Policy Analysis

No. 718 January 8, 2013

Should U.S. Fiscal Policy Address Slow Growth or the Debt?
A Nondilemma

by Jeffrey Miron

Executive Summary

The United States faces two economic challenges: slow growth and an ever-increasing ratio of debt to GDP. Many policymakers believe they face a dilemma because the policy solutions to the two problems are opposite. To address the slow recovery, standard—Keynesian—economics suggests further fiscal stimulus in the form of lower taxes or higher spending. But that recommendation runs head-first into the economy's second crucial challenge, the long-run fiscal imbalance.

Yet policymakers are wrong to see this as a dilemma. The Keynesian model does not evaluate government expenditure using the standard microeconomic concepts of economic efficiency (cost-benefit analysis); rather, it assumes that all expenditure is beneficial. Some government purchases, however, are not a productive use of resources, and transfer payments distort economic incentives and thus can reduce economic output. In contrast, broad-based tax cuts, especially those that lower marginal tax rates, enhance economic growth.

The implication is that tax cuts are the most appealing kind of fiscal stimulus because they are beneficial on both Keynesian and efficiency grounds. Higher transfers and government purchases—increased expenditures—are questionable because any Keynesian benefits must be balanced against potentially large efficiency costs.

Thus the United States should cut unproductive expenditures while keeping tax rates low. A high deductible for Medicare would save money and improve the efficiency of the health care market. With rising life expectancies, Social Security is more generous than necessary to accomplish any reasonable goal of the program. Much military spending goes to programs not related to the defense of the United States. Business subsidies, drug prohibition, and pork-barrel spending should be cut.

The United States therefore has a simple path to a brighter economic future: slash expenditures and keep tax rates low. Reducing expenditures will improve the debt outlook and make the economy more productive, implying higher levels of output and further debt reductions for any given tax rates. Keeping tax rates low will improve the incentives for labor effort, savings, and entrepreneurship, which promotes a more productive economy.

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The standard—Keynesian—argument for government spending as an anti-recession tool is misguided; the efficacy of most stimulus is debatable at best, and much current expenditure should be eliminated regardless of the debt.

Introduction

The United States faces two economic challenges.

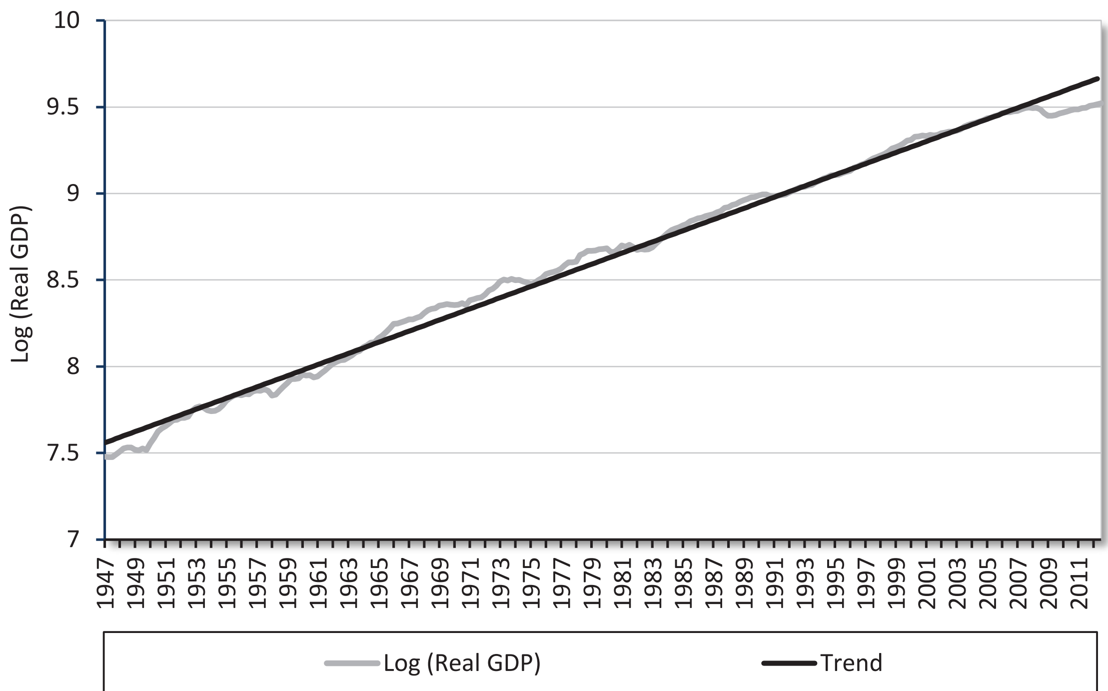
Since June 2009, when the recession ended, output has grown more slowly than in prior recoveries, leaving the level of output well below its long-term trend. Likewise, unemployment remains above the level usually considered full employment. Thus, although the recovery began more than three years ago, policymakers still seek further measures to stimulate the economy. And since monetary policy is probably out of ammunition, attention is focused on fiscal stimulus, meaning tax cuts or spending increases.

