The Heritage Foundation

HERITAGE ACTION FOR AMERICA

OPPORTUNITY FOR ALL

FAVORITISM TO NONE

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The Heritage Foundation & Heritage Action for America

OPPORTUNITY FOR ALL

FAVORITISM TO NONE

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FOREWORD

Jim DeMint

It is widely acknowledged among Americans of all political backgrounds that there exists—and has existed for some time—a corruption of the public and private sectors which touches nearly every aspect of law and regulation, serving to enrich the well-connected and immunize them from the consequences of their actions.

The only disagreement is where the fault lies. There are those who rail against the favored status of Big Business, and there are those who despise the suffocating grip of the special interests—from green energy to Big Labor—rendered protected classes by Big Government. Both sides have legitimate grievances.

In fact, it is the collusion between Big Government and the other Bigs which insulates the powerful and enriches the wealthy, while squeezing regular people out of the American dream.

For decades, each new scandal of private sector malfeasance has been met with demands for increased oversight by government. In many cases, these demands are actually made by the leading banks, manufacturers, exporters, and technology giants themselves; they assist Washington in crafting a regulatory machine which ensconces them in protection from competition, under the guise of promoting sunshine and honesty.

The Heritage Foundation is giving notice to those who use the law as profiteers, whether they walk the halls of Congress or Wall Street, who have bent the greatest institutions of the common good to serve their own ends. Our rallying cry: Opportunity for All, but Favoritism to None.

We expect a hard fight. Those who tilt the rules of the marketplace to their advantage, be they businesses seeking an edge over competition or politicians pandering for campaign contributions and votes, always find excuses to maintain the status quo. After all, no politician ever sells a bad law to his fellow citizens without inventing a reason why it's in their best interests.

The policy solutions contained within this book envision an America where the sweetheart deals are shattered and the smoke filled rooms are blown clear.

We propose free and fair energy markets that offer high wages and low prices. A health care market that replaces government control and massive subsidies with choice and competition. A labor market that matches skills to jobs without forcing working Americans to jump through hoops for unions that don't serve their interests.

All Americans, particularly families and small businesses, deserve a fair tax code that serves the interests of the people rather than special interests practiced in winning carve outs. It must be paired with an end to the "too big to fail" mindset that brought our economy to the brink and prioritized the interests of Wall Street over the needs of Main Street. This cannot be accomplished without a tamed regulatory state that no longer operates as an unaccountable fourth branch of government. Law is to be made by our elected, accountable representatives, not appointed bureaucrats.

We demand an education system that restores dollars and decisions to parents, teachers, and communities, and once and for all rejects the fallacy that centralized education is good for this country. We strive for a higher education market that gives students affordable access to the courses they need rather than committing them to a future of debt in the service of a bloated, over-subsidized university system.

It is not simply favoritism which hurts the most disadvantaged among us, but a paternalistic attitude which robs millions of Americans of choice in their own lives, sealing shut the door to prosperity. True charity demands a welfare system that encourages mobility and work, rather than permanent subsistence on the self-serving poverty industry.

Domestic freedoms must be protected with robust defense. A strong, focused foreign policy that makes clear to all the world over that America will stand up for her own interests and for her founding principles. When there is no doubt as to our commitments, there will be none who dare to test them.

Above all, we need a government that is friendly, not hostile, to the cultural institutions that have made our nation great. Economic freedom, choice in education, and security at home mean little, if our leaders remain contemptuous of convictions of their countrymen. It belongs to no congressman or judge or president to force his values upon an unwilling nation.

* * *

Left-wing populists argue that the free market is a playing field tilted toward the well-to-do. "The game right now in America is rigged," argue left-wing populists like Senator Elizabeth Warren. "The rules don't get better for America's middle class. The rules are getting better for those who are a thin slice at the top."

While there is a rigged game, it isn't the free market; it's Washington. It's the regulatory state that churns out dense rules so quickly that small businesses can't keep up with the compliance costs. It's the big-government mentality in Congress that seeks to involve Washington wherever possible, from the board room to the gas station to the living room light fixture—so long as the special interests that cozy up to lawmakers get a cut of the deal. It's the the lobbyist culture where money buys access and a seat at the table in the backrooms where thousand-page bills are crafted.

The special interests who benefit from that access profit at the expense of working Americans, who are seeing their cost of living soar. The housing subsidies that pad the realtor lobby's pocket boost Americans' mortgages; the health care subsidies and mandates undergirding Obamacare steal hard-earned dollars from Americans' paychecks in the form of higher premiums and more costly care; the energy regulations that the green-for-profit industry lives on drive up winter heating bills; the higher education subsidies that fuel the cartel of accredited colleges and universities fund administrative salaries paid for in the form of higher tuition.

Free markets, given a chance, can do better for all Americans—rich, poor, young, old, workers, and business owners alike. To the contrary of the caricature vision of American capitalism presented by the left, markets haven't been a ravenous force exploiting hard-working Americans. Rather, they've been shackled by a government that has forgotten its proper place in American life. Our cause is to unshackle them, to create the space for them to empower Americans to succeed. That means upsetting the status quo—that comfortable arrangement between government and its powerful clients in the private sphere who profit from its worst excesses.

This is the game plan. This is a cause all Americans can root for.

I hope you will join us.

The Honorable Jim DeMint *is President of The Heritage Foundation and a former member of the United States Senate.*

INTRODUCTION

Michael A. Needham

Despite all our victories in recent years, conservatives have much work left to do.

We have consolidated our gains in the House of Representatives. We have, at long last, forced Harry Reid to relinquish control of the U.S. Senate. We hold the majority of the governorships in the country. President Obama's big government agenda—with Obamacare as its centerpiece—has been persistantly unpopular.

But for all these achievements, have we rallied most Americans behind the cause of limited government? Have we broken through the false assumptions imposed by the media and the Washington establishment about the range of policy options within which our political debates can operate? Or are we still stuck debating the same issues over and over again on terms set by the left, with few policy successes to show for it?

MISSED OPPORTUNITIES

Conservatives have in recent memory had chances to build on the success of the Reagan era. With Republican control of the White House, the House, and the Senate, the Bush Administration had ample opportunity to usher in a real reform agenda. But this opportunity was squandered.

To some degree, that failure could be traced to the Administration's governing philosophy. In defending his "compassionate conservatism," President Bush correctly argued:

> Every American must believe in the promise of America, and to reach this noble, necessary goal, there is a role for Government. America doesn't need more big Government, and we've learned that more money is not always the answer. ... Yet we cannot have an indifferent government either.[1]

Proponents of this view saw it as an important corrective for a conservatism that struck some Americans as indifference to the concerns of those who faced obstacles in climbing the ladder to opportunity. But in practice, the emphasis on the positive role government

1 George W. Bush, "Remarks on Compassionate Conservatism in San Jose, California," The American Presidency Project at UC Santa Barbara, April 30, 2002, http://www.presidency.ucsb.edu/ws/?pid=62868.

could play was an overcorrection, blinding the Bush Administration to the danger of federal overreach. This suited the Republican Congress—long used to sealing the deal on legislative "compromises" with go-along-to-get-along spending boondoggles—just fine.

The result, well-intentioned as it may have been on the Administration's part, was an eight year expansion of the federal government's role in American life. Instead of focusing on real Medicare reform, President Bush signed into law a new unfunded prescription drug entitlement. Instead of enacting K-12 reforms to put parents in the driver's seat of their children's education, President Bush signed a massive federalization of the school system. Instead of trimming the federal budget, the Bush Administration allowed it to swell.

Too often in recent years, our politics have appeared to most observers to boil down to a conflict over the binary options of radical individualism and statist collectivism. This framing is deeply uncharitable to conservatism properly understood.

By 2008, Republicans had ceded not only the outcomes of the most important policy debates but even the terms of the debates to the left. They debated health care not in terms of cost and quality but in terms of expanding access to coverage; energy not in terms of market impact but in terms of environmental impact; taxes not in terms of broad growth shared by all but in terms of narrow impact felt by classes. The champions of conservatism in government had lost their vocabulary.

Simultaneously, they became increasingly desensitized to an important political vulnerability. For all the Republican Party's concessions to the left over the course of the Bush years, a deep, broadly shared sense emerged throughout our country that our market economy was working well only for those at the top. This sentiment permeated the debate over tax policy for years, and it crescendoed with the financial crisis and bailouts, which offered a free ride to those with most proximate responsibility for the calamity while leaving working Americans underwater and unemployed. Republicans, no longer understanding the language of limited government on their own terms, had little response when told capitalism itself had been the root of the crisis. They were forced to accommodate, to concede, to bail out, and to stand down.

The right held off for so long in standing up for our own beliefs that by the 2008 election, our champions forgot what it was that we did believe. Is it any surprise that the country was ready for an alternative?

RISE OF THE TEA PARTY

The emergence of the populist resistance to President Obama's first-term agenda was an equal and opposite countervailing force against these negative tendencies of Bush-era conservatism.

Where Bush-era conservatism had avoided recognizing clear distinctions between federal and state, governmental responsibility and societal responsibility, the Tea Party embraced those distinctions forcefully; its principal objection to much of President Obama's agenda was the Tenth Amendment bright line between enumerated federal power and state and local general jurisdiction. Where Bush-era conservatism had maintained the long-standing alliance between the finance class and the political class, the Tea Party put that nexus in its crosshairs.

The media interpreted this as the start of a "libertarian moment." The Cato Institute published polls and studies of the movement suggesting its influence was "functionally libertarian."[2] Ron Paul, godfather of the modern American libertarian movement, argued, "The tea party was actually started during the Ron Paul presidential campaign in 2007".[3] That interpretation still holds a great deal of sway. Just last year, the New York Times featured a 6700 word magazine by Robert Draper arguing in part that the emergence of the Tea Party signaled the rise of libertarianism in American politics—and the likelihood that the Republican Party's libertarian streak would become the standard borne by its 2016 nominee.[4]

Many candidates for high office interpreted this groundswell similarly, modulating their messages accordingly to capture the individualist mood they believed they sensed in their audiences. Perhaps the most famous of these efforts was Mitt Romney's response to a donor who asked him, "How are you going to do it, in two months before the elections, to convince everybody 'You got to take care of yourself?'" In responding, Romney decried the supposed 47 percent of Americans "who are dependent upon government, who believe that they are victims, who believe the government has a responsibility to care for them, who believe that they are entitled to health care, to food, to housing, to you name it. … I'll never convince them that they should take personal responsibility and care for their lives." If Barack Obama's was a campaign of "You didn't build that," Romney's was a campaign of "Yes, you did—with your own two hands alone."

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2 David Kirby and Emily McClintock Ekins, "Libertarian Roots of the Tea Party," Cato Institute, August 6, 2002, http://www.cato.org/publications/policy-analysis/libertarian-roots-tea-party.

3 Alex Altman, "Seven Highlights from Ron Paul's reddit AMA," *Time*, August 23, 2013, http://swampland.time.com/2013/08/23/seven-highlights-from-ron-pauls-reddit-ama/.

4 Robert Draper, "Has the 'Libertarian Moment' Finally Arrived?," *The New York Times*, August 7, 2014, http://www.nytimes.com/2014/08/10/magazine/has-the-libertarian-moment-finally-arrived.html?gwh=AB9E226E2BABDD13AF6146112FF74C03&gwt=pay&assetType=nyt_now.

Too often in recent years, our politics have appeared to most observers to boil down to a conflict over the binary options of radical individualism and statist collectivism. This framing is deeply uncharitable to conservatism properly understood. As David Azerrad and Ryan Anderson write of this "false choice" in the Heritage Foundation's *Index of Culture and Opportunity*:

> The question is not whether we will be independent or dependent. To be human is to rely on others. At issue, rather, is whom we will depend on. Families, friends, and neighboring fellow citizens who know us best and have our best interest at heart—these should be our primary sources of support. And, when government must help, it must not weaken these ties, supplanting and replacing them, but instead encourage people back into gainful employment, stable families, and communities of every sort. Policy should help bring people together, not create artificial roadblocks that keep them apart.[5]

The role of conservatism is not to guarantee that Americans are left to their own devices; it is to nurture the space in which they can come together—voluntarily—in common cause and in forms of their own choosing.

Why are so many politicians incapable of making the case for the space in which community thrives? In some sense, this hyperemphasis on bootstraps and individual freedom and the attendant inattention paid to the role of community and society in the issues of greatest concern to most Americans may be overcompensation on the part of many politicians who recognize how out of step they are with the movement they aim to represent. For as willing as so many of them are to embrace the rhetoric of individual initiative in the most searing terms, far too few are willing to embrace the real animating concern of the Tea Party: its strong distaste for the favoritism and special treatment embedded in our politics that serve to stifle conservatism at almost every turn.

That reluctance has rarely been clearer than in the aftermath of the Republican Party's defeat at the ballot box in 2012.

TWO SOLUTIONS: DONORISM AND CONSERVATIVE POPULISM AT ODDS

In the aftermath of the disappointing 2012 election, the Republican Party recognized ostensibly that business as usual was not achieving success. The party's leaders wrote an

5 David Azerrad and Ryan T. Anderson, "The Blessings of Liberty," Jennifer A. Marshall and Rea S. Hederman, *2014 Index of Culture and Opportunity* (Washington, DC: The Heritage Foundation, 2014), p. 10, http://index.heritage.org/culture/overview-of-2014-index/.

autopsy, diagnosing the failures of the 2012 cycle and laying out a vision for a supposed new direction.[6]

Much of its diagnosis was tonal. Too many Americans, the GOP argued, felt that Republicans "don't care" about the problems they face in their daily lives.[7] It was a hard charge to deny, particularly coming out of the election of the "47 percent." The rhetoric of radical individualism, the cold appeals to job creators rather than all working Americans, had clearly fallen flat.

But the solution, the party argued, wasn't to better define the conservative policies that would provide opportunity to Americans of all stations, to challenge the all-too-common view that free markets protect the privileged and undermine the hard work of most Americans seeking a better life; it was to dial down the detail on policy. "[W]hile Democrats tend to talk about people, Republicans tend to talk about policy," the party counseled. "Our ideas can sound distant and removed from people's lives. Instead of connecting with voters' concerns, we too often sound like bookkeepers."[8] Shockingly, the GOP actually conceded that its own policies lacked appeal to average Americans unless described the most abstract possible language. The only answer, therefore: more focus groups, fewer concrete ideas.

Or rather, fewer ideas except in select special cases. With prescriptions almost totally at odds with the positions of its movement base, the party's leaders outlined a series of concessions to core constituencies perceived as hostile to the conservative agenda. The key to victory, according to the consultant class, would be to buy off enough voters with special favors—to downplay social issues for the sake of winning over female voters, for example, or to embrace amnesty to appeal to Latinos.

The document's prescriptions were caricature interest group politics of the worst kind. They flowed from the very same view of politics held by the left—that individuals are best understood as demographics, that people can be bought off in mass groups.

The two-year push since 2012 for the Senate's "Gang of Eight" immigration bill is the posterchild for this kind of politics, and it demonstrates everything wrong with this shallow approach. Worst of all, that wasted effort, like most of the political class's similar ideas for a Republican revival, has diverted time, attention, and intellectual energy away from the far more pressing cause of developing a comprehensive agenda to address the anxieties of working Americans.

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6 "Growth & Opportunity Project," Republican National Committee, March 17, 2014, http://goproject.gop.com/rnc_growth_opportunity_book_2013.pdf.

7 *Ibid.*, p. 5.

8 *Ibid.*

As Sean Trende of *RealClearPolitics* and others have established at length, the Republican Party has lost core elements of its coalition. Relative to John McCain, Mitt Romney lost millions of votes that had been won four years prior, particularly among those Trende identifies as "H. Ross Perot voters." "That coalition was strongest with secular, blue-collar, often rural voters who were turned off by Bill Clinton's perceived liberalism and George H.W. Bush's elitism," Trende observes. "[O]ne can see why they would stay home rather than vote for an urban liberal like President Obama or a severely pro-business venture capitalist like Mitt Romney." This erosion can't be assumed to be related only to the perceived elitist economic sensibilities of the Republican Party's standard-bearer in 2012; exit polls indicate that one quarter of those who oppose redefining marriage supported President Obama even after his professed "evolution" on marriage.

Life is hard. Bills are getting bigger. And no one in Washington is listening.

Life is hard. Bills are getting bigger. And no one in Washington is listening. The Democratic Party is too consumed with the petty politics of inequality and pipe dreams like cap and trade to develop a responsive agenda. Meanwhile, the Republican Party's priority appears to be increasing corporate bottom lines rather than freeing up family budgets for food and gas. Worse yet, even where these disenchanted voters should be natural allies of Republicans—social issues that touch the fabric of their communities—they feel they have no real support from those in power.

Supporters of free markets, limited government, and robust civil society free from interference by federal overlords must find a way to speak to the people who are being left behind—and left on the table in election after election.

OPPORTUNITY FOR ALL BUT FAVORITISM TO NONE

This book is an effort to begin that conversation.

For years, Heritage has been at the cutting edge of policy research, laying out the kinds of pro-market, pro-family solutions that would empower all Americans to build lives that achieve the American dream so familiar to us all. But while we know what we'd like to see an ideal president implement in an ideal world, our current politics seem too stubborn to conform to those ambitions.

The establishment dismisses the power of a coherent governing vision to build coalitions. We aim to show here that this view is fatally lacking in imagination. We aim to help conservatives articulate the power of policy ideas built around themes that resonate with the country, and we are convinced that our political leaders can do the same if they are willing to depart from familiar modes of thought, comfortable talking points, and ideas that have long brought in campaign contributions from K Street.

These ideas do not represent a departure from conservatism; rather, they represent a return to a proper conservatism of free markets and a free society. Some are not new, but they are built around a new and important theme: that the policies that will help Americans meet the challenges they face in our modern world have been stifled for too long by the powerful political constituencies that benefit from and perpetuate the status quo: the insurance companies opposed to the emergence of a genuine free market for health care; the realtor lobby opposed to ending the government guarantees that distorted the housing market and brought the economy to the brink; the higher education accreditation cartel that opposes disrupting the expensive, highly subsidized traditional four-year institution model; the tax lobbyists holding tax reform hostage to preserve carve-outs for every special interest under the sun.

Overcoming these obstacles no doubt presents political challenges. The consultant class has dragged its feet for a reason. But we posit that our only hope of building a new governing coalition is not winning the crass game of interest group politics always played better by the left than by the right. Rather, it is to signal to the American people that our principles represent a different, better way than what the left has had on offer.

That is the kind of message the Tea Party has been waiting to champion. It is the kind of message working Americans never heard in 2012. It is the kind of optimism that rises above politics, as practiced best by one of our greatest former presidents. To quote:

“This is the issue of this election: Whether we believe in our capacity for self-government or whether we abandon the American revolution and confess that a little intellectual elite in a far-distant capitol can plan our lives for us better than we can plan them ourselves.”

President Reagan led Americans in his age to their rendezvous with destiny. Today it is our charge as conservatives to do the same in ours.

Michael A. Needham *is the Chief Executive Officer of Heritage Action for America.*

RESTORING OPPORTUNITY IN THE LABOR MARKET

James Sherk

Workers face many challenges in the aftermath of the Great Recession. Wages and job opportunities have grown slowly since the recovery began six years ago, while technology continues to change the nature of work. Although many workers enjoy opportunities unimaginable a generation ago, many others feel the economy has left them behind.

Policies that make employees more productive could help these workers get ahead, as average compensation has closely tracked workers' productivity in the postwar era. Regrettably, government policies have instead added to employment woes by creating labor cartels. Excessive occupational licensing makes it difficult for dislocated workers to apply for many jobs. Reduced competition from the unemployed raises the earnings of license holders at the expense of job opportunities and higher prices for everyone else. Such labor cartels hurt the economy and most workers.

To help workers get ahead, policymakers should eliminate licensing barriers and focus on increasing worker productivity. Ending these distortions driven by special interests would help more workers to realize the American dream.

THE 21ST-CENTURY U.S. LABOR MARKET

The U.S. labor market deteriorated significantly during the Great Recession. Between April 2008 and October 2009, the unemployment rate doubled from 5.0 percent to 10.0 percent—the highest rate in more than three decades. During that time employers shed 8 million net jobs.[1]

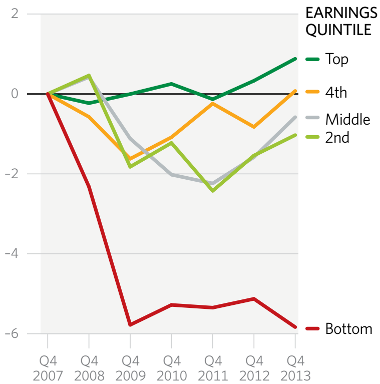
SLUGGISH RECOVERY FROM THE GREAT RECESSION

Unlike after previous severe recessions, the labor market did not quickly bounce back after the Great Recession. It took five years after the recovery's onset for the unemployment rate to fall to 6.3 percent—the highest rate after the 2001 recession. It also took five years for total employment to return its pre-recession level.[2] This is the slowest job recovery on record in the postwar era. It still takes unemployed workers an average of more than seven months to find new work.[3]

Low-Income Workers Hit Hardest by Recession

The proportion of workers with full-time jobs dropped by nearly six percentage points in the bottom quintile since the recession started.

PERCENTAGE POINT CHANGE IN FULL-TIME WORKERS SINCE 2007, BY EARNINGS QUINTILE



Notes: Full-time workers are those working 35 or more hours per week. Figures shown are for the fourth quarter of the given year.
Source: Heritage Foundation calculations using data from the U.S. Census Bureau, Current Population Survey.

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Yet even these lackluster figures overstate the economy's health. Labor force participation plunged during the recession and continued dropping in the recovery. Fewer Americans have a job or are looking for work now than at any point since the 1970s—a time when far fewer women worked outside the home. Demographic changes explain less than a quarter of this decrease. The labor force would swell by 5.4 million workers if those who dropped out of the labor force for non-demographic reasons began looking for work.[4] Overall, the economy remains weaker than the unemployment rate suggests.

Behind this labor market sluggishness lies a significant slowdown in job creation. Unemployment surged in 2008 and 2009 as many companies laid off employees en masse and curtailed hiring. Job losses quickly subsided after the recession ended, actually falling below pre-recession levels. However, hiring rates only partially recovered. Quarterly job creation remains 5 percent below pre-recession levels.[5] Entrepreneurs are starting fewer new businesses, while existing businesses continue to expand at slower rates.

Many factors contributed to the hiring slowdown. The collapse of the housing bubble and the ongoing economic weakness in the European Union would put a damper on the U.S. economy regardless of what American policymakers did, but Congress has added to the problem. Obamacare has significantly raised the cost of health insurance, especially for small businesses whose health care exchanges face many of the same problems

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1 U.S. Department of Labor, Bureau of Labor Statistics, Household and Payroll Surveys / Haver Analytics.

2 U.S. Department of Labor, Bureau of Labor Statistics, "The Employment Situation: Household Survey," Table A-1 / Haver Analytics. The unemployment rate hit 6.3 percent in April 2014, while in May 2014 total nonfarm employment exceeded its January 2008 peak.

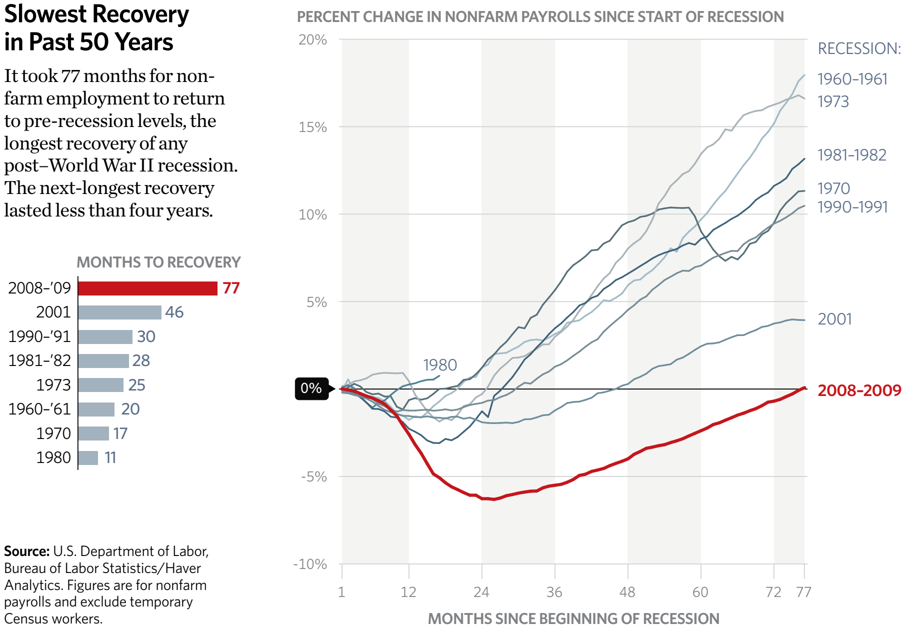
3 *Ibid.*, Table A-12.

4 James Sherk, "Not Looking for Work: Why Labor Force Participation Has Fallen During the Recovery," Heritage Foundation *Backgrounder* No. 2722, September 5, 2013, Table 4, http://www.heritage.org/research/reports/2013/09/not-looking-for-work-why-labor-force-participation-has-fallen-during-the-recession.

5 Heritage Foundation calculations using data from U.S. Department of Labor, Bureau of Labor Statistics, "Business Employment Dynamics," Tables 1–3 / Haver Analytics.

Slowest Recovery in Past 50 Years

It took 77 months for nonfarm employment to return to pre-recession levels, the longest recovery of any post–World War II recession. The next-longest recovery lasted less than four years.



Source: U.S. Department of Labor, Bureau of Labor Statistics/Haver Analytics. Figures are for nonfarm payrolls and exclude temporary Census workers.

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as the individual market. The Federal Reserve's Beige Book reports have frequently reported business owners citing the rising cost of health care as a reason for curtailing their hiring.[6] Federal Reserve surveys also find between one-sixth and one-fourth of manufacturers reporting that the law caused them to reduce hiring.[7] Dodd–Frank has also significantly increased the cost to businesses of accessing capital markets.[8] Small business owners now cite taxes and government regulations and red tape as their two greatest problems.[9]

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6 James Sherk, "Proof That Obamacare Is Hurting the Economy," The Daily Signal, October 22, 2013, http://dailysignal.com/2013/10/22/proof-that-obamacare-is-hurting-the-economy/, and James Sherk and J. J. Denevey, "Obamacare Is Already Reducing Employment," The Daily Signal, February 3, 2014, http://dailysignal.com/2014/02/03/federal-reserve-finds-obamacare-reducing-employment/.

7 Federal Reserve Bank of Philadelphia, "August 2014 Business Outlook Survey," http://www.philadelphiafed.org/research-and-data/regional-economy/business-outlook-survey/2014/bos0814.cfm, and Federal Reserve Bank of Dallas, "Texas Manufacturing Outlook Survey," http://www.dallasfed.org/microsites/research/surveys/tmos/2014/1408/specquest.cfm.

8 Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounder* No. 2905, April 23, 2014, http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem.

9 William C. Dunkelberg and Holly Wade, "NFIB Small Business and Economic Trends," July 2014, http://www.nfib.com/Portals/0/PDF/sbet/sbet201407.pdf.

Fewer companies hiring puts less pressure on businesses to raise wages. Since the recovery began, average hourly compensation has risen only 2 percent faster than inflation.[10] The weak economy has made it much harder for Americans to get ahead.

TECHNOLOGY AND THE LABOR MARKET

These struggles come on top of underlying changes in the nature of work. Technology has enabled businesses to automate routine tasks that once required human labor. Programmers can break down many jobs into well-defined tasks that machines can repeat quickly and accurately. Today, spreadsheets instantly complete calculations that once took accountants hours. Robots on the assembly line do much of the work that humans formerly performed.

Since 1980, relative employment in routine occupations has dropped sharply while relative employment in non-routine occupations has surged.[11] In other words, a smaller proportion of workers perform jobs involving doing the same thing over and over, while a larger proportion do jobs that can change significantly from moment to moment.

In part, economists attribute this shift to "skill-biased technological change." In English, this means that technology makes skilled workers even more productive so employers want to hire more of them. An engineer working with drafting software can design more and better systems than one using a pencil and paper. Manufacturers today need more technicians to keep the robots running. As technology has made skilled workers more productive, their wages and employment levels have risen. Between 1980 and 2005, the proportion of workers in occupations above the 60th percentile of skills (in 1980) grew considerably. Over this period, wages in these jobs also rose rapidly.[12]

Contrary to the skill-biased technological change hypothesis, employment and wages also grew rapidly in the least skilled occupations. The proportion of workers in occupations below the 15th percentile of skills (in 1980) expanded sharply between 1980 and 2005. For example, relative employment in truck driving, food service, and child care rose significantly. Wages in these occupations also rose faster than average.[13] At the same time the proportion of workers in moderately skilled occupations (between roughly the 15th and

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10 Heritage Foundation calculations using data from U.S. Department of Labor, Bureau of Labor Statistics, "Productivity and Costs: Nonfarm Business Sector" / Haver Analytics. Inflation was adjusted using the implicit price deflator. Figures are for the period between Q3 2009 and Q1 2014 and represent total real hourly compensation growth over that period—not annualized growth rates.

11 David H. Autor and Brendan Price, "The Changing Task Composition of the US Labor Market: An Update of Aurtor, Levy, and Murnane (2003)," Massachusetts Institute of Technology, June 21, 2013, p. 5, Table 1, http://economics.mit.edu/files/9758 (accessed August 8, 2014).

12 David H. Autor and David Dorn, "The Growth of Low-Skill Service Jobs and the Polarization of the US Labor Market," *American Economic Review*, Vol. 103, No. 5 (August 2013), p. 1554, Figure 1, http://economics.mit.edu/files/1474.

13 *Ibid*.

60th percentiles) fell.[14] Inflation-adjusted wages in these jobs grew slower than average. Economists term this growth of high-skill and low-skill occupations "job polarization."

Technology has not significantly increased the productivity of truck drivers or child care workers. So why did demand for their services grow?

Computers can automate many routine tasks, both manual (i.e., the assembly line) and cognitive (i.e., accountants). These jobs tend to lie in the middle of the skill distribution. But computers cannot yet automate many non-routine tasks, both abstract (i.e., conducting a public relations campaign) and manual (i.e., cleaning a hotel room). Automation reduces the relative demand for routine skills and thus increases the relative demand for non-routine skills—of both types. Americans might want the latest iPhone app, but they also still want to eat out and stay in hotels. Computers still cannot perform these jobs. This shift in relative demand raised the relative pay and employment in less skilled, but non-routine, manual occupations as well as in highly skilled non-routine cognitive jobs.[15]

While many liberals would like to blame job polarization on the free market and the decline of labor unions, leading liberal academics reject these claims. Writing about job polarization for the left-wing Center for American Progress, MIT economist David Autor finds that these labor market changes have occurred not just in America, but around the developed world. Indeed, many European countries experienced greater job polarization over the past generation than America did. For example, Germany and Sweden have more state interference in their economies than America, yet their job markets have polarized more sharply.[16]

For the same reason, Autor does not attribute polarization to falling union density. Union membership did not decline as quickly in many EU nations as in America, but these countries' labor markets polarized just as strongly. Furthermore, job polarization occurred across the U.S. economy, not just in formerly heavily unionized occupations.[17] Liberals who argue increasing union strength or government regulations would reverse these trends do not have the facts on their side. The effects of technology on the labor market transcend national boundaries and government policy.

NEW OPPORTUNITIES AND CHALLENGES FOR WORKERS

On balance, these changes in the labor market have benefited workers. Over the past generation, growth in high-skill, high-wage jobs considerably exceeded growth in less-skilled,

14 *Ibid*.

15 *Ibid*.

16 David Autor, "The Polarization of Job Opportunities in the U.S. Labor Market," Center for American Progress and The Hamilton Project, April 2010, pp. 16–18, http://economics.mit.edu/files/5554.

17 *Ibid*., p. 14.

low-wage jobs. The economy creates more "good jobs" now than a generation ago.[18] Consequently, compensation has risen for most workers. The earnings of nonelderly households in the middle quintile have risen by one-fifth since 1979.[19] Moreover, the increased relative demand for less-skilled workers has considerably raised their pay. Congressional Budget Office data show that between 1979 and 2011 average real compensation rose by more than 40 percent among the bottom quintile of nonelderly households.[20] The new economy creates better opportunities for low-skilled workers than existed in the past.

Furthermore, substituting robots for workers on the assembly line has automated many of the most dangerous jobs that people once performed. Workplace injury and death rates have fallen sharply in recent decades.[21] Automating routine tasks has removed some danger and drudgery of work.

Overall, the economy remains weaker than the unemployment rate suggests.

Nonetheless, these changes have hurt many workers, particularly moderately skilled employees in routine jobs. Many middle-class workers who would have worked on an assembly line or in a clerical position can no longer find those jobs. The total number of high school graduates working in manufacturing dropped by more than a third between 1992 and 2009. The number of high school dropouts working for manufacturers dropped by almost half during the same period. Simultaneously, manufacturing employment of workers with advanced degrees increased by more than two-fifths.[22] While technology has increased living standards overall, it has made it harder for some Americans to find jobs comparable to those they used to hold.

These changes will probably continue for the foreseeable future. Computer programmers and engineers continue to push the envelope of what machines can do and what constitutes "routine" work. Jobs once viewed as impossible to automate now appear almost certain to be automated. Google has already developed self-driving cars—an innovation

18 Autor and Dorn, "The Growth of Low-Skill Service Jobs," p. 1554, Figure 1, Panel A.

19 Inflation-adjusted compensation rose 23 percent among the middle quintile of nonelderly households with children. In the middle quintile of nonelderly households without children, real total compensation rose 19 percent. Congressional Budget Office, "The Distribution of Household Income and Federal Taxes, 2011," November 2014, supplemental data, Tables 14 and 16, https://www.cbo.gov/publication/49440.

