



WASTEFUL SPENDING DOES NOT STOP AT EARMARKS AND OVERPAYMENTS

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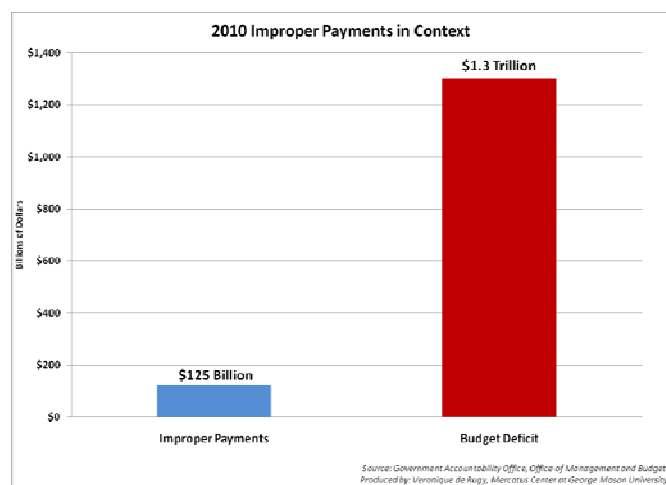
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INTRODUCTION

Fraud, waste and abuse in the form of improper federal payments are undoubtedly problems worthy of congressional attention. However, improper federal payments are only a small component of government waste in this country. Federal entities estimate improper payments totaled \$125.4 billion in fiscal year 2010, about 5.5 percent of the \$2.3 trillion in reported outlays for the related programs.¹ This \$125 billion in overt waste, however, pales in comparison to the pervasive waste that exists in current spending patterns. It certainly pales compared to the economic damage caused by misallocation of capital and the creation of perverse incentives such as moral hazard.

In fiscal year 2010, the federal government spent \$3.6 trillion dollars, or 24.6 percent of the gross domestic product (GDP),² well above the historical average. The consequence of this spending was \$1.3 trillion in budget deficits.³ A large part of this overspending was improper spending or spending that never should have happened at all.



¹ U.S. Government Accountability Office, *Government Accountability Office Auditor's Report: Fiscal Year 2010*, 245, <http://www.gao.gov/financial/fy2010/10gao2.pdf>.

² U.S. Office of Management and Budget, *Mid-Session Review: Fiscal Year 2011*, July 2010, 5, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/11msr.pdf>.

³ Congressional Budget Office, *Budget and Economic Outlook: Fiscal Years 2011 to 2021*, January 2011, 1, <http://www.cbo.gov/ftpdocs/120xx/doc12039/SummaryforWeb.pdf>.

According to the CBO's *alternative scenario* budget projection—the scenario under which widely expected policy changes occur, including legislators' concessions to interest groups such as physicians and senior citizens—at its current trajectory, spending will increase to 25.9 percent of GDP in 2020 and to 32.2 percent in 2030.⁴

The expansion of mandatory programs, such as Medicare, Medicaid, and Social Security, is the driving force behind this spending growth. According to the CBO's alternative scenario, the combined cost of these three programs, which was roughly 10 percent of GDP in 2010, will reach 12.4 percent in 2020 and 15.7 percent in 2030.⁵

As the debt grows, fed by increased Medicare and Medicaid spending, the interest payment on that debt grows as well. If the United States does not change course, payment on the debt will end up as its biggest budget item. There is consensus that this path is unsustainable. According to the United States Treasury, in fiscal year 2010, gross federal debt was \$13.6 trillion, or roughly 90 percent of the United States' GDP.⁶ Nine trillion of this debt was owed to outside investors.⁷ If we continue along our current fiscal path, by the year 2030 debt held by the public will reach \$34.3 trillion or nearly one and a half times the entire GDP of the United States.⁸ Indeed, interest on the debt as a percentage of GDP will explode from a mere 1.8 percent of GDP in 2012 to more than 46 percent of GDP in 2084.

But these debt numbers pale in comparison to unfunded liabilities. According to the *Financial Statement of the United States*, in 2010 the net present value of the promises made to the American people for which the United States does not have the money to pay is roughly \$75 trillion.⁹

The harsh reality is that if the country does not deviate from its current path, the majority of future federal spending will finance the spending of the past.

Here, I focus on three types of systemic spending waste that must be addressed: federal spending on functions that should be reserved for the private sector, federal spending on functions that should be reserved for the states and federal spending on things that government has no business doing in the first place.

FEDERAL SPENDING IN PLACE OF THE PRIVATE SECTOR

Economic theory suggests that governments provide public goods more efficiently than the private sector, but that the private markets provide non-public goods, especially commercial ones, more efficiently than government. Unfortunately, according to Office of Management and Budget, about half of all federal employees perform tasks that are not “inherently governmental.”¹⁰ Having the government run businesses—such as Amtrak and the Postal Service—and oversee infrastructure—such as the air traffic control system—is not just inefficient. It also hinders economic growth, and costs the taxpayers money while providing low-quality services to customers.¹¹

Not only should the federal government not operate private businesses, it should also not pick winners or losers in private business by giving subsidies to private operators—including farmers, small business owners, automakers or energy providers—or by guaranteeing loans to small businesses or energy companies.¹² This “corporate welfare” consists in, in essence, picking winners and losers. And this introduces distortions and unfair competition into the private sector.

