

Chapter 5

Guns and Butter

When Eisenhower entered the Oval Office, the new President confronted “a ticking fiscal time bomb.”¹ The federal government had more missions than money and no one was sure how Washington was going to pay its bills. Eisenhower was worried. Winning the long war required adequate security and a strong economy. America needed guns and butter, but all the future had to promise was an increasingly unsustainable budget deficit. Making government fiscally responsible, Ike believed, had to be high on his agenda.

The former commander of America’s military legions had scant training in economic policy, but he had a strong dose of Midwestern common sense and he knew what he wanted; lower taxes, balanced budgets, and less government interference in the marketplace. As far as Eisenhower was concerned, Americans—not the government—understood best how to spend their money. On the other hand, an economy directed by Washington, Ike believed, would lead to “slavery.”² Above all, Ike was determined to shake government from its wartime habits of centralized economic controls and high taxation. Such measures might be suitable for titanic, violent, armed struggles like World War II, but they did not suit strategies for long wars.

As in matters of national security, Eisenhower decided that the government’s fiscal policy required presidential leadership. Ike might charge his Cabinet with implementing policies, but the policies would be made in the Oval Office: He would make them and they would be, if nothing else, fiscally sound. While temporary deficits might be necessary to fight a downturn in



Soviet Premier Nikita Khrushchev and President Dwight Eisenhower at Camp David. (COURTESY OF THE NATIONAL ARCHIVES)

the business cycle or fight a short, hot war like the Korean conflict, Eisenhower believed they should not be a permanent government addiction.

Leaks from the Gaither Report proved to be one of the greatest challenges Eisenhower faced in trying to add fiscal responsibility to the congressional dictionary. From the beginning of his presidency, Ike had tried to reassure Americans that he took the Soviet threat seriously, but at the same time, remind them that the Soviets were not ten feet tall. America should not and did not have to spend itself into bankruptcy to fend off the threat of Communist expansion. The Gaither Report, much like NSC-68, challenged that logic—calling for \$44 billion in additional spending within five years to slow the Soviet juggernaut.³

Eisenhower not only thought that Gaither's findings overstated the threat, but he complained that the report's prescriptions were simply unrealistic. How could damaging the U.S. economy help diminish the Soviets? Raising the kind of cash called for by the Gaither panel would have required new taxes, massive deficits, and probably wage and price controls to keep inflation in check. "This administration has gotten rid of controls as soon as it came into office," Eisenhower fumed, "because of a conviction that in the absence of controls the American economy would develop more rapidly. Are we now to advocate the re-introduction of controls?"⁴ Eisenhower would simply not compromise good economic policies in the face of irrational fears.

The Balancing Act

The problem of balancing the competing demands for security and prosperity is reflected in the interdependent nature of military and economic power. In the short term, military power can be created more rapidly, but without economic power it is, as the Soviets discovered, ultimately unsustainable. By 1980, the Soviet Union had built a military behemoth equal to the United States', but it rested on a foundation as fragile as porcelain. By 1991, in the face of impending economic collapse, Soviet military capacity rapidly withered. The single-minded pursuit of either security or prosperity means failure in the long war. The necessity for maintaining security against immediate threats must be balanced against the long-term requirements for expanding prosperity.

Today, the challenge facing both the President and Congress is little different from the decisions faced by Eisenhower—defining the right policies to achieve security and economic growth. As in the coldest days of the Cold War, achieving both goals will require leadership that is steadfast and unswerving in its commitment to sound domestic economic policies. Part of winning the long war—a large part—is remaining a good steward to the world's premier economy.

No one understood the challenge better than R. Glenn Hubbard. On May 11, 2001, President George W. Bush appointed the Columbia University economics and finance professor to be the Chairman of the White House Council of Economic Advisers (CEA). Established in 1946 under the emerging shadow of the Cold War, the CEA drew its initial inspiration from the famed British economist John Maynard Keynes, who believed government spending could be used to fine-tune the economy and create full employment. In practice, the



Competing with the Soviet economy, Russian workers grind grain in a church. (PHOTO FROM THE NATIONAL ARCHIVES)



Glenn Hubbard explaining the need for tax cuts. (PHOTO FROM THE HERITAGE FOUNDATION COLLECTION)

CEA evolved into something far more academic and less threatening than a cabal of omnipotent technocrats trying to steer the national economy like a golf cart. In practice, for most of the Cold War, the CEA's role was fairly benign and its chairman was considered to be more a kibitzer than a player in White House economic policies. "CEA Chairmen," as Reagan's appointee Martin Feldstein noted, "have generally regarded their role as presenting professional

advice on what is economically correct rather than on trying to balance economic and political considerations in determining the ‘best’ policy.”⁵ President Bush wanted something different from the CEA. So did Glenn Hubbard.

With a boyish face, sandy hair, wire-rim glasses, and a broad smile that seemed more reminiscent of Harry Potter than John Maynard Keynes, Hubbard nevertheless was an economist of the first order, with a Ph.D. from Harvard and a score of books to his credit. Unlike Keynes, however, Hubbard’s view of the government’s role in the economy was to get it out of the way. He believed that government’s primary responsibility in setting economic policies was to do no harm.

