades)	3.7%	3.6%	3.5%	11.2%	-1.2%

Sources: Calendar-year averages of monthly totals of bank reserves and the monetary base beginning in 1918, Federal Reserve Bank of St. Louis; calendar-year averages of month-end total-return indices for the S&P 500 stocks beginning in 1871, Cowles Commission, Standard & Poor's, University of Chicago and Dimensional Fund Advisors; and calendar-year totals of real GDP beginning in 1790, *Historical Statistics of the United States, Millennial Edition,* Bureau of Economic Analysis.

cost to taxpayers of adapting to the change. Constant changes in tax rates, or merely uncertainty about tax rates, are counterproductive. Thus, there is strong evidence that the federal government cannot do much to improve output and employment using fiscal policy in the conventional, counter-cyclical way. However, the evidence shows that reductions in marginal tax rates of 10 percentage points or more lead to higher levels of investment and higher stock prices.

Some skeptics who agree about the ineffectiveness of fiscal policy conclude that monetary policy (interest rate management or quantitative easing) must bear the whole burden of stimulus. But broad experience in many countries suggests that artificially low interest rates produce lower rather than higher growth rates.[10]

Even the creation of new money via the monetization of the debt fails to boost the economy, according to historical evidence from the varying growth of bank reserves in the decades since World War I.[11] Table IV contrasts economic performance in peacetime decades during which the monetary base grew faster and decades in which it grew slower than usual. (The decade that includes World War II is reported separately.)

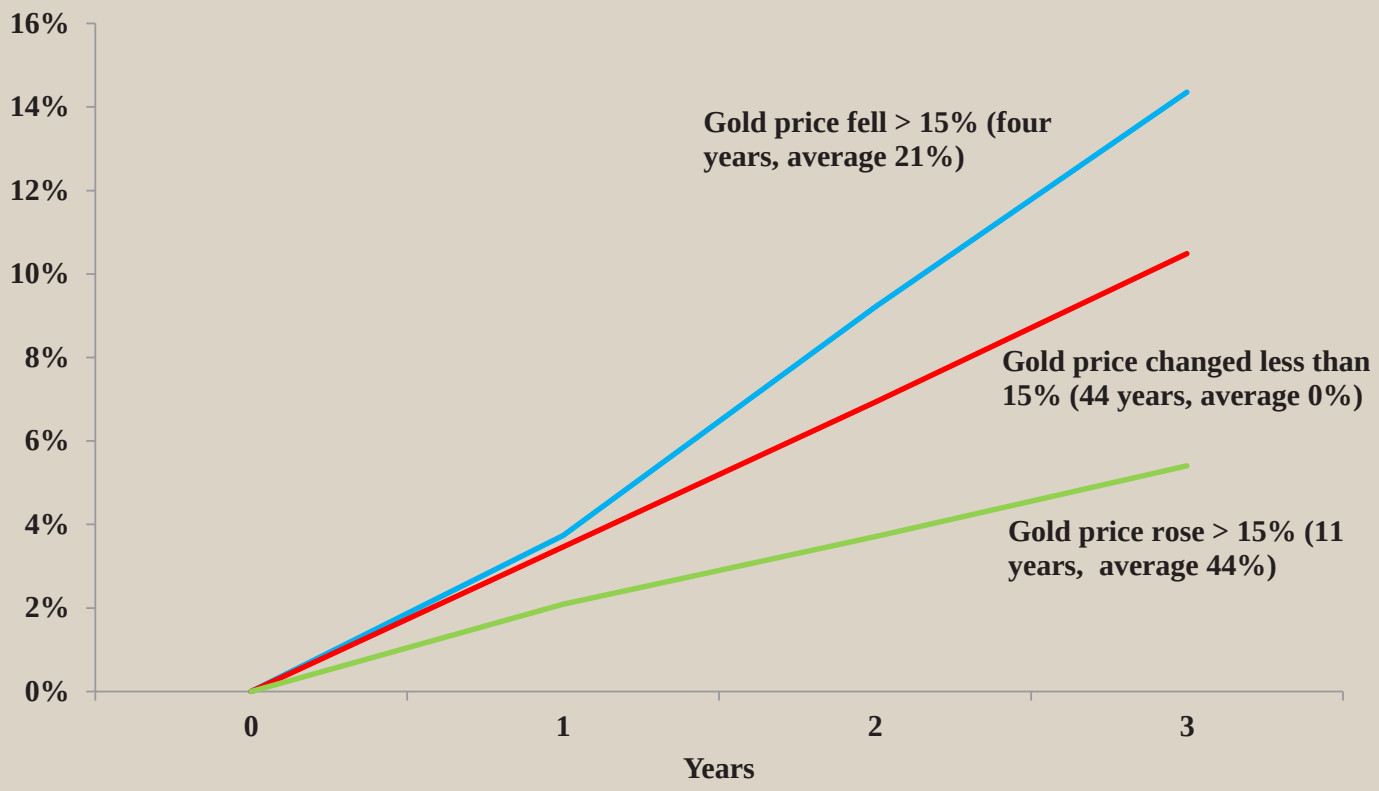
Table IV shows that higher growth and better stock-market performance occur when the Federal Reserve creates less rather than more money! Moreover, debt monetization stimulates the rate at which the dollar depreciates, as expressed by the price of gold. In this sense, easy monetary policy stimulates inflation but not growth.

