



Curing America's Growth Gap

Addressing Causes Instead of Symptoms

September 19, 2013

Executive Summary

A more comprehensive understanding of the relationship between government spending and debt and the effect on the broader economy is imperative for all policymakers. Spending and debt can stunt economic growth, which in turn leads to a vicious cycle of further deficit spending and debt.

The fourth anniversary of the current economic recovery offers a poignant reminder: The post-2008 financial crisis recovery ranks dead last in terms of economic growth when compared with all other recoveries since World War II from recessions that have lasted longer than a year; and the "Growth Gap" going forward is bigger than ever.

The Growth Gap between what real GDP is and what it would be if America had simply experienced an average post-1960 recovery is large – \$1.3 trillion. Real disposable income per capita has inched up 2.7 percent compared with an increase of 11.1 percent over the same period in an average post-1960 recovery. That is an annual difference of \$2,987 per capita; which would be a difference of \$11,948 for a family of four.

Even more troubling, America's economic growth prospects going forward may have diminished. The Congressional Budget Office (CBO) recently reduced its estimate for future growth in potential real GDP from 3.2 percent to 2.2 percent per year. Over the next 50 years, a one-percentage point reduction in real annual GDP growth is the difference between an \$80 trillion economy and a \$50 trillion economy, a nearly 40 percent smaller economy, in 2062.

Massive stimulus spending and an expansion of entitlement programs since 2008 have failed to deliver the promised jump that our economy needs. Now, left with an even larger base of federal spending ahead of demographic changes that will place an excessive strain on existing entitlement programs, the growth of the federal government is squelching private enterprise and innovation with spending increases; crushing debt with higher interest

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payments; burdensome and byzantine regulations; maligned incentives; and an ever-broadening scope of government functions.

The dual problems of fiscal unsustainability of the federal government and the Growth Gap are interrelated. So are their solutions.

The dual problems of fiscal unsustainability of the federal government and the Growth Gap are interrelated. So are their solutions. Without economic growth, the United States cannot achieve fiscal sustainability; without long-term government fiscal sustainability, the economic growth gap will persist.

How Government Grows despite Policymakers' Intentions

- **Government often behaves in ways that neither policymakers nor the electorate intend.** Bad government is not commonly the result of bad people; dysfunctional outcomes occur in spite of rational reasons and means. For example, the Federal Reserve's current near-zero interest-rate policy combined with the current tax system has increased the likelihood of negative real yield on investments, further reducing the incentive to invest, which is vital to economic growth. Neither policymakers nor the public wish for stunted economic growth and investment, but this has been a significant negative outcome of a plethora of rational and often "temporary" marginal tax code changes in combination with a highly interventionist Federal Reserve's rational intent to boost lending and reduce unemployment.
- **People often argue that government should run like a business; there will always be differences in the types of incentives driving the private sector and the government sector.** If you want to change government, you must change the rules; the government responds to incentives that have been put in place, and these incentives remain a real challenge to those who want reform. He who writes the rules, designs the game. Much of government growth that can stand in the way of fiscal consolidation and major reforms relate to the precedents that were set by institutions in the past. What politicians are able to do is shaped by context.
- **The current set of rules incentivizes government growth and further centralization and must change if the United States is to remain a sustainable economic force in the world in the long term.** The composition of spending has dramatically changed over the past 50 years, moving from discretionary spending that policymakers debated and prioritized every year to an automated, centralized spending machine that doles out funds based on unsustainable obligations, fueling interest payments on debt in the process. These rules also have the unintended effect of blurring the line between revenue intake and program spending, and impeding state and local government experimentation that leads to better program outcomes and greater efficiency. For example, the

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transition of control from state and local levels to federal subsidization with strings attached has been made possible by a growing spending category in the federal budget, grants-in-aid. States receiving federal funds lack the incentive to spend those funds as carefully and efficiently as the funds they must raise from their own revenue base.

Recommendations

Following earlier papers from the Joint Economic Committee Republicans—*Spend Less, Owe Less, Grow the Economy* and *Maximizing America's Prosperity*—this study takes a broader look at why government growth is so pervasive, and what policies can be enacted to place America on a fiscally sustainable course and prioritize core government programs. Using medical analogies, key considerations in this inquiry include:

- **Balancing the budget alone is insufficient to prevent the disease of government growth.** Demonstrating a path to budget balance alone does not address the underlying problems that have thrown the budget out of balance in the first place. Projections of budget balance in the future can be misconstrued as factual and mask systemic problems. The government is growing in multiple dimensions: size (i.e., relative to the economy), scale (i.e., central and federal intergovernmental roles) and scope (i.e., in new authority that can impede the effectiveness of government functions as well as the economy).
- **Misdiagnosing the symptoms as causes of the disease must be avoided.** Policymakers must shift focus from the symptoms of government growth to what the root cause is—overspending. Growth in scope of government can pervade agency core mission creep and drift away from the original, government-specific role. Congressional mandates and burgeoning regulations consume the resources available for government to perform its roles well, begetting more spending and borrowing to make good on ever expanding obligations. Entitlement spending has also shifted the budget landscape, placing a majority of government spending on automatic pilot and disconnecting spending from revenue. Monetary instability reduces the accuracy of budget projections and undermines the strength of the U.S. dollar.
- **The body will reject the medicine if the rest of the body perceives it as harmful.** Fiscal rules must not only be carefully designed, but they must receive broad bi-partisan and public support. If bi-partisan support is absent, then the fiscal rule design could undergo alterations that render it flawed and ineffective. In addition, for a fiscal rule to stick, it needs the credible commitment of both parties and wide acceptance and understanding from the public, especially since the current Congress cannot bind future Congresses.

Policymakers must shift focus from the symptoms of government growth to what the root cause is.

- **Ensuring that the disease of government spending is not channeled in another form is critical.** Taking a multifaceted approach to prioritizing core government spending programs ensures that government growth does not overflow into another form (i.e., cutting spending and seeing an increase in regulatory action). With fiscal rules come the understanding of how to manipulate them; this is why credibility plays such an important role, and why reform of other forms of government expansion (i.e., tax reform, entitlement reform, regulatory reform, addressing intergovernmental transfers) must occur concurrently in order to reduce the opportunities and subsequent temptation to circumvent fiscal rules.

Pro-growth reforms coupled with expenditure-based fiscal consolidation increases the chances of success for reducing debt-to-GDP ratios and boosting economic growth.

- **A cure for the disease will come from an arsenal of policies designed to amplify one another, not a single silver bullet.** Pro-growth reforms coupled with expenditure-based fiscal consolidation increases the chances of success for reducing debt-to-GDP ratios and boosting economic growth. According to research from Veronique de Rugy and Alberto Alesina, pro-growth reforms enhance the success of fiscal consolidation by mitigating the short-term negative effects and bolstering long-term economic growth.¹

With these points in mind, this study:

- (1) Identifies the multifaceted causes of expansive government growth and subsequent symptoms and consequences;
- (2) Notes the common roadblocks preventing successful fiscal consolidation and real reform of government spending;
- (3) Offers several broad policy recommendations that emphasize spending prioritization and promote strong and sustainable economic growth; and
- (4) Demonstrates the benefits of credibly committing to pro-growth policies coupled with successful fiscal consolidation.

Government is more dependent upon strong, continued economic growth than most politicians realize. The goose that lays the golden eggs for government revenue is currently weak, and Congress needs to pursue policies that strengthen economic growth rather than provide short-sighted solutions that do nothing more than redistribute existing resources and shift economic activity from the future to the present. If business as usual persists, then both government and the economy will suffer far worse than if Congress takes bi-partisan action on difficult issues now. As the public begins to converge on the understanding that major reforms are necessary to give the bright and hopeful vision of America a chance, it is time for policymakers to do the same.

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Introduction

The U.S. government is on a fiscally unsustainable course, and the U.S. economy suffers from a tremendous Growth Gap. The current recovery is the weakest among all recoveries since 1960 lasting at least one year, and the ability of the U.S. economy to continue strong growth in the future may have declined.

These two problems and their solutions are interrelated. The United States cannot achieve fiscal sustainability without accelerating long-term economic growth. Similarly, the United States cannot close its Growth Gap without making the federal government fiscally sustainable over the long term.

To date, policymakers have focused on passing a budget resolution that would bring federal spending back into balance with federal revenues over the course of the next decade. While imposing sufficient spending restraint to achieve a balanced budget in ten years without tax increases would be a necessary step toward fiscal sustainability and faster growth, a balanced federal budget ten years from now would not be sufficient by itself to achieve these two goals. Other reforms are necessary to obtain fiscal sustainability and accelerate economic growth over the long term.

Policymakers must focus on the size, scope, and scale of the federal government, not simply whether receipts exceed outlays in a particular fiscal year. The size, scope, and scale of the federal government have profound effects on economic growth. In turn, economic growth affects the ability of the Treasury to collect revenue from existing taxes. The size of government refers to the level of government spending, revenues, and debt and the percentage of each to a common measure such as gross domestic product (GDP). The scale of government refers to the level of government at which functions are performed. The scope of government refers to the number of different functions in which the government engages.

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Beyond a certain point, a larger government slows economic growth. Similarly, a broader scope for government also slows economic growth. Finally, a greater centralization of the functions of government at the federal level breeds inefficiencies. Therefore, achieving fiscal sustainability and

Washington policymakers must define what functions the federal government should continue to perform and what functions the federal government should cease performing.

Policymakers must correct the perverse incentives sometimes created by well-intended, but ill-designed entitlement programs, regulations, and taxes that discourage economically productive behavior.

closing the Growth Gap require Washington policymakers to reduce the drag on the economy from the size, scope, and scale of government.

Washington policymakers must define what functions the federal government should continue to perform and what functions the federal government should cease performing. In addition to the prioritization of spending, entitlement programs must be reformed to make them sustainably solvent. Further, policymakers must correct the perverse incentives sometimes created by well-intended, but ill-designed entitlement programs, regulations, and taxes that discourage economically productive behavior. And Washington policymakers must be conscious of how U.S. laws and regulations affect the international competitiveness of U.S. businesses.

This study seeks to update and expand upon prior Joint Economic Committee (JEC) research of successful fiscal consolidations, focusing on the evidence that has led to fiscal sustainability, and the identification of fiscal rules that enable reductions to federal spending. The first commentary, *Spend Less, Owe Less, Grow the Economy* demonstrated that fiscal consolidations based mostly upon government spending reductions were most successful at achieving smaller budget deficits and stabilizing government debt as a percent of GDP relative to consolidations that consisted mostly of tax increases. The follow-up commentary, *Maximizing America's Prosperity*, identified certain fiscal rules that would enable Congress to credibly commit to federal spending reductions; to return to a fiscally prudent budget; and to boost economic growth. The most critical component to reduced federal spending includes a statutory spending cap on noninterest spending with a credible enforcement mechanism.

This study:

- (1) Identifies the multifaceted causes of expansive government growth and subsequent symptoms and consequences;
- (2) Notes the common roadblocks preventing successful fiscal consolidation and real reform of government spending;
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Causes of Fiscal Unsustainability

Major Causes of Government Growth

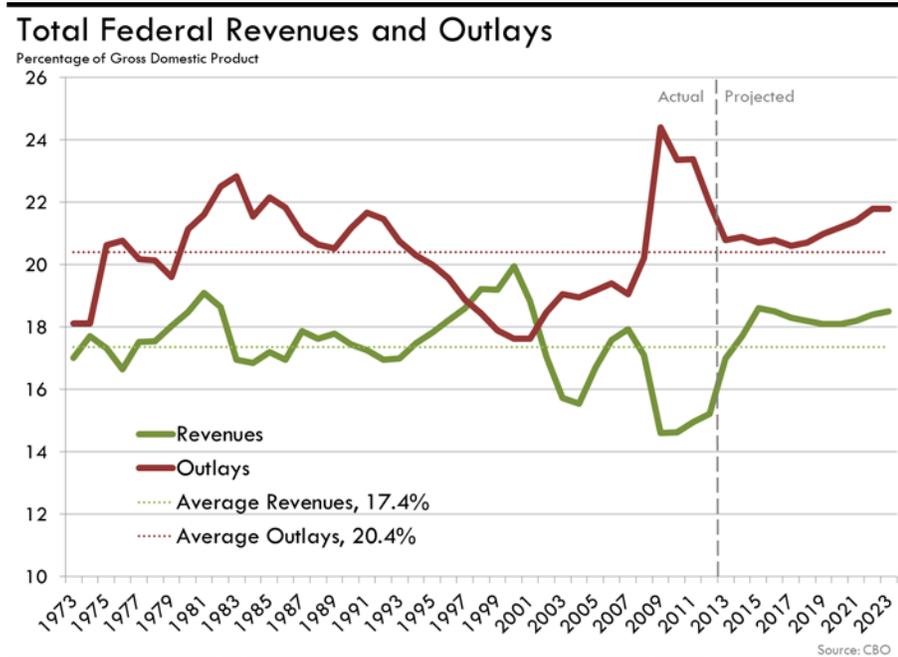
Expansive and unchecked government growth begets fiscal unsustainability. However, there are a few dimensions to consider when describing how government expands to a point beyond fiscal sustainability.

Size

Measures of the size of government, such as spending or debt as a percent of Gross Domestic Product (GDP); real annual spending and debt; or as a proportion of government debt to its annual income (e.g., revenue) have reached unprecedented highs in the post-WWII era. Measuring spending, revenues, and debt-to-GDP is a common practice in order to use the size of the economy as a benchmark for government spending, and is most easily comparable in both historical time series and in projections.

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Figure 1



Using data from the Congressional Budget Office’s (CBO) August 2013 data update to the *Budget and Economic Outlook*, measuring government size as federal spending as a percentage of GDP, total spending for 2012 was 22.0 percent of GDP, down from the recent high of 24.4 percent in 2009, but well above 19.0 percent in 2007, as shown in Figure 1 above. The 40-year historical average for federal outlays as a percent of GDP is 20.4 percent. In the last few years, federal outlays have dramatically increased from \$2.7 trillion in fiscal year 2007 to \$3.5 trillion five years later to a projected \$5.9 trillion in 2023. Though the CBO updated budget data as a percent of GDP to incorporate the Bureau of Economic Analysis’s (BEA) comprehensive revision of GDP, recognizing that the economy is roughly three percent

larger than previously expected, the CBO finds that “the economic data that have become available since our previous projections do not suggest that significant changes in our economic projections are warranted.”² Data from the Office of Management and Budget (OMB), the Treasury, and references to other studies using GDP-related data published earlier than August 2013 mentioned in this paper therefore do not reflect the GDP update. JEC Republican Staff calculations and CBO data reflect the GDP revision.