Looking forward, however, the United States faces an ever-increasing ratio of debt to GDP, which will eventually generate a fiscal crisis and sovereign default. This outcome is not inevitable; appropriate policy changes can avoid a fiscal meltdown, and any crisis might be decades away. Projections by the Congressional Budget Office, however, show that under "current policies," the United States debt path is not sustainable. That implies a need for spending cuts and tax increases, the opposite of what is suggested by the slow recovery.

It might appear, therefore, that the United States is stuck between a rock and a hard place. Policymakers can fight the slow recovery with tax cuts or spending increases, but that means leaving the debt for another day and in the meantime making it worse. Or policymakers can address the debt, but at the risk of slowing the economy or even generating a new recession.

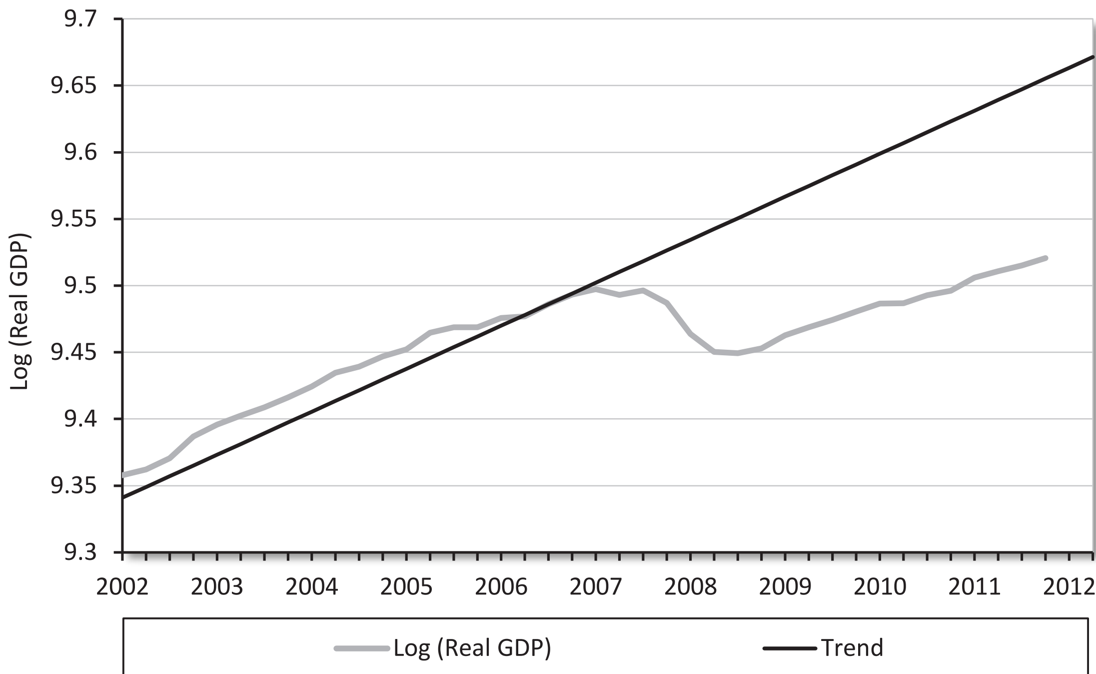
Yet policymakers face no such dilemma; the United States can have its (policy) cake and eat it too. That is because the standard—Keynesian—argument for government spending as an anti-recession tool is misguided; the efficacy of most stimulus is de-

Figure 1
Log of U.S. Real GDP, Quarterly, 1947:1–2012:3



Source: Data are from http://www.bea.gov/national/xls/gdplev.xls, linked from http://www.bea.gov/national/index.htm.
Note: The trend is estimated by regressing the log of real GDP on a constant plus a time trend.

