

2011

## Fiscal Policy in an Era of Austerity

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### Recommended Citation

David M. Schizer, *Fiscal Policy in an Era of Austerity*, COLUMBIA UNIVERSITY SCHOOL OF LAW, THE CENTER FOR LAW & ECONOMIC STUDIES WORKING PAPER NO. 408 (2011).

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## **Fiscal Policy in an Era of Austerity**

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Working Paper No. 408

Draft of October 17, 2011

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## **Fiscal Policy in an Era of Austerity**

David M. Schizer<sup>1</sup>

Draft of October 17, 2011

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<sup>1</sup> Dean and the Lucy G. Moses Professor of Law, Columbia Law School. I appreciate helpful comments from Mihir Desai, Michael Graetz, Glenn Hubbard, Alex Raskolnikov and Daniel Shaviro. I am grateful to Erin Dickerson and Lynn Beller for their research assistance. This Article is forthcoming in the *Harvard Journal of Law & Public Policy*.

We face a time of stagnant economic growth, severe unemployment, massive budget deficits, and an increasingly competitive global economy. These daunting challenges are the legacy of a number of unwise policy decisions in both the public and private sectors. While the good news is that unsound policies can be changed, the bad news is that no single step will do the trick. Monetary policy is tapped out, and there is a great deal of uncertainty about the effectiveness of a traditional Keynesian stimulus – and, not surprisingly, a heated debate among economists. One thing we do know is that a stimulus is quite difficult to execute effectively. For example, it is a challenge to identify “shovel ready” projects that contribute to long-term economic growth, particularly on short notice.

There is no uncertainty, though, about the need to address a broad range of specific problems contributing to our economic woes. We have to promote economic growth and fiscal stability over the long-term. To do so, we should reform our housing and mortgage markets, our entitlement programs, our tax code, and much more. A short symposium article cannot delineate all the challenges Congress is facing or provide definitive guidance about how to address them. As an illustrative example, this Article emphasizes the perils of having the highest corporate tax rate in the Organisation for Economic Co-operation and Development (“OECD”) in a competitive global economy. Cutting our corporate tax rate will encourage businesses to invest and hire more employees, while also reducing incentives to engage in wasteful tax planning and to shift taxable income and jobs overseas.

In addition to these problems with our substantive law, we also face problems of process that are undercutting our government’s effectiveness. An important (and familiar) one is that politicians are consistently tempted to accommodate organized interest groups, especially if the costs of these favors can be quietly passed on to the general public. This is all the more true if special interest deals can be financed with deficit spending, so that the bill will not come due until long after our current political leaders have retired. Various measures can constrain this familiar political dynamic, and this Article sketches three strategies as illustrative examples. First, we should make the costs of special interest deals more visible through better budgetary accounting. Second, we should enlist specific institutions within our government to target waste and pork. For example, we should empower special House and Senate committees to cut particular budget items or, alternatively, to sever them from the rest of the budget and subject them to a separate public vote. Third, we should create stronger institutional barriers to deficit spending. Scarcity focuses the mind, so that our leaders will have greater incentive to reject initiatives that are not cost-justified.

Part I of this Article lays out the relevant economic challenges and calls for a broad agenda to promote economic growth. Part II outlines difficulties and uncertainties with a Keynesian stimulus. Part III surveys a few substantive challenges that require our attention and, as an illustrative example, shows the importance of cutting corporate tax rates. Part IV discusses the need to reform our budgetary process. Part V is the conclusion.

## **I. The Need for a Policy Agenda to Promote Economic Growth**

The U.S. economy has taken a beating since 2008. Median household income has fallen to 1996 levels, and 22% of American children are living in poverty, the highest level since

1993.<sup>2</sup> The jobless rate has remained above nine percent during the Summer and Fall of 2011,<sup>3</sup> and almost half of the 14 million Americans classified as unemployed have been out of work for more than six months.<sup>4</sup> The jobless rate is even higher among young people and minorities (e.g., 44.2% among African-American teenagers).<sup>5</sup> If we also count people who have given up looking for work (2.5 million), and people working only part-time because they cannot find full-time jobs (9.3 million), the overall unemployment rate in the United States is 16.5%.<sup>6</sup> The problem does not seem to be getting better. We need to create 125,000 jobs per month just to accommodate population growth,<sup>7</sup> but in August and September of 2011 we have not met even that threshold.<sup>8</sup> The human costs are staggering. Meanwhile, growth has slowed, so that our GDP is expected to increase less than 1.5% in 2011.<sup>9</sup> After nine quarters of recovery, aggregate output is still not back to its level before the financial crisis.<sup>10</sup>

### A. *Deleveraging Hangover for Consumers*

The crisis – and the bleak economic conditions that followed -- were triggered by the bursting of the U.S. housing bubble. Encouraged by low interest rates, consumers borrowed money to buy homes they could not afford. Financial institutions lent recklessly, rating agencies blessed the packaging of these flawed loans for investors,<sup>11</sup> and government regulators stood silently by or actively encouraged these practices. Representative Barney Frank was not alone, as he famously put it, in “want[ing] to roll the dice a little bit more in this situation towards subsidized housing.”<sup>12</sup> But when it became clear that securitized mortgages were riskier than the market thought, storied financial institutions collapsed, triggering a financial panic and recession.

We are still living with the hangover from this excess. Most recessions have “typically sowed the seeds of their own recoveries,” Ben Bernanke observed, “as reduced spending on investment, housing, and consumer durables generates pent-up demand.” But this recession is

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<sup>2</sup> Conor Dougherty, *Income Slides to 1996 Levels*, WALL ST. J., Sept 14, 2011, at A1 (quoting Census report for 2010).

<sup>3</sup> Bureau of Labor Statistics, U.S. Department of Labor, *News Release: The Employment Situation – September 2011*, 26 tbl.A-15 (Oct. 7, 2011), <http://www.bls.gov/news.release/empsit.nr0.htm> (Sept. rate was 9.1%).

<sup>4</sup> *Id.* (44.6% (6.2 million) out of work for more than 27 weeks)

<sup>5</sup> *Id.* at tbl.A-2.

<sup>6</sup> *Id.* at tbl.A-15.

<sup>7</sup> John Mauldin, *It's All About the Jobs...and Gold*, THOUGHTS FROM THE FRONTLINE, (Sept. 3, 2011), <http://www.johnmauldin.com/frontlinethoughts/its-all-about-the-jobs-and-gold>.

<sup>8</sup> BLS, *supra* note 3, at tbl.A-15 (reporting that 103,000 jobs were created in September and 57,000 in August).

<sup>9</sup> See *Confronting the Nation's Fiscal Policy Challenges: Hearing Before the Joint Select Committee on Deficit Reduction*, 112<sup>th</sup> Cong. 8 (Sept. 13, 2011) (statement of Douglas W. Elmendorf, Dir., Cong. Budget Off.) (noting that latest *Blue Chip* forecast, representing average of 50 private sector analysis, is 1.3%).

<sup>10</sup> Ben Bernanke, Chairman, Fed. Reserve, Address at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, WY: The Near- and Longer-Term Prospects for the U.S. Economy, (Aug. 26, 2011), available at <http://www.forbes.com/sites/steveschafer/2011/08/26/ben-bernankes-jackson-hole-speech/>; see also Elmendorf, *supra* note 9, at 13-14 (estimating output gap at 5 percent of potential GDP at end of 2011, such that cumulative difference between actual and potential GDP is roughly \$2.5 trillion).

<sup>11</sup> See generally Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity and Systemic Risk*, 64 STAN. L. REV. (forthcoming 2012).

<sup>12</sup> *The Fannie Mae Dice Roll Continues*, WALL ST. J., Nov. 11, 2009, at A20.

different because it was “associated with both a very deep slump in the housing market and a historic financial crisis.”<sup>13</sup> Banks with weak balance sheets are less likely to lend,<sup>14</sup> consumers with underwater mortgages have less money to spend, and businesses that otherwise would sell to them have to cut back. In short, deleveraging is a painful and slow process.<sup>15</sup>

### ***B. Ballooning Government Deficits***

Meanwhile, government debt has reached record levels. There has been a sea change since 2000, when the U.S. Government ran an \$86 billion surplus. During the Bush Administration, two wars, a tax cut, and undisciplined federal spending took us from a \$32 billion deficit in 2001 to a \$641 billion deficit in 2008.<sup>16</sup> During this period, the federal budget went from \$1.86 trillion to \$2.98 trillion and the outstanding indebtedness of the U.S. Treasury increased from \$3.3 trillion to \$5.8 trillion.<sup>17</sup>

During the first three years of the Obama Administration, these numbers skyrocketed, as tax revenues fell during the recession and government spending increased dramatically. The federal budget for 2011 -- \$3.819 billion -- is 28% larger than 2008; it represents 25.3% of the nation’s gross domestic product (up from 20% in 2008). The projected deficit for 2011, \$1.645 trillion, represents 43% of the federal budget and nearly 11% of GDP, a level not seen since World War II.<sup>18</sup> The deficit is more than 2.5 times larger than in 2008. Meanwhile, the Treasury debt held by the public has grown to more than \$10.1 trillion,<sup>19</sup> which is more than 50% larger than in 2008. The national debt held by the public is now about 67% of the gross domestic product, compared to 40% in 2008 and the 37% average over the past four decades.<sup>20</sup> At the same time, the budgets of state and local governments have been under great strain as well.<sup>21</sup>

The proliferation of government debt is not confined to the United States. Anxiety about unsustainable debt levels in the European Union has been casting a shadow over the global economy. In 2010, the deficit in Greece represented 10.5% of GDP; in Ireland, it was 32.4%; in

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<sup>13</sup> Bernanke, *supra* note 10.

<sup>14</sup> Joe Nocera, *No Extra Credit*, N.Y. TIMES, Sept. 20, 2011, at A31.

<sup>15</sup> See Rolfe Winkler, *Kiss of Debt for the Flagging U.S. Economy*, WALL ST. J., Sept. 17, 2011, <http://online.wsj.com/article/SB10001424053111904060604576575063238033694.html> (noting that household, business, and government debt in the US now totals \$36.5 trillion, which is a new nominal record, and that “debt overhang remains a key problem for the U.S. economy because it limits growth drivers like consumer spending”).