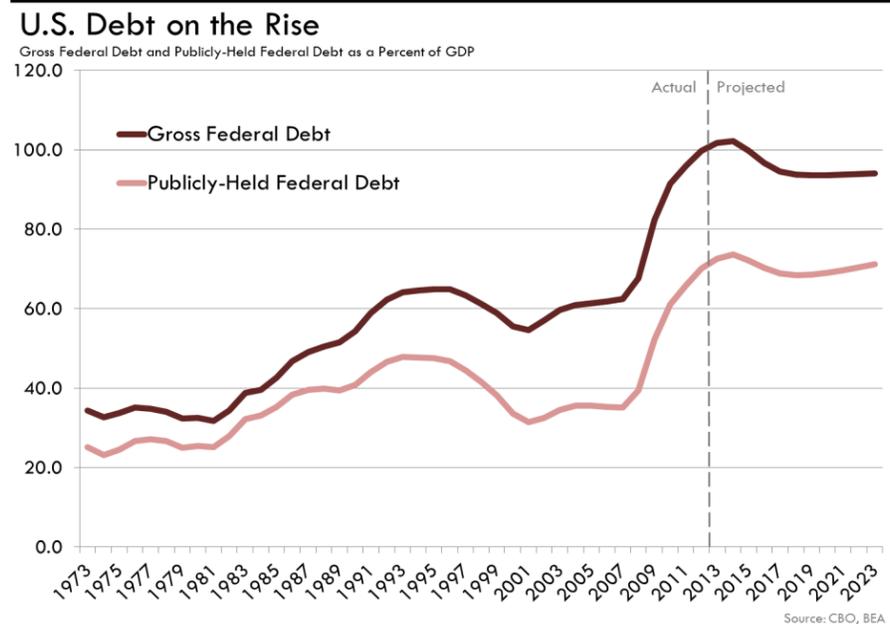
As demonstrated in August 2013 CBO data, revenues have languished during and following the recent recession, falling from 17.9 percent of GDP in 2007 to 14.6 percent in 2009 and 2010, and have only recovered to 15.2 percent in 2012. In contrast, the historical 40-year average for revenue as a percent of GDP is 17.4 percent. The CBO expects revenues to increase to 18.6 percent of GDP by 2015, but then decrease for a few years before settling at 19.1 percent in 2023, averaging 18.9 percent of GDP over the next ten years.

Excluding deficits incurred during the two world wars, the recent record high deficits are unprecedented in the United States, trumping the deficit-financed Civil War.

The CBO reports that the deficit was eight percent of GDP for 2012, totaling \$1.1 trillion. For the first time since 2008, the budget deficit is expected to shrink to \$642 billion in 2013. By the end of the ten-year projection, however, deficits are expected to return near the \$1 trillion mark. Excluding deficits incurred during the two world wars, the recent record high deficits are unprecedented in the United States, trumping the deficit-financed Civil War.

As noted by the CBO, publicly-held federal debt has notably risen from the recent low of 35.1 percent of GDP in 2007 to 70.1 percent in 2012. The CBO expects publicly-held federal debt to rise to a high of 73.6 percent of GDP in 2014 under current law, but according to the CBO’s September 2013 *Long-Term Budget Outlook*, publicly-held federal debt is projected to continue climbing beyond 2023 to reach 100 percent in 2038.³

Figure 2



As shown in Figure 2 above, gross federal debt as a percent of GDP is estimated to be 99.7 percent of GDP in 2012, and is expected to rise to or above 100 percent of GDP for 2013 and 2014 before leveling off at 94.1 percent of GDP in 2023 at the end of the ten-year window, still more than 30 percentage points above pre-recession levels.⁴ The last time gross federal debt exceeded GDP, it occurred for three years (1944-47) as a result of World War II. With no world war at hand, this level of debt in the United States is historically unparalleled. In this dimension, the size of government is unprecedented, unchecked and expanding.

Scale

Scale is a function of government size; and there is a certain level at which the scale of government relative to the economy becomes debilitating for government-specific processes. At a certain point, legitimate functions of government can grow to a size that is no longer efficient. To avoid this, government should perform government-specific tasks at the smallest size and appropriate level of government that allows the greatest efficiency to perform the function.

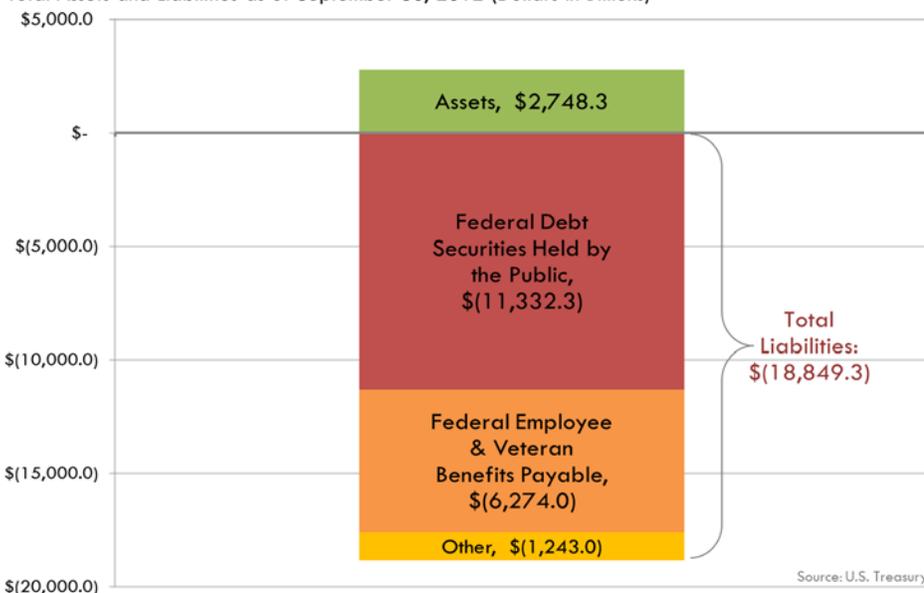
Government should perform government-specific tasks at the smallest size and appropriate level of government that allows the greatest efficiency to perform the function.

Although the thresholds are widely debated, at a certain size—relative to the economy, or the population, or an alternative metric—government does more harm than good. According to the recent Financial Report of the United States Government from the Treasury Department, as shown in Figure 3 below, the government’s assets (i.e., land, buildings, equipment, and software) totaled \$2.7 trillion compared to \$18.8 trillion in liabilities (i.e., \$11.3 trillion in federal debt securities held by the public, \$6.3 trillion in federal employee and veterans benefits payable, and another \$1.2 trillion in miscellaneous liabilities).

Figure 3

Government Assets and Liabilities

Total Assets and Liabilities as of September 30, 2012 (Dollars in Billions)



Long-term projections from the Treasury show that publicly held federal debt is projected to reach nearly 400 percent of GDP by 2087.

In addition, long-term projections from the Treasury show that publicly held federal debt (which is a component of gross federal debt) is projected to reach nearly 400 percent of GDP by 2087. The Treasury recommends for this “75-year fiscal gap,” to be closed sooner than later because “it is estimated that the magnitude of reforms necessary to close the 75-year fiscal gap increases by nearly 20 percent if action is delayed by 10-years and by more than 50 percent if action is delayed 20 years.”⁵ Despite passage of the *American Taxpayer Relief Act* (ATRA), publicly held federal debt is still projected to climb to 200 percent of GDP in 27 years, merely one year later than before passage of ATRA. Even with sequestration fully implemented under the *Budget Control Act* (BCA), debt-to-GDP would reach 200 percent in 28 years.⁶

Alternatively, if the federal government’s budget was compared to a household, and measured in terms of debt to annual tax revenue received by the federal government, then as of fiscal year 2012, the ratio of publicly-held government debt (70.1 percent of GDP) to government revenue (15.2 percent of GDP) is about 440 percent.⁷ In contrast, though not directly comparable, the ratio of household and nonprofit debt to gross disposable income was 103 percent in the same fiscal year.¹

Yet another measure of scale that is popular with credit ratings agencies is the ratio of interest on debt relative to revenue. In a recent study from former senior director of Moody’s Analytics, Marc Joffe from the Macdonald-Laurier Institute finds evidence from historical surveys that default is likely at a 25 percent interest expense to total revenue ratio. Joffe found that Canadian provinces pose high sovereign risk in the long term due to the lack of fiscal rules to balance their budgets.⁸ In addition, according to Moody’s Analytics’ Pierre Cailleteau, the largest size U.S. federal interest payments can be on public debt as a percent of tax revenue is an 18 to 20 percent outer limit for the AAA rating.⁹ Current estimated net interest payments on the debt relative to revenue are 8 percent as of 2013. However, CBO alternative extended baseline projections indicate that interest payments on the debt are expected to exceed 25 percent by 2025 and 30 percent as a share of revenue in 2027.

Scope

Using more resources under current authority has strictly to do with size and scale of government; obtaining new authority to operate newly acquired power is a function of scope. There are a limited number of roles in which solely government action is best. Examples include law and order, defense, and essential public goods.¹⁰ While there has been much talk in recent years

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¹ Data calculated by Haver Analytics by taking outstanding household debt as a percent of seasonally adjusted gross disposable income at an annual rate. Fiscal year calculation was determined using quarterly data. Debt and revenue figures reported with updated GDP revision data.

about the size and scale of government, debate over the scope of government has been less frequent.¹¹

In the book *Crisis and Leviathan*, economist Robert Higgs' main concern dealt with the "widening scope of the legislative, executive, administrative, and judicial powers exercised by the persons who constitute the federal government." Higgs identified several common motifs behind historical explanations for government growth, including:

- (1) Modernization hypothesis: a modern, complex economy requires active, extensive government;
- (2) Public goods hypothesis: the cost of producing government-specific nonexclusive public goods has grown over time;
- (3) Welfare state: increasingly crowding out private social-service roles with government roles;
- (4) Political redistribution hypothesis: growth of government is the product of political actions to seek or wield coercive powers;
- (5) Ideology hypothesis: prevailing ideologies affect the growth of government; and
- (6) Crisis hypothesis: "under certain conditions national emergencies call forth extensions of governmental control over or outright replacement of the market economy."¹²

Higgs finds the modernization hypothesis and the public goods hypothesis offer only partial explanations at best because most government expansion has been disconnected from increased complexity of the economy and nonexclusive public goods. Alternatively, he finds the welfare state, the political redistribution hypothesis, the ideology hypothesis, and the crisis hypothesis to have played a considerable role in government growth. Most notably, government expansion tends to be concentrated around highly intense events.¹³

As a caveat, despite the parameters of the Constitution, there remain some gray areas into which the federal government's role has bled; some things that are appropriate for the government to do may not necessarily be best executed at the federal level. For example, while the implementation of initial interstate road construction may be considered a role suited for the federal government, maintenance to the existing system may be better suited for state governments. These considerations could be extended to which level of government is best suited to handle reform of welfare and Medicaid. As will be discussed in greater detail further on, international examples abound for instances where there is a recognized need for funding, but no single provider, as is the case with education. Misallocated roles between levels of government can lead to distortions in both scale and scope of government. Clearly defining federal, state and local government roles is critical to determining an appropriate scope for each level.

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Congressional Mandates and Cumulative Regulations

Congressional mandates and cumulative regulations have had a large part in expanding government in terms of scope, which indicates that the government has not only expanded beyond its budgetary means, but beyond its statutory means as well. As mentioned by Representative James Lankford before the Subcommittee on Technology, Information Policy, Intergovernmental Relations, and Procurement Reform on the subject of unfunded mandates and regulatory overreach, “the preferences of a regulatory agency should not determine the budget or priorities of a State or local leader.”¹⁴ Unfortunately, this has become a common cause of government expansion, with costly effects on the private sector.

Former Bureau of Labor Statistics Commissioner Keith Hall notes that the effect that regulations have on jobs is routinely dismissed or not fully accounted for even though regulations can negatively affect jobs in a number of ways, including: (1) temporary or transitional effects that raise the cost of production; (2) long-term effects on economic efficiency as labor is used more for compliance than for production; (3) the function of matching worker skills with jobs demanded which can determine labor force participation, the unemployment rate and relative wage rates; and (4) dynamic effects on economic growth relating to international competitiveness, entrepreneurship, product development, firm creation and growth, innovation, and productivity growth. While the latter two effects are quite difficult to assess when determining the effect of a regulation, Hall argues these are the effects that may be the most important to the economy.¹⁵ Though a specific effect cannot be determined, regulatory impact analyses should recognize that the employment effect is not always insignificant even though it cannot be accurately measured.

In addition, regulation is not treated as the last-resort option to correcting a perceived problem. Agencies will state a perceived problem as required by Executive Order 12866, “Regulatory Planning and Review,” but may frequently fail to argue why regulatory action is necessary over other actions to correct said problem. As noted by economists Richard Williams and Jerry Ellig, pursuing regulation requires effective problem-solving; consideration of a range of options must include understanding the root causes of the problem and defining the outcome in order to determine the solution best fit to achieve the intended public objective.¹⁶ Absent quality analysis and justification for regulation, with consideration of the marginal cost that each new regulation adds to the existing regulatory structure, regulation may be burdensome, duplicative, or outright contradictory. Such unchecked expansion of growth in regulatory scope is destructive not only to the budget, but to the economy as well.

With consideration of the marginal cost that each new regulation adds to the existing regulatory structure, regulation may be burdensome, duplicative, or outright contradictory.

Core Mission Creep & Drift

Core mission creep refers to the expansion of a federal agency's goals or responsibilities, often after initial success. Core mission creep is a common explanation for growth in the scope of government. Similarly, core mission drift refers to a movement away from a federal agency's original goals or responsibilities toward a duplication of the goals or responsibilities of other federal agencies. Core mission creep and drift are phenomena that can sometimes occur separate from mandates.

Core mission creep can exacerbate problems associated with overlap, duplication, and fragmentation, as reported by the Government Accountability Office (GAO). The GAO defines fragmentation as circumstances in which more than one agency is involved in the same general area of national interest. Duplication occurs when two or more agencies engage in the same activity or same service to the same recipients. Overlap occurs when programs have similar goals, strategies and activities that also target similar users. In its Annual Report for 2013, the GAO identified 17 new areas where evidence of duplication, overlap or fragmentation have occurred among federal programs, with 31 additional areas where agencies could potentially achieve greater efficiencies or effectiveness in providing government services. The GAO identifies 81 actions that the executive branch or Congress could take to reduce cost or enhance revenue collections.¹⁷ In the two prior annual reports, 131 areas were identified that could achieve greater efficiency, and GAO identified 308 actions that could be taken to reduce cost. Out of the 131 areas, only 16 were fully addressed, 87 were partially addressed and 27 were not addressed at all. The green building and housing assistance initiatives had among the most agencies or entities with fragmented, duplicative or overlapping programs. As an example, as of 2011, there were 53 programs that supported entrepreneurs in a variety of ways (i.e., technical, financial, contracting), 12 of which came from Housing and Urban Development (HUD), 19 from Small Business Administration, 14 from the Department of Agriculture (USDA), and 8 from the Department of Commerce. The GAO noted that for 39 of the 53 programs, the four agencies had either not conducted a performance evaluation or conducted only one in the last decade, making it difficult to determine the performance and effectiveness of these programs.¹⁸

In a study examining the politics and precedence set by the *Administrative Procedures Act* (APA), two pitfalls within core mission drift were identified: agency drift and political drift. Agency drift refers to the instances in which an agency adopts policies that are inconsistent with its statutory mandate as originally agreed upon by elected officials. For example, if an agency's purpose is to ensure domestic markets remain competitive, then the capture of the agency's purpose by a regulated industry intending to achieve protection from competition represents agency drift. Political drift occurs

Core mission creep can exacerbate problems associated with overlap, duplication, and fragmentation.