A fall in the dollar results from fiscal policy (the growth of debt shown in Table I) and monetary

Figure V (A)

Growth of Real Gross Domestic Product Following Changes in Gold Prices

(years from 1950 to 2010)



Note: Average cumulative gain in real gross domestic product following years in which the dollar price of gold changed.

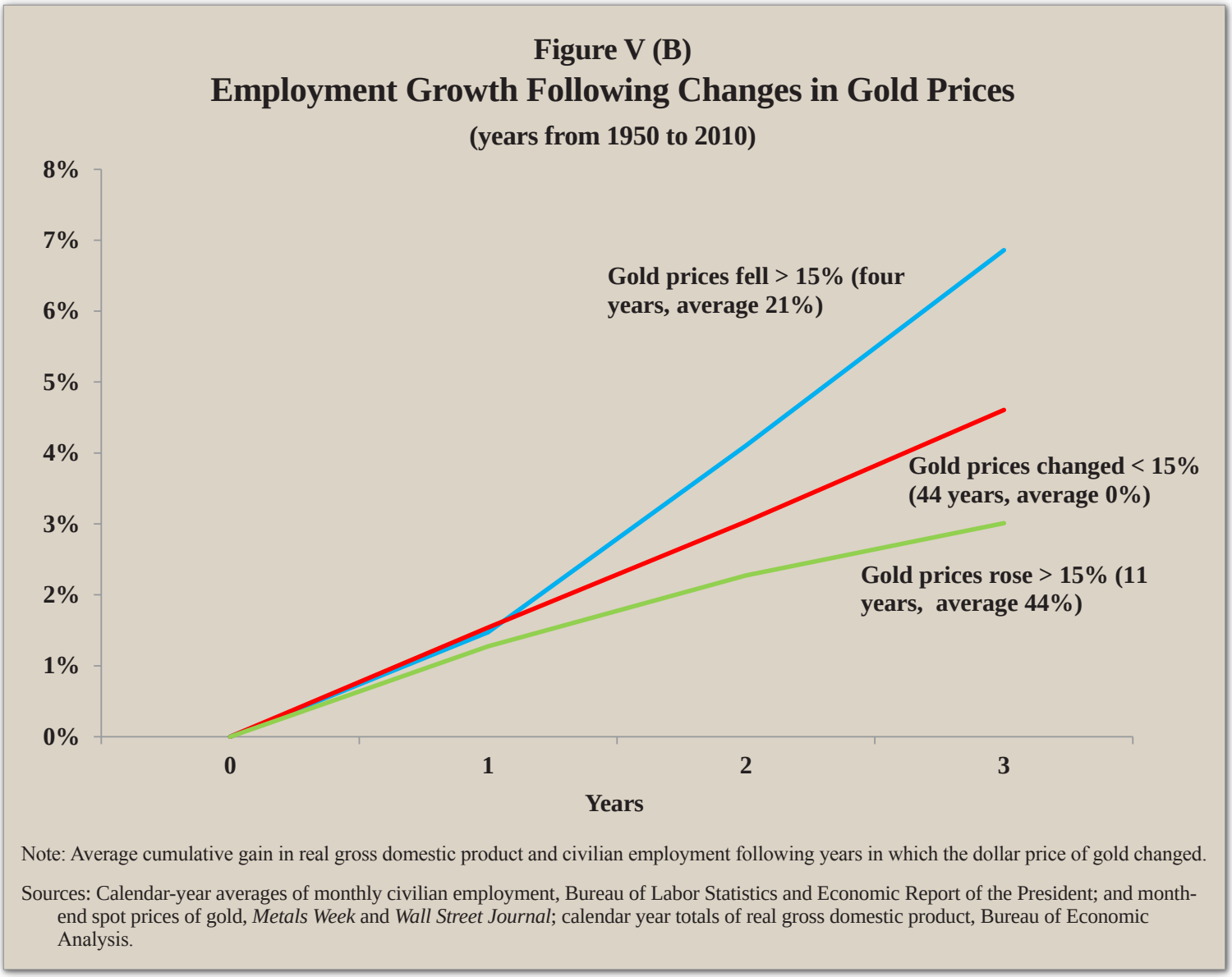
Sources: Calendar-year averages of monthly civilian employment, Bureau of Labor Statistics and Economic Report of the President; and month-end spot prices of gold, *Metals Week* and *Wall Street Journal*; calendar year totals of real gross domestic product, Bureau of Economic Analysis.

