STATEMENT OF RICHARD K. ARMEY

before the

THE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

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Mr. Chairman and Members of the committee: thank you for inviting me to comment on the economic stimulus package that was signed into law on Tuesday, February 17, 2009. My name is Dick Armey and I am currently chairman of the grassroots organization FreedomWorks. Many of you may know me from my time serving as the Majority Leader of the House of Representatives, but today I will be drawing more on my experience as an economics professor, which was my career before coming to Congress.

Last February the nation's economy had a problem, and something needed to be done. However, attempting to fix a problem caused by government policies that push too much borrowing and spending by instituting a new government policy of too much borrowing and spending was a terribly poor decision. In fact, such an approach ignored the vast strides made by the economics profession over the last 40 years that suggest such a stimulus plan would do little for the economy. If too much government spending brought economic prosperity, we would be experiencing the Bush Boom now. Clearly, we are not.

I will begin by looking at the economic theory on which the stimulus bill was based, discuss its shortcomings with both historical and current evidence, and then suggest a better path toward sustained prosperity.

The intellectual foundation for the stimulus package comes straight out of Economics 101—it is basic Keynesianism, named after famous British economist John Maynard Keynes. When I was a professor, I, like almost all other economics professors, taught Keynesianism to students who lacked an economics background. They learned that Keynes argued that government could intervene in an economy to maintain aggregate demand and full employment, with the goal of smoothing out business cycles. And they learned about how he redefined economics by suggesting that increased government spending during an economic downturn "primes the pump" to get the economy going again.

During recession, Keynes explained, government should borrow money and spend it to drive aggregate demand because consumers and businesses in the private

sector were unable to boost demand on their own. This was a decisive departure from classical economics, which maintained a more laissez faire approach to the economy. Indeed, Keynesian economics—premised on the notion that some prices (such as labor) were "sticky" and would not adjust in response to an economic shock—advocated a more active role for government on the grounds that markets were unable to adapt without help.

Students who made it through that lesson would then learn that history had debunked Keynesianism, and modern economics challenged many of the notions championed by Keynes, and empirical evidence supporting the effectiveness of Keynes' ideas has been scant.

Unfortunately, right or wrong, it is undeniable that Keynes' work offers a convenient justification for deficits and government spending that has since proved irresistible to politicians.

It is difficult to get economists to agree on anything, and exactly what is wrong with Keynesian-style stimulus spending is no exception. Several schools of economic thought point to different problems with Keynes' "stimulus" theory.

- The monetarists say any effects of extra spending or easy credit would be short lived and ultimately prices and wages must adjust to market conditions. Their views are more in line with classical economics, emphasizing the importance of market adjustments to eliminate unemployment and foster economic growth. To facilitate these adjustments, the government should focus on maintaining a stable money supply while exercising prudent fiscal policy.

- Rational expectations economists argue that intervention would have no effect on output or unemployment because economic actors are not short sighted and would anticipate and adapt to the government's actions, thus neutralizing attempts at counter-cyclical policy. This was an important critique of the feasibility of Keynesian economics. Many Keynesians believed there was a trade-off between unemployment and inflation—known as the Phillips curve—that could be exploited for policy purposes. In a downturn, for example, employment could be increased through government borrowing and spending, something that would ultimately need to be paid back through a higher inflation rate. Yet with rational expectations, consumers and businesses adapt and offset the potential impacts of government intervention, thus eliminating any policy trade-off and eliminating the benefits of counter-cyclical fiscal policy.

- Austrian economists argue that attempts by government to plan the economy are doomed to fail because government actors will have insufficient knowledge to coordinate the plans of the millions of economic

actors that make up the economy. Fiscal policy requires taking resources from those in the private sector and concentrating them in hands of the government. This problem compoundes other counter-cyclical Keynesian policies that force interest rates lower, because such polices distort important price signals that guide market behavior. In the end, Keynesian fiscal policies actually cause more fluctuations in total output, leading to deeper recessions and more unemployment.