Within core mission drift, agency drift refers to the instances in which an agency adopts policies that are inconsistent with its statutory mandate. Political drift occurs when an elected official has power to mandate the agency to adopt policies that differ from its core mission.

when an elected official has power to mandate the agency to adopt policies that differ from the coalition of elected officials that enacted the original statute. Both agency and political drift represent a movement away from an agency’s core purpose. In cases of political drift, if institutional arrangements allow for a subset of elected officials to have influence over an agency (i.e., congressional committee oversight, presidential appointment of agency leaders or judges who review agency decisions), policy decisions can be pulled away in ways that would not be possible by statute. The study postulates that when significant differences of opinion divide the House, Senate and President, corrective legislation to amend agency drift is not possible because at least one of the three will prefer the deviation from the agency’s core purpose.¹⁹

The Disconnected Spending and Revenue Processes

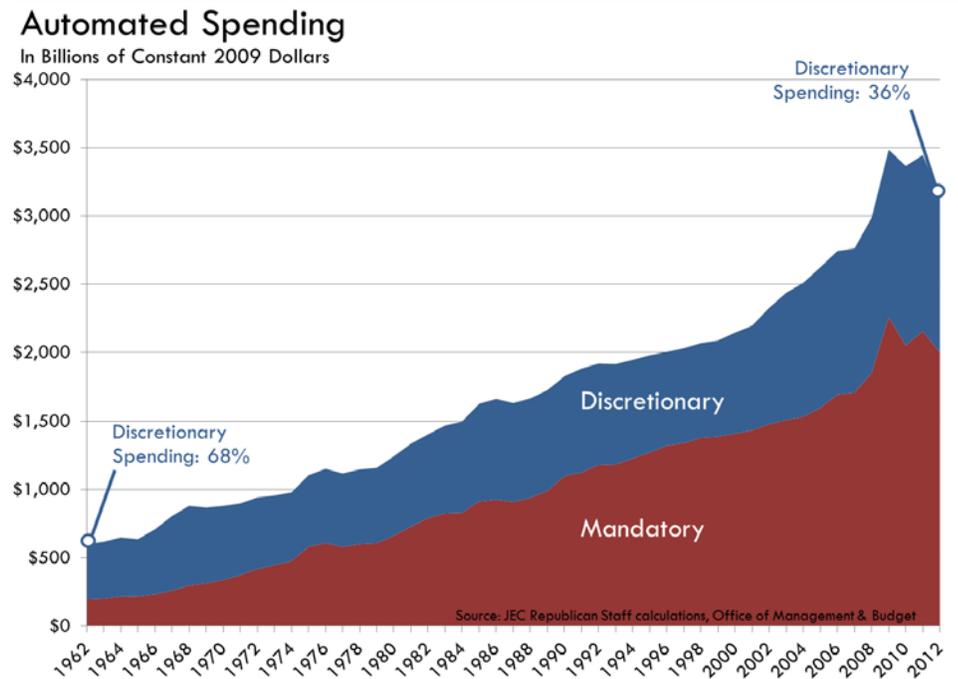
Automated Spending

The composition of spending has dramatically changed over the past 50 years. At one time, discretionary spending comprised 68 percent of federal spending.

In 2012, however, discretionary spending fell to a mere 36 percent of federal spending.

The composition of spending has dramatically changed over the past 50 years. At one time, discretionary spending, which is debated and voted upon annually by Congress, comprised 68 percent of federal spending, with the remainder spent on mandatory programs, such as Social Security and Medicare, and interest spending. In 2012, however, discretionary spending fell to a mere 36 percent of federal spending, virtually reversing the former ratio to mandatory spending programs and interest spending, as shown in Figure 4.²⁰

Figure 4



Nondefense discretionary spending as a percent of GDP is expected to reach historic lows by 2022 and beyond, despite the CBO’s forecast of total

spending reaching an above-average 21.8 percent of GDP in 2022 and 2023. This decrease in nondefense discretionary spending, and in discretionary spending overall, is offset by increases in mandatory spending and interest spending.²¹

As statistician Nate Silver observes, in the post-WWII period, defense spending remained the outright majority of the primary spending category until 1970, at which point entitlement programs combined with interest, infrastructure, and services spending shifted defense spending to less than half of total spending, though it was still the largest single category. Notably, between 1972 and 2011, spending on entitlement programs grew 4.8 percent annualized while spending on infrastructure and services grew 2.7 percent annualized, and defense grew only two percent annualized, relative to 2.7 percent annualized growth in GDP, all net of inflation. As an alternative view, as a percent of total federal budget growth over the same time period, entitlement programs grew 10.2 percent relative to 0.1 percent growth in infrastructure and services spending, and defense shrank in net contribution to the budget by 1.8 percent.²²

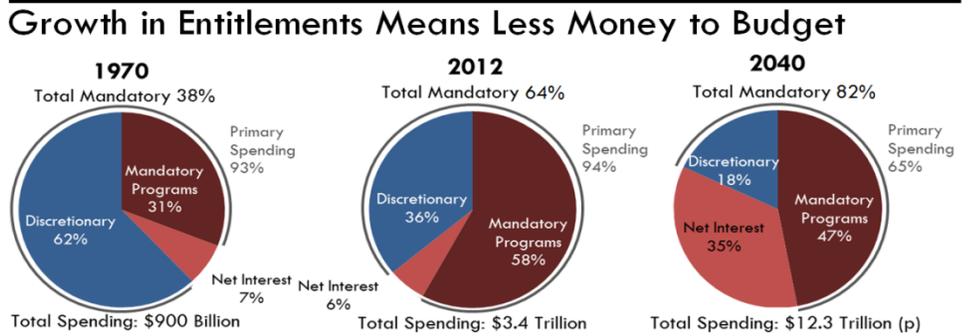
While the amount of federal spending has grown by virtually every measure, the ratio is notable because, between 1962 and 2012, mandatory outlays grew 925 percent in constant fiscal year (FY) 2009 dollars while discretionary spending grew 182 percent. However, GDP grew 367 percent between 1962 and 2012 in constant FY 2009 dollars. Relative to GDP, mandatory outlays grew 136 percent while discretionary outlays shrank 35 percent over the same time period.ⁱⁱ

According to the Federal Reserve Bank of Philadelphia, between the 1960s and 2010, the composition of spending shifted from temporary and redistributive expenditures. Hence, while more than half of federal spending was devoted to national defense in the '60s and to fund other temporary expenditures, this spending has diminished in favor of targeted and redistributive expenditures such as unemployment, Social Security, health and education.²³ Economists Veronique de Rugy and Jason Fichtner find that the shift in the composition of government spending on the current trend would result in 82 percent mandatory programs including interest (47 percent entitlement programs and 35 percent in net interest) and a mere 18 percent in discretionary spending in fiscal year 2040 as shown in Figure 5.²⁴

While more than half of federal spending was devoted to national defense in the '60s and to fund other temporary expenditures, this spending has diminished in favor of targeted and redistributive expenditures such as unemployment, Social Security, health and education.

ⁱⁱ JEC Republican Staff calculations based on data from the Office of Management and Budget and Haver Analytics using revised GDP data.

Figure 5



Source: Veronique de Rugy and Jason Fichtner, Mercatus Center at George Mason University, Office of Management and Budget, Government Accountability Office, Congressional Budget Office via Peter G. Peterson Foundation. Note: All figures are in constant 2009 dollars. Authors calculations for 2012.

As shown in Figure 5 above, primary spending is mandatory and discretionary spending less interest spending. Mandatory spending consists of mandatory programs and net interest spending, while discretionary spending, including defense, is subject to annual budgets. With less and less of the budget to prioritize every Congress, policymakers are left to debate over a relatively decreasing portion of the budget, whereas if the process changed to allow for all programs excluding interest to be on the table for debate every year, growth could be restrained based on primary spending prioritization. As Silver notes in his *New York Times* blog:

*We may have gone from conceiving of government as an entity that builds roads, dams and airports, provides shared services like schooling, policing and national parks, and wages wars, into the world’s largest insurance broker... Most of us don’t much care for our insurance broker.*²⁵

While there are repeated calls for ending wasteful spending, and plenty of examples identified as waste, addressing these items alone fails to solve the less politically feasible problem of reforming entitlements.

While there are repeated calls for ending wasteful spending, and plenty of examples identified as waste, addressing these items alone fails to solve the less politically feasible problem of reforming entitlements, as pointed out by Gerald Seib in a *Wall Street Journal* article. Even as payrolls at all levels of government fall, mandatory entitlement spending continues to increase, notably spiking in 2008 and remaining at elevated levels as a percent of GDP. As Seib states, government “is turning increasingly into an entitlement machine, dispensing benefits to those who qualify, while a combination of recession, deficits and an aversion to new taxes is squeezing most remaining government activity.” Similar to Silver’s sentiments above, Seib concludes that it’s too simplistic to argue that government is only growing or shrinking; it is changing, shifting and redefining the debate more broadly than on size, but rather on the roles of government for the future.²⁶

Federal Transfers to States

Federal transfers to states have increased in recent years, increasing the dependence of state governments on federal transfers with strings attached in order to balance budgets. From the federal side, this is a manifestation of

the disease of government growth; increased state dependency on this form of revenue is then the symptom. As economist Veronique de Rugy notes, the transition of control from state and local levels to federal subsidization with strings attached has been made possible by a growing spending category in the federal budget, grants-in-aid. There were 1,724 grants doled out in FY 2011, ranging in purpose from hiring teachers to farm subsidies, reaching \$515 billion and up 160 percent since the start of the 1990s. This sum is reflected in state spending habits as well; within a decade, the federal share of total state spending increased from nearly 26 percent in 2001 to over 34 percent in 2011. With strings attached to these dollars comes micromanagement from the federal level, particularly in primary education programs. Since federal micromanagement programs generally come with “one-size-fits-all” rules, natural policy diversity and the drive for states to find innovative and unique solutions to their problems are diminished.²⁷

States receiving federal funds as part of their resources tend to spend those funds less efficiently than if the funds came from their own state revenue. Research demonstrates that when the *American Recovery Reinvestment Act* (ARRA) allocated \$144 billion in funds to states, states generally used the funding to patch revenue gaps in the short term, which covered up persistent structural problems. In one case, a Pacific Northwest state analyst cited strict “maintenance-of-effort” requirements that reduced the efficiency of the state administration’s resources, and state taxes increased in order to maintain state spending at ARRA stimulus levels.²⁸

In fact, in relation to the effects of federal aid to the states, recent research has focused on what is known as the “ratchet effect,” which occurs as a result of temporary government programs implemented in a crisis having a permanent effect in the long term of increasing spending even after the crisis has passed. The evidence shows that in the short term, for every \$1 of federal grants received, a state can reduce its total state-specific revenue by \$0.73 and its total tax revenue by \$0.64. In the long term, however, every \$1 in federal aid received in past federal grants, states must increase their total state-specific revenue by \$0.42 and their total state tax revenue by \$0.33. Applying this to ARRA, the study estimates that future state taxes will increase by between 33 and 42 cents per \$1 in federal aid received. This suggests that an expansion at the federal level will also lead to a permanent expansion at the state and local levels of government.²⁹

Monetary Instability

Monetary instability can be a source of unchecked government growth. Monetary policy affects output and employment in the short term and determines prices in the medium and long terms. Therefore, monetary policy affects program spending, tax collections, and interest costs, which in turn can affect productivity growth and innovation. The shift away from a “rules-based” monetary policy in favor of activist, interventionist, and discretionary monetary policy since the end of the Great Moderation has

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affected the accuracy of budget projections and increased fiscal unsustainability by undermining the strength of the U.S. dollar. In addition, the expected persistence of future budget deficits begets political pressure leading to inflationary monetary policy and meddling in fiscal policy.

As discussed in a recent JEC Staff Commentary, while the interventionist actions of the Federal Reserve in the early 2000s are not solely to blame for what led to the financial crisis and subsequent recession, the cumulative effect of monetary ease via rapid reduction in the target rate for federal funds—in light of deflationary fears following the tech stock bubble and 9/11 terrorist attacks—certainly added to the turbulence and economic volatility, including the housing bubble that followed.³⁰ Unfortunately, the Federal Reserve has continued to use unconventional measures, including quantitative easing, to artificially boost lending. Presently, as a result of quantitative easing, more than \$1.9 trillion sits as excess reserves for lending potential in depository institutions. As economist Bruce Yandle notes in his quarterly economic update, most of the money that the Federal Reserve has injected into the economy remains in banks' reserves. If these excess reserves were lent too quickly, there would be rapid inflation as a result. Given that the economy is averaging annual growth at roughly two percent, fears of high inflation rates are minimal.³¹ Yet the Fed's actions have resulted in increased market uncertainty; increased risk of inflation once the recovery strengthens; and are associated with a period of economic volatility and subpar economic performance.³² Subpar economic performance and slower economic growth have the effect of magnifying government growth relative to the economy, which results in less revenue and resources for government spending to consume sustainably.

The current near-zero interest-rate policy, combined with the current tax system, has increased the likelihood of a negative real yield on investments, further reducing the incentive to invest, which is vital to economic growth.

In fact, the current near-zero interest-rate policy, combined with the current tax system, has increased the likelihood of a negative real yield on investments, further reducing the incentive to invest, which is vital to economic growth. Higgs extends an example described by Richard Rahn in *The Washington Times*:

...given the currently prevailing rates of interest, rate of inflation, and tax rates, a small investor who earns a nominal yield of 1% and pays a 20% marginal tax rate, while the rate of inflation is 3.5 %, actually ends up paying a real tax rate of 370%. For example, an investor buys a \$100,000 CD, earns \$1,000 in annual interest, pays a tax of \$200, and incurs a loss of \$3,500 in purchasing power on the invested principal. Total (nominal) income is \$1,000; total real tax (nominal tax plus inflation tax) is \$3,700.³³

Higgs' goes on to note that savings and small-time deposits, overnight repos at commercial banks, and non-institutional money market accounts total to more than \$7.5 trillion. If the investment loses 2.7 percent annually by way of tax on the nominal yield and through inflation, the loss amounts to

roughly \$204 billion. Considering that the money stock increased and subsequently decreased the dollar's purchasing power, capital that investors have accumulated during their working years in anticipation for retirement is depleting significantly as a result of recent Fed actions. This puts a strain on both savers and recent retirees attempting to make ends meet between Social Security and nest eggs, ultimately placing further dependence upon the already-strained Social Security trust fund and entrenching recipients that have little alternative.

