Prepared Statement

of

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Mr. Chairman and Members of the Committee: thank you for inviting me here today, and thank you for addressing this important legislative proposal. The Maximizing America's Prosperity (MAP) Act sets forth an important goal, and goes about accomplishing it in an efficient manner. I welcome the opportunity to discuss this with you and with my distinguished fellow panelists, Bob Reischauer and Dan Mitchell.

The goal of the MAP Act is prosperity, and the focus is on government spending. Why is that? The reason is that there is an acknowledged relationship between size of government and prosperity, and spending is the most common measure of size of government.

Only the most naïve conservative among us would argue that prosperity is enabled by having no government (spending) at all, and only the most naïve liberal among us would argue that prosperity is enabled by having government account for all spending. Thus, as shown in the graph,[2] prosperity is maximized somewhere in between these two extremes. Initially, as the public sector grows, total output does as well, as property rights are established, as contracts are enforced, as important infrastructure is put in place, and so forth. But past some

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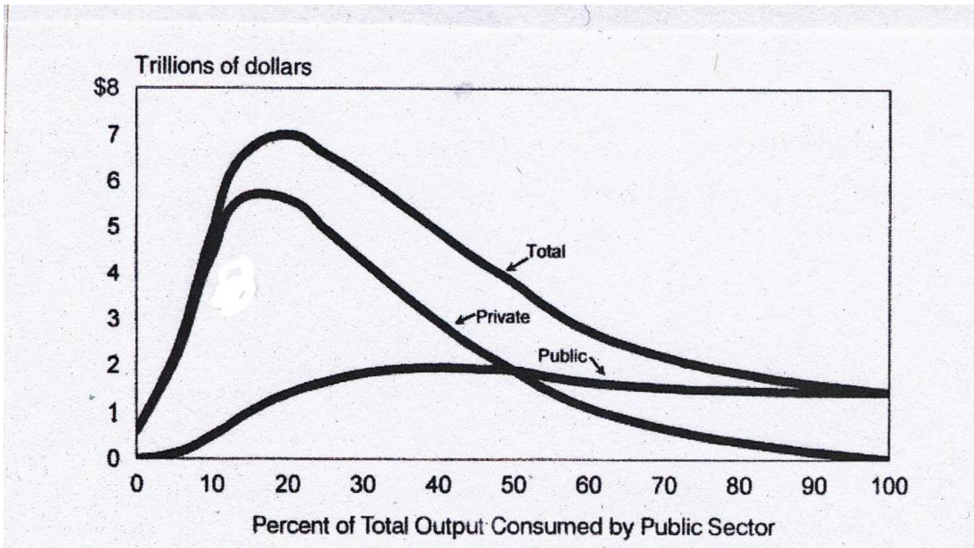
[2] The rough approximation of the relationship shown on the next page is taken from the author's Monopoly Politics (Stanford: Hoover Institution Press, 1999), p. 9. Obviously, the economy is larger today than it was then. For further discussion of the nature of the curves depicted, see ibid., pp. 9-11.

point, the public sector adds less and less value, and in a sense crowds out the private sector, and total output and income per capita actually fall, even though government's share of the economy continues to rise.



As you know, at just what point between the two extremes prosperity is maximized is the subject of debate among economists. The prevailing opinion is that prosperity is maximized at a smaller size of government than we have today. That's a basic rationale for trying to control spending and to bring down the ratio of spending to GDP.

We ought to ask as well why government spending tends to exceed levels that maximize prosperity. The answer is that inherent in the political budgeting process is a propensity to spend far beyond what is justified – and to be wasteful with spending as well. Like everyone else, elected officials respond to incentives, and when the incentive structure is biased toward ever-larger-government, that's what you get. Moreover, I conjecture, the larger government grows, the larger are the incentives to grow government even further.

For this reason, it is imperative that any solution to the problem of overspending address the issue of incentives, either by changing the incentives directly or by limiting the excesses produced by the system – which, of course, is another way of changing incentives. The MAP Act does some of both. It places limits on non-interest spending as a proportion of potential GDP, and it provides for institutional changes that will make it easier to meet spending limits in an efficient manner. Specifically, it requires the President's budget submission to comply with the overall spending limits, it gives the President an item reduction veto, it provides for sequestration of budget resources in case spending is likely to exceed limits, and it establishes a commission to recommend sunsetting of agency functions and an expedited procedure for consideration of these recommendations by Congress.

This is an excellent proposal. It incorporates spending limits that are in accord with what would be most beneficial to the economy as a whole and thus to prosperity in general. It adopts measures to assure meeting those targets with institutional reforms that would be effective and efficient in the sense of assuring that priorities are addressed.

That said, let me make three additional points for your consideration.

First, alternative and/or supplementary approaches to meeting spending limits do exist. For example, the recent House-passed "cut, cap, and balance" bill puts before the state legislatures for approval or disapproval a requirement that the federal budget be balanced. Although in a perfect world the federal government would incur deficits at times and surpluses at times, the world is not perfect, and a balanced budget requirement would lead to more prosperity. A major reason is that the failure of citizens and their elected representatives to fully "capitalize" the cost of borrowing reduces the perceived cost of government and leads to harmful increases in spending.

Second, the cost of government includes not only spending but the cost of regulation as well. At some point you may wish to consider incorporating the cost of federal regulation in a revised cap. Probably the best way of doing this would be to establish a "regulatory budget," with a legislative process that parallels the fiscal budget process.

Third, the cost of government is disguised, to some extent, by "tax expenditures." As you know, these are dispensations in the tax code that accomplish government goals through the revenue side of the fiscal equation instead of the spending side. Without question, these "expenditures" are just like direct spending, and you may want to include them in a revised cap.

Fourth, without meaning to cast aspersions on anyone, let me emphasize that even under the current MAP Act's restraints on spending, strong incentives will lead to efforts to circumvent it's provisions. As implied by my last two points, you may well experience a rise in regulatory activity as a substitute for spending and also an increase in tax expenditures as another way of growing the size of government. Thus, you may wish to address these possible "loopholes" by including regulatory and tax-expenditure costs within the cap or to limit them by some other means.

Mr. Chairman, that completes my statement. I shall be happy to address any questions you and your colleagues may have.