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On Power and the Use of Coercion

Cutting Spending to Revive Federalism

by Chris Edwards

House Republicans have promised major spending reforms, but GOP leaders are tongue-tied when they are asked which specific programs they want to cut. The GOP wants to cut domestic spending to 2008 levels, but that's just an accounting goal.

The GOP needs a larger vision to guide their reforms. Republicans need to communicate to the public how a smaller government would benefit America and which federal agencies and activities are damaging and counterproductive.

A key part of this strategy should be to revive a central theme of the 1981 and 1995 budget-cutting drives — getting the federal government out of what are properly state and local activities. Constitutional federalism has taken a beating as federal aid to the states has doubled over the last decade to $646 billion this year. This aid goes to public housing, community development, urban transit, and hundreds of other local activities.

The cost of federal aid has soared, and so has the number of different aid programs. By my count, the number of federal aid programs for the states totaled 1,122 in 2010. That is up 72 percent from 2000, and it is more than triple the number of aid programs in the mid-1980s, after terminations by President Reagan.

Reagan pushed hard to cut state aid. He argued in a 1987 executive order that "federalism is rooted in the knowledge that our political liberties are best assured by limiting the size and scope of the national government." Our liberties are imperiled by the explosive growth in federal aid because the aid is turning the states into little more than regional subdivisions of an all-powerful national government.

The huge federal deficit is one reason to cut state aid, but cutting aid makes sense for many reasons:

• Every dollar of federal aid sent to the states is taken from federal taxpayers who live in the 50 states. Sending all that money to Washington and back again creates a huge administrative burden in tracking the funding flows and dealing with all the regulations attached to each of 1,122 programs.

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Cutting Spending to Revive Federalism by Chris Edwards

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• Federal aid reduces state policy innovation because it comes with top-down rules that mandate conformity. State governments can't be "laboratories of democracy" if they operate under one-size-fits-all rules from Congress.

• Aid programs spur overspending by every level of government, since politicians can appease special interests with the spending while imposing part of the funding costs on other levels of government. State politicians over-expand Medicaid, for example, because the feds kick in more than $1 for every $2 in new benefits.

• Liberals imagine that federal experts can rationally distribute aid to the neediest local activities. The reality is that politics determines the activities and congressional districts that receive the most aid. Even if politics were taken out of it, the federal government does not have the knowledge to efficiently allocate local funding across a diverse nation of 308 million people.

• The huge scope of the aid system means that federal politicians spend much of their time on local issues. Rather than focusing on national defense, they are busy fixing potholes in their districts. Pres. Calvin Coolidge was prescient in warning that state aid was "encumbering the national government beyond its wisdom to comprehend, or its ability to administer" its proper roles.

• The three levels of government would work better if they resembled a tidy layer cake with separate functions, rather than a marble cake with jumbled lines of responsibility. The failure of our marble-cake government was evident in the disastrous lead-up to, and aftermath of, Hurricane Katrina.

Politicians often claim that certain local activities are "national" priorities. The George W. Bush administration, for example, claimed a "compelling national interest" in providing federal aid for the K–12 schools. Yet in Canada, the federal government is generally not involved in the schools, and their kids do much better than U.S. kids on international tests. Thus, the desire of federal politicians to solve local problems must be tempered with an understanding that federal involvement is usually counterproductive.

The federal-aid system does not deliver high-quality and cost-efficient services to citizens. It delivers bureaucracy, overspending, and regulatory micromanagement from Washington. In addition to helping balance the budget, Republicans can start a national

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What Would Harding Do?

by John Hendrickson

The size and scope of the federal government will be the focal point of debate as President Barack Obama and Republicans in Congress negotiate over the federal budget. Government spending — at all levels of government — is the major domestic policy issue facing the nation. Currently, the national debt is over $14 trillion and the federal government is running budget deficits. A budget deficit of $1.5 trillion is projected for 2011, which is on top of a 2010 deficit of $1.3 trillion and a deficit of $1.4 trillion in 2009. At the heart of the fiscal crisis is the surging entitlement costs of Social Security, Medicare, and Medicaid, which have estimated unfunded liabilities approaching up to $100 trillion. Clearly, the federal government has a spending problem and the current fiscal path is not only unsustainable, but will lead the nation into economic decline. Policymakers need to address the spending issue by examining spending within constitutional bounds.

Recently, President Obama released a $3.7 trillion budget for 2012, which "pledges $1.1 trillion in deficit savings over the next decade through spending cuts and tax increases."[1] In addition, the budget proposal calls for additional spending in "investments" in fields such as education, energy, scientific research, and high-speed rail, among others.[2] This is additional Keynesian-style stimulus spending. Although the proposed budget claims to cut spending, deficits in the trillions will continue in 2012. "Under the President's budget, the deficit in 2011 will hit a new record of $1.65 trillion, and the national debt held by the public over the next 10 years will nearly double, rising by $7.2 trillion."[3] *The Washington Times* reported that "President Obama projects that the gross federal debt will top $15 trillion this year, officially equaling the size of the entire U.S. economy, and will jump to nearly $21 trillion in five years' time."[4] The proposal does not address entitlement reform and it does contain tax increases, including allowing a portion of the Bush era tax cuts to expire.

