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TESTIMONY

“BIDENOMICS" IS NOT THE SOLUTION TO HELPING LOW-INCOME AMERICANS

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US Senate Committee on the Budget
Reducing Inequality, Fueling Growth: How Public Investment Promotes Prosperity for All

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Chairman Whitehouse, Ranking Member Grassley, and members of the US Senate Committee on the Budget, I thank you for the opportunity to testify today. My name is Veronique de Rugy, and I hold the George Gibbs Chair at the Mercatus Center at George Mason University, where I study tax and fiscal policy, the federal budget process, and the implications of government spending for economic growth.

Attempts to address income and wealth inequality through redistribution and excessive spending will be counterproductive in large part because there are other bigger problems that have and will continue to have adverse effects on lower-income Americans. As American Enterprise Institute’s Scott Winship noted a few years ago before this Committee, “That so many people believe otherwise is, in no small part, a result of mismeasurement on the part of a team of influential economists. As a result of this mismeasurement, a conventional wisdom has developed—which is likely to be wrong—that inequality has risen dramatically since the early 1980s.”[1]

Rather than focusing on income or wealth concentration, policymakers should focus on the fact that excessive fiscal expansion has required equally large increases in public debt to finance this spending. This has led to inflation and higher interest rates. High public debt is also associated with slower growth. Furthermore, the rate of return of government spending is usually lower than that of private spending. The added intervention in the economy encourages cronyism, increases economic inequality and decreases growth. While these changes hurt us all, they are likely more detrimental to those Americans at the bottom of the income distribution.

[1] Scott Winship, “Is There an Inequality Crisis?” (Statement before the Senate Committee on the Budget, On the Wealth and Income Inequality Crisis in America, American Enterprise Institute, Washington, DC, March 17, 2021), https://www.aei.org/wp-content/uploads/2021/03/Winship-Testimony-3.17.21.pdf?x91208.

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THE HIGH COST OF INFLATION

The administration has been quick to praise its policies for the state of the economy. Superficially, the current state of the US economy looks quite solid. Real GDP increased at an annual rate of 2.1 percent in the second quarter of 2023. The unemployment rate rose slightly to reach 3.8 percent in August. Wages are rising, and average hourly earnings are up 2.82 percent from January 2022.

These numbers are less impressive when put in perspective. Employment growth was inevitable. We lost 20 million jobs in one month during the pandemic, and many of these jobs were going to come back. Unemployment is low, but that's the result of an economy that had way too much spending, along with participation in the labor force that had not fully recovered. Inflation-adjusted median household income also declined from $76,660 in 2021 to $74,580 in 2022, leaving Americans worse off. Labor tensions and strikes are intensifying across the country.

This is, in part, the result of inflation, which continues to take a tremendous toll on the American people. As measured by the Consumer Price Index (CPI), year-over-year inflation has risen to 3.7 percent in August 2023, after peaking at 9.1 percent. So-called "core" (non-food, non-energy) CPI was down slightly to 4.3 percent in August 2023. These numbers are an improvement after having experienced their highest levels since 1982, but they remain stubbornly high.

This is bad news for Americans who have seen their standard of living decline since the beginning of 2021. After adjusting for the CPI for All Urban Consumers (CPI-U), the Bureau of Labor Statistics (BLS) reports that average hourly earnings fell by 2.0 percent and 1.6 percent in 2021 and 2022, respectively. That's a 3.2 percent decline since 2021. In addition, over one-half of the typical family budget is devoted to food, energy, and shelter, all of which have seen a large increase in price since 2021. Food prices, for instance, increased by 19.3 percent. Shelter increased by 16.5 percent since 2021 (shelter represents about a third of a family's budget). Gasoline inflation is up by 62.5 percent since 2021.

Inflation is a tax on families' standard of living. If one cares about economic inequality, inflation should be a serious concern. Inflation hits lower-income workers the hardest since these workers tend to experience higher-than-average levels of household inflation.[2] A BLS analysis of household inflation between 2005 and 2023 found that lower-income households generally faced a larger inflation burden than higher-income households.[3] Meanwhile, the fight against inflation and rapidly rising interest rates also hit lower-income Americans the hardest. Lower-income workers tend to consume a higher proportion of their incomes and hold more of their assets in cash or low-yielding bank deposits.

