214 Massachusetts Avenue, NE • Washington DC 20002 • (202) 546-4400 • heritage.org

CONGRESSIONAL TESTIMONY

Government Intervention: A Threat to Economic Recovery

Testimony before The House Committee on Foreign Affairs' Subcommittee on Terrorism, Nonproliferation and Trade

June 10, 2009

Ambassador Terry Miller
Director, Center for International Trade and Economics
The Heritage Foundation

My name is Terry Miller. I am Director of the Center for International Trade and Economics at The Heritage Foundation and editor of the Index of Economic Freedom. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Though we sit today at what may well be the low point of a recession that has seen world economic growth slow to near zero, it is important to remember that what we are experiencing is a temporary setback. If one takes a longer view, it is clear that the economic policies that have come to dominate world economic thinking over the last 60 years, and especially since the fall of the Soviet Union, are producing strong broad-based growth, growth that is increasing prosperity and reducing poverty around the world.

The numbers are not ambiguous. Over the last decade, per capita income in all countries of the world combined has increased by an average of about three percent per year. Over the 10 years, that adds up to an increase of over one third in average world incomes.

The growth in incomes is remarkably broad-based, not concentrated in just a few countries or regions. Of the 156 countries for which we have reliable data, only 12 failed to participate in this positive growth over the decade.

The economic system that has been producing these remarkable results is known by various names. Most economists would call it the free market system or capitalism. Some identify it with globalization. Some call it the Washington Consensus, because it represents the consensus of views and policies espoused by the World Bank, the International Monetary Fund and, at least until recently, the government of the United States.

At The Heritage Foundation, we call it economic freedom, and we measure it each year in the Index of Economic Freedom, which we publish jointly with The Wall Street Journal.

The key principles of economic freedom are individual empowerment, non-discrimination, and the dispersion of power:

- Individual empowerment means that individuals retain control of where they live and how much they work. They have the right to own property and decide when and how to spend their wealth and income.

- Non-discrimination means that there should be no preferences based on race, gender, religion, class, family connections or any other such trait. Each individual deserves an equal opportunity to prosper to the full extent of their ability and effort. Transparency in decision-making is a key aspect in ensuring such fairness; it is behind walls of secrecy that discrimination most often flourishes.

- Dispersion of power means pursuing policies and practices that foster competition in labor markets, in capital markets, between firms and even among countries. The separation of political and economic power is a key aspect in the dispersion of power.

Countries that respect these principles of economic freedom do far better on average economically than countries in which governments play a more intrusive role. The countries ranked as most free in the 2009 Index of Economic Freedom had average per capita incomes of over $40,000, more than 10 times the income levels in countries where economic freedoms are repressed.

Some criticize the free market system as good for the rich but not for the poor. The data show otherwise. When we compare economic freedom scores with poverty levels as measured in the United Nations Human Poverty Index, we find that countries that gained at least 5 points of economic freedom in the decade between 1997 and 2007 moved almost 6 percent of their populations out of poverty on average. Countries that lost at least 5 points of economic freedom, by contrast, saw poverty levels increase.

Economic freedom's positive influence is also evident in connection with social development in areas like education, health, child or maternal mortality, and overall life expectancy, as well as in protection of the environment, where countries that are more economically free do a far better job than their less free counterparts.

Given these positive long term trends, and the proven good economic results in countries around the world that respect principles of economic freedom and market-based decision-making, I would submit that the first responsibility of policy makers in leading economies, especially in a time of downturn or crisis, is to preserve the capitalist system and to do no harm. Markets are by and large self-correcting. Government interventions, which are almost always designed to restore or protect the status quo ante, impede the corrective action of the market and thus slow recovery.

The record of government interference in the economy, whether in the United States or in countries around the world, is not pretty. The TARP and TALF programs, both initiated under the previous administration, are good examples of the problems of government interference in markets. The policy-makers involved argued that the programs were necessary to avoid an immediate melt-down in financial markets. We cannot, of course, know what would have happened in the programs' absence. However, from the perspective of six months following their passage, we can see that their lasting result has been not the hoped for increase in stability and lending in credit markets, but rather greater uncertainty and volatility. Markets need sure and stable government laws and policies in order to properly price assets. The TARP, in particular, has created confusion and interfered with the establishment of a market-clearing price for the troubled assets in question. There has been a disappointing lack of transparency in the program's decision-making processes that leaves potential investors uncertain of the direction of the market and therefore unwilling to invest. The TARP may have artificially inflated the value of the troubled assets, but it has done little to get them off the books of the financial institutions.