The Wall Street Journal noted that government spending will constitute 25.3 percent of GDP, which is "more spending than in any year since 1945."[5] The budget proposal represents "the largest federal budget in the history of the United States of America."[6] This budget proposal does not seriously address the fiscal crisis that threatens the security of the nation. Unemployment currently stands at 9 percent and although the economy is showing signs of recovery, the national debt and continual trillion dollar deficits are causing uncertainty over the economy. The national debt and deficits represent the possibility of higher interest rates as well as significant tax increases in order to pay for the largess of government. This is in addition to the anxiety caused by the Federal Reserve policies of "quantitative easing," which is injecting more money into the money supply bringing a greater risk for serious inflation, as noted by the recent increase in commodity prices.

The good news coming out of this proposal is that it opens up a serious debate over government spending and more importantly, a debate over constitutional government. Senator Barry Goldwater, the author of the landmark *Conscience of a Conservative*, correctly stated "neither of our political parties has seriously faced up to the problem of government spending."[7] Both Republicans and Democrats can share in the blame for the massive increase in government spending. Currently solutions are being offered to address the spending issue such as Representative Paul Ryan's "Roadmap" proposal which reforms both entitlements and spending, the Simpson-Bowles Commission, which has offered some good solutions to reduce spending and reform entitlements, and currently Republicans are pushing to cut $100 billion from the budget and other policymakers such as Senator Rand Paul (R-KY) are

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pushing for a $500 billion cut in government spending.

Policymakers would be wise to look at the administrations of President Warren G. Harding and President Calvin Coolidge in implementing spending and tax reform policies. President Harding, elected in the 1920 presidential campaign, inherited a severe recession with unemployment as high as 11 percent along with a massive federal budget, debt, and high levels of taxation. With recent reforms to the budget process with the Budget and Accountability Act of 1921, Harding and Charles G. Dawes, the first director of the Budget Bureau, started on a path to rein in government spending, pay down the national debt, and pursue tax reform. As economist historian Thomas E. Woods wrote, "federal spending declined from $6.3 billion in 1920 to $5 billion in 1921 and $3.3 billion in 1922."[8] By the end of 1923 there was a surplus and Harding and Dawes saved over one billion in their commitment to fiscal prudence.[9]

Paul Johnson in his book *Modern Times* wrote that "Harding can be described as the only President in American history who actually brought about massive cuts in government spending," which can be reflected in his commitment to constitutional limited government.[10] Coolidge also pursed significant spending and tax reductions and the result was that "spending and taxes were cut 50 percent during the 1920s, and about 30 percent of the national debt was paid off," while the economy went into a period of expansion with budget surpluses and low unemployment.[11]

Today's political and economic climate is different from the 1920s, especially since the emergence of New Deal and Great Society entitlement programs, but nevertheless, the policies that Harding and Coolidge utilized can be applied to the problems of today. Policymakers must force a debate over federal spending and entitlement reform. The reforms offered in Rep. Ryan's "Roadmap" and the Simpson-Bowles Commission offer a good starting point to seriously address the need to rollback federal spending and reform entitlements. Considering a serious constitutional amendment to require a balanced budget should also be on the table. Avoiding spending reductions and reforming entitlements will be costly for the nation. Michael Boskin, a Senior Fellow at the Hoover Institute, wrote that "the immense growth of government spending and soaring public deficits and debt are the major sources of systemic economic risk, here and abroad, threatening enormous costs by higher taxes, inflation, or default."[12] And as Scott Powell, a Visiting Fellow at the Hoover Institution, argues:

> Excessive debt and easy money facilitated the financial crises of the past 12 years: In 1998 it was long-term capital management that melted down; in 2000-2002 the dot-com bubble burst; and starting in 2007 the housing and mortgage market collapsed — leading to the current predicament. The debt dynamics that underlay these crises are alive and well today, only larger and more fundamentally systemic. Risk has now shifted from the private to the public sector, with the U.S. government debt market being the new bubble.[13]

Rolling back and reining in government spending and reforming entitlements will not be an easy process. In the end this debate goes further than just economics, but centers on political philosophy. "The root of the evil is that the government is engaged in activities in which it has no legitimate business," argued Goldwater.[14] Goldwater argued that the federal government was involved in too many areas that were outside of the constitutional realm.

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"The government must begin to withdraw from a whole series of programs that are outside its constitutional mandate…and all other activities that can be better performed by lower levels of government or by private institutions or by individuals," argued Goldwater.[15]

Certainly liberals and progressives will reject this view as either being extreme or old-fashioned, but the solution to the fiscal crisis resides in returning to constitutional principles. Both the Harding and Coolidge administrations were rooted in a conservative philosophy backed by traditional limited government. In addition, both understood the importance of the private sector of the economy being the engine of growth. President Ronald Reagan understood this truth as well. It is only by returning to a limited government agenda that a solution will be found to the fiscal crisis and restoring the economy.

