The Liberty Bullhorn Economic Newsletter

News and Commentary based in Free-Market Economics

Publisher and Editor: Sven R Larson

March 21, 2012:

The GOP Budget

Short Take

Spending within 20 percent of GDP?

One of the key selling points with the 2013 GOP budget is that it will keep federal government spending at or below 20 percent of GDP. The theory behind this lock-in is that spending would grow on par with the broadest conceivable tax base. This would guarantee a balanced budget on an annual basis. In practice, though, this does not work. There are three reasons for this.

1. History. The long-term current-price GDP growth trend is 4.5-5.5 percent while federal spending grows at 6-8 percent. Just to stop spending from outgrowing GDP, Congress must cut annual spending growth in half. Nothing in the GOP budget aims to achieve this.
2. Growth parameters. Federal spending growth is dictated not by the growth rate in GDP but by a complex system of rules, regulations and income thresholds in the myriad of federally sponsored entitlement programs. There are no explicit changes to these growth parameters in the GOP budget. Indirectly the budget opens for such reforms, primarily through block-granting a significant portion of Federal Aid to States, but if states maintain status quo the federal government is still stuck with a 6-8 percent growth rate in its state-bound funds.
3. The business cycle. Entitlement programs such as Medicaid are designed to become more costly in recessions. The federal corporate and especially the individual income tax systems are of a design that reduces revenues in a recession. Consequently, federal spending growth speeds up in a recession when the growth rate in GDP slows down.

The 20-percent cap will only become credible if it is backed up with structural reforms to entitlement programs. Hopefully that is on the GOP's to-do list.

Four Areas of Reform

The new GOP budget is probably the most compelling fiscal-policy documents produced by Republicans in Congress since the 1990s welfare reform. It draws a line in the sand between the Obama administration's ambitions to continue America's march into a European-style welfare state and a return to a more traditional American safety-net oriented welfare society.

What makes this budget stand out is that the talk about limited government is backed up by relatively credible reform proposals. The authors of the budget also went to great length to emphasize that not all government spending is the same. Or, in their own words:

> The first responsibility of the federal government is the safety and security of all Americans. … This overarching governmental responsibility – securing the inherent rights of all Americans to life, liberty and the pursuit of happiness – is the principle and the purpose that informs this entire federal budget.

The budget then outlines four areas where it suggests more or less far-reaching reforms:

1. Safeguard the free enterprise system.

The budget authors stress the rule of law as a foundation of a free-market system. This rule of law is jeopardized. The National Labor Relations Board, they say, "offers another good example of bureaucratic overreach and the decline of the rule of law" in America.

Ending corporate welfare is another part of the defense of free enterprise. There is a problem here, though: the actual proposals under this headline do little to end corporate welfare. The proposals are limited to privatizing Fannie Mae and Freddie Mac and repealing the Affordable Care Act. Both are welcome and necessary, but have little to do with corporate welfare.

As for regulations and free enterprise, the budget mentions only the Dodd-Frank Act, which:

> offers another example of the trend of government overreach in the private sector. [It] has expanded the power of unelected bureaucrats, created a mandate for hundreds of new regulations, and entrenched the role of influence-peddlers in Washington. … While the authors of the Dodd-Frank Act went to great lengths to denounce bailouts, this law only sustains them.

It is not spelled out whether or not they want to repeal Dodd-Frank.

Free enterprise is also hampered by government spending. The budget suggests eliminating "wasteful" areas of government spending (p. 33). This term is curious, as it suggests that there is government spending that is not wasteful.

2. No-fault safety net.

This is the strong point of the budget. Its significance goes deeper than most commentators seem to realize.

The academic literature on the welfare state distinguishes between active and passive welfare states. The former redistributes income between citizens on a general, permanent basis, while the latter provides a means-tested safety net. The U.S. welfare state is relatively passive by comparison, although with every expansion of the eligibility requirements in, e.g., Medicaid the balance is shifting in an active direction. The GOP budget aims to reverse this trend. It identifies one of the most significant problems with our welfare state and points to a solution (p. 37):

> [Some] aspects of the safety net impose barriers of their own. For instance, the elimination of certain benefits as income rises has the effect of imposing a tax that discourages some low-income Americans from seeking lives of independence and self-sufficiency. … In particular, it is essential to prevent benefits structures from becoming barriers to upward mobility.

In a nutshell, the problem that this passage in the budget addresses plagues every welfare state in the free world. It is encouraging to see it mentioned here. The next article in this newsletter discusses the significance of this in more detail.

3. Retirement security.

The budget leaves no doubt: the GOP wants to preserve Medicare and Social Security. With the exception of minor reforms to the former, the budget essentially defers to Congress the issue of how to restore credibility in government-provided retirement security.

The absence of serious reform proposals on Medicare and Social Security is surprising for two reasons. First, Representative Paul Ryan (R-WI) is the author of one of the most comprehensive papers on reforming Social Security currently available. The plan is credible and would give Social Security quite a bit more time before bankruptcy.

Secondly, the GOP budget opens with very clear references to the unsustainability of both Social Security and Medicare. However, the only solutions offered to retirement security are reduced access to health care for younger workers as they enter the program. This is a type of reform that preserves the program and thereby the inherent structures that drive Medicare costs.