Rather than offer dry analysis, Hubbard believed the CEA’s job was to push for strong pro-growth policies—and that meant tax cuts. Although Hubbard’s reasoning came from years of study and Eisenhower’s from small town pragmatism, they both reached the same conclusion. Tax cuts make sense. They might create a short-term deficit, but they will unleash long-term growth that will more than offset near-term costs. As for federal spending, it simply had to be kept in check. Rapid growth in federal spending was anathema to pro-growth tax policies. Hubbard, like Eisenhower, knew that tax increases slowed economic growth and slow growth weakened the economy. An anemic economy cannot meet the expectations of its citizens and it cannot fight the long war.

Hubbard felt confident that his unabashed advocacy for disciplined federal spending and tax cuts would find favor with the new President. “I’m not a very political person,” Hubbard confided, “but I have observed in this president a great concern about long-term growth. I think it’s a credible...economic and political story to say you’re concerned with long-term living standards. I think the American people are much smarter than many politicians give them credit for.”⁶ The President agreed: He had found his war economist.

Economics 101

Understanding the role of the economy in the long war begins with understanding the federal government’s relationship with the domestic economy. That means appreciating that it is the total cost of government that is important, not just government activities related to security. The Soviet Union’s economic collapse stemmed from more than just its government’s insatiable appetite for military spending. It followed at least as much from the Kremlin’s determination to control economic activity in the civilian sector while ignoring

the enormous costs of imposing controls. The Soviet treatment of the economy is an object lesson in how *not* to fight the long war. Avoiding disaster means ensuring that the burden of government (in terms of spending, taxes and regulation) is not so high that it places an excessive burden upon the economy.

Preventing unnecessary tinkering with the economy is easier said than done. Politicians always want to do something. It is a condition Hubbard learned to understand well as he tried to shape the CEA's recommendations. As the jobs market in 2003 continued to languish, members of Congress felt compelled to show that they could do something to create jobs. Numerous bills were touted as "jobs bills" or cited for the jobs they would create, asserting that this would "grow" the economy. Most notable were the multi-billion dollar transportation and energy bills that were supposed to create employment and expand the economy through government spending.

All the rhetoric about government job creation had little prospect for actually creating economic growth. Even though Hubbard knew this, he encountered a great deal of flak from his critics and from Congress, in part because he always found himself fighting the ghost of John Maynard Keynes.

During the 1930s, in response to the trials of the great global depression, Keynes posited that government spending could be used to pump new money into the economy. He asserted that when the economy's total demand is lacking, government could act as a consumer and make purchases itself. Since the gross domestic product (GDP) is the sum of all purchases on final goods and services, these government purchases will add to GDP and the economy will grow.

Yet Keynes's version of fuzzy math raised the obvious question: Where does the government get the money that it pumps into the economy? The government does not have its own money, so every dollar the government pumps into the economy must first be taxed or borrowed.⁷ This means that government spending does *not* create new income; it merely shifts existing income from one group of people to another.

To help explain exactly what Keynes was advocating, economists differentiate between two types of government spending: "transfer spending" and "direct purchasing." Transfer payments, such as Social Security and farm subsidies, tax or borrow money from one group and transfer it to another group. Even Keynesian economists acknowledge that transfer payments only move existing income and do not affect GDP.

Direct purchasing simply means buying things. For example, the Defense Department buys fighter jets from Boeing, and Medicare buys health care services from doctors. Keynesians believe these purchases expand

GDP. However, the money spent on them had to be first taxed or borrowed from people who otherwise would have spent the money themselves. Consequently, these government purchases merely displace private purchases, leaving total economic activity unchanged.

In either case, the reality is simply that every dollar government injects into the economy must first be taken from the economy. *The Wall Street Journal's* Robert Bartley called this “Government Budget Restraint” (GBR).⁸ GBR highlights the futility of government “pump-priming.” The government is not priming anything: It is just moving wealth around, and probably far less efficiently than people could do it themselves.

This does not necessarily mean that government spending can never help the economy. Under certain circumstances, the right government spending could add to the economy’s long-term *supply side*. A growing economy requires not only consumers and investors willing to spend money; it also requires businesses that are willing and able to supply goods and services.

There is some government spending that is unavoidable. At the most basic level, businesses and consumers require government spending for defense and justice to enforce the property rights and rule of law necessary for markets to function. Sustained economic growth also requires consistent investment in public infrastructure (such as roads), private capital (to expand businesses and technologies), and human capital (such as education and a motivated workforce). These investments create economic growth by helping businesses to produce and sell more goods and services more efficiently.

On the other hand, government spending is not the real engine behind economic growth. The private sector, motivated by profit, funds most investment needs by itself. If private investment falls short for some reason, governments could tax consumers to fund investment—although excessive taxes would harm investment and worker motivation, negating the policy’s effects. Investment expands the economy *not* because the government pumps new money into it, but because structural changes increase its long-run capacity for growth. These structural changes can take years, therefore, government spending does not provide adequate short-run economic stimulus.

