Statement of
David R. Malpass before the
Senate Budget Committee
February 26, 2013

Chairman Murray, Senator Sessions, members of the Committee, thank you for the invitation to testify on the impact of federal spending on economic growth.

My view is that reducing the path of federal spending would cause faster economic growth and more jobs. The private sector would celebrate. Government spending is a drain on the private sector because it has to provide the funding to the government through either taxes or loans. If you want more growth and jobs, you should convince the private sector that you will begin restraining spending. The best way to do this is to announce a few cutbacks today. The more convincing you can be in lowering the path of spending, the more the private sector will respond by investing and hiring workers.

Before continuing, I'd like to provide a little of my background. I am president of Encima Global, which I founded in 2008. We provide economic research to a variety of firms primarily in the financial industry. I also write a regular column in Forbes magazine with historians Paul Johnson and Amity Shlaes and Lee Kuan Yew of Singapore. I served at Treasury and State in the Reagan and Bush-41 Administrations and, prior to that, was the tax analyst on this Committee's staff during the development of the 1986 tax reform. I was a CPA before that and have a long-standing interest improving the federal budget. I live in New York with my wife Adele who was also worked on the staff of this Committee.

I was privileged to testify before this committee two years ago on the fiscal crisis. My February 1, 2011 statement recommended an upheaval in our federal spending and budgeting culture and made policy recommendations which I think would improve growth and jobs creation. I would like to repeat those recommendations today and hope that you will consider them:

- The expiration of the continuing resolution on March 4, 2011 (and on March 27, 2013) should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.

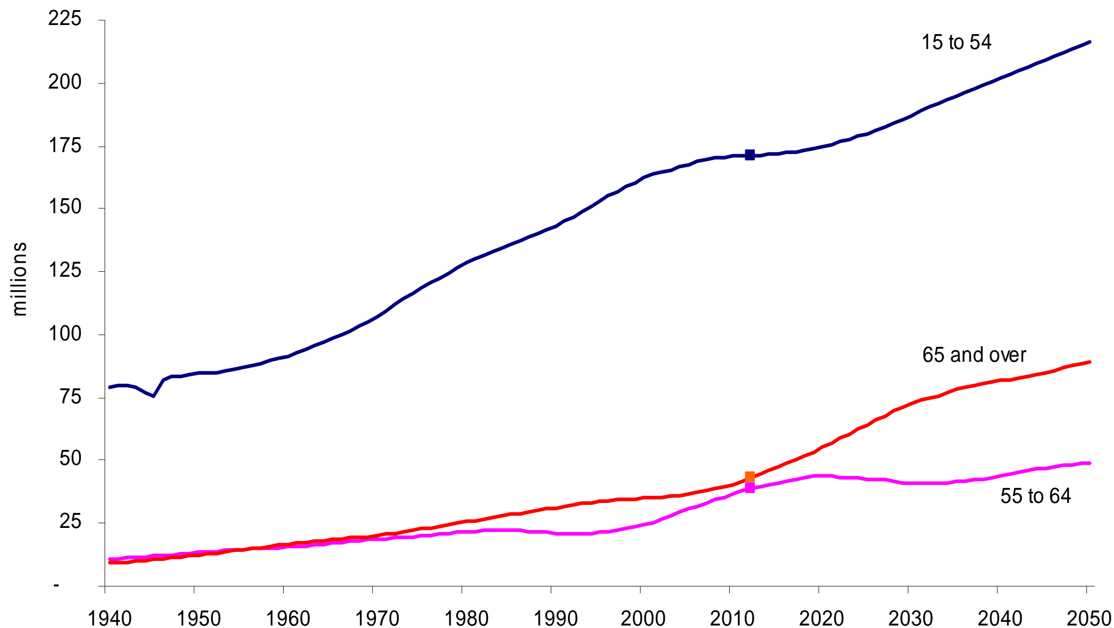
- The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington. There should also be a minimum maturity for the debt to stop the government from artificially lowering near-term interest costs.

- By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions.

- I believe these policy approaches would give new confidence to American businesses and financial markets, causing an inflow of capital and jobs to the U.S. private sector. (The above is an extract from my 2/1/2011 statement.)

Most of the issues you face are the same as they were in 2011, with the added urgency that the economic recovery continues to be much slower than normal, the unemployment rate is still 7.9% and the growth in the nation's prime working age population has stalled. The demographic climate points to weakness in payroll and income taxes, especially given high unemployment, at a time when federal outlays on the elderly will be increasing.