policy (the growth of the monetary base shown in Table IV). But it is also a policy in its own right.

Figure V summarizes the evidence concerning government stimulus and restraint or, more specifically, the distinction between "true" and "false" stimulus. Figure V shows the economic implications of a rise and a fall in the price of gold. Rises in the gold price are followed by slower growth in both (a) real GDP and (b) employment, and declines are followed by faster growth.

The sensitivity of employment to changes in the value of the dollar is only half as great as the sensitivity of output to changes in the value of the dollar. This suggests that one of the consequences of a decline in the dollar is lower labor productivity.

Conclusion. The historical evidence explains why the economy is performing so poorly. Many policies pursued by the Obama administration, as well as some pursued by the preceding Bush administration, have widely been thought to be stimulative. They have led instead to prolonged economic weakness, a careful reading of history suggests. To turn the situation around, Washington needs to stabilize the dollar, freeze and reduce spending, cut tax rates, and let the markets set interest rates freely.



Note: Average cumulative gain in real gross domestic product and civilian employment following years in which the dollar price of gold changed.

Sources: Calendar-year averages of monthly civilian employment, Bureau of Labor Statistics and Economic Report of the President; and month-end spot prices of gold, *Metals Week* and *Wall Street Journal*; calendar year totals of real gross domestic product, Bureau of Economic Analysis.

Ironically, economic stimulus implies government restraint. Copious evidence covering many decades shows that activist policies such as government spending, government employment, and the creation of money tend to restrain the performance of output, employment and stock prices. If so, the current failure of the economy to recover rapidly from the 2008 recession is easy to explain, since policies advertised erroneously as "stimulus" have been pursued on an unprecedented scale.

About the Author

R. David Ranson is a senior fellow with the National Center for Policy Analysis and president and director of research at H.C. Wainwright & Co. Economics.

Endnotes

1. Adapted from David Ranson, "What Federal Policies Have Historically Been Conducive to Superior or Inferior Economic Growth?" presentation to Congressional staff sponsored by the National Center for Policy Analysis, Washington, D.C., June 26, 2012.