- The public choice school, which studies the incentives of the government actors implementing fiscal policy, notes the allure of deficit spending and the difficulty of turning off the spigot in better economic times. Commenting on the pitfalls of Keynesian policies Noble Laureate James Buchanan and economics professor Richard Wagner note, "A regime of permanent budget deficits, inflation, and an increasing public-sector share of national income—these seem to us to be the consequences of the application of Keynesian precepts in American democracy."

These differing schools also agree that Keynes' policies ignore the long term effects of deficit finance and easy credit. His famous glib response to this critique was "we are all dead in the long run". While this is true, most of us will still be alive when the economic impact of a near $1 trillion spending package comes home to roost.

Keynes warned that policy prescriptions are often based on outdated ideas from the past. In 1936, as he was concluding his famous *General Theory*, he wrote, "Practical men, who believe themselves to be quite exempt from any intellectual influences are usually slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back." It is ironic, today, that the "academic scribbler of a few years back" is Keynes himself.

One of the main flaws with the stimulus was that the money government spent had to come from somewhere, and thin air was not an option. The only way the government gets money is through higher taxes, borrowing, or printing—that is, it has to take it out of the economy in order to put it back into the economy. Consequently, as George Mason University economics professor Richard Wagner points out, "any so-called stimulus program is a ruse. The government can increase its spending only by reducing private spending equivalently."

If government borrows the money, then it either has to print money later or raise taxes to pay it back. If it raises taxes, it is, in effect, robbing Peter to pay Paul possibly with interest. If it prints the money, inflation decreases the value of the dollar for every American also robbing Paul to pay Paul.

Given that the government was playing at best a zero-sum game, it is difficult to see how the stimulus—the reshuffling of money—was supposed to create more wealth.

Supporters argue there is a "multiplier" at work—that for every dollar spent by the government there is even more created in the economy as a result. They point out that the dollars spent subsidizing the purchase of electronic golf carts—which was included in the stimulus bill—supposedly creates more wealth because the electronic golf cart dealer is then able to buy himself some new golf clubs from the golf shop owner who is then able to buy a new watch, and so on.

This appealing line of thinking has a long history, but it does not hold up to scrutiny. Harvard economics professor Robert J. Barro recently said, "when I attempted to estimate directly the multiplier associated with peacetime government purchases, I got a number insignificantly different from zero."

His findings highlight a fundamental weakness of Keynesianism. It is what Henry Hazlitt referred to in his book, *Economics in One Lesson*, as "what is seen and what is not seen". The new electronic golf cart is seen, as are the ensuing purchases and the associated jobs. What is not seen is that government had to take the money from someone else to subsidize the person buying the electronic golf cart—me, for example. What is not seen are the 10 Willie Nelson records I would have purchased with that money, enabling the record store owner to buy his own electronic golf cart from someone who could then buy a new set of clubs, and so on.

Importantly, what is also not seen are the few extra dollars the government takes from me that are lost to inefficiency on the way to subsidizing the purchase of an electronic golf cart and as a result create nothing. Also not seen are the extra hours I might have worked if my taxes were lower; if they were cut to stimulate the economy or not raised to pay for the "stimulus". These dollars, too, would have been put into the economy and they would have been used to create jobs. This is where government spending decreases, rather than increases, economic growth.

The limitations of Keynesian fiscal policies are even more important to understand today, given the structural shifts in public expenditures that have taken place. Today entitlement spending—which is consuming ever-increasing amounts of the federal budget—and existing large deficits provide greater limitations of the ability to conduct counter-cyclical Keynesian fiscal policies.

History has shown that this sort of money-shuffle does not create wealth. Take, for example, the Keynesian responses of the bipartisan cast of Herbert Hoover, Franklin Roosevelt, Gerald Ford, and George W. Bush.

Hoover and Roosevelt dramatically increased spending and watched unemployment climb with it. In one year in of Hoover's administration, from 1930 to 1931, the federal government's share of GNP skyrocketed from 16.4 percent to 21.5 percent. Keynesian deficit spending between 1929 and 1939 averaged 3.5 percent of GDP. The average rate of unemployment over the same period was 18.6 percent.