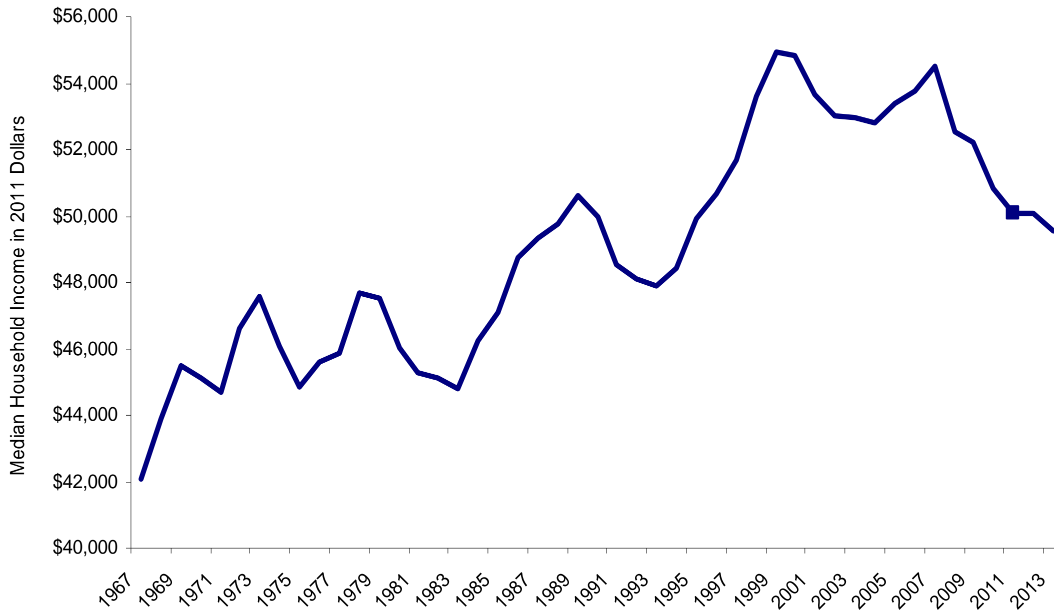
U.S. Population by Age Groups (last obs. 2012, projected to 2050)



Source: Census Bureau; Encima Global

In nominal terms, our economic growth of 3.3% in 2012 was even weaker than in 2010 or 2011. **Apart from recessions, 2012 was the weakest nominal four quarter growth rate since World War II.** The real median household income has fallen over the last 13 years, and especially in the last 5 years, a dismal economic performance.

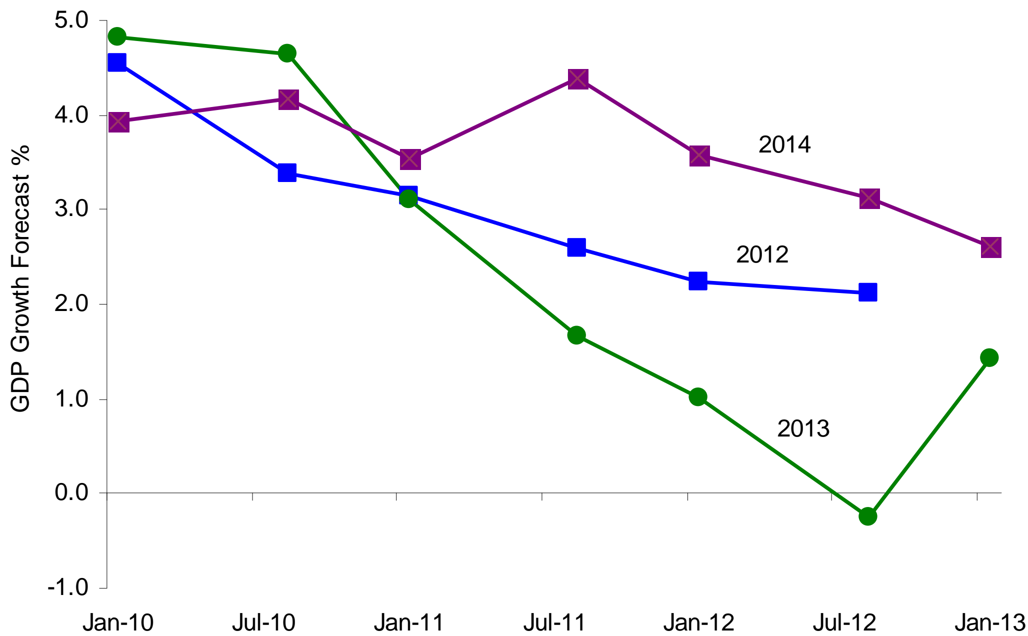
Real Median Household Income (last obs. 2011, estimates to 2013)



Source: Census Bureau; Encima Global

- CBO's growth forecasts have been overly optimistic and been reduced.

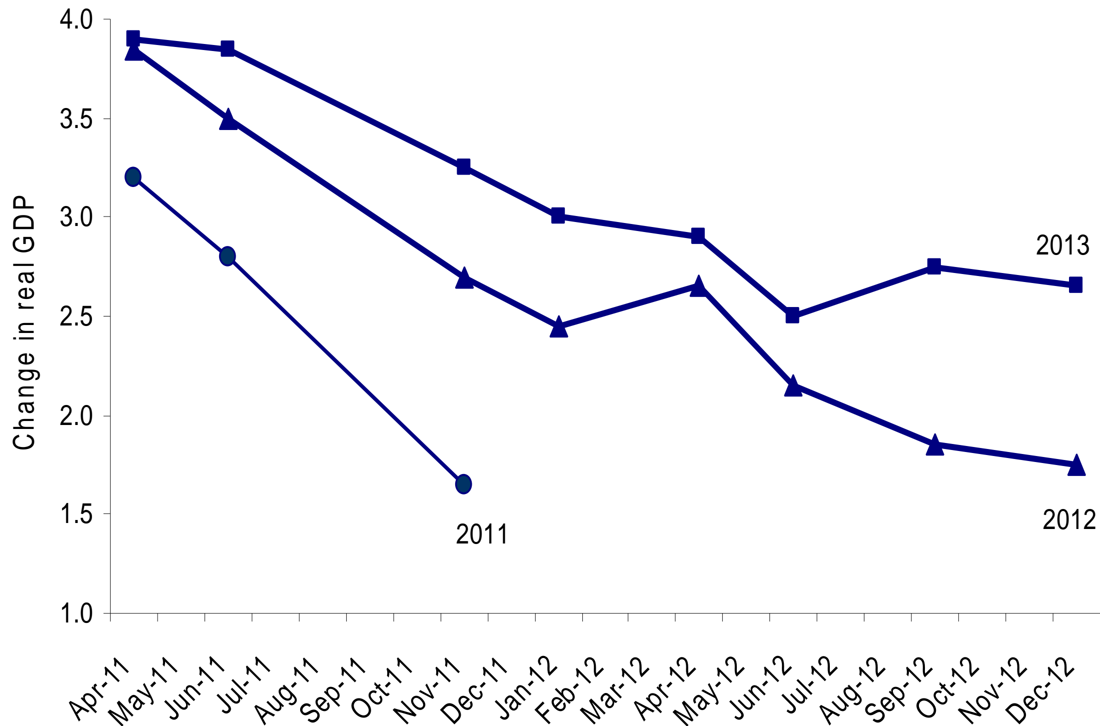
CBO Declining Growth Rate Forecasts for '12, '13 and '14 (last obs. 2-5-13)