<sup>16</sup> Congressional Budget Office, U.S. Congress, *Budget and Economic Outlook: Historical budget data*, tbl.E-1 (Jan. 2011), available at [http://www.cbo.gov/ftpdocs/120xx/doc12039/HistoricalTables\[1\].pdf](http://www.cbo.gov/ftpdocs/120xx/doc12039/HistoricalTables[1].pdf).

<sup>17</sup> *Id.*

<sup>18</sup> U.S. Office of Mgmt. & Budget, *The Budget of the United States Government, Fiscal Year 2012*, 171 tbl.S-1, available at <http://www.whitehouse.gov/omb/budget/Overview/>.

<sup>19</sup> The Debt to the Penny and Who Holds It, TREASURYDIRECT.COM (as of Oct. 6, 2011), <http://www.treasurydirect.gov/NP/BPDLogin?application=np> (listing debt held by the public as over \$10.1 trillion, with an additional \$4.7 trillion held by intergovernmental agencies).

<sup>20</sup> Elmendorf, *supra* note 9, at 16.

<sup>21</sup> Kimberly Lyons, *Special Comment: 2010 State Debt Medians Report*, MOODY’S INVESTORS SERVICE (Report Number: 125068, May 2010), <http://www.wpri.org/blog/wp-content/uploads/Moodys.pdf> (total indebtedness of state governments increased by 10.3% in 2009).

the UK, 10.4%; and in Spain, 9.2%.<sup>22</sup> Thirteen member states had government debt ratios of higher than 60% of GDP in 2010.<sup>23</sup>

A further fiscal challenge in the United States is the need to meet a broad range of other government obligations, including Social Security and Medicare. These entitlement programs for retirees are funded with taxes on those who are still working. Costs increase with life expectancies and the price of medical care. At the same time, there will be fewer workers to bear this burden as the population ages.<sup>24</sup> As a result, these programs are projected to run massive deficits in the coming years.<sup>25</sup>

### *C. Intense International Competition*

Meanwhile, another source of pressure on the U.S. economy – and, in particular, on job creation – is global economic competition. The weakening of the dollar has strengthened our exports, but the United States is still running a large trade deficit.<sup>26</sup> Although the economic downturn has been global, some countries have bounced back more quickly. In contrast to the U.S. economy, which grew by 2.9% in 2010, China grew at 10.3%; India grew at 9.7%; Brazil grew at 7.5%; and Mexico grew at 5.5%.<sup>27</sup> It is well understood that we operate in an increasingly global economy, in which the competition for capital and jobs is intense. In recent years, our competitors have reduced the tax burdens on business, adding additional reasons why businesses may prefer to expand in other jurisdictions, instead of in the United States.<sup>28</sup>

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<sup>22</sup> Eurostat, European Commission, Table of *General Government Deficit/Surplus – Percentage of GDP* (Sept. 30, 2011), <http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&plugin=1&language=en&pcode=tsieb080>

<sup>23</sup> See Eurostat News Release: *Euro area and EU27 government deficit at 6.3% and 6.8% of GDP respectively*, (Apr. 22, 2011), [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-22042010-BP/EN/2-22042010-BP-EN.PDF) (Italy (115.8%), Greece (115.1%), Belgium (96.7%), Hungary (78.3%), France (77.6%), Portugal (76.8%), Germany (73.2%), Malta (69.1%), the United Kingdom (68.1%), Austria (66.5%), Ireland (64.0%) and the Netherlands (60.9%)).

<sup>24</sup> See Elmendorf, *supra* note 9, at 20 (noting that number of people age 65 or older will increase by roughly one-third between 2011 and 2021, increasing from 13% to 17% of the population as a whole).

<sup>25</sup> *Id.* at 6 (noting that “spending on Social Security and the major health care programs... is projected to be much higher than has historically been the case, reaching 12.2 percent of GDP in 2012, compared with 10.4 percent of GDP in 2011 and an average of 7.2 percent of GDP during the past 40 years”). See also DANIEL N. SHAVIRO, TAXES, SPENDING, AND THE U.S. GOVERNMENT’S MARCH TOWARD INSOLVENCY 125 (2006); David Galland, *Is the U.S. Monetary System on the Verge of Collapse?*, John Maudlin’s OUTSIDE THE BOX, (Sept. 13, 2011), <http://www.johnmauldin.com/outsidethebox/is-the-us-monetary-system-on-the-verge-of-collapse/> (estimating a “fiscal gap,” which is the sum of outstanding U.S. obligations as well as the present value of our projected deficit in our entitlement programs, of \$60 trillion).

<sup>26</sup> Census Bureau & Bureau of Econ. Anal., U.S. Dept. of Commerce, *U.S. International Trade in Goods and Services: Annual Revision for 2010*, (June 9, 2011), [http://www.census.gov/foreign-trade/Press-Release/2010pr/final\\_revisions/10final.pdf](http://www.census.gov/foreign-trade/Press-Release/2010pr/final_revisions/10final.pdf) (deficit was \$500 billion in 2010, compared with \$698 billion in 2008).

<sup>27</sup> GDP growth (annual %), THE WORLD BANK, [http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?order=wbapi\\_data\\_value\\_2010+wbapi\\_data\\_value+wbapi\\_data\\_value-last&sort=desc](http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?order=wbapi_data_value_2010+wbapi_data_value+wbapi_data_value-last&sort=desc) (last visited Oct. 16, 2011).

<sup>28</sup> See generally George R. Zodrow, *Capital Mobility and Tax Competition*, 63 NAT. TAX J. 865 (2008) (noting that in the past two decades most countries have reduced their statutory corporate income tax rates in response to global economic competition, while the U.S. has not done so); Michael P. Devereux, *Developments in the Taxation of*

## D. Promoting Economic Growth

These challenges are enormous, and there are no easy answers. But we should begin with an obvious point: If we could find ways to help our economy grow faster, it would be enormously helpful. A growing economy creates more jobs, generates more tax revenue, and reduces the need for certain types of government services, so that both unemployment and the deficit decline. The problem is that this is easier said than done. A traditional lever for promoting growth – monetary policy – has been essentially exhausted. The Federal Reserve has pushed short-term rates to zero and committed to keeping rates there through 2013.<sup>29</sup>

At this point, an essential missing ingredient is confidence. Through rigorous cost-cutting, American businesses have become profitable again and have cash on hand,<sup>30</sup> but so far they are not hiring. “[T]hey simply cannot budget or manage for the uncertainty of fiscal and regulatory policy,” said Richard Fisher, the President of the Federal Reserve of Dallas. “In an environment where they are already uncertain of potential growth in demand for their goods and services and have yet to see a significant pickup in top-line revenue, there is palpable angst surrounding the cost of doing business.”<sup>31</sup> A crucial challenge is to restore business confidence, so that firms increase their hiring. This will, in turn, enhance consumer purchasing power, which will prompt further hiring, and so on. But how do we induce this virtuous cycle to begin?

## II. Uncertainties and Challenges With A Keynesian Stimulus

A traditional remedy for a stalled economy, dating back to John Maynard Keynes, is for the government to borrow money to purchase goods and services. This sort of fiscal stimulus is meant to increase aggregate demand and, thus, employment. In the winter of 2009, the Obama administration began an \$862 billion stimulus. Unfortunately, it underperformed expectations,<sup>32</sup> and economists disagree about why. Some say a stimulus was the wrong medicine,<sup>33</sup> while

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*Corporate Profits in the OECD Since 1965: Rates, Bases, and Revenues* (Oxford University Centre for Business Taxation, Working Paper No. 0704, 2007) (noting that rates in OECD have been cut significantly in recent years).

<sup>29</sup> Jon Hilsenrath, *Fed Prepares to Act*, WALL ST. J., Sept 8, 2011,

<http://online.wsj.com/article/SB10001424053111904103404576556943051259236.html> (having deployed traditional monetary instruments, the Federal Reserve is considering unconventional tactics).

<sup>30</sup> See, e.g., Catherine Rampell, *Corporate Profits Were the Highest on Record Last Quarter*, N.Y. TIMES, Nov. 24, 2010, at B2 (third quarter of 2010, at \$1.655 trillion, was highest in nominal terms in 60 years, and is seventh consecutive quarter of profits growth); Bureau of Econ. Anal., U.S. Dept. of Commerce, *National Income and Product Accounts, Gross Domestic Product 2<sup>nd</sup> quarter 2011 (third estimate) Corporate Profits, 2<sup>nd</sup> quarter 2011 (revised estimate)*, (Sept. 29, 2011), [http://www.bea.gov/newsreleases/national/gdp/2011/gdp2q11\\_2nd.htm](http://www.bea.gov/newsreleases/national/gdp/2011/gdp2q11_2nd.htm) (profits from current production increased by \$61.2 billion in the second quarter, compared with \$19.0 billion in the first quarter, and internal funds available to corporations for investment increased \$86.2 billion in the second quarter, compared with an increase of \$21.1 billion in the first).

<sup>31</sup> Richard W. Fisher, Pres., Fed. Res. Bank of Dallas, Remarks at the Midland Community Forum: Connecting the Dots: Texas Employment Growth; a Dissenting Vote; and the Ugly Truth (with Reference to P.G. Wodehouse) (Aug. 17, 2011), available at <http://dallasfed.org/news/speeches/fisher/2011/fs110817.cfm>.

<sup>32</sup> The Administration projected that the unemployment rate would not rise above 8%. Christina Romer & Jared Bernstein, *The Job Impact of the American Recovery and Reinvestment Plan 4* (Fig. 1) (Jan. 10, 2009), available at [http://www.politico.com/pdf/PPM116\\_obamadoc.pdf](http://www.politico.com/pdf/PPM116_obamadoc.pdf). Unfortunately, it rose above 10%, and has remained above 9% in the Summer and Fall of 2011.

<sup>33</sup> See, e.g., Robert J. Barro, *Keynesian Economics vs. Regular Economics*, WALL ST. J., Aug. 24, 2011, at A13 (“There are two ways to view Keynesian stimulus through transfer programs. It’s either a divine miracle – where



others claim that we need a bigger dose.<sup>34</sup> Following the latter camp, President Obama proposed another \$447 billion stimulus. Yet this debate is difficult to resolve because, as Gregory Mankiw observed, “the theory of business cycles . . . is the topic we economists understand least of all: We are still deeply divided on the validity and utility of the basic Keynesian paradigm.”<sup>35</sup> Drawing on this macroeconomic debate, this Part offers four reasons why there is so much uncertainty and why, ultimately, a Keynesian stimulus is so difficult to execute effectively.

