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Cato Policy Report

November/December 2011 Vol. XXXIII No. 6

The Case for Cuts

BY CHRIS EDWARDS

Washington has been the scene of vigorous budget battles this year, but there are even larger struggles to come. The Budget Control Act (BCA), signed into law by President Obama in August, barely scratched the surface of needed reforms. The Act included caps on discretionary spending and it set up a “supercommittee” to find further savings. However, the deficit for 2012 will still be \$1 trillion or more, and the budget caps only attempt to slow the growth rate of discretionary spending. The large spending increases of recent years have not been reversed, and we can see from Obama’s recent “jobs” proposals that the urge to spend is alive and well.

To avert a Greek-style fiscal train wreck, we need much larger spending reforms than the leaders of either party are currently talking about. Most experts agree that we need to reform Social Security and Medicare, but the reality is that we need to pursue cuts in every federal activity from A to Z—from agriculture subsidies to the National Zoo. We should cut entitlement benefits, aid to the states, subsidies to individuals and businesses, and military spending. In many cases we should eliminate whole programs, or privatize activities where possible to remove them from the federal budget altogether.

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DAMAGE FROM RISING SPENDING

Federal spending soared over the past decade, growing from 18 percent of gross domestic product (GDP) in 2001 to 24 percent by 2011. That expansion was fueled by war costs, growing spending on discretionary and entitlement programs, and various efforts to “stimulate” the economy.

Government spending growth has already created giant deficits and displaced private-sector economic activity, but it could get much worse. The “alternative fiscal scenario” from the Congressional Budget Office (CBO) shows that federal spending could rise to 34 percent of GDP by 2035, *Continued on page 6*

The screenshot shows the Libertarianism.org website. At the top, there are navigation links: Introduction, History, People, LIBERTARIANISM (highlighted), Media, Publications, and Blog. Below this is a dark banner with the text: "LIBERTY. It's a simple idea, but it's also the linchpin of a complex system of values and practices: justice, prosperity, responsibility, toleration, cooperation, and peace. Many people believe that liberty is the core political value of modern civilization itself, the one that gives substance and form to all the other values of social life. THEY'RE CALLED LIBERTARIANS." There are two buttons: "60 Second Introduction" and "What is Libertarianism?". Below the banner is a "FEATURED MEDIA" section with a search bar and social media icons. The featured media includes a video titled "Are Liberty and Equality Compatible?" by Jan Narveson and James P. Sterba, dated August 3, 2010. There are also three smaller video thumbnails with captions: "ADAM SMITH: AN ENLIGHTENED LIFE" (January 12, 2011), "REALIZING FREEDOM: LIBERTARIAN THEORY, HISTORY, AND PRACTICE" (June 6, 2011), and "THE RATIONAL OPTIMIST: HOW PROSPERITY EVOLVES" (May 20, 2010). On the right side, there is a "RECENT POSTS" section with two entries: "WELCOME TO LIBERTARIANISM.ORG" by Aaron Ross Powell (dated 01 NOV) and "DO WE NEED THE CONSTITUTION?" by John Samples (dated 01 NOV).

In November, the Cato Institute launched Libertarianism.org, a new website focused on the theory and history of the libertarian tradition. By examining the philosophy of freedom at a deeper level, the site seeks to shed light on the animating principles behind an open and civil society. **PAGE 17**

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while federal debt held by the public could rise from 67 percent of GDP today to 187 percent by that year. Indeed, the problem is even worse than that because CBO does not take into account the negative effects of soaring spending and deficits on its benchmark projections of long-run economic growth. Thus, as CBO acknowledges, the rising debt would suppress GDP in coming decades, so we could end up in a death spiral of soaring debt in a shrinking economy.

Despite the obvious problem of rising spending, some policymakers are calling for “balanced” reforms that include tax increases. But CBO projections show that our fiscal problems are caused by abnormally high spending, not a shortage of revenues. Federal revenues are currently down due to the sluggish economy, but when the economy recovers, revenues are expected to rise to the normal level of about 18 percent of GDP—even with all the tax cuts of recent years in place.