Figure 2
Log of U.S. Real GDP, Quarterly, 2002:2–2012:3



Source: Data are from http://www.bea.gov/national/xls/gdplev.xls, linked from http://www.bea.gov/national/index.htm.
Note: The trend is estimated by regressing the log of real GDP on a constant plus a time trend.

batable at best, and much current expenditure should be eliminated regardless of the debt. This means that cutting both expenditure and taxes can speed the recovery in the short run and foster growth in the long run, while simultaneously putting the U.S. fiscal house in order.

The issues addressed here remain timely beyond the "fiscal cliff" discussion of tax hikes and expenditure cuts, as the United States still faces serious long-term fiscal debt issues. In the mainstream view, both the tax hikes and the spending cuts are undesirable because they will slow the economy, yet they are necessary to address the debt. In the view presented here, however, only the tax hikes are problematic; most (perhaps all) of the expenditure cuts are beneficial. Thus if policymakers cancel (or expand) the tax hikes but retain (or expand) the expenditure cuts, they can address the short run and long run problems in one fell swoop.

The Challenges Facing the U.S. Economy

To understand the controversy over fiscal policy, it is useful to review several facts about the U.S. economy.

Figure 1 shows (the log of) real output over the post-WWII period. The figure also shows the trend growth in output implied by these data. The striking fact is the steady increase in output over this horizon, at roughly 3.2 percent per year. Output has sometimes fallen below its long-term trend, but it has typically then grown faster and caught up to trend within a few years. Output was essentially back on trend, for example, about five quarters after the trough of the 1981–1982 recession.

Output has not yet returned to trend, however, some three years after the bottom of the 2007–2009 recession. Figure 2 makes this point more clearly by showing the same

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The "solution" of addressing the recovery now, via fiscal expansion, and the debt later, via fiscal contraction, is a pipe dream; the "right time" for fiscal contraction will never arrive.

data as in Figure 1, but for just the past 10 years. Output has increased in every quarter since the end of the recession in June 2009, but average growth has been only 2.2 percent. That implies a growing gap between the 3.2 percent trend line and the level of real output.

Figure 3 makes a similar point by showing the unemployment rate for the post-war period, along with a line indicating the average value over this period. Unemployment rose as output fell during the recession and then declined as output recovered. But just as real output is still well below trend some three years after the recession's end, unemployment is still well above its long-run average.

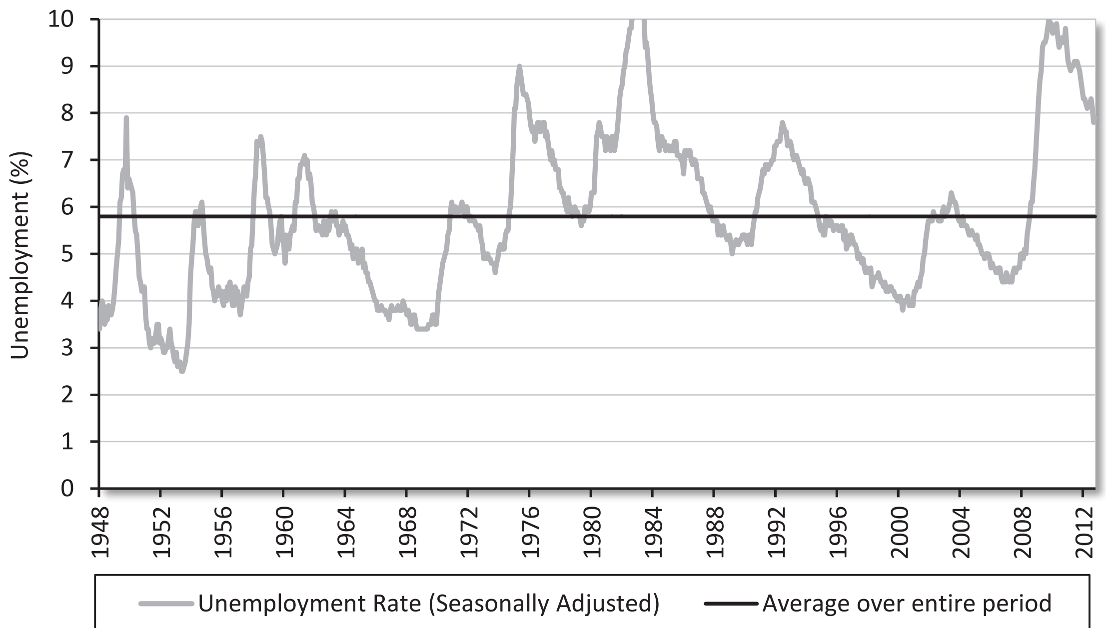
To address this slow recovery, Keynesian economics suggests further fiscal stimulus in the form of lower taxes or higher spending.[1] But that recommendation runs headfirst into the economy's second crucial challenge, the long-run fiscal imbalance.

