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POLICY BRIEF

Cutting Red Tape to Cut the Deficit: An Innovative Approach to Balancing the Budget

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To rein in fiscal deficits, policymakers traditionally raise taxes or cut public spending. However, many economists worry that those policies can slow down the economy. By contrast, faster economic growth—without changing taxes or spending—reduces the deficit on two fronts, by raising revenue and by reducing demand for safety-net public spending. In this policy brief, we argue that boosting economic activity by reducing the regulatory burden works indirectly as a deficit-reducing policy.

This brief offers a pragmatic roadmap for reducing the budget deficit through cutting red tape.[1] First, we highlight how boosting productivity performance is critical to achieving faster economic growth. Second, we discuss how economic growth impacts the deficit. We conclude by offering evidence that regulation tends to worsen productivity, especially in product and labor markets, and that regulatory reform that results in productivity-enhancing growth could be a powerful way to improve the dire budget outlook for the United States.

TOTAL FACTOR PRODUCTIVITY

Total Factor Productivity (TFP) is a measure of how much total production (output) is not explained by observed factors of production (inputs). The Bureau of Labor Statistics (BLS) takes into consideration the following inputs into the production process: capital (K), labor (L), energy (E), materials (M), and purchased services (S).[2] Under a standard growth accounting framework, any changes in output (Y) that cannot be attributed to changes in the measured factors of production are the result of changes in TFP, as expressed in equation 1.

$$\Delta TFP = \Delta Y - (\alpha \Delta K + \beta \Delta L + \gamma \Delta E + \delta \Delta M + \varepsilon \Delta S) \quad (1)$$

Economists have long stressed the importance of TFP in explaining economic growth. For example, Moses Abromovitz, Robert Solow, and John Kendrick have documented the importance of the TFP "residual" in accounting for the bulk of measured growth since the early 20th century.[3] Recent research on the components of economic growth corroborates these claims, with some studies finding that as much as 80 percent of growth in the United States since 1948 is the result of broadly defined changes in TFP.[4] While TFP includes the unmeasurable inputs or unknown components of economic growth, it is widely believed that some of these difficult-to-measure inputs are innovations related to new technologies, ideas, and production processes.[5]

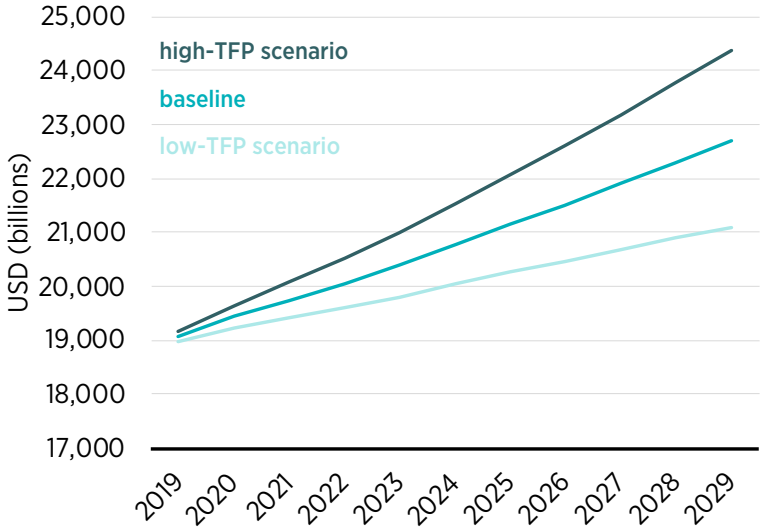
Productivity-driven growth reduces government deficits through several channels: First, strong growth in TFP increases GDP and, by extension, government revenues.[6] This is partly the result of real bracket creep. Higher real and nominal income pushes some taxpayers into higher tax brackets, so tax revenue rises.[7] Second, the use of programs such as unemployment insurance and food stamps tends to decrease during periods of economic expansion.[8] Such programs are known as automatic stabilizers because they increase public spending during economic downturns. In addition to shrinking government deficits, increases in TFP drive living standards higher, in part because worker compensation and payments to capital tend to track productivity changes,[9] and in part because increases in TFP occur alongside technological innovation, which has far-reaching beneficial consequences for human well-being.[10]