Other policymakers don’t object to rising federal spending because they think that the United States has a uniquely small government. But that is no longer the case. Data from the Organization for Economic Cooperation and Development (OECD) show that total federal, state, and local government spending in the United States this year is a huge 41 percent of GDP. That compares to the average of the 32 advanced economies in the OECD of 45 percent. Until the big-spending Bush and Obama years, we enjoyed a government size advantage compared to the OECD average of about 10 percentage points of GDP. But that advantage has now shrunk to just 4 points, and we are fast becoming just another bloated welfare state.

The economic damage from rising government spending is caused by two basic factors. First, the spending itself transfers resources from higher-valued private uses to lower-valued government uses. Because the government is already so large, new spending very likely has a negative return and thus reduces GDP.

Second, the financing of rising spending causes damage. Taxes impose distortions, or

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“deadweight losses,” on the economy that come in addition to the costs on the private economy of the money seized by the government. If tax rates on working and investing are increased, for example, GDP will shrink because there will be less working and investing.

If new government spending is financed by debt, that pushes the damage of higher taxes into the future. But the rising debt itself will create economic uncertainty and a greater risk of financial crises. Recent academic research also indicates that economic growth tends to fall as gross government debt rises above about 90 percent of GDP, and gross federal debt in the United States has already surpassed that at about 100 percent of GDP.

Stanford University’s Michael Boskin calls government spending a “leaky bucket” because the benefits are a fraction of the costs. For every \$1 spent on a government program, the required taxes cause about \$1.50 of damage to the private economy. And because programs are so inefficient, every \$1 dollar of spending may only produce a return of perhaps 50 cents. Thus, “it costs taxpayers \$3 to provide a benefit worth \$1 to recipients,” notes Texas A&M University’s Edgar Browning.

The larger the government grows, the leakier the bucket becomes. On the revenue side, tax experts agree that economic distortions rise rapidly as marginal tax rates rise. On the spending side, funding is allocated to activities with ever lower returns as the government expands. In his 2008 book on government spending, *Stealing From*

Ourselves, Browning concludes that our excessively large government reduces average U.S. incomes by about 25 percent. If spending keeps on rising, American incomes will be pushed down even further.

This essay focuses on economics, but the damage caused by rising spending is much broader. The larger Washington becomes, the more it is creating a top-down bureaucratic society that is alien to American tradition of individual liberty. Growing federal power is destroying diversity and innovation in state and local governments by imposing a web of one-size-fits-all rules. New federal spending programs nearly always come with a raft of regulations that reduce freedom and choice, such as the individual mandate in the 2010 health law. In sum—whether or not we run trillion-dollar deficits—federal spending cuts are beneficial because they disperse power and expand freedom.

BALANCING THE BUDGET BY CUTTING SPENDING

In recent years, budget-reform discussions have focused on the three main entitlement programs: Social Security, Medicare, and Medicaid. That focus makes sense because these rapidly growing programs gobbled up \$1.6 trillion of the \$3.6 trillion federal budget in 2011. However, aside from interest costs, that still leaves \$1.8 trillion in spending on a vast array of other programs, and many of those programs are also growing rapidly.

Thus, it is important to look for savings in all areas of the budget. We should pursue cuts to the big-three entitlement programs, aid to the states, subsidies to individuals and businesses, military spending, and federal business activities that could be privatized. I’ve proposed a “Balanced Budget Plan” to cut spending to 18 percent of GDP by 2021, which would match the level of revenues that year with all the 2001 and 2003 tax cuts still in place. The plan is further detailed at www.DownsizingGovernment.org.

The table here lists the proposed cuts, which would reduce spending in 2021 by \$1.4 trillion, including interest savings, or about one-quarter of projected spending that year. By contrast, the Budget Control

Act (BCA) is supposed to reduce deficits in 2021 by just \$343 billion, which includes the savings from discretionary spending caps and the congressional supercommittee. The BCA savings are not only small, they are also more likely to be reversed than the full program terminations that my budget plan features.