⁴ Congressional Budget Office, *Long-Term Budget Outlook*, Supplemental Material, Summary Data for the Alternative Fiscal Scenario, June 2010, <http://www.cbo.gov/doc.cfm?index=11579>.

⁵ Ibid.

⁶ U.S. Department of Treasury, *Monthly Statement of the Public Debt of the United States*, September 30, 2010, <http://www.treasurydirect.gov/govt/reports/pd/mspd/2010/opds092010.pdf>.

⁷ Ibid.

⁸ Congressional Budget Office, *Long-Term Budget Outlook*, Supplemental Material, Summary Data for the Alternative Fiscal Scenario, June 2010, <http://www.cbo.gov/doc.cfm?index=11579>.

⁹ U.S. Department of Treasury, *Financial Statement of the United States FY2010*, <http://www.gao.gov/financial/fy2010/10frusg.pdf>.

¹⁰ Chris Edwards, “Privatization,” *Downsizing the Federal Government*, February 2009, <http://www.downsizinggovernment.org/privatization>.

¹¹ Dong Fu, Lori L. Taylor, and Mine K. Yücel, “Fiscal Policy and Growth” (Working Paper 0301, Federal Reserve Bank of Dallas, January 2003), 10.

¹² See Veronique de Rugy, “Banking on the SBA,” *Mercatus on Policy* 2, (Arlington, VA: Mercatus Center at George Mason University, 2011), <http://mercatus.org/publication/mercatus-policy-banking-sba>.

It is unfair, for instance, that a restaurant owner who got a private small business loan on the merit of his business plan has to compete with another restaurant owner who benefited from a government-backed loan because he could not get a one from the private sector. Moreover, these subsidies make no sense they either target companies that should be failing because the companies produce goods and services that costumers do not want or they target successful companies that do not need subsidies in the first place. Either way, these subsidies represent a drag on the economy.

Moreover, in some areas the absence of private enterprise is actually the direct result of government subsidies and/or government-granted monopoly positions. For instance, an article in the *Journal of Monetary Economics* finds that: “[T]here is substantial crowding out of private spending by government spending.... [P]ermanent changes in government spending lead to a negative wealth effect.”¹³

Additionally, the existence of government hand-outs or privileges introduces incentives for private firms to focus more energy on obtaining government favors than on the production of goods and services that consumers would be willing to pay for.¹⁴

After all, the government’s provision or subsidy of private services can have problematic consequences for taxpayers. In 2000, American Enterprise Institute scholar Peter Wallison showed that the government-chartered and government-sponsored corporations Freddie Mac and Fannie Mae were performing far worse in financing low-income housing—especially in minority areas—than ordinary banks.¹⁵ Also, the operations could lead to a serious liability for taxpayers. Unfortunately, Wallison was right about the financial burden to taxpayers.¹⁶

Privatization of federal assets makes sense for several reasons. First, privatization could help resolve some of this country’s debt and deficit problems by yielding one-time revenues of hundreds of billions of dollars over the next decade while leading to annual reductions in outlays. Even though the amount of money saved through privatization at the federal level would not be enough to address the fiscal challenges of retiring baby boomers, the potential deficit reduction would still be substantial.

Second, privatization would spur economic growth by opening new markets to entrepreneurs. As Chris Edwards points out, “The privatization of the USPS and the repeal of its legal monopoly would bring major innovation to the mail business, just as the breakup of AT&T monopoly in the 1980s brought innovation to the communication business.”¹⁷ A significant privatization program might also enhance government productivity. By reducing the responsibilities of the federal government, members of Congress could focus on core responsibilities like homeland security.

Finally, the federal government would not be the first to privatize government holdings or activities. Several states have done it. In August 2009, the state of California, for instance, hosted the “Great California Garage Sale” of unused assets such as Blackberries, vehicles, desks, ZIP drives, file cabinets, and tables. That sale grossed \$1.6 million.¹⁸ While \$1.6 million is a drop in the bucket compared a \$38.9 billion shortfall, the push to sell unused state assets should be applauded.

Luckily for taxpayers in California, small assets are just the tip of the iceberg for potential asset sales. In May, Gov. Arnold Schwarzenegger proposed selling several major assets including San Quentin State Prison, Orange County Fairgrounds, Del Mar Fairgrounds and Race Track, Cow Palace (an exhibition hall in Daly City), Cal Expo, Ventura County Fairgrounds, and Los Angeles Memorial Coliseum.¹⁹ Such assets are valuable enough to make a significant dent into California’s budget shortfall. For example, some estimates put the value of San Quentin State Prison,

¹³ Shaghil Ahmed, “Temporary and Permanent Government Spending in an Open Economy,” *Journal of Monetary Economics*, Vol. 17, No. 2 (March 1986), pp. 197-224.