TFP AND GROWTH

To project how changes in the economy can affect economic growth as well as the federal government's fiscal position, the Congressional Budget Office (CBO) has developed a new interactive data tool that allows users to see how changes in certain economic conditions affect the federal budget.[11] Figure 1 illustrates the TFP-GDP relationship. Since TFP is a one of the strongest predictors of economic growth, it follows that low TFP growth would constitute a drag on GDP growth and high TFP growth would correspond with robust economic growth.

The CBO baseline GDP estimate for 2029 is $22.7 trillion (2012 dollars), which corresponds with real GDP per capita of around $64,000.[12] We estimate the growth effects of changes in TFP growth for the coming decade using the minimum and maximum values allowed by CBO's interactive tool to simulate TFP growth. The low-productivity-growth scenario assumes a TFP growth rate of 0.4 in 2019, 0.5 in 2020, and 0.6 thereafter up to 2029, while the high-productivity-growth scenario assumes a TFP growth rate of 1.4 percent in 2019, 1.5 percent in 2020, and 1.6 percent thereafter. The CBO TFP baseline is 0.9 percent for 2019, 1.0 for 2020, and 1.1 thereafter. The scenario of low productivity growth assumes levels similar to those experienced in the United States during the period 1975–1990,[13] and the high-productivity-growth scenario assumes levels similar to some estimates of the levels experienced during the period 1996–2004.[14]

Figure 1. Real GDP under Low- and High-Productivity Scenarios



Source: Congressional Budget Office, "How Changes in Economic Conditions Might Affect the Federal Budget," January 28, 2019, https://www.cbo.gov/publication/54052.

Under a scenario of low TFP growth, with all economic variables fixed at CBO's baseline projection rates,[15] real GDP would be about $1.6 trillion below baseline projections by 2029. Under CBO's high-TFP-growth scenario, by contrast, real GDP in 2029 would be almost $1.7 trillion higher than the baseline projection. The high-growth scenario equates to a real GDP per capita around $69,000 in 2029, a difference of approximately $5,000 per capita compared to the baseline and over $9,000 compared to the low-TFP-growth scenario. In the long run, this represents a significant boost in living standards for Americans.

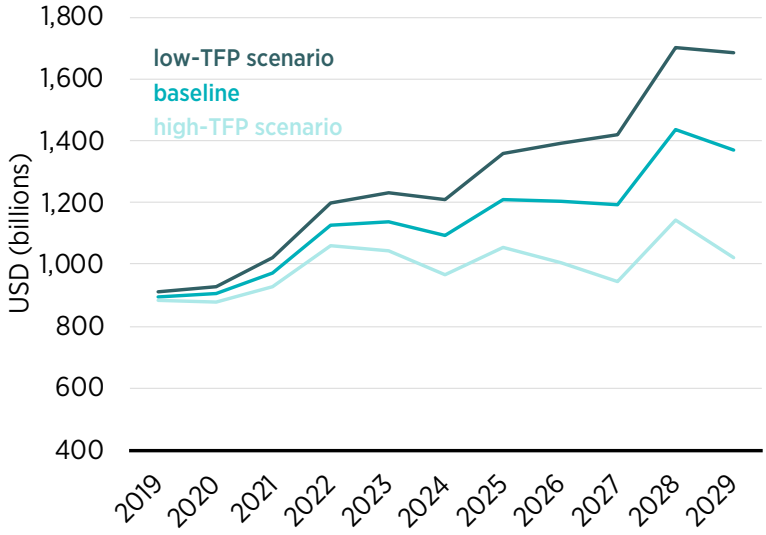
The impact of TFP growth on real GDP is significant. These relatively small changes in growth scenarios constitute a difference of around $3.3 trillion in the size of the US economy by 2029—this is larger than the entire economies of France or the United Kingdom today.[16]

TFP AND THE BUDGET

We also estimate the budgetary effects of changes in TFP growth for the coming decade using the minimum and maximum values allowed by CBO's interactive tool. Figure 2 illustrates the changes in the federal deficit under both a high- and a low-TFP-growth scenario.