How did the United States develop this inflation problem? In response to the pandemic emergency, the US Department of the Treasury first issued $3 trillion of new debt, which the Federal Reserve (Fed) quickly bought in exchange for $3 trillion of new reserves that the Treasury sent out as checks and

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[2] Republican Joint Economic Committee of the US Congress, The 2023 Report of the Joint Economic Committee, Congress of the United States on the 2023 Economic Report of the President, Republican Response, June 27, 2023, p. 8. https://www.jec.senate.gov/public/_cache/files/11e319fe-949d-460c-8cf2-635bfe5a7f07/2023-erp-republican-response.pdf; Greg Kaplan and Sam Schulhofer-Wohl, "Inflation at the Household Level," (Working Paper 22331, National Bureau of Economic Research, Cambridge, MA, June 2016), p. 20, https://www.nber.org/system/files/working_papers/w22331/w22331.pdf.

[3] Bureau of Labor Statistics, United States Inflation Experience Across Income Distribution, June 2023, https://unece.org/sites/default/files/2023-05/4.3%20United%20States%20CPIs%20by%20income.pdf

other forms of payments to Americans. The Treasury then borrowed another $2 trillion or so to send out another round of checks and payments to Americans. Overall federal debt rose by almost 30 percent of GDP. This action was the product of a misdiagnosis of economic problems: that the pandemic-induced recession was mostly an aggregate demand shock, not one of aggregate supply.

The size of fiscal stimulus was also an issue. For instance, the American Rescue Plan Act of 2021 (ARP) added a total of $1.9 trillion of stimulus spending to the economy, bringing the total "emergency" stimulus spending to address the COVID-19 pandemic to almost $6 trillion.[4] That was far in excess of the Congressional Budget Office's (CBO) 2021 projection of the output gap, which was estimated to be $700 billion through 2023, the period when most of the $1.9 trillion in spending would take place. The $1.9 trillion was two- or three-times more than the amount needed to fill the gap. Even by Keynesian economics standards, the $6 trillion injected into the economy was larger than any plausible output gap, at any level of multiplier.

Numerous academic studies confirm that government-induced demand with oversized government spending was a key player in creating this inflation.[5] One study suggests that ARP fiscal stimulus increased peak inflation by 3.1 percentage point from 5.5% to 8.6%. Due to unfunded spending, especially the ARP, it may take until 2025 for inflation to retrench to a 2% target.[6]

Since the ARP, the spending has not stopped. Congress passed the Infrastructure Investment and Jobs Act, known as the Bipartisan Infrastructure Framework (BIF). While the bill may have limited effect on inflation, other legislation—such as the Inflation Reduction Act (IRA) and the CHIPS and Science Act—did contribute to the durability of the inflation problem.

Expansionary fiscal policy is making it harder for the Fed to pull back on overall demand and will require more drastic actions than would have been necessary otherwise. This is compounded by the fact that in the first year in office, the Biden administration also restricted supply by imposing an additional $200 billion in regulatory costs on the business community. The pace continues to this day. Expanding demand while restricting supply will only worsen inflation.

THE HIGH COST OF ASTRONOMICAL PUBLIC DEBT

This excess spending resulted in even larger deficits than already projected and a record debt level. According to the Congressional Budget Office (CBO), the most recent estimate of the full-year deficit

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[4] Veronique de Rugy and Garrett Jones, "Keynesian Stimulus: A Virtuous Semicircle?" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, June 2021).

[5] Francesco Bianchi, Renato Faccini, and Leonardo Melosi, "A Fiscal Theory of Persistent Inflation," The Quarterly Journal of Economics, forthcoming in 2023; Francesco Bianchi and Leonardo Melosi, "Inflation as a Fiscal Limit," (Working Paper No. 2022-37, Federal Reserve Bank of Chicago, August 2022), https://www.chicagofed.org/publications/working-papers/2022/2022-37; François de Soyres, Ana Maria Santacreu, and Henry Young, "Fiscal policy and excess inflation during Covid-19: a cross-country view," FEDS Notes, Washington: Board of Governors of the Federal Reserve System, July 15, 2022, https://doi.org/10.17016/2380-7172.3083; Julian diGiovanni et al. "Quantifying the Inflationary Impact of Fiscal Stimulus Under Supply Constraints" (NBER Working Paper No. 30892, National Bureau of Economic Research, Cambridge, MA, January 2023), https://www.nber.org/system/files/working_papers/w30892/w30892.pdf.

[6] Francesco Bianchi, Renato Faccini, and Leonardo Melosi, "A Fiscal Theory of Persistent Inflation," The Quarterly Journal of Economics, forthcoming in 2023.

for 2023 is $1.5 trillion, up from $946 billion in fiscal year (FY) 2022.[7] Federal debt is more than $32 trillion, up from $28.5 trillion in 2021.[8] While the debt-to-GDP ratio is lower than it was during the pandemic, most of the reduction is the result of inflation. Not only has the credit agency Fitch Ratings downgraded the Treasury debt, but soon we might be in even more trouble and in uncharted territory, as federal borrowing is projected to be $120 trillion over the next 30 years.[9]

The prospect of crisis-size deficits during good times and as far as the eyes can see is making investors nervous, as demonstrated by yields on benchmark 10-year treasury notes climbing above 4.3 percent. It is their highest levels since 2007.[10] Other borrowing costs are also rising, such as the average rate on a 30-year fixed mortgage.