¹⁴ Timothy Carney, *The Big Rip-Off: How the Government and Big Businesses Steal Your Money?* (John Willey and Sons, New Jersey, 2006).

¹⁵ Peter Wallison, “The Fundamental Problem with Fannie Mae and Freddie Mac,” American Enterprise Institute, Friday, December 1, 2000.

¹⁶ Peter Wallison, Dissenting Statement, Financial Crisis Inquiring Commission, January 2011, http://c0182732.cdn1.cloudfiles.rackspacecloud.com/fcic_final_report_wallison_dissent.pdf.

¹⁷ Chris Edwards, “Downsizing the Size of the Federal Government,” *Cato Institute Policy Analysis* 515, 34, http://www.heartland.org/custom/semmod_policybot/pdf/15352.pdf

¹⁸ <http://www.dgs.ca.gov/GarageSale>

¹⁹ <http://articles.latimes.com/2009/may/14/local/me-budget14>

which sits on a prime piece of real estate overlooking San Francisco Bay, at \$2 billion even in a down market.²⁰ Such sales are nothing new. In 2001, the state sold surplus properties in Silicon Valley for \$149 million.²¹ From FY 2002–03 to FY 2006–07, the state sold, transferred, or exchanged 43 surplus properties grossing over \$218 million.²² There are likely many more surplus properties ripe for sale. As of January 5, 2010, the state owns 2,813 properties, covering 6,818,057.93 acres, and the California Performance Review has identified nearly 50 high-value, state-owned urban properties that combined could sell for up to \$4.3 billion.

A number of states also have started to finance and operate highways privately, like Virginia's Dulles Greenway, a 14-mile private highway opened in 1995 and paid for by private bond and equity issues. Similar private highway projects have been completed, or are being pursued, in California, Maryland, Minnesota, North Carolina, South Carolina, and Texas. In Indiana, Governor Mitch Daniels even leased the highway and made a \$4 billion profit for the state's taxpayers.

Other countries have also had experience with privatization. The French A14 in Paris has been funded with private funds and has not only managed to stay in business but has even helped to reduce the nation's traffic congestion. Also, while almost all major U.S. airports are owned by state and local governments and receive federal government subsidies for renovation and expansion, many countries have privatized or partly privatized their airports, including airports in Athens, Greece; Auckland, New Zealand; Brussels, Belgium; Copenhagen, Denmark; Frankfurt, Germany; London, UK; Melbourne and Sydney, Australia; Naples and Rome, Italy; and Vienna, Austria.²³ Interestingly, most of these countries have also privatized or partly privatized their postal services.

FEDERAL SPENDING IN PLACE OF THE STATE SPENDING

Just as the federal government is not the best-suited entity to deliver services that should be delivered by the private sector, so too it is not the best entity to provide public goods that should be delivered at state or local levels.

Take the protection of the United States. In theory, the protection of the country against international enemies is a public good. Yet, not all protections should be delivered by the federal government. Espionage, intelligence, and immigration control have, by nature, a national scope, so the federal government should make these investments. But the protection of public infrastructures such as bridges and water treatment plants that benefit the residents of a particular state or locality should fall to the state or local government. Even if there might be adverse effects throughout the economy if a specific bridge were to be destroyed, the principal economic impact of such an unfortunate event would be felt primarily locally.

But unfortunately, during recent American history, the federal government has expanded its reach and taken over many state functions. The main reason behind this centralization is the lack of distinction, as President Reagan noted in a 1987 Executive Order, "between problems of national scope (which may justify federal action) and problems that are merely common to the states (which will not justify federal action because individual states, acting individually or together, can effectively deal with them)."²⁴

This confusion over federal versus state authority extends to areas such as education, transportation, and homeland security. For instance, Congress allocates most of homeland security spending to pay for things that are local in nature such as hazmat suits and first responders' radios.

This allocation happens mainly through the federal distribution of grants to state and local governments, the so-called grants-in-aid. Figure 1 shows federal grant spending in constant (2000) dollars from 1960 to 2013. Total grant outlays increased from \$285.9 billion in fiscal year 2000 to \$363.3 billion in fiscal year 2010—a 27.1 percent increase. Grants also account for an increasing share of federal spending: 18 percent in 2009 as compared to 7.6 percent in 1960. The data show the federal government is taking over more and more state-confined activities, such as education or even transportation.