2. Updated from "The Price of Gold in the Long Run," *Strategic Asset Selector*, H.C. Wainwright & Co. Economics Inc., March 25, 2010, Figure One.

3. "Two Centuries of U.S. Experience with Balanced and Unbalanced Budgets," *Strategic Asset Selector,* Wainwright Economics, November 25, 2010, Table 1.

4. "Good and Bad Debt — Good and Bad Austerity," *Economy Watch*, Wainwright Economics, January 30, 2012, Table 2.

5. Roy W. Jastram and Jill Leyland, *The Golden Constant* (Cheltenham, England: Edward Elgar, 2009).

6. Updated from "Good and Bad Debt — Good and Bad Austerity," Figure Two.

7. "Contrary Economics for Troubled Times," *The Capitalist Perspective*, Wainwright Economics, October 31, 2010, Exhibit 1.

8. For historical data, see "Washington's Inability to Forecast Its Own Fiscal Picture," *Economy Watch*, Wainwright Economics, April 30, 2011, Figure Three.

9. "The Impact of Changing Income Tax Rates on the Stock Market," *Strategic Asset Selector*, Wainwright Economics, January 24, 2011, Table 2.

10. "The Role of Zero Interest Rates in Subnormal U.S. Recovery," *Interest-Rate Outlook*, Wainwright Economics, February 29, 2012.

11. "In Combination, Washington's Tax and Monetary Policies Can Be Lethal," *Strategic Asset Selector*, Wainwright Economics, September 22, 2011, Table 2.

The NCPA is a nonprofit, nonpartisan organization established in 1983. Its aim is to examine public policies in areas that have a significant impact on the lives of all Americans — retirement, health care, education, taxes, the economy, the environment — and to propose innovative, market-driven solutions. The NCPA seeks to unleash the power of ideas for positive change by identifying, encouraging and aggressively marketing the best scholarly research.

Health Care Policy.

The NCPA is probably best known for developing the concept of Health Savings Accounts (HSAs), previously known as Medical Savings Accounts (MSAs). NCPA President John C. Goodman is widely acknowledged (*Wall Street Journal*, WebMD and the *National Journal*) as the "Father of HSAs." NCPA research, public education and briefings for members of Congress and the White House staff helped lead Congress to approve a pilot MSA program for small businesses and the self-employed in 1996 and to vote in 1997 to allow Medicare beneficiaries to have MSAs. In 2003, as part of Medicare reform, Congress and the President made HSAs available to all nonseniors, potentially revolutionizing the entire health care industry. HSAs now are potentially available to 250 million nonelderly Americans.

The NCPA outlined the concept of using federal tax credits to encourage private health insurance and helped formulate bipartisan proposals in both the Senate and the House. The NCPA and BlueCross BlueShield of Texas developed a plan to use money that federal, state and local governments now spend on indigent health care to help the poor purchase health insurance. The SPN Medicaid Exchange, an initiative of the NCPA for the State Policy Network, is identifying and sharing the best ideas for health care reform with researchers and policymakers in every state.

NCPA President John C. Goodman is called the "Father of HSAs" by *The Wall Street Journal*, WebMD and the *National Journal*.

Taxes & Economic Growth.

The NCPA helped shape the pro-growth approach to tax policy during the 1990s. A package of tax cuts designed by the NCPA and the U.S. Chamber of Commerce in 1991 became the core of the Contract with America in 1994. Three of the five proposals (capital gains tax cut, Roth IRA and eliminating the Social Security earnings penalty) became law. A fourth proposal — rolling back the tax on Social Security benefits — passed the House of Representatives in summer 2002. The NCPA's proposal for an across-the-board tax cut became the centerpiece of President Bush's tax cut proposals.

