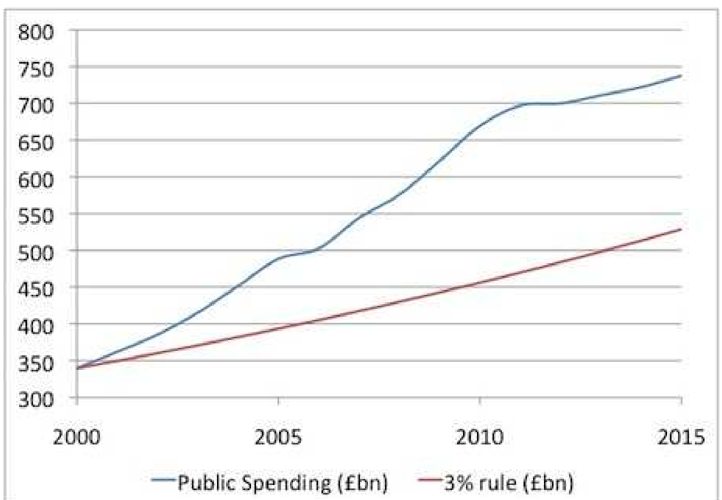
The 3 percent rule

Written by Tom Clougherty
Wednesday, 09 March 2011 17:34

3 Comments and 2 Reactions

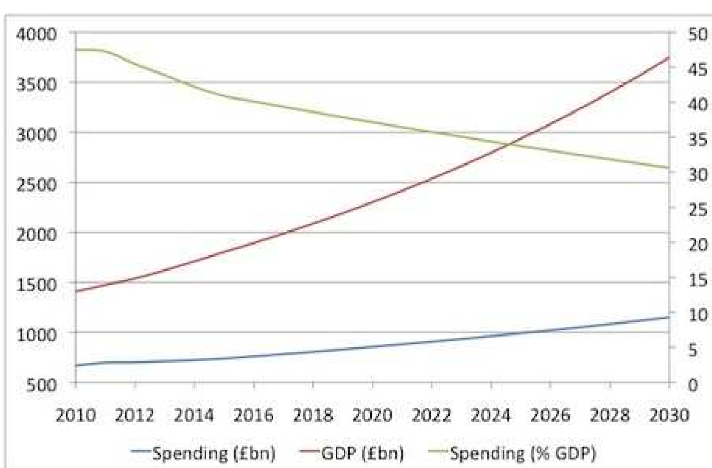
Over on Cato-at-Liberty, Chris Edwards proposes a new rule for US public spending – that its growth should be limited, by law, to a maximum of three percent a year (roughly equivalent to inflation plus population growth). That seems a reasonable goal, he says, and could gain broad centrist support.

It is easy to see the appeal: if UK public spending had only grown by 3 percent a year since 2000, we would currently be spending £470bn rather than £697bn a year. That 'saving' of £227bn would wipe out the budget deficit with enough left over to abolish VAT (not that this would necessarily be the priority). The graph below shows how things might have been.



But how about projecting the 3 percent rule forward? The graph below assumes that the coalition government meets it spending targets up until 2015-16, and that public spending grows by only three percent a year thereafter. Based on project nominal GDP growth of 5 percent a year, spending would decline from 48 percent of GDP now,

to 37 percent in 2020, and then 31 percent in 2030.



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Words of wisdom

"There is no art which one government sooner learns of another than that of draining money from the pockets of the people."

***The Wealth of Nations*, Book V Chapter II Pt II**

"What improves the circumstances of the greater part can never be regarded as an inconveniency to the whole. No society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable."

***The Wealth of Nations*, Book I Chapter VIII**

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Now, that might be a much slower rate of progress than many of us would like. But it does show that – in the long run – you don't need to do anything all that dramatic in order to significantly reduce the share of the economy consumed by the state. All you need is a long-term commitment to fiscal responsibility, and the discipline to stick to it.

Edwards also flags up a couple of additional benefits of the 3 percent rule: (1) "one advantage of an annual growth cap is that it would lock-in any spending cuts that are made, and thus spending would be ratcheted downwards" and (2) "A fixed percent cap would also encourage policymakers to support a low-inflation policy by the Fed because the lower was inflation, the higher the budget limit in constant dollar terms."

It gets my vote.

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Cahal 13 hours ago

I'm always wary of rigid rules like this because it would make it hard for the government to respond to shocks.

However, I saw a similar type of idea from Chris Dillow:

http://www.investorschronicle....

Linking spending to bond market yields could effectively eliminate the risk of debt default if done properly, and would also prevent politicians from getting complacent (Re: Gordon Brown).

Eamonn 5 hours ago

Excellent stuff. Doing the right thing for a long time leaves you in a good position. Doing the wrong thing for a long time leaves you in a big hole. If we had proper restraints on government spending and borrowing, our economy would, eventually, come right.

Gh 2 hours ago

What about war?

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