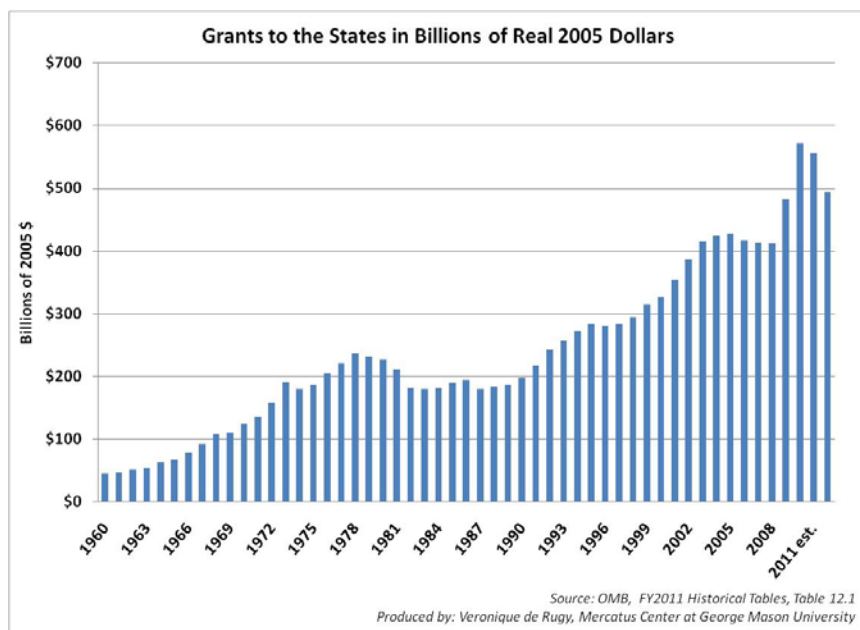
²⁰ http://www.cnn.com/2009/US/03/31/oceanfront.prison/index.html?eref=rss_mostpopular

²¹ <http://reason.org/blog/show/california-holds-garage-sale-t>

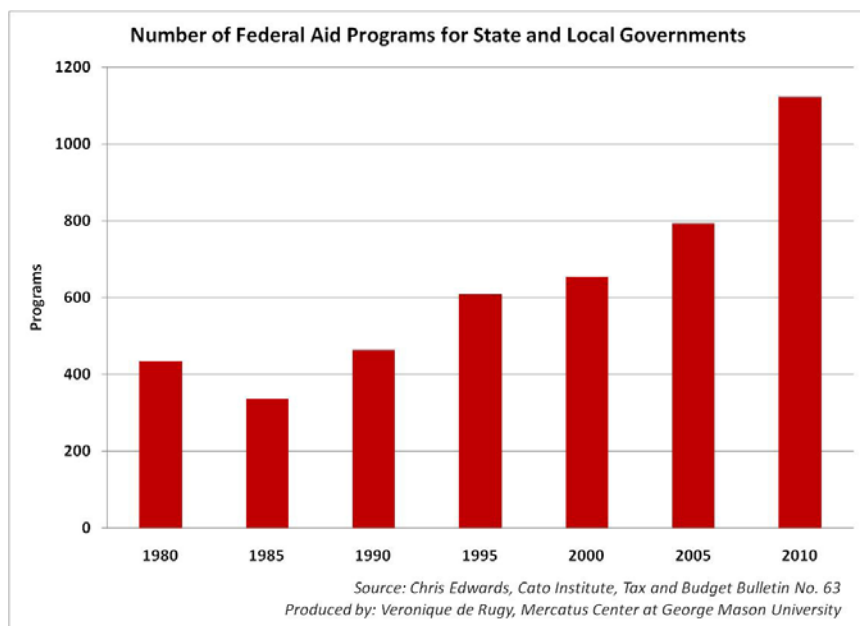
²² <http://www.documents.dgs.ca.gov/Legi/Publications/2008/Surplusproperty.pdf> Legislative Reports

²³ Chris Edwards, "Privatization," *Cato Institute Handbook for Policymakers*, 7th Edition,

²⁴ Ronald Reagan, Executive Order 12612, October 26, 1987, www.reagan.utexas.edu/archives/speeches/1987/102687d.htm.



The total number of federal grant programs displays the same pattern. According to Chris Edwards of the Cato Institute, there are now 1,122 aid-to-state programs, 72 percent more programs than just a decade ago. Indeed, federal spending throughout the recession has only exacerbated the trend with an estimated \$291 billion dollars going to states through increased unemployment benefits, the Supplemental Nutrition Assistance Program, Medicaid matching, Build America Bonds, and the state fiscal-stabilization fund.²⁵



²⁵ Author's calculation based on Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2010 to 2020*, January 2010, Appendix A.

This increased funding to the states has serious consequences.

Federal grants to state and local governments spur wasteful spending. The incentive structure of aid programs encourages lawmakers at all levels of government to overspend. These programs allow lawmakers to claim credit for spending on a program without the responsibility of collecting the entire tax bill necessary for the funding.

