Slash expenditure to balance the budget

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The daily headlines are about jobs, the markets, property values. But underpinning all of those, the fundamental economic issue facing the United States is whether and how to reduce government spending.

Under current policy, federal expenditure will remain at unprecedented peacetime highs for the foreseeable future, yet political opposition to spending cuts is strong. Many advocates believe this high spending is both beneficial in its own right and necessary to end the recession.

If this view is correct, the U.S. faces higher taxes or sustained deficits for decades. Neither option is attractive. We need to re-examine the case for big government before the U.S. goes further down the high-spending path.

The first defense of government spending is that private markets do not supply key goods and services, so government should fill the gap. Private markets, for example, might under-supply national defense, education, infrastructure, scientific research, or anti-poverty programs. In this case government spending improves economic welfare by making up for deficiencies of private markets.

The "market failure" argument is reasonable in some cases, but it justifies some spending, *not* unlimited spending. Even productive programs hit a point at which their costs outweigh their benefits, rendering expenditure beyond this point wasteful.

Fielding an army provides national security, but does not make every war or weapons system a good idea. Education subsidies for poor children are defensible, but that does not mean government should fund a college degree for everyone. Some government roads enhance private productivity, but "bridges to nowhere" are just pork.

The political process, alas, does not lend itself to objective balancing of costs and benefits. Most programs benefit well-defined interest groups (the elderly, teachers unions, environmentalists, defense contractors) while imposing relatively small costs per person on everyone else. Thus the winners from excess spending fight harder than the losers, and spending far exceeds the level suggested by cost-benefit considerations.

That brings us to the second argument for higher spending: the Keynesian claim that spending stimulates the economy. If this is accurate, it might seem the U.S. should continue its high-spending ways until the recession is over.

But the Keynesian argument for spending is also problematic. To begin with, the Keynesian view implies that any spending—whether for vital infrastructure or bridges to nowhere—is equally good at stimulating the economy. This might be true in the short term (emphasis on might), but it cannot be true over the long haul, and many "temporary" programs last for decades. So stimulus spending should be for good projects, not "digging ditches," yet the number of good projects is small given how much is already being spent.

More broadly, the Keynesian model of the economy relies on strong assumptions, so we should not embrace it without empirical confirmation. In fact, economists find weak or contradictory evidence that higher government spending spurs the economy.

Substantial research, however, does find that tax cuts stimulate the economy and that fiscal adjustments—attempts to reduce deficits by raising taxes or lowering expenditure—work better when they focus on tax cuts. This does not fit the Keynesian view, but it makes perfect sense given that high taxes and ill-justified spending make the economy less productive.

The implication is that the U.S. may not face a tradeoff between shrinking the deficit and fighting the recession: it can do both by cutting wasteful spending (Medicare, Social Security, and the wars in Iraq and Afghanistan, for starters) and by cutting taxes.

The reduced spending will make the economy more productive by scaling government back to appropriate levels. Lower tax rates will stimulate in the short run by improving consumer and firm liquidity, and they will enhance economic growth in the long run by improving the incentives to work, save, and invest.

Deficits will therefore shrink and the economy will boom. The rest of the world will gladly hold our debt. The U.S. will re-emerge as a beacon of small government and robust capitalism, so foreign investment (and talented people, if immigration policy allows) will come flooding in.

A happy ending all around.

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