Symptoms of Fiscal Unsustainability

Symptoms of the causes identified in the last section have the effect of distorting the underlying problems and their negative effects on economic growth as well as making it more politically difficult to focus and come to a consensus on fiscal consolidation and pro-growth reforms. These conditions affect biases toward higher government spending.

Higher, More Progressive Taxes

Tax Progressivity

Increased tax progressivity is a symptom of expanding government commitments in an effort to afford those commitments and usually predicated upon ensuring the wealthiest pay what is deemed “fair.” Recognizably, the more something is taxed, the less there is of it. However, the higher tax—increasing the user cost of capital, the minimum rate of return an investment must yield to be profitable—translates into an increasing likelihood that resources are misdirected away from their best uses:

High marginal tax rates reduce wealth creation in more ways than is immediately obvious. High tax rates not only reduce incentives overall, they also alter and rearrange incentives... The worst damage done by high tax rates is the way they distort decisions in the economy and result in a misallocation of resources.³⁴

The user cost of capital is the real rate of return sufficient to cover the investment's tax cost, depreciation, and its real opportunity cost of funds. Increasing capital investment is a vital component to economic growth, and government policies should be designed to enhance and encourage private sector opportunities to make productive investment decisions. Unstable policy can affect not only the amount of investment, but the timing and the type of investment as well. Certain tax incentives that promote specific types of investment can lead to “overinvestments,” which are investments in too much of a particular line of production, and can also lead to “malinvestments,” which are investments in the wrong lines of production compared to the real long-term demands of the economy. As a result, these

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The United States has among the most progressive taxes by comparison to other OECD countries.

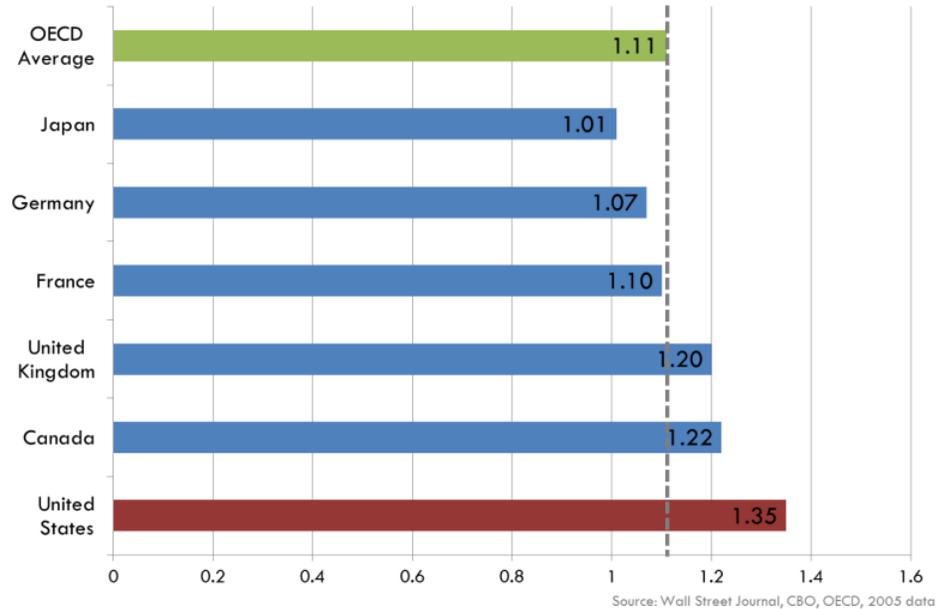
misled investments may contribute to unsustainable asset bubbles, distort the natural market process, and prevent investments from channeling to the best and most efficient use.³⁵ Furthermore, temporary incentives only promulgate the uncertainty about the long-run direction of government policy and discourage long-term investment decisions.

From both an international and historical perspective, the U.S. tax code is quite progressive. As pointed out in a recent JEC Republican Staff Study, the Joint Committee on Taxation (JCT), the Organisation for Economic Co-operation and Development (OECD) and many others note that the U.S. tax system is quite progressive relative to other major developed economies, and this progressivity has been growing steadily.³⁶ For example, the richest ten percent in the United States pay 1.35 times their share of income compared to Canada’s 1.22 times, and the OECD average of 1.11, as shown in Figure 6 below.³⁷ According to *The Wall Street Journal’s* David Wessel, in the 1980s, the top five percent earned an average 22.6 percent of income and paid an average 28.5 percent of taxes, compared with the 2000s during which the top five percent earned an average 28.4 percent of income but paid an average 40.3 percent of taxes.³⁸

Figure 6

Taxes vs. Income for the Richest 10%

By country



Economist Kevin Hassett finds that with the passage of ATRA and the new top marginal tax rate increases, the top federal income tax rate on single earners making \$400,000 annually and married earners making \$450,000 annually rises to 40.8 percent, or three times what an average earner with \$30,000 in annual income pays, once the phase outs for deductions and exemptions are accounted. By this measure, Hassett goes on to point out only four modern economies have higher rates: Finland, Germany, France and the Netherlands. While the analysis dealt strictly with income tax and

excluded items like the value-added tax (VAT), if value-added taxes were added in—which are regressive consumption taxes in place in most OECD countries—this addition would make the United States appear to have even more progressive taxes by comparison. Hasset goes on to point out a 2008 OECD study found similar results:

... [T]he wealthiest 10 percent of Americans paid 45.1 percent of taxes (including direct taxes, such as income and payroll taxes, national and local, but excluding sales and other indirect taxes), compared with the OECD average of 31.6 percent; and wealthy Americans paid more than the wealthy in any other OECD country even if one takes into account their share of total national income.³⁹

With the United States reaching unmatched progressive levels of taxation, evidence shows that more progressive taxation harms growth. At the state level, it is noted in a recent study discussing the macroeconomic effects of progressive taxation that with three years of lag, a current year's tax progressivity has a strong negative effect on current year annual gross state product growth. The author, Tae-hwan Rhee, concludes that while the regressions show only correlation and not causality, they do reinforce the theory that there is a "tradeoff between economic growth and egalitarian redistribution." Possible reasons Rhee offers for the tradeoff include: (1) migration of highly productive, high earners that leave when a state's tax code becomes more progressive; (2) reduced incentive to work as productive earners tradeoff higher income under progressive taxation for more leisure; and (3) weaker entrepreneurship as gains from taking big risks diminish under a more progressive tax scheme.⁴⁰

Taxes Favor Consumption

The income tax penalizes saving and investment, which are a major source of economic growth over time. Economist Alan Viard notes, "Under an income tax, a worker who saves to consume in the future is taxed more heavily than a worker who consumes today." In both cases, the worker pays taxes on wages, but the worker who saves must also pay taxes on the returns to his or her savings.⁴¹ Thus at the federal level, investment is taxed twice, whereas consumption is only taxed once. Currently, the income tax and taxation of capital create a less than optimal amount of saving because savers receive less in after-tax interest than borrowers pay in pre-tax market interest, thus creating the "wedge" to which economists commonly refer.⁴²

If corporate income tax was included, that adds a third level of taxation to dividends and capital gains. Because corporations may deduct interest payments and not dividends, the double taxation (first on earnings from new investments, and again on dividends and capital gains) induces corporations to rely on debt finance in part, or if a large corporation, rely on their retained

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earnings (to which lower tax rates currently apply), to make investments. As an example, a corporation that would raise 50 percent debt and 50 percent equity in a scenario with no tax distortion might actually raise 70 percent debt and 30 percent equity under the current tax treatments of debt and equity.⁴³

The savings rates in most advanced economies have been falling for the past quarter of a century.

As reported in a prior JEC Republican Staff Commentary, taxes on capital gains are typically lower than the initial taxation of wages because policymakers have understood that: (1) investment has positive effects on productivity, output, employment, and wages; (2) the effects of inflation erodes capital gains; and (3) lower tax rates on investment minimizes the “lock-in effect” in which investors hold onto assets instead of selling them to avoid taxes.⁴⁴ Thus, lower savings and investment rates can be problematic. According to a report from the Tax Policy Center, low saving rates reduce economic growth and economies become more dependent upon capital imports to continue investment. Notably, the savings rates in most advanced economies have been falling for the past quarter of a century.⁴⁵ Knowing that the government still must collect revenue, this has prompted many scholars to advocate a consumption tax, a tax on what is spent rather than what is earned, in place of an income tax, because it would eliminate the tax wedge on savings between current consumption and future consumption, and thus increase savings in the total economy to the optimal amount.⁴⁶

Tax Gimmickry

In recent research from the Mercatus Center, four types of tax gimmicks were identified that can mislead taxpayers about the incidence, purpose, and degree of particular taxes: (1) legislative gimmicks (e.g., complex tax provisions that mask the effect of tax changes to the individual taxpayer), (2) economic gimmicks (e.g., employer-paid taxes on behalf of employees), (3) communication gimmicks (e.g., confusion in discussions of marginal and effective tax rates), and (4) perceptual gimmicks (e.g., “temporary” tax provisions). The more hidden a tax is from voters, the more easily the tax can be increased.

As an example from the research, calling taxes or tax cuts, “temporary” is a perceptual gimmick, because it implies that the tax will occur for only a short period of time, when in fact, policymakers may frequently extend the provision, or write legislation in such a way that the tax is made permanent by inaction to remove it. Another perceptual gimmick is income tax withholding, which removes the portion of taxed income before the payee even receives it. The endowment effect (the perception that something is more valuable when owned than when the same thing is not owned) would make a taxpayer feel worse and more cognizant of receiving \$1,000 in income and having to pay \$100, than he would if he received \$900 with the \$100 in tax already taken out.

The study notes that inflation can be used as both a legislative and economic gimmick. In the former, legislation can exclude provisions that account for inflation, such as the new Medicare tax on unearned income, which is not indexed for inflation. In the latter, expanding the money supply can have the same effect on taxpayers as if the government had increased tax rates.⁴⁷

Tax Loopholes versus Tax Reform

In order to understand the difficulties associated with tax reform, it is important to distinguish between types of expenditures offered in the current tax system to reduce effective tax rates. The Tax Policy Center explains that tax expenditures are generally implemented to measure income accurately, distribute benefits and burdens based on ability to pay, and promote particular activities and behaviors. Tax expenditures can come in the form of deductions, exemptions, exclusions, preferential rates, deferrals, or credits. Credits themselves can be refundable (i.e., earned income tax credit, additional child tax credit), which can reduce tax below zero resulting in a refund or negative tax liability, or non-refundable (i.e., child and dependent care credit, lifetime learning tax credit), which can reduce tax owed to zero. According to the Tax Policy Center, in 2008, deductions and exclusions amounted to 81 percent of major individual income tax expenditures, with the remaining one percent non-refundable tax credits, and 18 percent in refundable credits.⁴⁸ Depending on the type of expenditure, the incidence can be either (1) a reduction in tax owed, or (2) federal spending to offset more than, all, or part of taxes owed, but the effect remains a reduction in tax revenue.⁴⁹ According to the Tax Foundation, in 2010, the percent of tax filers with zero or negative tax liability was at a high within the past 50 years, at 41 percent of all filing units (those that filed tax returns).⁵⁰ Including non-filing units, with its own data the JCT estimates approximately 51 percent of all tax units had zero or negative tax liability.⁵¹

Also termed tax “loopholes,” tax expenditures implemented to offset progressive rates are more politically feasible than tax reform, but not broadly beneficial to taxpayers or the economy. The *Budget Act of 1974* defines tax expenditures as “revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.”⁵² There is some contention surrounding what can be considered a tax expenditure. For example, while the mortgage deduction could be argued to be a tax expenditure because the government is subsidizing owner-occupied housing, when a business can take advantage of an accelerated depreciation schedule, this could be argued as a tax preference rather than a tax expenditure because it does not redistribute or subsidize, but rather abstains from taking additional resources from the business.

In a Taxpayer Advocate Service (TAS) survey conducted in 2012, 73 percent of respondents said “the wealthy have ways of minimizing their Federal

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Tax complexity clouds the transparency of the tax system, and transparency is critical to maintaining high rates of tax compliance.

taxes that are not available to the average taxpayer.”⁵³ For fiscal year 2013, the JCT estimates that tax expenditures will amount to \$1.3 trillion with \$1.1 trillion from individual tax expenditures.⁵⁴ Tax complexity clouds the transparency of the tax system, and TAS notes that transparency is critical to maintaining high rates of tax compliance. Note, for example, the way in which the current tax system distorts resources, even when it comes to paying taxes. As the Tax Foundation pointed out in 2005, at that time, the federal tax system cost \$265.1 billion in compliance, or six billion hours due to complexity.⁵⁵

A more recent example of how loopholes proliferate in the absence of tax reform can be found in the ATRA. As noted by de Rugy, the \$68 billion cost of extending special-interest tax breaks for businesses for fiscal year 2013 (another “temporary” set of tax provisions, which were set to expire with the onset of the fiscal cliff) will exceed the \$62 billion ten-year average revenue estimate expected to be raised from increasing taxes on the rich.⁵⁶ Notably, the revenue raised from increasing tax rates on the rich is essentially cancelled out, or made up for, by allowing special-interest deductions to redirect resources away from their best use and entrench special-interest groups with generous government subsidies.

Raising taxes fails to solve the problem of spending revenue inefficiently, and instead turns spending inefficiently into the status quo.

Economist Russ Roberts emphasized in written testimony before the Senate Budget Committee that eliminating wasteful spending in the tax code extended beyond the prevention of spending more than is received. Raising taxes fails to solve the problem of spending revenue poorly and instead turns poorly spent funds into the status quo. Roberts notes that no one is against helping the needy, children, or the elderly, but that a lot of the spending goes to people who are politically important (and therefore most likely to lobby or vote for special interests) rather than to those who need it most.⁵⁷

The last time large-scale tax reform occurred was with passage of the *Tax Reform Act* (TRA) of 1986. No major changes on par with TRA had occurred in the 50 years prior. Even in 1986, the reform, though broad and deep, wasn’t complete simplification. As of 2006, in the 20th year of TRA’s anniversary, Congress had passed nearly 15,000 changes to tax law.⁵⁸ While some loopholes that TRA eliminated have returned, most tax expenditures implemented since TRA are new. Now, 27 years later, taxes have gradually risen; the top marginal federal individual income tax rate rose to 39.6 percent with the passage of ATRA, partially reversing the original top tax rate cut from 50 percent to 28 percent in 1986. There are now many tax brackets, whereas 1986 reform brought about only two: 15 percent and 28 percent. Tax treatment of interest expense and passive activity losses have remained complicated despite reform.