Also, grant design often gives states an incentive to increase their spending on these programs. A funding formula based on “matching” provisions for instance means that for every dollar the state spends the federal government will shoulder some of the total amount, thereby lowering the states’ burden of the cost and giving states an incentive to increase its provision. Under a 50-50 matching rule, for every \$1 a state spends on a program, the federal government chips in \$1. Matching reduces the consequences of increasing spending, thus prompting the states to expand programs.

The quintessential example of a matching grant leading to overspending is Medicaid. As my colleague Matt Mitchell wrote recently, “Medicaid is financed by a federal matching grant. This means that for each dollar a state adds to its Medicaid budget, the federal government will kick in from 1 to 3 additional dollars. This gives states an incentive to expand beyond the point where additional costs begin to exceed benefits.”²⁶

Because of the open-ended federal match under Medicaid, state governments have continuously expanded health benefits and the number of eligible beneficiaries. Mitchell writes, “Adjusting for growth in health care prices, states increased spending on Medicaid by 116 percent from 1987 to 2007. From 2000 to 2007, the rate of Medicaid enrollment grew four times as fast as the general population.”²⁷

Unfortunately, two-thirds of federal aid spending is on grant programs that have matching requirements. One way to limit the never-ending expansion of matching grants is to convert them to block grants. According to Chris Edwards, “Block grants provide a fixed sum to states and give them flexibility on program design. For example, the 1996 welfare reform law turned Aid to Families with Dependent Children, an open-ended matching grant, into Temporary Assistance for Needy Families, a lump-sum block grant. Similar block grant reforms should be pursued for Medicaid and other programs. Converting programs to block grants would reduce incentives to overspend and would make it easier for reformers to cut and eliminate programs in the future.”²⁸

Federal grants to state and local government forces states to increase spending and taxes. Building on a large economic literature, a recent paper by economists Russell Sobel and George Crowley finds new evidence of what economists term the “flypaper effect,” wherein federal money given to states prompts additional spending.²⁹ In addition, however, they show that every dollar in temporary federal grants to states and localities leads to 40 cents of future tax increases.

This was former South Carolina governor Mark Sanford’s argument for trying to reject the stimulus money back in 2009. Referring to when the temporary federal stimulus funding runs out two years in the future, he states: “[...] or do we just summarily end programs, [o]r are we to plan on yet another round of stimulus windfall from Washington in two years. The easiest of all things would be to take and simply spend all of Washington’s well intended efforts, but in our case it would guarantee lost opportunities that I don’t think our state can afford.”³⁰

The data show that Governor Sanford was correct. When states accept federal aid today to create or expand public programs, they will inevitably be forced to decide whether to cut the programs or raise taxes when federal aid ends. Generally they decide to raise taxes, averaging 40 cents in state and local tax increases for every federal grant dollar lost. Thus some of the blame for states’ current fiscal crises also lies at the Capitol’s doorstep.

²⁶ Matt Mitchell, “The Eligibility Explosion,” Room for Debate, *New York Times*, December 6, 2010,

<http://www.nytimes.com/roomfordebate/2010/12/05/how-to-save-medicaid/expanded-eligibility-busted-budgets>.

²⁷ Ibid, <http://www.nytimes.com/roomfordebate/2010/12/05/how-to-save-medicaid/expanded-eligibility-busted-budgets>.

²⁸ Chris Edwards, “Fiscal Federalism,” in *Downsizing the Federal Government*, Cato Institute, February 2009,

<http://www.downsizinggovernment.org/fiscal-federalism>.

²⁹ Sobel and Crowley, “Do Intergovernmental Grants Create Ratchets in State and Local Taxes? Testing the Friedman-Sanford Hypothesis” (working paper, Mercatus Center at George Mason University, 2010).

³⁰ Mark Sanford, “Prudence on Stimulus in State’s Best Interest,” *Myrtle Beach Sun-News*, April 6, 2009.

Federal grants to state and local functions destroy meaningful competition between states for taxpayers and businesses by obviating any differences between the states. In theory, fiscal federalism—the idea that, acting under some federal constraints, states should set their own economic policies rather than follow directives from the central government—is a great tool that holds state and local governments accountable for their policy actions. In practice, it hardly exists. The increasing scope of federal programs and grants has largely eroded fiscal federalism’s effect on state and local governments’ policy decisions and made tax considerations almost irrelevant in people’s decisions about where to live.

First, as federal grant programs continue to grow, so does the federal taxation required to fund this redistribution. Today, federal taxation has grown so much that differences in state tax rates contribute only marginally to a taxpayer’s total tax burden. Sixty percent of all government revenues in 2008 came from the federal income tax, making it the dominant tax burden in Americans’ lives. By contrast, in 1930, the federal income tax provided only 30 percent of all government revenues.

All other things being equal, it remains less costly to live or run a business in a low tax-rate state than in a high tax-rate one. However, when the central government imposes an ever-increasing percentage of each taxpayer’s total tax burden, differences in state taxes become less important. If your main tax burden is going to be the same wherever you live, why bother even moving to another state, especially if you get to deduct your state taxes from your federal ones? Being able to deduct state taxes from the federal burden obviates any differences between the states.