With all other interactive variables fixed at CBO's baseline projections, the low-TFP-growth scenario would add $1.49 trillion more to the national debt over the next decade relative to the baseline scenario. Under a high-TFP-growth scenario, by contrast, the fiscal deficit would be *reduced* over the next decade by almost $1.61 trillion relative to CBO's baseline scenario. In other words,

Figure 2. Federal Deficit under Low- and High-Productivity Scenarios



Source: Congressional Budget Office, "How Changes in Economic Conditions Might Affect the Federal Budget."

the cumulative fiscal impact of low vs. high TFP growth in the coming decade equates to a $3.1 trillion change in the national debt.

IMPROVE PRODUCTIVITY PERFORMANCE THROUGH REGULATORY REFORM

There are both direct and indirect ways by which regulation can impact the government's finances. First, red tape often results in more government spending than is necessary and less tax revenue. Ineffective and wasteful regulations require government administrators to write and enforce them. This costs money. Furthermore, compliance costs eat away at the profits of regulated businesses and by extension the earnings of households. This reduces tax revenue. Cutting regulations, therefore, should directly reduce government overhead and increase firm profits and household incomes, thereby raising government revenue.

In addition to these direct channels by which regulations increase government spending and lower tax collections, empirical research finds a connection between regulations and productivity, which provides an indirect mechanism by which regulations impact government finances. For example, previous research from the Mercatus Center at George Mason University has found that regulations, particularly in product and labor markets, harm firms' productivity.[17] This is consistent with a large body of academic research that has found that mandated employment protections reduce TFP growth,[18] that product market regulations reduce productivity growth, and further, that product market and labor market regulations interact in ways that are harmful to productivity.[19] Economist Antony Davies, using data from the BLS and the Mercatus Center's RegData

tool, has similarly found that industries with lower levels of federal regulation outperform more heavily regulated industries in a variety of measures of productivity.[20]

A complete literature review of the evidence that regulation impacts productivity is beyond the scope of this brief.[21] Nonetheless, the evidence presented here suggests that regulations negatively impact productivity and, by extension, growth. These effects seem to be more pronounced in countries farther from the technological frontier,[22] suggesting that regulations have more detrimental effects in the developing world than in the developed world, and they have more harmful effects in industries that haven't caught up to the latest technology. For instance, countries with lower entry barriers and less state control have a faster process of catching up to best-practice technologies, especially in manufacturing.[23] This suggests that within developed countries, rural areas, which tend to be less technologically developed than urban areas, may be disproportionately impacted by regulation.

CONCLUDING REMARKS AND RECOMMENDATIONS FOR REFORM

Several regulatory reforms could begin to improve the fiscal position of the United States: First, regulations have effects on the government's budget directly, and legislators and regulators should make it a priority to limit the fiscal impacts of regulations. To start, these impacts should be tracked and scored by an entity like CBO.[24] Once they are measured, it will be easier to rein in public expenditures resulting from regulatory programs.

Second, placing limits on the amount of regulation, through regulatory caps or by setting explicit reduction targets for the overall level of regulation, could reduce regulatory burdens and stimulate productivity growth.[25] In general, the magnitude of reductions will have to be significant in order for the impact to be discernable at a macroeconomic level.

Finally, mandating sunset provisions for all new regulations could increase the likelihood that outdated regulations will be allowed to expire rather than exist in perpetuity. Florida, for example, is a state where the executive recently took the step of mandating that sunset provisions be built into new regulations.[26] The US president could do something similar through an executive order or a presidential memorandum.