### A. *Dueling Models and Multipliers*

First, economists disagree about how much a dollar of deficit-financed government purchases actually contributes to economic growth. Using an “Old Keynesian” model, the Obama administration assumed in 2009 that it would add \$1.50 to the economy – a so-called “government purchases multiplier” of 1.5.<sup>36</sup> In contrast, neoclassical models never predict multipliers higher than 1.0, since they assume that interest rates, wages, and prices rise in response to a fiscal stimulus, crowding out private activity.<sup>37</sup> Meanwhile, “New Keynesian” models generally predict multipliers between .6 and 1.0,<sup>38</sup> although they can support multipliers as high as 1.5 during a limited period in which short-term interest rates have fallen to zero.<sup>39</sup> Most empirical studies, meanwhile, conclude that government purchases multipliers are below 1.0. For example, according to Barro and Redlick, a dollar increase in U.S. defense spending has contributed only about 70 cents of economic growth.<sup>40</sup> The experience in Japan, which

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one gets back more than one puts in – or else it’s the macroeconomic equivalent of a bloodletting. Obviously, I lean toward the latter position, but I am still hoping for more empirical evidence”).

<sup>34</sup> See, e.g., Paul Krugman, *The Fatal Distraction*, N.Y. TIMES, Sept. 5, 2011, at A19 (calling for a “much needed second round of federal stimulus”).

<sup>35</sup> N. Gregory Mankiw, *Crisis Economics*, NATIONAL AFFAIRS (Summer 2010), <http://www.nationalaffairs.com/publications/detail/crisis-economics>.

<sup>36</sup> Romer & Bernstein, *supra* note 32.

<sup>37</sup> See Michael Woodford, *Simple Analytics of the Government Expenditure Multiplier* 2-4 (NBER, Working Paper No. 15714, 2010) (discussing neoclassical model); see also Robert J. Barro & Robert G. King, *Time Separable Preferences and Intertemporal Substitution Models of Business Cycles*, 99 Q. J. ECON. 817 (1984) (developing a neoclassical model).

<sup>38</sup> See, e.g., John F. Cogan, Tobias Cwik, John B. Taylor, & Volker Wieland, *New Keynesian Versus Old Keynesian Government Spending Multipliers* 4, 7, 15 (ECB, Working Paper No. 1090, 2009) (describing assumptions in New Keynesian models and using Smets-Wouters to show that 2009 stimulus is projected to have “much smaller” multiplier than predicted by Romer & Bernstein’s Old Keynesian model; predicting multiplier of .63 for fourth quarter of 2010).

<sup>39</sup> Woodford, *supra* note 37, at 19, 24 (“government purchases should have an especially strong effect on aggregate output when the central bank’s policy rate is at the zero lower bound” and “[t]he degree to which the multiplier exceeds 1 in this case can, in principle, be quite considerable”).

<sup>40</sup> Robert J. Barro & Charles J. Redlick, *Macroeconomic Effects from Government Purchases and Taxes* (NBER, Working Paper No. 15369, 2009) (estimated multiplier for temporary U.S. defense spending is 0.4-0.5 contemporaneously and 0.6-0.7 over two years and for permanent spending it increases by 0.1-0.2); Robert J. Barro & Charles J. Redlick, *Stimulus Spending Doesn’t Work*, WALL ST. J., Oct. 1, 2009, <http://online.wsj.com/article/SB10001424052748704471504574440723298786310.html> (“The available empirical evidence does not support the idea that spending multipliers typically exceed one, and thus spending stimulus programs will likely raise GDP by less than the increase in government spending.”); see also Robert E. Hall, *By How Much Does GDP Rise if the Government Buys More Output* 11 (NBER, Working Paper No. 15496, 2009) (noting that most studies using vector autoregressions estimate multipliers as in the range of .5 to 1.0 and concluding that “regression evidence from big wars demonstrates that the government purchase multiplier is probably at least 0.5”); Valerie A. Ramey, *Can Government Purchases Stimulate the Economy?*, 49 J. ECON. LIT. 673, 683 (2011) (surveying the literature and concluding that “the bulk of estimates imply that the aggregate multiplier for a

implemented 15 fiscal stimulus packages between 1990 and 2008, generally also involved government purchases multipliers below 1.<sup>41</sup>

### ***B. The Challenge of Identifying “Shovel Ready” Projects***

Second, whatever the purchases multiplier proves to be, it stimulates the economy only if the government actually uses stimulus funds for *purchases*. As it turns out, though, only a tiny fraction of the 2009 stimulus was used for government purchases. John Cogan and John Taylor show that in 2009 and the first half of 2010, only \$18 billion – that is, only 2.1% of the \$862 billion program -- funded government purchases, with only \$2.4 billion supporting infrastructure (0.3%).<sup>42</sup> Much of the money was given to states. While the Administration assumed that 60% of these grants would be used for government purchases,<sup>43</sup> they were used instead to reduce state borrowing – for example, states received \$132 billion in stimulus payments and reduced debt levels by \$136 billion in the third quarter of 2010 – and also to fund Medicaid and other transfers.<sup>44</sup> Transfers are less likely to stimulate the economy, since they generally are thought to involve lower multipliers.<sup>45</sup>

One reason why so little was used for government purchases – and, indeed, why it is so difficult to rely on deficit-financed purchases to stimulate the economy – is that infrastructure projects are slow and difficult to plan. After all, the spending needs to begin (or at least to be announced) quickly, or the stimulus will not be timely. But government-funded infrastructure projects are not famous for their speed.

### ***C. The Problem of Politically-Motivated Projects***

Of course, if we rush, the challenge of ensuring that the money is used wisely becomes more daunting.<sup>46</sup> This brings us to the third challenge with a Keynesian stimulus: “[I]t is important to ask whether the spending will produce something society needs . . .,” Gregory Mankiw has observed. “Money spent on a new road that allows farmers to get their products to market faster and in better condition, for instance, creates more value than money spent building

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temporary rise in government purchases not accompanied by an increase in current distortionary taxes is probably between 0.8 and 1.5”).

<sup>41</sup> See, e.g., Marcus Bruckner & Anita Tuladhar, *Public Investment as a Fiscal Stimulus: Evidence from Japan’s Regional Spending During the 1990s* 7, 12 (IMF, Working Paper No. 10/110, 2010) (describing 15 stimulus programs and estimating impact multiplier at .28 and medium-term multiplier at .67). See also Martin Fackler, *Japan’s Big-Works Stimulus is a Lesson*, N.Y. TIMES, Feb. 6, 2009, at A1 (noting that Japan spent \$6.3 trillion on construction-related public investment between 1991 and 2008).

<sup>42</sup> John F. Cogan & John B. Taylor, *What the Government Purchases Multiplier Actually Multiplied in the 2009 Stimulus Package* 2 (Jan. 2011), available at <http://www.stanford.edu/~johntayl/Cogan%20Taylor%20multiplicand%20Jan%202011%20rev.pdf> (“Our main finding is that the increase in government purchases due to the ARRA has been remarkably small, especially when compared with the large size of the ARRA package.”).

<sup>43</sup> Romer & Bernstein, *supra* note 32, at 5.

<sup>44</sup> John F. Cogan & John B. Taylor, *The Obama Stimulus Impact? Zero*, WALL ST. J., Dec. 9, 2010, <http://online.wsj.com/article/SB10001424052748704679204575646603792267296.html>.

<sup>45</sup> Cogan et al., *supra* note 38, at 20 (using a coefficient of .3 for the impact of transfers on consumption, which they describe as “likely an upper bound and certainly a generous assumption”).

<sup>46</sup> Mankiw, *supra* note 35 (“rushed spending is, in many important ways, likely to be less efficient and less useful than spending that is carefully planned”).

a ‘bridge to nowhere,’ even if both projects create the same number of construction jobs.”<sup>47</sup> Indeed, “[o]ne lesson from Japan is that public works get the best results when they create something useful for the future.”<sup>48</sup> For this reason, multipliers are higher when funds are allocated in a process that draws on good information and is insulated from political influence.<sup>49</sup>

Although in principle government infrastructure spending can contribute substantially to long-term growth, the process in the 2009 stimulus bill, unfortunately, was not effective at weeding out duds. For example, it allocated \$2.6 billion to building a high-speed rail line from Tampa to Orlando. The train would be about 30 minutes faster than driving (54 minutes versus 83 minutes).<sup>50</sup> But mass transit options in both cities are quite limited, so passengers would have to rent a car when they arrive – something that, presumably, would persuade most to drive instead of taking the train.<sup>51</sup> So why fund this project? It could be launched quickly, since the government already owned much the right of way. In addition, Florida is, of course, a politically pivotal swing state.<sup>52</sup> Fortunately, the Governor of Florida pulled the plug on this project, fearing the state would be on the hook for some of the cost overruns.

It is not hard to find other federally funded infrastructure projects that are better explained by politics than economics. The proposed 1.7 mile extension of the San Francisco subway in Chinatown is another example. Because riders will have to go eight stories underground to ride the subway and walk a quarter mile to connect to the Market Street light-rail lines, it will always be five or ten minutes faster to take the bus.<sup>53</sup> So why is the Federal

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<sup>47</sup> Mankiw, *supra* note 35; *see also* Robert J. Barro, *The Stimulus Evidence One Year On*, WALL ST. J., Feb. 23, 2010, <http://online.wsj.com/article/SB10001424052748704751304575079260144504040.html> (“How attractive this short-run deal [from deficit-financed government spending] looks depends on how much one values the added governmental activity.”); Woodford, *supra* note 37, at 31 (“government purchases should be undertaken if and only if they have a marginal utility as high as that associated with additional private expenditure -- *i.e.*, if they satisfy the conventional (microeconomic) cost-benefit criterion”).

<sup>48</sup> Fackler, *supra* note 41 (quoting Toshihiro Ihori, an economics professor at the University of Tokyo). This theme is well documented in the economics literature on the stimulus in Japan. *See, e.g.*, Haruo Kondoh, *Political Economy of Public Capital Formation in Japan*, 4 PUB. POL’Y. REV. 77 (2008) (finding that local special interest groups wield substantial influence in the process of budget formation and the allocation of public investment); Norihiko Yamano & Toru Ohkawara, *The Regional Allocation of Public Investment: Efficiency or Equity?*, 40 J. REGIONAL SCI. 205 (2000) (political factors prevented public investment from being allocated in accordance with marginal productivity; instead, inefficient rural projects were favored for political reasons).