A recent study by two economists at UCLA found that government policy under FDR prolonged the depression by seven years. They claim that a long depression is not likely unless "lawmakers gum up a recovery with ill-conceived stimulus policies." And gumming up the recovery process is exactly what the stimulus Congress passed is doing. It stopped the market from making the corrections it needed to make, after years of government intervention pushed overinvestment in housing and banking.

The failure of a federal fiscal stimulus was not lost on FDR's Treasury Secretary Henry Morgenthau, who testified in May 1939:

> We are spending more money than we have ever spent before, and it does not work ... after eight years of this administration we have just as much unemployment as when we started ... and an enormous debt, to boot.

More recently, former President Gerald Ford failed to stimulate the economy in 1975 when he gave every American a rebate check. This failure led the Carter administration to pull a similar proposal in 1977. Recently, the Bush administration failed to learn this lesson and signed a similarly useless "rebate" bill. The problem is that people understand that the checks from the government are an anomaly, so they do not change their long-term behavior like they would if major reform like the flat tax were implemented. Rebate schemes that fail to lower marginal tax rates on investment and productive activity do not change the incentive to work, save, and innovate, the true drivers of economic growth.

If increasing federal spending created jobs and economic growth, we should be in the middle of the Bush Boom right now. President Bush oversaw a dramatic increase in federal spending, raising it by more than 50 percent during his eight years—including his failed "stimulus" rebate checks, which, as economists predicted, had zero impact on economic growth. Deficit spending mushroomed at the end of Bush's presidency, while unemployment continued to rise. Sadly, the lesson that many drew was Bush's failure was that we needed an even larger stimulus. Rejecting the failures of previous levels of record spending, some in Congress and the administration called for as much as a trillion dollars in new government spending. To the dismay of many, they got what they asked for.

The idea that spending creates prosperity gets it backwards—spending is the result of prosperity, not its cause. What is needed is growth-creating reform.

Government spending programs to boost the economy have similarly failed overseas. Japan—after a dramatic market crash and a drop in real estate prices—responded with government spending not unlike what the U.S. Congress passed back in February. In fact, they had 10 stimulus bills between 1992 and 2000, spending billions on infrastructure, construction, building bridges, roads, and airports as well as pouring money into biotech and telecommunications. While many countries enjoyed

booming economies and falling unemployment during this time, Japan had a lost decade, seeing its unemployment more than double. They spent double the U.S. level of GDP on infrastructure, but are still not seeing a return. Instead, Japan has one of the highest national debts in the world. After 10 stimulus packages, Japan has gone from having the second biggest economy in the world by a long shot, to being well behind the new number two, China, and is close to falling behind India, as ranked by GDP purchasing power parity. Many warned that the U.S. may see similar disappointing results from a massive federal spending program. And unfortunately, they are being proven correct.

According to the government website set up to track stimulus funds—Recovery.gov—stimulus spending is directly responsible for "saving or creating" 640,329. Shortly after this figure was announced, however, it came under intense scrutiny. ABC News uncovered some misleading figures. Of the money spent to "save or create" new jobs, Recovery.gov reports:

- $761,420 was spent to create or save 30 jobs in Arizona's 15th district
- $34 million was spent in Arizona's 86th congressional district in a project for the Navajo Housing authority
- $0 were spent in Connecticut's 42nd district but 25 jobs were created
- $8.4 million was spent in the 99th congressional district of the U.S. Virgin Islands to create 40.3 jobs.
- $1.5 million spent in the 69th district and $35 million in the 99th district of the Northern Mariana Islands with .3 jobs created and 142 jobs created respectively.
- $47.7 million spent in Puerto Rico's 99th congressional district to create 291 jobs.

According to ABC News, "none of these districts actually exist."

And ABC is not alone in its skepticism of the job figures released by Recovery.gov. According to the Boston Globe, Massachusetts' stimulus job figures were "wildly exaggerated." USA Today reports that the Texas recipient of a $26,174 roofing contract reported that 450 jobs were created or saved when, in all actuality, six were. And the list goes on and on.