Research from the Tax Foundation’s Gerald Prante in 2006 noted that those who forget history are doomed to repeat it, recalling that economists Milton Friedman and Martin Feldstein, former Council of Economic Advisers (CEA)

chairman under President Ronald Reagan, warned that the TRA was not real reform because it failed to completely overhaul the system. At the time, Feldstein penned an article in *The Wall Street Journal*, “All of the major tax-code provisions targeted by tax reformers for so long... have now been judged to be either socially desirable or politically untouchable.”⁵⁹ Feldstein noted in an article 20 years later that where the TRA of 1986 reform failed, there is considerable opportunity for benefitting from real reform. Feldstein noted that, based on experience, the combination of base broadening and rate reduction could increase tax revenue by an amount equivalent to four percent of existing revenue in 2011.⁶⁰ However, Prante notes that real reform is difficult because specific tax provisions benefit special interests heavily even though the typical taxpayer benefits only marginally; thus, while the overall benefits of a real tax overhaul outweigh the status quo, special interests have a much stronger incentive than the typical taxpayer to lobby Congress for specific tax provisions.⁶¹

While it is unlikely that all tax expenditures would be eliminated, ideally, tax reform would remove the necessity of tax expenditures in the first place. For example, taxes on dividends and long-term capital gains are given “preferential treatment” for their aforementioned benefits as discussed earlier in the section, “Taxes Favor Consumption.” They are the second and fifth largest tax expenditures ranked by the JCT and Treasury, respectively.⁶² However, if hypothetically, tax reform were to shift from taxation of income to solely taxation of consumption, the need for preferential treatment would no longer exist. A study from the Mercatus Center’s Jason Fichtner and Jacob Feldman notes that a broad-based consumption tax with no exemptions in place of an income tax could restrict the very opportunities for special-interest rent-seeking behavior that crept back into the income tax code in the years following TRA. The study further argues that TRA failed to remove the largest tax expenditures that have continued to grow in the years since, and that these expenditures thought to be “politically untouchable” must be on the table if the tax code is to promote strong and stable economic growth, which will generate strong and stable revenue. The study concludes suggesting that perhaps institutional reforms are necessary to prevent the proliferation of future tax expenditures.⁶³

Persistent Deficits

Deficit spending persists because, although most people can agree that cutting spending is necessary, there is currently very little agreement on specific cuts for the very reasons that tax reform is also so difficult: Virtually every spending program is a sacred cow to some particular interest group.

Automatic sequestration, for example, was publicly acceptable and politically feasible to attach to the *Budget Control Act of 2011* because across-the-board cuts achieve the sense of general spending cuts without naming particular programs that are known and liked. However, the goal of

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finding specific cuts, in order to avoid the pain of across-the-board cuts, proved too elusive.

Agreements on specific spending reductions, let alone agreements to slow the overall growth of spending, are made more difficult to obtain by political tactics intended to incite fear about said reductions. In the weeks leading up to, and through, the implementation of sequestration, there were claims made about the degree of damage that across-the-board cuts could do in absence of targeted cuts. As economist Thomas Sowell argues, when an agency faces cuts, often programs with the highest priority are cut, because budget politics dictates that cuts in priority spending will ensure that budget cuts will be restored since it raises public alarm. As an example, Sowell points out that at the local level, the first response is to cut spending on police departments and fire departments.⁶⁴ This tactic is also known as “Washington Monument Syndrome” or “firemen first principle,” which is used to cut the most visible and valued services provided by government.⁶⁵ If less important projects were cut, then the likelihood of restoring cuts decreases because the necessity of less important projects could be called into question.

Warped Incentives and Moral Hazard

Resource Misallocation

Relating to the efforts employed by special interest groups for particular tax expenditures or spending programs, resources in the forms of money and talent can be redirected away from their best use to be spent instead on legally avoiding penalties and taxation, or on gaining political favors against competition. In turn, individual taxpayers may base their decisions in part upon specific tax incentives for a particular activity, when in its absence the individual would abstain from putting resources, or as many resources, to that particular use. When a number of individuals or businesses are responding to a particular incentive in this way, it can help to create instability in the marketplace or often manifest in a bubble, which once burst, can have detrimental effects on the whole economy.

Resource misallocation can occur when individuals and firms must place undue effort into compliance with myriad regulations at the opportunity cost of time spent creating innovative products and services.

Resource misallocation can occur when individuals and firms must place undue effort into compliance with myriad regulations at the opportunity cost of time spent creating innovative products and services. Economists Nicole V. Crain and W. Mark Crain found that annual regulatory compliance costs amounted to \$1.752 trillion in 2008.⁶⁶ Based on data for the cost of “major” regulations alone (those estimated to cost more than \$100 million) issued between 1993 and 2011, the Manufacturers Alliance for Productivity and Innovation (MAPI) estimates the cost to be between \$265 billion and \$726 billion (in constant 2010 dollars) annually for the economy.⁶⁷ However, it is important to note that 95 percent of the 4,128 regulations in the pipeline as of 2012 did not meet the minimum threshold to be

considered “major” regulations requiring cost-benefit analysis, and thus the cumulative cost is difficult to determine, but no less burdensome.⁶⁸

Unsustainable Commitments

Unsustainable commitments to expanding entitlement programs become politically difficult to cut or eliminate in the face of automatic spending with a strong constituency that supports its continuation. According to the CBO, entitlement spending will reach the current 40-year annual average for revenues, 17.4 percent of GDP, in 2064 and continue to climb, leaving virtually no revenues for other federal spending programs.⁶⁹ Evan Soltas notes in a recent *Bloomberg* article that a new class division may be coming that stems not from income, but from age. According to the International Monetary Fund (IMF), Americans that were between 60 and 65 years old in 2010 have underpaid \$292 billion in taxes to cover the costs of pensions and medical care for themselves. If benefits remain unreformed for future generations, the IMF estimates that tax revenue would have to rise another 57 percent to fully fund the gap. If benefits were reformed instead to keep tax receipts unchanged, Social Security would have to be cut by 27 percent and Medicare by 33 percent.⁷⁰

This does not bode well for younger generations, who according to a recent Urban Institute study, have not accumulated as much wealth as their parents did at their age. Between 1983 and 2010, the study notes that Generation X (ages 20-28), have seen their average net worth rise 26 percent, while Generation Y (ages 38-46) saw only a 5 percent increase. Most strikingly, the age group overlapping Generation X and Y (ages 29-37) saw a 21 percent decrease over the same time period. These pale in comparison to the gains of the Baby Boomers and the Silent Generation, whose average net worth increases are as follows: 76 percent for ages 47-55, 120 percent for ages 56-64, 79 percent for ages 65-73, and 149 percent for those age 74 and older.⁷¹ Considering that younger generations already have fewer assets on average than the older generations, there will likely be less that younger generations can afford to pay into Social Security and Medicare in the face of shifting demographics and the continued influx of retiring Baby Boomers.

Discouraged Savings

Evidence demonstrates that entitlements have the discernible effect of discouraging savings, and the recent policy responses to the recession have amplified this effect.

Economist Daniel Mitchell notes that Americans used to save for their retirement, but with the advent of Social Security and funding through the mandatory payroll tax, this incentive has notably diminished. So too for saving for health care expenses: government health care programs, including Medicare and Medicaid, have replaced savings for health care related expenses, and created some additional maligned incentives in the

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process, such as opting for unnecessary health care services and procedures. Numerous studies have demonstrated the effects that programs like Social Security have on private savings, reducing private savings by as much as 60 cents for every dollar of Social Security benefit. Unlike Social Security, which pays current retirees with payroll tax dollars taken from current workers, private systems are typically based on a certain percentage of income that workers set aside every year.⁷²

Unfortunately, many in the United States have come to view Social Security as their main form of retirement income, either by inability or by choice to save very little else in retirement savings programs like 401(k)s and IRAs. This results in an increased difficulty to make reforms to entitlement programs, because many believe they have paid a substantive amount into the Social Security system through payroll taxes. As aforementioned, however, the typical retiree has paid into a system that has underfunded the retirement benefits it currently provides because it has failed to collect enough payroll tax revenue tantamount to the cost of those benefits.

In a recent survey from the Employee Benefit Research Institute of workers' retirement savings habits, those who responded they were "not at all confident" they would have enough money in retirement rose sharply from just ten percent in 2007 to 28 percent in 2013, which is the highest level in the survey's 23-year history, while those who responded "very confident" fell from 27 percent in 2007 to 13 percent. Fortunately, based on 2012 projections, many workers now can expect to live much longer than previous forecasts estimated in 2000, but this can stretch currently low levels of retirement savings even thinner. In 2008, 49 percent responded they had less than \$25,000 in savings and investments (excluding homes and traditional pensions), but this number has dramatically increased to 57 percent in 2013.⁷³

There are international examples that provide alternative solutions, such as the system in place in Australia, which has changed incentives to encourage private savings:

Encouraging people to make provision for themselves can also have important political effects. This helps build consensus that funding is not just the job of the government, and means that rather than demanding expansion of the welfare state, voters will look to governments to introduce pro-growth policies.⁷⁴

An aging population will put pressure on countries with a relatively small private contribution to further expand their welfare states, while countries with larger private contribution would have greater flexibility to implement competitive tax systems and other pro-growth policies.

According to a recent study, which highlights the merits and pitfalls of the welfare states in the United Kingdom, Australia and New Zealand, Australia has set itself apart by encouraging a nation of savers and increasing private contributions to health care. The study finds that countries with welfare states in the best shape have strong "private pillars" as well as a public one, because then public resources can be targeted to those with the greatest

need and made more efficient by spreading out risk. The study goes on to note that an aging population will put pressure on countries with a relatively small private pillar to further expand their welfare states, while countries with larger private contribution would have greater flexibility to implement competitive tax systems and other pro-growth policies.⁷⁵

Crowding-Out Effects

As noted in a working paper from the Mercatus Center, the term “crowding out” refers to the contraction in economic activity due to deficit-financed government spending. “Crowding out” affects private enterprises in a number of ways, including through government transfers or by creating a lack of private initiative in the presence of government resources. For example, government competes with entrepreneurs to finance their programs and activities, raising the cost of financing similar programs and thereby reducing the return on the cost of capital for the entrepreneur. At the aggregate level, the paper cites CBO figures that demonstrate the effect that crowding out has on GDP, which estimates that crowding out will reduce real GDP per capita by six percent in 2025 and by 15 percent in 2035, amounting to a cost of \$1.2 trillion in lost economic activity by 2025.⁷⁶

In testimony before the Senate Budget Committee, Russ Roberts also argued that if government spending fell, there would be more private spending, noting that great organizations (and in particular, great charitable organizations) cannot be replicated, but that they must be grown. Government does a better job of providing the “soil,” or rather the foundation of rule of law and property rights that enable businesses to spend on worthy initiatives that government fails to replicate. Smaller government thus enables organizations to thrive.⁷⁷

Not only does government spending crowd out private business initiative and investment, but a high debt-to-GDP ratio can crowd out capital resources for business investment as well. In testimony before the Joint Economic Committee, former chair of the Council of Economic Advisers, Michael Boskin, points out that a high debt-to-GDP ratio also crowds out private business investment as holdings of government debt replace capital. Less capital investment means slower development and distribution of innovative new technologies, which also reduces future income.⁷⁸

State Dependency on Federal Transfers

As previously noted, federal transfers to states are a cause of government growth, and transfers from the federal level to the state and local levels can impair the ability and function of state and local governments in their roles to carry out what is best for their unique geographic and demographic characteristics. Centralizing funding and decisions handed down from the federal level impedes the natural “lab experiment” that occurs as a result of having fifty states trying out policies that befit the individual needs in each

Not only does government spending crowd out private business initiative and investment, but a high debt-to-GDP ratio can crowd out capital resources for business investment as well.

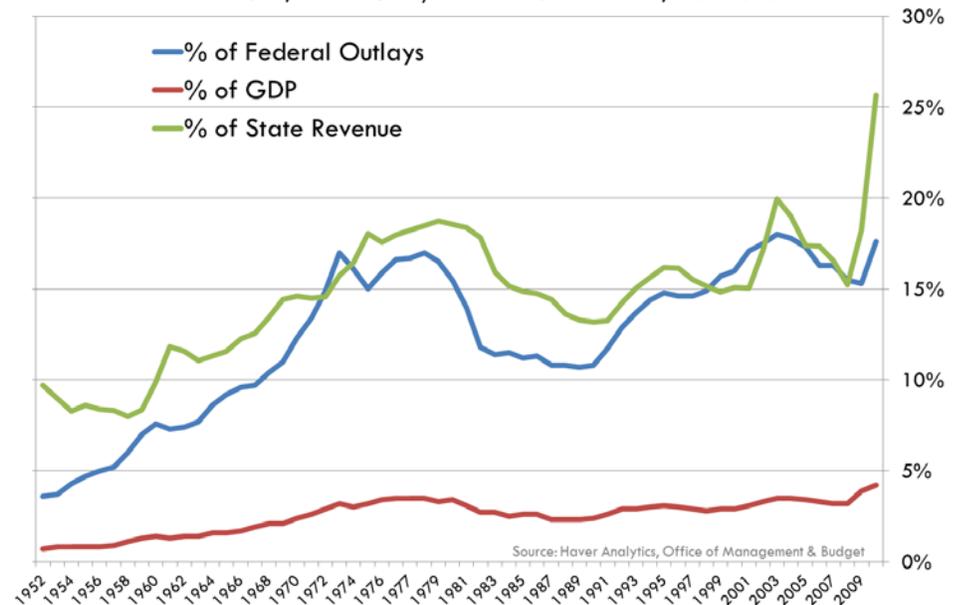
Transfers from the federal level to the state and local levels can impair the ability and function of state and local governments in their roles to carry out what is best for their unique geographic and demographic characteristics.

state. However, if federal funds come attached with specific mandates, these mandates may not match the needs of the demographic or geographic makeup across all states. The CBO found that in 2011, the federal government provided \$607 billion in grants to state and local governments, equaling 17 percent of federal outlays; 4 percent of GDP; and about 25 percent of state and local government revenue for that year (see Figure 7).⁷⁹