SOCIAL SECURITY, MEDICARE, AND MEDICAID

The aging of the population and rapid health care inflation are causing the costs of Social Security, Medicare, and Medicaid to soar. To control costs and to increase freedom and choice, these programs should be fundamentally restructured. The insolvent Social Security system should be converted to a system based on personal savings accounts. The centrally planned Medicare system, which relies on a mass of regulations and price controls, should be converted to a system based on individual vouchers, savings, and consumer choice.

While they are pursuing these major

“Government spending transfers resources from higher-valued private uses to lower-valued government uses. Taxes impose distortions, or ‘deadweight losses,’ on the economy.”

care law of 2010 should be repealed. For Medicare, modest cost savings should include raising deductibles and premiums so that beneficiaries pay a larger share of their own costs. Medicaid’s matching grants to the states should be converted to fixed block grants, which would spur the states to make cost-saving innovations. Health care cost savings can also be found in tort reform and reducing high error rates in provider payments.

left to the states. The Tenth Amendment reads: “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” Federal and state governments are supposed to have separate areas of activity, with federal functions being “few and defined,” as James Madison noted.

In recent decades, however, Congress has undertaken many activities that were traditionally reserved to state and local governments. A key method has been through “grants-in-aid,” which are programs that combine federal subsidies to the states with regulations that micromanage state and local activities. President George W. Bush, for example, tied the regulations of his No Child Left Behind program to federal grants-in-aid for K–12 public schools. Federal aid to the states totals more than \$600 billion a year, and it is distributed through more than 1,100 programs.

Since the explosion of aid in the 1960s, it has become increasingly obvious that the federal government cannot efficiently solve local problems, such as improving school performance. One problem is that federal aid comes with a web of complex regulations that destroy state innovation. Another problem is that the aid system undermines government accountability because each level of government blames the other levels when programs fail. The system has been called a “triumph of expenditure without responsibility.”

The grants-in-aid system should be phased out over time. The proposed plan to balance the budget by 2021 would end federal aid for K–12 education, urban transit, public housing, rental housing, community development, job training, and various local justice and environmental activities. In addition, it would cut in half aid for food stamps, school lunches, and various Department of Health and Human Services subsidies.

These reforms would save \$257 billion annually by 2021. If state governments thought that these programs were crucial, they could raise funding from their own residents. After all, residents of the 50 states are funding those programs right now, but in

BUDGET AREA	ANNUAL SAVINGS IN 2021
SOCIAL SECURITY, MEDICARE, AND MEDICAID	\$490 BILLION
AID TO THE STATES	\$257 BILLION
SUBSIDIES TO INDIVIDUALS AND BUSINESSES	\$237 BILLION
MILITARY SPENDING	\$150 BILLION
PRIVATIZATION	\$22 BILLION

overhauls, policymakers should also take steps to start reducing costs right away. The growth in initial Social Security benefits should be linked to price increases rather than wage increases, and the program’s normal retirement age should be raised over time to 70. Social Security disability benefits have soared in cost in recent years, and there appears to be large amounts of fraud and abuse in the program. These benefits are cut 10 percent in the proposed plan.

The unaffordable and damaging health

All in all, these changes would generate growing savings over time, hitting about \$490 billion annually by 2021. Entitlement programs should be fundamentally restructured, and the reforms mentioned here would be good first steps to get costs under control.

AID TO THE STATES

Under the Constitution, the federal government was assigned specific limited powers, and most government functions were

a very inefficient and roundabout way through Washington.

SUBSIDIES TO INDIVIDUALS AND BUSINESSES

The federal government operates more than 2,000 separate subsidy programs, a doubling of subsidy programs since the mid-1980s. Thus, not only has the size of the federal budget expanded in recent decades in terms of dollars spent, but so has the scope of federal activities. About 1,100 of these subsidy programs are state aid programs, as noted, but the rest are subsidies to individuals and businesses.