Second, such grants come with strings attached, strings that further weaken states’ diversity. In order to retrieve some of the money that their residents have paid in federal taxes, states must compete with each other to get money from the federal government instead of more directly competing with each other to gain residents.

This lack of meaningful interstate competition has a negative effect on taxpayers. As programs become more centralized, state authorities must increasingly comply with procedures and regulations set forth by Washington. These homogenous procedures and regulations often ignore the needs of local taxpayers. In effect, the states and the federal government act as a tax cartel, charging higher taxes for lower quality services that do not address the unique needs of communities.

We should mourn the death of fiscal federalism. The fear of losing taxpayers to another jurisdiction gives policy makers an incentive to keep taxes, regulations, and other intrusions modest; but homogenized, top-down policy diminishes the incentives for states to compete for residents. Instead of competing for residents, states compete for central government funding and privileges. It’s a system that rewards the best lobbyists while wasting taxpayers’ money.

In order to bring fiscal federalism back to life, Congress needs decentralize radically the government’s power to tax and to spend.³¹ Today, lawmakers need to revive federalism by transferring many programs back to the states. States are, after all, in a better position than the federal government to determine their needs when it comes to roads or schools.

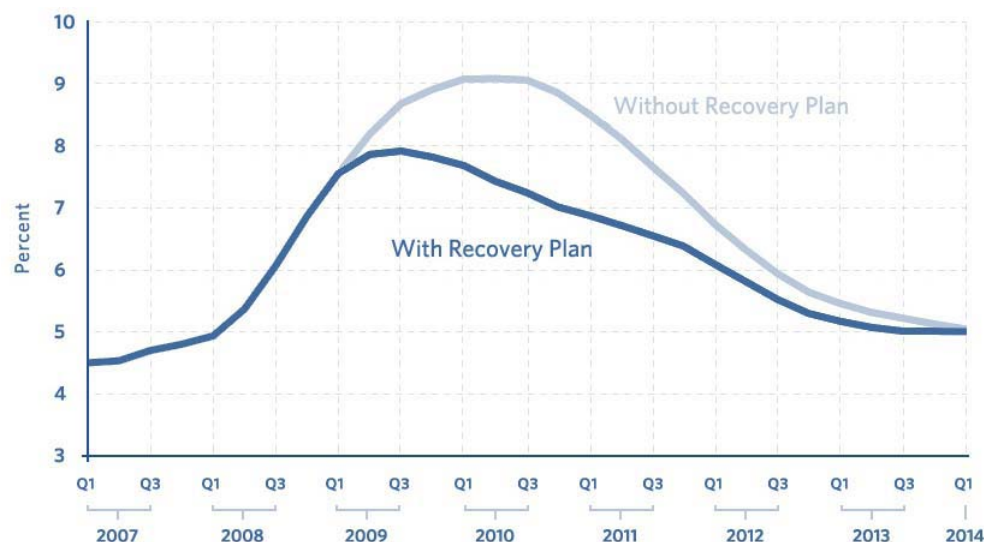
A first step would be to cut federal aid to the state governments dramatically. Eventually, the federal government would have to abolish the national income tax and cease giving grants to state and local governments, thereby expelling central government from state and local functions and making true fiscal federalism possible.

States’ requests for federal bailouts from their financial woes seem imminent. Such bailouts would likely take the form of transfers from the federal government to the states to pay for teachers and other public employees. But such bailouts won’t help the states. What the states need is tough love that would force them to address the problems that are the sources of their crises, including pensions, Medicaid, and education spending.

³¹ The Reagan administration’s policy of “new federalism” attempted to sort out the mess of federal grants by redefining federal and state priorities so that each level of government should have full responsibility for financing its own programs. For example, the Omnibus Budget Reconciliation Act of 1981 eliminated 59 grant programs and consolidated 80 narrowly focused grants into nine block grants, reducing their regulatory burden. Unfortunately, this progress was subsequently reversed.

FRUITLESS FEDERAL SPENDING

The largest and most obvious example of wasteful federal spending is that which has occurred under the American Recovery and Reinvestment Act.



This figure, drawn from a January report by White House economists Jared Bernstein and Christina Romer, compares projected unemployment rates with and without the passage of a \$700 billion stimulus package.³² Comparing the unemployment rates projected by Romer and Bernstein, which peak at 8.8%, to reality suggests that the Administration's promise that the ARRA bill would reduce unemployment rates and create jobs did not materialize. As of February of this year, recipients of loans, grants, and contracts through the stimulus have reported \$275 billion received through the stimulus bill, and yet unemployment hovers around 9%. In fact, data from the Bureau of Labor statistics shows that since the passage of the stimulus, employment has fluctuated wildly, reaching a peak of 10.1% in October of 2009, a rate much higher than the 8.8% unemployment the Administration claimed the country would face if Congress didn't pass the gigantic American Recovery and Reinvestment Act spending bill.