Figure 4, based on CBO data and analysis, documents the magnitude of this imbalance. The graph shows past debt-to-GDP ratios along with CBO's forecasts under its "Alternative Fiscal Scenario." These forecasts assume that Congress extends a number of expiring tax cuts while avoiding several scheduled spending cuts. These assumptions are consistent with Congress's recent behavior.

Under CBO's "alternative fiscal scenario," the debt-to-GDP ratio increases indefinitely, implying a fiscal crisis and default. The alternative scenario is not the only plausible forecast, and the fiscal meltdown implied by this scenario may take decades to materialize. But even if these forecasts are somewhat pessimistic, the situation is still dire.[2]

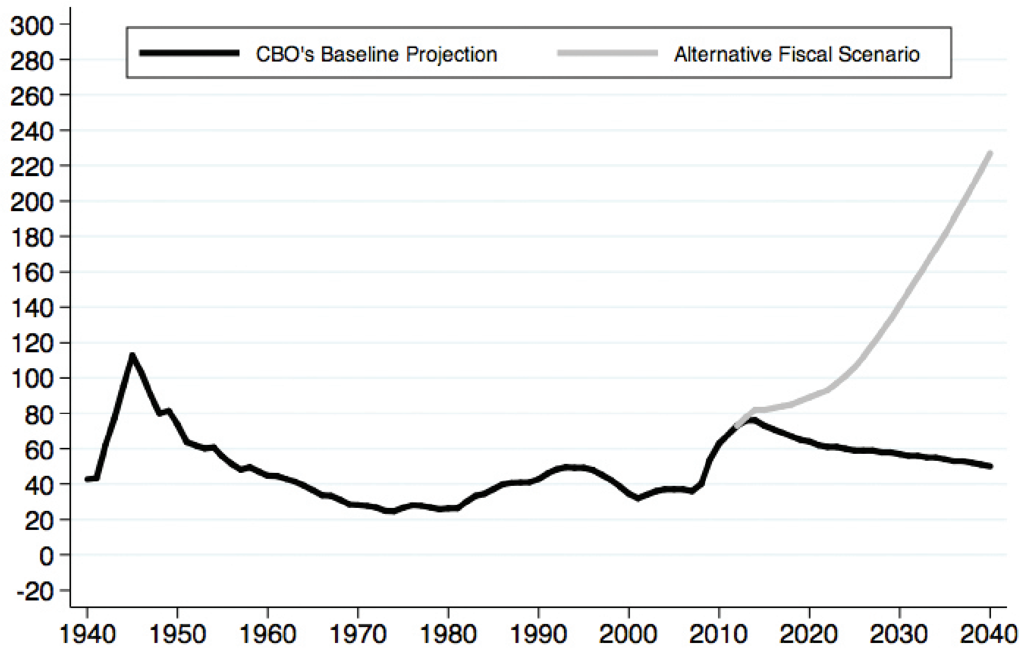
Thus, the apparent dilemma for policymakers is that what is required to deal with the slow recovery is the opposite of what is required to address the exploding debt. And the "solution" of addressing the recovery now, via fiscal expansion, and the debt later, via fiscal contraction, is a pipe dream; the "right time" for fiscal contraction will never arrive.

