Should U.S. Fiscal Policy Address Slow Growth or the Debt? A Nondilemma

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The United States faces two economic challenges: slow growth and an ever-increasing ratio of debt to gross domestic product (GDP). Many policymakers believe they face a dilemma because the policy solutions to the two problems are opposite, says Jeffrey A. Miron, a senior fellow at the Cato Institute and the director of undergraduate studies in the department of economics at Harvard University.

- To address the slow recovery, standard - Keynesian -- economics suggests further fiscal stimulus in the form of lower taxes or higher spending.
- But that recommendation runs head-first into the economy's second crucial challenge, the long-run fiscal imbalance.

Yet policymakers are wrong to see this as a dilemma.

- The Keynesian model does not evaluate government expenditure using the standard microeconomic concepts of economic efficiency (cost-benefit analysis); rather, it assumes that all expenditure is beneficial.
- Some government purchases, however, are not a productive use of resources, and transfer payments distort economic incentives and thus can reduce economic output.
- In contrast, broad-based tax cuts, especially those that lower marginal tax rates, enhance economic growth.

The United States therefore has a simple path to a brighter economic future: slash expenditures and keep tax rates low. Reducing expenditures will improve the debt outlook and make the economy more productive, implying higher levels of output and further debt reductions for any given tax rates. Keeping tax rates low will improve the incentives for labor effort, savings and entrepreneurship, which promotes a more productive economy.

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