<sup>49</sup> Bruckner & Tuladhar, *supra* note 41, at 13 (noting that in Japan the projects planned by cities have a higher multiplier (.78) than ones planned by the central government, and theorizing that the reason is, among other things, “better targeting of projects”).

<sup>50</sup> Michael Cooper, *Stimulus Plan for Rail Line Shows System of Weak Links*, N.Y. TIMES, Mar. 23, 2010, at A14.

<sup>51</sup> Michael Cooper, *How Flaws Undid Obama’s Hopes for High-Speed Rail in Florida*, N.Y. TIMES, March 12, 2011, at A12 (“It would have linked two cities that are virtually unnavigable without cars, and that are so close that the new train would have been little faster than driving.”).

<sup>52</sup> *Id.* (“It was, after all, a multibillion-dollar federal project being lavished on Florida, an important swing state that President Obama had won in the last election, with the money focused squarely on the Interstate 4 corridor between Tampa and Orlando, the home of one of the most crucial blocs of independent voters in the state.”).

<sup>53</sup> *Off the San Francisco Rails*, WALL ST. J., Aug. 23, 2011, <http://online.wsj.com/article/SB10001424053111903918104576500452522248360.html> (describing project as “case study in government incompetence and wasted taxpayer money” and noting that “Tom Rubin, the former treasurer-controller of Southern California Rapid Transit District, calculates that taking the bus would be five to ten minutes faster on every segment”).

Government planning to cover \$942 million of the \$1.6 billion cost? It is probably not irrelevant that the project is in Nancy Pelosi's district.<sup>54</sup>

A key challenge with a stimulus, then, is to allocate the funding wisely. The size of the stimulus – though a central question in the recent public debate – is in ways less important than how the money is used. An important risk is that it can be hijacked for pork, and then it will be much less effective at promoting economic growth.

#### *D. The Costs of Deficits*

Even if we solve this problem by ensuring that stimulus funds are used only for high value infrastructure projects, we still need a plan to manage the deficit. Although steps to cut the deficit can slow growth in the short term – as occurred in the U.S. in 1937<sup>55</sup> and in the UK in recent months<sup>56</sup> – there is unfortunately a risk that *increasing* the deficit can *also* slow growth by undermining consumer and business confidence.<sup>57</sup>

Specifically, as the deficit increases, the future tax burdens associated with servicing this debt grow as well. If businesses and consumers focus on these future tax burdens, they may spend less today, as David Ricardo observed over a century ago.<sup>58</sup> Of course, it is impossible to forecast exactly who will bear tax burdens, especially if the political process has not allocated them yet, and Ricardo himself recognized that people are not always this farsighted.<sup>59</sup> But those who run businesses – and are deciding whether to hire another person – constantly have to make predictions about the future. Their “most likely reaction,” according to Richard Fisher, the President of the Federal Reserve Bank of Dallas, “is to cross your arms, plant your feet and say: ‘Show me. I am not going to hire new workers or build a new plant until I have been shown’ how the deficit will be addressed.<sup>60</sup> The plan needs to be “sufficiently specific and widely supported,” the Director of the Congressional Budget Office has testified, “so that households, businesses, state and local governments, and participants in the financial markets believ[e] that the future fiscal restraint w[ill] truly take effect.”<sup>61</sup> In essence, we have to focus on short-term recovery and long-term deficit reduction at the same time, and this is not an easy balance to

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<sup>54</sup> Beth Duff-Brown, *SF Chinatown fears new subway could be scrapped*, ASSOCIATED PRESS, Sept. 17, 2011, available on Westlaw at 9/17/11 APONLINEUS 22:29:40.

<sup>55</sup> SHAVIRO, *supra* note 25, at 73.

<sup>56</sup> *BCC Cuts its Forecast for UK Economic Growth in 2011*, BBC BUSINESS, (Sept. 1, 2011), <http://www.bbc.co.uk/news/business-14735753> (noting that growth in the UK slowed in the fourth quarter of 2010, but increased in the first quarter of 2011 and unemployment did not rise as much as expected).

<sup>57</sup> See Elmendorf, *supra* note 9, at 5 (“credible steps to narrow budget deficits over the longer term would tend to boost output and employment in the next few years by holding down interest rates and by reducing uncertainty and enhancing business and consumer confidence”).

<sup>58</sup> See DAVID RICARDO, *Essay on the Funding System*, in THE WORKS OF DAVID RICARDO WITH A NOTICE OF THE LIFE AND WRITINGS OF THE AUTHOR BY J. R. MCCULLOCH 115 (1888) (“In point of economy there is no real difference in either of the modes, for 20 millions in one payment, 1 million per annum forever, or £1,200,000 for forty-five years are precisely of the same value.”) For a more modern formulation of “Ricardian equivalence,” see Robert J. Barro, *Are Government Bonds Net Wealth?* 82 J. POLIT. ECON. 1095 (1974).

<sup>59</sup> RICARDO, *supra* note 58 (“But the people who paid the taxes never so estimate them, and therefore do not manage their private affairs accordingly. We are too apt to think that the war is burdensome only in proportion to what we are at the moment called to pay for it in taxes, without reflecting on the probable duration of such taxes.”).

<sup>60</sup> Fisher, *supra* note 31.

<sup>61</sup> Elmendorf, *supra* note 9, at 5.

strike.<sup>62</sup> It is like navigating between Scylla and Charybdis, and it is hard to be confident that we will chart exactly the right course.

If we allow the deficit to grow unchecked, though, we face the familiar long-term costs of growing deficits.<sup>63</sup> Higher long-term interest rates can crowd out private investment (although long-term rates are quite low now). Likewise, the government may be tempted to use inflation to reduce the real value of the debt.<sup>64</sup> We are also burdening future generations, and constraining the government's capacity to pursue other initiatives, going forward.<sup>65</sup>

The bottom line, then, is that there is a great deal of uncertainty about the effectiveness of a Keynesian stimulus. Much depends on how the money is used and on how we propose to pay for the stimulus over the long-term. One thing we can say with confidence is that a Keynesian stimulus is hard to do well. For all these reasons, it is unlikely to serve as a magic bullet for reviving our economy.

### **III. Tackling Problems of Substantive Law: The Example of Cutting Corporate Tax Rates**

#### ***A. Addressing a Broad Range of Problems***

At the same time, we know that there are a broad range of problems that need to be addressed. Since consumers with underwater mortgages have less purchasing power, we should explore ways to help them refinance.<sup>66</sup> Unwise lending helped to precipitate this crisis, and better financial regulation is needed, going forward. Social security and Medicare have sizable projected deficits, so we need to reform these systems to ensure their solvency. We should eliminate unnecessary regulatory burdens so businesses will expand. Obviously, there are many more examples as well.

As we look for legal regimes to modify in order to encourage economic growth, we have ample reason to focus on the tax code. It is overly complex, so that compliance and enforcement are costly and special interest deals are harder to see. Poorly crafted tax rules obviously can undermine incentives to work and invest. A growing body of empirical research shows that

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<sup>62</sup> Bernanke, *supra* note 10 (asserting the importance of pursuing “the two goals of achieving fiscal sustainability—which is the result of responsible policies set in place for the longer term—and avoiding the creation of fiscal headwinds for the current recovery” and arguing that the two goals are “not incompatible”).

<sup>63</sup> See, e.g., Carmen M. Reinhart & Kenneth S. Rogoff, *Growth in a Time of Debt*, 100 AM. ECON. REV. 573 (2010) (arguing that government debt slows economic growth).

<sup>64</sup> Paul A. Volcker, *A Little Inflation Can Be a Dangerous Thing*, N.Y. TIMES, Sept. 19, 2011, at A27 (warning against using inflation to deal with overhang of the debt).

<sup>65</sup> SHAVIRO, *supra* note 25, at 77.

<sup>66</sup> See, e.g., Alan Boyce, Glenn Hubbard & Chris Mayer, *Streamlined Refinancings for up to 30 Million Borrowers*, (draft of Sept. 1, 2011),

[http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file\\_id=739308](http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=739308) (urging reforms to overcome frictions in mortgage market to allow holders of Fannie and Freddie mortgages to refinance at lower rates; this will encourage them to spend more, and will reduce the rate of default); see also John Geanakoplos & Susan P. Koniak, *Mortgage Justice is Blind*, N.Y. TIMES, Oct. 30, 2008, at A39 (proposing that responsibilities for restructuring mortgages be assumed by public trustee).

certain tax cuts can provide an effective fiscal stimulus.<sup>67</sup> All tax cuts are not created equal, though, since some – including temporary rebates – have a much weaker record.<sup>68</sup>

### ***B. The Case Study of Corporate Tax Reform***

Of the many ways we could reform our tax system to promote economic growth, cutting the corporate tax rate should be high on our list, and so this reform is offered as an illustrative example here. There are three reasons for this.

First, by reducing the tax on business income, we increase the after-tax return when businesses invest and hire more people. This incentive effect was hard to document in early studies measuring tax rates over time, since it was difficult to disentangle changes in tax rates from other changes in the economy.<sup>69</sup> But more recent empirical studies, focusing on microeconomic and cross-sectional data, offer strong evidence that lower taxes lead to more (and higher quality) investment.<sup>70</sup> Similarly, reducing the tax burden on business increases their cash flow, which helps them expand and add workers.<sup>71</sup> “A consensus has emerged that investment

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<sup>67</sup> For example, Christina Romer (before serving as the head of President Obama’s Council of Economic Advisors) co-authored a study finding that the multiplier from tax cuts was 3.0, which is twice the (optimistic) level the Obama stimulus assumed for government purchases. Christina Romer & David Romer, *The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks*, 100 AM. ECON. REV. 763 (2010) (identifying changes in tax policy made during times of relative economic stability, and driven by a desire to influence economic behavior or activity, and concluding that tax cuts in this context involve a multiplier of 3.0); see also Andrew Mountford & Harald Uhlig, *What are the Effects of Fiscal Policy Shocks?* (NBER, Working Paper No. 14551, 2008) (concluding that deficit-financed tax cuts are four times as effective at stimulating the economy as deficit-financed increases in government spending). Likewise, Alberto Alesina and Silvia Ardagna found that, of all the stimulus packages implemented by OECD countries between 1970 and 2007, those that succeeded cut business and income taxes, while those that failed relied on government purchases and transfer payments. Alberto Alesina & Silvia Ardagna, *Large Changes in Fiscal Policy: Taxes Versus Spending*, 24 TAX POL’Y & ECON. 35 (2010).