Bad Spending Habits

GBR means government spending will have a neutral effect on demand. In fact, government spending (beyond the necessary investments, such as

defense and public goods) can actually harm the economy's supply side and impede economic growth.⁹ Here are the reasons why:

1. Diminishing Effectiveness. Empowered by the opportunities for economic growth provided by defense, law enforcement, and basic public goods, governments often mistakenly conclude that they can solve any problem. Consequently, they tend to expand their efforts into services that the market is better equipped to provide, such as education, housing, food, and pensions. With each expansion, the government not only blocks the market from functioning, but also becomes less effective itself, until it ultimately becomes a barrier to economic growth.

2. Politics. Markets use the profit motive to ensure that resources are allocated efficiently. Businesses seeking profits must consistently respond to consumer demand with quality products at low prices. Governments, by contrast, are monopolies with no real profit motive or incentive to spend money efficiently. Therefore policymakers make re-election their "profit" and consequently allocate resources to even the most wasteful programs if it will help to ensure their return to office. Although innovation and "evolving with the times" are required for businesses to survive, they represent an unnecessary risk for politicians who are guaranteed re-election as long as they do not interrupt the flow of government funds to their districts. Hence, while markets helped the evolution of the Model T into the Porsche and the Apple IIe into the supercomputer, the federal government continues to run many of the same federal agencies—now obsolete—that it established as far back as the 1800s.

3. High Taxes. Increased government spending makes it difficult for working families to make ends meet. Even when the government funds itself by borrowing money, repaying those loans will eventually require higher taxes. Those higher taxes will leave families with less income to spend on necessities such as health insurance, retirement, housing, and education. Regrettably, many people praise government spending on families without acknowledging that families first had to be taxed—and that the burden of those taxes often outweighs the benefits of the government programs.¹⁰ In addition to their high cost, taxes hurt the economy by distorting incentives. Families and businesses work, save, and invest because they expect a financial reward. These productive behaviors also make the rest of the nation wealthier by creating additional economic activity. Yet burdensome tax rates reduce the financial reward for being productive. Consequently, families and businesses cut back their productive behavior to escape taxes, and the entire economy slows down.

To see the consequences of excessive spending and taxation, one need look no further than Western Europe, where politicians have promised to provide for all of their citizens' needs in exchange for higher taxes and bigger government. Western Europeans have incomes 40 percent below Americans' and unemployment rates twice as high. They also pay 50 percent of their income in taxes.

The lesson of Economics 101 is that excessive government spending and other controls are bad for all economies. They are, however, especially deadly to countries fighting the long war. *In the long war, a growing economy is not just essential for prosperity. It is essential for survival.* Long wars are not lost on the battlefield, but in the hearts and minds of men and women—and often in their pocketbooks as well.

Budget Priorities

Avoiding excessive spending is a challenge both for homemakers and for nations—differing only by degree. Budgets are about setting priorities. Budget writers must juggle a finite supply of dollars and an endless demand for spending. The first task, then, is to rank budget priorities and separate necessities from unaffordable luxuries.

Most Americans would likely agree that the top priority of government is providing for the common defense and safety. Thus, defense, homeland security, and law enforcement must be sufficiently funded. Most Americans would also likely agree that the second priority of government is maintaining a healthy economy that creates jobs and raises incomes. History has shown that free-market economies create substantially more jobs and higher incomes than socialist economies and welfare states. Because government spending beyond security and public goods often reduces economic growth and incomes, lawmakers should reduce spending for lower-priority programs in order to reduce the tax burden and keep money in the productive private sector.

Some people focus obsessively on balanced budgets as the sole criterion for good government. Although balanced budgets are indeed desirable, they are not as high a priority as national security and a healthy economy. About national security, few would argue that the nation should not have fought World War II or the Cold War out of a reflexive fear of the budget deficits they required. Even Eisenhower, perhaps the nation's most balanced-budget phobic President in history, recognized that deficits had their time and place.

Economic growth and the increased prosperity and higher incomes that come with it is a higher priority, not only because it has a larger positive effect on people's lives than balanced budgets, but also because a larger economy can better repay its deficit debt in the future. Budget deficits themselves do not harm short-run economic growth, as they have not been shown to significantly raise interest rates.¹¹ The main long-run cost to budget deficits is the high future taxes required to finance and repay this borrowing and the negative economic effect of those taxes. Therefore, lawmakers should aim to minimize long-term budget deficits without sacrificing security and economic growth. Specifically, this means funding defense and homeland security and reducing wasteful spending in order to maintain low taxes and minimal deficits.

Although it is easy to argue that defense and homeland security must be funded first, that is a difficult prescription to put in to practice. Setting priorities, writing a budget, and getting it passed is Washington's version of the Twelve Labors of Hercules. That is because every budget carries with it the dead weight of history—and that history makes for heavy lifting.

History of Federal Spending

The federal government has expanded substantially during the past century. One of the best measures of the burden that the federal government, as a whole, imposes on the national economy through its spending policies is the percentage of GDP taken up by outlays. During the nation's first 140 years, the federal government rarely consumed more than 5 percent of the GDP. In accordance with the U.S. Constitution, Washington focused on defense and certain public goods while leaving most other functions to the states or the people themselves.

