The primary economic challenge facing America right now is neither a lack of government stimulus nor large budget deficits; it is a loss of economic vitality that has reduced our ability to create jobs, compete globally, increase productivity, and raise living standards across the board.\(^1\)

Solving this challenge will require, among other measures, reduced business taxes and increased public investment, especially in R&D, education and training, and infrastructure. However, finding the budget resources to increase American productivity would be difficult even in the best of times, but with the federal debt held by the public close to 75 percent of GDP, it becomes almost insurmountable. Addressing America’s budget deficit and “investment deficit” at the same time will require a new approach to the budget grounded in the discipline of “innovation economics.”

Unfortunately, the current budget debate is not grounded in innovation economics and therefore concentrates on only one or two aspects of America’s problem: either the high unemployment and low growth rates associated with the current economy, or the high levels of government debt. Many on the left emphasize the need to increase economic activity through government spending. They either maintain that government debt is not a problem, or to the extent that it is, they would increase taxes on corporations and the wealthy in order to pay for increased social spending. Conversely, many on the right are so concerned with the size of government spending and the budget deficit that they would cut
spending indiscriminately. In doing so, they risk cutting those programs that are crucial to future growth in order to eliminate the waste in other programs. Finally, many, especially those in the center, hold to the “Washington budget consensus” that our main problem is the unsustainability of current budget policies. To generate political support for addressing this long-term problem, they advocate putting “everything on the table,” including cuts to key public investments and business tax increases even though these steps would reduce long-term growth.

As a result, the debate over the budget—whether from the right, left or center—has largely failed to see that budget discipline is a means, not an end, and that the end is robust economic growth. One benefit of robust economic growth is that it will reduce the debt-to-GDP ratio, which is the more accurate measure of the federal government’s true long-term fiscal condition. Countries that grow rapidly are able to manage their budgets fairly well. Countries that stagnate eventually have budget troubles unless they embrace austerity, which in turn can hurt growth if it reduces public investments and leaders to higher taxes on business.

ITIF has argued elsewhere that the nation actually faces three critical deficits: the budget deficit, an investment deficit, and a trade deficit. Each of these adversely affects our future prosperity. Yet the budget debate has largely ignored the fact that underfunded investments in the future (e.g., in infrastructure and research) are an unfunded liability similar to entitlements and accumulating FHA (Federal Housing Administration) foreclosures. They just do not show up on the books. Similarly, policies that reduce the deficit but make it harder for the United States to attract and keep the best companies also undermine our long-term prosperity in return for a short-term boost to consumption or deficit reduction.

To ensure a vibrant and growing economy, Washington needs to do more than simply cut the budget deficit in the hope that this will have some magic effect on markets and firms. Rather, we need a different approach, one that focuses first and foremost on boosting productivity growth and international competitiveness through a thoughtful combination of specific policies that reduce the budget deficit while simultaneously increasing investment and cutting corporate taxes. To do this, Congress should increase investments in research, education and training, and infrastructure while reducing effective business tax rates (particularly on those companies competing in global markets). It should pay for these investments by reforming entitlements to increase workforce participation (e.g. raising the retirement age); cutting spending that does not lead to growth or have a compelling social purpose; and raising taxes on individuals, especially higher income Americans.

This report describes the four competing economic doctrines at play today in the United States and how they shape thinking about budget policy. It then describes a general approach to policy reform to address the nation’s economic challenges. The general approach is to focus on three major deficits simultaneously and to concentrate on the debt-to-GDP ratio rather than the deficit as the relevant metric for addressing our budget issues. In the near future ITIF will issue a more specific list of policy recommendations that would implement this broad approach.
ECONOMIC DOCTRINES AND BUDGET POLICY

Budget policy is one aspect of economic policy and as such is shaped by economic thinking. When considering economic issues, it is important to realize that much of what appears to be objective theorizing and unbiased analysis is in fact deeply determined by the doctrine of the economic policy analyst. Economists’ and policymakers’ beliefs about what policy works best for the economy, including their beliefs about the appropriate budget policy, are not simply independent constructs applied to new contexts; such beliefs constitute and are a reflection of coherent worldviews or doctrines. Such doctrines profoundly shape how proponents view the economy, what they consider important, and most importantly, what they believe to be correct versus misguided public policy.3

The debate over the budget—whether from the right, left or center—has largely failed to see that budget discipline is a means, not an end, and that the end is robust economic growth.