Each subsidy program costs money, generates a bureaucracy, spawns lobby groups, and encourages even more people to demand freebies from the government. Individuals, businesses, and nonprofit groups that become hooked on subsidies essentially become tools of the state. They lose their independence, have less incentive to innovate, and shy away from criticizing the government. Subsidies undermine America's traditions of individual reliance, voluntary charity, and entrepreneurialism, and they should be ended.

The proposed plan to balance the budget by 2021 would terminate subsidies for farm businesses, rural activities, economic development, conventional and alternative energy, student aid, and home purchases. It would eliminate the refundable part of the child tax credit and half of the earned-income tax credit. It would cut federal worker compensation by 10 percent and cut foreign aid in half.

These proposed cuts to subsidies would save about \$237 billion annually by 2021. Subsidy recipients may be initially hurt by the cuts, but people would adjust over time and learn to survive—even thrive—without subsidies. Before welfare reform in 1996, liberals in Congress screamed that it would be the Apocalypse, forcing hordes of poor families to sleep on street grates. But after welfare reform, the poverty rate fell, the welfare rolls plunged, and many people moved into gainful employment. Or consider that before farm subsidies were abolished in New

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Zealand in the 1980s, farmers marched in the streets opposing the change. But after the reforms, New Zealand farmers found that they could do very well without subsidies, and these days they are proud of their independence from government.

MILITARY SPENDING

Cato defense experts Christopher Preble and Benjamin Friedman have proposed a list of cuts to U.S. military spending at www.DownsizingGovernment.org. They argue that to cut military spending, the United States should exercise restraint in its foreign policy, rather than trying to be the world's policeman, fixing failed states, and intervening in foreign civil wars. We should also let friendly nations bear more of the costs of their own defense.

By shedding such extraneous activities and refocusing resources on the core mission of defending the nation, we could reduce our overall force structure. Preble and Friedman's 19-point proposal would reduce spending by about \$150 billion annually by 2021. It includes a reduction in the size of the Army and Marine Corps, cuts to the Pentagon's civilian bureaucracy, and reduced purchases of low-priority ships, aircraft, and other equipment. The Constitution tasks the federal government with providing for the “common Defence,” not policing foreign lands and solving their political and military conflicts.

PRIVATIZATION

In recent decades, governments around

the world have sold state-owned assets and businesses to private investors. Airports, railroads, electric utilities, post offices, and other assets have been privatized. Privatization generally leads to reduced costs, higher-quality services, and increased innovation.

America has lagged behind in privatization, but not for lack of opportunities. Our air traffic control system, for example, has been mismanaged for decades. The Federal Aviation Administration (FAA) has struggled to upgrade its technology, and a series of workplace incidents in 2011—such as controllers falling asleep on the job—indicates that the FAA has serious labor problems. Meanwhile, Canada privatized its air traffic control system in 1996, with excellent results. The system is structured as a private nonprofit corporation, and it is self-supporting from charges on aviation users. The Canadian system has received high marks for sound finances, solid management, and investment in new technology.

Privatizing air traffic control, Amtrak, and the Army Corps of Engineers would produce annual budget savings of about \$22 billion, which would be in addition to the one-time receipts gained from the asset sales. Other government assets and activities that could be privatized include postal services, dams, electric utilities, land, and even the National Zoo in Washington.

CONCLUSION

Unless rising spending and debt are cut, we may be headed for years—even decades—of sluggish economic growth and frequent financial crises. Hopefully, Americans will reject a future of crippling debt and growing government power, and the results of the 2010 elections suggest that the public has already started to revolt.

Reform-minded policymakers have their work cut out for them. The small cuts of the 2011 Budget Control Act won't be enough. Our budget problems are so large that policymakers need to start terminating whole programs and agencies, and the sooner they get started the less of a debt anchor they will put around the necks of the next generation. ■