The Great Depression brought about President Franklin Roosevelt's New Deal, a program that expanded government in an attempt to relieve poverty and revive the economy. President Roosevelt created the Social Security program in 1935 and also created dozens of new agencies and public works programs. Although the economy remained mired in depression, the federal government's share of the GDP reached 10 percent by 1940.¹²

World War II pushed the United States into the largest war mobilization effort the world has ever seen. From 1940 through 1943, the federal government more than quadrupled in size—from 10 percent of GDP to 44 percent.

The enormity of this government expansion cannot be understated: An equivalent expansion today would cost \$3.9 trillion, or \$37,000 per household (compared with \$2.1 trillion or \$20,000 per household in 2003). Even with a top income tax rate of 91 percent, the nation could not fund World War II on tax revenues alone. The nation ended the war with a national debt larger than the GDP (which is three times the size of today's national debt).

Following the war, Washington's share of the economy fell back to 12 percent of GDP in 1948. Among the many ways this time changed America was by making its citizens more comfortable with expanded federal powers. The Supreme Court, under threats from President Roosevelt, had upheld these new federal powers by broadly interpreting the Constitution's Interstate Commerce Clause. From 12 percent of GDP in 1948, federal spending began a 35-year growth spurt that finally reached a peacetime record of 24 percent of GDP in 1983.

In the long decades of federal expansion from the end of World War II to President Ronald Reagan's election, Washington expanded into several new policy areas, creating the Departments of Health, Education and Welfare (in 1953; eventually becoming Health and Human Services), Housing and Urban Development (in 1965), Transportation (in 1966), Energy (in 1977), and Education (in 1979; it had been a part of Health, Education and Welfare).

The largest new programs were created in the 1960s as part of President Lyndon Johnson's Great Society initiative. Medicare and Medicaid, which provide health care services to the elderly and the poor, were created in 1965 and expanded throughout the next fifteen years. Along with Social Security, they now are the largest entitlement programs.¹³

Federal spending generally fluctuated at just over 20 percent of GDP throughout the 1980s and early 1990s. However, in the last few years spending has sharply increased again as the war on terrorism collided with a domestic spending spree.

Over time, the composition of federal spending has evolved as well. Between 1962 and 2000, defense spending plummeted from 9.3 percent of GDP to 3.0 percent. Nearly all of funding shifted from defense spending into mandatory spending (mostly entitlement programs), which jumped from 6.1 percent of GDP to 12.1 percent during that period.

The importance of this evolution cannot be understated. For most of the nation's history, the federal government's chief budgetary function was funding defense. The two-thirds decline in defense spending since 1962 has substantially altered the make-up and structure of the U.S. national defense.

At the same time, the expanding entitlement state has completely filled the spending void. Entitlements such as Social Security, Medicare, and Medicaid are projected to continue growing rapidly in coming decades—until they *alone* top 20 percent of GDP. If global events ever warranted a return to the defense spending levels of the 1960s, it would be nearly impossible to find room in the budget without raising taxes to catastrophic levels.

Budget Burdens

Defense. Those who are inclined to spend less on defense may argue that the nation's fiscal woes are not the result of the growth of domestic program spending, but that defense spending is the problem because it is crowding out other spending. History shows that this is not the case. While the overall level of federal government spending, relative to the size of the economy, has remained reasonably constant over the last 32 years, the same cannot be said regarding the major components of federal outlays. The defense budget has trended down, while entitlements in particular have trended up.

Other Budget Spending. Since 1962, defense outlays have grown from \$52.6 billion to \$404.9 billion. Major entitlement expenditures (Social Security, Medicare, and Medicaid), on the other hand, have exploded from \$14.1 billion to \$905.5 billion during the same period. Even outlays for all other federal programs (excluding defense and the three major entitlements) have grown faster than defense during this 42-year period. What is crystal clear, however, is that the spending on the three major entitlement programs has been growing at a rate that dwarfs all the other major categories of federal spending.¹⁴ (See Appendix 10.) This is a huge concern for the defense budget, as well as the future implications for the economy, because this entitlement growth is unsustainable.

Share of Federal Outlays. As would be expected, the relatively rapid rise in entitlement spending during the last 42 years resulted in higher shares of overall federal outlays going to those programs. Meanwhile, restraints on defense expenditures resulted in a reduction in its share of the federal budget. In fiscal year 1962, defense outlays accounted for 46.2 percent of all federal outlays. By fiscal year 2003, the defense share of the budget had fallen to 18 percent. Meanwhile, outlays for the major entitlements grew from 12.9 percent of all federal outlays in 1962 to 40 percent in 2003. Outlays for other spending and interest on the national debt remained relatively constant from

1962 to 2003 in terms of their respective shares of overall federal spending.¹⁵ (See Appendix 11.)