Figure 3
U. S. Unemployment Rate, Monthly, January 1948–October 2012



Source: Data are from http://data.bls.gov/pdq/SurveyOutputServlet.

Figure 4
Historical and Projected Ratios of U.S. Debt-to-GDP



Source: Data are from the Summary 1 tab of http://www.cbo.gov/sites/default/files/cbofiles/attachments/43539-AugustUpdate-Data_underlying_figures.xls, linked from http://www.cbo.gov/publication/43539. See also http://cbo.gov/sites/default/files/cbofiles/attachments/06-05-Long-Term_Budget_Outlook_2.pdf.

Determination of the appropriate path for fiscal policy is pressing, given the looming—and delayed—deadlines for the debt ceiling and the sequester.[3] The "fiscal cliff" deal didn't solve any of the fundamental fiscal issues. Taxes will rise for high-income taxpayers, with some possible negative effects on investment and growth. Possible spending cuts have been deferred yet again and must be addressed in March. Nothing has been done about the anticipated growth rates in transfer payments. Supporters claim the deal will reduce the 10-year deficit by $600 billion, a negligible impact on trillion-dollar-a-year deficits.[4]

In the Keynesian view, therefore, policymakers face a dilemma. But this dilemma is more apparent than real.

Why There Is No Policy Dilemma

To understand why the United States does not face a tradeoff between accelerating the recovery and avoiding a debt crisis, consider the logic behind the Keynesian perspective on fiscal policy.

The Keynesian model assumes that, in the short-term, most prices and wages are "sticky" at their existing levels. This is in contrast to the standard neoclassical assumption that prices in each market adjust quickly to equilibrate supply and demand. If prices and wages are (temporarily) stuck, then the main factor determining output is the demand for goods and services.

Aggregate demand in any economy comes from consumers (consumption), firms (investment), government (government purchases), and the rest of the world (net exports). In the long run, prices and wages adjust to changes in demand, so the amount of output is determined by the technology, the available factors of production (labor and capital), and government policies. In the short run, however, output can fall below potential if demand is insufficient.

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The Keynesian model does not evaluate government expenditure and tax policies using the standard microeconomic concepts of economic efficiency (cost-benefit analysis).

In the Keynesian model, therefore, recessions reflect a decline in the demand for goods and services. This might occur because consumers or firms become pessimistic and stop spending or investing. It might occur because government decides to retrench, or because other countries switch their purchases from the United States to elsewhere. A decline in demand might also occur if a financial crisis impairs the ability of consumers and firms to obtain loans for productive spending and investment.

The Keynesian model therefore suggests that government can reduce or eliminate recessions by stimulating the demand for goods and services whenever private demand lags. One method is cuts in taxes or increases in transfer payments; that puts more disposable income in the hands of consumers, who then spend more. A second mechanism is tax credits that encourage investment now rather than later. And a third approach is increased government purchases of goods and services, whether on roads, defense, education, R&D, or green energy. The increase in government demand helps offset the decline in private demand, thereby stabilizing output.

The Keynesian model is taught in most college and high school economics courses around the world. It is accepted wisdom in the halls of government. But a key implicit assumption, not mentioned so far, deserves further discussion.

The Keynesian model does not evaluate government expenditure and tax policies using the standard microeconomic concepts of economic efficiency (cost-benefit analysis). Instead, the model assumes the policy goal is to increase measured GDP. This might sound sensible and not inconsistent with economic efficiency. In fact, the merits of fiscal stimulus measures can differ radically between these two perspectives.

Government expenditure has two components: purchases of goods and services (such as for roads, education, research and development, or the military) and transfer payments (such as for unemployment insurance, welfare, foods stamps, Medicaid, Medicare, and Social Security).

The problem with the government purchases component is that the National Income and Product Accounts (NIPA) values government purchases as equal to expenditure on these purchases. This means that bridges-to-nowhere or military expenditures aimed at an imaginary alien invasion are both desirable policies from the Keynesian perspective because they cause measured GDP to increase (one component of GDP is government expenditure on goods and services). Yet such expenditures make no sense from a cost-benefit perspective.