Each or all of these reforms could prove powerful, and the time to act is sooner rather than later. In recent years, the fiscal outlook for the United States has worsened considerably. Part of this deterioration owes to taxes being lowered and spending increasing. But part of the problem emanates from a slowing of economic growth relative to historical norms. While policymakers in Washington tend to focus on raising taxes or cutting spending to reduce the deficit, they should also be looking at policies that increase growth through channels other than fiscal policy. Regulatory reform is one such option.

ABOUT THE AUTHORS

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NOTES

1. It is pragmatic in the sense that overregulation is an issue that both major political parties tend to agree can be a problem, at least in certain areas. For example, occupational licensing and local zoning ordinances that restrict the entry into particular professions or the creation of new housing are areas where both major political parties find some common ground. See, for example, James Broughel, "A Reform That Offers Hope for Centrists," *Washington Post*, March 14, 2018; and James Broughel and Emily Hamilton, "To Rein in Housing Prices, Cut the Red Tape," *Los Angeles Times*, July 3, 2019.
2. "Multifactor Productivity," Bureau of Labor Statistics, accessed January 14, 2020, https://www.bls.gov/mfp/. Note the terms "Multifactor Productivity" and "Total Factor Productivity" can be used interchangeably—the terms are synonymous.
3. Moses Abramovitz, "Resource and Output Trends in the United States since 1870" (Occasional Paper No. 52, National Bureau of Economic Research, Cambridge, MA, 1956); Robert M. Solow, "A Contribution to the Theory of Economic Growth," *Quarterly Journal of Economics* 70, no. 1 (1956): 65–94; Robert M. Solow, "Technical Change and the Aggregate Production Function," *Review of Economics and Statistics* 39, no. 3 (1957): 312–20; John W. Kendrick, *Productivity Trends in the United States* (Princeton, NJ: Princeton University Press, 1961).
4. Charles I. Jones. "The Facts of Economic Growth" (NBER Working Paper No. 21142, National Bureau of Economic Research, Cambridge, MA, May 2015), 10, table 3.
5. James Broughel and Adam Thierer, "Technological Innovation and Economic Growth: A Brief Report on the Evidence" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2019).
6. According to the Congressional Research Service, "Net deficits tend to decline in periods of high economic growth due to both increased revenues (through a rise in earnings and subsequent tax payments) and reduced outlays (through a decline in demand for unemployment benefits and other programs). Conversely, deficits tend to increase in periods with lower economic growth." Grant A. Driessen, Molly F. Sherlock, and Donald J. Marples, "Debt and Deficits: Spending, Revenue, and Economic Growth" (In Focus No. 11037, Congressional Research Service, Washington, DC, December 4, 2018).
7. Jena Nielsen and Max Gulker, "Bracket Creep: A Real Problem for Taxpayers," American Institute for Economic Research, September 7, 2017.
8. Congressional Budget Office, *The Effects of Automatic Stabilizers on the Federal Budget as of 2013*, 2013.
9. The evidence is clear that productivity growth drives compensation levels higher, despite claims by some that the link between the two is broken. See, for example, Anna M. Stansbury and Lawrence H. Summers, "Productivity and Pay: Is the Link Broken?" (NBER Working Paper No. 24165, National Bureau of Economic Research, Cambridge, MA, December 2017); Veronique de Rugy, "Contrary to White House Claim, Compensation Has Been in Line with Productivity," Mercatus Center at George Mason University, April 14, 2016; Richard Hornbeck and Enrico Moretti, "Who Benefits

from Productivity Growth? Direct and Indirect Effects of Local TFP Growth on Wages, Rents, and Inequality" (NBER Working Paper No. 24661, National Bureau of Economic Research, Cambridge, MA, January 2019); Martin S. Feldstein, "Did Wages Reflect Growth in Productivity?," *Journal of Policy Modeling* 30, no. 4 (2008): 591–94; Dean Baker, *Behind the Gap between Productivity and Wage Growth* (Washington, DC: Center for Economic and Policy Research, 2007).