The Burden on the Economy. Not surprisingly, the same trends hold true for the burden these spending categories place on the economy. In 1962, defense absorbed roughly 9.2 percent of GDP. However, by 2003, defense outlays consumed only 3.7 percent of GDP.¹⁶ The reverse trend occurs for the major entitlements. In 1962, major entitlement programs consumed 2.5 percent of GDP. By 2003, 8.3 percent of GDP went to these programs.¹⁷ Spending on programs other than major entitlements and defense fluctuated during the same period, although spending growth in this category of the budget has outstripped economic performance in recent years.¹⁸ Interest payments went up as a share of GDP in 1980s and 1990s, but have fallen back in recent years.¹⁹ (See Appendix 12.)

Security Spending. Following the terrorist attacks of September 11, 2001, the federal government began tracking spending for homeland security outside the defense budget. In 2003, this spending (including a supplemental appropriation) totaled \$34 billion.²⁰ This spending is distributed among a wide variety of federal departments and agencies, including the new Department of Homeland Security. Offsetting receipts, however, covered about \$3.4 billion of this spending. The net outlay for homeland security outside the defense budget, therefore, constituted 0.28 percent of GDP in fiscal year 2003. Given the short record of tracking this spending, the question is whether this new category will expand to the degree that it outstrips overall federal spending or national economic performance.

Current Federal Spending Trends

After 28 consecutive years of budget deficits, the 1998 fiscal year ended with a \$69 billion budget surplus. These budget deficits, which had reached 6 percent of GDP in 1983, were eliminated by a combination of three factors: First, real defense spending plummeted by 30 percent in the 1990s as a result of winning the Cold War. Second, tax revenues reached their highest level since World War II as a result of the economic boom. Third, legislative gridlock between Democratic President Bill Clinton and the Republican Congress doomed most new spending initiatives and allowed spending growth to slow to a crawl.

The arrival of budget surpluses, however, saw federal spending accelerating once again. These spending increases went mostly unnoticed because tax

revenues continued pouring in at a pace rarely seen in American history, culminating in a \$236 billion budget surplus in 2000.

With the economic boom predicted to continue indefinitely, a January 2001 Congressional Budget Office report forecast a cumulative budget surplus of \$5.6 trillion over the next decade. In response, Congress adopted President George W. Bush's tax cut proposal, which was estimated to reduce revenues by up to \$1.3 trillion over the decade, and in tandem accelerated the federal spending spree. Lawmakers were not yet aware that the technology bubble had burst, the economy was falling into recession, and tax revenues would soon begin plummeting. Against this budget backdrop came the September 11 attacks. A reeling economy was suddenly faced with a massive defense and homeland security mobilization.

Between 2001 and 2004, wars with Afghanistan and Iraq were funded by a 48 percent increase in defense spending. Homeland security spending, which had not even existed as a category before September 11, leapt from \$16 billion to \$33 billion.²¹ The low defense spending that helped bring balanced budgets in the late 1990s was over.

Lawmakers typically blame war and homeland security costs for the barrage of new spending since 2001. That explanation is incomplete. In the two years following the terrorist attacks, federal spending jumped by \$296 billion. Of this, \$100 billion (34 percent) went for defense and \$32 billion (11 percent) went for other 9/11-related costs such as homeland security, international assistance, rebuilding New York City, and compensating terrorism victims. This leaves \$164 billion in new spending—which represents 55 percent of the total increase—unrelated to defense and the terrorist attacks.²²

Furthermore, lawmakers usually cut non-security spending in time of war. Budgets are about setting priorities, and sometimes non-defense programs must take a back seat to the nation's security needs. During World War II, President Roosevelt reduced non-war-related spending by an average of 11 percent each year. President Truman signed budgets during the Korean War that reduced non-defense spending by 6 percent annually. This trend was reversed during the Vietnam War, as President Johnson signed budgets expanding the non-defense spending by 14 percent per year. Tax increases and economic stagnation followed.

Although not quite reaching the levels it did under Johnson, federal spending during the war on terrorism has more closely reflected the Vietnam-era spending binges than the spending restraint of World War II and

the Korean War. Spending not related to defense and 9/11 increased by an average of 5 percent per year from 2001 through 2003. That two-year, 11 percent increase in non-security spending represents the fastest growth in a decade.²³ At a time when defense and homeland security priorities require especially tight non-security budgets, lawmakers have not made necessary trade-offs, and in fact, have *accelerated* non-security spending growth.

Where did all this money go? Apart from defense and homeland security, the 2001 through 2004 period saw:

- A 2002 farm bill that is estimated to cost \$180 billion over ten years—an 80 percent increase over the baseline;
- A 2003 Medicare drug bill that is estimated to cost \$534 billion in the first ten years, and as much as \$2 trillion in the following decade, according to the Congressional Budget Office;
- The 2001 No Child Left Behind Act, which authorized billions in new education spending, and is largely responsible for the 77 percent education spending increase;
- Several extensions of unemployment benefits, combined with the automatic new costs that occur when recessions expand unemployment rolls, resulting in a 60 percent increase in unemployment spending;
- An amount of \$20 billion in federal assistance to states; and
- Expansions of the refundable Earned Income Tax Credit and Child Tax Credit, resulting in \$10 billion in new spending.²⁴

From 2001 to 2004, a span of only three years, the following program categories received major spending increases: international affairs (108 percent), general government (78 percent), education (77 percent), unemployment benefits (60 percent), community and regional development (59 percent), and health research and regulation (54 percent).