Rapidly rising interest rates have also dramatically raised the direct costs of servicing the national debt. According to the CBO, interest costs stand at $663 billion, a 40 percent increase over last year.[11] Interest costs consume 2.8 percent of the economy, a postwar record high, and they are on track to increase to 3.6 percent of GDP by 2033. If interest rates don't increase further than projected by the CBO, interest payments will become the most expensive items in the federal government over the next 30 years.

Considering that 31% of all outstanding US government debt, or $7.6 trillion, will mature over the next year, that amount of $7.6 trillion will have to be refinanced at a higher rate. Meanwhile the average maturity on the debt is 73 months.[12] As Brian Riedl notes, "So if interest rates rise at any point in the future, nearly the entire escalating national debt will roll over into those rates within a decade. Consequently, continued massive federal borrowing means gambling America's economic future on the hope that interest rates never rise again in the future. And there is no backup plan if rates do rise."[13]

High interest rates affect the entire economy by making credit more expensive. As loans become more expensive, businesses are less inclined to invest. Mortgages become more expensive, and housing becomes less affordable.

But this is only the beginning. The consensus of economic research shows that each percentage-point increase in the debt-to-GDP ratio raises real interest rates by 2 to 5 basis points, while each percentage-point increase in the deficit-to-GDP ratio raises real interest rates by 18 to 28 basis points.

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[7] Congressional Budget Office, Monthly Budget Review August 2023, https://www.cbo.gov/system/files/2023-09/59474-MBR.pdf.

[8] Congressional Budget Office, Federal Debt and the Statutory Limit, July 2021, https://www.cbo.gov/publication/57371.

[9] Congressional Budget Office, The 2023 Long-Term Budget Outlook, June 28, 2023, https://www.cbo.gov/publication/59014.

[10] Prashant Gopal. "Mortgage Rates in the US Jump to 7.23% in July 2023 Highest since May 2001," Bloomberg News.

[11] Congressional Budget Office, *An Update to the Budget Outlook: 2023 to 2033*, May 2023. https://www.cbo.gov/publication/59096

[12] US Treasury, "Average Maturity of Total Outstanding Treasury Marketable Securities, (dataset) last updated April 9, 2023. https://data.nasdaq.com/data/USTREASURY/AVMAT-average-maturity-of-total-outstanding-treasury-marketable-securities

[13] Brian Riedl, "Interest Payments Are a Ticking Time Bomb," *The Dispatch*, July 12, 2023.

In addition, extensive literature shows that a high debt level slows economic growth. There are at least 40 academic studies published since 2010 observing the debt-growth nexus.[14] The broad economic consensus revealed in the literature is that while threshold levels for advanced economies vary from 70 to 100 percent of GDP, large and growing public-debt levels do indeed have serious negative effects on economic growth.

Most studies that estimate the economic effects of public debt–levels find that for every 10 percentage-point increase in the debt ratio, future economic growth is reduced by 0.2 percentage points. Before the COVID-19 pandemic our debt-to-GDP ratio was 78 percent, and it is now 98.3 percent—this constitutes a loss in future economic growth of almost one-half percentage point. While at 78 percent debt the US economy could have expected a 2.5 percent future growth on average, today we can expect a growth of only 2 percent thanks to our debt addiction. Compounded over the years, the average American will be significantly worse over time. With our debt ratio expected to hit 181 percent in the long run, the economic reality of Japanese-style stagnation is something we should be cognizant of in the debate surrounding our debt trajectory.

This should concern those who claim to care about lower-income Americans. Economic growth has been the most effective way to improve the lives of people at the very bottom. The lack of growth will hurt them the most. Less growth means lower government revenues and less to spend on helping them if necessary. In addition, the slowdown of growth increases the risk that we lose ground on political democracy, individual liberty, and all those good noneconomic things.[15] That is true even if the absolute level of prosperity remains high. Economic growth and political stability are deeply connected. A 1992 study coauthored by Alberto Alesina found that there is a higher propensity for government collapse in countries where—and time periods when—economic growth is significantly lower.[16]

GOVERNMENT SPENDING HAS LOWER RETURN ON INVESTMENT (ROI)

Contrary to this pessimistic outlook, the administration claims that its policies and smart public-sector investment will build a strong foundation for future growth. We should be skeptical. Sustained high deficits, especially in a full-employment economy, tend to crowd out private-sector investments and lead to a negative impact on productivity. In a study I coauthored with Professor Garrett Jones, we reviewed the recent literature on the short-term effects of government spending, including recent findings on what economists call the "multiplier." We found that government purchases probably reduce the size of the private sector as they increase the size of the government sector.[17] On net, privately produced incomes shrink. When economists like Robert Barro and Charles Redlick looked at the multiplier, they found that once the future taxes required to pay for all that spending are accounted for, the multiplier could be negative.