The fiscal stimulus package passed under the current administration is even worse. Even if one accepts the Keynesian notion that increased government spending can increase economic growth, and there are real doubts about this, almost none of the money has actually been spent, or will be spent, in a timely fashion. One estimate this month is that only about $37 billion of the $787 billion stimulus package has been spent so far. Most of the money is projected to be spent in the future when government stimulus will no longer be appropriate and will most likely only contribute to inflationary pressure.

The cost of these programs is creating a huge debt for our children that will have to be financed somehow. If we continue them, we are going to see either inflation or increased taxes or both, as well as a fall in the value of the dollar and decreased foreign investment in the United States, lower productivity overall, and reduced economic growth in the future. That is far from doing no harm.

Between January and April this year, the International Monetary Fund reduced its projection of U.S. economic growth in 2010 from a positive 1.6 percent to zero. The most significant U.S. public policy change during this period was the passage of the stimulus package. Now we are seeing bond markets driving up the cost of Treasury borrowing in response to unprecedented government spending. This is a path to impoverishment rather than recovery. We need to stop.

Some have expressed the hope that increased international cooperation, such as among the G-20, could contribute to a solution to the problem. I have very modest expectations in this regard. The G-20 can play a positive role in exchanging information and promoting mutual confidence among governments, but the most important macro-economic variables under the control of governments, the money supply and spending levels, must and will remain the province of individual governments.

There was much talk about regulatory reform at the recent G-20 summit, and such reform is, in fact, needed. Financial market regulation needs to change to encourage more transparency, greater competition, and a reduction in regulatory distortions that increase lending risk. The probability, unfortunately, is that international cooperation will lead to just the opposite, a regulatory system that is more complex, more subject to manipulation, and more restrictive.

The general rule is that more regulation leads ultimately to the provision of less of the regulated product. It is extremely unlikely that increasing regulation of financial and credit markets could lead to any result in the end other than a reduction in the availability of credit to individuals and businesses and an increase in its cost.

Looking forward, as we begin to recover from the financial crisis, there are different and even greater potential risks to the U.S. and world economies. Policies that would greatly and artificially increase the cost of energy will cut U.S. and world growth and lead to increased poverty worldwide. It is imperative that these costs be fully considered in the development of any policies to address climate change.

In addition, actions that would restrict or reduce the flows of goods and services or capital among the countries of the world would also have a devastating impact on world growth. Trade flows increase productivity and growth rates. Income from trade dwarfs all other aspects of financing for development in poorer countries. Trade restrictions go by the name of protectionism, but what they protect are the unfair privileges of politically-connected special interests.

If policies must be developed in any of these areas, it is most important that they be as simple, straight-forward and transparent as possible. As the size and reach of the Federal Government increases in the U.S. economy, there is an ever-present risk of increased graft and corruption. These factors, more than any others, account for low levels of development in much of the world. Corruption thrives where economic regulations are complex and government involvement pervasive. It must not be allowed to take root here.

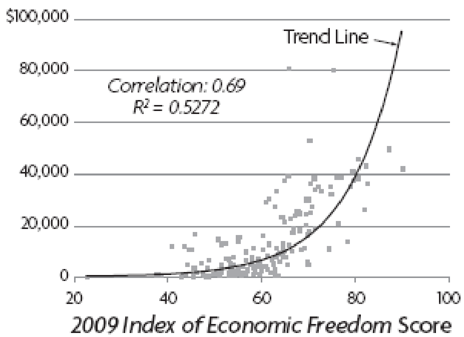
Over the past decades we have maintained in America, and exported to most of the rest of the world, a free market economic system that encourages openness, the free flow of goods, services and capital, and interconnectedness among the nations and people of the world. The result has been greatly increased prosperity for all. A time of crisis may be a time to examine what has been done and what might be done better, but it is surely not the time to fundamentally undo the policies and practices that have brought so much benefit to so many.

