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COMMENTARY

How the House Budget Would Boost the Economy

Slowing federal spending will alleviate fears of higher future taxes, spurring more investment and consumption.

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This week the House of Representatives will vote on its Budget Committee plan, which would bring federal finances into balance by 2023. The plan would do so by gradually slowing the growth in federal spending without raising taxes.

Still, the plan has been denounced by naysayers who assert that it would harm the economic recovery and that, at the least, any spending reductions should be put off until later. This thinking is just as wrong now as it was in the 1970s.

According to our research, the spending restraint and balanced-budget parts of the House Budget Committee plan would boost the economy immediately. With the Budget Committee's proposed tax reform included, the immediate impact would be even larger. The entire plan would raise gross domestic product by one percentage point in 2014, equivalent to about a $1,500 increase for each U.S. household. Ten years from now, at the end of the official budget horizon, we estimate that the entire plan would raise GDP by three percentage points, or more than $4,000 for each U.S. household.

Our assessment is based on a modern macroeconomic model (developed with Volker Wieland of the University of Frankfurt and Maik Wolters of the University of Kiel) whose features include a recognition that the resources to finance government expenditures aren't free—they withdraw resources from the private economy. The model provides for other essential attributes of the economy—that consumers, businesses and workers respond to incentives, and they are influenced by their expectation of future economic conditions when making decisions today. None of these features is provided for in old-style Keynesian models.

The House budget plan keeps total federal outlays at their current level for two years. Thereafter, spending would rise each year, but more slowly than if present policies continue. By 2023, federal expenditures would decline to 19.1% of GDP in 2023 from 22.2% today.

Since the Congressional Budget Office projects that revenues will equal 19.1% of GDP in 2023, the House plan will balance the budget that year. Also by 2023, the publicly held federal debt relative to GDP would decline to 55% from its current high level of 76%.

The House budget is hardly austere: The federal spending claim on GDP would still be considerably higher than it was in fiscal 2000 (18.2%) and only slightly below its claim on GDP in 2007 (19.7%).

The reductions in the growth rate of spending are to be achieved primarily through entitlement reforms. The Affordable Care Act would be repealed. Medicaid and food-stamp administration would be turned over to the states. Medicare would be fundamentally reformed. Anti-fraud measures would be applied to federal disability programs. Among the major entitlement programs, only Social Security would remain unchanged; this is a deficiency in the plan. As for discretionary spending, the House budget plan would provide for only slight reductions from the levels that are set by the budget sequester.

The long-run economic gains from restraining government spending would not, despite what critics claim, harm the economy in the short run. Instead, the economy would start to grow right away. Why?

First, the lower level of future government spending avoids the necessity of sharply raising taxes. The expectation that tax rates won't need to rise provides incentives for higher investment and employment today.

Second, since the expectation of lower future taxes has the effect of raising people's estimation of future disposable income, consumption increases today. This change comes thanks to Milton Friedman's famous "permanent income" hypothesis that the behavior of consumers reflects what they expect to earn over a long period. According to our macroeconomic model, the higher level of consumption induced by the House budget's effect on consumer expectations is large enough to offset the reduced growth of government spending.

Third, the new budget's reduction in the growth of government spending is gradual. That allows private businesses to adjust efficiently without disruptions.

Still, our macroeconomic model likely underestimates the positive impact of the House budget plan. The model doesn't account for the greater economic certainty that results from preventing the national debt from soaring to dangerously high levels and from stabilizing the federal tax burden. Nor does the model account for beneficial changes in monetary policy that could accompany enactment of the budget plan. Lower deficits and national debt would reduce pressure on the Federal Reserve to continue buying long-term Treasury bonds.

The U.S. economy has been experiencing its slowest recovery from a deep recession in modern history. Tragically, fewer people are working as a percentage of the working-age population than when the recovery began—and economic growth was only 1.6% last year. The large federal budget deficits—by increasing uncertainty and delaying private spending—are an important cause of this lackluster economic performance.

For too long, policy makers have been misguided by models that lend support to bigger government or to the politically convenient objective of delaying any reduction in spending. It is better to recognize the flaws in this approach and get on with the sensible budget reforms the country so sorely needs.

Messrs. Cogan and Taylor are professors at Stanford and senior fellows at the Hoover Institution. The macroeconomic model used in their research was published last month in the Journal of Economic Dynamics and Control, with updated results at Hoover's Economic Policy Working Group website.