Furthermore, my review with Jack Salmon of the growing economic literature on the relationship between the fiscal position and the size of the fiscal multiplier reveals a significant negative relationship

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[14] Jack Salmon, "Impact of Public Debt on Economic Growth," Cato Journal 41, no. 3 (Fall 2021).

[15] Benjamin Friedman, The Moral Consequences of Economic Growth, (New York: Penguin Random House, 2005).

[16] Alberto Alesina, Sule Ozler, Nouriel Roubini and Philip Swagel, "Political Instability and Growth" (NBER Working Paper Number 4173, September 1992).

[17] Veronique De Rugy and Garrett Jones, "Keynesian Stimulus: A Virtuous Semicircle?" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, June 2021).

between public-debt levels and the size of fiscal multipliers. In other words, as debt levels continue to rise, multipliers will continue to fall, requiring larger packages of stimulus spending during economic downturns, and increasing inflationary risk in the process.[18]

What about the administration's infrastructure investment? A 2021 study by the CBO looked at the public and private return of infrastructure spending and found that based on existing literature, a 1 percent increase in "public physical capital" leads to 0.06 percent economic growth.[19] It also estimates that though there are positive effects of federal investment on transportation spending, there are also negative ones, mostly because of the 33 cents in private-investment decline for every deficit-funded federal dollar spent. As the CBO explains, "That would result in a smaller capital stock, higher interest rates, and lower output over time than would otherwise be the case."

In the 2016 study, CBO also noted that "productive federal investment has an average annual rate of return of about 5 percent, or half of the agency's estimate of the average rate of return on private investment."[20] In other words, private-sector investments generate more return than those made by the government.

THE HIGH COST OF GOVERNMENT-GRANTED PRIVILEGES

Under the Biden administration, Congress has authorized between $1.2 and $2.1 trillion in domestic subsidies for preferred manufacturing industries.[21] The administration likes to talk about the "reindustrialization of America" by pointing to the current increase in real manufacturing spending as evidence that his plan is working. However, we should be careful not to draw too fast a conclusion from the simple correlation between government spending and new private spending in one discrete sector.

For instance, an increase in real manufacturing spending doesn't mean a manufacturing boom. According to the Institute for Supply Management Report on Business, in August 2023 economic activity in the manufacturing sector contracted for the 10th consecutive month following a 28-month period of growth.[22] Job growth in manufacturing has also been increasing at a slower rate than in the rest of the economy.[23]

Moreover, manufacturing is a very small portion of the economy. As a result, even if the sector was growing due to the subsidies, it wouldn't mean that these benefits would be shared throughout the

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[18] Veronique de Rugy and Jack Salmon, "Declining Fiscal Multipliers and Inflationary Risks in the Shadow of Public Debt" (Mercatus Center Policy Brief, Mercatus Center at George Mason University, Arlington, VA, August 2022).

[19] Congressional Budget Office, *Effects of Physical Infrastructure Spending on the Economy and the Budget Under Two Illustrative Scenarios*, August 2021. https://www.cbo.gov/system/files/2021-08/57327-Infrastructure.pdf

[20] Congressional Budget Office, *The Macroeconomic and Budgetary Effects of Federal Investment*, June 2016. https://www.cbo.gov/publication/51628

[21] Scott Lincicome and Adam Michel, "Charting Some Industrial Policy Policy's Opportunity Costs," *Cato Institute*, June 8, 2023.

[22] Institute for Supply Management, *Manufacturing PMI® at 47.6% August 2023 Manufacturing ISM® Report On Business*, August 2023. https://www.ismworld.org/supply-management-news-and-reports/reports/ism-report-on-business/pmi/august/

[23] St Louis Federal Reserve, "All Employees, Manufacturing" (dataset), accessed September 18, 2023. https://fred.stlouisfed.org/graph/?g=18zlw

entire economy. Manufacturing represents 11 percent of the economy.[24] While manufacturing output is nearly as high as it ever was, the share of employment in manufacturing is less than 7.7 percent of total employment.[25] In other words, only a small share of Americans still work in manufacturing, since the US economy is mostly service based.