Economic Freedom Improves Lives

Economic Freedom and Prosperity

Each dot represents a country in the Index of Economic Freedom.

GDP Per Capita, Measured by Purchasing Power Parity (PPP)



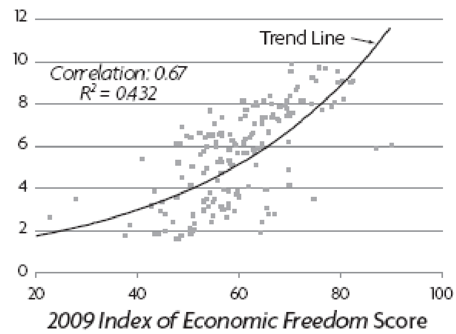
Source: *2009 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2009), at *http://www.heritage.org/index*; International Monetary Fund, World Economic Outlook database, April 2007, at *http://www.imf.org/external/pubs/ft/weo/2008/01/weodata/index.aspx*.

Chart 3 heritage.org

Economic Freedom and Democratic Governance

Each dot represents a country in the Index of Economic Freedom.

Economist Intelligence Unit's Index of Democracy

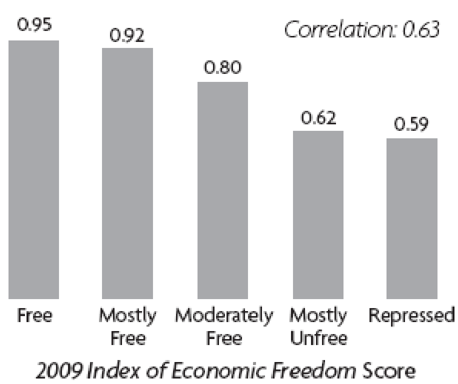


Source: *2009 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2009), at *http://www.heritage.org/index*; The Economist Intelligence Unit's Index of Democracy, Country Forecasting Services, Economist Intelligence Unit, at *http://www.economist.com/media/pdf/ Democracy_Index_2007_v3.pdf*.

Chart 4 heritage.org

Economic Freedom and Human Development

U.N. Human Development Index

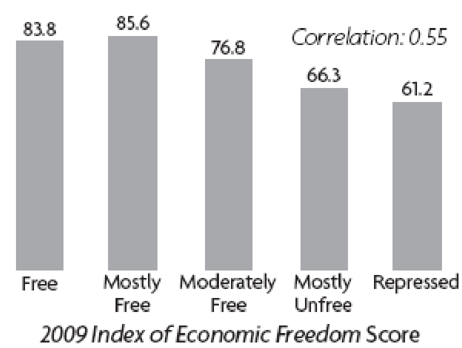


Source: *2009 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2009), at *http://www.heritage.org/index*; *Human Development Reports 2007/2008*, United Nations Human Development Programme, at *http://hdr.undp.org/en/statistics*.

Chart 5 heritage.org

Economic Freedom and the Environment

Environmental Performance Index



Source: *2009 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2009), at *http://www.heritage.org/index*; Daniel C. Esty, M. A. Levy, C. H. Kim, A. de Sherbinin, T. Srebotnjak, and V. Mara, *2008 Environmental Performance Index* (New Haven: Yale Center for Environmental Law and Policy, 2008), at *http://epi.yale.edu/Framework*.

Chart 6 heritage.org

Graphics reprinted from the 2009 Index of Economic Freedom

****

The Heritage Foundation is a public policy, research, and educational organization operating under Section 501(C)(3). It is privately supported and receives no funds from any government at any level, nor does it perform any government or other contract work.

The Heritage Foundation is the most broadly supported think tank in the United States. During 2008, it had nearly 400,000 individual, foundation, and corporate supporters representing every state in the U.S. Its 2008 income came from the following sources:

Individuals	67%
Foundations	27%
Corporations	5%

The top five corporate givers provided The Heritage Foundation with 1.8% of its 2008 income. The Heritage Foundation's books are audited annually by the national accounting firm of McGladrey & Pullen. A list of major donors is available from The Heritage Foundation upon request.

Members of The Heritage Foundation staff testify as individuals discussing their own independent research. The views expressed are their own and do not reflect an institutional position for The Heritage Foundation or its board of trustees