20 *Ibid*. Inflation-adjusted compensation rose 43 percent among the bottom quintile of nonelderly households with children. In the bottom quintile of nonelderly households without children, real total compensation rose 45 percent.

21 James Sherk, "A Good Job Is Not So Hard to Find," Heritage Foundation *Center for Data Analysis Report* No. 08–04, July 17, 2008, p. 14, Chart 13, http://www.heritage.org/research/reports/2008/06/a-good-job-is-not-so-hard-to-find.

22 James Sherk, "Technology Explains Drop in Manufacturing Jobs," Heritage Foundation *Backgrounder* No. 2476, October 12, 2010, http://www.heritage.org/research/reports/2010/10/technology-explains-drop-in-manufacturing-jobs.

that will probably eliminate taxi driving within a few decades. California engineers have invented a machine that can cook almost 400 gourmet hamburgers per hour.[23] RFID tags could eliminate checkout aisles in stores, taking the jobs of many cashiers with them.

PARTICULAR CHALLENGES FOR LOW-SKILLED MEN

Men with fewer job skills face particular challenges in today's labor market as a result of technological change. In part, this is because far more men than women tend to work in manufacturing, an industry especially conducive to automation. Many men formerly employed in routine manufacturing occupations moved into the construction sector, only to see those jobs vanish along with the housing bubble.

Moreover, social changes since the 1970s have brought women into the labor market en masse. Over the successive decades women have shattered glass ceiling after glass ceiling, competing for jobs that were once the exclusive domain of men.

A supply and demand model would predict that increased employer demand for female employees would raise women's wages. It would also predict that large numbers of new workers competing for jobs would put downward pressure on men's pay. The Congressional Budget Office finds exactly that happened. Between 1979 and 2009 the real wages of the median male worker rose just 8 percent, while the real wages of the median female workers increased 37 percent.[24] While the overall labor market has improved over the past generation, many men understandably feel this growth has left them behind.

THE NEED TO BOOST PRODUCTIVITY IN THE U.S.

The challenge facing struggling middle-class workers remains how to become more skilled or find more new ways to use their existing skills productively in a changing economy. If they do, their pay will rise commensurately. Policymakers need to pursue policies that will help workers do this.

AVERAGE PAY CLOSELY FOLLOWS PRODUCTIVITY

Many on the left contend that workers' pay has grown disconnected from their productivity. They argue that workers have grown more and more productive over the past generation, yet have seen barely any increase in their pay. A superficial analysis of the data appears to support their argument. Between 1973 and 2014, productivity more than

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23 See Momentum Machines, "The Next Generation of Fast Food," http://momentummachines.com/.

24 Congressional Budget Office, "Changes in the Distribution of Workers' Hourly Wages Between 1979 and 2009," February 2011, p. 5, Table 1, http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12051/02-16-wagedispersion.pdf.

doubled while a prominent government survey finds wages stagnated. Many on the left look at these figures and conclude employers have expropriated the wealth their employees have created.[25]

However, these wage and productivity figures come from different surveys that are not directly comparable. Making an apples-to-apples comparison requires looking at total compensation, not just cash wages, and adjusting pay and productivity with the same measure of inflation.[26] Noncash benefits have become an increasingly large share of workers' earnings over the past generation. Furthermore, a large part of the apparent gap between productivity and pay stems from differences in the methodologies used to adjust for inflation. This says more about differences in mathematical formulas than anything else.

The chart on the next page shows the real relationship between worker compensation and productivity. While productivity has more than doubled over the past 41 years, average hourly compensation has risen almost as fast—86 percent.

The remaining difference still overstates the gap between pay and productivity. The chart does not account for depreciation. Computers and robots break down—or become obsolete—faster than buildings. Depreciation rates have increased as businesses have increased their use of technology. This reduces net income available to pay workers without affecting gross productivity. As the liberal economist Dean Baker put it, "[N]o one can eat depreciation."[27] Faster depreciation accounts for one-fourth to one-half of the remaining gap.[28]

Federal Reserve Board economists also believe that the official statistics overestimate productivity growth. They find that problems with how the government measures prices causes savings from using inexpensive imports to show up as productivity gains.[29] Some or all of the remaining gap between measured pay and productivity is a statistical illusion: Productivity has not grown quite as fast as the official figures suggest.

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25 William A. Galston, "Closing the Productivity and Pay Gap," *The Wall Street Journal*, February 18, 2014, http://online.wsj.com/news/articles/SB10001424052702303945704579391070814416410.

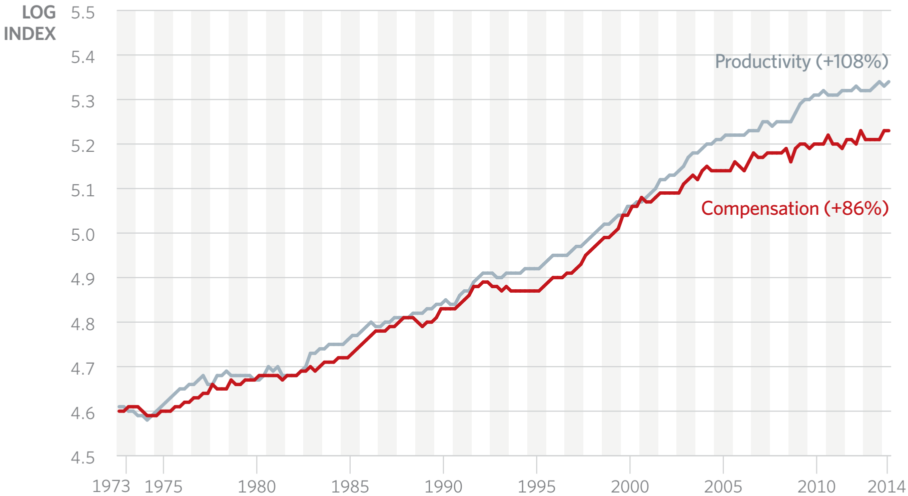
26 Heritage Foundation calculations using data from U.S. Department of Labor, Bureau of Labor Statistics, "Labor Productivity and Costs," Nonfarm Business Sector, Q1 1973–Q2 2014. Total compensation inflation was adjusted with the implicit price deflator. For more information on this methodology, see James Sherk, "Productivity and Compensation: Growing Together," Heritage Foundation *Backgrounder* No. 2825, July 17, 2013, http://www.heritage.org/research/reports/2013/07/productivity-and-compensation-growing-together.

27 Dean Baker, "Behind the Gap Between Productivity and Wage Growth," Center for Economic and Policy Research *Issue Brief*, February 2007, http://www.cepr.net/documents/publications/0702_productivity.pdf.

28 Sherk, "Productivity and Compensation: Growing Together," pp. 10–12.

29 Susan Houseman et al., "Offshoring Bias in U.S. Manufacturing," *Journal of Economic Perspectives*, Vol. 25, No. 2 (Spring 2011), pp. 111–132, and Benjamin R. Mandel, "Offshoring, Terms of Trade and the Measurement of U.S. Productivity Growth," presentation at the Washington Area International Trade Symposium at George Washington University, Washington, DC, March 11, 2011, http://www.gwu.edu/~iiep/waits/documents/Mandel-Offshoring.pdf.

Productivity and Compensation Growth



Notes: Productivity and compensation are for nonfarm businesses. Figures are adjusted for inflation using the implicit price deflator.
Source: Heritage Foundation calculations using data from the U.S. Department of Labor, Bureau of Labor Statistics, "Productivity and Costs," http://www.bls.gov/lpc/ (accessed September 30, 2014).

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Average pay has closely followed average productivity over the past generation. On the whole employees have been paid according to the value they have created. Workers have generally received the fruits of their labor.

AVERAGE EARNINGS VERSUS TYPICAL EARNINGS

The primary problem is that the productivity growth of many workers has lagged well behind the average. According to the Congressional Budget Office, compensation growth from 1979 to 2011 among nonelderly households without children has been 45 percent in the bottom quintile, 19 percent in the middle quintile, 47 percent in the ninth decile, and 136 percent in the top 1 percent of earners.[30] (These figures report only market income. They do not include either changes in taxes or government benefits.[31])

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30 The CBO reports detailed income breakdowns for three categories of households: elderly households, nonelderly households without children, and nonelderly households with children. Nonelderly households without children were chosen to control for demographic changes and minimize the impact of rising numbers of two-income parent households—a phenomenon that raises household incomes irrespective of wage rates.

31 These figures differ from those reported in average hourly compensation in the chart for several reasons: (1) They measure the period 1979–2011, not 1973–2014; (2) they are inflation adjusted with the Personal Consumption Expenditures price index, not the Implicit Price Deflator; and (3) they measure the income of nonelderly households with children, not all workers.

In other words, Americans at all income levels have grown wealthier over the past generation. The poor and middle class grew along with those at the top. However, earnings grew fastest at the top and bottom of the income distribution, with slower growth in the middle. The pay of workers with routine skills has grown more slowly as technology has reduced their relative productivity. The CBO's data illustrate the polarization of earnings as well as employment.

THE DISAPPOINTING 2000s

Moreover, labor market conditions slowed for most workers in the 2000s. Employment in less-skilled jobs has continued to grow, but the supply of workers willing to fill those jobs has risen commensurately. Thus, while job polarization produced rapidly rising wages in lower-skill jobs in the 1980s and 1990s, wage growth in these occupations has slowed significantly since the tech bubble burst.[32]

The labor market's woes have also affected more highly skilled workers. The proportion of workers in "high-skill" jobs declined slightly in the 2000s. While employers want to hire many more highly skilled workers than they hired in the 1980s, the proportion of workers in these occupations has fallen slightly since the peak of the tech bubble. Employers appear to have "overinvested" in highly skilled workers and have found that they do not need quite as many as previously believed.[33]

However, the supply of highly educated workers has not decreased. As a result, wage growth among new college graduates also stalled in the 2000s. Many college graduates have had to accept moderately skilled jobs that do not require a college degree, pushing the workers who would have filled those jobs into less skilled positions.[34] Even many well-educated workers now worry about their prospects in today's labor market.

LABOR POLICY AND OCCUPATIONAL LICENSING

Regrettably, many government policies have made the labor market even less hospitable to displaced workers. For example, nearly every state engages in widespread occupational licensing.

32 David H. Autor, "Polanyi's Paradox and the Shape of Employment Growth," presented at the Federal Reserve Bank of Kansas City's economic policy symposium "Re-Evaluating Labor Market Dynamics," Jackson Hole, WY, August 22, 2014, pp. 42–43, Figures 6 and 7, http://www.kc.frb.org/publicat/sympos/2014/093014.pdf.

33 Paul Beaudry, David A. Green, and Benjamin M. Sand, "The Great Reversal in the Demand for Skill and Cognitive Tasks," March 2013, http://www.nber.org/papers/w18901, and Autor and Price, "The Changing Task Composition of the US Labor Market."

34 Beaudry et al., "The Great Reversal in the Demand for Skill and Cognitive Tasks," and Autor and Price, "The Changing Task Composition of the US Labor Market."

For some occupations this makes perfect sense. Mandatory government-imposed qualifications can protect consumers from quacks who could endanger health or safety. No one wants a poorly trained surgeon operating on them or an uneducated pharmacist filling their prescription. However, occupational licensing now extends far beyond jobs with serious health and safety concerns. One-third of all jobs in the economy now require a government license to work in them.[35]

For example, all 50 states license cosmetology, and 49 have licensure requirements for barbers.[36] Yet these licenses do nothing to protect public safety. Unlicensed hair braiders pose no health risk. Nor do states need licensing to protect quality. Consumers can easily shop around, and for most men the difference between a good haircut and a bad haircut is three weeks.

Further, many occupations are licensed in only some states, suggesting the remaining states found licensing unnecessary. Thirty-nine states license massage therapy, 24 states license school sports coaches, 13 impose licensure on bartending, three states and the District of Columbia license interior designers, and Louisiana licenses florists.[37] Apparently, the 49 other states see no compelling need to protect consumers from ugly flower arrangements.

Licensing requirements also vary considerably from state to state. For example, 10 states require landscaping contractors to be licensed. Some of these states have moderate requirements, such as Arkansas, which requires an application and $150 fee. Others, such as North Carolina, make it quite onerous by requiring three years of study or experience in the field before becoming a contractor. Nearby Tennessee does not license landscape contractors at all.[38] If residents face genuine safety risks, why would three nearby states have such radically different legal requirements for the same job?

LICENSING CREATES A LABOR CARTEL

In fact, researchers find that most pressure to license an occupation comes from its practitioners, not the public. Professional associations frequently lobby state legislatures to impose licensing requirements on their occupation. These laws often "grandfather" existing practitioners, exempting them from the new standards.[39]

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35 Morris Kleiner and Alan Krueger, "Analyzing the Extent and Influence of Occupational Licensing on the Labor Market," *Journal of Labor Economics*, Vol. 31, No. 2, Part 2 (April 2013), pp. S173–S202.

36 Dick M. Carpenter et al., "License to Work: A National Study of Burdens from Occupational Licensing," Institute for Justice, May 2012, Table 3, http://ij.org/licensetowork.

37 *Ibid*.

38 *Ibid*.

39 Morris Kleiner, *Licensing Occupations: Ensuring Quality or Restricting Competition?* W. E. Upjohn Institute for Employment Research, 2006, p. 31.

Why would anyone want the government to make it harder to work in their field?

Licensing reduces the competition by making entry into the licensed occupation more difficult. This locks out many prospective job seekers. This in turn drives up the wages of those who remain.

Economists have a term for an institution that restricts the supply of a good or service in order to raise its price: a cartel. Just as OPEC reduces the oil supply to drive up its price, licensing restricts access to jobs in order to raise wages.

Occupational licensing benefits those inside the cartel. Economists estimate that it inflates wages in regulated occupations by an average of 18 percent.[40] However, as with all cartels, these gains come at the cost of even greater losses to the rest of society.

Excessive licensing hurts those without licenses in two ways. First, the inflated wages are passed onto consumers in the form of higher prices. Second, unnecessary licensing freezes out many unemployed workers from job opportunities. The government has placed significant barriers in front of one-third of the economy to them. As a result, they look for work in jobs with fewer openings and that are a poorer fit. The increased supply of workers pushed into unlicensed occupations also drives down wages in those jobs. Excess licensing forces the unemployed to look longer for work and accept lower wages when they find it.

Labor economists have found that the economic losses to the workers outside a labor cartel exceed the gains to the members inside it.[41] In the aggregate, excessive licensing harms consumers and job seekers more than it benefits licensed employees. Licensing redistributes income from less well paid unlicensed workers to more highly paid licensed workers, with additional economic losses coming from inefficiently high prices, longer job searches, and poorer job matches.

Those with occupational licenses like this arrangement. Professional associations fiercely resist any attempt to remove licensing requirements, but the evidence shows most occupational licenses do little to protect safety or improve quality.[42] Instead, licenses primarily redistribute income to politically favored insiders at the expense of those with less political clout. In public choice terminology, licensing is a form of "rent seeking."

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40 Kleiner and Krueger, "Analyzing the Extent and Influence of Occupational Licensing on the Labor Market."

41 George Borjas, *Labor Economics*, 3rd ed. (Columbus, OH: McGraw-Hill, 2005), pp. 413–415. The efficiency implications for a cartel formed by occupational licensing follows that of one formed by labor unions.

42 Kleiner, *Licensing Occupations*, pp. 43–65; Morris Kleiner and Robert Kudrle, "Does Regulation Affect Economic Outcomes? The Case of Dentistry," *Journal of Law and Economics*, Vol. 43, No. 2 (October 2000), pp. 547–582, and Dick Carpenter, "Blooming Nonsense: Experiment Reveals Louisiana's Florist Licensing Scheme as Pointless and Anti-Competitive," Institute for Justice, March 2010, http://www.ij.org/blooming-nonsense-experiment-reveals-louisianas-florist-licensing-scheme-as-pointless-and-anit-competitive.

Government at all levels, particularly in the states, could improve job opportunities throughout the economy by scaling back licensing requirements. This would expand opportunity for those harmed by the slow recovery or increasing automation. Reducing artificial barriers to work would give them more ways to get ahead.

Even liberal economists recognize this. Alan Kreuger and Morris Kleiner have done some of the best academic research on the problem of excessive licensing.[43] Krueger served as the chairman of President Obama's Council of Economic Advisers. Kleiner sits as the AFL-CIO Chair of Labor Policy in the Humphrey School of Public Policy at the University of Minnesota. Prominent liberal activists Dean Baker and Matthew Yglesias have also called for scaling back licensing.[44]

LABOR UNIONS: LABOR CARTELS

Perhaps surprisingly, most liberal activists—including many who recognize the damage of excessive licensing—prescribe reinvigorating another type of labor cartel to boost job opportunities: unions. Private-sector union density has fallen below 7 percent—a two-thirds drop in the past generation.[45] Liberal economists argue that expanding union membership would improve opportunities for workers. They support questionable measures, such as eliminating secret ballots in union elections, to increase union membership.[46] Indeed, rejuvenating union membership has become a central labor policy prescription from the left.

However, labor unions raise wages the same way that occupational licenses do—by creating a labor cartel that restricts access to jobs. Like occupational licenses, unions reduce the labor supply. While licenses directly reduce employment, which then raises wages, unions directly increase wages, which reduces the number of workers that companies hire. Both approaches have the same economic consequences: higher wages in unionized industries

43 Kleiner and Krueger, "Analyzing the Extent and Influence of Occupational Licensing on the Labor Market," and Morris Kleiner and Alan Krueger, "The Prevalence and Effects of Occupational Licensing," *British Journal of Industrial Relations*, Vol. 48, No. 4 (December 2010), pp. 676–687.

44 Matthew Yglesias, "Licensed to Decorate," *Slate*, May 20, 2012, http://hive.slate.com/hive/10-rules-starting-small-business/article/licensed-to-decorate, Matthew Yglesias, "Occupational Licensing Run Amok," Think Progress, December 3, 2009, http://thinkprogress.org/yglesias/2009/12/03/195315/occupational-licensing-run-amok/, and Dean Baker, *The Conservative Nanny State* (Washington, DC: Center for Economic and Policy Research, 2006), http://manybooks.net/titles/bakerdother09conservative_nanny_state.html.

45 News release, "Union Members—2013," U.S. Department of Labor, Bureau of Labor Statistics, January 24, 2014, http://www.bls.gov/news.release/pdf/union2.pdf.

46 See Lawrence Mishel, Richard B. Freeman, and Frank Levy, "The Employee Free Choice Act Is Needed to Restore Balance in the Labor Market," Economic Policy Institute, February 24, 2009, http://www.epi.org/publication/prominent_economists_call_for_passage_of_the_employee_free_choice_act/. For details on the problem of eliminating secret ballot elections in organizing drives, see James Sherk and Paul Kersey, "How the Employee Free Choice Act Takes Away Workers' Rights," Heritage Foundation *Backgrounder* No. 2027, April 23, 2007, http://www.heritage.org/research/reports/2007/04/full-text-how-the-employee-free-choice-act-takes-away-workers-rights.

at the cost of fewer jobs, higher prices, and lower wages in non-union firms. As with occupational licenses, the union labor cartel benefits its members at the cost of greater losses to everyone else.[47]

For example, the Detroit automakers General Motors, Ford, and Chrysler once comprised nearly the entire U.S. auto market. The the United Auto Workers (UAW) in turn organized almost their entire workforces. This gave the union a monopoly on hourly labor in the auto industry. Unless the automakers paid what the union demanded, the workers would strike. The Big Three repeatedly caved to union demands. Until the financial crisis, the automakers paid more than $70 an hour in wages and benefits.[48]

UAW members benefitted tremendously from their union's monopoly. Many high school graduates in Detroit earned more than scientists with PhDs.[49] However, the union also made American drivers poorer. The union premium added roughly $800 to the cost of every Detroit vehicle.[50] The automakers passed those costs onto consumers, and drivers paid higher monthly car payments. These higher costs also priced a new vehicle out of reach for many Americans. Consequently, the automakers sold fewer cars and needed fewer workers, as did their (potentially non-union) suppliers in the steel, plastic, and other industries. The workers who would have been employed in the auto industry and its suppliers worked elsewhere, slightly reducing wages in those sectors.[51]

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47 Borjas, *Labor Economics*, pp. 413–415.

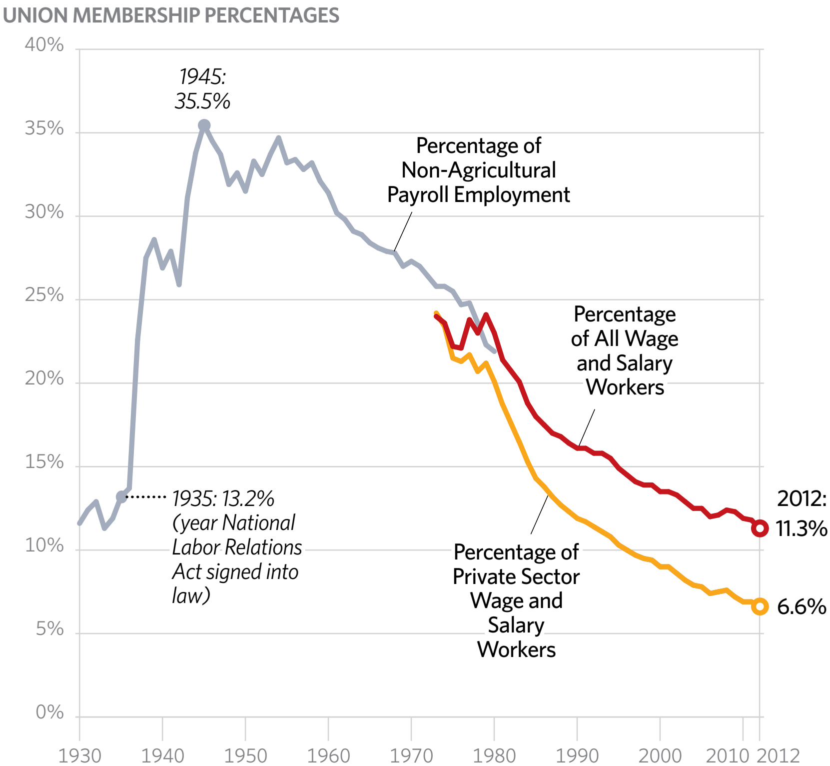
48 James Sherk, "Auto Bailout Ignores Excessive Labor Costs," Heritage Foundation *WebMemo* No. 2135, November 19, 2008, http://www.heritage.org/research/reports/2008/11/auto-bailout-ignores-excessive-labor-costs. Many in the media claim the $70 per hour figure included the legacy cost of previous retirees. It did not. It included the discounted value of future retirement and health benefits that current workers earned while on the job. See James Sherk, "UAW Workers Actually Cost the Big Three Automakers $70 an Hour," Heritage Foundation *WebMemo* No. 2162, December 8, 2008, http://www.heritage.org/research/reports/2008/12/uaw-workers-actually-cost-the-big-three-automakers-70-an-hour.

49 U.S. Department of Labor, Bureau of Labor Statistics, "Occupational Employment and Wages, May 2007: 19-1029 Biological Scientists, All Other," April 3, 2008, http://www.bls.gov/oes/2007/may/oes191029.htm, and "Occupational Employment and Wages, May 2007: 19-1011 Animal Scientists," April 3, 2008, http://www.bls.gov/oes/2007/may/oes191011.htm.

50 Heritage Foundation calculations were based on an average $30 per hour difference in compensation costs in 2006 for hourly employees in the Big Three over an average of 30 hours per unit, with hourly employees making up 73 percent of all U.S. employees, as well as union contracts adding an additional two hours per unit to construction times at General Motors relative to Toyota. See Sherk, "Auto Bailout Ignores Excessive Labor Costs"; Sherk, "UAW Workers Actually Cost the Big Three Automakers $70 an Hour"; U.S. Securities and Exchange Commission, "General Motors Corporation: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Year Ended December 31, 2006," http://www.sec.gov/Archives/edgar/data/40730/000095012407001502/k11916e10vk.htm, and HARBOUR Consulting, "The HARBOUR Report: 2007 North America Press Release," http://www.autonews.com/assets/PDF/CA2018861.PDF.

51 These are known as "crowding" and "complements" models. In the crowding model, the reduction of jobs in the union sector pushes workers into the non-union sector, lowering their wages. In the complements model, reduced demand for the goods of unionized companies because of higher prices also reduces the demand and hence wages for non-union workers, whose jobs are connected to that sector (e.g., suppliers to the unionized industry).

Union Membership Rates Continue Decline



Note: This chart displays union membership using two separate data sources: assorted union reports filed with the Department of Labor between 1930 and 1980 and data from the Current Population Survey. Data for 1982 have been interpolated.

Sources: Data for 1930–1980: U.S. Department of Labor, assorted labor union reports, and Haver Analytics; 1977–2012: Heritage Foundation calculations using data from Barry T. Hirsch and David A. Macpherson, "Union Membership and Coverage Database from the Current Population Survey," Unionstats.com, http://www.unionstats.com (accessed January 23, 2013), and from the U.S. Department of Labor, Bureau of Labor Statistics.

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COMPETITION UNDERMINES CARTELS

Fortunately, competition has undermined the union cartel. When non-union competitors enter a market, their lower costs enable them to sell at lower prices. Unionized companies must match these prices—and costs—or they lose customers en masse. Thus, non-union competition limits the power of unions to benefit their members at the expense of others.

Detroit again illustrates this. Starting in the late 1970s foreign automakers gave Americans the choice to buy less expensive cars made by non-union workers, and car buyers voted with their wallets. "Foreign" nameplates—many built in the U.S. with American workers—now sell a majority of vehicles in the U.S.[52] Competition meant more affordable cars, lower costs for consumers, more jobs, and the collapse of unionized Detroit.[53] UAW members now enjoy much less generous benefit packages. New hires in Detroit actually make less than their non-union counterparts in the foreign automakers.[54]

Over the past generation, deregulation and free trade have made the American economy much more competitive. As a result, the union movement no longer has much power to impose costs on others to benefit its members. Studies find wages do not rise at most newly unionized companies.[55]

While licenses directly reduce employment, which then raises wages, unions directly increase wages, which reduces the number of workers that companies hire. Both approaches have the same economic consequences: higher wages in unionized industries at the cost of fewer jobs, higher prices, and lower wages in non-union firms.

Despite liberal laments, the decline of unions has benefitted most workers. Unions do not—and cannot—simply redistribute from "the rich." While unions harm businesses' profitability, they also hurt low-income and middle-income workers. The higher prices imposed by unions hurt rich, poor, and middle-class consumers alike, but lower-income workers feel the sting of price increases more acutely. Restricting jobs in unionized companies reduces demand in related industries and pushes more workers into the non-union sector. Both effects depress the pay of non-union employees.[56] Most of the income that unions redistribute comes from other workers, not stockowners.

52 "Auto Sales," *The Wall Street Journal*, August 1, 2014, http://online.wsj.com/mdc/public/page/2_3022-autosales.html .

53 Barry Hirsch, "Sluggish Institutions in a Dynamic World: Can Unions and Industrial Competition Coexist?" *Journal of Economic Perspectives*, Vol. 22, No. 1 (Winter 2008), pp. 153–176.

54 Sean McAlinden and Kristin Dziczek, "2011 Detroit 3-UAW Labor Contract Negotiations," Center for Automotive Research *Research Paper*, November 2011, http://www.cargroup.org/?module=Publications&event=View&pubID=36.

55 Robert J. Lalonde, Gerard Marschke, and Kenneth Troske, "Using Longitudinal Data on Establishments to Analyze the Effects of Union Organizing Campaigns in the United States," *Annales d'Economie et de Statistique*, Vol. 41/42 (January–June 1996), pp. 155–185, http://annales.ensae.fr/anciens/n4142/vol4142-08.pdf, Richard B. Freeman and Morris M. Kleiner, "The Impact of New Unionization on Wages and Working Conditions," *Journal of Labor Economics*, Vol. 8, No. 1 (January 1990), pp. S8–S25, and John DiNardo and David S. Lee, "Economic Impacts of New Unionization on Private Sector Employers: 1984–2001," *The Quarterly Journal of Economics*, Vol. 119, No. 4 (November 2004), pp. 1383–1441.

56 David Neumark and Michael L. Wachter, "Union Effects on Nonunion Wages: Evidence from Panel Data on Industries and Cities," *Industrial and Labor Relations Review*, Vol. 49, No. 1 (October 1995), pp. 20–38.

POLICY RECOMMENDATIONS

Creating labor cartels—whether through occupational licensing or unions—will not produce general prosperity. Government should get out of the business of mandating such restraints on trade. Instead, policymakers should make it easier and less expensive for workers to increase their skills and productivity. Policymakers should make reform of basic education a high priority, and the government should make it less difficult for workers to acquire the more advanced skills needed by today's employers.

At the same time, the government should make it easier for workers to use their existing skills more productively. Not every worker needs a college degree. The government should expand access to new job opportunities to help current workers get ahead, and it should relax or eliminate policies that unnecessarily restrain innovation and investment in key sectors, such as energy production.

BOOSTING U.S. PRODUCTIVITY

Education and skills have become much more important in today's economy. Helping current and prospective workers become more skilled would do much more for them than almost any other policy. Workers' pay has tracked their productivity over the past generation. As employees have become more productive, market forces have compelled businesses to pay them more.

The government can take many steps to help, most importantly by improving public education and making college less expensive:

- **Reforming K–12 education.** Too many American schools fail to prepare their students for the modern workforce. One-fourth of U.S. 12th graders read below a basic level.[57] One in seven American adults are functionally illiterate.[58] Anyone lacking basic reading skills will have great difficulty getting ahead. States should immediately end education policies, such as extremely onerous firing procedures, that serve the adults who run public schools at the expense of the children who need to learn. Union job protections make it prohibitively difficult for schools to remove ineffective teachers. Economists have found that replacing the 5 percent to 8 percent of least effective teachers with average quality teachers would dramatically increase the lifetime earnings of their students.[59]

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57 U.S. Department of Education, "The Nation's Report Card: 2013 Grade 12 Reading and Mathematics Results," http://nationsreportcard.gov/reading_math_g12_2013/#/what-knowledge.

58 Institute of Education Sciences, National Center for Educational Statistics, National Assessment of Adult Literacy, 1992 and 2003, http://nces.ed.gov/naal/kf_demographics.asp.

59 Eric Hanushek, "The Economic Value of Higher Teacher Quality," *Economics of Education Review*, Vol. 30, No. 3 (June 2011), pp. 466–479, and Raj Chetty, John N. Friedman, and Jonah E. Rockoff, "Measuring the Impacts of Teachers II: Teacher Value-Added and Student Outcomes in Adulthood," *American Economic Review*, Vol. 104, No. 9 (September 2014), pp. 2633–2679.

- **Expanding access to charter and private schools.** Opportunity scholarships and charter schools expand educational options, enabling parents to send their children to schools better suited to them. This makes them more productive workers as adults. Researchers find that students who have scholarships to attend private schools or who attend public charter schools are much more likely to graduate high school.[60] A new Mathematica study also found that going to charter schools increases children's earnings as adults. The researchers found that Florida youth who enrolled in charter high schools earned an average of 12.7 percent more—more than $2,300 per year—when they reached their mid-20s.[61] Improving education makes workers more productive, which raises their earnings.

- **Reducing the cost of higher education.** Technology has made non-routine cognitive, social, and analytical skills more important than ever before. A college degree has become a prerequisite for most high-paying jobs in the economy. This has dramatically increased the demand to attend college over the past generation. Regrettably, the supply of college openings has increased only modestly. Federal accreditation requirements make starting a new school very expensive. This combination of rising demand and limited supply has combined to send college tuition costs surging. As Lindsey Burke argues elsewhere in this book, the government should reform accreditation to increase access to college education, while ensuring state regulators do not stop low-cost innovations such as Massively Open Online Courses, which could make education dramatically less expensive.[62] Lower costs would facilitate gaining the skills and productivity that enable workers to earn more.

NEW USES FOR EXISTING SKILLS

Reforming the U.S. education system to help students learn more effectively would make them more productive workers as adults, but such reforms would address only part of the problems in the labor market. Employers do not need every worker to have a college degree, as the recent stagnation in pay for college graduates attests. Moreover, going back to school makes little sense for many workers. Policymakers can further improve the labor

60 Lindsey Burke and Rachel Sheffield, "School Choice in America 2011: Educational Opportunity Reaches New Heights," Heritage Foundation *Backgrounder* No. 2597, August 17, 2011, http://www.heritage.org/research/reports/2011/08/school-choice-in-america-2011-educational-opportunity-reaches-new-heights.

61 Kevin Booker et al., "Charter High Schools' Effects on Long-Term Attainment and Earnings," Mathematica Policy Research *Working Paper*, January 2014, http://www.mathematica-mpr.com/~/media/publications/PDFs/education/charter_long-term_wp.pdf.