As ITIF has noted, there are four competing U.S. economic doctrines:4

Conservative Neoclassical Economics Approach: In this view, most government spending is wasteful and encourages rent-seeking. Government is largely inefficient and most functions are best left to market. Moreover, taxes impose large “deadweight” losses on the economy, and as such deficits are less important than tax cuts. However, its principal weakness is the refusal to admit that some government spending is in fact a valuable investment and that in an era of demographic challenges, some tax increases are needed.

Moderate/Liberal Neoclassical Economics Approach: In this view, the principal sin of deficits is that they crowd out savings, leading to higher interest rates and reduced investments. For them, entitlements, especially to seniors, are an unsustainable burden that will only turn government into a vehicle of income transfer. While they support maintaining total spending in the near term to help jump start a weak economy, over the moderate and longer term they see fiscal discipline as the key to growth, even if it comes at the cost of higher taxes on corporations and reduced public investment. Its principal weakness is that it would sacrifice the need for increased public investments and lower corporate taxes on the altar of fiscal discipline.

Liberal Neo-Keynesian Approach: In this view, government has to make up for falling private spending and concentrate on spurring near-term consumption, not long-term investment. Deficits are not a problem, and in fact a focus on deficit reduction only leads to reduced social spending. Its principal weakness is the failure to see that the United States is now in intense global competition and cannot afford a budget that is largely focused on transfer payments, rather than on investment and globally competitive tax rates.

Moderate Innovation Economics Approach: In this view, economic growth trumps pure deficit reduction and the right measure is debt-to-GDP ratio, not simply aggregate debt. Any approach to the budget must focus on ensuring that U.S. effective corporate rates are globally competitive, that we favor investment over consumption, and that we reform entitlements to encourage greater workforce participation rates.
Until quite recently, three economic doctrines competed for intellectual supremacy in America: conservative neoclassical (often called “supply-side economics”); liberal neoclassical (what used to be sometimes called “Rubinomics,” referring to the policies and views of former President Bill Clinton’s Secretary of the Treasury Robert Rubin); and neo-Keynesian. In the last decade, however, a small but growing number of economists began to argue that these conventional doctrines provide a poor guide to understanding the 21st century innovation-based economy, and that a new economic doctrine—what is termed here “innovation economics”—is a better guide to making effective economic policy.

**Moderate and Conservative Neoclassical Doctrines: Cut Spending Across the Board**

Both moderate and conservative adherents of the neoclassical economics doctrine see the budget deficit and national debt as a serious problem. Conservatives believe that capital accumulation, as opposed to the demand for capital, is the most important driver of economic growth. They believe that virtually all taxes and most government spending distorts the market and leads to reduced economic welfare. In their view, markets, while not perfect, do a much better job of allocating scarce resources and encouraging innovation than government does. They stress the deadweight loss imposed by taxes, the rent-seeking encouraged by government spending, and the loss of freedom brought about by the government’s growing role in the economy. Both conservative and moderate neoclassicalists (NCs) believe that budget deficits crowd out private capital and drive up interest rates, which reduces private investment and growth. Moreover, because they minimize the role of government in driving growth and reject the notion that government intervention can generate greater economic welfare than pre-tax market-based outcomes, NCs generally hold that when it comes to cutting spending “everything should be on the table.” Conservative NCs in particular do not, however, apply this same reasoning to tax increases, tending to oppose almost all net increases in revenue.

