Rightsizing Government: Reduce Spending and Restore Growth
Prepared by the Working Group on Rightsizing Government
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The Optimal Size of Government
The late economist Gerald Scully (1941–2009) pioneered a field of economics focused on studying the optimal size of government.1 Father of the “Scully Curve,” he taught that government spending can contribute to economic growth – but only up to a point, and only if the spending is focused on core activities of government.

According to Scully, spending on national defense, education, police, courts, fire protection, and essential infrastructure (roads, highways, bridges, sanitation, dams, and flood protection) tends to be the most encouraging of growth.

Up to a point, every dollar spent on such activities adds more than a dollar to the nation’s gross domestic product (GDP) by facilitating and protecting commerce and investment. Scully concluded the optimal level of such pro-growth spending for all levels of government was about 20 percent of GDP, based on the history of such spending and GDP growth in the United States and other countries.2

Government spending more than this optimal level detracts from economic growth and general prosperity. At today’s level of total government spending in the United States – 35 to 40 percent of GDP – the next dollar of taxation financing the next dollar of spending costs the economy $2.75 in lost GDP, Scully calculated.3

Total government spending in 1948 was 23 percent of GDP. If that level of spending had been maintained over the 50-year period between 1948 and 2008, Scully calculated U.S. annual GDP growth over the period would have averaged 5.8 percent, rather than the 3.5 percent growth rate actually achieved.4 That higher annual growth rate would have resulted in $37 trillion more in GDP by 2004.5 Incomes for the average American family would be three times higher than they are today.6

With the higher economic growth resulting from holding government spending to 23 percent of GDP, tax revenues would have risen by $60 trillion more over that period – enough to finance all programs for the poor with no increased national debt.7 If spending and taxes were reduced to 20 percent of GDP in 2011, by

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3 Ibid.
4 Ibid.
5 Ibid.
6 Ibid.
7 Ibid., pp. 2–3.
2030 GDP would be double what is expected otherwise.8

Scully’s analysis was confirmed by work published by the Federal Reserve Bank of Cleveland, which studied the history of government spending and GDP growth in the United States.9 As total government spending rose from 1946 to 1989 from 13.7 percent of GDP to more than 22 percent, GDP growth declined by more than two percentage points per year on average.

Economist Dan Mitchell, a senior fellow at The Heritage Foundation, also studied the effect of government spending on GDP growth worldwide in 2005.10 He found consistently that as total government spending increased in a country, the rate of economic growth in that country declined. Based on this research, he recommended reducing government spending to 10 percent of GDP to maximize production.

In another such study,11 James Gwartney, Randall Holcombe, and Robert Lawson found the optimal, growth-maximizing level of government spending to be between 15 and 20 percent of GDP. Gwartney et al. reached their conclusion based on the history of government spending and growth throughout all Organisation for Economic Co-operation and Development (OECD) countries.

By the period 1990 to 1996, OECD countries with the smallest increase in government spending since 1960 were growing more than twice as fast as OECD countries with the largest increase in government spending. Countries with government spending less than 25 percent of GDP grew at a real rate of 6.6 percent, while countries with government spending at more than 50 percent of GDP grew at a real rate of 2 percent or less.

Three countries – Britain, Ireland, and New Zealand – reduced government spending as a percent of GDP at various times in recent decades. Their economic growth rates increased sharply during those times, with New Zealand’s more than tripling and Britain’s increasing by two-thirds.

Gwartney et al. say government spending over the optimal level reduces GDP growth because the higher tax rates needed to sustain that spending reduce incentives to produce. In addition, higher government deficits and debt drain resources out of the private economy, and income redistribution discourages the recipients of welfare payments from contributing to the economy by working.

Booming Economic Growth
To rightsize the federal government, policymakers must find ways to restore booming economic growth, maximizing GDP.

That effort could start with the federal budget proposed by the House Republican Study Committee (RSC) for 2017. That proposal would balance the federal budget within eight years – two presidential terms. It would cut unnecessary government spending by $8.6 trillion and enact pro-growth tax reform, reducing tax rates and closing loopholes.

The RSC’s proposed tax reform would result in just two income tax rates: 10 percent on the first $100,000 in income, and 25 percent on all income above that. The tax rate for poor and low/moderate income families would effectively be zero percent – or even less for those who actually receive money from the IRS through “refundable” tax credits. Currently, those families are not taxed at all by the federal income tax, and they would not be subject to federal income tax under the RSC tax reform either.

The RSC reform also would cut the current federal corporate income tax rate of 35 percent to 25 percent. Pass-through income from smaller businesses operating as sole proprietorships, S-corporations, limited liability corporations (LLCs), partnerships, etc. – which are currently

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8 Ibid., p. 3.
9 Ibid., p. 2.
taxed under individual, personal income tax rates – would be taxed under the reform at a top rate of 25 percent. Capital gains and corporate dividends would be taxed at more revenue-maximizing rate of 15 percent.