For some government purchases, the cost-benefit assessment is more favorable, so the point raised above does not mean that additional expenditure can never make sense as stimulus. But it shows that the case for such spending depends on whether it would be desirable independent of the recession, and that spending more just to spend more is problematic. Plus, the case for additional spending depends on the existing size of government. Even if some expenditure on a particular program passes a cost-benefit test, this does not mean additional expenditures will pass as well.

Transfer payments are also problematic as stimulus because they distort economic incentives. Unemployment insurance discourages work effort, which reduces labor supply and keeps wages artificially high. Social Security encourages early retirement. Medicare and Medicaid induce moral hazard in health insurance, reducing the efficiency of the health care market. Thus, even if increased transfers have the textbook Keynesian effect of stimulating consumer spending, their net effect on the economy is, at a minimum, unclear.

For tax cuts, the efficiency consequences are normally beneficial rather than harmful, since lower tax rates improve economic incentives and reduce distortions, thereby providing an additional mechanism by which tax cuts can stimulate. Exceptions to this rule of thumb exist; tax cuts that favor one

industry over another, for example, are usually bad for economic efficiency. Likewise, tax cuts that increase progressivity can reduce the incentive to work and develop human capital. Broad-based tax cuts, and ones that lower marginal tax rates, however, will normally enhance economic growth.

This discussion has two implications. Tax cuts are the most appealing kind of fiscal stimulus because they are beneficial on both Keynesian and efficiency grounds. Higher transfers and government purchases—increases in expenditure—are more problematic because any Keynesian benefits must be balanced against potentially large efficiency costs.

Consistent with this characterization, the evidence suggests that tax cuts consistently stimulate economic growth, while expenditure cuts have modest if any negative impact on GDP growth.[5] The impact of tax cuts and expenditure cuts varies from one episode to another, as the discussion above implies: some kinds of expenditure makes more sense on efficiency grounds than others. Overall, however, the evidence does not confirm the Keynesian prediction that expenditure cuts are a major impediment to economic recovery; at the same time, it makes a strong case for the efficacy of tax cuts.

What Should Fiscal Policymakers Do Now?

The discussion above implies that the United States should cut unproductive expenditure while keeping tax rates low. The question is then whether the United States has enough inefficient expenditure to make a real difference to the debt path.

Yes, it does.

Medicare, which accounts for 13.5 percent of the federal budget, is far more expensive than implied by the economic argument for government provision of health care.[6] This argument, based on asymmetric information and adverse selection, suggests only that government guarantee access to a high-deductible policy that covers large, unanticipated expenditures; this argument does not justify insurance that covers virtually all health care expenses. Yet Medicare makes modest use of deductibles, reimbursing beneficiaries for most expenses and for all kinds of health costs, large or small.

The cost of Medicare's low-deductible approach is heightened moral hazard, which is the tendency for people with insurance to purchase more health care than is implied by a balancing of costs and benefits. Medicare therefore generates inefficiency in the health care market, as when doctors order tests or procedures that do little to diagnose or treat patients. The extra expenditure also encourages government to limit reimbursements to health care providers or to ration care, and providers respond with creative accounting and other nonproductive behavior to raise revenues. The limits on reimbursements then discourage innovation and reduce the supply of talented people who want to be doctors and other health care professionals.

The way to reduce moral hazard is to raise the Medicare deductible substantially. An increase of $6,400 per person, with roughly 40 million elderly beneficiaries, would generate savings of more than $250 billion per year.[7] More importantly, a far greater fraction of decisions about health care would reflect a balancing of costs and benefits, implying a more efficient health care system.

Social Security, which accounts for 20.3 percent of the federal budget, is also far more generous than necessary to accomplish any reasonable goal of this program.[8] When the United States adopted Social Security in 1935, life expectancy was 63, two years younger than the age of eligibility. Thus most Social Security recipients were in poor health and unable to work. Now, with life expectancy around 78 and health-status at age 65 much improved, many recipients could extend their working lives without undue hardship.[9] Thus it makes sense to cut Social Security, whether by increasing the age of retirement or by slowing the growth in benefits. Once phased in, these modifica-

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Table 1
Expenditure Savings from Reductions in Inefficient Programs

Program	Savings ($ billion)
Medicare	250
Social Security	100
National Security	100
Nondefense Discretionary Spending	100
Tax Expenditure	250
Total	**800**

Source: Author's calculations.

tions could easily yield $100 billion in reduced expenditure per year.

