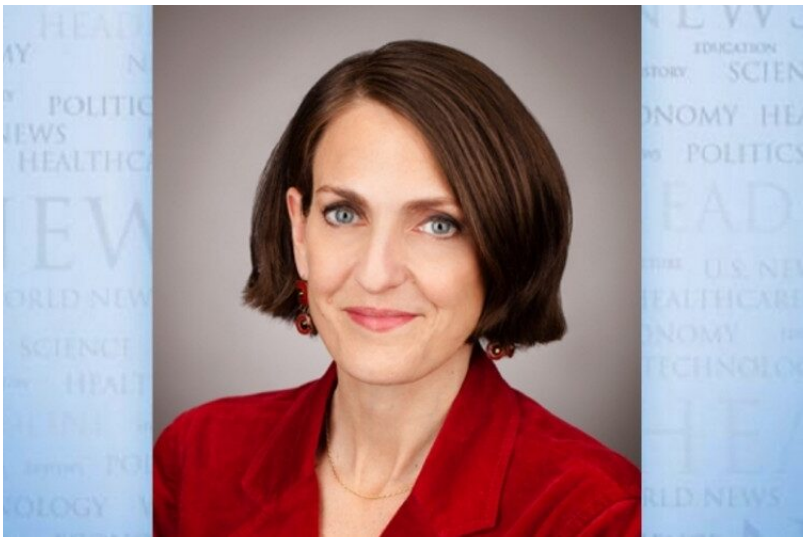
Written by **Veronique de Rugy** on July 7, 2022

With Spending and Inflation, It's More of the Same



Veronique de Rugy
Veronique de Rugy

The go-to policy for dealing with nearly every modern problem is more government spending. So it was just a matter of time before Democrats tried to revive the failed "Build Back Better" (BBB) program to address today's economic troubles. Of course, if they succeed, the result will be much the same as what we've experienced over the past 18 months: more debt and rising inflation.

As a reminder, the $2 trillion proposed BBB legislation came on the tail of an oversized $2 trillion third COVID-19 relief bill and a $1 trillion infrastructure bill. It was killed when two Democratic senators, Joe Manchin and Kyrsten Sinema, joined all Republican senators in opposition. They rightfully worried that more spending would inflate our debt and produce inflation. But now, their party is back at it again. In the midst of the largest inflation in four decades, they've been negotiating behind the scenes for weeks in hopes of passing a slimmer BBB.

According to Politico, they hope to pass the bill before September by using the budget reconciliation process. The bill includes tax increases, deficit-reduction measures, prescription-drug reform and renewable-energy subsidies, but most of the details are still unclear. If we wind up with more of the spending and favoritism that's become so common, it would be tragic.

First and worst, these policies are destined to be counterproductive. Subsidies to suppliers of green energy, for instance, increase the cost of that energy and hinder the innovation that could make it more commonplace. The Democrats' prescription-drug policy would be costly and in the long run perhaps even deadly. As the Paragon Institute's Brian Blase recently wrote in a newsletter, "Former Chairman of the Council of Economic Advisers Tomas Philipson … estimates that these proposals would lead to 135 fewer new drug approvals over the next two decades. This reduced innovation would translate into a loss of life years many times larger than the life years lost from COVID-19."

Second, as the spending flows through the economy, it will continue to fuel inflation. The recent price hikes are caused by irresponsible fiscal and monetary policies during the pandemic, followed by a failure to implement — or even talk about — policies for reducing the budget deficit and debt once the crisis passed. Indeed, one of the implicit fiscal rules that politicians have lived by until now is that while government can spend big during an emergency, it should go on a diet once the emergency is over. Doing otherwise might trigger a calamitous suspicion that the government will fail to repay its debt and instead rely on inflation to chip away at it.

Furthermore, another huge spending spike is costly especially if paid for with borrowed money. It is particularly expensive at a time when the Federal Reserve is hiking interest rates to tame inflation. Thirty percent of U.S. debt needs to be rolled over within a year. Higher interest rates mean higher interest payments on our debt, a difference in cost that will be felt rapidly.

Finally, higher interest rates and the resulting slowing of the economy could reduce inflation — but that could be a costly and short-lived victory unless Congress implements austerity. Any initial success in taming inflation could backfire by temporarily increasing households' real wealth and interest receipts from bond investments. In this scenario, more wealth and higher incomes end up boosting the aggregate demand that's been driving inflation. Implementing a fiscal consolidation plan would reduce the wealth effect and keep inflation under control. On the other hand, adding more spending to the economy, like most Democrats want to do, would aggravate the wealth effect and fuel demand-driven inflation.

As the Hoover Institution's John Cochrane reminds us, this is exactly what happened during the Great Inflation. He writes: "In 1970 and 1974, the Fed raised interest rates more promptly and more sharply than now, from 4% to 9% in 1970 and from 3.5% to 13% in 1974. Each rise produced a bruising recession. Each reduced inflation. Each time, inflation roared back." This is what will happen if the Biden administration fails to implement austerity or, even worse, if it uses fears of an upcoming recession as an excuse to increase spending and the debt further.

A soft landing was never a credible option. Once inflation starts, there's no easy way out. But there are plenty of ways to make things worse and more painful. This is what will happen if Democrats proceed with their current BBB plan.

Veronique de Rugy is the George Gibbs Chair in Political Economy and a senior research fellow at the Mercatus Center at George Mason University. To find out more about Veronique de Rugy and read features by other Creators Syndicate writers and cartoonists, visit the Creators Syndicate Web page at www.creators.com.