The RSC’s proposed tax reform would create millions of new jobs and restore rising wages. Combined with the RSC’s proposed spending cuts, we would have in place two of the four components of the enormously successful economic growth strategy under President Ronald Reagan, which ignited historic, booming growth for a generation, from late 1982 to late 2007.

A third component of Reagan’s proven growth plan was deregulation, which today would be most productively focused on energy, liberating American energy producers to maximize production. The United States today has enough energy resources to be the world’s No. 1 producer of oil, No. 1 producer of natural gas, and No. 1 producer of coal, all at the same time. Deregulating the energy sector would thus provide an enormous boost to economic growth.

The fourth component for growth today would be to restore the gold standard. Reagan never achieved that. But he did achieve a close equivalent, by appointing people to the Federal Reserve Board who supported the price rule for Fed monetary policy. That rule guided Fed policy by the market prices of precious commodities, including gold. That achieved a stable, strong dollar for a generation, with negligible inflation.

In their recent book, JFK and the Reagan Revolution: A Secret History of American Prosperity, Larry Kudlow and Brian Domitrovic explained the powerful pro-growth record of the two components of major tax-rate reductions and strong, stable-dollar monetary policies. That combination was central to Kennedy’s economic boom in the 1960s and Reagan’s in the 1980s and beyond.

This four-component plan – spending cuts, tax cuts, deregulation, and sound monetary policy – would restore the booming economic growth of the American Dream. That alone would sharply slash government spending as a percent of GDP.

**Balancing the Federal Budget and Paying Off the National Debt**

The next step to rightsize federal spending would be to balance the federal budget and pay off the national debt, which would restore the pro-growth policies of America’s first Treasury Secretary, Alexander Hamilton.

The RSC budget would be the first step toward that, cutting $8.6 trillion in federal spending over 10 years, which would balance the budget within eight years.

Further reforms would make that balanced budget permanent and, along with booming economic growth, produce regular surpluses that would ultimately pay off the national debt.

**Far-Reaching Welfare Reform**

An important step would be to extend to all federal means-tested welfare programs the successful 1996 reform of the Aid to Families with Dependent Children (AFDC) program. Today, roughly 150 federal means-tested welfare programs spend about $1 trillion per year.

AFDC primarily paid cash to single mothers with children. Federal funding for the program was based on a matching formula: The more a state spent, the more money it received from the federal government. Most states received a federal dollar for each dollar they spent, but some received as much as four federal dollars for every state dollar, depending on average incomes in the state. This created new counterproductive incentives, with the federal government effectively paying the states to spend more on welfare. And spend they did, signing up increasing numbers of welfare recipients in good economic times, when states had more money to spend, and bad economic times, when there was more need.

Under the 1996 reforms, the federal government’s share of AFDC spending was returned to each state in a “block grant” to be used in a new program designed by the states based on mandatory work for the able-bodied. The federal grant is finite, not matching, so it does not vary with the amount the state spends. If a state wants to spend more, it must pay for the extra spending itself. If a state spends less, it
keeps the savings. The reform thus replaced the counterproductive incentives of the old system with positive incentives to weigh costs against benefits.

Under these new positive incentives, the states were permitted to redesign the program as each thought would best serve the poor of their state. To reflect the new emphasis on work, the program’s name was changed to Temporary Assistance for Needy Families (TANF).12

The reform was remarkably successful, with two-thirds of persons formerly dependent on the program leaving AFDC/TANF for work. Academic studies showed their incomes increased by 25 percent on average as a result. For taxpayers, after 10 years, the program cost 50 percent less than it would have otherwise based on prior trends.

Extending that block-grant-style reform to all federal means-tested welfare programs would benefit the poor and taxpayers. Each state would have the power to revamp its welfare system, making all public assistance for the able-bodied of working age contingent on showing up for work assignments, similar to the original Reagan concept of workfare.

That alone holds the prospect of eliminating poverty entirely, as under current law, the minimum wage plus the Earned Income Tax Credit plus the Child Tax Credit equals or exceeds the poverty line for every family combination.13 For taxpayers, reforming all federal means-tested welfare programs with fixed, finite block grants, based on the 1996 experience, would save $4 trillion to $5 trillion over the first 10 years alone, with the savings growing substantially each decade into the future.

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Deregulating the Energy Sector

Trillions of dollars more would be available to the federal government just from adopting policies to maximize private-sector energy production on federal lands and waterways.

While oil and gas production on private and state-owned lands soared in recent years, exploration, development, and production on federal lands and waters plummeted due to the Obama administration’s anti-energy policies. Reversing those policies to maximize energy production on federal lands and waterways would produce trillions of dollars for the federal government in increased lease rents, royalties, and tax payments.