Endnotes:

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[13]Scott Powell, "Denial puts U.S. deeper into debt," *Atlanta Journal Constitution*, February 9, 2011, <http://www.ajc.com/opinion/denial-puts-u-s-833076.html> accessed on February 15, 2011.
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Question of the Quarter:
Do you think the corporate tax should be reduced?

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Time for Corporate Tax Reform

by John Hendrickson

"The need for 'economic growth' that we hear so much about these days will be achieved, not by government harnessing the nation's economic forces, but by emancipating them," wrote the late Senator and former Republican presidential candidate Barry Goldwater.[1] Goldwater's assumption is true that emancipating the economy from excess taxation and regulation will lead to economic growth. Historically, cutting tax rates across the board has proven successful, as demonstrated by the Mellon tax cuts of the 1920s, the Kennedy tax cuts of the 1960s, and the Reagan tax cuts of the 1980s. In order to restore both employment and the economy, policymakers must address tax, spending, and regulatory reform. Reducing the corporate tax rate is one area that would encourage not only additional job creation, but also create incentives for business to grow and develop within the United States. A lower corporate tax rate would also provide an incentive for American businesses in a very competitive global market.

Reducing the corporate tax rate should not be controversial. In his State of the Union address, President Barack Obama hinted at supporting some form of corporate tax reform. The federal corporate tax rate currently stands at 35 percent, which is significantly higher than most other nations. The Heritage Foundation recently noted that "the U.S. has had the second-highest corporate tax rate among other developed nations represented in the Organization for Economic Cooperation and Development (OECD) since 2004."[2] In addition, the federal rate of 35 percent, "when including the average of state corporate tax rates, is just over 39 percent," while "the average of all industrialized countries in the OECD is about 25 percent."[3]

Currently, the high corporate income tax rate of 35 percent is stifling economic growth. The economy, which is still emerging out of the "Great Recession," is continuing to struggle with the uncertainty over escalating federal government debts and deficits and an increase of regulatory activity, which also includes the Patient Protection and Affordable Care Act (healthcare reform). Lowering the corporate tax rate would provide further incentive for businesses to not only create more jobs, but also invest more in the economy. "The corporate tax system influences economic growth because it is one of the key factors businesses consider when they decide where to invest," stated Curtis Dubay, a Senior Policy Analyst with The Heritage Foundation.[4]

The Business Roundtable is also recommending lowering the corporate tax in its "Roadmap for Growth" plan.[5] The Business Roundtable argues that "changes in tax policy can create the conditions for more robust job creation in the private sector, stronger capital formation, higher exports and increased foreign investments."[6] In an increasingly globalized economy, the high corporate tax rate hinders United States economic growth and competiveness as well as harming job creation.

Lowering the corporate income tax rate would create a stimulus for the economy by encouraging investment, expansion, and job creation. A recent analysis by The Heritage Foundation studied the economic impact of lowering the corporate income tax rate to 25 percent.[7] Reducing the corporate tax rate to 25 percent would create a scenario of economic growth:

- •The number of jobs in the U.S. would grow on average by 581,000 annually from 2011 to 2020, with 531,000 on average being created in the private sector each year;
- •U.S. real gross domestic product would rise on average by $132 billion per year;
- •A typical family of four's after-tax income would rise on average by $2,484 per year;

- •U.S. capital stock would grow by an average of $240 billion per year; and
- •Gross private domestic investment would increase by $57.2 billion per year.[8]

Although lowering the corporate tax rate would bring significant positive economic growth to the economy, it must also be accompanied with lower federal spending. Tax cuts are good for the economy, but they must be aligned with reductions in spending. Reducing taxes can create additional revenues for the government, but this is not always the case. The looming debt crisis is an albatross on the economy as the national debt is over $14 trillion and the federal government is facing a projected $1.5 trillion deficit for 2011, which is on top of the $1.3 trillion deficit in 2010 and $1.4 trillion deficit in 2009. "Lower tax rates on businesses would no doubt boost the ailing economy, but the growth would not be enough to offset the tax revenue lost from lower rates in the short term," noted Dubay.[9]

It is clear that the benefits of lowering the corporate income tax rate would be beneficial for the economy, but it is also clear that government spending and unnecessary regulations must be rolled back. As an example "in fiscal year (FY) 2010 alone, the Obama Administration unleashed regulations that will cost more than $26.5 billion annually, and many more are on the way."[10] Further tax reform, as in reducing the corporate income tax, along with reducing spending, paying down the debt, and eliminating unnecessary regulations will be essential in restoring the economy, while encouraging business growth and entrepreneurship.

Endnotes:

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debate about the proper role of the federal government by pushing to terminate the vast array of costly state aid programs.

Chris Edwards is the Director of Tax Policy studies at the Cato Institute and a top expert on federal and state tax and budget issues. He is also editor of the Cato Institute's Downsizing Government.org.

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