Source: CBO; Encima Global

- Similarly, the Federal Reserve's original growth projections for 2011, 2012 and 2013 were too optimistic.

Fed Projected Real GDP Growth Rates (last obs. December 12, 2012)



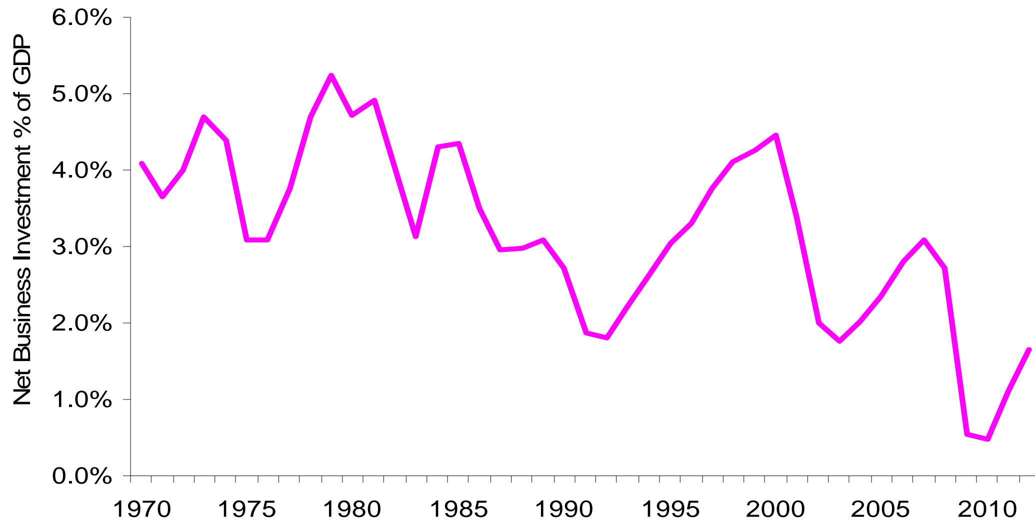
Source: Federal Reserve; Encima Global

Spending and Debt Contribute to Weak Growth

Current spending policies contribute to our economic weakness. In rough terms, the current policy consists of the federal government spending $3.6 trillion per year, 50% greater than the tax revenues of $2.4 trillion. The inability to control spending is hurting growth -- including the expansion of entitlement spending, the lack of a Senate budget in 2010, 2011 and 2012, the routine side-stepping of the pay-go scorecard and the decision not to offset spending increases with restraint elsewhere in the budget. **The result is a policy that will require much higher future debt and taxes, discouraging business investment.**

- Net business investment (gross non-residential fixed investment less depreciation) was only 1.1% of GDP in 2011 and an estimated 1.7% in 2012.

Net Business Investment as a % of GDP (last obs. 2011, estimated for 2012)



Source: Bureau of Economic Analysis; Encima Global

Milton Friedman explained that government spending has the effect of a tax. In a 2000 Media Research Center essay, he argued it this way: "An increase in government spending clearly benefits the individuals who receive the additional spending. Considered by itself, it looks as if the additional spending is a stimulus to the economy… But that is hardly the end of the story. We have to ask where the government gets the money it spends." He concludes that: "Government spending crowds out private investment."

In CBO's discussion of this problem, its recent study on alternative budget paths finds that "larger deficits would reduce national saving and 'crowd out' domestic investment (as savings that would otherwise fund private investment were instead used to purchase government debt), lowering output."