<sup>68</sup> *Economic Growth and Job Creation: The Road Forward: Hearing Before H. Comm. on Fin. Serv.*, 112<sup>th</sup> Cong. 1-2 (Jan. 26, 2011) (testimony of John B. Taylor, Prof. of Econ., Stanford University) (“The one-time stimulus payments to people did not jump-start aggregate consumption. . . . None of this should be surprising. Well-known economic theories of consumption – such as the permanent income or life-cycle theory – predict that temporary payments to households will not increase consumption by much.”).

<sup>69</sup> Kevin A. Hassett & R. Glenn Hubbard, *Tax Policy and Business Investment*, in 3 HANDBOOK OF PUBLIC ECONOMICS 1293, 1316 (Alan J. Auerbach & Martin Feldstein eds., 2002) (“the tendency for a number of aggregate variables to move together over the business cycle makes it difficult to isolate effects of individual fundamentals on investment using time series data”).

<sup>70</sup> J.G. Cummins, Kevin A. Hassett and R. Glenn Hubbard, *Have Tax Reforms Affected Investment?* 9 TAX POL’Y & ECON. 131 (1995) (elasticities of investment with respect to user cost of capital between -0.5 and -1.0); R.J. Caballero, Engel & J.C. Haltiwanger, *Plant-Level Adjustment and Aggregate Investment Dynamics*, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 1-54 (1995) (aggregate elasticity of investment with respect to user cost is between -0.5 and -1.0); R. Carroll, D. Holtz-Eakin, M. Rider & H.S. Rosen, *Entrepreneurs, Income Taxes and Investment, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH* 427 (Joel B. Slemrod ed., 2000) (cross-sectional variation in changes in personal tax rates following 1986 tax reform was associated with variation in small business investment; for many taxpayers, rates declined in 1986, so there was more investment in 1988 than in 1985); V.R. Fuchs, A.B. Krueger, & J.M. Poterba, *Economists Views About Parameters, Values, and Policies: Survey Results in Labor and Public Economics*, 36 J. ECON. LIT. 1387 (1998) (median respondent said a decline in user cost from a switch to expensing would increase investment consistent with elasticity of about unity); Austan Goolsbee, *Taxes and the Quality of Capital*, 88 J. PUB. ECON. 519 (2004) (tax reform associated not just with increased quantity of investment, but also with improved quality).

<sup>71</sup> Carroll et al., *supra* note 70, at 427 (“taxes exert a statistically and quantitatively significant influence on the probability that an entrepreneur invests. For example, a five-percentage-point rise in marginal tax rates would

demand is sensitive to taxation,” Kevin Hassett and Glenn Hubbard have observed, “and neoclassical investment models are useful for policy analysis.”<sup>72</sup> Experts from both political parties have contributed to this literature, including Austan Goolsbee and Christina Romer, who were senior economic advisors to President Obama.<sup>73</sup>

Second, lower tax rates also reduce the incentive to engage in distortive tax planning. There is less reason to favor debt over equity, to prefer tax-free reorganizations to taxable ones, to remain a private company (and thus to stay eligible for pass-through tax treatment), to favor some types of investments or sectors over others, and the like. The corporate tax, in particular, prompts a great deal of distortions and wasteful planning.<sup>74</sup> The “virtually unanimous view among economists and other tax policy analysts,” Michael Graetz has observed, “[is] that the corporate tax is a bad tax, if the goal is to enhance our nation’s economic wellbeing.”<sup>75</sup>

Third, cutting the corporate tax rate is all the more important in a competitive global economy. This year, our corporate tax rate has become the highest in the OECD, now that Japan has cut its rate.<sup>76</sup> Our 35% rate is significantly above the median OECD rates of 24% (Israel) and 25% (Austria).<sup>77</sup> By comparison, China’s rate is 25% (with a reduced 15% rate for high tech firms), the UK’s rate is 26%, Italy’s is 27.5%, Korea’s is 22%, Turkey’s is 20%, and Ireland’s is 12.5%.<sup>78</sup> Given the mobility of capital – and, thus, of jobs – we ignore our competitors’ tax rates at our peril. There is strong empirical evidence that high tax rates discourage foreign direct

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reduce the proportion of entrepreneurs who make new capital investments by 10.4 percent. Further, such a tax increase would lower mean capital outlays by 9.9 percent”).

<sup>72</sup> Hassett & Hubbard, *supra* note 69, at 1338.

<sup>73</sup> See Goolsbee, *supra* note 70, at 519 (“[T]ax policy toward investment, by changing the relative prices of capital varieties even within narrow classes of equipment, can have a direct effect on the quality composition of capital goods that firms purchase. Detailed data on farming, mining, and construction machinery suggest that this impact is economically important.”); Romer & Romer, *supra* note 67, at 764 (“The most striking finding . . . is that tax increases have a large negative effect on investment”).

<sup>74</sup> See generally Office of Tax Policy, U.S. Dept of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21<sup>st</sup> Century* (Dec. 20, 2007), <http://www.treasury.gov/resource-center/tax-policy/Documents/Approaches-to-Improve-Business-Tax-Competitiveness-12-20-2007.pdf>; JANE GRAVELLE, THE ECONOMIC EFFECTS OF TAXING CAPITAL INCOME (1994); Gaetan Nicodeme, *Corporate Income Tax and Economic Distortions* (CESifo, Working Paper No. 2477, 2008). Of course, cutting the tax rate can prompt a different type of planning, in which taxpayers shift income from themselves personally (where it would be taxed at the marginal rates for individuals) to their controlled corporation. See generally Roger H. Gordon & Joel Slemrod, *Are “Real” Responses to Taxes Simply Income Shifting Between Corporate and Personal Income Tax Bases*, in DOES ATLAS SHRUG? THE ECONOMIC CONSEQUENCES OF TAXING THE RICH 240 (Joel B. Slemrod ed., 2000). But since corporate profits are taxed twice – once at the corporate level and again when the profits are paid as a dividend – corporate rates have to be considerably lower than individual rates before this strategy becomes attractive. For example, if the corporate rate is reduced to 25%, and dividends continue to be taxed at 15%, the nominal effective rate here is 37% (i.e., 25%, plus another 15% of the remaining 75%, or 12%), which is still higher than the 35% maximum rate currently in effect for individuals.

<sup>75</sup> *Tax Reform and Consumption-Based Tax Systems: Hearing Before the H. Comm. on Ways and Means*, 112<sup>th</sup> Cong. 8 (July 26, 2011) (statement of Michael J. Graetz, Prof. of Law, Columbia Law School).

<sup>76</sup> Hiroko Tabuchi, *Japan Will Cut Corporate Income Tax Rate*, N.Y. TIMES, Dec. 14, 2010, at B4.

<sup>77</sup> Cf. *Examining Whether There is a Role for Tax Reform in Comprehensive Deficit Reduction and U.S. Fiscal Policy: Hearing Before Subcomm. on Fiscal Responsibility & Econ. Growth of the S. Comm. on Fin.*, 112<sup>th</sup> Cong. 8 (2011) (statement of Hon. John M. Engler, Pres., Business Roundtable) (noting that U.S. corporate tax rate is significantly higher than 25% average tax rate in OECD).

<sup>78</sup> *Basic (non-targeted) corporate income tax rates*, OECD TAX DATABASE, tbl.II-1 (2011), [http://www.oecd.org/document/60/0,3746,en\\_2649\\_34533\\_1942460\\_1\\_1\\_1\\_1,00.html#C\\_CorporateCapital](http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#C_CorporateCapital)

investment.<sup>79</sup> High U.S. marginal rates also create an incentive for U.S. businesses to shift taxable income overseas – and with it our tax base and, in some cases, real economic activity and jobs.<sup>80</sup> U.S. national welfare is likely to suffer when startups incorporate overseas to avoid U.S. tax on offshore income, when a tech company holds intellectual property overseas so that royalty payments to offshore affiliates can reduce its U.S. taxable income, and when manufacturing companies and financial firms move facilities and jobs to lower tax jurisdictions.<sup>81</sup> All of these steps would be less tempting to businesses if U.S. marginal corporate tax rates were lower.

The main problem with cutting the corporate tax rate is political. Unsophisticated voters might think this was an unfair sop to the rich. But the reality is that the corporate tax is borne not only by wealthy investors, but also by less wealthy ones (*e.g.*, the beneficiaries of pension funds) as well as by consumers (through higher prices for the corporation's products) and labor (through reduced wages). There is no consensus about how the corporate tax burden actually is allocated – that is, about what the tax's economic incidence is.<sup>82</sup> Recent research suggests, though, that labor's share of the corporate tax burden has been growing, given the increasingly competitive global market.<sup>83</sup> If cutting the tax rate leads to more hiring in the United States – as it should, for all the reasons discussed above – the distributional benefit of this tax cut will be quite broad. In any event, we can pair a corporate tax cut with other measures, such as an extension of unemployment insurance, to attain whatever overall distribution we are seeking for the tax and transfer system as a whole.

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<sup>79</sup> Ruud De Mooij & Sjef Ederveen, *Taxation and Foreign Direct Investment: A Synthesis of Empirical Research*, 10 INT'L TAX & PUB. FIN. 673 (2003) (surveying literature to show that foreign direct investment is sensitive to tax rates, with elasticities of approximately 1.0, and noting that effect seems to be increasing over time); Roger H. Gordon & James R. Hines, Jr., *International Taxation*, in 4 HANDBOOK OF PUBLIC ECONOMICS 1935 (Alan J. Auerbach & Martin Feldstein eds., 2002) (same).