America has the resources to be the world’s No. 1 oil producer, No. 1 natural gas producer, and No. 1 coal producer. Reversing current policies to maximize production of such reliable low-cost energy on federal land and water would produce trillions of dollars for the federal government in increased payments for oil and gas leases and increased federal royalties from energy production.

The abundant and reliable supply of low-cost energy resulting from booming, world-leading oil, natural gas, and coal production industries would promote growth throughout the economy, and in the energy-intensive manufacturing sector in particular. Plummeting costs for natural gas have already begun an American manufacturing renaissance.

In addition to taking better advantage of the economic resources under federal lands, the federal government should capitalize on the value of the lands themselves – by organizing orderly auctions of lands that are not environmentally sensitive, including national parks, national forests, and other preserves.14 Some of that property includes fully developed, vacant and unused office buildings.

The federal government owns more land than it should, especially in states west of the

Mississippi River. In some of those states, the federal government owns well over half the land, approaching over 90 percent in some states.

Auctioning those lands to the private sector could produce trillions of dollars in additional revenues for the federal government as well. In addition to the auction proceeds, private ownership would put the lands to sue more productively, increasing economic growth and thus tax revenues for the federal government. Those increased funds can and should be earmarked to pay off the national debt.

Conclusion
With permanently balanced budgets over the long term and reduced national debt, federal interest payments on debt would be sharply reduced. Obama’s final budget, for fiscal year 2017, estimates net interest payments of $6.2 trillion over the next 10 years alone. The RSC budget would reduce net interest payments to $1.1 trillion – a savings of more than $5 trillion.

Trillions more in reductions in unnecessary government spending are identified in budget plans and publications produced by The Heritage Foundation, Cato Institute, Mercatus Center, and others. This plan to permanently balance the budget, pay off the national debt, and ultimately rightsize government buttresses the national grassroots campaign to adopt a Balanced Budget Amendment to the U.S. Constitution to ensure the national debt is never exploded again.
About the Authors

Peter Ferrara is senior fellow for entitlement and budget policy at The Heartland Institute and a senior fellow at the Social Security Institute. He served in the White House Office of Policy Development under President Ronald Reagan and as associate deputy attorney general of the United States under President George H.W. Bush. He is a graduate of Harvard College and Harvard Law School.

Ferrara is author of several books, including The Obamacare Disaster, from The Heartland Institute, President Obama’s Tax Piracy, and America’s Ticking Bankruptcy Bomb: How the Looming Debt Crisis Threatens the American Dream – and How We Can Turn the Tide Before It’s Too Late. Ferrara’s latest book (Heartland Institute, 2015) is Power to the People: The New Road to Freedom and Prosperity for the Poor, Seniors, and Those Most in Need of the World’s Best Health Care.

Lewis K. “Lew” Uhler is founder and president of the National Tax Limitation Committee, one of the nation’s leading grassroots taxpayer lobbies. With offices in the Sacramento area and Washington, DC, NTLC works with the White House, members of Congress, legislators in states across the nation, and grassroots organizations to limit state and federal spending through legal restrictions and constitutional change.

Uhler has been at the forefront of the national movements for a tax limitation/balanced budget amendment to the United States Constitution and for term limits. He has written numerous articles and opinion pieces on taxes and spending. In 2010, Uhler co-authored with Erick Erickson the book Red State Uprising: How to Take Back America. Uhler also wrote the book Setting Limits: Constitutional Control of Government, with a foreword by Milton Friedman, published in 1989. Uhler speaks internationally on fiscal issues and has appeared on numerous national, regional, and local television and radio programs and has been widely quoted in the print media.

About the National Tax Limitation Committee

The National Tax Limitation Committee (NTLC) was organized in 1975. Its mission is to provide national leadership to achieve the optimal size and functions of government and promote candidates and initiatives that support these goals.

NTLC and its foundation, the National Tax Limitation Foundation (NTLF), have organized numerous conferences and seminars around the nation on critical issues. Uhler speaks regularly at the annual Conservative Political Action Conference (CPAC) in Washington, sponsored by the American Conservative Union (ACU), on whose board he served for many years. NTLC’s operating philosophy has always been to partner with other groups and individuals in the accomplishment of mutual goals. NTLC and NTLF are further supported by a distinguished Board of Advisors.

For more information, visit our website at www.limittaxes.org or visit us at 1700 Eureka Road #150A, Roseville, CA 95661.

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Heartland has a full-time staff of 38. Joseph Bast is cofounder, president, and CEO. Dr. Herbert Walberg is chairman of the 12-member Board of Directors. Approximately 350 academics participate in the peer review of its publications and more than 200 elected officials pay annual dues to serve on its Legislative Forum.

For more information, visit our website at www.heartland.org, call 312/377-4000, or visit us at 3939 North Wilke Road, Arlington Heights, Illinois.