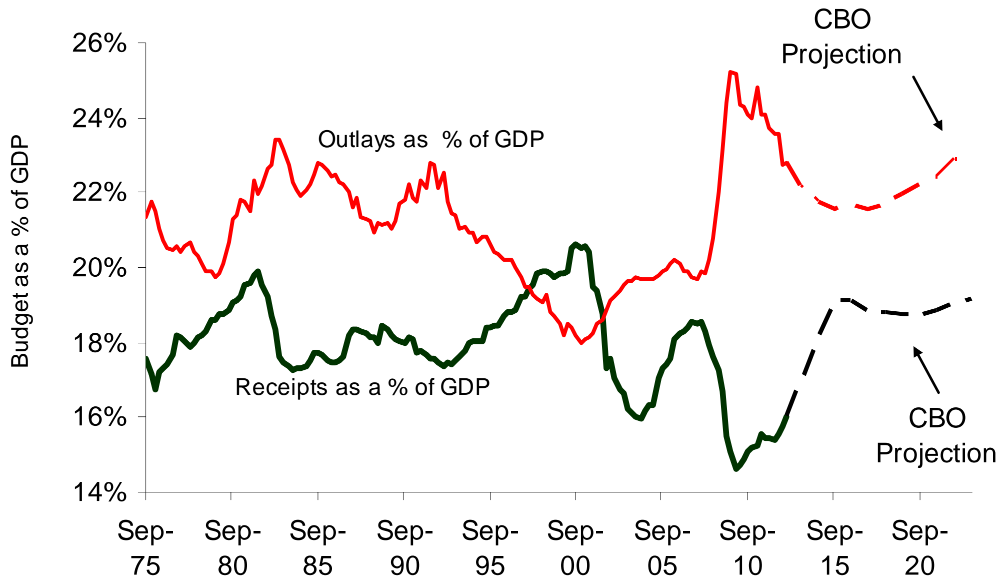
The issue before the Committee, as I understand it, is how much the government should spend in trying to encourage growth and jobs. **The short answer is that you should spend much less if you want a stronger economy and, if possible, you should make spending reductions now rather than putting them off.** Government spending causes the private sector to expect more taxes and government debt issuance, causing it to reduce investment and hiring.

Again quoting Friedman: "Japan provides a dramatic recent example. During the 1990s, the Japanese economy was depressed. The government tried repeated fiscals stimulus packages, each involving increases in government spending financed by borrowing. Yet -- or maybe therefore -- the Japanese economy remained depressed."

The converse is also true. **A convincing reduction in the long-term growth of government spending would encourage private sector investment and hiring.** Looking at CBO spending forecasts on the graph below, the economic growth problem is

clear – government spending per GDP is high and goes up in the out years, confronting the private sector with the prospect of paying more taxes and lending more to the government rather than to the private sector.

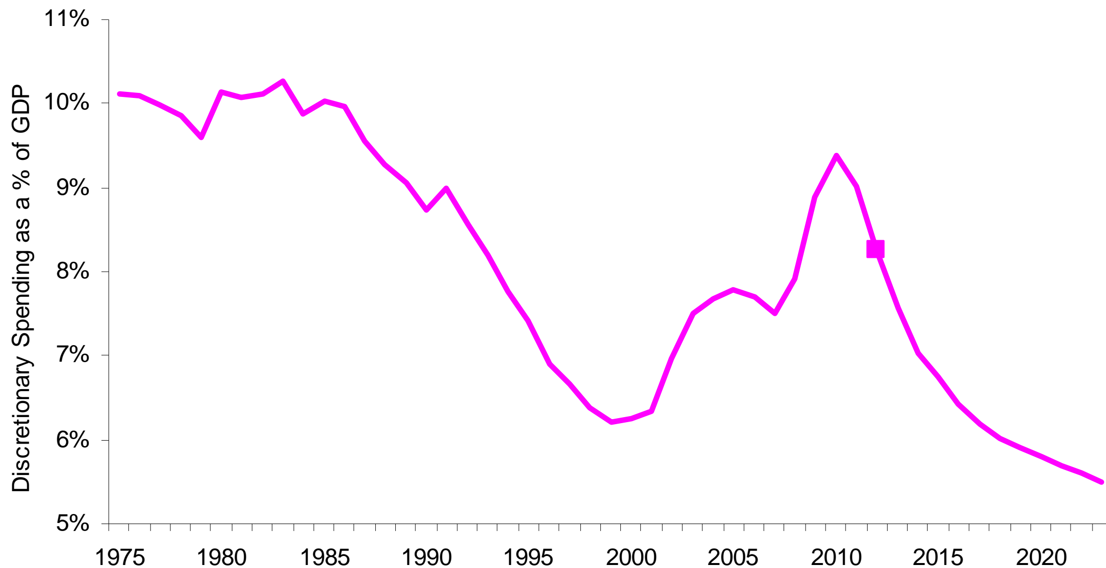
CBO Baseline: Federal Receipts and Outlays as pct of GDP (last obs. Q4 2012)



Source: CBO; Encima Global

- The picture facing the private sector is even worse than CBO's baseline forecasts because they are based on two rosy assumptions: that interest rates stay very low by historical standards despite high debt levels and the assumption of faster growth; and that discretionary spending plunges from 8% of GDP now to 5.5% of GDP by 2023, a highly unlikely degree of spending restraint.

CBO Baseline: Discretionary Spending as pct of GDP (last obs. 2012, est. to 2023)



Source: CBO; Encima Global

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. The confusion is that austerity or "fiscal consolidation" encompasses two separate economic policies, government downsizing on the one hand, which I think causes more growth; and private sector downsizing on the other hand, which causes recessions.

Many of the reform programs underway in Europe are harmful because they are built on austerity aimed at the private sector. The austerity often takes the form of higher value-added taxes, wealth taxes, reductions in transfer payments to private sector retirees and increases in government fees for its monopolies. In the Asian and Latin American crises that I worked on, the austerity included currency devaluations, while the European programs are relying on "internal devaluations," primarily cuts in private sector wages, in an effort to respond to high unemployment and low productivity. This type of austerity has repeatedly failed.

In general, the unsuccessful programs provide minimal reductions in the size of government, few labor reforms, and minimal asset sales (the Greek government sold no assets in 2012 despite a severe cash shortage). I discussed the different forms of austerity in two Wall Street Journal articles: The Crisis Winner Is Government on 12-16-11 and Greece's False Austerity on 5-24-12.

