First Trust
ECONOMIC RESEARCH REPORT
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Tax Cuts Matter, Spending Cuts Matter More

While tax cuts grab the headlines, the bigger issue for long-term economic growth is government spending. Tax receipts are above their long-term average as a share of GDP, but the government is still spending over $650 billion more than it takes in. And this government spending crowds out private sector growth.

Government spending since 2000 has risen from 17.6% of GDP (when the US had a surplus) to around 21% of GDP today. The more the government spends, the more it crowds out private sector growth and the slower the economy grows. It's not that complicated.

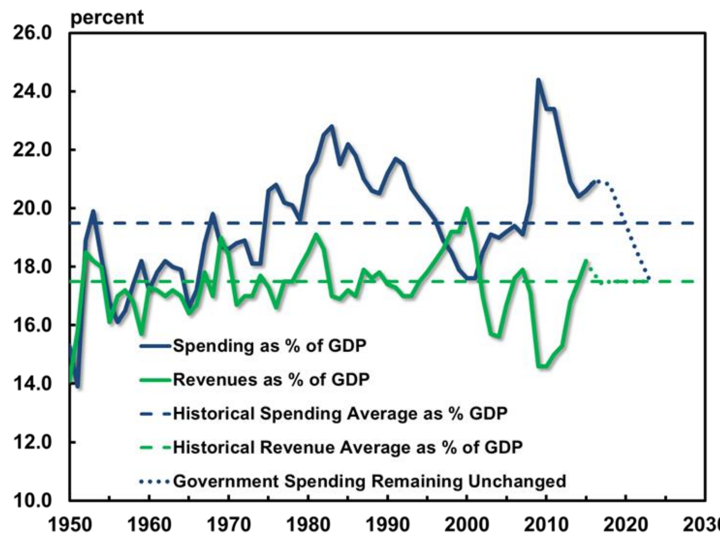
Yes, tax cuts can help boost growth – at least temporarily – but without cutting spending, faster economic growth can't be sustained, and eventually politicians will push tax rates back up in an attempt to pay the tab. Tax cuts are never "permanent" unless spending is contained.

We got into the current budget mess thanks to the 2009 jump in government spending as TARP and other supposed temporary stimulus programs added $535 billion to already excessive federal spending. This pushed spending as a share of GDP to 24.4% from 20.2% in a single year. But instead of unwinding that spending as the economy recovered from the financial crisis, government embraced Milton Friedman's maxim that "nothing is as permanent as a temporary government program."

As Friedman predicted, government spending never went back to its 2008, pre-crisis level of about $3 trillion per year. It flat-lined near $3.5 trillion over the next five years as the sequester helped contain it, but the sequester has since been scuttled and spending is now up to $3.98 trillion with the new 2018 budget, passed by the House and Senate, pushing it to $4.1 trillion.

Over recent decades, the US has never balanced its budget when spending was greater than 19.5% of GDP. As a result, unless tax cuts boost the economic growth rate high enough above the growth rate of spending, tax cuts will not have a long-term impact on GDP and living standards.

That said, two pieces of good news have developed in recent weeks. First, tax cuts seem to be on the way. Second, if the $4.1 trillion budget is passed, spending will be up around 3% from 2017, slightly slower than nominal GDP. This slower growth in spending paired with better policies should help the economy to accelerate in 2018 and drop spending to around 20.5% of GDP.



But what if Congress and the President went one step further and froze spending at the current bloated level? As the included chart shows, if we make the conservative assumption that tax revenues remain near their historical 65-year average of 17.5% of GDP and if nominal GDP (real GDP plus inflation) grows only 3.5% annually – in-line with the 3.6% annual growth rate over the past five years – with a spending freeze, the budget would balance in six years (2023). If fewer regulations and tax cuts boost nominal growth the budget would be balanced even sooner.

The last time we saw spending near 17.5% of GDP was in the early 2000's. And, as you can see from the chart, revenues came in much stronger than their historical average. We don't think this was a coincidence. A smaller government leads to a larger private sector. It becomes a virtuous cycle of faster growth, higher tax receipts and less need for government spending. Living standards would rise.

There is a lot of fat to trim within government. We believe if the private sector were running all of Washington, spending would fall drastically.

If President Trump passed a spending freeze, government would be forced to become more and more efficient. No more spending $283,500 on Department of Defense bird-watching, or nearly $150,000 to understand why politics stresses us out, or $65,473 to figure out what bugs do near a lightbulb. There are plenty of areas to cut excess…

But there are some issues that would need to be addressed with a spending freeze. First our military over the coming years is going to get bigger and stronger. Spending on defense will increase.

Second, what really drives a large part of government spending today is entitlements like Social Security, Medicare and Medicaid. With demographics and population growth, there is no question that these will continue to grow, but something needs to be done to bring down costs. It sounds trite, but we can even get efficiencies out of entitlements, and we hope the Trump administration can help government think more efficiently.

As President Trump said in his inaugural address "… today we are not merely transferring power from one administration to another, or from one party to another – but we are transferring power from Washington, D.C. and giving it back to you, the American People." The best way to do this is by cutting the size of government. Freezing spending would be a big step in the right direction.

After all, from 1776, when the US was a backwater colony, to 1913, when it had become a leading power and would soon help save Europe in WWI, there was no Federal Reserve, or income tax. Government was much smaller. It's time to shrink the burden of government and allow that magic of private sector growth to happen again.