Conservative supply-siders favor incentives, like lower taxes, for private capital accumulation. As supply-side economist Larry Kudlow states, “Tax-cut incentives will promote capital formation, productivity, jobs, and growth.” The logic of supply-siders is straightforward. In the neoclassical model, if you want more of anything, you lower its price. If you want more savings, you lower the price—in this case, tax rates on capital. Supply-siders also want public expenditures to be limited to the essential activities that the market and individuals cannot easily pay for on their own, like national defense and the legal system, in part because they believe most government spending is inefficient. For this reason, conservatives focus most of their deficit cutting efforts on cutting spending, especially in the non-defense, discretionary portion of the budget. For example, after complaining about Congress’s inability to come to a budget agreement, the Heritage Foundation’s budget plan states that “total spending must be brought under control to balance the budget without raising taxes.”

Moderate neoclassicalists also believe that large federal deficits can crowd out private investment, and that government policy influences investment decisions. However, they are more supportive of the need for government programs, both to promote growth and to provide a safety net. Nevertheless, like conservatives, they view deficit reduction primarily...
as a way to reduce consumption and make room for private investment, believing in the 
primacy of the supply of capital (e.g. net) savings in driving growth and the idea that public 
debt crowds out private capital. Perhaps the best summary of liberal neoclassicalists’ beliefs 
comes from then-CBO (Congressional Budget Office) Director Peter Orszag writing in the 
eyear 2000s (at a time when CBO was forecasting large surpluses):

The fundamental benefit of higher national savings—achieved by preserving a 
substantial portion of the projected budget surplus—is that it will expand economic 
output in the future. Higher national saving leads to higher investment, which means 
that future workers have more capital with which to work and are more productive as a 
result.7

In contrast to conservative NCs, moderate NCs are more likely to distinguish between 
investment and spending. They generally favor the former, but because of their overriding 
emphasis on fiscal discipline, they are usually wary of significant increases in public 
investment. They generally prefer to use savings to pay down the national debt because 
they believe that doing so will free up capital for private investment, despite the fact that 
capital markets are global in nature.

The neoclassical doctrine is reflected in the major budget proposals of the first Obama 
term, including Simpson-Bowles and the Bipartisan Policy Center’s Domenici-Rivlin plan. 
These plans are bipartisan only in the sense that they include as members holders of both 
the moderate and conservative neoclassical doctrines. They reflect a deep neoclassical 
economics consensus.

In part because of the neoclassical concern that public spending crowds out private 
investment, these proposals define the problem as one of too much spending, not too little 
revenue or too little economic growth. Simpson-Bowles, for example, states that 
“government must also be willing to do more with less and live within its means.”8 Likewise, Domenici-Rivlin states, “America must learn to live within its means.”9

Because of the overriding emphasis in neoclassical thought on the primacy of capital 
accumulation to support capital investment, NC-based budget proposals stress budget 
cutting over all else, even if it means cutting public investment. Domenici-Rivlin states, 
with little evidence, that “large deficits put upward pressure on interest rates over the long 
r
run, making investment more costly.”10 Even if this were true, raising the effective 
corporate tax rate to reduce the budget deficit, as they propose, makes investment more 
costly, not less. If they really want to make investment less costly, an investment tax credit 
would be more effective.11

As a result, in order to reduce the crowding out of capital from federal spending, NC-based 
proposals tend to view all spending as equal, and hence call for putting everything on the 
table to be cut. Domenici-Rivlin states, “everything should be on the table,” including 
public investment.12 Other groups echo this catchy, but intellectually simplistic, position. Pete Peterson’s Concord Coalition calls for “applying budget discipline to all parts of the 
budget, implying that all areas should be trimmed.”13 The Center for Strategic and 
If the focus is only reducing the numerator in the debt-to-GDP ratio, and not on increasing the denominator, then cutting investments gets the same result as cutting spending.
foster growth by eliminating tax distortions of private economic decisions, especially with respect to saving and investment, and to make the system simpler and more transparent.” But for these groups, this should be at worst a “revenue-neutral tax reform plan,” and at “best,” a plan that cuts the deficit.” As a result, by cutting incentives in their quest to put deficit reduction above virtually all else, these NC-inspired plans would not only eliminate some growth-enhancing incentives (like the R&D credit), but they would also increase the effective U.S. corporate tax rate (companies would lose deductions and credits and pay more in taxes), reducing growth and making economic activity in the United States relatively less competitive. If these advocates take their logic to the full extent (we cannot afford to cut the effective corporate tax rate because it would increase the deficit), the logical extension of this would be on them to support eliminating all corporate tax incentives while also increasing the statutory corporate tax rates.