Even on the lowest-priority programs, restraint remains absent. During that same three-year period, massive funding increases were granted to low-priority programs such as the National Technical Information Service (900 percent), Commerce Department management (311 percent), and the Natural Resources Conservation Service (205 percent).²⁵ The number of annual “pork” projects (grants for often unnecessary projects back in the lawmakers’ districts) surpassed 10,000 for the first time ever, and this \$23 billion cost included grants to the Please Touch Museum in Philadelphia (\$725,000) and

the Rock & Roll Hall of Fame in Cleveland (\$200,000).²⁶ Each dollar given to these projects represents one less dollar for security, tax relief, or deficit reduction.

Waste has proliferated as well. The federal government was unable to account for \$25 billion that was spent in 2003. Auditors estimated that employees embezzled 3 percent of the entire Department of Agriculture budget by placing personal purchases on their government credit cards. Over \$20 billion in annual program overpayments plagues Washington's social programs.²⁷

Overall, from 2001 through 2004, federal spending leaped 24 percent, from \$1.86 trillion to \$2.32 trillion. Discretionary spending increased 39 percent and mandatory spending surpassed 11 percent of GDP for the first time ever. Dozens of small, lower-priority programs received historic spending increases, and no programs of significance were eliminated or even substantially reduced. On a per household basis, federal spending exceeded \$20,000 per household for the first time since World War II (adjusted for inflation).²⁸ In only four years, the \$236 billion budget surplus was replaced with a budget deficit topping \$400 billion.

Why Spending Accelerated

Most Americans say they prefer smaller government, yet majorities consistently support government expansion. The reason for this apparent contradiction is rooted in common sense. To wit: A bill in Congress would add \$1 each to 100 million peoples' taxes and distribute that entire bounty to the pork industry. The 100 million people may oppose the tax, yet the small \$1 cost is not worth the effort of discovering the legislation, fighting it, and voting against elected officials who favor the legislation. Because the pork industry has a \$100 million stake in the legislation, they will produce more lobbying, campaign contributions, and electoral pressures on elected officials than the 100 million citizens combined. The legislation will likely pass.

Now, apply this logic to several hundred programs that benefit specific groups of people, each of which will fight to its subsidy. An iron triangle develops between the beneficiaries, the agency administering the program, and the congressional committee overseeing the program, all of which have an interest in preserving it.

A budget process that encourages federal spending has aided such special interest politics. Because there are no limits on federal spending, lawmakers can fund all spending demands and simply pass the cost on to taxpayers.

Although public choice theory explains the general growth of government, the acceleration of non-war spending during a time of higher priorities requires additional explanation. Three chief factors induced this recent spending spree.

No Discipline. The Republican majority in Congress, still haunted by the 1995–1996 government shutdown, began to consider spending cuts the new “third rail” of politics. The ambitious 104th Congress had sought such cuts to balance the budget, but oddly began by targeting the most popular programs, including many in which the savings would be miniscule. Its popularity plummeted when President Clinton capitalized on its tactical errors by forcing a government shutdown. Rather than regrouping and changing tactics, shell-shocked GOP legislators dropped spending restraint altogether. In the White House, as well as among congressional Republicans, “Remember the 104th” became checkmate against anyone foolish enough to suggest spending cuts.

No Limits. The balanced budgets of the late 1990s removed the most popular argument for spending restraint. Before then, lawmakers could use the deficit as a reason to keep spending for popular programs in check. Yet when a tax revenue boom first balanced the budget in 1998, the floodgates opened. Gloomy deficit reduction was replaced with a sunny “balanced budget liberalism,” which funded colossal education, health, and social spending increases with soaring tax revenues from an economy that—it seemed—would boom forever. Economic reality quickly returned tax revenues to their historical levels, but it was too late: Both parties now measured their compassion by how much they spend on these popular programs. No one wanted the thankless job of setting limits and saying no.

No Majority. The nation’s 50/50 partisan split accelerated pandering and special interest politics. Republicans and Democrats entered their campaign seasons believing that congressional control would be won or lost on the last few thousand votes. When both sides move so close to victory, bold political risks become too dangerous. Federal spending has been used to play to any remaining special interest that can provide support in elections. In 2002, Senate leaders identified farmers as the swing voters who would decide control of the Senate. The ensuing bipartisan bidding war resulted in the most expensive farm bill in American history. By 2004, all the momentum favored expanding government. It is critical that in the short term this

momentum be upset in order to fund key priorities like defense and homeland security—and in the long term to protect economic security from huge tax increases necessary to address the entitlement explosion.