Figure 7

States More Reliant on Federal Transfers

Measured as a Percent of GDP, Federal Outlays and Total State Revenue, 1952-2010



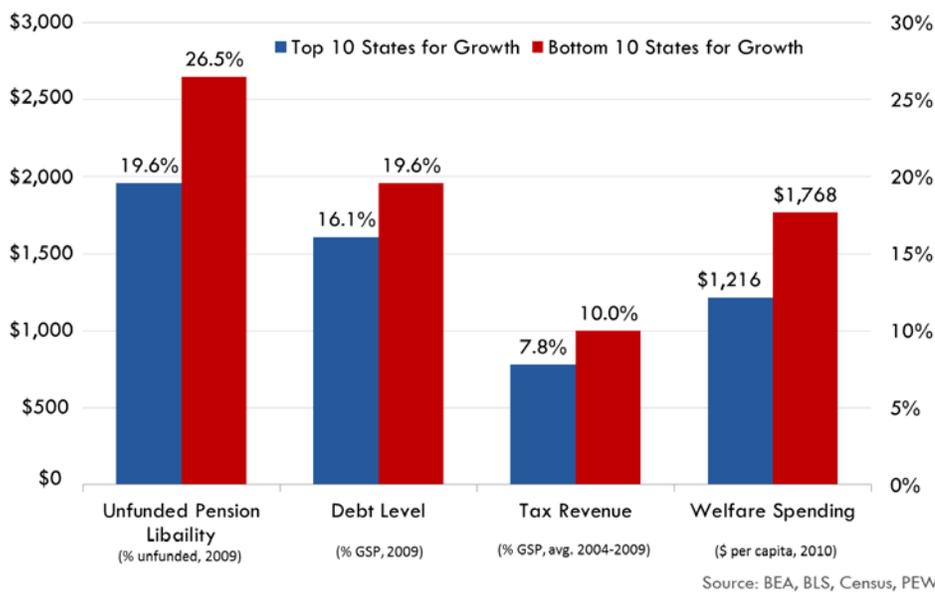
Federal transfers to states have more than doubled since 2000, and as noted in a recent *Forbes* article, ARRA disproportionately allocated more funds to “spending-heavy” states.⁸⁰ Revenue that is received from states and redistributed to other states creates greater imbalance between states in addition to increasing dependence on federal transfers. States that are fiscally responsible thus inadvertently become net payees to other states, which is cause for concern especially for state pension funds. The estimated funding level of state pensions has deteriorated from 98 percent in 2000 to 76 percent in 2009. In 2010, employee contributions represented 30 percent of total contributions compared to the remaining 70 percent left for taxpayers to cover. As pointed out in a JEC Republican Staff Commentary series on the issue, many sources, including the CBO, have estimated state and local unfunded pension liabilities ranging between \$2 and \$3.5 trillion. These liabilities are coming to term soon for some states. According to Joshua Rauh, pension plans in Louisiana, Oklahoma, New Jersey, Illinois and Connecticut are expected to run dry by 2018, and half of all states will run dry within twelve years.⁸¹ In addition, some jurisdictions spend more on retired workers than on current employees, and more on retired teachers than on current students and schools.⁸²

States that are fiscally responsible thus inadvertently become net payees to other states, with particular concern surrounding state pension funds.

Figure 8

Policies Promoting Economic Growth

Top 10 Growth States vs. Bottom 10 Based on average annual GSP Growth from 1990-2010



The top ten states with the highest economic growth had 26 percent smaller unfunded pension liabilities, 18 percent lower debt levels as a percent of GSP, 22 percent lower tax revenue as a percent of GSP, and 31 percent lower welfare spending per capita compared to the bottom ten states.

The divergence between more fiscally responsible states and their counterparts is already noticeable. As noted in the JEC commentary and shown in Figure 8 above, the top ten states with the highest economic growth had 26 percent smaller unfunded pension liabilities, 18 percent lower debt levels as a percent of gross state product (GSP), 22 percent lower tax revenue as a percent of GSP, and 31 percent lower welfare spending per capita compared to the bottom ten states with the least economic growth over the past two decades. In addition, states with no income tax were shown to have greater economic growth, job gains, and more than twice the rate of population growth. Furthermore, relative to the ten states with the highest debt-to-GSP ratios, the ten states with the lowest debt ratios had: 35 percent lower unfunded pension liabilities; 11 percent lower taxes; 20 percent greater economic growth; and 38 percent greater employment growth.⁸³ Therefore, as the series concludes, the burden of a federal bailout would be disproportionately placed upon states that already pay the highest shares of per capita federal taxes and states with relatively sound pension systems.⁸⁴

States with no income tax were shown to have greater economic growth, job gains, and more than twice the rate of population growth.

With the natural experiment among the states notably diminishing, a new study on competitive federalism recommends granting states the ability to shape their own Medicaid policies, reducing the increasing costs and paperwork burden associated with federal compliance costs, as well as removing the cross subsidization of state transportation projects, noting that Texas, Florida, and South Carolina receive less than 85 percent of transportation funds paid to the federal government, while New York, Connecticut and Massachusetts receive more than 100 percent.⁸⁵

As an international example of decentralizing power and reducing dependency upon the federal level, Canada reduced payments to provinces

resulted in provincially-paid health, and the provinces have the incentive to be more fiscally responsible and accountable for how money is spent, with reasonable exceptions, since the persons receiving the services are those being taxed for said services. This is also important because the level of government at which the services are now provided and paid for is at the most efficient provincial level, rather than cumbersomely distributed at the federal level. Cato Institute's Chris Edwards notes that Canada cut federal aid to provinces and consolidated the remainder into three large block grants, which was a key move in halving national debt from 68 percent in the 1990s to 34 percent in 2012. As a result, just 38 percent of all government spending in Canada is at the federal level, in contrast to the 71 percent of federal spending in the United States.⁸⁶

Moral Hazard

By definition, moral hazard describes the tendency of one party to take on risk-taking or costly behavior because another party is responsible for bearing the consequences. If the party taking the risk is liable for the consequences, then it will act more responsibly, but if it doesn't bear the consequences, then the incentive is to take excessive risk.

In the context of government policy, moral hazard sets a precedent for rewarding unnecessary risk-taking when government may come to the rescue.

In the context of government policy, moral hazard sets a precedent for rewarding unnecessary risk-taking when government may come to the rescue. This was true of the incentives that led up to and through the financial crisis, some of which live on in the form of "too big to fail" banks. This is also true of conditions in the Eurozone of relatively fiscally prudent countries having to bail out bankrupt countries. This could come true in the United States with fiscally irresponsible states requesting a federal bailout, forcing fiscally prudent states to foot the bill. In both the financial crisis and the Eurozone, if the federal government or fiscally prudent countries are there for the rescue, it diminishes the incentive for the entities bailed out to avoid bankruptcy again. On a large scale, as in the aforementioned situations, moral hazard today begets future crises, which highlights the importance of aligning incentives of the risk takers with the consequences of outcomes.

Rent Seeking

Rent seeking does not encourage productivity, because unlike productive transactions, resources are wasted on obtaining the benefit of others, or preventing others from seizing one's benefit.

First identified by economist Gordon Tullock and later labeled by Anne Krueger, rent seeking is "the use of resources for the purpose of obtaining rents for people where the rents themselves come from some activity that has some negative social value."⁸⁷ Rent seeking does not encourage productivity, because unlike productive transactions, resources are wasted on obtaining the benefit of others (for example, seeking a barrier to entry from more business competition), or preventing others from seizing one's benefit (e.g., lobbying the government for a tax benefit for one's industry). For firms and individuals that engage in the practice of rent seeking, or "privilege seeking," the government for protection or other advantages, such

behavior may be cheaper than competing in the current business environment. For example, at the individual level, homeowners could be said to seek the privilege of the mortgage interest deduction; at the firm level, steel producers can lobby for restrictions on the importation of steel.⁸⁸ This produces problems with misdirecting talents and resources away from new ways to bring value to the economy and instead incites intelligent and diligent individuals to redistribute government-sanctioned privileges and monopoly protections that reduce competition, innovation and growth, which is what economist Joseph Schumpeter describes as “unproductive entrepreneurship.”

With so many resources misallocated to privilege-seeking, this has a significant, though difficult-to-measure, negative effect on productivity growth and innovation, even though it may benefit the recipient of those privileges handsomely. According to economists Kevin Murphy, Andrei Shleifer and Robert Vishny, a ten percentage point increase in the share of students concentrating in law is associated with a 0.78 percentage point slower annual growth in per capita GDP.⁸⁹ Using their data, which covers dozens of countries, economist Matthew Mitchell found that if compounded since 1980, 2011 per capita production would have been \$54,000 rather than \$43,000, arguing that a large proportion of lawyers per capita may indicate a nation’s tendency to rent-seek and suffer slower economic growth as a result.⁹⁰

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Obstacles to Successful Fiscal Consolidation

As discussed in detail in the prior two JEC staff commentaries, evidence of successful fiscal consolidations abound particularly when focusing on certain types of spending cuts, with the composition of consolidation based significantly upon spending cuts relative to tax increases. While the evidence of past countries’ experiences is clear, there remain significant obstacles to the success of any future attempt at fiscal consolidation in the United States.

Ideological Differences

Economist Glenn Hubbard points out that the President’s economic advisors surely know that fiscal consolidations are successful when they are mostly composed of spending reductions. Given this, Hubbard argues that the battle surrounding the fiscal cliff was about political rather than economic differences on the size and scope of government. As mentioned earlier, the political differences surround the roles that government should play going forward, rather than the measurement of the size of government as a percent of GDP. Hubbard explains that if the goal is only to provide a safety net for the neediest, then the size of government need not change much from its historical norms; but if entitlements for the middle class are the goal, then the size and scope of government must increase, and with that comes higher taxes on everyone. However, even with higher taxes, the coming

Studies consistently show that high debt levels slow growth. Any resolve between political differences will nonetheless have to include a credible and binding plan for fiscal sustainability.

fiscal crisis of crushing high debt cannot be escaped without stronger economic growth.⁹¹ Unfortunately, studies consistently show that high debt levels slow growth. Any resolve between political differences will nonetheless have to include a credible and binding plan for fiscal sustainability.

Returning to the ideology theory of the growth of government, Higgs argues ideology plays a decisive permissive role in government growth, noting that both John Maynard Keynes and Friedrich A. Hayek agreed that the growth of government is dependent upon ideas, or ideology. For example, our modern, complex economy has yielded some differences in opinion as to the proper size and scale of government. Public awareness focuses on particular issues and topics that are promoted and popularized by politicians and the media, but there is dissonance between the economic interests of constituents and their representatives' actions, as well as between opinions or ideologies of constituents and their representatives' actions.⁹² In other words, often what is in the interests of constituents is lost in political promotion of "public interest," or because those in government instead cater to the highest bidder, which can lead to the problem of entrenched special interest groups.

Entrenched Interest Groups

As discussed briefly in prior sections of this commentary examining the prevalence of tax provisions and rent seeking, interest groups have proliferated to obtain and retain massive gains for small special interests at a cost to the general population. These groups can often be the highest bidders for government action.

The "iron triangle," described by Milton Friedman as an insurmountable connection between interest groups, bureaucracies, and politicians makes reform and right-sizing government particularly difficult.

The "iron triangle," described by Milton Friedman as an insurmountable connection between interest groups, bureaucracies, and politicians makes reform and right-sizing government particularly difficult because major, credible reform significantly affects the darlings of the "iron triangle." For example, in his book, *Tyranny of the Status Quo*, Friedman identifies the banking industry as a special interest group, the Federal Deposit Insurance Corporation (FDIC) as regulators, along with politicians. Friedman argues that when a pro-consumer group goes up against a relationship such as this, the interests of the pro-consumer group virtually always lose out.⁹³ Whether well-intentioned or not, this symbiotic relationship tends to negatively affect the broader population.

Regulatory capture, identified by public choice theorists as a form of government failure and the predecessor to George Stigler's economic theory of regulation, refers to when an agency created to promote the public interest operates instead to advantage a particular interest group that it is intended to regulate. This can result in negative externalities such as anti-consumer and anti-competitive outcomes. For example, Fannie Mae's lobbying efforts enabled it to take excessive risk on mortgages to the

detriment of the economy. Fannie Mae as yet remains unreformed in the aftermath of the financial crisis, despite the passage of the *Wall Street Reform and Consumer Protection Act of 2010*.⁹⁴ As noted by economist Mancur Olson in his study of special-interest privileges, nations that allow entrenched interest groups to grow in power and influence over time engender the relative decline of those nations.⁹⁵

Precedential Justification for Additional Government Growth

Revisiting Higgs' theories about the growth of government, much of government growth that can stand in the way of fiscal consolidation and major reforms relates to the precedent set by institutions in the past:

*Those who built the Big Government worked within an (evolving) institutional and ideological context. What they could do—even what they wanted to do—was shaped by this context. Grover Cleveland and his governmental associates could not have created a National Recovery Administration or an Agricultural Adjustment Administration; nor would they have wanted to. But Franklin Roosevelt and his governmental associates, with the wartime mobilization programs as precedents, readily established the NRA and the AAA.*⁹⁶

Historical experience demonstrates that it takes a lot to overcome the status quo, which is why a large shock—such as a fiscal or financial crisis—precipitates a moment in which the status quo could change.

Established Institutional Norms

The establishment of institutional norms is usually set by a precedent that normalized the institution or action. The expansion of federal powers goes hand in hand with the growth of government scope. The estate tax established in its modern day form in 1916 set a precedent for taxing estates that has remained more or less unchanged (with the exception of 2010). The taxation of personal income in 1913 formally established precedence for taxing income at first on the highest income individuals, and then over time, on a broader expanse of earners. The establishment of agencies, such as Homeland Security and the Consumer Financial Protection Bureau are establishments of institutional norms following the shock of a major event. A notable example of established institutional norms is the precedence of taxing payrolls to provide an increasing number of programs: retirement benefits, unemployment insurance, and ultimately health care benefits. The aforementioned income and payroll taxes set a precedent for the treatment of the “individual mandate” of the Patient Protection and Affordable Care Act (PPACA) as a tax. Once a precedent is set, it can be very difficult to reverse.

Institutional norms pervade the federal budgets, as the establishment of entitlements has significantly altered the norm of a century ago. Nobel

Historical experience demonstrates that it takes a lot to overcome the status quo, which is why a large shock—such as a fiscal or financial crisis—precipitates a moment in which the status quo could change.