4. Tax reform.

Perhaps the most tangible proposal in the budget is a shift from today's income tax system to one with two brackets, 10 and 25 percent. On the corporate income tax side the proposal is even more radical: a cut of the federal rate from 35 to 25 percent and a shift to a territorial system. (Today the IRS can tax American corporations on income they make globally, a model that almost no other country uses.)

These four areas define the budget. But one is more important than the others, namely the one that addresses the founding principles of the American welfare state.

More on that next.

From Welfare State to Safety Net: A Shift in Focus

Not since the days of welfare reform in the 1990s has the Republican Party presented a fiscal document that emphasizes limited government with such strength as the 2013 GOP budget. It comes close to proposing a Welfare Reform 2.0.

Two features make this budget's focus on welfare programs compelling. First, it recognizes the difference between an active, redistributive welfare state and a passive welfare state that provides a no-fault safety net. The Scandinavian welfare state is redistributive: its spending programs – entitlements – provide permanent cash and in-kind services to people who are well above the poverty limit. By contrast, in the American welfare state tradition, with roots in the early 19th century, government provides a passive safety net that people fall into only when they have exhausted all other ways to provide for themselves.

Over the past two decades the expansion of the American welfare state has been increasingly Scandinavian in nature. The traditional American model still defines most of the programs under the welfare state, but the balance is shifting in an active direction.

With its emphasis on a no-fault safety net, the GOP budget declares an intention to return the American welfare state to its passive roots. This is philosophically important: the GOP puts on full display the difference in intent between their no-fault safety-net model and the efforts by Democrats to continue in the direction of the Scandinavian model.

The second compelling part of the budget's welfare section is its recognition of a need to transform the current welfare-state model in a more sustainable direction. There is a tendency in the general public policy debate to propose clean-cut immediate closings of welfare state programs. Such measures are, however, likely to cause more economic problems than they solve. They will also do harm to vulnerable citizens in the bargain. Therefore, it is refreshing to see that the GOP budget recognizes the need for transitional elements in welfare reform. (It is another debate whether or not their vision of a more sustainable welfare model is economically realistic or philosophically desirable.)

The budget's proposal for how to transition from an active to a passive welfare state puts some emphasis on job training. The idea originates in the 1990s welfare reform which replaced perpetual cash assistance with workfare programs (p. 41):

> If government is to require able-bodied recipients of aid to find work, as it should, then it must also help them return to productive working lives. To that end, federal education and job-training programs need to be modernized to keep the workforce competitive in a 21st century, global economy. Government must do a better job of targeting resources to make sure that America's workforce can successfully pursue new opportunities and adopt new skills, if necessary.

It is notable that the GOP budget suggests coupling government-run and tax-funded workfare to equally government-run, tax-funded welfare. It would have been illuminating to see a discussion about private solutions, especially on the workfare side.

However, if:

a) a welfare recipient can transition out of welfare and become self sufficient as a result of a workforce program, and
b) the transition is part of a reform that, over time, reduces the population supported by government welfare,

then the tax-paid welfare-workfare model serves a temporary purpose, especially in lieu of political will to privatize welfare entirely.

Beyond reformed workfare and philosophical clarity, the GOP budget has relatively little to offer on welfare reform. It wants to replace today's top-down funding model with block grants for the states; about 80 percent of Federal Aid to States is welfare-state programs. It is tempting for Congress to transform much or all of that money into a block-grant appropriation.

The block-grant model has its appeal. It removes federal regulations while in theory not touching program funding. In practice, though, the block grant can easily become a convenient tool for panic-driven budget cuts. The block grant:

a) nominally preserves the spending program – it is still funded – which is appealing to some voters and politically vain legislators; and
b) transfers the responsibility for designing the program to the states, which creates legislative competition but also makes state lawmakers responsible for executing painful spending cuts.

If Congress can learn to work with the states, it is theoretically possible for them to avoid this significant downside of block grants.

The GOP budget does not go farther than this. It could do so, but it recognizes that there are significant problems with moving too quickly into the territory of welfare reform. One major problem which requires a carefully designed solution is the negative marginal-income effect of income-dependent benefits. When the income of a welfare recipient increases, he or she loses benefits, a phenomenon that discourages pursuit of a job and a career.

One suggestion is to remove benefits at a slower rate than the rise in a person's income. The problem is that this extends dependency and tends to actually raise costs to taxpayers.

The Earned Income Tax Credit is an excellent example of a benefit with this inherent, work-discouraging effect. It imposes the steepest marginal income tax rates in the current income tax system. (My forthcoming book Ending the Welfare State proposes a solution.) But the problem spans across all welfare-state entitlement programs.

The PRWORA reform in California in the 1990s sought to find a state-based solution to this marginal income problem. The experience is mostly negative: cash assistance and other welfare costs per capita in California soon climbed above the national average. The blame is in good part on the California legislators who adopted the most generous rules possible for its welfare programs. This effectively eliminated the intended effects of welfare reform.

A future Welfare Reform 2.0 must solve the "marginal" problem. Is the GOP up to that job?