10. Broughel and Thierer, "Technological Innovation and Economic Growth."

11. Congressional Budget Office, "How Changes in Economic Conditions Might Affect the Federal Budget," January 28, 2019, https://www.cbo.gov/publication/54052.

12. Real GDP per capita population calculations are based on population projection data. Census Bureau, "2017 National Population Projections Datasets," September 6, 2018, https://www.census.gov/data/datasets/2017/demo/popproj/2017-popproj.html, table 1.

13. TFP grew at an average annual rate of around 0.6 percent from 1975 to 1990. Federal Reserve Bank of St. Louis, "Total Factor Productivity at Constant National Prices for United States," June 11, 2019, https://fred.stlouisfed.org/series/RTFPNAUSA632NRUG#0.

14. TFP grew at a rate of about 1.75 percent annually in the United States between 1996 and 2004. Roberto Cardarelli and Lusine Lusinyan, "U.S. Total Factor Productivity Slowdown: Evidence from the U.S. States" (IMF Working Paper No. 15/116, International Monetary Fund, Washington, DC, May 2015), 3.

15. Other CBO variables include changes in labor force growth, changes in interest rates, and changes in the inflation rate.

16. World Bank, "GDP (Current US$)," accessed September 30, 2019, https://data.worldbank.org/indicator/NY.GDP.MKTP.CD.

17. Steven Globerman and George Georgopoulos, "Regulation and the International Competitiveness of the U.S. Economy" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2012).

18. For example, see David H. Autor, William R. Kerr, and Adriana D. Kugler, "Do Employment Protections Reduce Productivity? Evidence from U.S. States" (NBER Working Paper No. 12860, National Bureau of Economic Research, Cambridge, MA, January 2007); Stefano Scarpetta and Thierry Tressel, "Boosting Productivity via Innovation and Adoption of New Technologies: Any Role for Labor Market Institutions?" (Research Working Paper No. 3273, World Bank, Washington, DC, April 27, 2004).

19. Christopher Kent and John Simon, "Productivity Growth: The Effect of Market Regulations" (Research Discussion Paper No. 2007-04, Reserve Bank of Australia, Sydney, June 2007); Sotiris K. Papaioannou, "Regulations and Productivity: Long Run Effects and Nonlinear Influences," *Economic Modelling* 60, issue C (2017): 244–52; Giuseppe Nicoletti and Stefano Scarpetta, "Regulation, Productivity and Growth: OECD Evidence" (Policy Research Working Paper No. 2944, World Bank, Washington, DC, January 13, 2003); Balázs Égert, "Regulation, Institutions, and Productivity: New Macroeconomic Evidence from OECD Countries," *American Economic Review* 106, no. 5 (2016): 109–13.

20. Antony Davies, "Regulation and Productivity" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2014).

21. A forthcoming paper for the Mercatus Center by James Broughel and Robert Hahn reviews this literature in more depth.

22. Giuseppe Nicoletti and Stefano Scarpetta, "Regulation, Productivity and Growth: OECD Evidence," *Economic Policy* 18, no. 36 (2003): 9–72.

23. Patrik T. Hultberg, M. Ishaq Nadiri, and Robin C. Sickles, "Cross-Country Catch-Up in the Manufacturing Sector: Impacts of Heterogeneity on Convergence and Technology Adoption," *Empirical Economics* 29, no. 4 (2004): 753–68.

24. For more details on this kind of reform, see James Broughel, "Government Regulation on Autopilot" (Testimony before the US Senate Committee on Homeland Security and Governmental Affairs, Subcommittee on Federal Spending Oversight and Emergency Management, Washington, DC, July 17, 2019).

25. For an example of an effective regulatory cap, implemented with a corresponding reduction target, see Laura Jones, "Cutting Red Tape in Canada" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2015).

26. Ron DeSantis, letter to governor's agency heads, November 11, 2019.