Institutional norms pervade even the federal budgets, as the establishment of entitlements has significantly altered the norm of a century ago.

prize-winning economist James M. Buchanan argued that deficit spending would progress to a permanent disconnect between revenues and spending because it brings about short-term gains, which institutionalized fiscal irresponsibility in the federal government. This institutionalization is expected to fall away only when it becomes abundantly clear that reform is necessary and the resources to make good on federal obligations are gone.⁹⁷

Starving the Beast vs. Serving the Check

Proponents of the “starve the beast” theory to curtailing government growth find it plausible that revenue reductions will limit some portions of the budget more effectively than others, such as in nondefense discretionary spending. However, that type of spending is notably low by historical standards, and currently does not significantly contribute to the fiscal problems of the future. Another reason for the limited effectiveness of this theory is because the effects of revenue fluctuations on federal spending may not be consistent over time, such as in times of war or crises.⁹⁸

Former acting chairman of President Reagan’s Council of Economic Advisors, William A. Niskanen, has argued that starve the beast fails to limit government because it fails to reduce the demand for federal services and benefits. Niskanen also argued it runs counter to the evidence, which has shown that changes in federal spending as a percent of GDP have a somewhat negative relationship with revenues as a percent of GDP. Furthermore, “starving the beast” has diverted attention away from political reforms that limit government growth because it misdirects focus from the fiscal discipline necessary to control total federal spending. Niskanen believed the longer-term challenge will be to convince voters to reduce their demand for services from the federal government.⁹⁹

“Starving the beast” has diverted attention away from political reforms that limit government growth because it misdirects focus from the fiscal discipline necessary to control total federal spending.

Buchanan saw excess government spending as a symptom of the ease with which the government is able to borrow rather than predicated upon the government’s ability to tax. In fact, reducing current federal tax rates in favor of borrowing has been found to produce long-term growth in spending, as explained by Buchanan’s theory of “fiscal illusion,” because current policies or practices have the effect of lowering the perceived cost of government. Additionally, the “debt illusion” emerges when current services are paid for by deficit financing, because citizens are otherwise more aware of the actual costs of federal benefits and services when they are paid for with current tax revenues rather than future ones.¹⁰⁰

The “serving the check” theory rests on the notion that the voters will only favor spending restraint when they are required to pay for that spending with tax increases. There remains no consensus, however, that either ideological solution will produce the desired result to right-size government, and the results for each are mixed at best. Evidence shows that neither “starving the beast” nor “serving the check” consistently limits government spending.¹⁰¹

Policy Recommendations

While these policy recommendations include suggestions for fiscal adjustment and reform, these concepts in practice are complex; more detailed suggestions for reform that follow the basic criteria set out in this section are plentiful and outside the focus of this study.

Parse the Disease from Its Symptoms: Right-Size Government and Core Purposes

Prioritize Core Roles and Spending

Given the size, scale and scope of government growth, a solution must encompass a multifaceted approach with a credible commitment to a timely schedule for reform processes. Having identified reasons for government growth in previous sections across different dimensions, it is important to prioritize what is considered worthy of maintaining and improving those programs that are identified as best left to government.

Policymakers should identify and prioritize well-defined, core roles and spending programs, and determine if their current structure is best for today's economy. For example, is infrastructure spending a core role of government? What specifically should be defined under infrastructure spending within this government-specific role? At what level of government should the funding and spending be executed? Are the current dissemination and rules associated with infrastructure spending maximizing benefits from dollars spent on the particular program in question, or are they complicated and outdated? Policymakers should recognize the tradeoffs associated with identifying a particular goal or program as government-specific, including potential slower economic growth associated with crowding out private investment.

Tax Reform Should Eliminate Biases

As a part of addressing the causes of government growth, it is necessary to reform the tax code to eliminate biases against capital formation and savings and reduce incentives that lead individuals and businesses to redirect investments away from their best use. Stable tax and regulatory policies encourage investment, and recent regime uncertainty has undoubtedly taken a toll on investment. Lowering and broadening taxes has the effect of not only eliminating bias in favor of debt-financing, but also removes special loopholes that prevent taxation of certain activities. This reduces the cost of capital, induces investment in productive private enterprise, and boosts sustainable economic growth, job creation, and living standards.

Among the biases in the tax system, current corporate taxation in the United States is anticompetitive, making it more difficult for companies located within the United States to compete with firms that already benefit from lower tax rates elsewhere. Corporate tax reform should reduce the

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corporate tax rate to a level that is competitive with the rest of the world and should move the tax system towards a territorial system for foreign source income in place of the current worldwide system. As the U.S. Chamber of Commerce notes, tax reform should not be piecemeal; should be timed to allow for businesses to adjust; should be absent of temporary provisions; and should remain industry-neutral in order to allow the marketplace to determine the best use of resources rather than the tax system.¹⁰²

Pro-growth tax reform can be coupled with spending-based fiscal adjustments in order to mitigate the possible negative short-term effects of the adjustment.

Additionally, pro-growth tax reform can be coupled with spending-based fiscal adjustments in order to mitigate the possible negative short-term effects of the adjustment. *Spend Less, Owe Less* cited the work of Alberto Alesina and Silvia Ardagna on the success of fiscal consolidations based largely upon spending cuts.¹⁰³ In their more recent work, Alesina and Ardagna confirm the former evidence that fiscal adjustments based on the spending side are less likely to be reversed, and additionally cause smaller recessions than tax-based fiscal adjustments. Furthermore, the authors find that certain policies combined with fiscal adjustments temper negative short-term effects and enable economic growth, particularly pro-growth policies that improve the labor market and liberate the goods market. For example, lowering taxes on labor improves the labor market and encourages investment, offsetting some or most of the effects of spending-based fiscal adjustments.¹⁰⁴

Reform Entitlement Programs

Reform of entitlement programs such as Social Security and Medicare should have greater focus on providing a safety net, and reduce beneficence for wealthier individuals.

Reform of entitlement programs such as Social Security and Medicare should have greater focus on providing a safety net, and reduce beneficence for wealthier individuals. As Higgs poignantly states in his description of the welfare state as a cause of government growth, “Governmental policies for the limited purpose of saving the most unfortunate citizens from distribution have merged into governmental policies for the unlimited purpose of redistributing income and wealth among virtually all groups, rich as well as poor.”¹⁰⁵ Credible entitlement reform requires addressing the current growth trends in federal programs like Social Security, Medicare and Medicaid and subsequent programs associated with the PPACA. Reforms in entitlement programs should have already begun, and must begin now because it is not credible to commit to reform ambiguously in the future.

With regard to Social Security, the benefits per retired worker have concurrently increased over time as longevity has also lengthened the average life per retiree. If providing retirement benefits as a supplement to worker’s retirement income remains a priority core spending program of the federal government, then credible reform will likely have to include increasing the retirement age to receive full benefits, increasing the payroll tax to fund the current system, or some combination of the above. Alternatively, policymakers could return to the initial purpose of Social

Security: to ensure seniors do not fall into poverty, and that means limiting the people eligible to receive benefits by means-testing.

In health care, if policymakers deem government has an appropriate core role in providing basic health care, they will have to address many of the unaffordable health policies currently in place. While it is possible for a government to sustainably borrow at low levels indefinitely into the future, there are finite amounts of resources the government can use right now to sustainably fund prioritized spending. Several studies have suggested block-granting Medicaid to the states to allow the state governments to address the needs of their demographics. One alternative offered is changing Medicare to a premium support system much the same as what federal employees and members of Congress have today.¹⁰⁶

One reform strategy put forth to address the costs associated with caring for the aging population was detailed in a study by former lead economist at the World Bank, Estelle James. She identified several variations of a multi-pillar reform model that have been implemented in several countries. The pillars among those implemented include: (1) a public pillar providing a social safety net that is smaller and better focused; (2) a private pillar that designates defined contribution mandatory retirement savings; and (3) a voluntary pillar, voluntary saving and annuities of supplemental income for people who wish or expect to consume more in old age. All three pillars “co-insure” and diversify against the risks faced in old age. James notes that many countries that have moved toward this multi-pillar approach have moved into a better position to affordably care for their elderly while raising productivity and allocating capital to its most efficient uses.¹⁰⁷ While in the case of the United States a mandatory savings option may or may not be an ideal option, slight changes in the current private retirement savings system could improve voluntary contributions, such as switching 401(k) and similar plans to automatic enrollment with the option to opt-out rather than opt-in. The *Pension Protection Act of 2006* may have made automatic enrollment a more attractive option for employers, but according to the annual survey by the Plan Sponsor Council of America, under half (46 percent) of 401(k) plans were taking advantage of automatic enrollment in 2011, though participation continues to increase annually.¹⁰⁸ Since not all choice mechanisms are neutral (i.e., actively joining is perceived as costlier paired with the human tendency to procrastinate), such a nudge may decrease the likelihood of individuals deviating from the new opt-out status quo.¹⁰⁹ Evidence appears to support this notion; according to Fidelity, 76 percent of those ages 20-24 stay in opt-out plans compared to 20 percent of that age group who sign up for opt-in plans.¹¹⁰

The question ultimately remains as to what obligation do citizens have to fund retirement and health care while they are able, prior to taking advantage of those programs.

While it is possible for a government to sustainably borrow at low levels indefinitely into the future, there are finite amount of resources the government can use right now to sustainably fund prioritized spending.

The question ultimately remains as to what obligation do citizens have to fund retirement and health care while they are able, prior to taking advantage of those programs.

Independent Regulatory Review

Setting up independent regulatory review is one viable option in order to have a check in place against often conflicting and cumulatively burdensome regulations. Many regulations are mandates passed down from Congress, and this can put agencies in a difficult position to produce the results that Congress wants instead of quality analysis, should there happen to be a better alternative than government intervention. This is important because not all agencies are subject to the same regulatory impact analysis standards. For example, the *Clean Air Act* forbids the EPA from considering costs when setting standards, although it can use economic evidence when enforcing the standards.¹¹¹ In addition, regulatory agencies should consider the direct and indirect costs of job loss associated with the regulation of a particular industry, which can result in lower labor force participation and higher unemployment rates.¹¹²

All regulatory bodies, not just executive agencies, should meet the same standard and quality of analysis for rule implementation. Regulatory review should ensure that agencies and their rulemakings are meeting the desired outcomes clearly identified and that the outcomes are demonstrably solvable by the regulation in question, with alternatives fully considered in the decision. Regulatory reform should also broaden, strengthen, and standardize cost-benefit analysis under independent review that will enable agencies and policymakers alike to make better informed decisions about the necessity and effects of a potential regulation.

Treat the Disease: Rein in Primary Spending of Governments

Spending Guardrails

Adopting a credible, enforceable fiscal rule forces policymakers and the public to make trade-offs among competing priorities by constraining the size of government spending, taxes, budget deficits and debt.

Adopting a credible, enforceable fiscal rule forces policymakers and the public to make trade-offs among competing priorities by constraining the size of government spending, taxes, budget deficits and debt. As aforementioned in *Maximizing America's Prosperity*, evidence shows that fiscal rules are most likely to be effective and lasting when there is: (1) public understanding for such rules; (2) political debate leads to broad consensus on such rules; and (3) a clear, well-planned and gradual path of convergence in key economic indicators.¹¹³

Ideally, this would include passing a constitutional balanced-budget amendment to encourage fiscal restraint instead of persistent deficits. While the way fiscal rules are crafted is of critical importance, it is also important to note that fiscal rules encourage governments to make better, more fiscally responsible decisions than they would otherwise.¹¹⁴ As David Primo writes in his book, *Rules and Restraint*,

...[r]ule design is inherently a political process, and reforms will often occur after political pressure is applied. Because of the

*many players involved, effective rule design is a challenging endeavor. It is not surprising, then, that newer rules, like tax and expenditure limits, achieve little, while strict balanced budget rules are more effective. Nor is it surprising that many reform attempts... are unsuccessful. In the final analysis, the deck is stacked against effective reform.*¹¹⁵

Crisis should not be an excuse to deviate from sound principles. Spending projections do not take into account unexpected downturns or financial crises, and implementing spending cuts only to what is marginally sustainable will easily be overwhelmed by an adverse shock to the economy. Spending guardrails should guide spending back down to its cap in the short term when an adverse shock to the economy temporarily increases spending. For example, a spending cap that focuses on primary spending as a percent of potential GDP forces advocates of various programs to compete for available funds rather than allowing policymakers to increase total government spending.

Enforcement Mechanism

As previously mentioned in *Maximizing America's Prosperity*, Primo states that common problems working against fiscal rules include: (1) the “creeping risks” in the federal budget; (2) the incentive for policymakers to secure funding for their constituents at the cost of the rest of the country; and (3) promises made today remain difficult to keep tomorrow.¹¹⁶ Credibly committed, permanent reductions in spending avoid the common pitfalls of influencing spending limits through budget gimmicks. Manipulating cost projections so that they will fit into the budget; cherry picking numbers and projections; using rosy scenarios to depict less spending growth in the face of stronger projected economic growth; accounting gimmicks in trust funds; keeping spending items “off-budget;” timing spending such as advance appropriations or large payments to contractors in the following fiscal year to depict savings in the prior year; and using an emergency loophole for nonemergency funding are among several ways that debt continues to increase despite fiscal rules tried in years past. All of the above would lead one to believe the budget process is broken. Policymakers who understand fiscal rules know how to manipulate them. However, if the scale and scope of government is also reduced, then opportunities to manipulate fiscal rules will shrink as well. In order to ensure that fiscal rules remain enforceable, a mechanism that is perceived by policymakers and the public as fair is likely to be a successful enforcement procedure.

In cases where policymakers run into the common problem of favoring cuts in discretionary spending but disagreeing on the specifics, overcoming the public choice dynamics present in a crisis could include a spending commission modeled after the Base Realignment and Closure (BRAC) Commission that is, as economist Jerry Brito argues, “focused, independent, composed of disinterested citizens giving clear criteria for their decisions,

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and be structured in a way that allows its recommendations to be operative unless Congress rejects them.”¹¹⁷ The spending commission would break down the “iron triangle,” effectively remove Congress from the lobbying efforts of the constituencies associated with each federal program by providing the political cover of an all-or-nothing approach.