<sup>80</sup> In some cases, real economic activity relocates outside the jurisdiction. *See, e.g.*, Michael P. Devereux & Rachel Griffith, *Taxes and the Location of Production: Evidence from a Panel of U.S. Multinationals*, 68 J. PUB. ECON. 335 (1998) (concluding that level of investment is determined primarily by marginal effective rate and location is determined primarily by average effective rate); Rosanne Altshuler & Harry Grubert, *Governments and Multinational Corporations in the Race to the Bottom*, 110 TAX NOTES 459 (2006) (finding that elasticity of foreign direct investment with respect to the cost of capital is 4.0). In other cases, the real economic activity does not actually move, but planning strategies are used to shift taxable income to low tax jurisdictions and deductible expenses to high tax jurisdictions. *See, e.g.*, James R. Hines, Jr., *Lessons From Behavioral Responses to International Taxation*, 52 NAT'L TAX J. 305 (1999) (concluding that after-tax profitability tends to be higher in low tax jurisdictions, and suggesting that firms are using planning strategies to shift taxable income there); Harry Grubert, *Intangible Income, Intercompany Transactions, Income Shifting, and the Choice of Location*, 56 NAT'L TAX J. 221 (2003) (estimating that location of intangibles and allocation of debt explain differences in profitability between high-and low-tax jurisdictions); Harry Grubert, William Randolph & Donald Rousslang, *Country and Multinational Company Responses to the Tax Reform Act of 1986*, 49 NAT'L TAX J. 341 (1996) (noting that corporations in high tax jurisdictions tend to pay deductible royalties instead of nondeductible dividends to offshore affiliates); James R. Hines, Jr., *Taxes, Technology Transfer and R&D by Multinational Firms*, in TAXING MULTINATIONAL CORPORATIONS 51 (Martin Feldstein, James R. Hines, Jr. and R. Glenn Hubbard eds., 1996) (noting that allocation of research and development expenses is tax sensitive and observing large increases in taxable income shifting over time).

<sup>81</sup> In addition to national welfare, global welfare may suffer as well when firms take these steps solely for tax reasons, since tax-motivated distortions can generate social waste.

<sup>82</sup> Don Fullerton & Gilbert E. Metcalf, *Tax Incidence*, in 4 HANDBOOK OF PUBLIC ECONOMICS 1787, 1812-15 (Alan J. Auerbach & Martin Feldstein eds., 2002) (reviewing various findings about incidence of corporate tax).

<sup>83</sup> Graetz, *supra* note 75, at 8.



A further challenge in cutting the corporate tax rate is how to make up the lost revenue. The corporate tax collected \$278 billion in 2010, representing 11% of I.R.S. collections.<sup>84</sup> Some revenue will be recovered automatically when the rate cut reduces taxpayer incentives to engage in tax planning. At the margin, some will replace debt with equity (since the interest deduction will be less valuable) – which is likely to be a socially valuable change in and of itself<sup>85</sup> – some will become less aggressive about shifting income to other countries (as the spread between the rates in the U.S. and other jurisdictions narrows), and the like. We have only limited data about the magnitude of this planning – and, thus, the revenue we would recover in stopping it – but a great deal of money is likely to be at stake.<sup>86</sup>

To recover additional revenue, we can broaden the corporate tax base in other ways as well. For example, current law includes a number of targeted benefits for particular activity, such as special deductions for domestic manufacturing.<sup>87</sup> To the extent that these preferences breed inefficiency by treating various industries and assets differently, repealing them is likely to be good policy anyway.<sup>88</sup> More generally, in deciding what preferences to eliminate, we should prioritize ones that are better explained by politics than economics, while preserving provisions that are especially effective at promoting investment and economic growth.<sup>89</sup> We can choose to

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<sup>84</sup> INTERNAL REVENUE SERVICE, DATA BOOK 2010, Publication No. 55B, 3 tbl.1 (Mar. 2011).

<sup>85</sup> See generally RUUD A. DE MOOIJ, IMF STAFF DISCUSSION NOTE: TAX BIASES TO DEBT FINANCE: ASSESSING THE PROBLEM, FINDING SOLUTIONS, 13-14 (May 2011) (noting that debt bias leads to substantial welfare costs by exacerbating business cycles and distorting corporate finance decisions).

<sup>86</sup> For example, Bartlesman and Beetsma estimate that a 1% increase in a country's tax rate leads firms to reduce reported income by 2.7% through transfer pricing, so that the government loses about two-thirds of the revenue it otherwise would have raised through the increase. Eric J. Bartlesman & Roel M.W.J. Beetsma, *Why Pay More? Corporate Tax Avoidance Through Transfer Pricing in OECD Countries*, 87 J. PUB. ECON. 2225 (2008); see also, e.g., Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT. TAX J. 703 (2009) (estimating that income shifting in 2004 reduced U.S. corporate income tax revenues by about 35 percent or roughly \$60 billion); Kimberly A. Clausing, *Tax-Motivated Transfer Pricing and U.S. Intrafirm Trade Prices*, 87 J. PUB. ECON. 2207 (2003) (estimating that prices for intra-firm imports and exports are strongly affected by international tax differentials, such that reducing a country's statutory rate by one percent results in changes in prices of intra-firm traded goods of roughly 2%).

<sup>87</sup> I.R.C. § 199.

<sup>88</sup> Cf. Don Fullerton, Yolanda K. Henderson & James Mackie, *Investment Allocation and Growth Under the Tax Reform Act of 1986*, in COMPENDIUM OF TAX RESEARCH 173 (Office of Tax Analysis, Dept. of Treasury, 1987) (in reducing inter-asset and inter-industry distortions, the 1986 tax reform led to efficiency gains).

<sup>89</sup> For example, one recent study concludes that a rate reduction funded partially (but not completely) by base broadening would increase GDP. See John W. Diamond, Thomas S. Neubig & George R. Zodrow, *The Dynamic Economic Effects of a U.S. Corporate Income Tax Rate Reduction* (June 17, 2011) (on file with Oxford University Said Business School), available at [http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/Diamon\\_Zodrow%20Neubig%20final.pdf](http://www.sbs.ox.ac.uk/centres/tax/symposia/Documents/Diamon_Zodrow%20Neubig%20final.pdf). The study also argues that growth would be slowed somewhat by a rate reduction that is revenue neutral, since attaining revenue neutrality would require repeal of investment incentives that are economically valuable. In coming to this conclusion, the study assumes that rate reductions offer less economic growth per dollar of lost revenue – in effect, less “bang for the buck” – than these investment incentives. The theory is that investment incentives offer more “bang for the buck” because they reduce the tax burden only on *new* investment, while rate reductions also reduce the tax burden on investments that are already in place. The study assumes that this benefit to old capital is wasteful, since the relevant investment decision has already been made. But this conclusion is naïve in a world of mobile capital flows; even “old” capital is in play, since firms might decide to move it offshore (or, relatedly, to implement planning strategies that shift the taxable income it generates to a different jurisdiction). As a result, low rates contribute to economic growth not only by inspiring *new* investment, but also by allowing us to keep *old* investment within the United States. Once this added benefit of rate reductions is taken into account, the argument

limit the rate cut to a level that can be funded through repeal of uneconomic preferences, or we can decide to cut the rate even more and make up the revenue in other ways. Obviously, important details need to be worked out here, and my goal is not to resolve them all, but to offer an example of the type of growth-enhancing-tax reform that should be high on our agenda.

#### **IV. Tackling Problems of Process: Promoting Better Fiscal Decisionmaking**

Just as we need to reform our tax system and a host of other regimes of substantive law, we also should improve our budgetary processes. In a time of austerity, we have to be more rigorous about priorities and more efficient in pursuing them.<sup>90</sup> Whether we are implementing a new stimulus or seeking to reduce our deficit, public spending should focus on high-value projects, not pork. Our tax system should promote growth with low rates and a broad base. Budgets should balance the value of the goods and services we are buying against the cost of the taxes (and borrowing) needed to fund them. These recommendations are as uncontroversial -- even bland -- as advocating baseball and apple pie on the Fourth of July. But unfortunately, few would argue that we are already attaining these goals and, in my view, we aren't even close.

##### ***A. Problems of Information and Political Incentives***

The dynamics holding us back are familiar as well. Some challenges involve information. In deciding what projects to pursue and how to pursue them, the government often has limited information and faces significant uncertainty. It is often hard to predict how taxpayers will respond to a change in the tax law, whether a particular infrastructure investment will come in under budget or, for that matter, what it will take to win a war.

In my view, the incentive problems are even more serious because of two familiar failings of our political marketplace. First, political leaders know that pleasing organized interest groups helps attract campaign contributions and votes, especially if the cost of special interest legislation can be passed on to everyone else in a way that will not attract attention.<sup>91</sup> After all, the American people will not notice if you take a penny from each of them every day in order to please some interest group; in a nation of 300 million people, that is over \$1 billion dollars per year. Instead of fighting over which interest groups to please, it is easier for congressional leaders to let all legislators offer pet projects to their friends.<sup>92</sup>

Second, politicians have the incentive to focus more on the short-term -- on today's polls and the next election -- than on the long-term health of the nation. As a result, interest-group log-rolling is even harder to resist when financed with deficit spending. This way, the cost can be paid far in the future -- when our current political leaders will have retired and when the taxes

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that investment incentives offer more "bang for the buck" -- and thus that a revenue neutral rate reduction would not increase GDP -- becomes much less persuasive.

<sup>90</sup> See Elmendorf, *supra* note 9, at 8 ("The nation cannot continue to sustain the spending programs and policies of the past with the tax revenues it has been accustomed to paying. Citizens will either have to pay more for their government, accept less in government services and benefits, or both").

<sup>91</sup> See generally MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* (1965).

<sup>92</sup> See Kenneth A. Shepsle & Barry R. Weingast, *Legislative Politics and Budget Outcomes*, in *FEDERAL BUDGET POLICY IN THE 1980S* 355 (Gregory B. Mills & John L. Palmer eds., 1984) ("Expenditure programs are . . . biased away from least-cost methods of production so as to favor those methods that yield greater electoral support.")

will be paid by people who aren't even born yet.<sup>93</sup> It is tempting to use the same dynamic to resolve (or, really, to avoid having to resolve) policy differences, while letting everyone “bring home the bacon” to their constituents. Instead of choosing between lower taxes and more spending, why not do both? Not surprisingly, studies show that divided governments are more likely to run deficits<sup>94</sup> and that deficits are less likely to be cut during election years.<sup>95</sup> Unfortunately, these incentive and information problems reinforce each other. Political leaders often justify special interest legislation with half-baked policy claims, which may seem more plausible when uncertainties are great and information is limited.