The neoclassical view fails to recognize that not all incentives are equal. Some incentives, like the charitable contribution deduction, help advance important societal goals and reflect the truly American value of encouraging a thriving civil sector. Others, like the R&D tax credit, help correct for very real market failures and lead to more, not less, growth. Because firms cannot capture all the value from a wide array of investments—including in R&D, workforce training, and machinery, equipment and software—they underinvest in these activities relative to what would otherwise maximize growth. Tax incentives targeted at these activities increase growth.

The dominant neoclassical view also tends to treat corporate and individual taxes the same. This is based on the belief that all taxes are equally distortionary and thus should be reduced whenever possible. However, as the OECD (Organisation for Economic Co-operation and Development) has found, corporate taxes are more of a drag on productivity, innovation and competitiveness than individual taxes are. One reason for this is that businesses in globally traded industries are more likely to move production offshore or lose global market share in response to relatively higher taxes. Moreover, higher corporate taxes reduce incentives to invest in productivity- and innovation-enhancing activities. In contrast the most part, modestly higher taxes on individuals would have no or little negative effect on work effort, work location, or overall growth.

Finally, holders of the neoclassical doctrine either do not believe that the trade deficit is a problem, or that its main cause is America’s failure to save rather than consume. The story told by most NC economists is that the trade deficit is a simple accounting function: low U.S. savings requires overseas borrowing, which by definition requires running a trade deficit. Former George W. Bush administration economist Greg Mankiw reflects this conventional view when he writes: “My view is that the trade deficit is not a problem in itself but is a symptom of a problem. The problem is low national saving.” The Council on Competitiveness agrees, stating: “These threats [e.g., the trade deficit] stem from global financial imbalances rather than from the inability of American companies or American workers to compete in global marketplaces.” As a result, to the extent that holders of the NC doctrine even care about international economic competitiveness and the trade deficit (most do not), reducing the budget deficit is their solution—not cutting corporate taxes or increasing investment in areas like research and workforce training.
But as non-neoclassical economist Robert Blecker states, “This identity does not prove causality, and is consistent with other causal stories about the trade deficit.” The conventional story fails to recognize that savings are a function of national competitiveness. If, for example, the Chinese allowed the value of their currency to rise, the U.S. trade deficit would fall and the Chinese would buy less of our government debt. The result would be a rise in both U.S. exports and interest rates. Both would spur more savings: higher interest rates would lead more Americans to save, and increased exports (and fewer imports) would boost U.S. corporate earnings. On top of this, more jobs and higher wages through exports (wages in exporting firms are 9.1 percent higher than those in other firms) would boost individual savings and reduce the budget deficit.

The Neo-Keynesian Doctrine: Maintain Spending and Boost Fairness

If NC-inspired budget hawks want everything to be on the table, liberal neo-Keynesians (NKs) want practically nothing on the table, except higher taxes on the wealthy and business. NKs are relatively unconcerned about budget deficits, in part because they believe that growth comes from the demand for goods and services (not the supply of capital). Cutting the budget deficit, either through reduced spending or increased taxes, will reduce demand and hence growth. When private consumption and investment falter, there is no alternative but for government to make up the difference. Failing to do so courts the risk of a deflationary cycle similar to the Great Depression and Japan’s lost decade. As Paul Krugman states, “the whole deficit panic is fundamentally misplaced,” and “[the United States is] actually supposed to run deficits in a depressed economy to help support overall demand.”

As such, most NKs ignore the budget deficit generally, and specifically the need for entitlement reform. They believe that, as the issuer of the world’s reserve currency, the United States will always have a market for its debt. If it doesn’t, it can always print money. For example, NK economist Jamie Galbraith would simply take entitlement reform off the table. He has even advocated expanding Social Security by paying people to retire early, thereby purportedly freeing up jobs for others, even though this would dramatically increase entitlement payments and reduce GDP growth.