But even if we take the estimated job creation in question as fact, the 640,329 jobs supposedly "saved or created" by the stimulus is still 3 or so million less than the 3 to 4 million jobs Democrats predicted the stimulus would create. It is also hard to ignore the extraordinary disparity between the 640,329 jobs "saved or created" by the stimulus and the 3.8 million jobs that have been lost since the stimulus was passed in February. These staggering statistics help to account for an unemployment rate that currently stands at a staggering 10.2 percent. 10.2 percent is more than 27 percent higher than the 8 percent joblessness the Obama Administration promised would be the high point of unemployment if we rushed through a trillion dollars in new "stimulus" spending earlier this year. Worse still, many economists predict that it will remain above 10

percent for months and even years to come.

President Obama's Chairman of the Council of Economic Advisers, Christina Romer, knows that fiscal policy has repeatedly failed to create growth. She found in a study that "[C]ountercyclical fiscal policy is not achieving its intended purpose" because "it is difficult for fiscal policy to respond quickly to economic developments."

When Obama's Keynesian stimulus package was enacted, I warned that there were two possible outcomes. At best, it could have had a neutral effect on the economy and at worst it could have driven the recession into prolonged depression, much like the UCLA economists found FDR's "stimulus" did. I may be biased, but I think the economic theory that best describes why such a stimulus was doomed from the get go is the Armey Curve—the economic theory I developed. Drawing heavily from the Laffer Curve, the Armey Curve shows that—after a certain point—increased government spending becomes detrimental to economic growth. And we are now well past that point.

We can agree that zero government spending would result in little economic growth. Without the government securing property rights in courts and our liberties from enemies at home and abroad, chaos would likely reign. Similarly, if the government accounted for 100 percent of the economy, we would be the Soviet Union and have little real economic growth. The top of the Armey curve is somewhere in-between, where maximum economic output occurs. Comparing the economic output and growth of the United States with the countries of the European Union suggests that the EU countries are further down the slope toward poor performing countries with an excessively large public sector than the US. This helps explain why EU per capita output lags at around just 70 percent of American output, suggesting a move toward their level of government spending—with actions such as the near trillion dollar stimulus package—results in similarly slower growth.

We need to move in the other direction on the Armey Curve by reducing the size of government to achieve better economic success. The only way to see real growth in the long run is to increase productivity where all wealth is created, in the private sector, not by furthering the policies of deficit spending or loose credit that created the current situation. While the federal government can produce nothing itself, it can facilitate economic growth by altering the incentives in favor of working, saving, and investing by lowering the tax burden on those activities and letting productive people keep more of what they earn.

This is what Presidents Harding, Kennedy, and Reagan all did to great success.

Harding inherited a post-World War I depression that was almost as bad as what FDR inherited from Hoover. GNP dropped 24 percent from 1920 to 1921, and unemployment had more than doubled, from 2.1 million to 4.9 million. The policies Harding used to stop this depression were the opposite of the ones FDR would use a

decade later. Harding campaigned on "less government in business," cut corporate taxes, and slashed federal government spending almost in half—from $6.3 billion in 1920 to $3.2 billion in 1922. In 1922 GNP rebounded and unemployment plummeted back to 2.8 million. Rather than the 1920s being a prolonged depression like FDR's 1930s, they roared.

President Kennedy, after reflecting on the recessions of 1958 and 1960-61, proposed a dramatic tax cut, arguing, "The billions of dollars this bill will place in the hands of the consumer and our businessmen will have both immediate and permanent benefits to our economy. Every dollar released from taxation that is spent or invested will help create a new job and a new salary. And these new jobs and new salaries can create other jobs and other salaries and more customers and more growth for an expanding American economy." And we all know the country prospered after the Kennedy cut taxes.

President Reagan also understood the lesson of what is seen versus what is not seen. Handed an economy that had been struggling through the anti-growth administrations of his predecessors, President Reagan slashed tax rates and unleashed an economic boom.