62 Lindsey Burke and Stuart M. Butler, "Accreditation: Removing the Barrier to Higher Education Reform," Heritage Foundation *Backgrounder* No. 2728, September 21, 2012, http://www.heritage.org/research/reports/2012/09/accreditation-removing-the-barrier-to-higher-education-reform.

market by creating new opportunities for workers to use their existing skills more productively. Such policies include:

- **Breaking down licensing barriers.** States should replace most occupational licenses with certification systems. Under a certification system, practitioners can complete criteria to advertise themselves as government certified. However, certification does not prevent uncertified practitioners from working. They simply cannot advertise themselves as certified. Certification eliminates the labor cartel that occupational licenses create, while providing a signal of quality to consumers. States should establish legal frameworks to determine whether a sufficiently pressing health or safety risk outweighs the negative effects of licensing. Almost any job could involve some safety risk, but that does not justify walling off those occupations to job seekers. The government should only license occupations with pressing health or safety risks. This would expand the non-routine job opportunities available to workers with routine skills displaced by modern technology. It would enable them to move into jobs in which they can use their existing skills more productively.

- **Permission-less innovation.** New innovations are creating jobs for tens of thousands of Americans. Food trucks have enabled Americans without the capital to open a brick-and-mortar restaurant to start their own restaurants. UberX has enabled many ordinary car owners to make tens of thousands of dollars outside their regular jobs. Such innovations enable workers who might otherwise face bleak job prospects to get ahead. Regrettably, existing businesses do not like the competition. Restaurant associations have heavily lobbied local governments to zone food trucks out of existence. Taxi associations have successfully persuaded some cities, including Seattle and Miami, to ban UberX. Americans should not need their competitors' permission to work, and the government should stop suppressing disruptive innovations that have enabled tens of thousands of workers to get ahead.

- **Expanding domestic energy production.** Oil and natural gas drilling requires extensive non-routine manual labor. Many workers displaced from factories or the construction sector could earn a good living in the energy-extraction sector. America has trillions of dollars of oil and natural gas. Regrettably, federal policy has locked vast quantities of these resources away from production. Congress should open more federal lands to oil and natural gas production, while requiring regulatory agencies to quickly approve permits for new oil and gas pipelines and liquid natural gas export terminals. This would create hundreds of thousands of new, relatively high-paying blue-collar jobs for workers with manual skills.

CONCLUSION

The labor market has changed dramatically over the past generation. Computers have automated many of tasks that humans once performed, while women have entered the labor market in large numbers. On the whole, these changes have benefited workers, especially women. Yet these changes have hurt many workers, particularly men with routine skills. Moreover, the Great Recession and the slow recovery following it have harmed the job prospects of workers across the country.

Government policies have also added to the challenges facing displaced workers. Excessive occupational licensing creates labor cartels that benefit some workers at the expense of society overall. The unemployed need government licenses to apply for one-third of jobs in the economy, including jobs such as barbers that present few health risks. These cartels raise wages in occupations by making it harder for the unemployed to enter them.

The government should not try to raise wages by restricting access to jobs through either licensing or union cartels. Instead, policymakers should help workers to increase their skills or use their existing skills more effectively. Workers' pay has closely tracked their productivity over the past generation. Reforms to increase the quality and reduce the cost of education would expand opportunity for millions of workers. Further reforms—such as eliminating unneeded licensing, expanding domestic energy production, and breaking down barriers to innovation—would help many more workers to get ahead.

The government should stop hindering workers who are trying to achieve the American Dream.

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* A version of this essay was published previously as "Creating Opportunity in the Workplace," Heritage Foundation *Backgrounder* No. 2962, December 16, 2014, http://www.heritage.org/research/reports/2014/12/creating-opportunity-in-the-workplace.

FREE MARKET ENERGY SOLUTIONS

Nicolas D. Loris

Energy production has been a bright spot in the economy over the past few years, driving job creation and creating opportunities for Americans across the country. Increased energy supplies have saved consumers money directly on their energy bills and indirectly through lower prices for goods and services. The energy boom has also revitalized parts of the country where businesses have taken advantage of abundant, affordable natural gas.

Not all of the news is positive, however. Despite the successes, America's energy policy is fraught with problems. The federal government has delayed projects, restricted access, and overregulated industry at great cost to consumers struggling to pay for home heating bills and gasoline and to workers struggling to hold on in the post-collapse economy to jobs at coal-fired power plants the left hopes to shutter. Furthermore, Washington provides taxpayer-funded subsidies and imposes arbitrary mandates that reward political connectedness over economic viability. Much of this occurs under the guise of promoting environmental protection, but even by the admission of more honest environmentalists, these rules and so-called "investments" are often special interest politicking of the worst sort. While this arrangement satisfies radical environmentalists and well-connected players in the subsidy-dependent green energy industry, working Americans who pay the price in higher energy costs lose out.

A common thread runs through the reforms needed to create more opportunity and remove favoritism in the energy sector: get government out of the way.

ENERGY PRODUCTION AND THE COST OF LIVING

Often, proponents of free markets struggle to respond to critiques from the left that the policies they support offer no promise to those with little immediate prospect of economic mobility. As much as any other issue, energy policy offers an important opportunity to disprove that assertion–and to highlight the devastating toll that misguided overregulation takes on Americans' living standards. All Americans–rich, poor, working, unemployed, and retired–benefit from efficient energy markets that deliver cheap power across the country and offer new, high-paying jobs for the unemployed and underemployed. Energy reform therefore should serve as a central plank of the conservative vision for American economic renewal and as an essential point of contrast with the left's domestic agenda.

ENERGY COSTS THIN POCKETBOOKS

Few Americans spend much time thinking about Washington regulators and policy debates on Capitol Hill. They're more concerned about their day-to-day lives, as they should be. But one concern common to all working families—indeed a concern that is always on their minds–is the price of their bills and daily expenses. Families dread receiving the electricity bill in the mail, especially in the dog days of summer when the air conditioning runs on full blast. Watching the meter at the gas pump rapidly tick upward is an incessant reminder of energy costs eating into our budget. Home heating oil bills in the dead of winter are a huge drain on the wallet, as well. These burdens fluctuate over time; gas prices in particular have fortunately slumped of late. But taken together, these costs always seem to eat up more money than families can spare.

The burden of high energy prices is especially borne by low and middle-income families because they spend a larger percentage of their overall budget on energy costs. According to a recent report by the American Coalition for Clean Coal Electricity, "the average American family with an after-tax income of $54,286 will spend an estimated $5,752 on energy in 2014, or 11% of the family budget. The 60 million households earning less than $50,000, representing 49% of U.S. households, will devote an estimated 20% of their after-tax incomes to energy, compared with an average of 8% for households with annual incomes above $50,000. For the 37 million lower-income families with pre-tax incomes less than $30,000, energy costs in 2014 will represent 26% of average after-tax incomes, compared with 16% in 2001."[1]

The pain to American families stemming from energy costs doesn't just stop at the pump or when the bill comes in the mail. We pay more for a gallon of milk at the grocery store and for most all goods and services because energy is necessary for just about everything we make and do. When energy prices rise, and families have less disposable income, they may take shorter vacations and reduce trips to restaurants, movie theaters, and shopping malls.

FUELING JOB AND WAGE GROWTH

Fortunately, the converse of negative impacts of higher energy prices is true. More energy production results not just in lower energy prices but also in cost savings through cheaper goods and services, which help Americans pad their wallets. In effect, the dramatic increase in oil and natural gas production over the past few years as a result of the technological one-two punch of directional drilling and hydraulic fracturing (fracking) has acted as a massive tax break for American families by dramatically lowering energy prices.

1 American Council for Clean Coal Electricity, "Energy Cost Impacts on American Families, 2001-2014, February 2014, http://americaspower.org/sites/default/files/Trisko_2014.pdf.

North Dakota: More Jobs *and* Better-Paying Jobs

North Dakota experienced an oil boom beginning in the mid–2000s. Thanks to a robust economy tied to energy development, median household income in North Dakota rose 9 percent between 2005 and 2010, trailing only the District of Columbia. Figures have been adjusted for inflation.

MEDIAN HOUSEHOLD INCOME

		2005	2010	Percentage Change
1	District of Columbia	$50,250	$55,528	10.5%
2	North Dakota	$47,122	$51,380	9.0%
3	Colorado	$56,344	$60,442	7.3%
4	West Virginia	$40,703	$42,839	5.2%
5	Wyoming	$49,943	$52,359	4.8%
6	New Hampshire	$63,642	$66,707	4.8%
7	Connecticut	$63,476	$66,452	4.7%
8	Virginia	$57,980	$60,363	4.1%
9	New Mexico	$43,498	$45,098	3.7%
10	Mississippi	$36,716	$37,985	3.5%
11	Oklahoma	$42,044	$43,400	3.2%
12	Texas	$46,262	$47,464	2.6%
13	Oregon	$49,319	$50,526	2.4%
14	Wisconsin	$49,867	$50,522	1.3%
15	Kentucky	$40,987	$41,236	0.6%

0% 5% 10%

Source: U.S. Census Bureau and Heritage Foundation calculations.

Energy & Environment heritage.org

The economic benefits from the shale oil and gas production boom in recent years go far beyond household savings. Directional drilling and hydraulic fracturing supported more than 2.1 million jobs in 2012—geologists, engineers, rig workers, truck drivers, pipe welders, and others.[2] Not all of this economic activity falls directly in the energy supply chain; new production has increased demand for restaurants, repair shops, hardware stores, hotels, box stores, and laundromats in energy-producing areas. In Williston, North Dakota, home to one of the country's most productive shale resource deposits, McDonald's is offering signing bonuses and Wal-Mart is hiring cashiers for $17.40 an hour, almost 2.5 times the minimum wage.[3] Lower natural gas prices are also encouraging more investment and attracting energy-intensive businesses like chemical manufacturers to locate to the United States.

Energy production has been a catalyst of economic revitalization across the country, rejuvenating old steel towns and making America an attractive place to locate new, energy-intensive businesses. With abundant shale oil and gas deposits across the country, the economic consulting firm IHS projects that the U.S. energy sector will grow stronger and that energy-related employment will increase to 3.9 million jobs by 2025, with over 550,000 jobs in the manufacturing sector.[4] Smart drilling technologies and the resulting energy production generated $284 billion in gross domestic product (GDP) in 2012, and IHS estimates that will jump to $533 billion by 2025.[5]

2 IHS, *America's New Energy Future: The Unconventional Oil and Natural Gas Revolution and the U.S. Economy*, Vol. 3, *A Manufacturing Renaissance*, September 2013.

3 Mark J. Perry, "A Report from the Bakken Oil Fields, Where the Jobless Rate is 0.9% and Walmart Is Paying 2.4 Times the Minimum Wage," American Enterprise Institute, June 9, 2014, http://www.aei-ideas.org/2014/06/a-report-from-the-bakken-oil-fields-where-the-jobless-rate-is-0-9-and-walmart-is-paying-2-4-times-the-minimum-wage/.

4 IHS, *America's New Energy Future: The Unconventional Oil and Natural Gas Revolution and the U.S. Economy*.

5 *Ibid*.

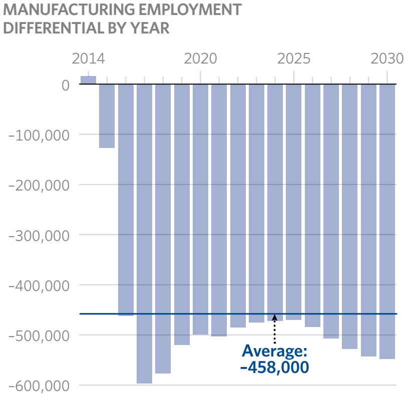
Additionally, households save money through lower energy bills and cheaper goods when businesses compete and pass cost savings onto consumers. IHS estimates that the average household saved $1,200 in 2012 through lower energy costs and increased income. Because of domestic energy production, those savings will nearly triple over the next decade.[6]

DAMAGING GOVERNMENT POLICY

Unfortunately, bad government policies are standing in the way of even greater energy savings. Consider the impact of this handful of regulations, which serve to drive up gas prices:

EPA Carbon Regulations Would Drastically Lower Manufacturing Employment

The U.S. manufacturing sector would decline soon after EPA regulations on carbon go into effect. On average through 2030, manufacturing employment levels would decrease by 458,000.



Source: Heritage Foundation calculations using the Heritage Energy Model.

heritage.org

- **The Renewable Fuel Standard (RFS).** The Congressional Budget Office recently published a report showing the RFS will increase gas prices by 13 cents to 26 cents per gallon as soon as 2017.[7] Multiple federal agency and government-backed studies demonstrate the RFS has harmed Americans, driving up fuel and food prices.[8]

- **The ban on crude oil exports.** Removing government restrictions on crude oil exports would decrease gas prices and grow the American economy by creating more opportunities to produce and sell oil and a more efficient distribution system for refining it. IHS projects that removing the ban would lower gasoline prices by 8 cents per gallon, saving motorists $265 billion over 15 years and adding nearly 1 million jobs by 2018.[9]

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6 *Ibid*.

7 Congressional Budget Office, "The Renewable Fuel Standard: Issues for 2014 and Beyond," June 2014, http://www.cbo.gov/publication/45477.

8 Randy Schnepf and Brent D. Yacobucci, "Renewable Fuel Standard (RFS): Overview and Issues," Congressional Research Service Report for Congress, March 14, 2013, http://fas.org/sgp/crs/misc/R40155.pdf.

9 Press release, "U.S. Crude Oil Export Decision," IHS, May 29, 2014, http://www.ihs.com/info/0514/crude-oil.aspx?ocid=coe:pressrls:01.

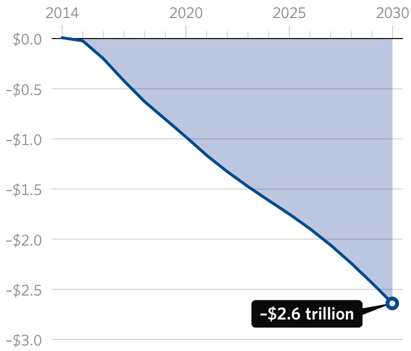
- **Tier 3 regulations.** The federal government has finalized Tier 3 gas regulations to lower the amount of sulfur in gasoline beginning in 2017. More stringent sulfur regulations could add 6 cents to 9 cents per gallon to the cost of manufacturing gasoline, and the EPA has acknowledged the more stringent regulation will produce no measurable improvement in air quality.[10]

- **The Jones Act.** Signed into law almost a century ago, the Jones Act mandates that any goods shipped by water between two points in the United States must be transported on a U.S.-built, U.S.-flagged vessel with a crew that is at least 75 percent American. By preventing foreign competition, the Jones Act significantly increases domestic maritime shipping prices, driving up costs for American businesses and consumers. A February 2014 International Energy Agency report estimates that repealing the Jones Act would reduce gasoline prices by 15 cents per gallon.[11]

U.S. Economy Would Shrink by $2.6 Trillion Under EPA Carbon Regulations

EPA regulations on carbon would eliminate an average of $155 billion a year in gross domestic product through 2030, with an aggregate total of $2.6 trillion.

CHANGE IN GDP, IN TRILLIONS OF 2014 DOLLARS



Source: Heritage Foundation calculations using the Heritage Energy Model.

heritage.org

And that's just the tip of the iceberg. A host of federal regulations coming down on the electricity sector is forcing inexpensive, base load power to retire earlier than it otherwise would, driving up electricity bills for families and businesses.

According to the government's own Energy Information Administration, the mercury air & toxics rule for power plants is causing more power plants to plan their retirements than had been expected.[12] On the surface, reducing pollutants emitted into the atmosphere

10 David C. Tamm and Kevin P. Milburn, "Addendum to Potential Supply and Cost Impacts of Lower Sulfur, Lower RVP Gasoline," Baker & O'Brien Incorporated, March 2012, http://www.api.org/news-and-media/news/newsitems/2012/mar-2012/~/media/Files/News/2012/12-March/Addendum-Potential-Impacts-of-Lower-Sulfur-Lower-RVP-Gasoline-Report.ashx.

11 Natasha Doff and Naomi Chase, "Frozen East Coast Pays as Law Blocks Cheaper Fuel Flows," *Bloomberg*, February 28, 2014, http://www.bloomberg.com/news/2014-02-28/frozen-east-coast-pays-as-law-blocks-cheaper-fuel-flows.htm. The full report is available for purchase from the International Energy Agency.

12 U.S. Energy Information Administration, "AEO2014 projects more coal-fired power plant retirements by 2016 than have been scheduled," February 14, 2014, http://www.eia.gov/todayinenergy/detail.cfm?id=15031.

sounds like a wise decision; the EPA claims this rule would produce $53 billion to $140 billion in annual benefits. However, the mercury reductions would produce at most $6 million in benefits.[13] The EPA exaggerates the environmental benefits by including estimated benefits from reducing particulates (co-benefits) already covered by existing regulations. Those co-benefits account for 99.996 percent of the agency's estimated benefits. The EPA estimates this rule could cost about $11 billion per year by 2015, but the Electric Reliability Coordinating Council estimates it could cost as much as $100 billion per year.[14] As is the case with most new burdensome regulations proposed and implemented by the federal government, the costs are overwhelmingly high and the diminishing marginal returns are almost at a vanishing point.

Also dangerous are the EPA's proposed greenhouse gas emissions limits for power plants. These new rules, which set harsh emissions reduction targets for both existing and new power plants, would effectively ban new coal-fired facilities and force the early closures of existing plants. President Obama boasted during his 2008 campaign about his ambition to end coal-fired power. He bragged then that under his ideal cap and trade system, "if somebody wants to build a coal-fired powered plant, they can; it's just that it will bankrupt them because they're going to be charged a huge sum for all that greenhouse gas that's being emitted."[15] Forcing plants to implement costly emissions reduction technologies accomplishes the same feat, except without the need for Congressional action.

The Heritage Foundation has modeled the effects of a decades-long phase-out of coal from the energy market, and unsurprisingly, they would be disastrous. By 2023, long before the conclusion of the phase-out, the economy would lose 600,000 jobs, including 330,000 in the manufacturing sector. GDP losses would total $2.23 trillion. A family of four would face a staggering $1,200 dip in income.[16] For working Americans struggling to achieve upward mobility, it's hard to imagine a more counterproductive policy.

FAVORITISM IN THE ENERGY SECTOR

All too often, decisions to delay crucial energy projects, mandate expensive modes of production, and restrict choice just so happen to redound to the benefit of special interests

13 Anne E. Smith, "Technical Comments on the Regulatory Impact Analysis Supporting EPA's Proposed Rule for Utility MACT and Revised NSPS (76 FR 24976)," NERA Economic Consulting, August 3, 2011, http://www.nera.com/nera-files/PUB_Smith_EPA_report_0811.pdf.

14 Scott H. Segal, "ERCC Comments on Utility MACT," Electric Reliability Coordinating Council, August 4, 2011, http://www.electricreliability.org/news/ercc-comments-utility-mact.

15 Michael James, "Republicans to Try Burning Obama on Coal," ABC News, November 2, 2008, http://abcnews.go.com/blogs/politics/2008/11/republicans-to/.

16 Nicolas Loris and Filip Jolevski, "EPA's Climate Regulations Will Harm American Manufacturing," Heritage Foundation *Issue Brief* No. 4158, March 4, 2014, http://www.heritage.org/research/reports/2014/03/epas-climate-regulations-will-harm-american-manufacturing.

with strong ties to those in charge of the regulatory process. Politicians tout these programs as means to usher in new technologies that will provide jobs and stimulate the economy. The reality, however, is often that rather than creating a playing field that provides opportunity for all to compete, these policies play favorites by allocating special benefits to the well-connected.

The story of Solyndra is infamous for good reason. The company, a solar cell manufacturing firm backed by George Kaiser, a major campaign contributor to the Democratic Party and President Obama, received a $535 million loan guarantee financed by the Obama Administration's 2009 stimulus package after a hastened governmental review process. The Obama Administration's Energy Secretary visited the company's factory at its groundbreaking, and President Obama promised the investment would produce a thousand jobs. "The future is here," he proclaimed in a visit to Solyndra's facilities. But for all the Administration's promises, the company closed its doors in 2011.[17] The situation was a microcosm of the worst of government favoritism: the well-connected navigate the regulatory process with remarkable ease and socialize the risk of their private endeavors. Increased transparency may marginally improve the protection of taxpayer dollars, but true protection will only come when policymakers remove the bad policies that foster the cozy relationships between lobbyists and the federal government in the first place.

Perhaps more perverse than the gross unfairness and corruption is that such policies significantly obstruct the long-term success and viability of the technologies and energy sources they intend to promote. Instead of relying on a process that rewards competition, taxpayer subsidies prevent a company from truly understanding the price point at which the technology will be economically viable. When the government plays favorites, it traps valuable resources in unproductive places.

Solyndra itself is an isolated case, but such favoritism extends beyond one-off loan guarantees and subsidies. At times, whole industries benefit from similar government largesse.

CLASSIC CRONYISM: THE RENEWABLE FUEL STANDARD

The classic case, the Renewable Fuel Standard, requires refiners to blend billions of gallons of ethanol into fuel each year. Most of the ethanol comes from corn. This artificially raises the cost for drivers because ethanol is less efficient and ultimately costs more, especially given the long-term damage it causes small engines.[18] Additionally, the mandate drives up food prices, not just for American families but also around the world because corn is a

17 Joe Stephens and Carol D. Leonnig, "Solyndra solar company fails after getting federal loan guarantees," *The Washington Post*, August 31, 2011, http://www.washingtonpost.com/politics/solyndra-solar-company-fails-after-getting-controversial-federal-loan-guarantees/2011/08/31/gIQAB8IRsJ_story.html.

18 Ed Perratore, "Gas with ethanol can make small engines fail," *Consumer Reports*, March 22, 2013, http://www.consumerreports.org/cro/news/2013/03/gas-with-ethanol-can-make-small-engines-fail/index.htm.

staple food in many countries as well as a staple feed for livestock.[19] As a result, many food associations and anti-hunger organizations oppose the mandate.[20]

Although environmental organizations initially supported the mandate to reduce oil use and greenhouse gas emissions, many now argue that the ethanol mandate is poor environmental policy.[21] According to a Rice University study, biofuel production is highly carbon-intensive after accounting for land-use conversion, the use of fertilizers, insecticides, and pesticides, and the conventional fuels used for production and distribution.[22] To meet the growing demand for ethanol, farmers must plow more land and plant more corn, which means less area for trees and increased release of carbon dioxide stored in trees, plants, and soil.[23] The EPA also acknowledges that increased soybean production as a result of the mandate can adversely affect water quality, ecosystems, and habitats and increase criterion pollutants, such as sulfur dioxide and nitrous oxide.[24]

One would think that a diverse coalition including the Clean Air Task Force, the National Chicken Council, the National Turkey Federation, the Milk Producers Council, Oxfam America, Taxpayers for Common Sense, Friends of the Earth, and dozens of other organizations as well as American families adversely affected as taxpayers and consumers would be influential enough to repeal the mandate.[25] Yet the mandate is set to increase to 36 billion gallons per year by 2022 because special interests, mostly in the Midwest, benefit from the policy.[26]

Regarding his own support for corn-based ethanol during his political career, former Vice President Al Gore observed several years ago:

> It's hard once such a program is put in place to deal with the lobbies that keep it going. One of the reasons I made that mistake is that I paid particular attention to the farmers in my home state of Tennessee, and I had a certain fondness for the farmers in the state of Iowa because I was about to run for President.[27]

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19 David W. Kreutzer, "Renewable Fuel Standard, Ethanol Use, and Corn Prices," Heritage Foundation *Backgrounder* No. 2727, September 17, 2012, http://www.heritage.org/research/reports/2012/09/the-renewable-fuel-standard-ethanol-use-and-corn-prices.

20 Action Aid USA et al., open letter to Members of the House Energy and Commerce Committee, October 7, 2013, https://ntuf.memberclicks.net/assets/rfs%20reform%20coalition%20letter%20to%20ec%202013%2010-7-13%20final%20 44%20signatures.pdf.

21 James A. Baker III, "Fundamentals of a Sustainable U.S. Biofuels Policy," Rice University *Baker Institute Policy Report* No. 43, January 2010, http://bakerinstitute.org/research/baker-institute-policy-report-43-fundamentals-of-a-sustainable-us-biofuels-policy/.

22 *Ibid*.

23 Joseph Fargione et al., "Land Clearing and the Biofuel Carbon Debt," *Science*, Vol. 319, No. 5867 (February 2008), pp. 1235–1238.

24 U.S. Environmental Protection Agency, "Regulation of Fuels and Fuel Additives: Identification of Additional Qualifying Renewable Fuel Pathways Under the Renewable Fuel Standard Program, *Federal Register*, Vol. 78, No. 43 (March 5, 2013), pp. 14190–14217.

25 Action Aid USA et al., open letter to Members of the House Energy and Commerce Committee.

26 Ken G. Glozer, *Corn Ethanol: Who Pays? Who Benefits?* (Stanford, CA: Hoover Institution Press, 2011).

27 "Al Gore's Ethanol Epiphany," *The Wall Street Journal*, November 27, 2010, http://online.wsj.com/article/SB10001424052748703572404575634753486416076.html.

Politicians will support a bad policy that concentrates wealth in a select few who live in their districts or states. Even though the policy harms other American consumers and taxpayers, politicians claim they are creating jobs and economic growth in their states. Even if those politicians recognize the policy is bad for America, it is still in their perceived self-interest to support the policy to maintain support for the next election. That Vice President Gore could only speak the truth about corn ethanol once out of office speaks to the strong pull of the incentive facing all politicians to please the powerful interests that benefit from distorted energy markets.

Therein lies the problem with favoritism in politics. Bad rules remain on the books or are expanded because perceived political importance trumps sound policy. Such rent seeking, long recognized for its pernicious effects in economic literature, is especially common in the energy sector.[28]

Targeted tax credits for renewables, nuclear, coal, oil, and alternative transportation technologies are the clearest examples.[29] But loan guarantees and taxpayer-funded grants do the same. The billions in Department of Energy spending ostensibly aimed at the noble-sounding purpose of research for technologies to reduce carbon dioxide emissions, including energy efficiency technologies, renewable energy sources, carbon capture and sequestration, clean coal technologies, nuclear energy, and alternative-energy vehicles tend to benefit select companies with the savvy and connectedness needed to navigate the grant process. And the list goes on.

THE NUCLEAR INDUSTRY: A CASE STUDY OF GOVERNMENT MICROMANAGEMENT

The federal government's obtrusive approach to nuclear regulation is a perfect case study both of the costly impact of overregulation and of the ease with which the energy economy can become wholly dependent on government largesse.

Nuclear energy supplies 19 percent of America's electricity, exceeded by only coal and natural gas. It is reliable, affordable, and creates no greenhouse gas emissions. Nuclear plants—including their byproduct, nuclear waste—have relatively small physical footprints for the billions of kilowatts produced. America's nuclear plants are among the safest in the

28 Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies, and Theft," *Western Economic Journal*, Vol. 5, No. 3 (1967), pp. 224–232, and Anne O. Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review*, Vol. 64, No. 3 (June 1974), pp. 291–303.

29 Nicolas Loris, "EFEPA Eliminates Corporate Welfare and Corporate Dependence," Heritage Foundation *Issue Brief* No. 3828, January 15, 2013, http://www.heritage.org/research/reports/2013/01/energy-tax-credits-impact-of-energy-freedom-and-economic-prosperity.

world and on average provide $470 million in economic activity and 400–700 well-paying jobs per plant.[30]

Yet protracted permitting timetables, ill-conceived regulations, and other government-imposed market distortions create so much risk and price inflation that some believe the industry needs subsidies to compete and offset the negative impacts of these policies. The Nuclear Regulatory Commission operates under an outdated regulatory system that is not adaptable to new technology and designs, and it overregulates existing nuclear plants and technologies.[31]

Because navigating this expensive and onerous regulatory gauntlet is nearly impossible for any private company to do alone, the industry relies on taxpayer help. The Department of Energy pays for some projects and provides loans and loan guarantees to a lucky few to test technology or to build plants that the government finds promising. The subsidies give the nuclear industry enough money to partially offset the cost of bad regulatory policy, feed the Washington bureaucracy, and allow politicians to claim that they support nuclear power. In the end, commercially relevant nuclear technology stagnates because the incentives to reform the broken system have been removed.

Perhaps the largest barrier to the American commercial nuclear industry is what has—or more accurately, has not—been done with waste. The Department of Energy is responsible for collecting and disposing of waste from commercial nuclear plants, and the resulting government monopoly has played a significant role in choking new growth in domestic commercial nuclear energy by adding political inefficiency and uncertainty to the process. To date, the government has not collected any commercial spent nuclear fuel, and the national repository at Yucca Mountain remains unfinished.

The commercial nuclear industry has a lot to offer American customers in the way of safe, efficient, abundant, and inexpensive energy, but that will require removing politics and burdensome government policies from the picture and replacing them with free-market policies to unlock nuclear energy's potential. The same is true across the energy sector.

POLICY RECOMMENDATIONS

Limiting the government's involvement in the energy economy will reduce the burden imposed on families by energy prices, create more jobs by opening up the space for

30 Nuclear Energy Institute, "Nuclear Power Plants Benefit State and Local Economies," July 2014, http://www.nei.org/Master-Document-Folder/Backgrounders/Fact-Sheets/Nuclear-Power-Plants-Contribute-Significantly-to-S.

31 Jack Spencer, "Nuclear Waste Management: Minimum Requirements for Reforms and Legislation," Heritage Foundation *Issue Brief* No. 3888, March 28, 2013, http://www.heritage.org/research/reports/2013/03/nuclear-waste-management-minimum-requirements-for-reforms-and-legislation.

innovative technologies like fracking to emerge, and end the corrupt alliance between big-government regulators and the companies that rely on sweetheart deals negotiated by lobbyists and regulatory lawyers for success at the expense of the taxpayer. Though energy is already a promising bright spot in the American economy, it's also an area of enormous untapped potential for policymakers eager to improve life in America.

To that end, Congress should pursue an energy agenda built on some of the following ideas:

- **End energy handouts.** Congress should ensure that no taxpayer dollars go directly to energy production, storage, efficiency, infrastructure, or transportation for nongovernment consumers. While this type of spending is important, the private sector is better positioned to make the investments that would meet consumers' needs.

  Special tax treatment serves the same purpose as a subsidy that favors one industry. Congress should not create any new tax credits for energy production, energy infrastructure, transportation (production and consumption), or energy efficiency initiatives. Congress should expedite the sunsetting of existing tax credits and reduce other taxes by the amount of revenue generated by eliminating the tax credits. In addition to providing direct and indirect payments to energy companies through subsidies and tax breaks, the federal government is also heavily involved in providing favorable financing deals to energy firms. The rationale for these initiatives is that a gap exists between basic research and economic viability and that spending more taxpayer money will attract private investment for commercialization. But when the government attempts to drive technological commercialization, it circumvents the competitive process that properly assigns risks and rewards in an open market. By removing capital from the private sector to support government-favored projects, this intervention also creates a dependency on the taxpayer that can hinder innovation over the long term.

  The U.S. Export–Import Bank plays a similarly pernicious role, providing government-backed loans, loan guarantees, and capital and credit insurance to foreign firms to buy U.S. exports. Producers of energy technologies and equipment have been a significant beneficiary of the bank, accounting for 30 percent of the loans and guarantees in the past year. While the bank was designed to promote exports, it is corporate welfare that benefits politically connected companies, distorts markets, and saddles taxpayers with risk.[32] It should be allowed to expire.

32 Nicolas Loris, "Ending Ex-Im Would Remove Wasteful Energy Subsidies," Heritage Foundation *Issue Brief* No. 4229, May 28, 2014, http://www.heritage.org/research/reports/2014/05/ending-exim-would-remove-wasteful-energy-subsidies.

- **Open access to domestic and foreign markets.** With its wealth of natural resources, the U.S. could offer even more opportunities to reap the economic benefits of domestic production by opening federal lands and federal waters that are currently off limits to exploration and development. Furthermore, the recent growth in domestic energy production has positioned the United States to export more energy. Free trade is imperative to a free society because it fosters economic growth and improves human well-being. Policymakers should treat energy like any other good or service that is traded freely around the world by allowing U.S. producers to export more energy and therefore should lift restrictions on export of liquefied natural gas and crude oil.[33]

- **Repeal the Renewable Fuel Standard (RFS).** By requiring fuel blenders to use biofuels regardless of the cost, the RFS has made most Americans worse off through higher food and fuel expenses. The higher costs paid by American families benefit a select group of special interests that produce renewable fuels. Moreover, the federal government should not mandate which type of fuel drivers use in the first place. Congress should repeal the RFS and stand up to big agribusiness.

- **Prevent new efficiency mandates and restructure existing ones.** The economy does not need government mandates, rebate programs, or spending initiatives to make businesses and homeowners more energy efficient. Consumers can make those choices by themselves and the government should not override their choices by nudging them toward its preferred outcome. Ultimately, Congress should eliminate existing efficiency mandates or restructure them as voluntary standards.[34]

- **Restructure public power.** Federal utilities known as Power Marketing Administrations were set up to provide cheap electricity to rural areas. They can sell electricity at below-market rates because of their favorable financing terms, such as federal tax exemptions and loans at below-market interest rates. Their construction, rehabilitation, operation, and maintenance costs are financed through the main Department of Energy budget, offset collections, alternative financing, and a reimbursable agreement with the Bureau of Reclamation. Congress should also rethink the role of rural electric cooperatives, private organizations, in many cases nonprofit, that provide about 12 percent of the nation's electricity sales. RECs receive special tax exemptions and low-interest loans

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33 Nicolas Loris, "Energy Exports Promote Prosperity and Bolster National Security," Heritage Foundation *Backgrounder* No. 2931, July 23, 2014, http://www.heritage.org/research/reports/2014/07/energy-exports-promote-prosperity-and-bolster-national-security.

