THE WALL STREET JOURNAL.

A Golden Fiscal Rule Nurtures Prosperity

IMF data show nations that imposed genuine spending restraint for multiyear periods reaped big benefits.

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April 6, 2014

The current debate between advocates of "austerity" and "growth" is frustrating for anyone who supports limited government. Austerity folks assert that deficits are economic poison and that balanced budgets, largely achieved with higher taxes, should be the goal of fiscal policy. So-called growth advocates believe more government deficit spending will boost economic performance.

Both miss the point. What matters, as Milton Friedman taught us, is the size of government. That's the measure of how much national income is being redistributed and reallocated by Washington. Spending often is wasteful and counterproductive whether it's financed by taxes or borrowing.

Rather than fixating on deficits and debt, I suggest another goal: Ensure that government spending, over time, grows more slowly than the private economy. Evidence from economies around the world shows this is the best path to bring down deficits and nurture prosperity.

Call it the golden rule of fiscal policy. Here's how it would work in the United States. The White House projects nominal GDP will climb 4.7% annually over the next 10 years, while the Congressional Budget Office estimated average growth of 4.5% over that time period. The golden rule simply requires that the burden of government spending climb at a slower rate. Even if the federal budget grew 2% each year, about the rate of projected inflation, that would reduce the relative size of government and enable better economic performance by allowing more resources to be allocated by markets rather than government officials.

A golden rule has several advantages over fiscal proposals based on balanced budgets, deficits or debt control. First, it correctly focuses on the underlying problem of excessive government rather than the symptom of red ink. Second, lawmakers have the power to control the growth of government spending. Deficit targets and balanced-budget requirements put lawmakers at the mercy of economic fluctuations that can cause large and unpredictable swings in tax revenue. Third, spending can still grow by 2% even during a downturn, making the proposal more politically sustainable.

Nations that followed versions of the golden rule have enjoyed significant improvements in fiscal aggregates. Data I've crunched from the International Monetary Fund's World Economic Outlook database—which includes all spending at all levels of government—show several notable examples of countries that imposed genuine spending restraint for multiyear periods. They've reaped big benefits, with reductions in the burden of government (as a share of economic output) and rapid reductions in deficits (both nominally and as a share of gross domestic product).

Consider Canada, which allowed spending to grow on average 0.8% per year between 1992 and 1997. During that five-year period, the amount of economic output diverted to government shrank by 9.4 percentage points of GDP. And red ink shrank by nearly the same amount, turning a large deficit into a surplus.

Sweden's government budgets expanded by an average of just 1.9% annually between 1992 and 2001, and the burden of government spending declined by a whopping 15 percentage points of GDP. This helped restore growth and also generated a budget surplus.

In Germany, government spending grew an average of less than 0.2% per year between 2003 and 2007. The public sector's claim on economic output dropped by 5.4 percentage points and a significant budget deficit became a surplus. In New Zealand between 1991 and 1997, government spending grew an average 0.5% annually. The economy revived, government spending dropped by 11 percentage points of GDP, and the budget went into surplus.

Most recently, Latvia has cut spending since 2008, with outlays dropping by an average of more than 4% per year. This has reduced the burden of government spending by more than seven percentage points of GDP and slashed a large deficit to less than 1% of economic output.

Other nations have successfully followed a golden rule, including Ireland (1985-89), Slovakia (2000-04), Singapore (1998-08), Italy (1996-2000), Lithuania (2008-present), Taiwan (2001-06), Israel (2002-05), Estonia (2008-11), Iceland (2008-present), and the Netherlands (1995-2000).

Al of these nations achieved better economic performance. The IMF's economic data show above-average growth in the nations that restrained spending, both during and after the period of fiscal discipline. Latvia, Sweden and Germany are doing better today than most other European nations. New Zealand and Canada have enjoyed faster growth since they reduced the size of government.

And then there is the United States under Bill Clinton. According to data from the Office of Management and Budget, total spending at all levels of government grew by "just" 3.5% per year from 1992-98. That's not very impressive compared with some other nations, but nominal GDP grew considerably faster, so the overall burden of spending declined as a share of economic output. This was the boom when the federal government went from having a big deficit to a budget surplus.

Spending has grown even more slowly in recent years—albeit after a huge spike at the federal level in 2009 because of so-called stimulus. Total federal, state and local spending has climbed by an annual average of only 0.1% over the past four years, reducing both the burden of spending and the level of red ink. This spending restraint is helping to offset the economic headwinds of higher taxes, red tape and ObamaCare.

Can any government maintain the spending restraint required by a fiscal golden rule? Perhaps the best model is Switzerland, where spending has climbed by less than 2% per year ever since a voter-imposed spending cap went into effect early last decade. And because economic output has increased at a faster pace, the Swiss have satisfied the golden rule and enjoyed reductions in the burden of government and consistent budget surpluses.

Nobody in Washington has proposed a duplicate version of the Swiss debt brake, but Congressman Kevin Brady's Maximizing America's Prosperity Act is somewhat similar. The Texas Republican would limit non-interest spending so that it grows more slowly than potential GDP. Outlays could still climb by an average of more than 3% over the next 10 years, but nominal GDP is expected to grow at a faster rate, so the overall burden of government would fall. In the long run, that's the best guarantor of American prosperity.

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