Fortunately, we would not even have to cut the tax rates as aggressively Presidents Kennedy and Reagan did. President Kennedy dropped the top income tax rate from 91 percent to 70 percent. That is a 233 percent increase in after income tax take-home pay on those last dollars earned—from 9 cents on the dollar to 30 cents on the dollar—a meaningful impact on the incentive to work, save and invest. President Reagan took the top rate from 70 percent to 28 percent. That meant instead of taking home 30 cents on the dollar, the individual who earned it took home 72 cents on the dollar—a 140 percent increase, in after-income tax return on work.

By comparison, cutting the current top rate from 35 percent to 0 would yield just a 54 percent increase in after-income tax return for addition work. And a reduction to a 20 percent tax rate would be a 23 percent take-home increase. While not as large as earlier cuts, the rate reductions would still create incentives to work, save, and invest. Given current limitations on providing cuts that parallel the pro-growth cuts Reagan and Kennedy made, it is important to find additional reforms to promote job growth and prosperity to get the economy humming again.

I propose scrapping the current tax code entirely to implement a flat tax, just as I had proposed while in Congress. Income would be taxed once, and only once, avoiding punitive taxes on interest earnings and capital appreciation through investments in stocks, bonds, and other financial instruments. A flat tax can provide both a lower marginal rate as well as substantially lower compliance costs. Americans would complete their taxes in minutes on a postcard.

There is no better way to meet President Obama's unanswered call for real tax

relief to help small businesses and the middle class. Our complex tax structure puts unproductive obstacles in front of entrepreneurs—the people who create wealth and will lead this country out of the recession we are in. It is entrepreneurs who create the meaningful jobs that the American people want. They do not want jobs building bridges to nowhere for a government make-work program. And they do not want our country to waste billions of unproductive hours filing taxes, when those hours could be spent producing jobs and income.

It is private equity that is going to help fund job creation, and it is the government's role to create the environment in which private equity wants to invest and entrepreneurs want to take risks and innovate. Much like the end of the uncertainty caused by FDR's dramatic policy changes when World War II created the environment that allowed prosperity to return to America in the 1950s, so too will ending the uncertainty caused by bailouts, near trillion dollar stimulus bills, tax and premium increasing healthcare bills, burdensome cape and trade legislation, and a complicated and ever changing tax system. Twenty four nations have adopted a flat tax system, which has repeatedly generated faster growth and more jobs—exactly what the United States needs right now.

Finally, last fall Congress and the Bush White House acted on panic rather than sound economic thought with the bailout package that did nothing but probably exacerbate the problem by increasing uncertainty, and I think the same has proven to be true of the panicked passage of the stimulus. The stimulus idea was more of a political exercise than it was an exercise in sound economic policy, and it is time for Congress to accept that.

I know that many of the 535 people in Congress wanted to be able to say they saved the economy by spending lots of money, but the American people know that the politics of greed is always wrapped in the language of love. They know the stimulus plan was the greed in Washington for more power, more dominion over people lives. The stimulus was just a long-term growth plan for big government, not an immediate response to the economic situation in America today.

The right plan was and still is to leave the money in the hands of the people who were smart enough to earn it in the first place—they are smart enough to spend it, too. Armey's Axiom is "Nobody spends someone else's money as wisely as he spends his own".

That much I know. But really, what no one knows is what the future holds. What is needed at this time, when so many bad decisions and bad policies have been made and supported by so many in power, is humility, not hubris, from both politicians and economists. As Noble Prize winning economist Frederick Hayek said to Keynes regarding his faith in the few in government knowing how to control the economy of the many: "Whatever may be our hope for the future, the one thing of which we must be painfully aware at the present time… is how little we really know of the forces that we

are trying to influence by deliberate management; so little indeed that it must remain an open question whether we would try if we knew more."

Thank you for the opportunity to present these views. I would be happy to respond to any questions you might have.

Richard K. Armey holds a Ph.D. from the University of Oklahoma. He was Chairman of the Economics Department at the University of North Texas before serving 18 years in the US House of Representatives where he became House Majority Leader in 1995. He is now Chairman of FreedomWorks and FreedomWorks Foundation.