34 Nicolas Loris, "Government Energy-Efficiency Programs Are Subsidy-Laden Paternalism," Heritage Foundation *Backgrounder* No. 2832, August 1, 2013, http://www.heritage.org/research/reports/2013/08/government-energy-efficiency-programs-are-subsidy-laden-paternalism.

from the government. Congress should remove privileges for federal utilities, municipal power companies, and electricity cooperatives, and ultimately sell the Power Marketing Administrations to private buyers.[35]

- **Restructure insurance and risk mitigation.** Several government programs offer liability insurance schemes for specific industries. Proponents usually argue that these programs support industries that are vital to the national interest but so high-risk that they would be unprofitable without subsidies. Two examples are the $75 million liability cap for offshore oil and gas operations and the Price–Anderson Act of 1957, which provides a liability regime for the nuclear industry that extends through 2025. The free-market solution is generally to eliminate these subsidies, but given the broken tort system and increasingly onerous federal regulation, these subsidies often offset government-created risks. Any discussion of removing liability insurance subsidies should include proposals to ease the regulatory burden on the affected industries.[36]

- **Repeal the Jones Act.** Enacted nearly a century ago, the Jones Act mandates that any goods shipped by water between two points in the United States must be transported on a U.S.-built, U.S.-flagged, and at least 75 percent U.S.-crewed vessel. By preventing foreign competition, the Jones Act significantly increases domestic maritime shipping prices to the benefit of the American shipping industry, driving up costs for American businesses and consumers.[37]

- **Allow all energy projects to form master limited partnerships.** Master limited partnerships (MLPs) are taxed as limited partnerships but are publicly traded on the stock market. In the energy sector, the ability to form MLPs is available for mineral extraction, natural gas, oil, pipelines, geothermal, and the transportation and storage of ethanol, biodiesel, and other alternative fuels. Other renewable energy generation and commercial nuclear activities do not qualify. Congress should allow all energy project investors to form MLPs. Congress should also lower the corporate tax rate to encourage investment.[38]

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35 Ken G. Glozer, "Time for the Sun to Set on the Tennessee Valley Authority," Heritage Foundation *Backgrounder* No. 2904, May 5, 2014, http://www.heritage.org/research/reports/2014/05/time-for-the-sun-to-set-on-the-tennessee-valley-authority.

36 For a comprehensive solution to offshore oil spill liability, see Nicolas Loris, Jack Spencer, and James Jay Carafano, "Oil Spill Liability: A Plan for Reform," Heritage Foundation *Backgrounder* No. 2446, August 2, 2010, http://www.heritage.org/research/reports/2010/08/oil-spill-liability-a-plan-for-reform.

37 Brian Slattery, Bryan Riley, and Nicolas Loris, "Sink the Jones Act: Restoring America's Competitive Advantage in Maritime-Related Industries," Heritage Foundation *Backgrounder* No. 2886, May 22, 2014, http://www.heritage.org/research/reports/2014/05/sink-the-jones-act-restoring-americas-competitive-advantage-in-maritime-related-industries.

38 Nicolas Loris, "Master Limited Partnerships and Renewable Energy Producers," Heritage Foundation *Issue Brief* No. 3922, April 24, 2013, http://www.heritage.org/research/reports/2013/04/master-limited-partnerships-and-renewable-energy-producers.

- **Prohibit regulations that drive out energy sources for little to no environmental benefit.** The federal government has implemented stringent regulations that disproportionately affect certain energy sources or technologies. For instance, the Environmental Protection Agency's New Source Performance Standards for new power plants set greenhouse gas emission regulations so stringent that they effectively prohibit construction of new coal-fired power plants.[39] By significantly reducing the use of coal, the EPA's greenhouse gas regulations will drive up energy costs for American families for no meaningful benefit.[40] Pollution should not go unchecked, but the EPA continually misrepresents costs, exaggerates benefits, and uses unsound science to justify unreasonably burdensome regulations that target particular energy sources.[41]

- **Finish the permit application for the Yucca Mountain nuclear materials repository.** Any sustainable, long-term solution for nuclear waste management requires geologic storage. Taxpayers have spent more than $15 billion on the Yucca Mountain site, and no technical or scientific evidence has yet disqualified it as a viable option. The Nuclear Regulatory Commission should complete its review of the permit application.[42]

- **Remove the responsibility for nuclear waste management from the federal government.** Like other commercial for-profit endeavors, nuclear power companies, not the government, should be responsible for the waste they produce. The private sector should be allowed to compete with a government-operated waste management service. Market-based pricing would allow the true costs of nuclear power to be known, spur innovation in waste management, and enable nuclear power companies to choose services that make the most sense for their customers and shareholders.[43]

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39 Nicolas Loris, "EPA Proposes Next Step of Regulatory Cap-and-Trade," Heritage Foundation *Issue Brief* No. 4232, June 3, 2014, http://www.heritage.org/research/reports/2014/06/epa-proposes-next-step-of-regulatory-cap-and-trade.

40 Chip Knappenberger, "Climate Impacts of Waxman–Markey (Part II)—Global Sign-Up," Master Resource, May 7, 2009, https://www.masterresource.org/climate-policy/part-ii-a-climate-analysis-of-the-waxman-markey-climate-bill-what-if-the-world-played-along/.

41 U.S. Senate, Committee on Environment and Public Works, Minority Staff, *EPA's Playbook Unveiled: A Story of Fraud, Deceit, and Secret Science*, March 19, 2014, http://www.epw.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=b90f742e-b797-4a82-a0a3-e6848467832a.

42 Jack Spencer, "Yucca Mountain and Nuclear Waste: A New Beginning?" Heritage Foundation *WebMemo* No. 3085, December 16, 2010, http://www.heritage.org/research/reports/2010/12/yucca-mountain-and-nuclear-waste-policy-a-new-beginning.

43 Jack Spencer, "Blue Ribbon Commission on Nuclear Waste: Missing Opportunity for Lasting Reform," Heritage Foundation *Backgrounder* No. 2600, August 22, 2011, http://www.heritage.org/research/reports/2011/08/blue-ribbon-commission-on-nuclear-waste-missing-opportunity-for-lasting-reform.

CONCLUSION

Both federal and state governments have other mechanisms that play energy favorites. For instance, some states have renewable portfolio standards that mandate meeting a certain percentage of their electricity with renewables, which guarantees a market for renewable energy. Rather than attempting to "level the playing field" by out-subsidizing one another for specific energy beneficiaries, federal and state government should remove all market distortions. If implemented, these policy reforms would go a long way toward removing the privileges that various special interests receive because of their political connections and create opportunities for all market participants. It's time for energy policy to reflect the interests of all Americans, not a select few special interests that know how to game the regulatory system. It's time for a free market energy economy.

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* A version of this essay was published previously as "Free Markets Supply Affordable Energy and a Clean Environment," Heritage Foundation *Backgrounder* No. 2966, October 31, 2014, http://www.heritage.org/research/reports/2014/10/free-markets-supply-affordable-energy-and-a-clean-environment.

FEDERALISM AND EDUCATION: PRE-K-12

Lindsey M. Burke

For conservatives, education reform has been a policy bright spot, with the mainstream debate increasingly focusing on concepts rooted in conservative principles. Many reform advocates embrace conservative ideas on education choice and have drawn attention to the pernicious effects of teachers' unions on education. That conservatives have made such progress on a policy debate of critical importance to the next generation of Americans is unambiguously good news.

That said, despite the victories conservatives have achieved, there is much work yet to be done. Although those engaged in education reform in and out of government have recognized the need to improve performance and increase education choice, some reformers have endorsed prescriptive means of forcing change at the local level. These proponents of federal coercion and mandates are often guilty of the single-instance fallacy, recognizing achievements accomplished on a small scale and rushing to nationalize success, without appreciating the difficulty of replication, the value of local experimentation, and the significance of federalism. They have come to view education reform as a national policy question, failing to recognize the advantages of allowing communities the freedom to develop their own approaches, or to recognize that those people closest to the students are best equipped to direct dollars and decision-making.

Local control should not be a peripheral concern in the education debate; it is central to the conservative vision.

Local control should not be a peripheral concern in the education debate; it is central to the conservative vision. As Congress considers various approaches to reforming federal education policy, a guiding principle should be to pursue reforms that situate dollars and decision-making closer to the student. Decisions about education policy and spending are best made by those who can see firsthand the costs and benefits of those decisions and who can be responsive to parents and other taxpayers. This does not mean conservatives should abandon the debate in Congress; far from it. Rather, conservatives should advance reforms that reduce federal intervention while simultaneously championing policies that empower parents themselves rather than far-off federal bureaucrats, who too often conflate federal regulation and accountability.

EARLY CHILDHOOD CARE AND EDUCATION

The Obama Administration, along with other federal policymakers, is engaging in a renewed push for federally financed universal preschool. Senator Tom Harkin and Representative George Miller introduced the Strong Start for America's Children Act, which would create a federally funded, universal preschool program for all four-year-old children from low- to moderate-income families around the country.[1] The proposal aligns with President Obama's call for a new $75 billion federal preschool program.[2] Both the Administration and liberals in Congress have also continued to push for an expansion of the federal Head Start program. These efforts stem from a belief that the federal government can and should direct the education and care of the youngest children from "cradle-to-career."[3]

The federal government currently operates 45 early learning and childcare programs. Taxpayers spend more than $20 billion annually to finance them.[4] In all, between two-thirds and three-quarters of four-year-old children are already enrolled in some form of preschool or care program.[5] Moreover, the vast majority of states already offer subsidized pre-kindergarten for children from low-income families. Given the already extensive involvement of the federal and state governments, efforts to grow government preschool programs would be duplicative of existing options, serving more to create an unnecessary preschool subsidy for middle- and upper-income families than to assist struggling families with unmet needs.

In addition to the redundancy of its efforts, the federal government has been particularly ineffective at providing quality preschool options to children, with its flagship preschool program—Head Start—having failed for decades to meet the program's goal of kindergarten readiness for children from low-income families. In December 2012, the Department of Health and Human Services, the agency that administers Head Start,

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1 News release, "U.S. Education Secretary Arne Duncan to Join Sen. Harkin, Rep. Miller, Rep. Hanna and Actress Jennifer Garner to Unveil Bipartisan Proposal to Expand Access to High-Quality Early Education Programs," U.S. Department of Education, November 13, 2013, http://www.ed.gov/news/media-advisories/us-education-secretary-arne-duncan-join-sen-harkin-rep-miller-rep-hanna-and-ac.

2 "Early Learning: America's Middle Class Promise Begins Early," U.S. Department of Education, http://www.ed.gov/early-learning.

3 Arne Duncan, "Remarks by U.S. Secretary of Education Arne Duncan at the National Academy Foundation NEXT Conference," U.S. Department of Education, July 17, 2012, http://www.ed.gov/news/speeches/remarks-us-secretary-education-arne-duncan-national-academy-foundation-next-conference.

4 Kay E. Brown, Government Accountability Office, "Federal Funds Support Multiple Programs with Similar Goals," testimony before the Committee on Education and the Workforce, U.S. House of Representatives, February 5, 2014, http://www.gao.gov/assets/670/660690.txt.

5 Enrollment of 3-, 4-, and 5-year-old children in preprimary programs, by level of program, control of program, and attendance status: Selected years, 1965 through 2012, Digest of Education Statistics 2013, National Center for Education Statistics, U.S. Department of Education, http://nces.ed.gov/programs/digest/d13/tables/dt13_202.10.asp, and W. Steven Barnett, Megan E. Carolan, James H. Squires, and Kirsty Clarke Brown, "The State of Preschool 2011: State Preschool Yearbook," The National Institute for Early Education Research, Rutgers Graduate School of Education, 2011, http://nieer.org/sites/nieer/files/2011yearbook.pdf.

released a scientifically rigorous evaluation of more than 5,000 children participating in the program. It found that Head Start had little to no impact on the cognitive abilities, social-emotional well-being, health, or parenting practices of participants.[6]

For their part, at the federal level, conservatives in Congress have rightly been skeptical of the wisdom of increasing federally funded early childhood education and care. They have been less willing, however, to acknowledge the shortcomings of Head Start, or to tackle those shortcomings legislatively. Instead of expanding the reach of government into early childhood education and care, policymakers can serve families and children best by maintaining a robust marketplace of private preschool providers. Head Start has failed to deliver on its promises, and children from low-income families deserve better than to be relegated to distant and unresponsive federal preschool programs. Growing federal or state involvement constricts that marketplace by forcing private and home-based providers to compete with "free" government programs. Policymakers should propose alternatives to the existing Head Start model and eliminate ineffective and duplicative federal preschool programs, replacing them with policies that empower more families to save for preschool, such as allowing preschool savings to be eligible for 529 tax treatment.

K-12 EDUCATION

Conservatives are winning the debate on school choice. Reforms adopted by states and school districts across the country increasingly reflect this outlook for K-12 education. State after state is creating options for parents out of recognition that choice, rather than monopolistic residential assignment schooling, will provide better opportunity for families.

Today, more than 300,000 students have access to private school choice programs in 24 states and the District of Columbia.[7] When deductions to help finance school choice options such as homeschooling are included, more than 1 million children are benefiting from school choice policies.[8] More than 3 million students across the country are now enrolled in public charter schools, and online learning is helping to ensure students have access to quality course content no matter where they live.[9]

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6 Mike Puma, Stephen Bell, Ronna Cook, Camilla Heid, Pam Broene, Frank Jenkins, Andrew Mashburn, and Jason Downer, "Third Grade Follow-up to the Head Start Impact Study Final Report, Executive Summary," OPRE Report # 2012-45b, Office of Planning, Research and Evaluation, Administration for Children and Families, U.S. Department of Health and Human Services, 2012, http://www.acf.hhs.gov/sites/default/files/opre/head_start_executive_summary.pdf.

7 Virginia Walden Ford, "School Choice Spreads … and So Does Hope," Jennifer A. Marshall and Rea S. Hederman, *2014 Index of Culture and Opportunity* (Washington, DC: The Heritage Foundation, 2014), p. 63, http://index.heritage.org/culture/overview-of-2014-index/.

8 *Ibid*.

9 "Get the Facts," National Alliance for Public Charter Schools, http://www.publiccharters.org/get-the-facts/.

Meanwhile, reformers at the state and local level are developing a new generation of choice policies. States like Louisiana are pioneering experiments in course choice, giving parents a new level of flexibility to tailor learning options to their children's particular needs.[10] Additionally, innovative financing options such as education savings accounts (ESAs), introduced in Arizona in 2011 and adopted by Florida in 2014, are enabling parents to customize their children's educational experience completely, by allowing them to direct every dollar of their child's state education funding to multiple education services, products, and providers of choice, such as private school tuition, educational therapies, online learning, and textbooks. ESAs also enable parents to rollover unused funds from year-to-year and to roll funding into a college savings account.[11]

These initiatives increasing parental choice represent a positive development, possible because states and local leaders have the flexibility to chart new, innovative paths in education financing. Unfortunately, though, the longer-term trend in education policy has favored increased federal involvement in education, generally at the expense of parental and local control.

FEDERAL INVOLVEMENT INCREASES OVER TIME.

In 1965, President Lyndon B. Johnson signed the Elementary and Secondary Education Act (ESEA) into law as the education component of his "Great Society" initiative. The ESEA's primary purpose was to authorize the federal government to engage in so-called "compensatory spending," providing approximately $1 billion in federal formula grants to states with high concentrations of children from low-income families. At just 32 pages and comprising 5 titles, the ESEA in 1965 was a relatively modest bill. But the law ultimately laid the groundwork for a litany of new programs and spending in the decades to follow, as the federal government quickly shifted from compensatory education policy to efforts at broader, more prescriptive and systemic education reform from Washington.

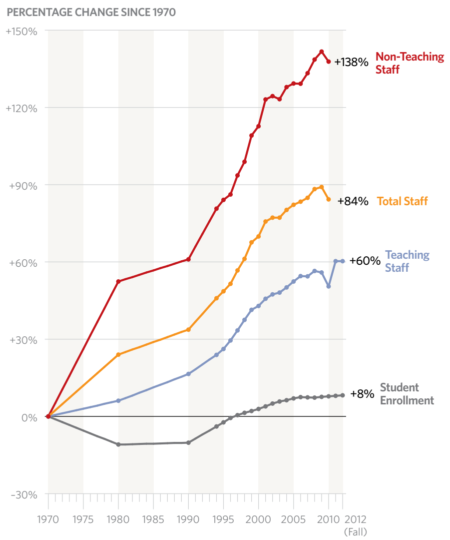
The federal government accelerated the push for comprehensive federal school reform under the Clinton Administration, and to a much greater extent, under the George W. Bush Administration with the advent of No Child Left Behind—the seventh reauthorization of Johnson's original ESEA. That law was built on federally mandated annual state assessments of children in grades three through eight, and once in high school, federal reporting requirements, and public school district scorecards meant to ensure accountability. But like any well-intentioned, massive regulatory structure, the law had unintended

10 Erik W. Robelen, "Louisiana's 'Course Choice' Program Gets Underway," *Education Week*, August 28, 2013, http://www.edweek.org/ew/articles/2013/08/28/02courses_ep.h33.html.

11 Brittany Corona, "These Lucky Parents Get To Control Their Kids' State Education Money," *The Federalist*, September 9, 2014, http://thefederalist.com/2014/09/09/these-lucky-parents-get-to-control-their-kids-state-education-money/.

Growth in Education Staffing Has Far Outpaced Student Enrollment

*Since 1970, total student enrollment in public schools increased by 3.7 million, or **8 percent.** However, during that same period, total education staffing rose by 2.8 million, or **84 percent.** Most notable was the growth in non-teaching staff which increased by **138 percent.***



Notes: Some figures have been interpolated. Figures for teachers and student enrollment for 2011 and Fall 2012 are projected.

Source: National Center for Education Statistics.

Education heritage.org

consequences. By requiring universal proficiency of all students within each state in core subjects, but leaving wide latitude to states to define proficiency, NCLB encouraged states to water down their assessments. The result: more resources devoted to compliance with federal regulation.[12]

Years of well-intentioned reforms like NCLB have contributed to the massive growth in federal intervention in the decades since the ESEA's enactment, resulting in roughly 100 federal education programs, the vast majority of which are housed at the U.S. Department of Education. The growth in federal education programs has been accompanied by a near tripling of inflation-adjusted federal per-pupil expenditures since the 1970s. Yet that spending is less directly related to teaching: while teachers once held over 70 percent of education jobs, today the teacher to non-teacher ratio in education has declined to 1:1, driven by the administrative burdens created in part by federal micromanagement.[13]

Unfortunately, the growth of federal intervention in education has not been followed by growth in student achievement and attainment. Mathematics and reading achievement of 17-year-old students has been stagnant over the past 40 years, as measured by the U.S. Department of Education.[14] Achievement gaps between children from low-income families and their more affluent peers, and between white and minority students, also persist. American students rank in the middle of the pack of their international peers in

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12 Lindsey Burke, "The Student Success Act: Reforming Federal Accountability Requirements Under No Child Left Behind," Heritage Foundation *Backgrounder* No. 3461, January 17, 2012, http://www.heritage.org/research/reports/2012/01/student-success-act-reforming-no-child-left-behind

13 National Center for Education Statistics, Digest of Education Statistics, "Staff employed in public elementary and secondary school systems, by functional area: Selected years, 1949–50 through fall 2009," Table 85, http://nces.ed.gov/programs/digest/d11/tables/dt11_085.asp, and National Center for Education Statistics, "Public Elementary and Secondary School Student Enrollment and Staff Counts From the Common Core of Data: School Year 2010–11," Table 3, http://nces.ed.gov/pubs2012/snf201011/tables/table_03.asp.

14 National Center for Education Statistics (2013). *The Nation's Report Card: Trends in Academic Progress 2012* (NCES 2013-456). National Center for Education Statistics, Institute of Education Sciences, U.S. Department of Education, http://nces.ed.gov/programs/coe/indicator_cnj.asp.

mathematics and reading achievement as measured by international assessments such as the Program for International Student Assessment (PISA) and the Trends in International Math and Science Survey (TIMSS). On the PISA exam, for example, U.S. students scored lower in mathematics than 29 education systems, lower in science than 22 education systems, and lower in reading than 19 education systems in 2012.[15] Academic attainment as measured by high school graduation rates has also languished for disadvantaged students since the 1970s.[16]

Despite this track record, federal intervention in education has continued to grow over the decades. For its part, the Obama Administration has continued by working outside of the normal legislative process. Acknowledging the unworkable nature of some of the NCLB mandates, it has instead used waivers from such onerous provisions to incentivize states' adoption of the even more centralizing White House-preferred education policies. It was via this non-legislative mechanism that the Obama Administration enticed states to adopt federally funded Common Core standards and tests, defining the content that will be taught in every public school across the country. With the alignment of the SAT and ACT college entrance exams and the GED high school equivalency exam, even private schooled and homeschooled students are being impacted by Common Core.

A DIFFERENT PATH

Opposition by parents, teachers, and taxpayers to Common Core national standards and tests has grown significantly. Four states, under the direction of conservative leadership, have exited Common Core in recent months. Yet more than 40 states remain entangled in the federally funded effort, many with otherwise conservative governors and legislatures.

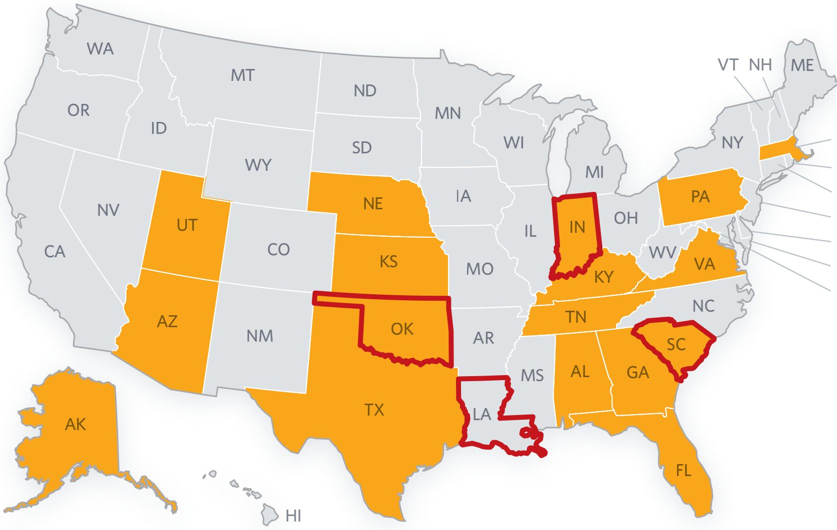
In this respect, the public has been ahead of the policymakers. But past mistakes do not preclude Congress from trying new approaches that empower the local actors most responsive to parents and taxpayers. In order to restore dollars and decision-making to the state and local levels, federal policymakers should eliminate ineffective and duplicative federal programs and, when appropriate, advance education choice within the existing framework of certain federal programs.

Policymakers should work to reduce federal intervention in a way that more closely mirrors the earlier goal of compensatory education through Title I of the ESEA and through IDEA, and then allow states to make those dollars portable. Transitioning these grant programs into student-centered funding options for states would help better target

15 D. Kelly, H. Xie, C.W. Nord, F. Jenkins, J.Y. Chan, and D. Kastberg, (2013), *Performance of U.S. 15-Year-Old Students in Mathematics, Science, and Reading Literacy in an International Context: First Look at PISA 2012* (NCES 2014-024), U.S. Department of Education, Washington, DC: National Center for Education Statistics, http://nces.ed.gov/pubs2014/2014024rev.pdf.

16 Jennifer A. Marshall and Rea S. Hederman, *2014 Index of Culture and Opportunity* (Washington, DC: The Heritage Foundation, 2014), p. 63, http://index.heritage.org/culture/overview-of-2014-index/.

More States Rejecting Common Core



State pushing back against Common Core	Never adopted	Paused implementation	Downgraded participation in or withdrew from national tests	Exited Common Core and reclaimed standard-setting autonomy
Alabama			X	
Alaska	X		X	
Arizona			X	
Florida			X	
Georgia			X	
Indiana		X	X	☐
Kansas			X	
Kentucky			X	
Louisiana				☐
Massachusetts		X		
Nebraska	X			
Oklahoma			X	☐
Pennsylvania		X	X	
South Carolina			X	☐
Tennessee			X	
Texas	X			
Utah			X	
Virginia	X			

Note: Pennsylvania has resumed implementation.

Source Heritage Foundation research as of June 2014.

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resources and empower parents with additional choices, within the confines of the federal government's earlier purpose of providing additional funding to states for disadvantaged children.

Congress can also advance choice in education through an expanded D.C. Opportunity Scholarship Program and through reforms to existing Coverdell K-12 and 529 College savings accounts.

These federal proposals to advance parental choice in education are consistent with the goal of limiting rather than growing federal intervention in education. By contrast, launching a new standalone federal school choice program, while well intentioned, is a misguided proposal. It would create a new federal intervention in education, while making private schools increasingly dependent on federal funding, and as a result, subject to federal mandates and regulations.

POLICY RECOMMENDATIONS

We are at a historic turning point in education policy. Choice and localism have, at long last, the potential to prevail over prescription and overregulation. Conservative policymakers are coming to recognize that accountability is not synonymous with centralized regulation. Conservatives must continue to fight for progress in education reform if the tide if it is truly to recede.

NEW IDEAS ON PRE-K

Ensuring dollars and decision-making stay close to home begins with the education policy that impacts children's earliest years. Proposals to spend billions on new federal preschool programs are largely duplicative of the existing robust network of preschool and childcare providers. Such proposals also threaten to crowd out the private provision of care and would provide subsidies to many families who have already found preschool options absent a large new government program. Moreover, federal preschool and day care would make families increasingly dependent on distant federal programs, which have historically performed poorly for the children they are supposed to serve. Therefore, federal policymakers should:

- **Sunset Head Start.** The federal Head Start program has failed to live up to its stated mission of improving kindergarten readiness for children from low-income families. Therefore, Congress should sunset Head Start over a period of 10 years, appropriating 90 percent of the program's FY 2015 funding in FY 2016, 80 percent of FY 2015 funding in 2017, etc., until federal funding for Head Start is eliminated in 10 years. The sunset provision will provide states with adequate time to determine whether they need to provide additional state funding to subsidize day care for low-income families.

The 10-year phase-out would allow time for states to ensure that children of truly needy families who were previously eligible for Head Start would have access to preschool and day care, through state or local subsidies, when necessary. This is a reasonable change in view of the fact that, among four-year-old children utilizing subsidized preschool and day care, just 10 percent use federal Head Start services, while 28 percent nationally take advantage of state-funded preschool options.[17]

One strategy for a non-disruptive phase-out would be for states to better target existing state preschool spending toward programs for those children from low-income families who are the most needy. By and large, middle- and upper-income families have found preschool and childcare options independent of state subsidies. Making any state subsidies available only to children from low-income families would ensure taxpayer dollars are spent wisely and would help prevent crowd-out of the private preschool market (which helps to keep prices low for all families).

Moreover, as Head Start is phased out over a 10-year period, and as states begin to manage the care of those children who were previously enrolled in the federal program, states will be able to shoulder the enrollment by funding former Head Start slots at a lower per-child cost. Currently, states spend approximately $4,600 per child in state-funded preschool programs. Head Start spending per pupil reached $7,700 per child in 2013.[18] As such, the federal program spends, on average, $3,000 more per child in preschool than state programs. Given the vast disparity, states could likely manage the new enrollments from Head Start at a far more modest cost. In assuming Head Start enrollments into state programs, states should set the per-pupil spending amount at their respective state averages—not the $7,700 per-child average of the federal program—which would mean that states could likely spend, cumulatively, $2.3 billion less to cover Head Start slots than the federal government spends.

As states assume a larger role in providing the services the federal Head Start program did, they should configure state preschool programs to allow dollars to be portable, following children to a private preschool provider of choice.

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17 W. Steven Barnett, Megan E. Carolan, James H. Squires, and Kirsty Clarke Brown, "The State of Preschool 2011: State Preschool Yearbook," The National Institute for Early Education Research, Rutgers Graduate School of Education, 2011, http://nieer.org/sites/nieer/files/2011yearbook.pdf.

18 *Ibid.*

Head Start has failed to meet its stated goal of kindergarten readiness over the past half century and has been a costly experiment in the federal provision of preschool. States and local school districts can be better, more responsive providers of preschool and daycare than the distant federal Head Start program has been.

- **Eliminate the dozens of federal pre-K spending initiatives and programs that do not have preschool or childcare as an explicit purpose.** The federal government currently operates 45 early learning and childcare programs, of which only 12 have as an explicit purpose to provide early childhood education and care. The remaining 33 programs permit funds to be used for such initiatives. Total federal pre-K spending (including Head Start) exceeds $20 billion annually. Policymakers can better target preschool and childcare resources by eliminating many of these programs. By curtailing federal preschool spending to fund just the 12 preschool programs for which preschool is an explicit purpose, policymakers can take a first step toward streamlining federal preschool spending to ensure it serves the most needy families.

- **Allow pre-K expenses to be 529-eligible**. Expanding section 529 of the Internal Revenue Code to allow families to save for preschool expenses would provide new incentives for families to save for their young children's education and care and would increase their ability to pay for educational options. As Heritage has previously written, 529 college savings accounts allow families to save money without federal tax penalties. These savings plans are municipal securities regulated by states, and contributions are largely managed by private investment firms. A number of states also allow interest earned on 529 accounts to accrue without state tax penalty. Additionally, money can be withdrawn from a 529 account without tax penalty as long as the money is used to pay for higher-education expenses: college tuition, textbooks, and other college expenses.[19] Providing the same tax treatment of preschool expenses could enable families to save more for their children's anticipated early education and care expenses.

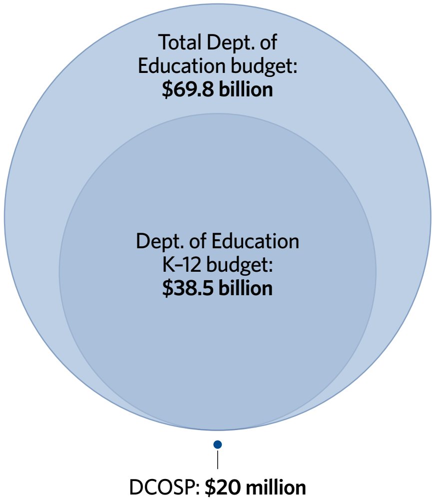
FEDERALISM AND CHOICE, NOT MANDATES, FOR K-12

As with early childhood education and care, decisions about education policy and spending are best made at the most local level possible. Policymakers should restore dollars and decision-making to states and localities by cutting spending and program count at the federal level and by enabling funding for disadvantaged children and children with special needs to be student-centered and portable. In order to restore education decision-making authority to states and local school districts, federal policymakers should:

19 Lindsey Burke and Rachel Sheffield, "13 Ways the 113th Congress Can Improve Education in America," The Heritage Foundation, May 15, 2013, http://www.heritage.org/research/reports/2013/05/13-ways-the-113th-congress-can-improve-education-in-america.

Making Choices in Education Spending

The D.C. Opportunity Scholarship Program (DCOSP), which falls under the jurisdiction of Congress, is a successful voucher program that provides scholarships to low-income children in Washington, D.C., to attend a private school of choice. The Obama Administration would eliminate this program while continuing to spend billions of dollars on many ineffective and duplicative education programs.



Note: Department of Education figures are for FY 2013.
Sources: U.S. Department of Education, "Fiscal Year 2013 Budget, Summary and Background Information"; "Digest for H.R. 471," 112th Congress, 1st Session, GOP.gov, at http://www.gop.gov/bill/112/1/hr471 (accessed April 9, 2012); and Office of Management and Budget, "Budget of the U.S. Government, Fiscal Year 2013," Appendix, p. 1321, at http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/appendix.pdf (accessed April 9, 2012).

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- **Grow the D.C. Opportunity Scholarship Program and aid D.C.'s transition to an all-charter school district.** This school year, the city of New Orleans has become the nation's first all-charter school district. One hundred percent of students in the once severely underperforming school district will be enrolled in schools of choice. As home to the second-highest proportion of students enrolled in public charter schools in the country (44 percent), Washington, D.C., is not far behind. Federal policymakers are in a unique position to continue momentum for charter schools in D.C. since the nation's capital falls under the jurisdiction of Congress.

  Policymakers can advance this goal through existing funding authorized through the D.C. School Choice Incentive Act, most recently reauthorized as the Students for Opportunity and Results (SOAR) Act. These bills created and continued the D.C. Opportunity Scholarship Program (OSP), which provides vouchers to children from low-income families in Washington, D.C., to attend private schools of choice. When the D.C. OSP was created in 2003, members of Congress funded the new school choice option through a "three-sector" approach: $20 million in funding for the D.C. OSP, $20 million in supplemental funding for D.C.'s public charter schools, and an additional $20 million for the D.C. Public School system. These additional finances for public and charter schools were tied to the OSP to help gather political support for the new program.

As charter schools become increasingly popular options for parents, federal policymakers could shift a portion of the additional federal funding provided to traditional public schools in the “three-sector” approach to charter schools and to additional vouchers for students to attend private schools of choice.

- **Allow states to make funding for Title I and IDEA portable.** Title I of ESEA authorizes federal funding for low-income school districts. Instead of continuing to funnel federal dollars through the Title I program to states and then school districts, states should have the option to make their Title I dollars portable, following students to private schools of choice. Similarly, states should be empowered to make Individuals with Disabilities Education Act (IDEA) funds portable, following children with special needs to the public or private education providers they choose. Transitioning these grant programs into student-centered funding options for states would help better target resources and empower parents with additional choices, within the confines of the compensatory funding model that motivated the federal government’s earlier effort at providing additional funding to states for disadvantaged children. Portability of funding would help these two largest federal programs for children from low-income families and students with special needs work better for those populations.