There is much evidence to suggest that the massive spending set into motion by the American Recovery and Reinvestment Act did not achieve its objectives.³³ Scholars throughout academia have formed thoughtful critiques of stimulus spending, including identifying fundamental flaws in the methods used to estimate job creation from the stimulus,³⁴ tracking how stimulus spending went primarily to prop up the borrowing of states and localities (therefore providing little net Keynesian stimulus),³⁵ and noting the propensity of fiscal stimulus to shift consumption to an earlier time, not increasing it on net.³⁶ Given the evidence, many scholars have arrived at the conclusion that the fiscal stimulus package passed in 2009 was a waste. The practical realities witnessed by the American taxpayer today bear out this academic truth.

³² Christina Romer and Jared Bernstein, *The Job Impact of the American Recovery and Reinvestment Act*.

³³ In *Did the Stimulus Stimulate? Real Time Estimates of the Effects of the American Readjustment and Recovery Act*, James Feyrer and Bruce Sacerdote compare states and counties that got heavy doses of stimulus spending with those that didn't, and look at the trends in growth and unemployment in these regions. They find that in the *short run*, the stimulus did boost the economy, though not to the extent promised by the Obama Administration at the passage of the American Recovery and Reinvestment Act. The authors also point out the difficulty of analyzing the effects of a stimulus relative to a counterfactual baseline. Why? Because the stimulus was designed so that large amounts of money went to the states. The states used the money to pay for existing education and law enforcement jobs. Paying for extant jobs does not stimulate an economy.

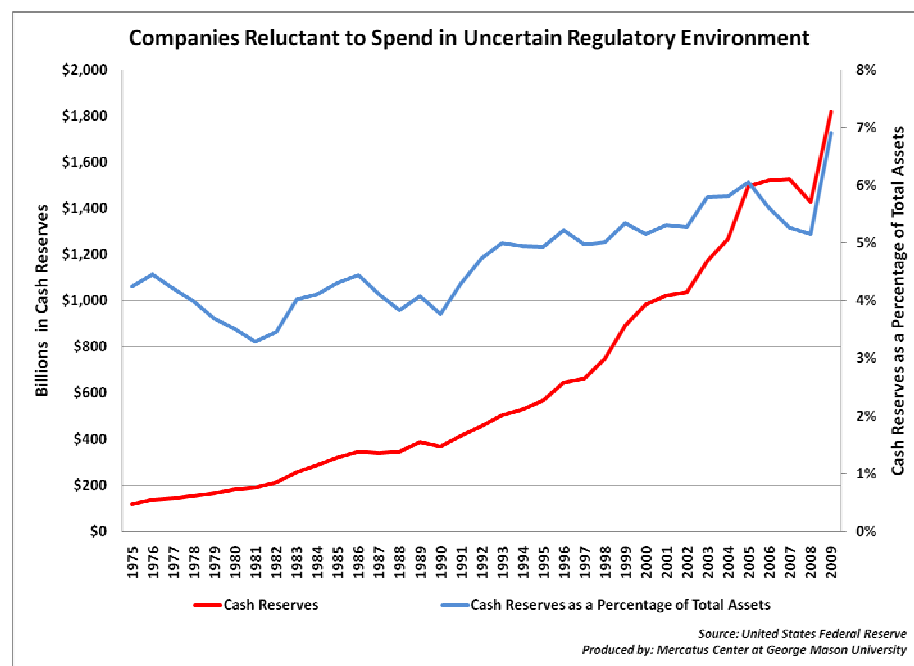
³⁴ For a discussion of the flaws of employing Keynesian estimators, see Cogan, Cwik, Taylor, and Wieland, "New Keynesian versus Old Keynesian Government Spending Multipliers," *Journal of Economic Dynamics and Control*.

³⁵ John Taylor and John Cogan examine data from the Department of Commerce to follow the path of stimulus dollars in research published in "Where Did the Stimulus Go?" *Commentary Magazine*, January 2011.

³⁶ Atif Mian, Amir Sufi, "The Effects of Fiscal Stimulus: Evidence from the 2009 'Cash for Clunkers' Program", (NBER Working Paper16351).

When coupled with the federal government's regulatory and monetary decisions during this recession, federal stimulus spending has led to decreased employment and economic growth. As Stanford economist John Taylor emphasizes in forthcoming research, raising private investment as a share of GDP is the best way to reduce unemployment. Investment (private investment, not government spending labeled as investment) is much more strongly correlated with decreasing unemployment than any components of government spending.

Thus a major factor in the current American stagnation becomes plain: Companies are not investing. They are hoarding capital.



Using data from the United States Federal Reserve Bank, the above chart shows the changes in American businesses' cash reserves since 1975. Billions of dollars in cash reserves is shown in red and cash reserves as a percentage of total business assets is shown in blue to provide historical parity. By both measures, companies are holding onto more cash than they have in 48 years: over \$1.8 trillion.