Future Spending Trends

Where do we go from here? Budgets are about setting priorities, and the central priorities of the federal budget are to defend the American people from external threats and to protect individuals' paychecks. This is what Eisenhower knew would help win the Cold War. It is what Glenn Hubbard believed would help win the war on terrorism. They were both right. We should learn the lessons of the Eisenhower presidency and stick to the economic strategies mapped out by the Bush Administration after 9/11. This requires appropriate funding for defense and homeland security while keeping taxes low. In doing so, policymakers must deal with two truths:

First, defense and homeland security spending are critical elements of our nation's future. The world has changed and so must America's security budget. Although defense and homeland security costs dropped to 3 percent of GDP in the 1990s, they have since rebounded to 4.4 percent of GDP—representing a \$160 billion increase. Given the long-term dangers posed by transnational terrorist groups—as well as the proliferation of weapons of mass destruction and other dangers that might arise from aggressor, enabler, or slacker states—American security spending must likely remain at this higher level indefinitely.

Second, entitlements represent the largest challenge to the nation's ability to fund defense and still keep taxes low. Entitlement spending topped 11 percent of GDP for the first time ever in 2003, and yet even this high level is considered the calm before the budgetary storm. The Baby Boomers will begin retiring at the end of this decade and an unprecedented Social Security and Medicare liability will be handed over to younger generations. The ratio of workers to retirees will complete its drop from 16:1 in the 1930s to 2:1 in 2030. In other words, a two-income couple will be supporting themselves, their children, and the full retirement and health care expenses of their very own retiree.

The Congressional Budget Office has calculated the costs of this coming entitlement explosion. It has projected that federal spending will increase by 5 percent of GDP by 2030 (the current equivalent of \$5,200 per household annually), and 13 percent of GDP by 2050 (the current equivalent of

\$13,500 per household annually).²⁹ This will require either massive tax increases, the elimination of most other government programs (including defense and homeland security), or a combination of the two.

Spending Recommendations for the Long War

Reform Entitlements. Taxpayers cannot afford the massive intergenerational transfer of wealth that Social Security and Medicare will soon require. European economies are already being crushed under the weight of these expensive social insurance programs, and the United States must reform now to avoid a similar fate. This means transitioning Social Security from the current “pay-as-you-go” system (in which today’s taxpayers fund today’s retirees) into one in which taxpayers are allowed to save and invest their own payroll taxes. Taxpayers would actually own their personal retirement accounts as assets that they could control—and even pass down to their children. Similarly, Congress should look at reforming Medicare into a market-based system that provides seniors with choices and incentives to shop around for the best deals. Additionally, lawmakers must revisit the 2003 Medicare drug law that threatens to add trillions of dollars to the tax burden.

Eliminate Low-Priority Programs. A major theme of this chapter is that budgets are about setting priorities. Washington should fully fund its highest priorities (defense and homeland security) and eliminate unaffordable non-priorities. Lawmakers should create a government waste commission that would submit legislation terminating all wasteful, ineffective, and outdated programs. Lawmakers should also eliminate corporate welfare, privatize functions that can be better run by the private sector, and devolve more functions to state and local governments that can best customize programs to match local needs.

Repair the Budget Process. Lawmakers still cling to the antiquated budget process created back in 1974. During the past thirty years, successive Congresses have punched this process full of holes and federal spending has correspondingly tripled. The current budget process provides no workable tools to limit spending, no restrictions on passing massive costs onto future generations, and no incentive to bring all parties to the table early in the budget to set a framework. America’s budget priorities have changed, and so must its budget process.

Reform the Tax Code. The tax rate reductions championed by Glenn Hubbard and implemented by President Bush have rejuvenated today’s economy.

Yet it sometimes seems as if tax policy is like running on a treadmill because the good tax legislation of some years is offset by bad developments in other years. Tax rates are increased in some years, the tax bias against saving and investment goes up in other years—and complexity gets worse every year.

As a result, today's tax system remains an obstacle to economic growth. Consider a few facts: Approximately 140 million taxpayers will send tax returns to Uncle Sam this year, a painful exercise involving 8 billion pages of paper that will help transfer more than \$2 trillion from the productive sector of the economy to the government. For America's most productive residents, the tax system takes more than one-third of the additional wealth they generate for the nation. Those who save and invest in America's future are penalized with extra layers of taxation. Indeed, it is possible for a single dollar of income to be hit by the capital gains tax, the corporate income tax, the personal income tax, *and* the death tax.

With more than 1,000 forms, notices, and publications, the Internal Revenue Code imposes an enormous compliance burden on taxpayers. Businesses get hit the worst. Two-thirds of compliance costs are borne by companies—expenses that are ultimately paid by workers, shareholders, and consumers. Yet this is just the tip of the iceberg. Businesses also are hit by a 35 percent federal tax rate (in addition to the states' 5 percent); this represents the second-highest corporate tax burden in the industrialized world.

Academic experts estimate that the current tax system imposes mammoth costs on the U.S. economy. Economic output may be about 15 percent lower than it could be as a result of bad tax law, and annual growth rates could be much more impressive if the tax system did not punish productive behavior. There are many reasons why bad tax law reduces economic performance. High tax rates discourage work and entrepreneurship. Discriminatory taxes against capital undermine saving and investment. Special loopholes and penalties undermine efficient allocation of resources by giving people an incentive to make decisions for tax reasons rather than economic reasons. Complexity imposes deadweight costs and diverts intelligent and capable people to careers that add nothing to America's economic output.