- **Abolish the cap on Coverdell Education Savings Accounts; allow K-12 expenses to be 529 eligible.** Federal policymakers also have an opportunity to shape federal tax policy to support choice in education. Congress should eliminate the cap on contributions to Coverdell savings accounts and extend 529 college savings account tax treatment to pre-K-12 education expenses. Coverdell savings accounts help families save for their children’s K-12 education expenses (such as private school tuition) by allowing interest earned in the accounts to accrue tax-free, as long as it is put toward approved education expenditures. Coverdell accounts provide a smart savings mechanism for families interested in paying for their children’s K-12 education, helping to advance choice in education. The accounts, however, are capped at $2,000 in annual contributions. The cap on Coverdell accounts should be eliminated. At the same time, 529 college savings accounts, which allow families to save money without federal tax penalties, should be expanded to extend the same tax treatment to pre-K-12 education expenses.

- **Stop the education spending spree and eliminate ineffective and duplicative programs.** Federal policymakers interested in limiting and better targeting education spending should work to streamline the existing labyrinth of federal education programs. All federal competitive grant programs authorized under ESEA should be eliminated, starting with those that are duplicative and ineffective. Federal spending should be reduced to reflect remaining formula programs authorized under Title I of ESEA, IDEA, and the handful of other programs that do not fall under the competitive grant category.

- **Advance the A-PLUS approach to restore state and local education autonomy.** The Academic Partnerships Lead Us to Success (A-PLUS) Act would allow states to completely opt out of the programs that fall under NCLB and to direct dollars to any lawful education purpose under state law. The A-PLUS approach, which has been advanced by conservatives in Congress over the past decade, would give states complete flexibility with the funding (roughly $23 billion) currently authorized under NCLB. The combination of advancing A-PLUS while eliminating ineffective and duplicative programs ultimately means that NCLB would no longer be used as the vehicle to drive K-12 education policy from the federal government. Such an approach would phase down the federal government's intervention to its original scope of compensatory education: distributing federal formula grants to states based on the proportion of low-income children and those with special needs.

- **Reject efforts to establish national standards and tests.** Conservatives in Congress should also remain vigilant against efforts to establish national standards and tests. The Obama Administration has awarded waivers from No Child Left Behind and billions in grant dollars to states willing to adopt standards that are "common to a significant number of states," largely understood to mean Common Core. This effort to establish national standards and tests would significantly grow federal intervention in education and runs counter to the spirit of the Department of Education Organization Act, the General Education Provisions Act, and the ESEA, all of which prohibit the federal government's involvement in, or direction of, curriculum. Congress should reject any additional efforts to appropriate funding to advance national standards and tests.

CONCLUSION

Reforms to pre-K-12 education policy should be guided by the goal of situating dollars and decision-making as close as possible to the student. Local leaders in schools and cities are far likelier than distant federal policymakers to be responsive to parents and other taxpayers. To achieve that goal, Congress should limit federal intervention in and spending on preschool and child care programs, eliminate ineffective and duplicative K-12 programs, and advance education choice, as appropriate.

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BEYOND STUDENT LOANS AND GRANTS: CHANGING THE GAME ON HIGHER EDUCATION

Lindsey M. Burke

In the aftermath of the Great Recession, few impediments to opportunity loom larger for young people than student loan debt. Most students graduate from college with tens of thousands of dollars in debt to their names—an especially heavy burden given the difficulties they continue to face in the post-2008 labor market. Yet for all the money Americans spend on higher education, the value of a college degree is hardly a clear proposition. Given the waste, both in terms of administrative costs and frivolous coursework, at many four-year institutions, students are increasingly turning to new options like online courses to trim the fat, learning precisely what they want without wasting money to subsidize university largesse. But these options remain unconventional for a reason: because their legitimacy is not recognized by the accreditation system bearing the federal imprimatur, they are at a major disadvantage in the higher education market.

This system does not persist because it is efficient. It remains because it serves the special interests of the higher education industry. Old models remain entrenched through the arbitrary legal advantage they receive under the existing accreditation regime, and students seeking jobs that require traditional degrees have no choice but to shoulder the cost.

Given the clear need for reform, why has Congress failed to act? The answer, in part, is that the debate over higher education has become stagnant, dominated by discussions of small-bore reforms that would only contribute to the problems in the market rather than solving them. This is a debate conservatives would do well to disrupt.

THE STAGNANT INTEREST-RATE DEBATE

For the past several decades, the higher education cost conversation has been defined by the debate over whether or not to increase federal student loans and grants.

Despite the fact that an open spigot of federal student aid has only exacerbated the college cost problem, Congress has consistently increased loan subsidies, expanded access to need-based grants such as Pell, and provided for generous caps on debt repayment, which can lead to a portion of a student's loans being forgiven entirely by taxpayers. By keeping interest rates artificially low or expanding eligibility for Pell Grants beyond those students most in need, policymakers contribute to increases in college costs over time.

Big government policies like a "millionaire's tax" to finance student loan forgiveness will do nothing to solve the college cost crisis in the long term. Similarly, other short-term fixes, such as capping monthly loan payments, will only serve as band-aids for college costs while giving license to universities to continue to spend profligately, confident that the federal government—via the three-quarters of taxpayers who don't hold bachelor's degrees themselves—will continue to pick up the tab.

Too often, these short-term "fixes" monopolize what little discussion there is in Congress on higher education. And the rhetoric surrounding these ideas is far loftier than is merited by their potential impact. In 2012, the New America Foundation calculated that preventing the then-current rate of 3.4 percent from jumping to 6.8 percent would in practice amount to a nine dollar difference in monthly loan payments.[1] Yet the potential for a rate increase was pitched in cataclysmic terms. In 2013, Sen. Harry Reid called a potential interest rate increase "unfathomable."[2] Students "don't want us to double their debt," insisted Rep. George Miller on the House floor, even though it would have been interest rates, not debt, that were set to double.[3]

Ultimately, Congress agreed to tie rates on federal student loans to the 10-year Treasury note, with an annual rate reset on July 1. But the debate that preceded that outcome was illustrative of how Congress has historically faced higher education issues and the stasis that restricts more significant debates from taking place.

The left succeeds in pushing ideas that at best tinker at the margins of higher education reform and at worst exacerbate the college cost problem by presenting its own case in populist terms. "This country invests in tax loopholes for billionaires," claims Sen. Elizabeth Warren, "and forces college students to pay for them through higher interest rates on their loans. That makes no sense at all."[4] Such appeals might resonate with a young, college-going audience, but that doesn't mean that the right should accept the terms of the debate as set by the left and the media. If conservatives are going to make inroads into higher education, they need a coherent counter-narrative—one that highlights the gross margins currently enjoyed

1 Claire McCann, "House Democrats' Data on Student Loan Interest Rates Misrepresent the Problem," New America Foundation, April 5, 2012, http://edmoney.newamerica.net/blogposts/2012/house_democrats_data_on_student_loan_interest_rates_misrepresent_the_problem-66133.

2 Jonathan Weisman, "Deadline Near With No Deal on Loan Rates for Students," *The New York Times*, June 26, 2013, http://www.nytimes.com/2013/06/27/education/deadline-near-with-no-deal-on-loan-rates-for-students.html.

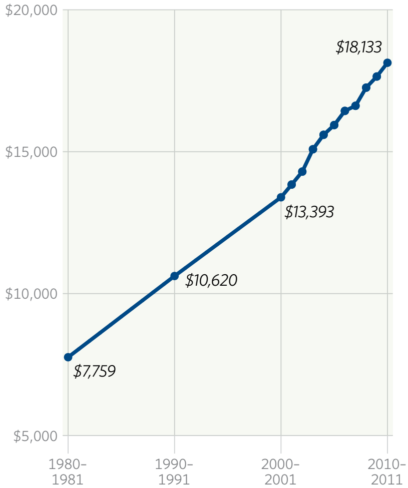
3 George Miller, "Rep. Miller Calls for Action on Student Loan Interst Rates - 6.26.2013," Youtube, http://www.youtube.com/watch?v=5_p7GDa1Al4.

4 Tim Dickinson, "The Student Loan Crusader: How Elizabeth Warren Wants to Reduce Debt," *Rolling Stone,* August 20, 2014, http://www.rollingstone.com/politics/news/the-student-loan-crusader-how-elizabeth-warren-wants-to-reduce-debt-20140820.

by the higher education industry thanks to government policy that not only subsidizes colleges and universities but that also secures incumbents' dominance in the space.

College Tuition Costs Have Risen Since 2000, Fueled by Government Subsidies

U.S. TUITION RATES, ALL UNIVERSITIES AND COLLEGES, IN CONSTANT 2009–2010 DOLLARS



Source: National Center for Education Statistics, Institute of Education Sciences, "Fast Facts: Tuition Costs of Colleges and Universities," http://nces.ed.gov/fastfacts/display.asp?id=76. (accessed April 26, 2013).

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Instead of allowing liberals in Congress to define the narrative on higher education, conservatives must make the case that continually increasing federal subsidies exacerbates the very problem proponents set out to solve, hurting students' ability to begin their careers unencumbered by high levels of debt. More broadly, we should begin the hard work of educating the public on the degree to which higher education has become a failed market—sapped of innovation, competition, and price pressure by government policy and the dominance of entrenched higher education special interests. Higher education is a space ripe for massive disruption in the interest of students, their families, and taxpayers. Conservatives should counter the left's proposals to continue increasing federal subsidies with fundamental reforms that will transform the way colleges and other providers do business.

THE FAILURES OF THE STATUS QUO APPROACH

There is growing recognition among education analysts that the traditional approach is not, in fact, making college more affordable for students. Researchers at Cornell University found that increases in federal student aid such as loans and grants contributed to increases in tuition for in-state students.[5] Research conducted by Stephanie Riegg Cellini and Claudia Goldin on for-profit colleges suggests that "institutions may indeed raise tuition to capture the maximum grant aid available."[6]

5 Michael Rizzo and Ronald G. Ehrenberg, "Resident and Non-Resident Tuition and Enrollment at Flagship State Universities," Chapter 7 in *College Choices: The Economics of Where to Go, When to Go, and How to Pay for It*, National Bureau of Economic Research, ed. Caroline M. Hoxby, September 2004, http://www.nber.org/chapters/c10103.pdf.

6 Stephanie Riegg Cellini and Claudia Goldin, "Does Federal Student Aid Raise Tuition? New Evidence on For-Profit Colleges," National Bureau of Economic Research working paper 17827, February, 2012, as found in Andrew Gillen, "The Bennett Hypothesis 2.0," The Center for College Affordability and Productivity, February 2012, http://centerforcollegeaffordability.org/uploads/Introducing_Bennett_Hypothesis_2.pdf.

As Jonathan Cowan, president of Third Way, told the *Washington Post*, "For both parties, in particular Democrats, our solution to the problem of rising cost of college has been to subsidize the rising cost. … That's been our official policy, to subsidize the rising cost, and that has to be seen as a fairly intellectually bankrupt approach. We need a dramatically different approach that is about driving down the rising price."[7] Even President Obama admitted as much in his 2012 State of the Union speech, arguing, "We can't just keep subsidizing skyrocketing tuition."[8]

These policies have contributed to a vicious lending and spending cycle: Congress increases the number of students eligible for federal Pell Grants, eases repayment requirements for student loans, and makes interest rates more generous for borrowers. This easy flow of federal student aid—which is available to students regardless, for the most part, of their credit-worthiness, major, or ability to repay the loans—enables universities to continue to raise tuition, sending students back to the federal trough for more financial aid.

"Subsidies raise prices, leading to higher subsidies, which raise prices even more. Yet this higher education bubble, like the housing bubble, will eventually pop," warns economist Veronique de Rugy of the Mercatus Center at George Mason University. "Meanwhile, large numbers of students will graduate with more debt than they would have in an unsubsidized market."[9]

> *This system does not persist because it is efficient. It remains because it serves the interests of those with power—particularly politicians and their patrons in the higher education industry—well.*

Since 1980, tuition and fees at public and private universities have grown at least twice as fast as the rate of inflation.[10] The result has been that 60 percent of bachelor's degree holders leave school with more than $26,000 in student loan debt, with cumulative student loan debt now exceeding $1 trillion. As average student loan debt continues to increase, the value of a college degree declines. Many students find themselves leaving college with bachelor's degrees that have not prepared them for challenging careers. Employers increasingly report that college graduates are unprepared to enter the workforce. And that is the reality just for

7 Dylan Matthews, "A Bachelor's Degree Could Cost $10,000 – Total. Here's How," *The Washington Post*, September 26, 2013, http://www.washingtonpost.com/blogs/wonkblog/wp/2013/09/26/a-bachelors-degree-could-cost-10000-total-heres-how/.

8 Remarks by the President in State of the Union Address, The White House, January 24, 2012, http://www.whitehouse.gov/the-press-office/2012/01/24/remarks-president-state-union-address.

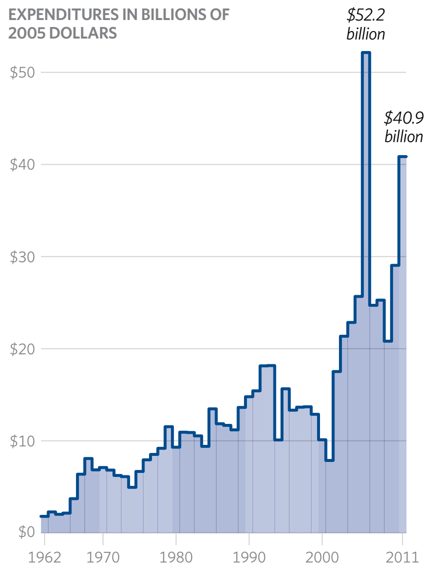
9 Veronique de Rugy, "Subsidized Loans Drive College Tuition, Student Debt to Record Levels," *The Washington Examiner,* July 11, 2013, http://mercatus.org/expert_commentary/subsidized-loans-drive-college-tuition-student-debt-record-levels.

10 *Ibid.*

the 60 percent of students who actually *do* graduate within six years of entering college. Those who take on tens of thousands of dollars of student loan debt without earning a degree find their ability to climb the economic ladder toward middle class stability or better is limited from the very start.

In short, the existing higher education system inhibits upward mobility by saddling students with debt without guaranteeing they have obtained the skills and competencies to achieve career success. Although a college degree has gained importance in recent decades, the payoff, after factoring in student loan debt and other opportunity costs, is sometimes below face value. Almost half of college graduates are in jobs that do not require college skills, and more than half of graduates cannot find full-time work related to their area of study.[11]

Higher-Education Spending Spikes Again Post-Recession



Sources: Data for 1962–1979: Office of Management and Budget, *Historical Tables: Budget of the United States Government, Fiscal Year 2013*, 2012, Table 3.2, p. 57, and Table 12.3, p. 265. Data for 1980–2012: U.S. Department of Education, "Education Department Budget History Table," http://www2.ed.gov/about/overview/budget/history/index.html (accessed November 27, 2012).

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MISGUIDED REFORM IDEAS

Current policy simply is not working. It's time for reform. But enhanced subsidies aren't the only bad reform concept currently on the table.

CAPPING LOAN REPAYMENTS

Some policymakers have suggested fixing loan repayments to a proportion of a graduate's income—even automatically enrolling graduates in such a plan—or otherwise capping loan repayments even more generously than already allowed for. In order to keep college costs in check, policymakers should be doing precisely the opposite.

Such efforts would enable colleges to continue raising tuition, knowing that borrowers' repayments would be capped. And there are already several such options already in place,

11 Stuart M. Butler and Lindsey M. Burke, "Climbing the Ladder of Upward Mobility Through Education," Jennifer A. Marshall and Rea S. Hederman, *2014 Index of Culture and Opportunity* (Washington, DC: The Heritage Foundation, 2014), http://index.heritage.org/culture/opportunity/.

such as income-based repayment (IBR), which caps eligible borrowers' monthly payments at 15 percent of discretionary income, with any remaining balance being forgiven after 25 years. If a student goes into "public service," including government jobs, loan forgiveness kicks in after just 10 years. Pay As You Earn caps eligible borrowers' monthly payments at 10 percent of discretionary income, with the remaining loan balance forgiven after 20 years. Pay As You Earn also includes 10-year forgiveness for working in public service. Income-contingent repayment calculates payments based on adjusted gross income and family size and sets payments on Direct Loans accordingly, with any remaining balance forgiven after 25 years. Income-sensitive repayment establishes borrowers' monthly payments based on annual income.

Repayment caps such as those offered through IBR and other policies put no downward pressure on college prices and spread the cost of attending college to taxpayers, the vast majority of whom do not hold bachelor's degrees themselves. IBR is also problematic because it makes students less sensitive to increases in college costs and likely encourages students to attend college who may be better off entering the workforce sooner or pursuing vocational education.

Since 1980, tuition and fees at public and private universities have grown at least twice as fast as the rate of inflation. The result has been that 60 percent of bachelor's degree holders leave school with more than $26,000 in student loan debt, with cumulative student loan debt now exceeding $1 trillion.

Automatically deducting payments from a borrower's paycheck, moreover, has its own problems. Because borrowers wouldn't be cutting the checks for their loan repayments themselves, they would be unlikely to internalize the cost of borrowing. Such a withholding provision would also enshrine a federal role in lending.

Instead of trying to figure out ways the federal government can manipulate debt repayment, policymakers should be proposing ideas that turn the tide of increasing college costs rather than encouraging even more borrowing.

FEDERAL SCORECARDS

Others, such as President Obama, have suggested a federal rating system or "scorecard" tied to federal financial aid. Such a scorecard would act as a college rating system to evaluate colleges on measures such as graduation rates, the number of low-income students served (i.e., the percentage of Pell Grant recipients), graduate earnings, and affordability, which would then be tied to access to federal student aid. But a government-run rating system would inevitably reflect what bureaucrats—rather than parents, students, and scholarly communities—determine is or is not important in education.

A competing range of private outcome-based scorecards already exists, sponsored by such outlets as *U.S. News & World Report*, *Forbes*, ACTA, and *Kiplinger's*. Each of these reflects the differing visions of quality held by different Americans, from post-graduation salary to the likelihood of a well-rounded education. These independent evaluators that parents and students have long trusted make a one-size-fits-all federal rating system unnecessary.

TRANSFORMING HIGHER EDUCATION

Real higher education reform would aim not to tackle the symptom—high costs—but the root of the problem: the sclerotic nature of the existing higher education sector, which is insulated from market pressures in large part by the federal accreditation system.

Currently, the Department of Education authorizes a group of organizations as federal accreditors. The process is highly selective, requiring several years of previous accreditation experience before recognition, notice in the *Federal Register* and public comment, and review by the National Advisory Committee on Institutional Quality and Integrity (NACIQI)—a cartel of higher education industry insiders that submits a recommendation on approval or denial to the Department of Education before any decision is made. Once selected, these accreditors have the authority to place an official stamp of approval of colleges recognized by the federal government—a process that favors entrenched institutions and old education models over upstart insurgents seeking to break into the market.

That seal of approval is more than symbolic. It is a gateway to federal financing, as student loans and grants may only flow to those institutions that have received federal accreditation. Given the degree to which higher education financing is dominated by the federal government, this means accreditation denial places those institutions whose methods do not meet with approval by the national accreditors at a massive disadvantage in the marketplace.

This poses three important problems.

First, the current accreditation system is a poor measure of quality, focusing more on inputs like the number of library books owned by institutions than on outcomes like performance and graduates' skill attainment. In the words of a report from the American Council of Trustees and Alumni, "If the accrediting process were applied to automobile inspection, cars would 'pass' as long as they had tires, doors, and an engine—without anyone ever turning the key to see if the car actually operated."[12] After all, the existing system places taxpayers on the hook for such courses such as "Cyberfeminism," and "Lady Gaga and the Sociology of Fame."[13] Because the existing accreditation system rates entire institutions, any course taught at an accredited university is an accredited course, usually credit-bearing—no matter how frivolous.

Second, it allows market players with heavy conflicts of interest to control their own competition through the bottlenecks of both accreditor licensure and accreditation of educational institutions. Aside from the obvious problem posed by allowing self-interested participants to deny entry to the market by their most threatening challengers, the current accreditation system also disincentivizes the removal of institutional accreditation attained by schools that have since lagged in performance, as withdrawal of accreditation would reduce the dues paid to the accreditation association.

Third, it entrenches outdated models of instruction, slowing down the emergence of new ideas such as online learning and course-level or skills-based certification and tilting the scales in favor of expensive tuition-based, multi-year, full-degree campus programs. Though the existing accreditation system allows some degree of more granular programmatic accreditation in addition to full institutional accreditation, program-level accreditation generally is only granted to institutions that have already received full organizational recognition by the national accreditors, not to standalone programs that operate outside fully accredited institutions.

POLICY RECOMMENDATIONS

The 114th Congress is likely to debate the reauthorization of the Higher Education Act (HEA), historically reauthorized every five years and now up for its tenth reauthorization. First signed into law in 1965 by President Lyndon Johnson as one of many programs composing his Great Society initiative, and reauthorized nine times since then, most recently in 2008, the 432-page HEA touches nearly every aspect of federal higher education policy.[14] Yet some of the law's titles and programs have outlived their purpose; others make it difficult to reform higher education financing in a way that would increase access for students and drive down college costs. Trade groups, professional organizations, accreditors,

12 American Council of Trustees and Alumni, "Why Accreditation Doesn't Work and What Policymakers Can Do About It," July 2007, http://www.goacta.org/images/download/why_accreditation_doesnt_work.pdf.

13 Lindsey M. Burke and Stuart M. Butler, Ph.D., "Accreditation: Removing the Barrier to Higher Education Reform," Heritage Foundation *Backgrounder* No. 2728, September 21, 2012, http://www.heritage.org/research/reports/2012/09/accreditation-removing-the-barrier-to-higher-education-reform.

14 "What You Need to Know about Reauthorization," *The Chronicle of Higher Education*, September 19, 2013, http://chronicle.com/article/What-You-Need-to-Know-About/141697/.

and universities have already begun to voice their concerns and recommendations for the 11 titles composing the law. Conservatives considering the reauthorization should not to put these special interests' priorities ahead of those of students and taxpayers.

One objective for this reauthorization should be to streamline the HEA in a way that more closely adheres to its primary purpose of allocating federal student loans and grants to ease the cost of college—part of President Johnson's goal of keeping "the doors to higher education open for all academically qualified students regardless of their financial circumstances."[15] That goal requires eliminating duplicative, unnecessary, or ineffective programs and titles that have accrued over the decades and considering reforms that would ensure the HEA best serves students. The following ideas offer the most promise:

- **Reform accreditation: Higher Education Reform and Opportunity Act.** A real higher education market would promote not just those programs offered by traditional colleges and universities, but also those credentialed by businesses and other non-college institutions. Enabling aid to follow students to those individually credentialed courses could reap massive savings and transform the industry. In order to harness the promise presented by budding higher education innovations—low-cost online courses and Massive Open Online Courses (MOOCS) that hold the potential to significantly drive down college costs—the existing *de facto* federal system of accreditation must be reformed. Senator Mike Lee and Representative Ron DeSantis have introduced the Higher Education Reform and Opportunity (HERO) Act. The bill would get to the root of the college cost problem by reforming accreditation. Rather than eliminating the federal accreditors, HERO would provide competition by granting states the power to establish their own accreditors, who in turn could grant approval to whole colleges and universities, degree programs, and even credential specific courses. These accredited and credentialed offerings would receive the same privileges as current institutions recognized by the federal accreditors, meaning that students would be able to apply federal loans and grants to a far broader array of programs and courses.

  This simple reform would open up a groundswell of change, allowing students to break free of the expensive, full-degree programs now offered by accredited colleges and universities and instead to chart their own path, selecting specific courses that meet their own and their employers' needs. Employers would benefit not just from an applicant pool better able to attain the skills needed to succeed but also from the ability to offer their own training courses on a level playing field with existing accredited institutions.

15 Angelica Cervantes et al., "Opening the Doors to Higher Education: Perspectives on the Higher Education Act 40 Years Later," TG Research and Analytical Services, November 2005, http://www.tgslc.org/pdf/hea_history.pdf.

- **Reform Pell Grants.** Reforming the Pell Grant program can help better serve low-income students. Expanded eligibility has meant that Pell funding has increased to cover twice as many students as it did a decade ago, instead of allocating funding to the students who need it most. To better serve the low-income students whom the Pell program was designed to help, an income cap should be set on Pell Grant eligibility, and grants should only be made available to those students who attend college at least half time. The 12-semester limit on Pell awards (put into place in 2012) should be maintained, and the current maximum grant award of $5,830 should not be increased. Finally, Pell funding should be shifted from mandatory funding to discretionary funding, enabling Congress to have more oversight of program funding from year to year.

- **Eliminate the PLUS loan program.** The PLUS program is comprised of Parent PLUS and Graduate PLUS loans. Parent PLUS loans are available to parents of undergraduate students, letting them borrow up to the cost of attendance at a given college. The loans are available in addition to federal loans that are already available to the students themselves. The availability of Parent PLUS loans, created in 1980, has resulted in families incurring substantial debt while failing to ease the cost of college over time. The Parent PLUS loan should be terminated. Similarly, the Graduate PLUS loan program should be eliminated. Grad PLUS, open to graduate students who elect to take out loans to finance graduate school, enables students to borrow up to the full cost of attendance. Undergraduate and Graduate students already have access to up to $138,500 in federal loans through the Stafford Loan program, and students enrolled in school to become health care professionals can borrow up to $224,000. Borrowing above those already high amounts should not be encouraged through the availability of the Grad PLUS program.

- **Employ Fair-Value Accounting.** In order to understand the true costs of federal higher education subsidies, policymakers should stipulate the use of fair-value accounting. Title IV of the Higher Education Act should be amended to require the Department of Education to use it. The Congressional Budget Office (CBO) explains the utility of using a fair-value accounting model to understand fully the cost of federal lending, noting, "The government is exposed to market risk when the economy is weak because borrowers default on their debt obligations more frequently and recoveries from borrowers are lower."[16] Fair-value estimates take this market risk into account and as a result are a more accurate reflection of the cost of federal student loans.

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16 Hank Brown, "Protecting Students and Taxpayers: The Federal Government's Failed Regulatory Approach and Steps for Reform," The American Enterprise Institute Center on Higher Education Reform, September 2013, http://www.aei.org/files/2013/09/27/-protecting-students-and-taxpayers_164758132385.pdf.

Any loan program should use a non-subsidizing interest rate, that is, the rate at which the program breaks even. Absent fair-value accounting, it is impossible to determine the extent to which the student loan programs are providing a subsidy to borrowers. Specifically, Congress should require the Department of Education to use fair-value accounting estimates calculated by the CBO and adjust loan rates accordingly, on an annual basis. This would help determine whether the loan programs are costing taxpayers and where to set interest rates to ensure the programs break even.

- **Additional Higher Education Act reform.** By streamlining the HEA to reflect more closely its primary purpose of allocating federal student loans and grants to ease the cost of college, policymakers can reduce bureaucracy, improve access for students from all walks of life, and make the college experience more affordable and meaningful for those who choose to attend. Such reforms should include eliminating programs with income-based repayment caps, which prevent consumer cost-consciousness; limiting federal intervention in teacher development programs by eliminating unnecessary Title II Teacher Quality Partnership Grants; repealing the authorizations for the GEAR UP and TRIO college counseling, mentoring, and tutoring services; eliminating Title VI international education funding and redirecting those dollars to the National Security Education Program administered by the Pentagon; and removing authorization for funding for the United State Institute of Peace (USIP) from the HEA (Title IX). Title IX authorizes the U.S. Institute of Peace (USIP), which promotes international peace and non-violent resolutions to conflict. If the federal government continues to fund the Institute for Peace, it makes more sense to authorize USIP through the Foreign Relations Committee since its work focuses on promoting international conflict resolution, which helps the U.S. meet its foreign policy objectives.[17]

CONCLUSION

By focusing on the big picture—the drivers of college debt such as an open spigot of federal student aid and ossified accreditation policies—policymakers can reframe the discussion around higher education. It's a conversation that's long overdue—one that demands conservative leadership and could revolutionize how we finance and think about the college experience.

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17 For more HEA reform proposals, see Lindsey Burke, "Reauthorizing the Higher Education Act—Toward Policies that Increase Access and Lower Costs," Heritage Foundation *Backgrounder* No. 2941, August 19, 2014, http://www.heritage.org/research/reports/2014/08/reauthorizing-the-higher-education-acttoward-policies-that-increase-access-and-lower-costs.

A FRESH START FOR HEALTH CARE REFORM

Edmund F. Haislmaier, Robert E. Moffit,
Nina Owcharenko, and Alyene Senger

Despite President Barack Obama's insistence that the national health care debate is over, and that he will not "re-litigate" Obamacare, the practical concerns, aggravated by implementation glitches and policy failures, guarantee that the debate over the law is far from over.[1]

In the next phase of the health care debate, supporters of Obamacare will undoubtedly attempt to fix or tweak the weaknesses and failures of the law. Such an approach would be based on preserving and expanding the government's role in health care. Indeed, some analysts have already proposed policies that would further strengthen the government's hand in managing and regulating the health care system.[2]

Since 2010, the 903 page statute, wrought from 2700 pages of legislative text, has generated thousands of pages of rules, regulations, and guidelines.

Those who reject the notion of increasing government control in health care can pursue an alternative path—a path based on the principles of patient-centered, market-based health care reforms. That alternative path not only gives individuals greater choice, but also empowers them to make their own health care decisions.

BETTER SOLUTIONS

The need for health care reform has never been questioned by health care policy analysts on either side of the political spectrum. Furthermore, the broad goals of controlling costs, improving quality, and expanding access are widely shared. Yet, while both sides agree that reform is necessary, their policy solutions differ dramatically, most importantly on the question of who controls the key decisions in health care.

For the Obama Administration and defenders of Obamacare, the common conviction is that for major issues in health care, government officials should be the key decision makers. Those government decisions are imposed through detailed federal rules and regulations. Obamacare epitomizes this approach, and the course of its regulatory implementation—strewn with the broken promises of the President—provides an excellent guide to the consequences and inherent challenges of such an approach.

In contrast, those who believe in a patient-centered, market-based approach to reform trust individuals, not the government, to be the key decision makers in the financing of health care. To achieve this goal, Congress should embark on a reform agenda that is grounded in the following policy cornerstones: (1) reforming the tax treatment of health insurance so that individuals choose the health care coverage that best fits their needs (not the government's dictates); (2) restoring commonsense regulation of health insurance by devolving it back to the states; and modernizing (3) Medicare and (4) Medicaid by adopting policies that harness the powerful free-market forces of choice and competition.

THE AFFORDABLE CARE ACT: AN EXERCISE IN GOVERNMENT CENTRAL PLANNING

Obamacare is the boldest attempt at government central planning in American history. The law gives federal officials new powers over major decisions in American health care, including: setting health plan benefits and levels of coverage; regulating how insurers spend premium dollars; mandating that employers and individuals purchase federally approved health insurance; and imposing hundreds of billions of dollars in new taxes and fees.

The law transfers comprehensive regulatory authority over health insurance from state officials to the federal government. The Secretary of the Department of Health and Human Services (HHS) is the key official in charge of managing this vast federal enterprise, in concert with the Internal Revenue Service (IRS) and scores of new boards, commissions, panels and programs. Since 2010, the 903 page statute, wrought from 2700 pages of legislative text, has generated thousands of pages of rules, regulations, and guidelines.

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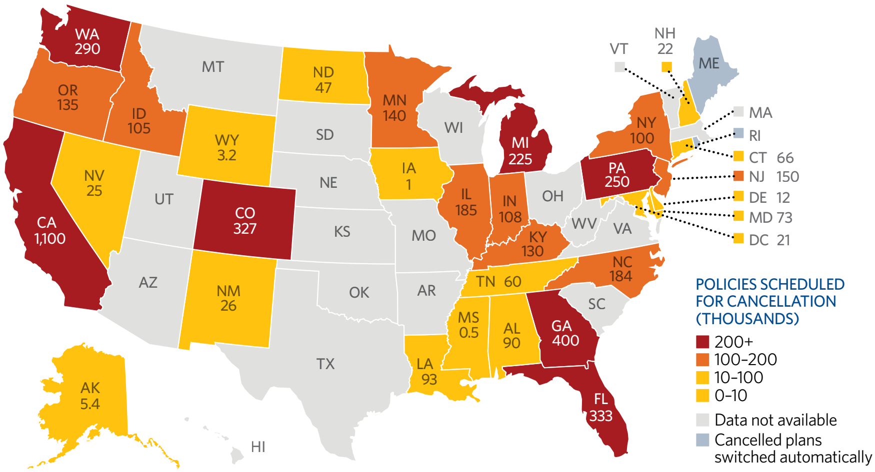
1 Heritage Foundation analysts and others predicted this from the very beginning of Obamacare's implementation. See Stuart M. Butler, "Why the Health Reform Wars Have Only Just Begun," Heritage Foundation *Lecture* No. 1158, July 6, 2010, http://www.heritage.org/research/lecture/why-the-health-reform-wars-have-only-just-begun, Robert E. Moffit, "The Prospects for Ending Obamacare: Learning from Health Policy History," Heritage Foundation *Backgrounder* No. 2424, June 21, 2010, http://www.heritage.org/Research/Reports/2010/06/The-Prospects-for-Ending-Obamacare-Learning-from-Health-Policy-History, and Grace-Marie Turner, James C. Capretta, Thomas P. Miller, and Robert E. Moffit, *Why Obamacare is Wrong for America* (New York: Harper Collins, 2011).