This is of course a hotly contested field in macro-economics because it gets to the heart of whether governments should spend less, or more. A 2009 study by Harvard's Alberto Alesina and Silvia Ardagna concluded that fiscal adjustments based on spending cuts tend to be successful whereas fiscal adjustments that involved tax increases tend to be unsuccessful. Kevin Hassett of AEI and others have repeated the Alesina research and

reached similar conclusions. This coincides with my experience working on several dozen country programs beginning with a review of Central American reform programs in 1984 for this Committee.

In contrast, the Congressional Research Service's Jane Gravelle reviewed the economic literature in January 2013 and concluded that the studies showing that spending cuts help economic growth "are generally inconsistent with the mainstream view of fiscal policy where short-term multipliers for spending decreases are negative and also tend to be larger in absolute value than those for tax cuts." The reference to multipliers means that spending cuts tend to hurt growth more than tax cuts help growth. Extending this logic, it might follow that spending increases help growth more than tax increases hurt growth, supporting an expansion of government.

The IMF issued a study in October 2012 prior to the G20 meeting supporting this mainstream government view. The study connected fiscal consolidation (i.e. smaller fiscal deficits) to slower-than-expected growth rates. It showed that countries which widened their deficits or reduced their fiscal surpluses grew faster-than-expected. This supported the French government's arguments to Germany that Germany should stop pushing so hard on austerity.

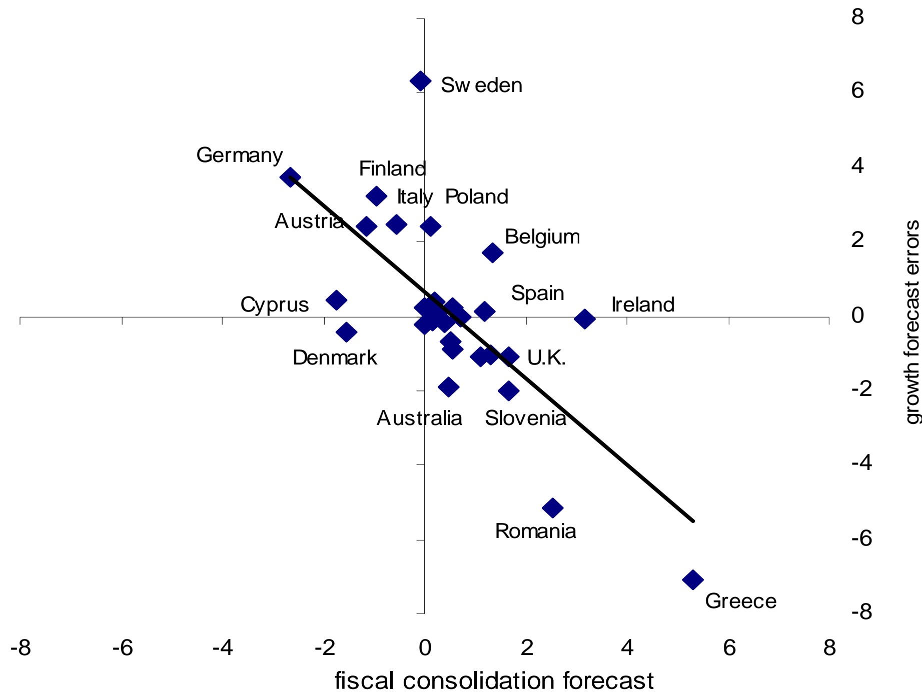
- This mainstream IMF view is lumping together two separate types of fiscal consolidation. Greece and the UK both imposed major tax increases as part of their consolidation, helping explain the deterioration in their growth forecasts during the IMF study.

- In contrast, Germany decided against tax increases, allowing the fiscal balance to move from a surplus of 0.2% of GDP in 2007 to a deficit of 4.1% of GDP in 2010 during the timeframe of the IMF study.

- It is clear to me from my experience in numerous countries that reforms that add to growth include labor mobility, restraint on government spending, asset sales and tax reform aimed at simplification and lower rates; whereas reforms that subtract from growth, as are often required in IMF programs, include value-added tax increases, wealth taxes and increased fees for government services.

- Whatever the conclusions from the various studies of government spending, the connection between spending and growth also depends on the level of debt. Spending increases will not be as damaging to growth (or spending cuts as helpful to growth) if the debt level is low, whereas spending increases will damage growth (and spending cuts help growth) when debt levels are high.

Fiscal Consolidation vs. Growth Forecast Error (IMF est. for 2010-2011)