## ***B. Institutional Strategies to Promote Better Fiscal Decisions***

We need to keep these challenges in mind not just when we *make* policy decisions, but also when we decide *how* to make policy decisions. Can we change the process in ways that will create better political incentives? Obviously, this is challenging because political leaders have reason to like things as they are. They might be willing to support changes that *seem* to improve the process – so that they can take credit – but they will be tempted to include loopholes that allow them to keep playing the same old games.<sup>96</sup> Even so, it is worth understanding what steps should be taken to improve fiscal decisionmaking. In a rare moment when the public is focused on these issues – as they seem increasingly to be now – something constructive can be done. How can we better align the incentives of public decisionmakers with the interests of the public as a whole? There is no magic bullet – and, indeed, more to say than can be covered in a brief Article – but it is worth outlining three strategies, involving disclosure, institutional mechanisms targeting waste and pork, and enforced scarcity.

### *1. Disclosure and Outside Fiscal Watchdogs*

First, it is easier to hold political leaders accountable – and, of course, they will *feel* more accountable – when voters know the details of their choices. It is well known that legislators often understate costs by manipulating budgetary accounting rules.<sup>97</sup> We should tighten these rules to clamp down on this gamesmanship.<sup>98</sup> In addition, we should also require more cost

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<sup>93</sup> See generally JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* (1962) (discussing the concept of “fiscal illusion”).

<sup>94</sup> James Poterba, *State Responses to Fiscal Crises: Institutions and Politics*, 102 J. POL. ECON. 799, 816-18 (1994) (empirical analysis of fiscal shocks from late 1980's and early 1990's shows that states with divided government eliminated deficit more slowly); see also James E. Alt. & Robert C. Lowry, *Divided Government and Budget Deficits: Evidence from the States*, 88 AM. POL. SCI. REV. 811 (1994) (states with governor of different party than legislature are more likely to run deficits); Nouriel Roubini & Jeffrey D. Sachs, *Political and Economic Determinants of Budget Deficits in the Industrial Democracies*, 33 EUR. ECON. REV. 903 (1989) (nations with divided governments have higher budget deficits).

<sup>95</sup> See Poterba, *supra* note 94, at 818 (citing empirical studies showing that states running deficits are less likely to raise taxes or cut spending in gubernatorial election year).

<sup>96</sup> Michael J. New, *U.S. State Tax and Expenditure Limitations: A Comparative Political Analysis*, 10 ST. POL. & POL'Y Q. 25, 26 (2010) (legislators sometimes enact budgetary limits that are easy to avoid because “it is not clear that legislators have the incentive to reduce their autonomy by placing meaningful constraints on their own behavior”).

<sup>97</sup> See, e.g., Charles Tiefer, *How to Steal a Trillion: The Uses of Laws About Lawmaking in 2001*, 27 J. LAW & POL. 409, 444 (2001) (noting that sunseting of 2001 tax cuts after nine years was motivated by budgetary accounting).

<sup>98</sup> See generally Cheryl D. Block, *Budget Gimmicks*, in *FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY* 39 (Elizabeth Garrett, Elizabeth A. Graddy & Howell E. Jackson, eds., 2008); Alan Auerbach,

benefit analysis for new appropriations and changes in the tax law, as well as estimates of how the costs and benefits are distributed. Are the benefits of a particular initiative concentrated narrowly among a small group of people? Or in a particular geographic area? Do the costs fall disproportionately on future generations?<sup>99</sup>

Individual members, the media, academics, lobbyists, and advocacy groups can (and do) also help disinfect our budget with sunlight by focusing attention on matters that the government has itself disclosed and, of course, by generating new information.<sup>100</sup> Senator William Proxmire's Golden Fleece Awards publicized unwise expenditures, and Representative Paul Ryan has followed in this tradition with his Budget Boondogle Awards.<sup>101</sup> In an era of social media, private wikis and other websites funded with tax deductible contributions can also serve as fiscal watchdogs.<sup>102</sup> A program analogous to *qui tam* awards can also be implemented to incentivize them further. The risk that special interest deals will be exposed and "go viral" on the web should exert some discipline on Congress.

## 2. Institutional Reform

Second, in addition to relying on better accounting and disclosure, we should create internal barriers to wasteful appropriations, tax loopholes, and the like. The ban on earmarks was a productive step, as was the creation of the Joint Select Committee on Deficit Reduction in the Budget Control Act of 2011.

Building on the latter model, we should task particular institutions within the government to root out waste and pork, so that they will seek professional glory in resisting the special-interest dynamics described above.<sup>103</sup> These institutions obviously would have to be willing to

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*Budget Windows, Sunsets and Fiscal Control 2* (NBER, Working Paper No. 10694, 2004) ("a budget window that is too short permits the shifting of costs beyond the window's endpoint. But a budget window that is too long includes future years for which current legislation is essentially meaningless, and gives credit to fiscal burdens shifted to those whom the budget rules are supposed to protect").

<sup>99</sup> SHAVIRO, *supra* note 25, at 103.

<sup>100</sup> While the focus here is on disclosure about *outputs* from the budget process, a different question is how much disclosure about the *process itself* is optimal. As Elizabeth Garrett and Adrian Vermuele have observed, this information can promote "bad" as well as "good" accountability; through the former, interest groups seek to verify that legislators are serving their interests. Elizabeth Garrett & Adrian Vermuele, *Transparency in the U.S. Budget Process*, in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY 68, 83 (Elizabeth Garrett, Elizabeth A. Graddy & Howell E. Jackson eds., 2008) (discussing tradeoff between good and bad accountability).

<sup>101</sup> *Senator Proxmire's Golden Fleece Awards Reborn*, RACINE POST, Jan. 31, 2008, <http://news.racinepost.com/2008/01/sen-proxmires-golden-fleece-awards.html>.

<sup>102</sup> For a discussion of news organizations supported by tax deductible contributions, see David M. Schizer, *Subsidizing the Press*, 3 J. LEG. ANAL. 1 (2011).

<sup>103</sup> The appropriations committees was once thought to play this role. See RICHARD FENNO, *THE POWER OF THE PURSE: APPROPRIATIONS POLITICS IN CONGRESS* (1966) (noting that the appropriations authorized less money than the President requested 73.6% of the time in a data set of 575 cases from 1947 to 1962); DAVID R. MAYHEW, *CONGRESS: THE ELECTORAL CONNECTION* 153 (1974) (arguing that members of appropriations "lean against particularism and also against servicing the organized"). But the appropriations committee lost some of its power in 1974, when the authority to set overall budgets was given to the budget committees, and some commentators argue that appropriations became less able – or at least, less willing – to play this role. ALLEN SCHICK, *CONGRESS AND MONEY: BUDGETING, SPENDING AND TAXING* (1980) (arguing that the 1974 reforms undercut the appropriations committee's role as fiscal guardian); cf. Matthew D. McCubbins, *Budget Policy-Making and the Appearance of Power*, 6 J.L.E.O. 133 (1990) (questioning impact of 1974 reforms); John Ferejohn & Keith Krehbiel, *The Budget*

displease particular interest groups. Their political incentive could be to respond to the growing anti-deficit sentiment within the voting public, or to claim credit for finding savings that spare us from tax increases or from cutting more important programs.

We can assign these “de-appropriations” institutions a range of different missions, depending upon how powerful we want them to be. At a minimum, their findings should be publicly disclosed, along with the names of those who sponsored and supported these suspect initiatives. Even better, bipartisan standing House and Senate Committees could be empowered to sever items from the budget, so that these provisions would be subjected to a separate (public) vote.<sup>104</sup> Going even further, we could give a congressional committee the functional equivalent of a “line-item” veto, such that it could kill items it does not consider cost-justified.<sup>105</sup> The mere possibility that pork could be cut in this way would itself discourage some log-rolling *ex ante*, since parties to a trade couldn’t be sure their side of the bargain would survive.

An even broader mandate would be for this new committee to identify a designated percentage of the budget every year that they consider least valuable, much like some companies have an annual process for identifying and replacing their least productive employees. The executive branch’s Office of Management and Budget (“OMB”) could engage in a parallel exercise. If implemented effectively, this would be an extremely important achievement. As Edward Lazear has observed, a one percent reduction in government spending each year, in real terms, would bring our budget into balance in about eight years.<sup>106</sup> How much would we really miss the least useful one percent of the budget if we were able to identify and eliminate it each year?

For this sort of unpopular mission, we also can rely on independent commissions to make recommendations and, of course, to deflect blame from elected officials.<sup>107</sup> Management consultants perform a comparable function for CEOs, distancing senior management from steps that are unpopular but necessary. Similarly, the process used for closing military bases after the

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*Process and the Size of the Budget*, 31 AM. J. POL. SCI. 296, 317 (1987) (member “preferences are the real predictors of congressional behavior in the budget process,” such that effects of 1974 reforms should not be overstated).

<sup>104</sup> The so-called Byrd Rule empowers individual members to sever items from reconciliation bills, but the statutory test for severing an item is whether it is “extraneous,” not whether it is wasteful. William E. Dauster, *The Congressional Budget Process*, in FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY 4, 30-34 (Elizabeth Garrett, Elizabeth A. Graddy & Howell E. Jackson, eds., 2008) (analyzing Byrd Rule).

<sup>105</sup> In most states, the governor has a line item veto. Congress enacted one for the President in the Line Item Veto Act of 1996, but the Supreme Court struck it down as unconstitutional. *Clinton v. City of New York*, 524 U.S. 417 (1998) (holding that line item veto violated Presentment Clause in giving President authority to amend statutes validly enacted by Congress). But Congress can presumably bring this function in-house under its authority to “determine the Rules of its proceedings.” U.S. Const., art. I, § 5, cl. 2. Studies show that the experience in the states varies quite a lot, but that it has been a fairly powerful instrument – with sizable dollar amounts of appropriations vetoed – and that, not surprisingly, it is used more often when the governor and legislature are from different parties. See generally Catherine C. Reese, *The Line-Item Veto in Practice in Ten Southern States*, 57 PUB. ADMIN. REV. 510 (1997) (analyzing 4185 line item vetoes cast between 1973 and 1992).

<sup>106</sup> Edward P. Lazear, *How to Grow Out of the Deficit*, WALL ST. J., Sept. 27, 2010, <http://online.wsj.com/article/SB10001424052748703989304575504221128887634.html>.

<sup>107</sup> See Peter Orszag, *Too Much of a Good Thing*, NEW REPUB., Sept. 14, 2011, <http://www.cfr.org/geoeconomics/too-much-good-thing/p25887> (advocating greater use of independent commissions of experts).