2 For a discussion of expanding government interventions in the exchanges, see Henry Aaron and Kevin Lucia, "Only the Beginning—What's Next at the Health Insurance Exchanges," *New England Journal of Medicine*, September 4, 2013, http://www.nejm.org/doi/full/10.1056/NEJMsb1205901. For a discussion on expanding the role of the Independent Payment Advisory Board in Medicare, see Michael Ettlinger, Michael Linden, and Seth Hanlon, "Budgeting for Growth and Prosperity," Center for American Progress, May 2011, p. 26, http://cdn.americanprogress.org/wp-content/uploads/issues/2011/05/pdf/budget_for_growth.pdf.

If you like your health care plan, can you really keep it?

At least 4.7 million health care plans in the individual market have been discontinued due to new Obamacare rules.



Source: Associated Press, December 26, 2013. heritage.org

The law establishes a system of government-run health insurance exchanges as the vehicle for implementing federal regulation and control of health insurance in every state in the union. The exchanges are also the administrative mechanism for expanding Medicaid and channeling new taxpayer premium subsidies for "qualified" insurance that meets federal approval. In addition, the exchanges serve as the platform for the federal government to sponsor at least two national health plans (administered by the U.S. Office of Personnel Management) to compete against all other "qualified" plans in the country. In sum, the exchanges are designed to be the central mechanism for implementing federal control over the financing and delivery of private health coverage. Simultaneously, the law's new taxes on insurance premiums, drugs, and medical devices mean that Americans, regardless of their state of residence, will pay more for their medical care and health insurance.

The ACA, then, is a herculean exercise in government central planning. The federal government attempting to make detailed decisions over an extremely complex sector of the American economy that is roughly the size of the entire economy of France means that there will be no end to the managerial problems inherent in this approach. The main provisions of the law will necessitate constant modifications and revision through even more rules and regulations. Indeed, in the first four years of its existence, the law has already undergone at least 42 major administrative, legislative and judicial changes.[3]

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3 Tyler Hartsfield and Grace Marie Turner, "42 Changes to Obamacare…So Far," The Galen Institute, July 18, 2014, http://www.galen.org/newsletters/changes-to-obamacare-so-far/.

Yet, despite all of the enormous expenditure of administrative energy, effort and money, it's not working. The law's implementation has validated the many of the early warnings of its critics on policy grounds.[4] From the standpoint of public trust, the President's claims about the effects of the law—most notably, his high-profile promise that if one liked one's health plan he or she could keep it—have turned out to be erroneous or simply false.

As it stands, the law is burdened by practical infirmities that render it unworkable and unfair, while its policy prescriptions are unaffordable. This combination of bad policy and inherently flawed management has had, and will have, consequences that render the law persistently unpopular.

PRINCIPLES OF PATIENT-CENTERED, MARKET-BASED HEALTH CARE REFORM

Traditionally, terms such as "patient-centered" or "market-based" have been used to contrast an alternative approach to greater government control in health care. However, the vocabulary of health care policy is often elastic, and different people sometimes use the same terms to express significantly different concepts. The linguistic elasticity adds to the general confusion among the public and policymakers that seems to plague this already complex area of public policy. Consequently, clarifying the rationale, objectives, and principles of patient-centered health care reform is important for properly understanding the concepts and implications of this approach.[5] Specifically, truly patient-centered, market-based health reform means that:

- **Individuals are the key decision makers in the health care system.** Under most current arrangements, the government or employers determine the type and scope of health care benefits and how those benefits are financed. In a reformed market, basic decision making authority would lie in the hands of consumers and patients.

- **Individuals buy and own their own health insurance coverage.** In today's system, individuals and families rarely have property rights in their health insurance coverage. The policy is owned and controlled by a third party—either the

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4 For a discussion of the first wave of several of the major problems, see Robert E. Moffit, "Four Years of Obamacare: Early Warnings Come True," Heritage Foundation *Backgrounder*, No. 2907, April 28, 2014, http://www.heritage.org/research/reports/2014/04/four-years-of-obamacare-early-warnings-come-true.

5 Edmund F. Haislmaier, "Health Care Reform: Design Principles for a Patient-Centered, Consumer-Based Market," Heritage Foundation *Backgrounder* No. 2128, April 23, 2008, http://www.heritage.org/research/reports/2008/04/health-care-reform-design-principles-for-a-patient-centered-consumer-based-market.

employer or government bureaucrats. In a reformed system, individuals would own their health insurance, just as they own virtually every other type of insurance or virtually any other product in other sectors of the economy.

- **Individuals are able to choose from a wide range of options.** Today, mostly employers or government officials choose the type of health plan design and level of coverage. In a reformed system, individuals would choose the type of plan design and coverage they think is best. Furthermore, there should be a level playing field with necessary flexibility for the suppliers of medical goods and services, including health plans, to offer consumers and patients innovated and better value solutions.

The challenge for policymakers is to undertake the reforms needed to transform the present system into one that rewards the search for and creation of better value.

Such a value-maximizing result can be achieved in health care only if the system is restructured to make the consumer the key decision maker. When individual consumers decide how the money is spent, either directly for medical care or indirectly through their health insurance choices, the incentives will be aligned throughout the system to generate better value—in other words, to produce more for less.

A FRESH START TO HEALTH CARE REFORM:THE RIGHT POLICY

As it stands, Obamacare is burdened by practical infirmities that render it unworkable and unfair. Its policy prescriptions are unaffordable. This combination of bad policy and inherently flawed management has had, and will have, consequences that render the law persistently unpopular.

Congress should start fresh. It should repeal Obamacare and focus on the fundamentals: reform of the tax treatment of health care; devolving health insurance regulation back to the states; and reform of the major health care entitlement programs of Medicare and Medicaid.

TIME TO REFORM THE TAX TREATMENT OF HEALTH CARE

The current tax treatment of health insurance is largely a relic of World War II wage and price controls. While those laws regulated cash wages, they exempted "insurance and pension benefits" of a "reasonable amount" from the definition of "wages" and "salaries," to which the controls were applied.[6] Faced with labor shortages (as working-age men joined

6 Stabilization Act of 1942, Public Law 77–729 § 10.

the armed forces) employers used that loophole to effectively skirt the wage controls by offering increased compensation in the form of employer-paid health insurance.

This distinction between cash wages and certain non-cash employee benefits also raised the issue of how the value of such benefits should be treated for tax purposes. When Congress enacted a major revision of the federal tax code in 1954 it explicitly excluded from the calculation of gross income any employer payments for a worker's medical care or health insurance.[7] Moreover, this exclusion applies to both federal income and payroll (Social Security and Medicare) taxes. Thus, the tax exclusion for employer-sponsored health insurance meant that working families could fund their medical care with income that was completely tax-free.

Furthermore, unlike the case with most other tax breaks, Congress did not set a limit on the amount of income that could be diverted into paying for employer-sponsored health benefits on a pre-tax basis. Thus, having more of their compensation paid in the form of tax-free health benefits, and less in the form of taxable wages, became particularly attractive to workers in periods of higher inflation and higher marginal tax rates, such as during the 1970s.

The aggregate value of this federal tax preference in 2014 is about $250 billion per year, with reductions in federal personal income tax accounting for about $175 billion of that figure and reductions in payroll taxes accounting for the other $75 billion.[8]

The principal effect of this policy was the widespread adoption of employer-sponsored health benefits as the dominant form of health coverage for American workers and their families. The share of the non-elderly population covered by employer-sponsored health insurance peaked at an estimated 71.4 percent in 1980.[9] Even though the share has gradually declined since then, in 2012, an estimated 58.5 percent of the non-elderly population was still covered under such plans.[10]

Yet that decline reveals some of the major drawbacks of this tax policy. Back in the 1950s and 1960s, it was fairly common for a worker to spend his entire career with the same employer. Yet the American workforce has become far more mobile since then. For instance, a Department of Labor survey of workers born between 1957 and 1964 found that they

7 Internal Revenue Act of 1954, Public Law 83–591.

8 Congressional Budget Office, "The Distribution of Major Tax Expenditures in the Individual Income Tax System," May 2013, http://www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf.

9 Robin A. Cohen et al., "Health Insurance Coverage Trends, 1959–2007: Estimates from the National Health Interview Survey," Centers for Disease Control *National Health Statistics Reports* No. 17, July 1, 2009, http://www.cdc.gov/nchs/data/nhsr/nhsr017.pdf.

10 Paul Fronstin, "Sources of Health Insurance and Characteristics of the Uninsured: Analysis of the March 2013 Current Population Survey," Employee Benefit Research Institute *Issue Brief* No. 390, September, 2013, http://www.ebri.org/pdf/briefspdf/EBRI_IB_09-13.No390.Sources1.pdf.

had an average of 11 jobs between the ages of 18 and 46.[11] Obviously, a tax policy that links health insurance to the place of work means that each time a worker changes employers, he must change his health plan.

This tax policy also produces what economists call "horizontal inequity," meaning that if two individuals have the same income, but one has employer-sponsored health benefits while the other buys his own health insurance, the first individual receives a larger tax break than the second. At the same time, this tax policy also creates "vertical inequity." If two individuals work for the same employer and participate in the same health plan with the same cost, but have different incomes, the tax benefit each receives will vary based on their different marginal tax rates. That is so because the value of the tax exclusion for employer-sponsored coverage is equal to an individual's combined marginal tax rates for both income and payroll taxes, with the consequence that the size of the tax relief provided by the tax exclusion varies according to the different marginal tax rates imposed at different income levels.

Yet, the biggest problem with the tax exclusion from the health policy perspective is that while it offers workers substantial tax relief, it does so only if the workers let their employers decide how that portion of their compensation is spent. That translates to less choice and competition in health insurance, reduced consumer awareness of the true costs and value of medical care, and incentives to tailor health plans more toward meeting the interests of employers than to the preferences of the workers and their families.

OBAMACARE AND THE TAX TREATMENT OF HEALTH CARE

Not only does Obamacare fail to correct these flaws in long-standing health care tax policy, it layers new complexity and distortions onto the existing system. It provides new, and substantial, subsidies for buying health insurance, but only to those individuals who have incomes between 100 percent and 400 percent of the federal poverty level (FPL) and purchase their coverage through government-run exchanges. Furthermore, it denies those new subsidies to individuals with access to employer-sponsored coverage, while at the same time imposing fines on employers with 50 or more full-time workers if they do not offer coverage.

Indeed, the only helpful change to health care tax policy that Obamacare makes is to limit the amount of employer-provided coverage that may be excluded from taxation. However, Congress did even that in a convoluted fashion. Rather than simply setting a limit—as Congress previously did with the tax exclusion for contributions to retirement plans—Obamacare imposes a punitive excise tax on any employer health plan whose value exceeds specified amounts.

11 Bureau of Labor Statistics, "Number of Jobs Held, Labor Market Activity, and Earnings Growth Among the Youngest Baby Boomers: Results from a Longitudinal Survey," U.S. Department of Labor, July 25, 2012, http://www.bls.gov/news.release/pdf/nlsoy.pdf.

A BETTER APPROACH

The proper goals for a true reform of the tax treatment of health insurance should be to make the system simpler and fairer for individuals, while also ensuring that it is neutral both with respect to how an individual obtains coverage (whether directly or through an employer or an association) as well as with respect to an individual's choice of plan design (such as a health-maintenance organization (HMO), a preferred-provider organization (PPO), a high-deductible plan, or another arrangement).

Various proposals for health care tax reform have been offered over the years. Most would repeal the tax exclusion and replace it with a new, universal tax deduction or tax credit for health expenses.

Replacing the current tax treatment of health benefits with a new design for health care tax relief that is both revenue and budget neutral (based on pre-Obamacare levels) is the first step in transforming the American health system into one that is more patient-centered, market-based, and value-focused. No amount of government regulation or micromanagement of the system—such as tinkering with provider reimbursement rates or payment arrangements—can produce better value. That desired result will only be achieved by giving consumers more control over how to spend their health care dollars, thus forcing health insurers and medical providers to respond to consumer demand by offering better quality and prices for their products and services.

Even so, there is the practical concern that simply replacing the tax exclusion with a new design for health care tax relief would be an abrupt and major change in tax policy—resulting in further dislocation, at least initially, to the existing health care financing arrangements of millions of Americans. One way to avoid that problem is by including a transitional mechanism in the design:

In order to minimize disruption to existing arrangements, lawmakers should stipulate that taxpayers with access to employer-sponsored plans would be allowed to choose which tax treatment (the tax exclusion or an alternative credit or deduction) to apply to their employment-based coverage. At the same time, Congress should convert the existing limitation on high-cost employer health plans into a straight forward cap on the value of the exclusion. That way, taxpayers with employer-sponsored coverage who receive more tax-relief from the tax exclusion could continue to be excluded from taxation of their employer health benefits (up to the amount of the cap), while those who would benefit more from the new tax relief design could elect to have the new or deduction applied to the value of their employer-sponsored coverage, (again, up to the maximum amount).

Lawmakers could ensure revenue neutrality under this arrangement by indexing the cap on the amount of the exclusion to decrease as needed in future years, so as to maintain at a baseline level the aggregate amount of tax relief provided by both the new option and the exclusion. For years in which the combined aggregate amount of tax relief provided by the alternative tax relief option and the exclusion exceeded the baseline level, the Treasury Department would be required to apply the indexing adjustment to lower the exclusion cap for the following year to make up the difference.

Over time, the indexing of the cap on the exclusion would eventually bring the value of the tax exclusion into parity with the value of the new tax relief option. However, that would occur gradually—not abruptly—and as a byproduct of individual workers exercising their personal preferences.

COMMONSENSE INSURANCE-MARKET REFORMS

Beyond reforming health care tax policy, the next step in creating a more patient-centered, market-based health system is to reform the regulation of health insurance to make coverage more competitive and value-focused. It is necessary not only for consumers to have incentives to seek better value, but also for insurers to have sufficient scope to innovate in offering better value products.

America's private health insurance market consists of two basic subgroups: the employer-group market, and the individual insurance market. Plans purchased from commercial insurers—whether individual or employer-group policies—are primarily regulated by state insurance laws.

There are, however, instances where federal regulations apply. The Employee Retirement and Income Security Act (ERISA), for example, establishes federal protections for the arrangements that an employer makes for providing benefits to his workers. The state, however, still regulates the commercial products that the employer might choose to purchase.

In 1996, Congress enacted the Health Insurance Portability and Accountability Act (HIPAA). That act, among other policy changes, set in place basic market rules for employer-group coverage and individual-market coverage. For employer plans, HIPAA included policies on a number of issues relating to guarantee issue, guarantee renewability, limitations on pre-exclusions, and prohibition on discrimination based on health status. For individual plans, HIPAA was limited to guarantee renewability and rules in the case of workers who lost their group coverage.[12]

12 For a more detailed account, see Edmund F. Haislmaier, "Saving the American Dream: The U.S. Needs Commonsense Health Insurance Reforms," Heritage Foundation Backgrounder No. 2703, June 22, 2012, http://www.heritage.org/research/reports/2012/06/saving-the-american-dream-the-us-needs-commonsense-health-insurance-reforms.

OBAMACARE AND INSURANCE REGULATION

While there were certainly some problems with insurance market regulation prior to Obamacare, those relatively modest problems could easily have been remedied with a few thoughtful and limited reforms. Instead, Congress enacted in Obamacare a raft of new regulations on insurers and health plans that standardize coverage, restrict innovation in plan design, and increase premiums for many Americans. Consequently, many of the new requirements imposed on insurers by the law—such as the new federal benefit mandates that standardize coverage and the rating rules that artificially increase premiums for younger adults—are counterproductive and lead to the need for the widely despised individual mandate to offset their destabilizing effects.[13]

A BETTER APPROACH

State governments have performed the basic function of regulating insurance reasonably well for over a century, and there is no need for the federal government to supplant these efforts as it is now doing under Obamacare. Therefore, Congress should immediately devolve the regulation of health insurance back to the states.

From there, states should initiate a policy agenda that aims to stabilize the market while expanding choice and competition by reducing burdensome and costly rating rules and benefit mandates. State lawmakers should also pursue policies to achieve greater harmonization among the states. For instance, reciprocity agreements between states would permit residents in one state to buy coverage that is issued and regulated in another state. In 2011, Maine included such a reciprocity provision in its broader health insurance reform law.[14] Enacting such policies would expand the choices available to consumers, increase competition among insurers, and help clear the way for potential federal interstate purchase legislation. Finally, states should advance medical liability reforms to help improve access and bring down the cost of practicing medicine.

To address the outstanding concern over protections for those individuals with pre-existing conditions, Congress could solve this issue in a relatively simple fashion without resorting to the kind of sweeping and complex regulation enacted in Obamacare.

Dating back to the 1996 HIPAA law, Congress enacted a set of modest and reasonable rules for employer-group coverage that specified that individuals switching from one

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13 Edmund F. Haislmaier, "Obamacare and Insurance Benefit Mandates: Raising Premiums and Reducing Patient Choice," Heritage Foundation *WebMemo* No. 3110, January 20, 2011, http://www.heritage.org/research/reports/2011/01/obamacare-and-insurance-benefit-mandates-raising-premiums-and-reducing-patient-choice, and Edmund F. Haislmaier, "Obamacare and Insurance Rating Rules: Increasing Costs and Destabilizing Markets," Heritage Foundation *WebMemo* No. 3111, January 20, 2011, http://www.heritage.org/research/reports/2011/01/obamacare-and-insurance-rating-rules-increasing-costs-and-destabilizing-markets.

14 Tarren Bragdon and Joel Allumbaugh, "Health Care Reform in Maine: Reversing 'Obamacare Lite,'" Heritage Foundation *Backgrounder* No. 2582, July 19, 2011, p. 9, http://www.heritage.org/research/reports/2011/07/health-care-reform-in-maine-reversing-obamacare-lite.

group plan to another (or from group coverage to an individual plan) could not be denied new coverage, be subjected to pre-existing-condition exclusions, or be charged higher premiums because of their health status.[15] Thus, in the group market, pre-existing-condition exclusions could only be applied to those without prior coverage, or to those who waited until they needed medical care to enroll in their employer's plan. Furthermore, there were limits even in those cases. Such individuals could still have obtained the group coverage, and any pre-existing medical condition could not have been excluded from that coverage for more than 12 months.

Under these employer group rules, individuals who received and kept coverage were rewarded, and individuals who waited until they were sick to enroll in coverage were penalized, but the penalties were neither unreasonable nor severe. That was also why those rules worked without needing to mandate that individuals purchase coverage, as required by Obamacare.

The problem, however, is that the same kind of rules did not apply to the individual market. Thus, an individual could have purchased non-group health insurance for many years, and still have been denied coverage or face pre-existing-condition exclusions when he needed or wanted to pick a different plan. Not only was that unfair to those individuals who had bought insurance while they were healthy, it also did little to encourage other healthy individuals to purchase coverage before they needed it.

Thus, the obvious, modest, and sensible reform would be to apply a set of rules to the individual-health-insurance market similar to the ones that already govern the employer-group-coverage market.[16]

REFORMING MEDICARE

Established in 1965, Medicare is the huge government health program for seniors over the age of 65, as well as for some disabled populations. It faces monumental challenges. The $583 billion Medicare program covering 52 million aged and disabled citizens is the most powerful force driving entitlement spending, and will generate a long-term unfunded liability (an "off-budget" debt) at an estimated $28 trillion to $35 trillion.[17]

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15 Health Insurance Portability and Accountability Act of 1996, Public Law 104–191.

16 Haislmaier, "Saving the American Dream."

17 Robert E. Moffit, "The Medicare Funding Problem Threatening Medicare's Future," The Daily Signal, July 30, 2014, http://dailysignal.com/2014/07/30/medicare-funding-problem-threatening-medicares-future/.

Medicare is also structurally complex.[18] The Medicare fee-for-service (FFS) (Parts A and B) program, or traditional Medicare, is the main component of the Medicare entitlement and has been slow to change. It is governed by an old-fashioned system of central planning and price controls that produce cost shifting and over-regulation, undercutting both economic efficiency and innovation. The program also fails the most basic test of insurance in that it does not guarantee patient protection for the financial devastation of catastrophic illness. Not surprisingly, that and other antiquated elements of the program's benefit design fuel demand for private supplemental insurance to fill traditional Medicare's notorious coverage gaps. Approximately 90 percent of seniors thus depend on such supplemental coverage which drives excessive utilization and fuels higher Medicare costs for taxpayers and beneficiaries alike.[19]

Medicare must also cope with an enormous demographic challenge.[20] America's aging population is steadily growing, but their Medicare coverage is being funded through taxation on a proportionally smaller working population. Current and future Medicare enrollees are also living, or expected to live, significantly longer than previous generations. By 2030, the average life expectancy will be almost 81 years of age, assuming current trends continue.

Meanwhile, the baby boomers have not replaced themselves in sufficient numbers, and the ratio of workers to beneficiaries is projected to decline from 3.2 in 2013 to 2.3 by 2030.[21] Younger Americans' future is thus darkened by the prospect of massive tax increases to sustain Medicare. Alternatively, senior and disabled citizens could face deep benefit cuts, or more likely, reduced access to care. The latter would be the inevitable result of relentless reimbursement reductions for medical professionals, doubling down on the cuts already scheduled under Obamacare.

Medicare, the fastest-growing program in the federal budget, also faces a severe fiscal challenge.[22] Many seniors today erroneously believe that their Medicare benefits are

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18 For a discussion of the structural problems of the Medicare program, see Robert E. Moffit and Alyene Senger, "Medicare's Outdated Structure—and The Urgent Need for Reform," Heritage Foundation *Backgrounder* No. 2777, March 22, 2013, http://www.heritage.org/research/reports/2013/03/medicares-outdated-structureand-the-urgent-need-for-reform.

19 Walton J. Francis, *Putting Medicare Consumers in Charge: Lessons from the FEHBP* (Washington, DC: The AEI Press, 2009), pp. 26–27.

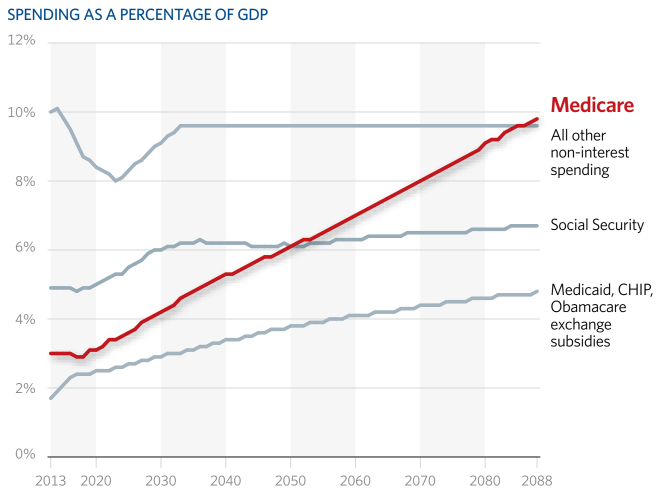
20 For an account of this demographic challenge, see Robert E. Moffit and Alyene Senger, "Medicare's Demographic Challenge—and the Urgent Need for Reform," Heritage Foundation *Backgrounder* No. 2778, March 21, 2013, http://www.heritage.org/research/reports/2013/03/medicares-demographic-challenge-and-the-urgent-need-for-reform.

21 Centers for Medicare and Medicaid Services, *2014 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds*, July 28, 2014, p. 67, http://www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/ReportsTrustFunds/downloads/tr2014.pdf, and see also Robert E. Moffit and Alyene Senger, "The 2014 Medicare Trustees Report: A Dire Future for Seniors and Taxpayers Without Reform," Heritage Foundation *Issue Brief* No. 4256, August 1, 2014, http://www.heritage.org/research/reports/2014/08/the-2014-medicare-trustees-report-a-dire-future-for-seniors-and-taxpayers-without-reform.

22 Robert E. Moffit and Alyene Senger," Medicare's Rising Costs—and the Urgent Need for Reform," Heritage Foundation *Backgrounder* No. 2779, March 22, 2013, http://www.heritage.org/research/reports/2013/03/medicares-rising-costsand-the-urgent-need-for-reform.

Medicare's Relentless Growth Surpasses All Other Spending

Growing entitlement spending is to blame for America's long-term spending and debt crisis. Medicare will grow the fastest due to the aging of society and rising health care costs.



Source: Congressional Budget Office.

impact-medicare-spending-growth heritage.org

somehow secure because they are "guaranteed" in statute by the federal government. But those benefit promises are not fully funded. In fact, Medicare's unfunded obligation ranges from $28 trillion to $35 trillion, meaning the government is currently short this amount of dedicated revenue to pay for future benefits over the long term.

Moreover, many seniors also erroneously believe that their benefits are secure because they paid for those benefits through the Medicare payroll tax. But the benefits of today's seniors are financed by the taxes of today's workers. In any given year, younger workers finance almost nine out of every ten dollars in Medicare benefits. Most seniors routinely receive more in Medicare benefits than they paid in premiums or payroll taxes. The average two-earner retired couple paid into Medicare $119,000 during their working years, yet now receives over $357,000 in Medicare benefits.[23]

OBAMACARE AND MEDICARE

Rather than putting Medicare on more solid financial footing, Obamacare takes a majority of the $716 billion in 10-year "savings" from Medicare to offset the costs of the law's other non-Medicare spending provisions, in particular the costly exchange subsidies and

23 C. Eugene Steuerle, Richard B. Fisher, and Stephanie Rennane, "How Lifetime Benefits and Contributions Point the Way Toward Reforming Our Senior Entitlement Programs," August 2011, The Urban Institute, p. 2, Figure 1, http://www.urban.org/UploadedPDF/1001553-Reforming-Our-Senior-Entitlement-Programs.pdf.

Medicaid expansion. These savings are mostly derived from statutory modifications to Medicare's complex administrative payment updates for providers, or regulatory changes to the conditions under which their services are reimbursed.[24]

The law requires an estimated $156 billion in payment reductions for the popular Medicare Advantage program (Medicare Part C) that offers enrollees the ability to get their Medicare coverage from competing private health plans. Medicare Advantage is today seniors' main alternative to enrollment in the FFS program

In addition and of greater significance is the law's creation of the unelected Independent Payment Advisory Board (IPAB) to develop proposals to reduce the growth of Medicare spending and a fast-track process for implementing its recommendations.[25]

Beyond these changes, the law increases Medicare payroll taxes on upper-income persons from 2.9 percent to 3.8 percent, while it authorizes a variety of delivery reforms, and also resurrects a form of government-sponsored managed care, the newly created accountable care organizations (ACOs), in which providers who are in compliance with government quality standards share in cost savings.

A BETTER APPROACH

That the Medicare program must change is not even a question. The best path for comprehensive reform is to transition the entire Medicare program from a defined-benefit system to a defined-contribution system ("premium support"), in which the government would make a defined contribution to the health plan of an enrollee's choice. Such a reform has potential for impressive savings.[26]

Congress should act now to sequester any of the 10-year $716 billion of estimated Medicare savings that accrue from Obamacare, along with any other Medicare savings, in a special account as savings *for* Medicare and Medicare alone, rather than using those savings to finance the new Obamacare spending programs.

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24 Robert E. Moffit, "Obamacare and Medicare Provider Cuts: Jeopardizing Seniors' Access," Heritage Foundation *WebMemo* No. 3105, January 19, 2011, http://www.heritage.org/Research/Reports/2011/01/Obamacare-and-Medicare-Provider-Cuts-Jeopardizing-Seniors-Access.

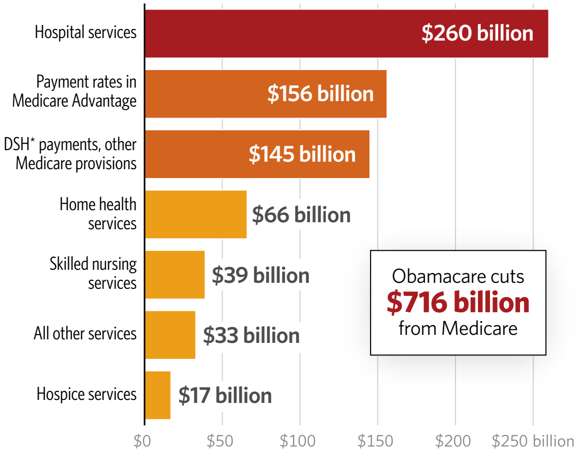
25 Robert E. Moffit, "Obamacare and the Independent Payment Advisory Board: Falling Short of Real Medicare Reform," Heritage Foundation *WebMemo* No. 3102, January 18, 2011, http://www.heritage.org/Research/Reports/2011/01/Obamacare-and-the-Independent-Payment-Advisory-Board-Falling-Short-of-Real-Medicare-Reform.

26 Congressional Budget Office, "A Premium Support System for Medicare: Analysis of Illustrative Options," September 18, 2013, http://www.cbo.gov/publication/44581, and Robert E. Moffit and Rea S. Hederman, Jr., "CBO Confirms: Medicare Premium Support Means Savings for Taxpayers and Seniors," Heritage Foundation *Backgrounder* No. 2878, February 3, 2014, http://www.heritage.org/research/reports/2014/02/cbo-confirms-medicare-premium-support-means-savings-for-taxpayers-and-seniors.

Obamacare cuts Medicare payments to fund other new programs

Projected Medicare savings from Obamacare do not improve the program's long-term solvency. Most of the savings are redirected to fund new Obamacare spending.

CUTS IN MEDICARE DUE TO OBAMACARE, 2013–2022



* Disproportionate Share Hospital, meaning supplemental payments that go to hospitals that serve a large number of low-income patients.

Source: Congressional Budget Office, July 2012.

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Beyond that necessary earmarking of Medicare savings for the Medicare program, Congress should embark on broader Medicare reform in stages. In the first stage, Congress should adopt some basic reforms to the traditional Medicare program, most of which already attract broad bipartisan support, to smooth the way for Medicare premium support:[27]

- Congress should increase the age of Medicare eligibility—gradually—to 68, and index it to longevity;
- Congress should gradually increase the Medicare Parts B and D premiums from 25 percent to 35 percent while retaining existing "hold harmless" rules for the poor, and should further reduce taxpayer subsidies for wealthy Medicare recipients;
- Congress should combine Medicare Parts A and B and replace the existing complex set of cost-sharing arrangements with a simple and unified deductible, a uniform coinsurance rate, and a catastrophic out-of-pocket limit;
- Congress should establish a Part A premium to be effective in any year that the Medicare HI Trust Fund is running a deficit; and

27 Robert E. Moffit, "The First Stage of Medicare Reform: Fixing the Current Program," Heritage Foundation *Backgrounder* No. 2611, October 17, 2011, http://www.heritage.org/research/reports/2011/10/the-first-stage-of-medicare-reform-fixing-the-current-program, and Robert E. Moffit and Rea S. Hederman, Jr., "Medicare Savings: 5 Steps to a Down Payment on Structural Reform," Heritage Foundation *Issue Brief* No. 3908, April 11, 2013, http://www.heritage.org/research/reports/2013/04/medicare-savings-5-steps-to-a-downpayment-on-structural-reform.

- Congress should repeal the statutory restrictions on Medicare private contracting, and allow Medicare beneficiaries to buy and use a health savings account to reimburse physicians and other medical professionals for their medical services.[28]

These reforms would preserve Medicare for future generations by ensuring its fiscal and structural stability and by building on the successful models based on choice and competition.

REFORMING MEDICAID

Medicaid, established alongside Medicare in 1965, is the massive federal and state health care program for the poor. In 2012, an estimated one in five Americans was enrolled in Medicaid for at least one month, and combined federal and state spending reached $431 billion.[29] Medicaid provides care to a very diverse group of individuals, including low-income children and pregnant mothers, low-income disabled, and low-income elderly seniors. Medicaid is consuming ever-larger shares of federal and state budgets and threatening other budget priorities. Continued growth in enrollment and spending, accelerated by Obamacare, sets the stage for future demographic, fiscal, and structural challenges in Medicaid.

Medicaid enrollment averaged 58.6 million enrollees in 2012 and is expected to climb to 71.3 million in 2015 and reach 80.9 million by 2022.[30] In 2012, there were 28.3 million children in Medicaid, 14.6 million able-bodied adults, 9.7 million disabled, and 5.1 million elderly enrolled.[31] A considerable increase in the number of adults enrolled in Medicaid is expected as a result of the expansion of the program included in Obamacare. It is projected that 27.9 million able-bodied adults will be enrolled in Medicaid in 2022, trailing only slightly behind the 33.1 million children expected to be enrolled in the program.[32] This demographic shift in enrollment changes the traditional makeup of the program where children were by far the largest category.

Spending in Medicaid is also expected to increase significantly over the next decade. In 2012, combined federal and state spending reached $431 billion—$248.8 billion in federal

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28 In the Balanced Budget Act of 1997, Congress and the Clinton Administration imposed a unique statutory restriction on physicians and patients freely entering into agreements for private care without submitting claims to Medicare. This restriction is insulting to doctors and patients alike. See Robert E. Moffit, "Congress Should End the Confusion Over Medicare Private Contracting," Heritage Foundation *Backgrounder* No. 1347, February 18, 2000, http://www.heritage.org/research/reports/2000/02/congress-shouldend-the-confusion-over-medicare-private-contracting.

29 U.S. Department of Health and Human Services, Center for Medicare and Medicaid Services, Office of the Actuary, *2013 Actuarial Report on the Financial Outlook for Medicaid*, 2013, p. iii, http://www.cms.gov/Research-Statistics-Data-and-Systems/Research/ActuarialStudies/Downloads/medicaidReport2013.pdf.

30 *Ibid*., p. 66.

31 *Ibid*., p. 63.