National defense, which accounts for 19.6 percent of federal expenditure, is again far larger than necessary.[10] National defense is the classic public good—something that everyone values but that free markets are unlikely to provide—so some expenditure on national defense makes sense. Yet many current or past military and national security activities have large and certain costs but hard-to-measure, intangible benefits, if any. Examples include the invasion and occupation of Iraq, the ongoing occupation of Afghanistan, provision of national security for Western Europe and other parts of the globe, not to mention misguided weapons systems, redundant military bases, and more.[11] Saving $100 billion per year should be easy.

Many current or past military and national security activities have large and certain costs but hard-to-measure, intangible benefits, if any.

A substantial fraction of nonmilitary, discretionary expenditure also fails any reasonable cost-benefit test and ought to be cut: drug prohibition, the National Endowments for the Arts and Humanities, the Corporation for Public Broadcasting, NASA, earmarks, the Post Office, Amtrak, foreign aid, agricultural subsidies, the Small Business Administration, and more. Even for expenditure categories that are defensible in moderation (e.g., transportation), many specific projects are wasteful (bridges-to-nowhere, the Big Dig, high-speed rail, and more). Many of these programs are small, but the number is large, so together they account for significant expenditure. Eliminating $100 billion—which will simultaneously improve economic efficiency—is a no-brainer.[12]

Last but not least, much of the implicit expenditure that occurs via the tax code is inimical to economic efficiency. A prime example is the tax-preferred status of employer paid health-insurance premiums. This gives employees an incentive to buy more generous insurance—especially policies with low co-pays and deductibles—which then means excessive purchase of health care. A second example is the deductibility of home mortgage interest, which spurs excess investment in residential capital rather than nonresidential capital like business plants, equipment, and R&D. The Office of Management and Budget estimates that elimination of these two tax expenditures would yield $235 billion per year in additional revenue, thus facilitating reductions in marginal tax rates.[13]

Thus any honest analysis of federal spending will conclude that, even accepting the standard goals of this spending, the current amount is far in excess of what is necessary to achieve these goals. Table 1 summarizes the expenditure savings suggested here, which come to at least $800 billion per year. Policymakers should cut these expenditures, regardless of the debt or the state of the economic recovery, because this expenditure

makes the economy less productive, lowers output, and slows economic growth.

Conclusion

The United States has a simple path to a brighter economic future: slash expenditures and keep tax rates low. Lower expenditures will improve the debt outlook and make the economy more productive, implying higher levels of output and further debt reductions for any given tax rates. Keeping tax rates low will improve the incentives for labor effort, savings, and entrepreneurship, which also promotes a more productive economy.

These lessons apply not just to the United States but to European countries as well. Indebted countries are being told to adopt austerity measures—lower spending and higher taxes—as a condition of debt relief. Predictably, given the analysis and evidence presented here, these measures have done little to ease the debt crisis because the tax hikes harm economic growth. Instead, therefore, debtor countries should undertake larger reductions in expenditures combined with constant or lower tax rates (plus labor market reforms in many cases). The direct impact on fiscal balance would be similar, but the effects on economic productivity would be far better. The debtor countries would recover more quickly, yielding increased tax revenue and smaller debts.

Many economists do not view the Keynesian perspective on government spending —that it should be used to boost the economy—as inconsistent with the standard microeconomic perspective—that spending should be determined by the costs and benefits of the expenditure in question. That is because many economists explicitly or implicitly endorse the view that the right amount of government spending, based on cost-benefit considerations, is much above current levels. If one accepts that view, then arguing for more spending stimulus is easy; additional bridges, weapons, schools, and the like appear beneficial regardless of the recession.

But that view assumes that the U.S. and other rich countries get more benefit than cost from current spending, despite convincing evidence that a large fraction is wasteful and that the standard goals of spending—such as providing a social safety net or national defense—are accomplished at much lower levels of expenditure. Indeed, substantial reductions would make sense even if the current debt outlook were much better than it is now because this spending does substantial harm over and above the fact that it is unaffordable.