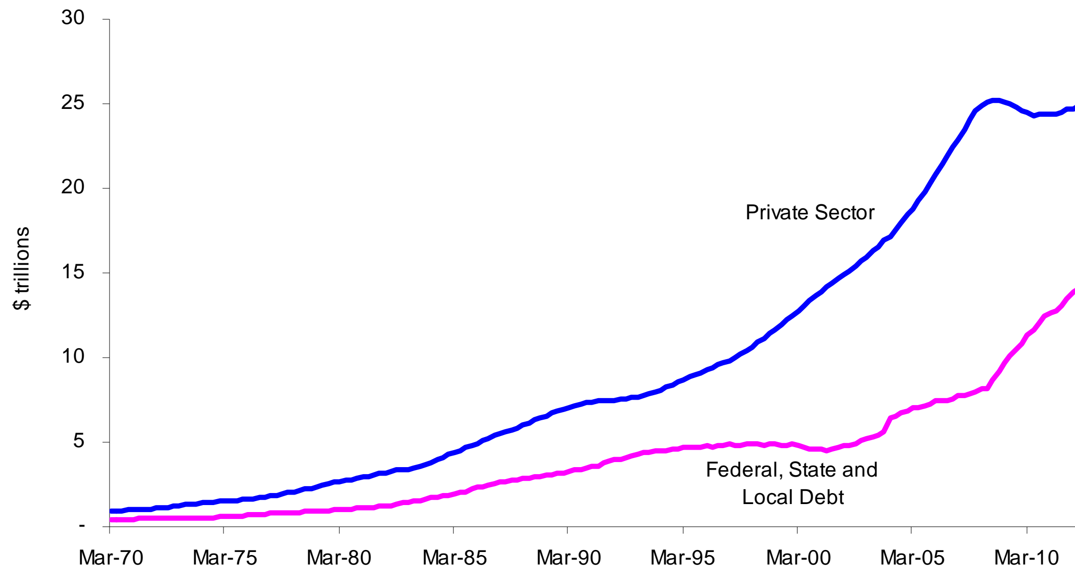
Source: IMF; Encima Global

Too Much Debt

The high and rising level of the U.S. national debt should be a key concern facing the Committee. It's clear from a variety of studies that the high federal debt burden slows growth. A key characteristic of our current economic policy is the rapid rise in government debt. When I testified here in 2011, federal debt was 64% of GDP. It's now 73% of GDP, very near the red flag levels established in recent economic studies. Including state and local debt, the IMF now puts our net debt level at 84% of GDP. While our debt probably won't go up as much in the next two years as it did in the last two, the current massive level of government borrowing undercuts the financial system's ability and desire to provide credit to the private sector.

- Credit to the government has been growing much faster than credit to the private sector, slowing growth. In effect, there's been a diversion of credit from the private sector to the government. This shows up in weak private sector investment which in turn has caused weak growth in labor productivity and GDP.

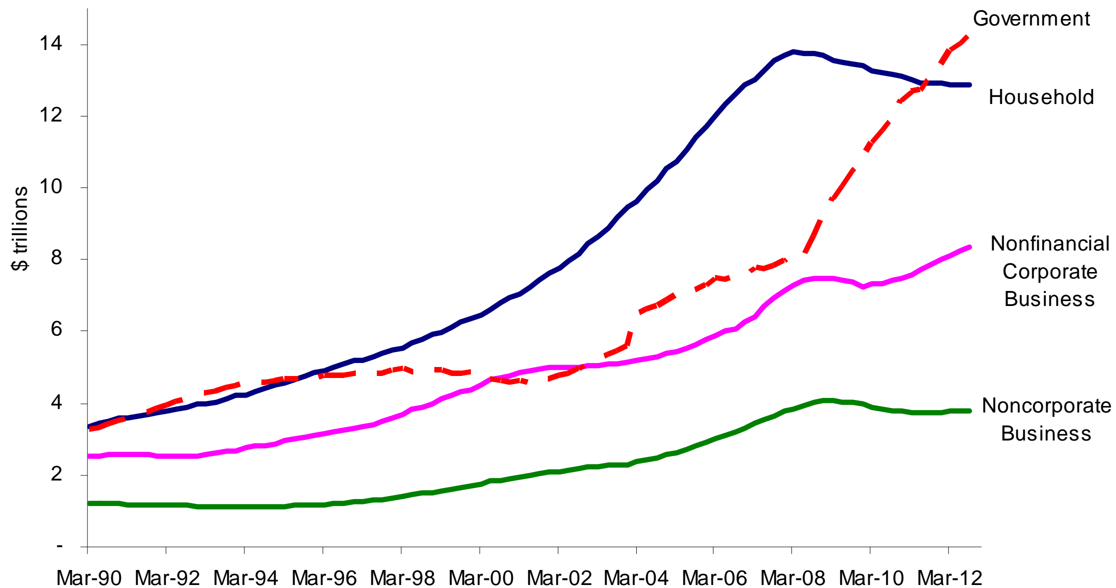
Credit to the Private Sector Vs. Government (last obs. Q3 2012)



Source: Federal Reserve; Encima Global

With the government borrowing huge amounts, the credit available to households and unincorporated businesses, which tend to be small, job-rich enterprises, has gone down, not up as it should. The Fed's flow of funds data makes clear the dramatic reallocation of credit to governments and corporations. In the year ending September 30, credit to the government was up 8.9% to $14.3 trillion (including federal, state and local marketable debt). Private sector credit was up only 1.9% year-over-year to $25 trillion. Credit to corporations was up 6.3% to $8.4 trillion, but non-corporate credit was up only 1% to $3.8 trillion and credit to households was down 0.5% to $12.8 trillion. The December 31 data, due from the Fed on March 7, is likely to show an extension of these trends. The economic result of the dramatic increase in government debt has been weak growth in jobs and GDP because small and new businesses have lagged.

Debt by Major Sectors (last obs. Q3 2012)



Source: Federal Reserve; Encima Global

Studies by Reinhart and Rogoff show that countries with debt levels approaching 90% begin to grow more slowly. A study by the BIS's Stephen Cecchetti found that each 10% increase in the debt-to-GDP ratio tended to cause a 0.2% decrease in subsequent growth rates once debt reaches excessive levels. Using different methodology, an IMF working paper by Kumar and Woo found about the same sensitivity – that growth slows by 0.2% for each 10% increase in debt, once debt levels exceed 90%, a direction we are heading.