Although he acknowledges that entitlements lead to spending in excess of revenues, his solution is to assume that the Chinese will keep making up the difference by buying our Treasury bills, ignoring the fact that this keeps the value of the dollar high, reducing U.S. global competitiveness. Likewise, Jeff Faux, founder of the liberal Economic Policy Institute (EPI) argues that “the deficit projections no more reflect a crisis of ‘entitlement’ overspending than they reflect a ‘crisis’ in any other category of spending, like military spending or agricultural subsidies. Sensible governance understands that the fact that a program area is expanding does not make it the source of fiscal imbalance.”

To the extent that neo-Keynesians even want to address the budget deficit, they generally oppose spending cuts, especially on social services and entitlements because they see such public spending as a means to help low- and moderate-income individuals and to spur consumer demand, which in turn, in their view, drives investment. Better to raise taxes on the privileged (e.g., wealthy individuals and corporations) who have a higher propensity to
save, while also cutting taxes on lower income Americans who have a higher propensity to spend. For example, the EPI argues that replacing a dollar of sequestration cuts with a dollar of progressive revenue would boost the economy by more than a dollar—and produce roughly the same effective deficit reduction because of improved fiscal feedback effects. Whether or not one believes this would be a good change, it reflects the focus on cutting taxes for low income Americans and raising it for companies. EPI would also not cut Social Security benefits, but would increase Supplemental Security Income taxes on higher income Americans. Likewise, for the liberal Center for American Progress, the goal is to “strengthen the middle class, for without a strong middle class, our economy will not grow as it should” (because of the demand for goods and services from middle class households). Thus entitlement cuts are to be avoided since they reduce demand.

But with entitlements off the table, it is virtually impossible to solve the government’s fiscal problem simply by raising taxes on the rich (which is needed) and on corporations (which would further reduce the competitiveness of the U.S. economy). Yet that is the EPI plan: “Under our proposals, high-income earners and corporations would contribute more, while negative tax rates for low-income households would be expanded.” These plans assume that tax rates have little effect on economic activity and that the U.S. economy is for all intents and purposes shielded from global competition.

For neo-Keynesians the goal of budget reform is to move to a more progressive society where the rich and corporations pay more and lower-income Americans pay less and get more. As EPI states, “Deficit reduction on its own will fail to boost living standards, opportunity, and security for current and future generations. To be successful, it must be paired with policies that push the labor market back to full employment,” presumably through increased government spending. But this will do little to boost productivity, and unless the retirement age increases and disability payments decrease—which they oppose—it will do little to expand work hours. And by calling for an end to pro-growth corporate tax incentives, like bonus depreciation and the R&D credit, and using most of the funds for deficit reduction and entitlement expansion, the policies would reduce productivity-enhancing investment.

Finally, like neoclassicists, neo-Keynesians typically do not distinguish between spending and investment. For them, spending on low-income housing or Medicare is in the same category as investment in research in terms of its impact on the economy. Both create jobs in the short term. That’s why they use the term “public investment” in such an expansive way as to encompass virtually all spending they favor. For example, while EPI does call for an increase in public investment of $200 billion a year for infrastructure, education and training, and research and development, it also calls for funding for “investments” by state and local government by providing $425 billion in state and local fiscal relief through 2017. But there is no assurance that even most of this money would go to true investment, as opposed to consumption.

**Innovation Economics Doctrine: Boost Investment While Cutting Spending**

In contrast to the other three doctrines, advocates of “innovation economics” believe it is neither the supply of capital nor the demand for goods and services that drives growth,
especially when growth is defined as maximizing productivity. Rather, it is the demand for capital by organizations that are trying to create value. In other words, an economy grows when organizations and entrepreneurs create new products and services and invest in new production processes that boost productivity. Rather than focus budget policy on ensuring an adequate supply of private capital or maximizing consumer spending, budget policy should include a focus on spurring productivity, innovation, competitiveness and greater work effort, which in turn drive demand for capital.