Regardless of one's view of the appropriate size of government, however, any objective observer must recognize that current debt projections, even if not fully accurate, are cause for great concern. And any set of policies that is grotesquely unaffordable over the long haul cannot possibly be sensible on cost-benefit grounds. Nor can reasonable people believe that higher tax rates on the rich, no matter how draconian, can remotely address the looming debt explosion.[14] Thus the case for substantial expenditure reductions is compelling.

The United States has a simple path to a brighter economic future: slash expenditures and keep tax rates low.

Notes

1. Some economists favor additional monetary expansion, but many doubt that further easing will have much impact. See, for example, Phil Izzo, "Economists Skeptical on More Fed Easing," *Wall Street Journal Online*, September 12, 2012, http://online.wsj.com/article/SB10000872396390444017504577647522852235502.html?mod=googlenews_wsj.

2. The CBO's projections account for both the explicit debt and the implicit debt due to future spending on entitlements.

3. David Malpass, "Nothing Is Certain Except More Debt and Taxes," *Wall Street Journal*, January 2, 2013.

4. Congressional Budget Office, "Estimate of the Budgetary Effects of H.R. 8, the American Taxpayer Relief Act of 2012, as passed by the Senate on January 1, 2013," January 1, 2013, http://cbo.gov/sites/default/files/cbofiles/attachments/

American%20Taxpayer%20Relief%20Act.pdf.

5. See especially Alberto Alesina, Carlo Favero, and Francesco Giavazzi, "The Output Effects of Fiscal Consolidations," NBER Working Paper no. 18336, 2012; Robert J. Barro and Charles J. Redlick, "Macroeconomic Effects from Government Purchases and Taxes," *Quarterly Journal of Economics*, 126, no. 1 (2011): 51–102; Christina D. Romer and David H. Romer, "The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks," American Economic Review 100, no. 3, (2010): 763–801; and Valerie A. Ramey, "Can Government Purchases Stimulate the Economy?" *Journal of Economic Literature* 49, no. 3 (2011): 673–85.

6. The 13.5 percent figure is from author's calculations for 2011 based on Table 3.1, Office of Management and Budget, http://www.whitehouse.gov/omb/budget/Historicals.

7. The number suggested in the Obama "Facts" campaign advertisement as the additional amount seniors would have paid under the Romney-Ryan Medicare plan was $6,400.

8. The 20.3 percent figure is from author's calculations for 2011 based on Table 3.1, Office of Management and Budget, http://www.whitehouse.gov/omb/budget/Historicals.

9. Social Security no longer has a single retirement age; instead, those who are eligible for Social Security can begin collecting benefits as early as age 62 or as late as age 70, with benefits an increasing function of age. In addition, the so-called "normal retirement age" is gradually being increased from 65 to 67.

10. The 19.6 percent figure is from author's calculations for 2011 based on Table 3.1, Office of Management and Budget, http://www.whitehouse.gov/omb/budget/Historicals.

11. See, for example, Benjamin Zycher, "Unfounded Hand-Wringing over Military Spending," Cato Institute Commentary, September 21, 2012, http://www.cato.org/publications/commentary/unfounded-handwringing-over-military-spending-cuts; Christopher Preble, "Are Military Spending Cuts Good for the Economy?" *Cato@Liberty* (blog), August 8, 2012, http://www.cato-at-liberty.org/are-military-spending-cuts-good-for-the-economy/; and Benjamin H. Friedman and Christopher Preble, "Budgetary Savings from Military Restraint," Cato Institute Policy Analysis no. 667, September 21, 2010.

12. For further discussion, see http://www.downsizinggovernment.org/.

13. Data for 2011 from Table 17-1, Office of Management and Budget, http://www.whitehouse.gov/omb/budget/Supplemental. Many other tax expenditures are difficult to justify on efficiency grounds. Some, however, make sense under consumption rather than income taxation (e.g., provisions that allow faster than "normal" expensing of investment, assuming these apply broadly), so they potentially increase economic efficiency.

14. See, for example, Jackie Calmes, "Tax Arithmetic Shows Top Rate Is Just a Starter," *New York Times*, December 8, 2012, http://www.nytimes.com/2012/12/09/us/politics/tax-arithmetic-shows-top-rate-is-just-a-starter-in-talks.html?smid=pl-share.

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