32 *Ibid*.

spending and $182.2 billion in state spending. Spending is expected to hit $544.4 billion ($328.4 billion federal/$216 billion state) in 2015 and top $853.6 billion ($511.1 billion federal/$342.5 billion state) by 2022.[33] Medicaid spending as a share of gross domestic product is also rising and is expected to reach 3.3 percent by 2022. At the state level, Medicaid is already consuming over 23 percent of states' budgets, diverting resources from other state priorities, such as education and transportation.[34] Moreover, the greater the spending on Medicaid, the more dependent states become on federal funding.

Growth in enrollment and spending puts pressure on the program in other ways. Medicaid has a history of providing lower quality health care.[35] In addition to reasons such as bureaucratic red tape, many physicians decline to participate in Medicaid due to low payment rates in many states.[36] Historically, FFS Medicaid pays physicians on average two-thirds of what Medicare pays for the same services, while Medicare typically pays less than the private market.[37] Moreover, states continue to depend on various cost-containment measures to keep Medicaid within budget, some of which impact access and quality of care.[38]

OBAMACARE AND MEDICAID

Rather than initiating any meaningful reforms that might improve the struggling program and bring spending under control, Obamacare simply fuels further expansion and spending.[39] Obamacare expands eligibility to able-bodied, working age adults—the vast majority of whom do not have dependent children—up the income scale to 138 percent of the federal poverty level. Furthermore, Obamacare fully funds this new expansion population for three years. The federal government assumes 100 percent of the Medicaid benefit costs (but not administrative costs) for this newly designated group in 2014, 2015, and 2016.

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33 *Ibid*., p. 24.

34 National Association of State Budget Officers, *State Expenditure Report: Examining Fiscal 2011–2013 State Spending*, November 21, 2013, p. 42, http://www.nasbo.org/sites/default/files/State%20Expenditure%20Report%20%28Fiscal%202011-2013%20Data%29.pdf.

35 Kevin D. Dayaratna, "Studies Show: Medicaid Patients Have Worse Access and Outcomes than the Privately Insured," Heritage Foundation *Backgrounder* No. 2740, November 7, 2012, http://www.heritage.org/research/reports/2012/11/studies-show-medicaid-patients-have-worse-access-and-outcomes-than-the-privately-insured.

36 For a discussion on the access and payment, see Medicaid and CHIP Payment and Access Commission, Report to the Congress on Medicaid and CHIP, June 2013, p. 50, http://www.macpac.gov/reports.

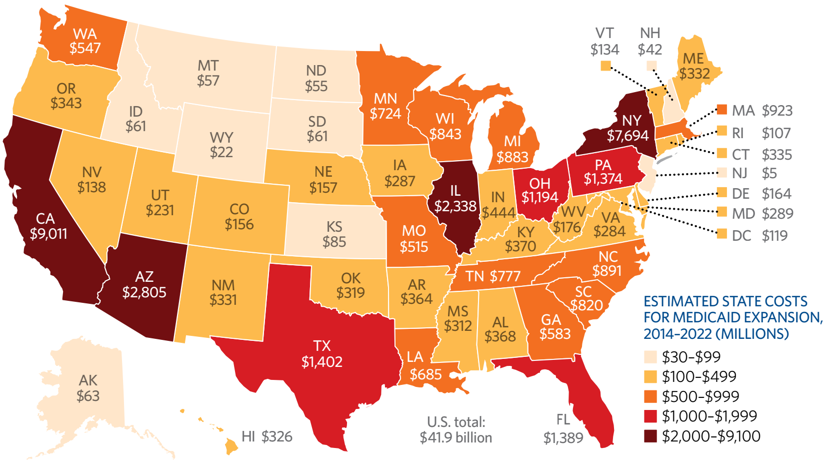
37 *Ibid*.

38 For a summary of the various state efforts on cost containment, see Vernon K. Smith et al. *Medicaid in a Historic Time of Transformation: Results from a 50-State Medicaid Budget Survey for State Fiscal Years 2013 and 2014*, The Henry J. Kaiser Family Foundation, October 2013,http://kff.org/medicaid/report/medicaid-in-a-historic-time-of-transformation-results-from-a-50-state-medicaid-budget-survey-for-state-fiscal-years-2013-and-2014/.

39 For a further discussion on Obamacare provisions and Medicaid, see Brian Blase, "Obamacare and Medicaid: Expanding a Broken Entitlement and Busting State Budgets," Heritage Foundation *WebMemo* No. 3107, January 19, 2011, http://www.heritage.org/research/reports/2011/01/obamacare-and-medicaid-expanding-a-broken-entitlement-and-busting-state-budgets, and Edmund F. Haislmaier and Brian Blase, "Obamacare: Impact on States," Heritage Foundation *Backgrounder* No. 2433, July 1, 2010,http://www.heritage.org/research/reports/2010/07/obamacare-impact-on-states.

Obamacare's Medicaid expansion burdens state budgets

In the vast majority of states, adopting the Medicaid expansion would require additional state spending.



Sources: Heritage Foundation calculations based on data from the Congressional Budget Office, March 2012, and Medicaid and CHIP Payment Access Commission.

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Thereafter, the federal share will gradually decline until it reaches 90 percent in 2020. However, that does not mean that state spending will be flat. The Heritage Foundation estimates that the vast majority of states will also incur additional costs.[40]

As a result of the Supreme Court decision in *NFIB v. Sebelius*, the Centers for Medicare and Medicaid Services Actuary adjusted its Medicaid spending projections to account for expectations that some states would choose not to expand Medicaid.[41] The Actuary now projects that Obamacare will increase Medicaid spending by $500 billion between 2013 and 2022 relative to what would have been spent without the law. The Actuary also projects that Medicaid enrollment will increase by 18 million individuals as a result of Obamacare.[42]

A BETTER APPROACH

The best solution for low-income individuals and families in need of quality health care is to reform the Medicaid program.

40 Drew Gonshorowski, "Medicaid Expansion Will Become More Costly to States," Heritage Foundation *Issue Brief* No. 3709, August 30, 2012, http://www.heritage.org/research/reports/2012/08/medicaid-expansion-will-become-more-costly-to-states.

41 For a discussion of the impact of the Supreme Court decision, see Nina Owcharenko, "The Supreme Court's Medicaid Decision: The Obamacare Mess Just Got Messier," Heritage Foundation *Issue Brief* No. 3663, July 11, 2012, http://www.heritage.org/research/reports/2012/07/obamacare-fallout-from-the-supreme-court-and-medicaid-expansion.

42 *2013 Actuary Report*, p. iv.

Congress should start by taking immediate action to reduce the enhanced funding for the new expansion population provided to the states under Obamacare. Rather than simplifying and stabilizing Medicaid's financing, Obamacare's higher federal funding for the expansion population creates a new layer of complexity in the program, further undermines the future stability of the program, and encourages states to shift attention from the traditional mission of the program—serving indigent children, parents, the elderly and disabled—toward a new group of able-bodied, working age adults.

In addition, like the new tax option for those with employer-based coverage, Congress should allow those currently enrolled in Medicaid—specifically the non-disabled, non-elderly—to opt out of Medicaid and purchase coverage of their choice using existing Medicaid dollars and without the burden of existing restrictions. Enrollees would be able to decide whether to stay in the traditional Medicaid program or to purchase private health insurance outside Medicaid. In a post-Obamacare environment, this would provide enrollees with short-term relief that expands their options as Congress tackles more fundamental Medicaid reform.

Long term, Congress should restructure the traditional federal funding formula to a per capita amount based on each eligibility group. Meaning, Congress should set a separate funding level for children, a separate funding level for parents, a separate funding level for the elderly, and a separate funding level for the disabled. This would begin transitioning Medicaid into more discrete, focused, and manageable programs while creating more stable and predictable budgets with savings for both federal and state taxpayers.

From there, low-income children and parents should have their federal Medicaid contribution converted into direct assistance to purchase private health insurance. States, of course, would be allowed to supplement the federal contribution as they see fit. Rather than depending on the Medicaid bureaucracy for their care, those low-income families would be able to purchase private health insurance of their choosing, including coverage at the place of work.

Currently, Medicaid also provides "wrap around" coverage to Medicare for the low-income elderly that pays their Medicare premiums, deductibles, and coinsurance. However, under a comprehensive, reformed Medicare premium support program, those funds would be reprogrammed to give those beneficiaries a greater contribution to cover premiums and cost sharing.[43] That way, low-income seniors would still receive the same level of assistance, but it would be provided through one program rather than two.

43 Jonathan Crowe, "How Competitive Private Plans Can Improve Care for Dual-Eligible Beneficiaries of Medicare and Medicaid," Heritage Foundation *Backgrounder* No. 2925, July 10, 2014, http://www.heritage.org/research/reports/2014/07/how-competitive-private-plans-can-improve-care-for-dual-eligible-beneficiaries-of-medicare-and-medicaid.

Finally, yet equally important, the low-income disabled enrolled in Medicaid, would, under the new financing arrangement, have more access to patient-centered options, such as personal accounts and counseling, to let them to exercise greater control over the direction and management of their care.[44]

These reforms would refocus the Medicaid program, provide budget reliability, better address the unique needs of the different diverse populations currently covered by the program, and provide beneficiaries with better access to medical care by embracing successful models based on patient choice and competition.[45]

OPPORTUNITY FOR A FRESH START

The debate over reforming America's health care system is far from over. The ongoing implementation and technical problems plaguing Obamacare, combined with consistent opposition to the law as a whole, will necessitate another debate over health care reform. That will offer opportunities for Congress to advance a much better alternative. The alternative is one that does not reinforce greater government control as does Obamacare, but rather provides a fresh approach based on patient-centered, market-based principles. Such an approach would address the ongoing challenges associated with the tax treatment of health insurance, the over-regulation of insurance markets, and the pressing need for serious reforms to health care entitlements.

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44 For a description of these types of consumer-based reforms, see "Cash and Counseling," Robert Wood Johnson Foundation, June 11, 2013, http://www.rwjf.org/content/dam/farm/reports/program_results_reports/2013/rwjf406468, and Centers for Medicare and Medicaid Services, "Self Directed Services," http://www.medicaid.gov/Medicaid-CHIP-Program-Information/By-Topics/Delivery-Systems/Self-Directed-Services.html.

45 Nina Owcharenko, "Medicaid Reform: More than a Block Grant Is Needed," Heritage Foundation *Issue Brief* No. 3590, May 4, 2012, http://www.heritage.org/research/reports/2012/05/three-steps-to-medicaid-reform.

* An expanded version of this essay was published previously as "A Fresh Start for Health Care Reform," Heritage Foundation *Backgrounder* No. 2970, October 30, 2014, http://www.heritage.org/research/reports/2014/10/a-fresh-start-for-health-care-reform.

REGULATION: KILLING OPPORTUNITY

James L. Gattuso and Diane Katz

In his January 2014 State of the Union address, President Barack Obama vowed to wield his executive powers when faced with congressional resistance to his legislative agenda: "America does not stand still—and neither will I," he said. "So wherever and whenever I can take steps without legislation ... that's what I am going to do."[1] This provocative declaration was startling in its bluntness, but it was hardly a new policy. During its first five years, the Obama Administration aggressively exploited regulation to get its way. Issuing 157 new major rules at a cost to Americans approaching $73 billion *annually*, this Administration is very likely the most regulatory in U.S. history.

Of course, preceding Administrations also have increased regulation, albeit to a lesser degree. And regulatory overreach by the executive branch is only part of the problem. Congress, too, is a major culprit. Lawmakers routinely delegate their policy-making powers to regulatory agencies. Furthermore, much of the red tape imposed over the past five years has been driven by "independent" agencies, such as the Securities and Exchange Commission (SEC) and Federal Communications Commission (FCC), which are outside direct presidential control. From finance to telecommunications, these agencies have added to the regulatory tide swamping American businesses and families. And there are many more regulations to come; agencies have identified 120 additional major rules they intend to work on, including dozens linked to the 2010 Dodd–Frank financial regulation law and Obamacare. Of particular concern is that the FCC has launched yet another attempt to regulate Internet traffic.

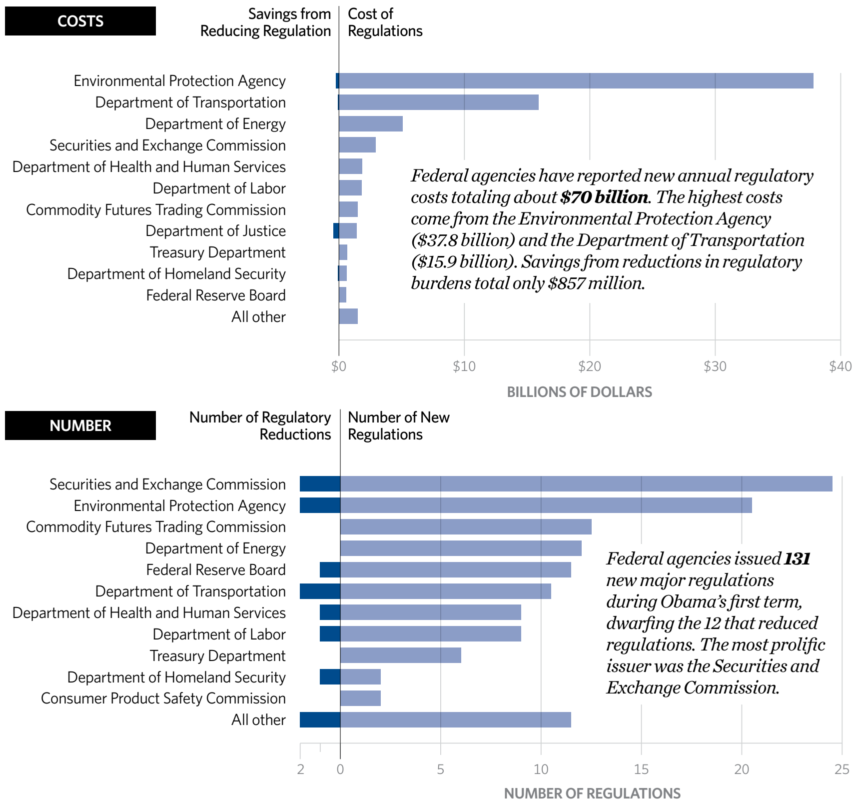
Reforms of the regulatory process are critically needed. Among these: requiring congressional approval before any new major regulation takes effect, requiring analyses of the regulatory consequences of all proposed legislation before a vote by Congress is held, setting sunset deadlines in law for all major regulations, and including "independent" agencies in the White House regulatory review process.

RED TAPE RISING

Unlike federal taxation and spending, there is no official accounting of total regulatory costs. Estimates range from hundreds of billions of dollars to more than $2 trillion each year. However, the number and cost of *new* regulations can be tracked, and both are growing unabated.

Obama's First Term: Costs and Number of New Major Regulations, by Agency

Figures are for January 21, 2009, to January 20, 2013.



Source: Heritage Foundation calculations based on data provided by individual agencies.

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The most comprehensive source of data on new regulations is the Federal Rules Database maintained by the Government Accountability Office (GAO). According to GAO data, 15,794 new rules were published in the *Federal Register* in the five years following President Obama's inauguration in 2009. Of these, 403 were classified as "major," essentially defined as having an expected economic impact of at least $100 million per year.

Most of these major rules were administrative or budgetary in nature, such as Medicare payment rates and hunting limits on migratory birds. But a total of 157 were "prescriptive" regulations, meaning they imposed burdens on private-sector activity. This compares to 62 such rules imposed during George W. Bush's first five years.

1 "Full Transcript: Obama's 2014 State of the Union Address," *The Washington Post*, January 28, 2014, http://www.washingtonpost.com/politics/full-text-of-obamas-2014-state-of-the-union-address/2014/01/28/e0c93358-887f-11e3-a5bd-844629433ba3_story.html.

Only 15 rule changes adopted during the first five years of the Obama Administration decreased regulatory burdens. This compares to 20 such "deregulatory" actions during President Bush's first five years.

The cost of the new mandates and restrictions imposed by the Obama Administration now nears $73 billion annually, based on analyses performed by the regulatory agencies. The $73 billion in total annual costs is more than triple the estimated $22 billion in annual costs imposed at the same point in the George W. Bush Administration.[2] Agencies also reported some $13 billion in one-time implementation costs for new rules over the past five years.

The cost of the new mandates and restrictions imposed by the Obama Administration now nears $73 billion annually, based on analyses performed by the regulatory agencies.

While regulatory growth has accelerated under President Obama, it did not start with his Administration. According to the Office of Management and Budget, the regulatory burden imposed on Americans and the U.S. economy has grown in each of the past 30 years. Total regulatory costs have not declined since 1982. Thus, regulatory growth is a long-term, persistent problem.

Not all regulations are unwarranted, of course. Some rules are justified. No one is talking about eliminating airline safety rules or allowing contaminated meat to be sold deceptively to consumers. But there are volumes of rules lacking rational justification, ranging from the trivial (requiring railroads to paint an "F" on locomotives to indicate the front) to the potentially catastrophic (the FCC regulating the Internet). This constant increase in regulatory burdens acts as a drag on the economy by shifting resources from innovation, expansion and job creation to regulatory compliance.

INDUSTRY'S ROLE IN REGULATION

One might expect the relationship between regulators and the regulated to be purely adversarial. After all, regulators' actions often cost firms significant amounts of money. But it is not unusual for businesses to cooperate with regulators in crafting rules—particularly if they have the resources on hand to hire lawyers and lobbyists. And the urge to exploit

2 James L. Gattuso and Diane Katz, "Red Tape Rising: Five Years of Regulatory Expansion," Heritage Foundation *Backgrounder* No. 2895, March 26, 2014, http://www.heritage.org/research/reports/2014/03/red-tape-rising-five-years-of-regulatory-expansion.

regulation for competitive advantage is not limited to big business. Small businesses, including real estate agents and car dealers, employ powerful trade associations that have long used regulation to limit competition.

Incumbent firms seek tariffs, price controls and even prescribed industrial processes to raise competitors' costs or to erect barriers to market entry for newcomers. For example, business support for export subsidies or strict energy conservation standards are not driven by corporate "social responsibility," as is often claimed by proponents. Rather, businesses support these regulations because they favor the operations of specific companies or industry sectors over those of competitors. Businesses may also pursue regulation to obtain cost advantages. Big-box retailers, for instance, pushed for the so-called Durbin Amendment to Dodd-Frank, which put government price controls on credit card transaction fees fees. Similarly, large Internet firms such as Google and Netflix are lobbying furiously for the FCC to regulate Internet access service as a way to limit transmission costs.

This strategy is by no means new. In a classic 1971 work, economist George Stigler described in detail some of the mechanisms by which businesses partner with regulators to hinder their rivals (known by economists as "regulatory capture"), citing examples dating to the turn of the 20th century.[3] Of course, the extent of such capture is directly proportionate to the size and scope of government. The bigger government grows, the more special interests it produces.

MEASURING THE BURDEN

Where are the new regulations coming from? The single most prolific generator of new rules in 2013 was the SEC, which was tasked with issuing literally dozens of new regulations under the Dodd–Frank Wall Street Reform and Consumer Protection Act. But the costliest rules come from the Environmental Protection Agency (EPA), which has imposed almost $40 billion in new annual costs on Americans since 2009—more than all other agencies combined.

The actual cost of new regulations is undoubtedly much higher than the totals reported by the agencies and cited here. As a first matter, the numbers include only "major" regulations. No cost-benefit analysis is typically performed for the thousands of non-major rules issued each year, although the cumulative costs are certainly substantial.

But the costs of even major rules often go unquantified. In 2013 alone, regulators failed to provide quantified costs for seven of the 26 major prescriptive regulations issued; another eight lacked cost data for key components of the rules.

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3 George J. Stigler, "The theory of economic regulation," *The Bell Journal of Economics and Management Science*, Vol. 2, No. 1 (Spring, 1971), pp. 3-6.

The lack of analysis is a particular problem for independent agencies, such as the FCC, that are not required—as are executive branch agencies—to analyze costs and benefits of proposed regulation.[4] Thus, many of the rules lacking quantified costs involve financial regulation or communications technology. For example, the Consumer Financial Protection Bureau failed to quantify the costs of its 2013 "Loan Originator" rules, which established stricter registration and licensing requirements on mortgage lenders and imposed new restrictions on mortgage fees—burdens that directly affect the availability of credit. Likewise, costs were not quantified by the Federal Deposit Insurance Corporation for its 2013 "Regulatory Capital Rules," which revised capital requirements for supervised institutions.

The executive branch agencies also fall short of the requirements to weigh costs and benefits. For example, the Department of Energy reported the annual paperwork burden for its 2013 cybersecurity rule as $56 million, but failed to quantify the substantial costs of materials, equipment, and labor that will be necessary to comply.[5]

Some costs are impossible to quantify, such as the value of lost innovation or violations of personal liberty. What cost, for instance, should be ascribed to the Department of Health and Human Services' requirement (now partially blocked in the courts) that all insurance plans cover contraceptive services, regardless of an individual's moral convictions?

But often the problem is simply inadequate or incomplete analysis. And the gatekeeper charged with ensuring thorough analyses—the White House Office of Information and Regulatory Affairs (OIRA)—is outmanned and outgunned by the regulators. With a staff of 50, OIRA is reviewing the work of agencies with a combined total of 282,000 employees, a personnel ratio of more than 5,600:1.[6] This would be a difficult job even with the support of the President. It is all the harder under the present Administration, which has not made controlling regulatory costs a priority.

The costs of the new regulations are felt in a variety of ways, including inhibiting economic growth, curtailing innovation, and impeding job creation. The employment effects, while difficult to measure, can be substantial. A 2013 EPA rule on industrial boilers, for example, threatens some 71,000 jobs related to the paper and pulp industry alone. Other proposed rules would hit the economy more broadly. One study forecast that adoption of "net

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4 Erica Smith, "D.C. Circuit Faults SEC on Cost-Benefit Analysis of Proxy Access, Vacates Rule 14a-11," Bloomberg Law, July 29, 2011, http://about.bloomberglaw.com/law-reports/d-c-circuit-faults-sec-on/.

5 "Department of Energy: Version 5 Critical Infrastructure Protection Reliability Standards," *Federal Register*, Vol. 78 (December 3, 2013), p. 72755, https://www.federalregister.gov/articles/2013/12/03/2013-28628/version-5-critical-infrastructure-protection-reliability-standards.

6 Susan Dudley and Melinda Warren, "Sequester's Impact on Regulatory Agencies Modest: An Analysis of the U.S. Budget for Fiscal Years 2013 and 2014," Regulatory Studies Center, George Washington University and Weidenbaum Center, Washington University in St. Louis, July 2013, http://wc.wustl.edu/files/wc/imce/2014_regulators_budget_0.pdf.

neutrality" rules by the FCC could reduce employment by hundreds of thousands of jobs.[7] An EPA rule on ozone could reduce employment by 7.3 million by 2020, according to a report by the Manufacturer's Alliance.[8]

The regulatory burden falls particularly hard on small businesses, which have far less margin to absorb compliance costs. That said, the interests of small businesses are not necessarily the same as those of consumers as a whole. Regulations that artificially protect small businesses can be as harmful to Americans as those that hinder small businesses. In fact, many of the most heated controversies in regulatory policy have involved rules that limit competition faced by politically well-connected small businesses—ranging from insurance agents to car dealers to law firms—at the expense of consumers. The goal of policymakers should be to eliminate unnecessary barriers on all firms, rather than provide regulatory advantage to a particular class of enterprise.

Neither costs nor benefits can be perfectly quantified. But while regulators have an incentive to minimize the costs of regulations, they have an incentive to inflate the benefits.

DISTORTED BENEFITS

The Obama Administration defends its regulatory record by touting the projected benefits of the rules. But the cost of regulation is a concern independent of benefits. Regulatory costs are like federal spending: Even if the benefits of a particular program exceed its costs, it is still important to track how much is being spent.

Moreover, benefit estimates—as calculated by the agencies—need to be considered with skepticism. Neither costs nor benefits can be perfectly quantified. But while regulators have an incentive to minimize the costs of regulations, they have an incentive to inflate the benefits.

A particularly egregious example is the Department of Energy's calculation of benefits for its energy conservation standards for microwave ovens.[9] The rule imposes limits on the amount of energy a microwave oven can consume when it is in standby mode or turned off (to keep the clock running and keypad lit, for example).

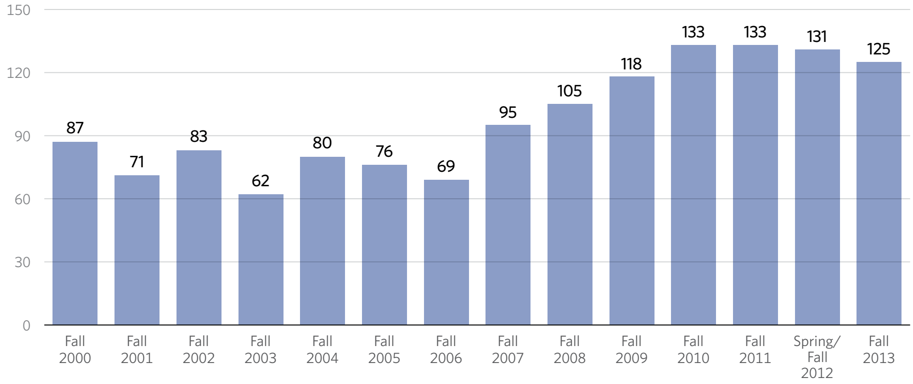
7 Charles M. Davidson and Bret T. Swanson, "Net Neutrality, Investment & Jobs: Assessing the Potential Impacts of the FCC's Proposed Net Neutrality Rules on the Broadband Ecosystem," Advanced Communications Policy and Law Institute, New York University, June 2010.

8 Donald A. Norman, "Economic Implications of EPA's Proposed Ozone Standard," Manufacturer's Alliance Economic Report, September 2010.

9 "Department of Energy: Energy Conservation Program: Energy Conservation Standards for Standby Mode and Off Mode for Microwave Ovens; Final Rule," *Federal Register*, Vol. 28, No. 116 (June 17, 2013), p. 36319, http://www.gpo.gov/fdsys/pkg/FR-2013-06-17/pdf/2013-13535.pdf.

Economically Significant Rules in the Fall Unified Agenda

NUMBER OF PLANNED REGULATIONS EXPECTED TO COST $100 MILLION OR MORE ANNUALLY



Source: Office of Management and Budget, "Unified Agenda and Regulatory Plan Search Criteria," http://www.reginfo.gov/public/do/eAgendaAdvancedSearch (accessed April 10, 2013). Note: Under "Agency or Agencies," select "All," then "Continue." Under the "Priority" subheading, select "Economically Significant." Under "Agenda Stage of Rulemaking," select "Proposed Rule Stage" and "Final Rule Stage."

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In attempting to justify the new standard, the Energy Department cited the benefits of preventing the damages supposedly associated with carbon dioxide emissions from electricity use. Evidently desperate to rationalize the regulation, and without public notice or comment, Energy Department officials doubled the purported "social cost of carbon" that had been applied in previous rules, thereby vastly inflating the claimed benefits. The new number also is likely to be used to justify stricter mandates on all manner of other appliances.[10]

Agencies also increasingly rely on "private benefits," roughly defined as benefits that are paid for by the consumers who receive them. For example, the microwave regulation treats energy efficiency as a benefit to consumers—regardless of whether a consumer would choose to pay extra for a more efficient model or buy a less expensive oven and use the savings for a benefit of his own choosing. Whenever government mandates such "benefits" through regulation, individuals lose the ability to choose for themselves whether the benefit is worth the cost. That loss of consumer choice carries a very steep cost.[11]

10 David Kreutzer and Kevin Dayaratna, "Scrutinizing the Social Cost of Carbon: Comment to the Energy Department," The Daily Signal, September 16, 2013, http://blog.heritage.org/2013/09/16/scrutinizing-the-social-cost-of-carbon-comment-to-the-energy-department/.

11 Susan E. Dudley, "OMB's Reported Benefits of Regulation: Too Good to Be True?" *Regulation* (Summer 2013), http://research.columbian.gwu.edu/regulatorystudies/sites/default/files/u41/Dudley_OMB_BC_Regulation-v36n2-4.pdf.

MORE IN THE WORKS

Hundreds of other costly regulations are also in the works. The most recent Unified Agenda—a semi-annual compendium of planned regulatory actions by agencies—lists 126 "economically significant" rules in the "proposed" or "final" stages.[12]

Among these are dozens of Dodd–Frank rulemakings. Despite the prodigious output of financial service regulators since 2010, there is still a backlog of rules waiting to be written. As of September 2, 2014, a total of 280 Dodd–Frank rulemaking deadlines had passed, but more than 40 percent of these deadlines were missed. Regulators had not yet released proposals for about a quarter of the rules.[13]

Rulemaking for Obamacare is also ongoing.[14] In late December, the Administration finalized a menu labeling requirement for which compliance will require an estimated 10 million hours of work by private-sector firms. Chain restaurants and vending machine operators will be required to disclose "in a clear and conspicuous manner" myriad specific nutrition information for each of their offerings—including the buffet.

Officials of the Occupational Safety and Health Administration intend to complete rulemaking on a new exposure standard for crystalline silica (fine particles of sand common to mining, manufacturing, and construction). If the rule is enacted as proposed, one industry analysis estimated compliance costs of $5.5 billion annually, as well as the loss of 17,000 "person-years" of employment and $3.1 billion of economic output each year.[15]

DANGER OF INTERNET REGULATION

Perhaps the most worrisome new rule is being developed by the FCC. Its proposed new rules would require Internet carriers to deliver all online content in a "neutral" fashion.

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12 Office of Management and Budget, "Unified Agenda and Regulatory Plan Search Criteria," http://www.reginfo.gov/public/do/eAgendaAdvancedSearch.

13 "Dodd–Frank Progress Report," DavisPolk, September 2, 2014, http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/.

14 Daren Bakst, "Obamacare's Menu Labeling Law: The Food Police Are Coming," Heritage Foundation *Issue Brief* No. 4008, August 6, 2013, http://www.heritage.org/research/reports/2013/08/obamacare-s-menu-labeling-law-the-food-police-are-coming.

15 See letter to OIRA Administrator Cass Sunstein dated September 30, 2011, from the National Association of Manufacturers, the National Federation of Independent Business, the Associated General Contractors of America, the American Road & Transportation Builders Association, the Steel Manufacturers Association, the Portland Cement Association, the Precast/Prestressed Concrete Institute, the California Construction and Industrial Materials Association, the American Concrete Pavement Association, the National Ready Mixed Concrete Association, and the American Chemistry Council Crystalline Silica Panel, http://db78bc60e308ad8dc7c2-6f6534a35fc09b927eb00e4333a7f4cf.r47.cf2.rackcdn.com/uploaded/r/0e896071_regulatorylegalcrystallinesilicacoalitionletter.pdf.

Defining such neutrality is, of course, easier said than done, and doing so without harm to the Internet is virtually impossible. For instance, advocates of "net neutrality" are urging the FCC to ban outright the "paid prioritization" of Internet content, that is, arrangements under which consumers and content providers could get expedited transmission service for an additional fee. Critics decry such prioritized service as "unfair."

But premium offerings would be neither unique nor a matter of concern. Almost every service offers some level of differentiated benefit at a discount or a premium rate. Airline passengers, for example, can fly coach or first class, sports fans choose between box seats or grandstand benches, cable service can be basic or enhanced tier. Paying more—or less—for a product or service according to the quality and quantity received is a sign of a robust, diverse marketplace, not an unfair one.

Nor do premium service offerings endanger competition. Priority services are not purchased just by the market leaders. Indeed, they can be more helpful to new entrants trying to win customers from a dominant firm than to an already entrenched firm.

Rather than preserve service levels for non-premium customers, banning paid prioritization would actually make a deterioration of service more likely. Broadband network owners invest tens of billions of dollars annually to maintain and expand their networks. In fact, the two biggest sources of capital investment in the U.S. economy in 2013 were AT&T and Verizon.[16] Regulations that limit revenue and thus discourage such investment —such as the proposed neutrality rules—are the real threat to consumers who rely on robust broadband service.

But what if competition fails? Without net neutrality rules, would consumers be left at risk? Not at all. Agencies such as the Federal Trade Commission can address any legitimate concerns under existing antitrust laws. And antitrust rules focus on consumer welfare—an approach far preferable to the FCC's vague charge to further the "public interest."

POLICY RECOMMENDATIONS

Much of the red tape imposed over the past six years has been driven by vast and vaguely worded legislation in which Congress granted broad discretion to regulatory agencies. Doing so allows lawmakers to claim credit for "doing something" while evading blame for specific regulations. Thus, for example, the FCC is charged with furthering the "public

16 Diana G. Carew and Michael Mandel, "U.S. Investment Heroes of 2014: Investing at Home in a Connected World," Progressive Policy Institute, September 19, 2014, http://www.progressivepolicy.org/issues/economy/u-s-investment-heroes-2014-investing-home-connected-world/.

interest and the new Consumer Financial Protection Agency with limiting "abusive" financial practices without a clear indication of what those terms mean. The result is power without accountability—a useful formula politically but an abysmal one for policymaking.

In theory, of course, these rules can always be modified or revoked by legislation. The 1996 Congressional Review Act (CRA) established "fast track" procedures for blocking new rules, ensuring an up-or-down vote in the House and the Senate on "resolutions of disapproval."

The CRA, however, has been successfully used only once to stop a rule, and that was more than a decade ago, when a rule on workplace ergonomics promulgated by the Clinton Administration was rejected shortly after George W. Bush was inaugurated. One problem is that a CRA resolution—like all other legislation—is subject to presidential veto, and few Presidents are keen on rejecting the work of their own appointees. As a result, the CRA and congressional review of rulemaking have been toothless tigers.

Critics claim that greater congressional oversight would displace the expertise of regulators with political decision making.[17]

But, outside of political science textbooks, that is not how government works. Regulators have their own self-interested agendas—and political considerations do influence the process.