Good Tax Policy Equals Good Long-War Strategy

To ensure that the economy grows faster and produces more wealth, jobs, and security, the tax system should be fixed. This requires both tax reduction

and tax reform. It is important to understand, however, that not all tax cuts are created equal. Some tax cuts, specifically “supply-side” reductions in tax rates on work, saving, investment, and entrepreneurship, can yield large benefits to the economy. Properly designed, they even can simplify today’s byzantine tax system. Yet it is also possible to cut taxes in ways that lead to a more complicated tax system, while simultaneously doing nothing to improve the economy’s performance.

To judge the desirability of tax policy changes, there must be a yardstick—a benchmark, so to speak—of an ideal tax system. This theoretical ideal would have a low tax rate and it would tax income only *one* time. Such a system would not impose a second layer of tax on income earned in other nations, and taxpayers would find it easy to understand. The “flat tax” is the best example of such a system. It would minimize the tax penalties imposed on productive behavior and it would get politicians out of the business of trying to micromanage the economy through the tax code.

Yet even if politicians are reluctant to junk the tax code and implement a flat tax—because it would take away too much power from Washington—there are many incremental changes that can create a better tax system. However, to reap these benefits, lawmakers must understand how taxes affect the economy. They also need to realize that economic growth occurs when people work more, save more, and invest more—the behaviors that increase national income and boost the nation’s wealth. When contemplating tax policy changes, policymakers should focus on the following questions:

- Will the provision lower the tax rate on productive behavior? To encourage growth, a tax cut should reduce the tax rates on work, saving, investment, risk-taking, and entrepreneurship. These are the activities that increase national income. As a general rule, credits, deductions, preferences, and exemptions do not help the economy grow faster.
- Will the provision make America more competitive in the global economy? It is increasingly easy for jobs and capital to migrate from high-tax jurisdictions to low-tax jurisdictions. The process, known as tax competition, enhances the rewards for nations that implement pro-growth tax policy.
- Will the provision encourage job creation? Companies do not hire workers because they feel sorry for them or because they have a social conscience. They hire workers in the expectation

of making a profit. High tax rates increase the cost of labor and discourage the capital formation that is necessary to boost worker productivity.

- Will the provision reduce the tax bias against saving and investment? Because of the capital gains tax, the corporate income tax, the personal income tax, and the death tax, the Internal Revenue Code imposes as many as *four* layers of tax on income that is saved and invested. Reducing or eliminating any of these extra layers of tax will boost capital formation by creating a level playing field between current consumption and future consumption.

Fixing the Tax Mess

There are a number of tax policy changes that meet the above criteria. Reducing the top tax rate imposed on personal income would be a positive step, particularly because today's 35 percent rate is still significantly higher than it was when Ronald Reagan left office. A similar reduction in the corporate tax rate also would be beneficial, especially since U.S. companies face a disadvantage in a competitive global economy due to this aspect of our tax law. Having a tax rate higher than either France or Sweden is a black mark against America.

Policymakers also should concentrate on reducing the tax bias against saving and investing. For example, eliminating the capital gains tax and the second layer of tax on dividends would ensure that there is no double tax on corporate profit. Making individual retirement accounts unlimited and universal would protect all saving from double taxation.

To promote simplicity and fairness—as well as to reduce compliance costs and help finance the pro-growth tax changes—lawmakers should eliminate as many special loopholes and exemptions as possible. The tax code is littered with special preferences that benefit lawyers, lobbyists, and accountants. Politicians are the biggest winners from tax code complexity, which is why tax reform also would be an ideal way of reducing corruption in Washington.

Because of globalization, the benefits of good tax policy have never been greater. Yet this also means that the costs of bad tax policy have never been higher. Many nations have enjoyed dramatic growth as a result of pro-growth tax policy changes. Ireland, for instance, has transformed itself from the “Sick Man of Europe” into the “Celtic Tiger” thanks to lower tax rates (including a

corporate tax rate of 12.5 percent, down from 50 percent less than twenty years ago). Former Soviet bloc jurisdictions, including Russia, are experiencing impressive results thanks to low-rate flat tax regimes. Hong Kong has been the world's fastest-growing economy since World War II, thanks in part to its flat tax.

The United States has been a modest winner in this international competition. America's aggregate tax burden may be high, but it is considerably lower than many other industrialized nations. The Reagan tax cuts certainly gave the United States a major boost in the 1980s, but there was backsliding in the 1990s: Policy mistakes in that decade have been only partially reversed by recent tax rate reductions. Ample room remains for tax reduction and tax reforms to improve America's competitive position. The better a competitor the United States is economically, the better able it will be to provide for its own security.

Spirit by Eisenhower, Economics by Hubbard

A strong economy is fundamental to winning the long war. Period. Solid economic policies not only stand side-by-side with good security practices, but they are natural partners in the war on terrorism. America *can* do both. If, when al-Qaeda is long gone, the United States does not stand as a stronger and more prosperous country than it did on September 10, 2001, it has no one to blame but itself. However, getting there will take more effort. Tax and spending reforms are the keys to the future prosperity that will provide a cornerstone to winning the war on terrorism.