This means, among other things, distinguishing between spending and investment. Innovation economists (IEs) generally see the economic benefits from increases in true public investments and reductions in corporate taxes as outweighing the economic benefits of deficit reduction. As such, they favor significantly expanding investments in innovation (e.g., direct public expenditures on research and indirect public investments like an expansion of the R&D tax credit); education and skills, particularly STEM education; and infrastructure, while focusing spending cuts on consumption items, like entitlements and farm subsidies. In this sense, everything should not be on the table. In fact, even in an era of budget constraint, it makes sense to expand certain kinds of public investments. This is all the more true when the goal is a reduction in the debt-to-GDP ratio.

They also distinguish between individual and corporate taxes. Because business investment is increasingly mobile, IEs support reducing the effective tax rate on businesses, particularly those in global competition, while increasing taxes paid by individuals. While French movie actor Gerard Depardieu may have become a Russian citizen to avoid French top marginal tax rates of 75 percent, few Americans will move to the Bahamas if the top marginal rate increases from 35 percent to 39 percent.

IEs also differentiate between tax provisions that have no economic rationale and are in place largely because of special interest pressures, and those that do have an economic rationale. Some tax incentives that “distort” decisions in fact lead to a larger and more productive economy. As Canadian government economist Aleb ab Iorwerth writes, “there is no presumption that distortions are necessarily welfare-reducing. Distortions that favor the contributors to long-run growth will be welfare-enhancing.” So the focus of innovation economics is not to relentlessly root out most or all provisions in the tax code, but to identify and expand the incentives that are welfare enhancing while cutting those that are welfare reducing.

CONCLUSION

Addressing the budget deficit and growing national debt is a means, not an end. As such, any debt reduction plan should focus on expanding growth and reducing the debt-to-GDP ratio, both by increasing growth and reducing spending, and by increasing taxes.

As a nation we need to decrease consumption (private and public) while increasing investment (private and public). We need to make sure that income supports do not reward people for not working, and in fact encourage more people to work more and longer in their lives. Increasing the employment-to-labor ratio while increasing the retirement age will not only boost the GDP, it will reduce entitlement payments.
And with regard to taxes, tax policy needs to take into account deadweight losses. The losses from corporate taxes are fairly high because companies can and do move production in response to marginal tax rates. In contrast, the losses from individual taxes on the rich are not high. Moreover, specific tax incentives, such as the R&D tax credit or an investment tax credit, lead to increased pro-growth investment.

The next ITIF report in this series will lay out a comprehensive and detailed budget plan reflecting the Innovation Economics framework.
ENDNOTES

4. Ibid.
10. Ibid.
12. Domenici and Rivlin.
21. Stuart M. Butler et al., *Saving the American Dream*, 49.
22. Ibid., 50.
24. This is not to say that the charitable contribution deduction could not be reformed, for example by creating a two-tier deduction where truly charitable organizations serving the poor or needy receive a higher deduction than donations to activities like culture and the arts.


40. Ibid, 48.

41. Ibid., 44.

42. Albeit, some neoclassical economists will acknowledge that a tax provision can be used to correct a market imperfection, most commonly an externality, but most view such market failures as occurring only rarely, and even then, most believe that acknowledging market failures opens up a Pandora’s box of all kinds of tax provisions, some useful, but most not.

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ABOUT THE AUTHOR
Dr. Robert Atkinson is the President of the Information Technology and Innovation Foundation. He is also the author of the books, Innovation Economics: The Race for Global Advantage (Yale University Press, 2012) and The Past and Future of America’s Economy: Long Waves of Innovation that Power Cycles of Growth (Edward Elgar, 2005). Dr. Atkinson received his Ph.D. in City and Regional Planning from the University of North Carolina at Chapel Hill in 1989.

ABOUT ITIF
The Information Technology and Innovation Foundation (ITIF) is a Washington, D.C.-based think tank at the cutting edge of designing innovation strategies and technology policies to create economic opportunities and improve quality of life in the United States and around the world. Founded in 2006, ITIF is a 501(c) 3 nonprofit, non-partisan organization that documents the beneficial role technology plays in our lives and provides pragmatic ideas for improving technology-driven productivity, boosting competitiveness, and meeting today’s global challenges through innovation.

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