There's a lot at stake as the U.S. debt-to-GDP ratio continues its rapid rise. Translating the growth impact from the high level of U.S. government debt into the impact on the employment rate, we may already be seeing a 0.5% increase in unemployment due to debt.

Federal Reserve's Role

In a change from past fiscal practices, the Federal Reserve is now providing much of the government's incremental borrowing capacity by borrowing from commercial banks to indirectly provide the funding for government spending.

The Fed's overnight IOUs to banks will soon reach $2 trillion, reminding me of the famous quote attributed to John Paul Getty: "If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem." The Fed will owe banks 20,000 times that amount and has plans to borrow another 10,000 times the Getty amount in 2013 alone. This will create a huge $3 trillion distortion in the composition of commercial bank assets, which are increasingly invested in the U.S. government through the Fed.

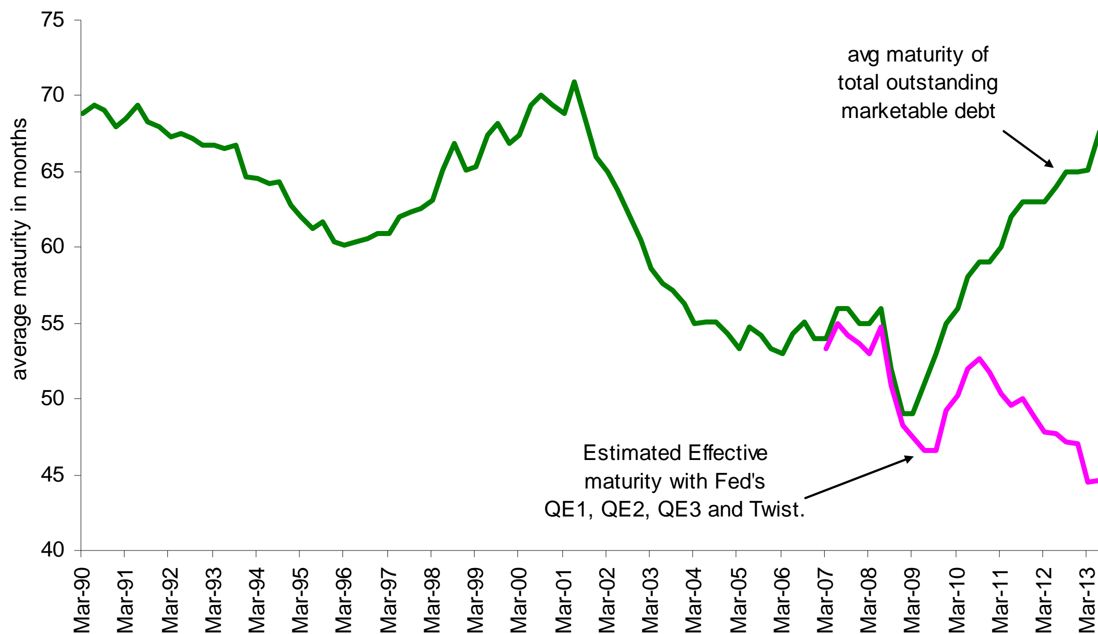
One goal of good financing policy is to lengthen the maturity of the debt. The U.S. is doing the opposite. This is a major risk in the event that interest rates rise, adding to the uncertainty in the business community from the expectation of higher taxes due to high levels of government spending.

The maturity of the U.S. national debt issued by Treasury is 65 months, only a little below the average maturity in the 1980s and 1990s.

- However, the Federal Reserve's large buyback of longer-dated Treasury notes and bonds, paid for by over-night loans from commercial banks, has substantially shortened the effective maturity of the U.S. national debt – to roughly 47 months -- which is near the crisis point of the 1970s.

- In addition to Treasury bonds, the Fed holds $1.1 trillion of long-maturity MBS and GSE agency notes financed overnight, an added exposure for the taxpayer in the event markets require higher interest rates -- as they did in the 1970s when the debt maturity was also short.

Maturity of Public Debt (last obs. Q3 2012, estimated through Q2 2013)



Source: Treasury Dept and Federal Reserve; Encima Global

Thus, the policy mix – high spending levels at a time of high debt levels, with funding provided by a wholly new financing scheme based on trillions of dollars in short-term Fed borrowing from commercial banks -- creates uncertainty about future interest rates and the dollar, further discouraging investment. This

uncertainty is compounded by the short effective maturity of the national debt held by the private sector.