Learn from International Experiences

According to a new study from Veronique de Rugy and Alberto Alesina, successful fiscal adjustments are possible when based upon mostly spending reductions and bolstered by policies that promote competitiveness. The study observed an 80 percent failure rate in more than 100 attempts to reduce debt-to-GDP in all developed countries in the past 30 years, noting that the 20 percent that were successful included both spending cuts and policy reforms that increased competitiveness. The authors particularly emphasize that successful fiscal adjustments are complex and multiyear undertakings. Successful fiscal adjustments were found to lower debt-to-GDP ratios and increase economic growth, generate substantial savings by cutting subsidies to politically-established businesses, and alleviate effects that could disproportionately affect lower income earners and the poor by improving how welfare programs are targeted.¹¹⁸

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International examples of reining in primary spending can be found across the globe. More recently, the Nordic countries of Sweden, Denmark, Norway and Finland have started down a path to fiscal sustainability with significant government reform, and dramatic decreases in their debt-to-GDP ratios; and they have done this while maintaining a relatively substantial welfare state with prioritized spending. Sweden, for instance, reduced public spending from 67 percent of GDP in 1993 to 49 percent in 2013; deficits decreased from 11 percent of GDP to a 0.3 percent surplus over the same period; and public debt fell from 70 percent of GDP in 1993 to 37 percent in 2010. Additionally, the public pension system and the education system have undergone major reforms, with a switch from defined benefit to defined contribution with adjustment for life expectancy, and the introduction of a universal system of school vouchers, inviting private schools to compete with public ones in the latter. Further, the corporate tax rate will be reduced from 26.3 percent to 22 percent this year. The results are noticeable: economic growth of 2.7 percent annually in Sweden over the past two decades has remained well above the 1.9 percent growth rate average for the main 15 EU countries.¹¹⁹

Overcoming the Commitment Problem

Hallmarks of successful and credible spending reforms include: (1) federal spending restraint, even if the spending programs are politically popular; (2) a timeframe that begins within a year even if the approach and implementation will take multiple years; (3) permanent tax reform that is unbiased, competitive and simplified; (4) putting everything on the table for

review and reform; and (5) including a credible enforcement mechanism for both the short and long terms.¹²⁰ Often, fiscal adjustments run into the problem of being unable to bind future policymakers and administrations to the promises made by the current ones; this is known as the commitment problem, explained by Philip Wallach as follows:

At first glance, this inability to bind the future — which political scientists call the "commitment problem" — would seem to preclude the very possibility of responsible representative government, at least on matters that require sustained discipline (such as the management of the public debt). If representatives today can always put off hard choices until tomorrow — and especially if their voting constituents want them to — it is hard to see how any sacrifices will ever be made. And yet we know that responsible choices are possible, because our predecessors often made them. Balanced budgets in peacetime were the norm for most of our country's history until after the Second World War. Even in the aftermath of the New Deal and Great Society expansions, the polity has managed a few impressive moments of self-control — reining in runaway spending and reducing the growth of entitlement costs... The lessons of these past budget commitment mechanisms suggest that the more impressively substantial cuts seem when enacted, the greater the political resistance they will engender when they actually kick in, reducing their chance of actually delivering promised savings.¹²¹

Philip Wallach from the Brookings Institution points out that, as in the past, a balanced budget statute may be watered down over time by subsequent policymakers to essentially reduce it to an ineffective statute. While more difficult to pass, a constitutional amendment is not completely politically impossible; in fact, there were several times when either the House or Senate passed a constitutional balanced-budget amendment, but fell short of achieving the support needed to send the amendment to the states. Wallach predicts dismal results for a constitutional amendment much as he does for a balanced budget statute. Although a constitutional amendment has a better chance of survival in future Congresses, what would be politically feasible for at least 38 states (at least three-quarters of states are necessary to amend the Constitution) to ratify would likely be subject to design flaws that commonly weaken and destabilize laws. One possible outcome of a constitutionally mandated budget balance rule would be the increase of government activity outside of the budget in the form of increased regulation (i.e., rent-control laws in place of subsidized government housing). This is why comprehensively addressing the growth of government in size, scale and scope is so important in order to prevent the growth of government from simply rechanneling in a different direction or increasing on a well-worn path.

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Like Primo, Wallach emphasizes design as critical to the success of a budget rule. He notes that Pay-As-You-Go (PAYGO), which replaced Gramm-Rudman-Hollings, established a “fiscal Hippocratic Oath” that new bills should cause no budgetary harm, and changes in taxes or cuts had to be offset within the same appropriations year. It also underestimated GDP growth by which spending increases were projected, which made adherence to the rule politically easier. Crucially, Wallach notes it was not a substitute for political agreement, which is critical to the chances of a fiscal rule’s success. In 2002, when PAYGO was allowed to expire, both parties were focused on recovery from recession rather than maintaining the recent surpluses that made restraining spending no longer a prerogative. Alternatively, Wallach also points to the 1983 reform of Social Security, which increased payroll taxes and raised the full-benefit retirement age to 67 gradually through 2027. Wallach argues that what made this reform durable was the lack of immediate opposition because future retirees had decades to plan for the changes, and the increase in life expectancy was a compelling argument for increasing the retirement age. Further, Wallach notes that trust funds are a budget mechanism that can be used to improve government finances because of the threat of a fund’s “bankruptcy.” Wallach sums up that any budget reform will require bipartisan support in order to be successful and durable, and in the absence of that support, jumping straight to rules and mechanisms will remain insufficient to rein in spending.

Manage the Disease: Reduce Debt to Fiscally Sustainable Levels

Curtail Debt Accumulation

Few governments choose to engage in fiscal consolidation until warning factors become reality, such as financial crisis, increased sovereign default risk, and sputtering economic growth that overwhelm business as usual.¹²² If bipartisan support for returning to fiscal sustainability remains out of reach, however, then the decision to become fiscally responsible will be made on behalf of the United States. Low interest rates are not a given. Investors may one day soon decide that the United States will no longer be capable of paying back its debts, and rates on government borrowing will skyrocket, and the United States will face a major credit rating downgrade. If policymakers wait until debt is too high and too cumbersome to economic growth, investors will view their behavior as risky, and gimmickry will give way to fiscal crisis.¹²³

Reduce Future Interest Payments

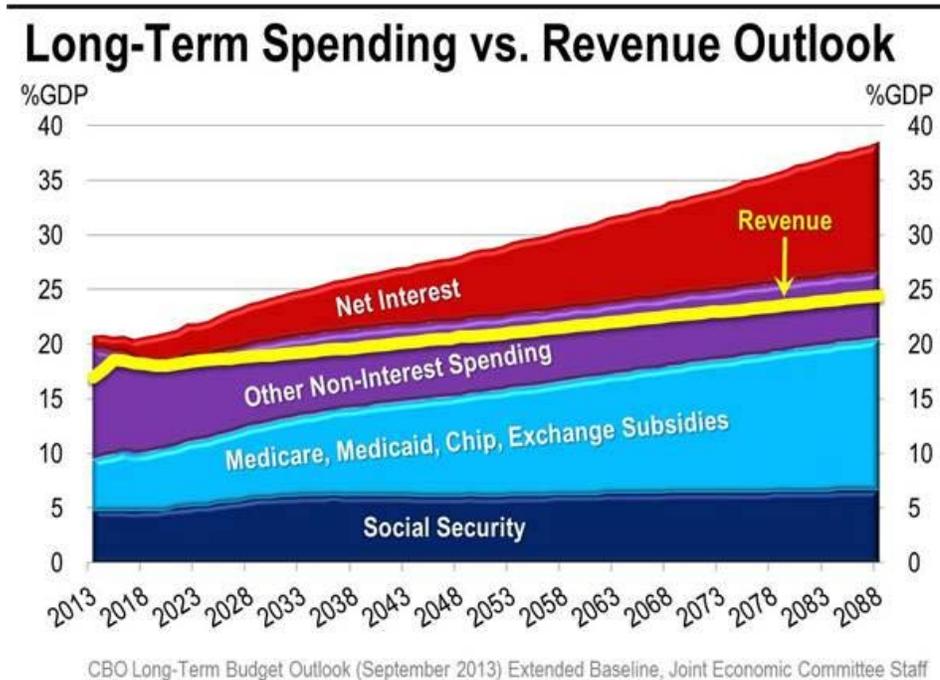
As a result of fiscal consolidation, lower debt reduces real interest rates and the burden of those interest payments. Higher interest payments only compound the problem of government spending and make abrupt and sharp spending cuts more likely than a controlled, multiyear fiscal consolidation package. Already there is concern that the CBO and other institutions are

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not fully accounting for the effect of higher interest payments on the growth of debt, but the current projections in the CBO’s September 2013 *Long-Term Budget Outlook* of a 12 percent interest spending-to-GDP ratio, a 38.7 percent overall spending-to-GDP ratio (see Figure 9), and a 245 percent debt-to-GDP ratio by 2088 is worrisome enough, barring another major negative shock to the current, slow pace of economic recovery.

Figure 9



In its analysis, the CBO assumes that interest rates will remain stable beyond 2023, but it is expected that interest payments will rise to 5 percent of GDP by 2038 under current law. Under CBO’s extended baseline forecast, interest rates are expected to surpass the growth rate of the economy, thus causing debt to increase relative to GDP even if noninterest spending equals revenues, but noninterest spending is also expected to exceed revenues, causing debt to grow even faster.

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The CBO’s analysis takes into account the aforementioned “crowding out” effect that higher debt has on investment, thereby lowering output, as well as the discouraging effects of higher marginal taxes on working and saving, which also reduce output. In the *Long-Term Budget Outlook*, the CBO put forth an extended alternative fiscal scenario and two illustrative scenarios incorporating economic feedback that budget policies have on the economy in addition to the extended baseline: (1) an extended alternative fiscal scenario in which certain policies in place that are scheduled to change under current law are instead allowed to continue, adding \$2 trillion in deficits excluding interest payments over the next decade; (2) an illustrative scenario in which deficit reduction is phased in such that deficits excluding interest payments are \$2 trillion lower than the baseline through 2023; and (3) a second illustrative scenario in which the amount of deficit reduction

excluding interest payments in the next decade is doubled to \$4 trillion through 2023 relative to the baseline, as shown in Table 1 below.

Table 1	Extended Alternative Fiscal Scenario	Illustrative Scenario #1	Illustrative Scenario #2
GNP relative to the baseline	7% lower	4% higher	7% higher
Interest rates relative to the baseline	1 percentage point higher	1/2 percentage point lower	1 percentage point lower
Publicly-held debt to GDP in 2038	190%	67%	31%

With lower future interest payments as a result of successful fiscal consolidation, the United States could restore its triple-A rating, remain the reserve currency of the world, and signal credible commitment to investors that the U.S. will honor its debts because it can afford them. Most importantly, less debt will mean stronger economic growth in its absence.

As the report notes, the current baseline scenario is anything but positive: “Specifically, given the policies of the extended baseline, the ratio of debt to output would rise significantly over the next 25 years, as would marginal tax rates; both of those changes would reduce future GDP relative to what it would otherwise be.” In contrast, under the two illustrative scenarios, the CBO finds that stable or declining debt-to-GDP ratios would decrease federal interest payments, yield positive effects on output, give policymakers greater leeway on tax and spending policies in response to crises, and the risk of sudden financial crisis would be less likely.¹²⁴

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Automate Government Contraction

Automating government contraction ensures that there are mechanisms in place to counteract the common problems that run against successful fiscal consolidation. This is not to say that shrinking government for the sake of shrinking it is the goal—rather, keeping worthy government programs around is the ultimate goal while ensuring that outdated and failed programs no longer waste finite resources. This also ensures that policymakers are actively voting to keep programs they identify as high priority rather than letting government growth run on automatic pilot. In addition, this has the effect of holding agencies accountable to perform cost-effective services that policymakers and the public identify as crucial.

For example, sunset provisions at the state level in many cases have proven successful at slowing the growth of state government marginally in size, but significantly in scope. As noted in *Maximizing America’s Prosperity*, twenty states have active sunset provisions that continually evaluate programs and

determine whether the existence of each government program is necessary. Sunset provisions are more likely effective when they: (1) include all programs and agencies as subject to review; (2) establish a regular review process administered by a commission with clear performance measures and transparent reporting methods; and (3) an agency undergoing sunset review that is recommended to be abolished should automatically be abolished unless the legislature passes a bill to preserve it until the next review.¹²⁵

Avoid the Need to Raise Additional Taxes

Evidence from the International Monetary Fund's (IMF) latest study of fiscal consolidations finds that fiscal consolidation is beneficial over the long term because it allows for further cuts to distortionary taxes that would otherwise crowd out investment and decrease output in the long term. Debt reduction and stability resulting from fiscal consolidation thus reduces pressure on the government to raise funds to cover exorbitant spending, or otherwise delay inevitable tax increases and burden future generations that did not vote or benefit from the government spending accrued in the present.¹²⁶

Conclusion

The federal government has some skin in the game when it comes to economic growth, but policymakers fail to fully grasp how much their vision of government priorities depends upon that economic growth. The incentive to encourage strong economic growth to receive the tax revenue necessary to afford federal spending in the long run is lost both in intertemporal choice (most commonly chosen: "kicking the can down the road") and in the ease of deficit-financed spending at such affordable interest rates. Because one Congress cannot bind future Congresses to their fiscal rules, it is important that policymakers recognize the incentive the federal government has to implement pro-growth policies in order to continue to afford the roles and services that the federal government provides to its citizens.

It is important that policymakers recognize the incentive the federal government has to implement pro-growth policies in order to continue to afford the roles and services that the federal government provides to its citizens.

The CBO assumes four percent growth in the short term before returning to the long term trend, which depicts a relatively rosy outlook going forward. If, however, 1.5 percent annual growth is the new normal and projected economic growth is much slower than the CBO projects, it is possible that a crisis will emerge rather quickly.¹²⁷

In his testimony before the Joint Economic Committee, Michael J. Boskin stated that under the current trend in growth of federal debt:

The negative effect on GDP grows and, by 2050, the higher debt ratio brings growth to a halt. The level of GDP is 30 percent lower than if the debt had not soared and the policies

*had not continued. That's most of a generation's gains wiped out or, put another way, it is as large as the gap between American and lower Western European per capita incomes.*¹²⁸

This is particularly alarming when Americans are focusing less on creating wealth and increasing prosperity. Economist Tyler Cowen notes that the notion of taking is gaining greater traction relative to making wealth, posing the question, "Is public policy being adjudicated on grounds of ethics and efficiency, or is the real story about lobbying and relative power of different interest groups?" Cowen suggests that many of the social and economic issues the United States currently faces, including global competitiveness, unemployment, public health and the budget deficit, would be solved through improvement of public schools and greater school choice, rather than the current system of transfers taking the place of more effective reforms.¹²⁹

A recent article from *The Economist* notes two divergent visions of America. One is the dysfunctional vision of an America in decline, replete with what has gone wrong in mediocre testing scores, crumbling infrastructure, burdensome regulations, the overcomplicated tax code, and an unwelcoming immigration system. The alternative, "can-do" picture of America is a bright and hopeful one, based on the entrepreneurialism and innovation of businesses that have marched forward into the uncertainty with improving technological advancements and the state governments that have recognized how to attract innovative and growing businesses. Parents, individuals and businesses alike are pushing for reforms of outdated and cumbersome systems of education, regulation and mandates of the past.¹³⁰ As the public begins to converge on the understanding that there are impending major reforms to be achieved in order to give the bright and hopeful vision of America a chance, it is time for policymakers to do the same.

As the public begins to converge on the understanding that there are impending major reforms to be achieved in order to give the bright and hopeful vision of America a chance, it is time for policymakers to do the same.

Ultimately, if fiscal consolidation and pro-growth reforms are to be successful, policymakers must credibly commit to addressing the multifaceted growth of government, including the size of government, the roles of government and how revenues are spent.

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