NCPA research demonstrates the benefits of shifting the tax burden on work and productive investment to consumption. An NCPA study by Boston University economist Laurence Kotlikoff analyzed three versions of a consumption tax: a flat tax, a value-added tax and a national sales tax. Based on this work, Dr. Goodman wrote a full-page editorial for *Forbes* ("A Kinder, Gentler Flat Tax") advocating a version of the flat tax that is both progressive and fair.

A major NCPA study, "Wealth, Inheritance and the Estate Tax," completely undermines the claim by proponents of the estate tax that it prevents the concentration of wealth in the hands of financial dynasties. Senate Majority Leader Bill Frist (R-TN) and Senator Jon Kyl (R-AZ) distributed a letter to their colleagues about the study. The NCPA recently won the Templeton Freedom Award for its study and report on Free Market Solutions. The report outlines an approach called Enterprise Programs that creates job opportunities for those who face the greatest challenges to employment.

Retirement Reform.

With a grant from the NCPA, economists at Texas A&M University developed a model to evaluate the future of Social Security and Medicare, working under the direction of Thomas R. Saving, who for years was one of two private-sector trustees of Social Security and Medicare.

The NCPA study, "Ten Steps to Baby Boomer Retirement," shows that as 77 million baby boomers begin to retire, the nation's institutions are totally unprepared. Promises made under Social Security, Medicare and Medicaid are inadequately funded. State and local institutions are not doing better — millions of government workers are discovering that their pensions are under-funded and local governments are retrenching on post-retirement health care promises.

Pension Reform.

Pension reforms signed into law include ideas to improve 401(k)s developed and proposed by the NCPA and the Brookings Institution. Among the NCPA/Brookings 401(k) reforms are automatic enrollment of employees into companies' 401(k) plans, automatic contribution rate increases so that workers' contributions grow with their wages, and better default investment options for workers who do not make an investment choice.

The NCPA's online Social Security calculator allows visitors to discover their expected taxes and benefits and how much they would have accumulated had their taxes been invested privately.

Environment & Energy.

The NCPA's E-Team is one of the largest collections of energy and environmental policy experts and scientists who believe that sound science, economic prosperity and protecting the environment are compatible. The team seeks to correct misinformation and promote sensible solutions to energy and environment problems. A pathbreaking 2001 NCPA study showed that the costs of the Kyoto agreement to reduce carbon emissions in developed countries would far exceed any benefits.

Educating the next generation.

The NCPA's Debate Central is the most comprehensive online site for free information for 400,000 U.S. high school debaters. In 2006, the site drew more than one million hits per month. Debate Central received the prestigious Templeton Freedom Prize for Student Outreach.

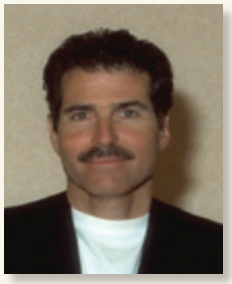
Promoting Ideas.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA scholars appear regularly in national publications such as the *Wall Street Journal*, the *Washington Times*, *USA Today* and many other major-market daily newspapers, as well as on radio talk shows, on television public affairs programs, and in public policy newsletters. According to media figures from Burrelles*Luce*, more than 900,000 people daily read or hear about NCPA ideas and activities somewhere in the United States.

What Others Say About the NCPA

"The NCPA generates more analysis per dollar than any think tank in the country. It does an amazingly good job of going out and finding the right things and talking about them in intelligent ways."

Newt Gingrich, former Speaker of the U.S. House of Representatives



"We know what works. It's what the NCPA talks about: limited government, economic freedom; things like Health Savings Accounts. These things work, allowing people choices. We've seen how this created America."

John Stossel,
host of "Stossel," Fox Business Network

"I don't know of any organization in America that produces better ideas with less money than the NCPA."

Phil Gramm,
former U.S. Senator

"Thank you . . . for advocating such radical causes as balanced budgets, limited government and tax reform, and to be able to try and bring power back to the people."

Tommy Thompson,
former Secretary of Health and Human Services

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