Not Worth the Risk

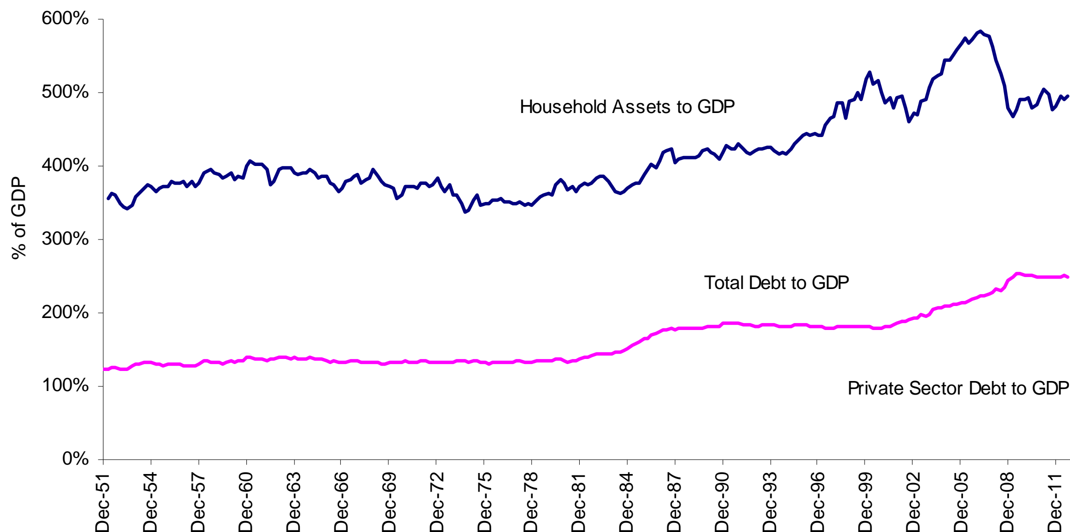
In evaluating the U.S. debt problem versus other countries, I look at the current debt burden relative to GDP (ours is now high); the rate of growth of the debt burden (ours is fast, given the fiscal deficit); the foreign currency exposure (ours is minimal); the nation's offsetting assets (ours have fallen, but are still very high); and the maturity of the debt (ours is way too short).

- On the positive side, very little of the U.S. national debt is non-dollar. Crises in Asia and Russia in the late 1990s and Mexico in 1994 involved foreign currency debts that mushroomed during their devaluations.

- U.S. household assets are the largest in the world by far ($78 trillion or 495% of GDP).

- By these metrics, the U.S. is in a less precarious debt position than several European countries, arguing against a near-term federal crisis.

Household Assets and Total Debt / GDP (last obs. Q3 2012)



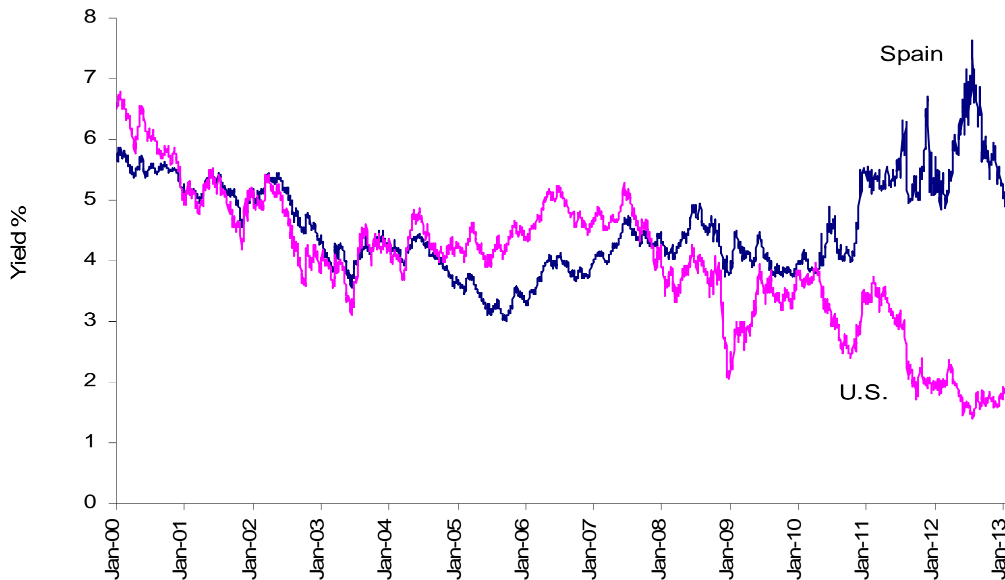
Source: Federal Reserve; BEA; Encima Global

No one knows whether the U.S. will hit a tipping point where creditors stop buying our debt. Such a problem would be catastrophic, so responsible public policy should be aimed at lowering the risk.

- Spain thought it was in good shape until early 2011 when its bond yields jumped and it found itself in deep fiscal trouble almost overnight. Unemployment is now

27%. One of the triggering events was the government's admission that the fiscal deficit was worse than it expected and the debt-to-GDP ratio was going to surge – it's now 90% of GDP and rising fast versus 107% for U.S gross general goverment debt under similar IMF methodology.

Spain and U.S. 10 Year Gov't Yields (last obs. February 22, 2013)



Source: Bloomberg; Encima Global

In conclusion, I would like to emphasize the urgency of this Committee's work in restraining spending growth and making decisions on a better composition of spending. Many government programs run on auto-pilot with little review of whether current spending levels are necessary in light of the huge national debt.

Much attention has been focused on the U.S. entitlement problem and the underfunding of the social security and Medicare trust funds. From an economic perspective, I think there's no real difference between dollars spent on entitlements and those spent on discretionary programs. Under our current system, all spending ends up being funded on a pay-as-you-go basis whether accounted for as an entitlement with a trust fund (like Social Security) or as discretionary spending (like defense.) In this way, all government programs are a commitment of future spending, though some will be harder to restrain than others. Rather than separate the categories of restraint between discretionary spending and entitlements, I think it is more important to agree that much more spending restraint is necessary and would be pro-growth, and then to get started on it.

Reducing the path of federal spending would cause faster economic growth and more jobs. The private sector would celebrate. Even though some economic models contend that cuts in government spending hurt GDP, the reality is that private sector investment is very responsive to future government spending and taxation – so cutting government spending helps growth by encouraging private sector investment and hiring.