This cash is being held to hedge against the risk produced by an exceptionally uncertain policy environment. Instead of putting them to work in the economy, companies are holding onto their dollars. Economists and the business community agree that recent policy changes have hampered business investment, making a bad situation worse.³⁷ Indeterminately large future debt and deficits pose a threat for increased taxes and for future government crowding out of capital markets.³⁸ Healthcare and financial reform measures have increased the regulatory burden on businesses.³⁹ Uncertainty about the future of energy and environmental policy looms. The cost of this uncertainty is that companies aren't building new plants, conducting technological research, or hiring workers. As policy makers attempt to reduce unemployment and encourage growth, they must realize their limitations and the unrealized opportunities for private-sector growth. Lasting economic stimulus will come when they allow American businesses to thrive.

³⁷ In a June 2010 speech to the Economic Club of Washington, Ivan G. Seidenberg, Chairman of Business Roundtable and CEO of Verizon Communications commented: "We have become somewhat troubled by a growing disconnect between Washington and the business community that is harming our ability to expand the economy and grow private-sector jobs in the U.S." said Seidenberg. "In our judgment, we have reached a point where the negative effects of the proposed policies are simply too significant to ignore." See also John Taylor, comment on "The End of the Recrudescence of Keynesian Economics," Economics One, comment posted November 21, 2010, <http://johnbtaylorblog.blogspot.com/2010/11/end-of-recrudescence-of-keynesian.html> and Gary Becker, comment on "The Sluggish U.S. Employment Picture," posted December 6, 2010, <http://uchicagolaw.typepad.com/beckerposner/page/2/>.

³⁸ Congressional Budget Office, *Long-Term Budget Outlook*, June 2010, <http://www.cbo.gov/doc.cfm?index=11579>, 18.

³⁹ Business Roundtable, *Roadmap for Growth*, December 2010, http://businessroundtable.org/uploads/studies-reports/downloads/Roadmap_for_Growth_Full_Report_5.pdf.

CONCLUSION

As representatives of the American taxpayer, it is your job to be the stewards of the nation's finances. Today, our nation suffers from severe, structural financial imbalances, which are the product of too many years of throwing more and more money at perceived problems and at interest groups. The real key to long-term prosperity in America lies first and foremost in realizing that the federal government can't and shouldn't be the solution to every one of our problems. There are activities specific to the federal government that should be handled as such, but many activities are better left in the hands of the private sector and others are better handled by the states and local governments. It is hard to overstate the inefficiencies, misallocations of capital and time, the moral hazards, and the waste of taxpayers' money that results from the centralization of most activities and the involvement of the federal government where it shouldn't be.

Understanding which player is best suited to address a problem or to produce a good or a service would make it easier for you to address budget issues and cut spending. In addition, when considering what to cut, I offer the following recommendations:

First, have an honest accounting that shows an accurate picture of the fiscal situation. Lawmakers use a countless number of budget gimmicks to hide the true cost or to artificially inflate the benefits of the policies they want to put in place. Budget gimmicks, however, have consequences beyond letting lawmakers get away with spending money. They lead to inefficient and wasteful spending and to irresponsible decisions that jeopardize this country's future.

With a limited budget, policy makers—like nearly everyone else in the world—must prioritize spending. They must choose the best policies to adopt based on available funds and forgo other projects. When legislators manipulate numbers in order to fund programs that might not otherwise pass muster, they are not obligated to show that the programs serve genuine social or financial policy objectives.

As a result, Congress must make sure that it fixes some of most prevalent budget gimmicks that U.S. government officials use to hide the size of deficits, debts, program costs, and revenue losses. Some of these strategies include pretending the spending does not exist by keeping it explicitly or implicitly off-the-record, pretending that non-emergency spending is an emergency, pretending the spending is smaller than it is, pretending that spending is really an investment, pretending the tax revenues will be bigger than should reasonably be expected, and/or pretending that future pension liabilities do not exist. And this list is by no means exhaustive.

Given the many spending limits in place that elected officials nonetheless manage to avoid, few methods will successfully cap spending. Nevertheless, if Congress does not address the accounting tricks and budget gimmicks that undermine spending rules, no matter how well intentioned the proposed reforms are, we should have no confidence that it will work to address our fiscal challenges. In the near term, serious, strict, and unavoidable budget rules need to be put in place to tie Congress' hands and restore fiscal discipline.

Second, all spending must be on the table. Real fiscal reform will require not just a change in the trajectory of government spending, but also a change in the political (or parochial) priorities of elected officials. Congress needs to make sure no areas of the budget are untouchable (not entitlement and not defense). All parts of the budget must be on the table for review and potential cuts. Failure to do so will jeopardize the goal of addressing our fiscal problems.

Thank you for your attention. I look forward to your questions.