While the administration likes to claim its manufacturing subsidies will ultimately benefit workers, especially non-educated workers, this outcome is unlikely. The subsidies are benefiting companies, often big and rich ones, for projects they would have likely taken on even in the absence of subsidies. For instance, about half of all Inflation Reduction Act (IRA) projects were announced before the IRA was passed, and the private green market was booming even before the subsidies. Moreover, if the subsidies were to benefit workers indirectly, they would benefit an increasingly college-educated and higher-income group.

It's also worth noting that the Bureau of Labor Statistics (BLS) is projecting that manufacturing employment will shrink in the next decade.[26] Additionally, subsidizing demand without addressing supply-side issues only leads to higher prices for technologies that would have been deployed anyway. Indeed, permit delays and other complications could mean that products will be obsolete before the first item rolls off the line. The subsidies also fuel a significant risk of distortions—not just overcapacity but also crowding out of other green technologies (for example, electric vehicles crowding out hybrids) as well as waste-creation, such as obsolete charging stations.

Finally, the question one must ask is, At what cost? For instance, the IRA will cost an estimated $3 trillion and increase the deficit with the consequences explained above. The administration argues that the bill includes taxes to pay for the deficit, but economic literature also suggests that for every additional dollar taxed, the government destroys three dollars in economic growth. The administration's blatant protectionism and violation of international trade norms have resulted in retaliations from many major trading partners, increasing the costs of goods for all Americans. Finally, while the subsidies may shift activities, capital, and workers towards the subsidized industry, it will be done at the expense of other sectors in the economy and the economy on net.[27]

The IRA further exacerbates the problems of cronyism and seeking of government-granted privilege. The government has stepped in and chosen to favor some industries and products.[28] This is a signal for others to seek similar privileges. The result is unproductive entrepreneurship, where innovators will use their skills to extract government privilege instead of innovating new goods and services for the

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[24] St Louis Federal Reserve, "Real Gross Domestic Product: Manufacturing (NAICS 31-33) in the United States/(Real Gross Domestic Product*1000)" (dataset), accessed September 18, 2023. https://fred.stlouisfed.org/graph/?g=18yZy

[25] St Louis Federal Reserve, "All Employees, Manufacturing/All Employees, Total Nonfarm" (dataset), accessed September 18, 2023. https://fred.stlouisfed.org/graph/?g=18z0b and Congressional Research Service, *Job Creation in the Manufacturing Revival*, July 2019. https://sgp.fas.org/crs/misc/R41898.pdf

[26] Bureau of Labor Statistics, "Employment Projections—2023-2032" September 6, 2023. https://www.bls.gov/news.release/pdf/ecopro.pdf

[27] Salim Furth, "Export Import Bank: What is The Scholarship Saying" (The Heritage Foundation, Washington, D.C., August 7, 2015); Manufacturing PMI® at 47.6%, August 2023, Manufacturing ISM® Report On Business.

[28] Veronique De Rugy and Tad DeHaven, "Corporate Welfare: Beyond the Budgetary Cost" (Mercatus Policy Brief, Mercatus Center at George Mason University, Arlington, VA, March 2020).

market. Such systems increase inequality, leaving the people without access to government privilege worse off.[29]

Rather than continuing to subsidize preferred special interests, the administration should focus on growth-oriented policies. One growth-oriented way to create more equitable income distribution is to eliminate all the programs—including tax favors—that redistribute funds to wealthy households (such as the green energy tax credit or the recent push for the expanded child tax credit to wealthy families), well-connected industries (for example, the oil, gas, airline, and banking industries) and other politically powerful groups, such as public-sector labor unions.[30]

Another effective way to promote economic growth is to reduce hurdles to all private investment in infrastructure. Policymakers should allow for capital expensing to increase returns for infrastructure investment. To spur privatization in states, they should end federal infrastructure subsidies to state governments. They should cut federal regulations that raise costs for building state infrastructure, including green-energy infrastructure, such as the Davis-Bacon labor rules and the National Environmental Policy Act; and they should cut regulations that restrict state privatization.

But first and foremost, Congress should get the debt under control.

Thank you.

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[29] Veronique De Rugy, Nita Ghei, and Michael Wilt, "Should the Export-Import Bank be Re-Authorized? Economic Perspectives" (Mercatus Policy Spotlight, Mercatus Center at George Mason University, Arlington, VA, July 2015).

[30] Charles Blahous, "To Stop Fueling Inflation, Stop Paying Rich People," *Discourse*, November 10, 2022.