Cold War offered political cover in allowing elected officials only an up-or-down vote on an independent commission's recommendation, without the ability to make changes.<sup>108</sup>

### 3. *Hard Budget Constraints*

Third, like better disclosure and institutional mechanisms to cut waste, scarcity also focuses the mind. Politicians are less likely to accommodate one interest group if they know this means offending another. As Michael Graetz has observed, “[l]egislators behave[e] quite differently when to pay Peter they ha[ve] to be explicit about how they inten[d] to rob Paul.”<sup>109</sup> As a result, hardening the budget constraint should encourage our leaders to be more rigorous about priorities and more efficient in pursuing them.

Over the years, the Federal government has pursued this goal in different ways. From 1985 through 1990, targets were set for the deficit and enforced with automatic cuts under the Gramm-Rudman-Hollings Act.<sup>110</sup> In 1990, President George H.W. Bush and Congress agreed on a new regime that limited existing programs with spending caps and also added the so-called “PAYGO rule,” which required Congress to fund any *new* tax cuts or spending programs with revenue offsets (*i.e.*, new spending cuts or tax increases).<sup>111</sup> In effect, Congress could not do something new without cutting something old or raising taxes. By forcing Congress to make tough choices, PAYGO reduced the deficit substantially.<sup>112</sup> This very success – and the budget surpluses that were projected as a result -- persuaded Congress to let key aspects of PAYGO expire in 2002.<sup>113</sup> Soon thereafter, the deficit, quite predictably, began increasing once again.

The states have also tried various ways to constrain deficits; indeed, every state except Vermont has a balanced budget requirement of some sort. One essential lesson, emphasized by Richard Briffault, is that the details matter enormously.<sup>114</sup> Some limits are so malleable as to be

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<sup>108</sup> Marcia Lynn Whicker & Nicholas A. Giannatasio, *The Politics of Military Base Closing: A New Theory of Influence*, 21 PUB. ADMIN. Q. 176, 183, 203-4 (1997) (describing process and arguing that it successfully enabled a decision that was a “political hot potato” and otherwise would have been blocked, but noting that political factors played some role in influencing commission's recommendations) .

<sup>109</sup> Michael J. Graetz, *Tax Reform 1986: A Silver Anniversary, Not a Jubilee*, TAX NOTES 3 (Oct. 17, 2011) (noting that “an important constituent cooled on an amendment that would have restored a 100 percent deduction for business entertainment expenses when that change was coupled with an increase of one point in the corporate tax rate”).

<sup>110</sup> See Dauster, *supra* note 104, at 10-11 (noting that Gramm-Rudman-Hollings stabilized the deficit but did not reduce it). The Comptroller General originally had final authority to determine the cuts, but the Supreme Court deemed this an unconstitutional intrusion on executive power, see *Bowsher v. Synar*, 478 U.S. 714 (1986), and so the OMB took over this authority. Kate Stith, *Rewriting the Fiscal Constitution: The Case of Gramm-Rudman-Hollings*, 76 CAL. L. REV. 593, 598 (1988).

<sup>111</sup> See generally Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Legislative Process*, 65 U. CHI. L. REV. 501 (1998) (discussing PAYGO rules).

<sup>112</sup> Elizabeth Garrett, *A Fiscal Constitution With Supermajority Voting Rules*, 40 WM. & MARY L. REV. 471, 481 (1999) (“Most of those who study the federal budget process believe that the [PAYGO] rules have had some bite; congressional spending patterns have been altered by this complicated framework.”); James A. Thurber, *Twenty Years of Congressional Budget Reform*, 25 PUB. MANAGER 6, 7 (1996) (“The primary impact of PAYGO has been to discourage spending”).

<sup>113</sup> See Block, *supra* note 98, at 41 (noting that PAYGO and spending caps were allowed to expire in 2002).

<sup>114</sup> See generally RICHARD BRIFFAULT, *BALANCING ACTS: THE REALITY BEHIND STATE BALANCED BUDGET REQUIREMENTS* 13 (1996) (“In short, the byzantine structure of state finances can undermine the discipline of balanced budget requirements that, on paper, seem quite severe”).

meaningless, allowing states to engage in accounting gimmicks to give the false illusion of fiscal discipline, to channel their deficits into separate accounts (e.g., for pensions or capital) that are not subject to the constraint, or to devolve functions to localities in order to move costs off of the state's budget.<sup>115</sup> Likewise, a constraint on spending would also be ineffective if the legislature could avoid it by recasting a program as a targeted tax break.<sup>116</sup>

Yet as a number of empirical studies have shown, well crafted state constraints do, in fact, make a difference.<sup>117</sup> For example, states that require supermajorities to raise taxes are less likely to do so,<sup>118</sup> and are more likely to have taxes that are broad-based.<sup>119</sup> Alternatively, some states have limits on taxes and expenditures ("TEL's"). TEL's are more effective if they cap spending increases based on population growth and inflation (as opposed to growth in personal income), if they require immediate refunds of surpluses, if they adjust the spending limit if governmental functions are taken off budget,<sup>120</sup> and if they measure whether the budget actually was balanced as of the *end* of the year (instead of merely whether a balanced budget was *projected* when the year began).<sup>121</sup> TEL's of this type generally slow state spending growth by a meaningful amount each year.<sup>122</sup> We should draw on this wealth of experience to develop effective budgetary reforms for Congress, such as a new and improved version of PAYGO, while keeping in mind that the experience of states and the federal government are not perfectly analogous. For example, the federal government can print money, while states cannot; at the same time, states do not have the same level of responsibility (e.g., for national defense), and usually can depend on help from the federal government in an emergency. In a sense, states are inherently more constrained than the federal government, and have less need of flexibility anyway.

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<sup>115</sup> Poterba, *supra* note 94, at 804 (noting that some states allow for changes in accounting rules so that the budget seems to be in balance, such as cash accounting for expenditures and accrual for income, changing actuarial assumptions in pension plan, etc.).

<sup>116</sup> See David F. Bradford, *Reforming Budgetary Language* (CESifo, Working Paper No. 619, 2001) (showing that spending programs can be converted to tax expenditures).

<sup>117</sup> See James M. Poterba, *Do Budget Rules Work* (NBER, Working Paper No. 5550, 1996) ("The preponderance of the evidence suggests that these [budget] rules matter"); Henning Bohn & Robert P. Inman, *Balanced-Budget Rules and Public Deficits: Evidence From the U.S. States*, 45 CARNEGIE-ROCHESTER CONF. SER. ON PUB. POL. 13 (1996) ("Our central empirical conclusion is that stringent balanced-budget rules can limit state general fund deficits").

<sup>118</sup> Ellen Seljan, *Supermajority Limits on Fiscal Policy* (APSA, 2011 Annual Meeting Paper, 2011) (states that require supermajority votes to raise taxes are less likely to do so in good economies (2%, compared to 8% in states with no supermajority requirement) and in bad economies (12% likely compared with 13% likely)).

<sup>119</sup> Jac C. Heckelman & Keith L. Dougherty, *Majority Rule versus Supermajority Rules: Their Effects on Narrow and Broad Taxes*, 38 PUB. FIN. REV. 738 (2010) (empirical support for Buchanan & Tullock claim that supermajority rules make it harder to pass redistributive taxes).

<sup>120</sup> New, *supra* note 96, at 30-31 (showing that TEL's of this type are more effective and tend to be enacted at the initiative of voters instead of legislators).

<sup>121</sup> Bohn & Inman, *supra* note 117, at 18 (finding states with year-end measure have surpluses on average of \$100 larger than states that focus only on the projected budget, and are only 11% likely to run a deficit instead of 26% likely).

<sup>122</sup> New, *supra* note 96, at 36 (strong TEL's reduce annual expenditure growth by \$100 per person or 3%); Poterba, *supra* note 94, at 799 (empirical analysis of fiscal shocks from late 80's and early 90's shows that states with weak anti-deficit rules adjust spending less than states with strict anti-deficit rules; for every \$100 of deficit, states with weak rules cut expenditures by \$17 and cut deficit by only \$79, while states with strong rules cut expenditures by \$44 and eliminate deficit entirely); Harold W. Elder, *Exploring the Tax Revolt: An Analysis of the Effects of State Tax and Expenditure Limits*, 20 PUB. FIN. REV. 47, 60 (1992) (conducting empirical study showing that "growth of tax burdens has been significantly reduced in those states that have used expenditure limitations").

In any federal regime of this sort, then, we need some flexibility for emergencies, without opening the floodgates. Obviously, it is easier to preserve flexibility – and to act quickly – with statutory rules than constitutional ones. We can allow the deficit to increase if, for instance, a supermajority of legislators believe this is necessary in response to a particular crisis (hopefully, for merits-based reasons and not because swing votes have been secured with pork). Likewise, we should exempt the defense budget during significant armed conflicts, while cabining this exception with rules policing what counts as defense expenditures (*e.g.*, so we exclude high speed commuter rails that incidentally benefit the defense industry).

Likewise, we need a mechanism for determining the budget if the process deadlocks. As a default, we can rely on the proposals of standing committees that target waste, as discussed above, along with a mix of automatic across-the-board spending cuts, government salary and hiring freezes, automatic tax increases, and the like. The threat of these automatic cuts will serve as a “hammer,” motivating Congress to negotiate a package of smarter ones.

Finally, it is worth emphasizing that the various recommendations here reinforce each other. For example, a constraint on deficits such as PAYGO requires tough accounting rules to keep Congress from evading it.<sup>123</sup> If successful, a PAYGO rule will motivate a “de-appropriations” committee to cut waste and pork – and will induce the rest of Congress to accept its work – as a way to preserve resources for higher priorities.

## **V. Conclusion**

Inefficiency in our tax system and in government spending obviously is never a good idea, but it is especially undesirable when times are tight. We cannot afford to waste money or miss opportunities to promote economic growth. With one-sixth of our workforce unemployed or underemployed, with a soaring budget deficit, and with global economic competition intensifying in every sector, we must not settle for flawed fiscal policies. Our corporate tax system is urgently in need of reform. Reducing the rate and broadening the base would contribute significantly to economic growth. This should be an important first step in a broader effort to improve our tax system. In addition, we should not settle for a budgetary process that wastes public money on pork and shies away from making difficult decisions. We can do much better, and now is the time to start.

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<sup>123</sup> Garrett, *supra* note 111, at 527-29 (discussing budget gimmicks used by Congress to avoid PAYGO).