Most regulatory decision making involves more than scientific or other technical factors, which often are manipulated or ignored. Rulemaking involves judgments as to who will bear the cost and who will secure the benefits. Such decisions properly involve Congress.

Congress and agency "experts" will not always agree. And since Members of Congress must regularly face the voters, they will have a different perspective from appointed regulators. That is not a bug in the system; it is a feature. Simply put, no rule should be adopted if the American people, as represented by Congress, do not agree that it is properly designed or necessary.

To that end, Congress should pursue the following reforms:

- **Require congressional approval of new major regulations promulgated by agencies.** Congress, not regulators, should make the laws and should be accountable to the American people for the results. To help ensure this, no major regulation should be allowed to take effect until Congress explicitly approves it.

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17 Sidney Shapiro, "The REINS Act: The Latest Conservative Effort to Gum Up the Regulatory Works," Center for Progressive Reform blog, January 14, 2011, http://www.cprblog.org/CPRBlog.cfm?idBlog=84F5CF0B-E804-F8D1-7197786456C5DC4F.

The Regulations from the Executive in Need of Scrutiny (REINS) Act approved by the House in August 2013, would impose such requirement.

This would be a significant change in the way rules are adopted. The effect is to reinforce the constitutional balance of powers. As a first matter, the change restores Congress's constitutional role of legislating, too much of which has been delegated to regulators in recent decades. As important, the change would also make lawmakers more accountable for their legislative actions.

Despite the claims by opponents, congressional review is not inherently anti-regulatory. Instead, it ensures scrutiny of new rules by Congress. It would apply just as much to agency decisions that reduce regulatory burdens as it would to those that increase such burdens.

This is not to say that equal numbers of regulatory and deregulatory actions would be subject to scrutiny. That is not because of any bias in the legislation, but rather is simply because agencies act to increase regulation far more often than they act to reduce it.

- **Require regulatory-impact analyses of legislation before Congress.** Lawmakers routinely vote on bills authorizing mandates or restrictions on Americans without any systematic assessment of the costs imposed or other potential effects. Just as a Congressional Budget Office review is required for any on-budget spending measures, a regulatory assessment should be required for any measure before it reaches the floor for a vote.

- **Establish a sunset date for regulations.** While every new regulation promulgated by executive branch agencies undergoes a detailed review by OIRA, there is no similar process for reviewing regulations already on the books. Old regulations tend to be left in place, even when they are no longer useful. To ensure that such retrospective review occurs, regulations should automatically expire if they are not explicitly reaffirmed by the relevant agency through a notice and comment rulemaking. As with any such regulatory decision, this reaffirmation would be subject to review by the courts. Sunset clauses already exist for some new regulations. Regulators, and if necessary, Congress, should make them the rule, not the exception.

- **Subject "independent" agencies to executive branch regulatory review.** Increasingly, rulemaking is conducted by so-called independent agencies outside direct executive branch control. Agencies such as the FCC, the SEC, and the Consumer Financial Protection Bureau are not subject to review by OIRA or even required to conduct cost-benefit analyses. This is a serious gap in the regulatory process. These agencies should be fully subject to the same safeguards applied to executive branch agencies.

CONCLUSION

President Obama's blunt assertion that he will use his executive authority to bypass Congress if it dares to block his agenda has stirred much controversy, but was nothing new for this Administration. During his first five years in office, an eye-popping 157 new major regulations have been imposed at a cost of $73 billion annually—and 120 more are in the pipeline. Congress—which shares much of the blame for enabling this flood of red tape—must act to stem it, ensuring that unnecessary and excessively costly rules are not imposed. Without decisive action, the costs of red tape will continue to grow, and the economy—and average Americans—will be the victims.

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ENDING TOO-BIG-TO-FAIL

Norbert J. Michel

The financial crisis of 2008 led to a "Great Recession" from which the nation is still recovering. The intervening years have not been good for the cause of free markets.

In the Obama years, the government has effectively turned one sixth of the economy into a public utility. Its labor agencies have cracked down against employers who choose not to employ union labor in their facilities. It has imposed vast new energy emissions regulations, drastically limiting the energy sector's potential growth. And, of course, President Obama has signed into law sweeping new financial regulations, further bringing the financial sector under government control and providing new protections to troubled, "too-big-to-fail" firms.

The last of these changes—increased financial regulation—has not been a peripheral development. In fact, the role of free financial markets was central to the public narrative that brought the Obama Administration to power and that has driven its policies throughout the president's tenure. The president and his supporters argue that the financial crisis of 2008 was a disaster resulting from the worst excesses of the free market. Despite the slow economic response to massive federal intervention, and in the face of contradictory historical evidence, these critics of free markets have convinced many Americans that a lack of regulation caused the crisis *and* that the federal response vindicates government's role in the economy. Supposedly, unbridled capitalism of the George W. Bush years crashed the economy, and the heroic application of federal power via emergency bailouts, massive stimulus, and new regulations spurred us to recovery.

In his first term, President Obama frequently made this case in terms like these:

> I believe in the power of the free market. I believe in a strong financial sector that helps people to raise capital and get loans and invest their savings. But a free market was never meant to be a free license to take whatever you can get, however you can get it. That is what happened too often in the years leading up to the crisis. Some on Wall Street forgot that behind every dollar traded or leveraged, there is a family looking to buy a house, pay for an education, open a business, or save for retirement. What happens here has real consequences across our country.[1]

This narrative had much to do with conservatives' failure in 2012 to convince the American people to reject the Obama presidency at the ballot box. President Obama painted his opponent as a thief—a one percenter who made his wealth in a zero-sum system by stealing from the poor. The very same sort of mentality caused the financial crisis, he argued, and a return to leadership of vulture capitalists would further harm struggling Americans.

A more accurate reading of history tells a very different story. Government involvement in the mortgage lending industry exerted a heavy influence on private firms to extend lending to subprime borrowers, enriching those firms and their executives in the process but generating enormous long-term risk for the taxpayer. Unsurprisingly, this distortion created a bubble, which popped in spectacular fashion. The effects of that bubble were magnified by government regulations that had encouraged financial institutions to entangle themselves in housing-related assets. When the ripple effect brought down Wall Street, taxpayer-financed bailouts were delivered to a select group of well-connected, irresponsible, and overextended firms, and legislators chose to punish other, smaller banks and financial institutions with egregious regulations in the name of reforming the system.

The relationship implied by critics of free markets between these changes and the financial crisis is dubious.

The truth is that the financial sector that collapsed in 2008 was hardly free. Just the opposite, in fact, is true. Since the crisis, the very institutions that played a central role in the collapse have been virtually untouched by any corrective regulation or action from Congress. Those regulations that were put in place subsequently have increased the likelihood of a future crisis and done more to entrench the established players in the system.

Conservatives must recast the crisis before the history books have been written if we hope to restore the faith in markets needed for Americans to recognize the danger of our current course and chart a path to a brighter future.

RISK, REGULATION, AND THE CRASH

Many critics blame "Wall Street" and the "banking industry" for taking excessive risks that caused the recent meltdown. That behavior, they allege, was made possible by lax financial regulations.

Deregulation, they argue, turned financial markets into a no-rules casino, with few controls on risky behaviors and the so-called animal spirits that might create unsustainable

1 News release, "Remarks by the President on Wall Street Reform," The White House, April 22, 2010, http://www.whitehouse.gov/the-press-office/remarks-president-wall-street-reform.

bubbles. The relationship implied by critics of free markets between these changes and the financial crisis is dubious.

THE DEREGULATION STRAW MAN

The most prominent villain in this story is the supposed repeal in the Clinton years of the 1933 Glass-Steagall Act, which established the Federal Deposit Insurance Corporation and walled off commercial and investment banks' operations. Glass-Steagall, the argument goes, had performed an essential service, staving off calamity by preventing commercial banks from participating in the stock market.[2]

This narrative depends on willful obfuscation of the details of the Glass Steagall repeal. In reality, it was amended, not repealed. The changes served merely to allow bank holding companies to affiliate with firms that underwrite and deal in stocks, but they did not allow them to play the same role as those firms.[3] Moreover, even these changes were of far less consequence than critics allege. Central to the crisis was the buildup of mortgage-backed securities (MBS) by institutions on both sides of the commercial and investment banking wall—a buildup that had absolutely nothing to do with the Glass-Steagall changes.

As Peter Wallison of the American Enterprise Institute explains, "Insured banks were always permitted under Glass-Steagall to acquire, and to buy and sell, MBS because these instruments were regarded as loans in securitized form. Similarly, the five largest investment banks that got into financial trouble in 2008—Bear Stearns, Lehman Brothers, Goldman Sachs, Morgan Stanley and Merrill Lynch—were not affiliated with insured commercial banks. They also got into trouble by holding the same MBS backed by subprime or low quality loans."[4]

Even when liberals deign to acknowledge that Glass-Steagall's amendment bore little of the responsibility assigned to it for the crash, they maintain that the crisis was a consequence of the government's unwillingness to regulate risk with a heavy hand. Paul Krugman and Robin Wells argue: "It's true that Glass-Steagall, a Great Depression–era law that forbade the mixing of securities trading and accepting FDIC-insured deposits under the same corporate roof, wouldn't have prevented the 2008 implosion of Wall Street. Instead, it was extraordinarily high levels of leverage at investment banks like Lehman

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2 For a representative example, see Elizabeth Warren, "The 21st Century Glass Steagall Act," Elizabeth Warren for Senate, July 11, 2013, http://elizabethwarren.com/blog/glass-steagall.

3 Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail'," Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail.

4 Peter Wallison, "Statement of the Shadow Financial Regulatory Committee on Glass-Steagall and the Volcker Rule," American Enterprise Institute, December 10, 2012, https://www.aei.org/wp-content/uploads/2012/12/-statement-no-334-glasssteagall-and-the-volcker-rule_121705399814.pdf.

and Merrill Lynch, as well as the holding of huge portfolios of toxic subprime mortgages by deposit-taking banks like Bank of America, that were the fuel for the conflagration. But progressives were right to feel that Wall Street had been dangerously underregulated for too long and that the entire country was now paying the price."[5]

In the aftermath of any crisis, of course, it's easy to criticize investment banks for being overleveraged. But the honest and uncomfortable truth is that financial risk is essential to the proper functioning of financial markets. It is risk that makes profit possible in a free market—from Wall Street investment in Fortune 500 companies to main street loans to mom and pop stores. A world without risk is one in which unproven ideas will find no resources to support them.

The real danger to the economy stems not from the mere existence of risk but from misperception of risk, often a consequence of rules that distort or socialize it, inducing firms to engage in dangerous behaviors they otherwise wouldn't participate in. The absurdity of the debate over financial regulation is that the most dangerous decisions made prior to the crisis—the actions that critics use to justify further government involvement in finance—were largely consequences of misguided government policy.

Contra Krugman and Wells's assertion that the crash demonstrated an unhealthy appetite for risk and leverage, the banks' MBS buildups were actually aimed at compliance with federal rules—rules that encouraged banks to stock up on assets the regulators deemed safe, such as, unfortunately, MBS. The government's assessment of the security of mortgage debt was itself undermined by a government-produced bubble. And underlying all of these problems was the implicit too-big-to-fail guarantee of the system, which reduced incentives for firms to think clearly about the then-profitable house of cards they and the government had been building together.

GOVERNMENT'S ROLE IN THE CRISIS

At the root of the crisis was the housing bubble inflated by government-sponsored enterprises Fannie Mae and Freddie Mac. These companies buy mortgages from banks, bundle them, and then sell the repackaged mortgages off as MBS. The GSEs guarantee the interest and principal payments on their MBS, ostensibly turning mortgages into a great investment. But the fact that the GSEs guarantee their MBS does not make mortgage risk disappear. When mortgage holders default, for example, someone still has to pay the investors. That's where the guarantee kicks in. The GSE guarantee has always ensured that MBS investors would be made whole if too many mortgages defaulted, and it has also meant that taxpayers would have to pay if the companies ever failed.

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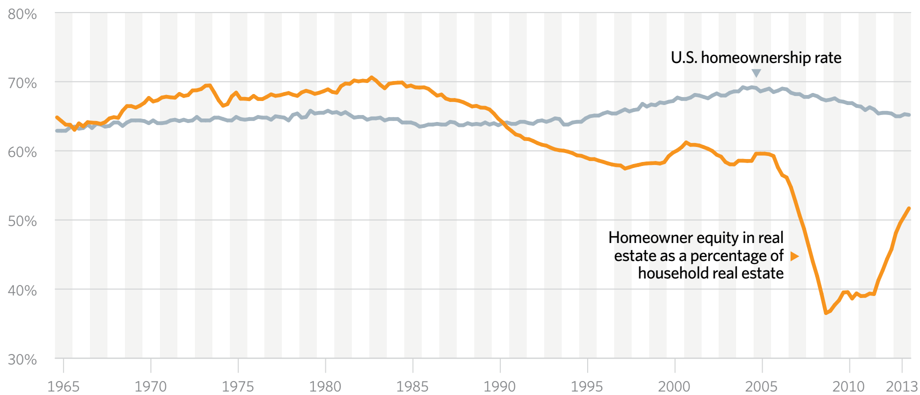
5 Paul Krugman and Robin Wells, "Getting Away with It," *The New York Review of Books*, July 12, 2012, http://www.nybooks.com/articles/archives/2012/jul/12/getting-away-it/.

Homeownership Rate and Homeowner Equity

While the overall U.S. homeownership rate has remained relatively steady for nearly 50 years, homeowner equity as a share of total household real estate began declining in the mid–1980s.



Source: Federal Reserve Bank of St. Louis, "Homeownership Rate for the United States," http://research.stlouisfed.org/fred2/series/RHORUSQ156N (accessed June 3,2014), and Federal Bank Bank of St. Louis, "Households; Owners' Equity in Real Estate as a Percentage of Household Real Estate, Level (HOEREPHRE), Percent, Quarterly, Not Seasonally Adjusted," http://research.stlouisfed.org/fred2/series/HOEREPHRE (accessed June 6, 2014).

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That guarantee had not been necessary to fuel past housing booms in the United States. Fannie Mae existed during the post-Great Depression period, which saw homeownership increase from 44 percent in 1940 to 62 percent in 1960, but the federal government was not the primary driver of the uptick. By the time Fannie Mae became a GSE in 1968, its mortgages had never made up more than 6 percent of the housing market. But in the 1990s, that changed rapidly, with GSE-backed mortgages ballooning from 5 percent to more than 20 percent of the market in a thirteen year period. The vast majority of new mortgages in that time—70 percent—were backed by Fannie or Freddie.[6]

The U.S. is the only major country in the world with a federal government mortgage insurer, government guarantees of mortgage securities, and GSEs in housing finance.[7] In retrospect, that this massive federal involvement aimed at promoting homeownership led to a real estate bubble should be no surprise. But although the distorted housing market was the central cause of the crisis, it need not have led to a full-scale financial panic. Unfortunately, it was amplified by financial regulations that encouraged firms to load up on assets that gave them greater exposure to the housing collapse once it hit.

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6 John L. Ligon and Norbert J. Michel, "GSE Reform: The Economic Effects of Eliminating a Government Guarantee in Housing Finance," Heritage Foundation *Backgrounder* No. 2877, February 7, 2014, http://www.heritage.org/research/reports/2014/02/gse-reform-the-economic-effects-of-eliminating-a-government-guarantee-in-housing-finance.

7 Michael Lea, "International Comparison of Mortgage Product Offerings," Research Institute for Housing America *Special Report*, September 2010, http://www.heritage.org/research/reports/2014/06/why-is-federal-housing-policy-fixated-on-30-year-fixed-rate-mortgages#_ftn5.

CAPITAL REQUIREMENTS AND THE MBS BUILDUP

The implementation of the Basel capital requirements in 1988 deserves special attention. The Basel accords were regulators' attempt to improve capital standards by better matching the riskiness of assets with the amount of capital held against the assets. Basel assigned "risk weights" to various categories of assets, allowing financial institutions to hold less capital against assets deemed safe by regulators. Because GSE-backed loans were considered safe by the regulators, they were hoarded by banks.[8]

Shortly after the Basel accords were adopted in the U.S., the Fed (jointly with the FDIC and OCC) amended the original capital requirements. As of 2001, due to this change, banks could hold less capital for highly rated *privately issued* MBS.[9] After the rule change, known as the recourse rule, certain AA- and AAA-rated asset-backed securities were given the same low-risk weight as GSE-issued MBS. Put differently, the regulators expanded the pool of assets that banks could purchase to lower their required capital.

While much has been made of the "reach for yield" leading up to the crisis, the 10 largest U.S. banks' risk-weight-adjusted assets barely increased even though their assets doubled from 2001 to 2007–clear evidence that the purchases were made for capital relief first and yield last.[10]

Normally, banks would have strong incentives to scrutinize the risk levels of their portfolios with their own private judgment based on experience. The arbitrary capital requirement rules undermine this mechanism for self-discipline without providing any guarantee that the behavior they encourage will actually make the system safer. As we saw in the financial crisis, at times they can do the opposite.

The Federal Reserve is responsible for these (and other) key regulatory failures. The Fed, which has been the primary regulator of bank holding companies since 1956, had resident examiners embedded in some of the largest firms that failed or nearly failed during the crisis. Furthermore, the minutes of the Fed's Open Market Committee meetings in 2008 show that the Fed did not fully understand the magnitude of the crisis as it was happening. Despite these facts, the Basel rules are still in place, financial firms now face more federal regulations, and the Fed's regulatory role has been increased. There is no clear economic logic behind mitigating financial crises in this manner, much less to solving the too-big-to-fail problem with more of the same regulations that clearly don't work. Nonetheless, that's basically what the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act did.

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8 Norbert J. Michel and John L. Ligon, "Basel III Capital Standards Do Not Reduce the Too-Big-to-Fail Problem," Heritage Foundation *Backgrounder* No. 2905, April 23, 2014, http://www.heritage.org/research/reports/2014/04/basel-iii-capital-standards-do-not-reduce-the-too-big-to-fail-problem.

9 See J. Friedman, and K. Wladmir, Engineering the Financial Crisis: Systemic Risk and the Failure of Regulation (Philadelphia, PA: University of Pennsylvania Press, 2011), chap. 2, p. 69.

10 *Ibid*., p. 81.

Further, even the nonbank financial companies that did not previously fall under risk-based capital requirements were, in most cases, regulated in some way before the crisis. For instance, life, property/casualty, and health insurance companies have been required to insure for losses (reinsurance) and hold reserves against estimated future losses since at least the 1940s, even though there was no federal mandate. In addition to reserve and reinsurance requirements, many states had adopted risk-based capital standards for insurance companies operating under their jurisdiction prior to 2008.[11]

In fact, the only large *insurance* company at the center of the 2008 crisis was a federally regulated company. The American International Group (AIG) was regulated by the Office of Thrift Supervision (OTS) because it was a holding company that owned savings and loan institutions.

If deregulation really had caused the crisis as some argue, Congress would have simply needed to restore those rules. Dodd–Frank did not mandate restoration of rules because there was nothing to restore. Given that Dodd–Frank expands financial market regulation with newer versions of the same rules and regulations that have been in place for years, there is little reason to expect less economic turmoil in the future. In fact, many of the private financial firms that had nothing to do with the 2008 meltdown now face expensive regulations that fail to fix the original problems.

Most important, underlying all of these failures was an implicit agreement by all actors in the system that the largest financial institutions were simply "too-big-to-fail." This insulation from the consequences of catastrophe made it easier for all parties involved in the questionable decisions of the 2000s–the massive lending to unqualified mortgage borrowers, the shoring up of MBS as low-risk assets–to avoid thinking about the potential for unforeseen risk. Too few had an incentive to question the fundamental assumptions keeping the bubble inflated and the system functioning. When the crash hit in 2008, Washington honored this silent commitment to the banks' preservation not only with the massive Troubled Asset Relief Program (TARP) bailout but also with various emergency Fed actions, only further perpetuating the notion that the federal government would serve as a permanent backstop to the big institutions. No doubt banks expect the same today in the event of a new crisis—an expectation that makes one far more likely.

11 National Association of Insurance Commissioners, "Risk-Based Capital: General Overview," July 15, 2009, http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf, and National Association of Insurance Commissioners, "The United States Insurance Financial Solvency Framework," 2010, http://www.naic.org/documents/committees_e_us_solvency_framework.pdf. For historical mortality tables used to estimate future life insurance claims, see Society of Actuaries, "Mortality and Other Rate Tables," http://mort.soa.org/.

ENABLING THE BAILOUT: THE FEDERAL RESERVE'S EMERGENCY LENDING AUTHORITY

During the 2008 crisis, the supposedly independent Federal Reserve worked closely with U.S. Treasury Department to provide loans to various financial companies, including banks and securities firms that might have otherwise filed bankruptcy. The government even forced some banks to take money against their objections.[12] In particular, the Fed facilitated bailouts to financially weak firms and their creditors by invoking its so-called emergency lending authority.

This emergency lending authority exists because the Fed has historically been viewed as the nation's lender of last resort, but it now mainly serves as a way to enable too-big-to-fail policies. A lender of last resort (LLR) is supposed to provide credit when funds are not available from any other source, but the essence of a true LLR is to avoid lending to financially troubled firms. Whenever possible, the LLR is supposed to avoid lending to specific institutions and, instead, is supposed to ensure the system-wide flow of credit. Overall, the Fed has rarely acted as the LLR it was designed to be. Throughout its history the Federal Reserve has repeatedly given special treatment to some by lending to financially troubled firms, thus jeopardizing the independence of its monetary policy decisions and putting taxpayers at risk.

During the recent financial crisis the Fed allocated credit directly to several firms through several broad lending programs. For instance, the Fed provided a $13 billion loan to Bear Sterns, one of the Fed's largest primary dealers, on March 14, 2008. The loan was repaid in days, but then the Fed provided a $30 billion loan to facilitate J.P. Morgan Chase's Acquisition of Bearn Sterns (via a special purpose vehicle named Maiden Lane, LLC). Shortly after this deal was completed, former Fed chairman Paul Volcker remarked that this loan was "at the very edge" of the Fed's legal authority.[13]

Overall, the U.S. Government Accountability Office (GAO) estimates that the Federal Reserve lent financial firms more than $16 trillion through its "Broad-Based Emergency Programs."[14] To put this figure in perspective, annual Gross Domestic Product (GDP)

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12 See James Gattuso, "Paulson and the Banks: What an Offer You Can't Refuse Looks Like," The Daily Signal, May 15, 2009, http://dailysignal.com/2009/05/15/paulson-and-the-banks-what-an-offer-you-can%E2%80%99t-refuse-looks-like/, Nina Easton, "How the Bailout Bashed the Banks," CNN Money, June 22, 2009, http://money.cnn.com/2009/06/19/news/economy/trouble_with_tarp_bailout.fortune/index.htm?postversion=2009062107, and John A. Allison, The Financial Crisis and the Free Market Cure: Why Pure Capitalism is the World Economy's Only Hope (New York: McGraw Hill, 2013), pp. 170–171.

13 See J. Brinsley and A. Massucci, "Volcker Says Fed's Bear Loan Stretches Legal Power," April 8, 2008, Bloomberg News at www.bloomberg.com/apps/news?pid=newsarchive&sid=aPDZWKWhz21c. Later, the Fed created two additional Maiden Lane entities to complete the American International Group (AIG) bailout. The combined net holdings of the three Maiden Lane LLC's are currently more than $1.7 billion, and nearly all of this total is in the original Maiden Lane LLC.

14 These loans were made from December 1, 2007 through July 21, 2010. See United States Government Accountability Office, "Federal Reserve System: Opportunities Exist to Strengthen Policies and Processes for Managing Emergency Assistance," July 2011, GAO-11-696, p. 131, http://www.gao.gov/new.items/d11696.pdf.

reached $16.8 trillion in 2013, an all-time high for non-inflation adjusted GDP in the U.S. During the crisis, the Fed created more than a dozen special lending programs by invoking its emergency authority under Section 13(3) of the Federal Reserve Act. The Dodd-Frank Act amended this authority after the 2008 crisis, but even if these changes had been in place prior to the crisis, the Fed still would have been able to conduct roughly half of those lending programs.

The FSOC has a broad, ill-defined mandate through which it designates certain "systemically important" financial companies for special regulations under the Federal Reserve. These designations effectively identify the firms whose failure regulators would consider catastrophic to the U.S. economy–that is, the firms considered too-big-to-fail.

THE FINANCIAL STABILITY OVERSIGHT COUNCIL IDENTIFIES TOO-BIG-TO-FAIL FIRMS

The 2010 Dodd–Frank Act greatly expanded the federal government's reach into financial markets through the Financial Stability Oversight Council (FSOC), a multi-regulator council that is supposed to constantly monitor and/or improve U.S. financial stability. The FSOC enshrines the too-big-to-fail problem because it identifies firms whose failure regulators believe would be catastrophic to the U.S. economy. The FSOC's very existence increases the likelihood of future financial crises and bailouts.

If history is any guide, the fact that the council expands regulations over financial markets should not inspire confidence that future crises will be mitigated. Less regulation, not more, gives firms the flexibility to learn and adapt in order to avoid repeating past mistakes. What's more, adhering to the rules and regulations provides the false notion that firms have not taken on too much risk.

In practice, the FSOC will lower competition, increase financial risks, and cost consumers money. The FSOC has a broad, ill-defined mandate through which it designates certain "systemically important" financial companies for special regulations under the Federal Reserve. These designations effectively identify the firms whose failure regulators would consider catastrophic to the U.S. economy–that is, the firms considered too-big-to-fail.

Aside from the authority to make these special designations, the FSOC can ultimately require new regulations for any financial company for virtually any stability-related reason. The FSOC framework assures the Federal Reserve will regulate even nonbank sectors of financial markets more extensively than ever before. In general, the process of imposing these regulations in the future can evolve largely in the absence of further Congressional action. The mere existence of the FSOC is wholly incompatible with the functioning of a dynamic private capital market.

DODD-FRANK'S ORDERLY LIQUIDATION AUTHORITY PROVIDES NEW POTENTIAL BAILOUTS

One of the 2010 Dodd-Frank Act's most troubling aspects is the creation of seizure authority—politely called "orderly liquidation authority"—for certain firms regulators perceive to be failing. While orderly liquidation sounds pleasant, Title II of Dodd–Frank achieves it by allowing federal regulators to seize troubled financial firms—with minimal judicial review—and close down their affairs. Title II also authorizes the Federal Deposit Insurance Corporation (FDIC) to hold taxpayers responsible for the most worthless assets on a company's books. The time-tested bankruptcy process, with its legal protections and judicial supervision, is a far better system.

Dodd-Frank's proponents argue that Title II will prevent taxpayers from being forced to bail out shareholders and creditors of failing institutions. In practice, though, there is little hope that Title II will end bailouts. In an orderly liquidation under Title II, the FDIC acts as the receiver of the firm's parent holding company and, as such, transfers the parent's assets, derivatives, and short-term obligations to a newly created "bridge" company. The bridge company, which is exempt from paying all federal, state, and local taxes, recapitalizes the subsidiaries as the FDIC deems necessary.

Theoretically, these actions *could* be supported through private borrowing, but a firm can be forced into a Title II proceeding only after the FDIC and the Fed certify that there are no private sector options for saving the company from default. Dodd-Frank supporters also point out that the bridge company can be supported by the "Orderly Liquidation Fund," thus avoiding taxpayer support. But the firms that pay into this fund pay taxes too, as do the firms' shareholders and customers who, ultimately, bear the burden of these fees. Furthermore, this fund is analogous to the FDIC deposit insurance fund in that it contains the proceeds of *obligations* issued by the FDIC and purchased by the Treasury Secretary. Another main problem with the orderly liquidation process is that it is specifically designed to allow the firm's operating subsidiaries to continue functioning. As a result, the managers of the subsidiaries—as well as the firm's creditors—all know they have a federal backstop for their activities. This backstop prevents the market from disciplining private actors and effectively ensures that there will be even more risky lending.

POLICY RECOMMENDATIONS

The notion that there has been any sort of substantive deregulation of financial markets in the last century is completely wrong. If anything, the constant expansion of our massive federal regulatory framework *contributed* to the crisis. It follows that most of the so-called solutions offered since the crisis–virtually all of which involved increasing regulations–will fail to make our financial markets any safer. In order to reduce the risk of future bailouts and financial crises, Congress should:

- **Repeal Dodd–Frank.** The 2010 Dodd–Frank Act's answer to the financial crisis was to institute more federal regulation and oversight, despite the fact that this approach has repeatedly failed in the past. Worse, many of the act's components did virtually nothing to address the root causes of the financial crisis and simply expanded the federal safety net for financial firms. This approach has only further socialized the cost of financial risk-taking and, therefore, has increased the likelihood of future financial crises and bailouts.

- **Amend bankruptcy laws to establish an orderly resolution process for large institutions.** There is clearly a need to fix this process and, short of repealing Dodd–Frank, eliminating Title II of the law would be a good start. Amending the bankruptcy laws so that a credible resolution process exists for large financial firms is a key component to ending the too-big-to-fail problem.

- **End the Fed's broken lender-of-last-resort function.** Congress should prohibit the Fed from making emergency loans under Section 13(3) of the Federal Reserve Act and via the discount window. There is, in fact, no clear economic rationale for the Fed to provide direct loans to private firms. Given the development and current sophistication of financial markets, there is even less reason to allow the central bank to serve as a lender of last resort now than there was in 1913. Congress should help to minimize the chances of future too-big-to-fail-style bailouts by revoking the Federal Reserve's emergency lending authority and closing the discount window.

- **End The Fed's role as a financial regulator.** Allowing the Fed to serve as a financial regulator opens the possibility that monetary policy decisions will be compromised as the Fed's employees become embedded in the financial firms they are supposed to be overseeing. Now that Dodd-Frank has charged the Fed with maintaining financial stability, the likelihood of this problem has increased. Removing the Fed from its role as a financial regulator would leave at least five other regulatory agencies in place throughout U.S. financial markets.

- **Require a GAO report on IOR.** Congress should require the Federal Reserve to give an official report on whether paying interest on reserves (IOR) has hindered the economic recovery and/or made other Fed efforts less effective. Prior to the crisis, the Fed paid no interest on banks' reserves. Yet, it began IOR at the same time it started to purchase massive quantities of securities in an effort to spur economic growth. The Fed should give an accounting of the impact IOR has had on its policies.

- **Permanently shut down Fannie and Freddie.** Government-sponsored corporations Fannie Mae and Freddie Mac should be eliminated altogether and the housing market made more stable by relying on private financial firms that are not backstopped by taxpayers.

- **Eliminate the Financial Stability Oversight Council.** One of the principal ways that the Dodd–Frank Act greatly expands the federal government's reach into financial markets is through the Financial Stability Oversight Council (FSOC). The FSOC has a broad, ill-defined mandate through which it designates certain "systemically important" financial companies for special regulations under the Federal Reserve. These designations effectively identify the firms whose failure regulators would consider catastrophic to the U.S. economy—that is, the firms considered too big to fail. Additionally, the FSOC can require new regulations for any financial company for virtually any stability-related reason. The FSOC framework also assures that the Federal Reserve will regulate even nonbank sectors of financial markets more extensively than ever before. Short of a full repeal of Dodd–Frank, the preferred solution, Congress should eliminate the FSOC.

- **Review the effectiveness of the Federal Reserve** with a formal commission, such as that proposed by Representative Kevin Brady and Senator John Cornyn in the Centennial Monetary Commission Act of 2013. This bill would "establish a commission to examine the United States monetary policy, evaluate alternative monetary regimes, and recommend a course for monetary policy going forward."

- **End discretionary monetary policy.** Congress can direct the Fed to implement rules-based policies that can move the U.S. toward a truly competitive monetary system. In particular, Congress could adopt a policy such as the one in the Federal Reserve Accountability and Transparency Act of 2014. This proposal, introduced by Representatives Bill Huizenga and Scott Garrett, would require the Fed to choose a monetary policy rule and clearly state that rule. The plan gives the Fed the flexibility to choose its own rule, and also the flexibility to stop following that rule as long as it explains such a decision to Congress.

- **Reverse QE.** The Fed should minimize any negative effects to reversing its bond buying by announcing a deliberate plan to sell the bulk of these securities over, for instance, the next six years. The Fed can also partly offset (or sterilize) these sales with its normal temporary open-market purchases of short-term Treasuries. As an example, the Fed could announce the following plan:

    - Through 2020, 75 percent of the long-term securities and MBS will be sold, and the remainder will be held until maturity.

    - Each month, the Federal Reserve will sell $45 billion of its long-term securities and MBS.

- **Allow investors to assume their own risks.** In exchange for relief from the federal regulatory burden, Congress can allow financial firms to assume the risk of their operation, as should be the case with any businesses in any sector of the economy. For instance, Congress could allow banks to opt out of all federal banking regulations and government assistance if they convert to a partnership entity. This option should be paired with an explicit statement that these entities will not be eligible for any federal assistance, including FDIC deposit insurance.

CONCLUSION

Congress can still act to ensure that history does not repeat itself. Conservatives can and should ensure that taxpayers will never again bail out large institutions. Instead of bailouts, large financial institutions that fail should be allowed to wind down through an orderly bankruptcy process. Government corporations Fannie Mae and Freddie Mac should be eliminated altogether and the housing market made more stable by relying more on private financial firms that are not backstopped by taxpayers. Lastly, Congress should undertake a major reform of the Federal Reserve, an institution which bears little resemblance to the central bank that was created in 1913.

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WELFARE REFORM

Robert Rector and Rachel Sheffield

The size of the welfare system has been on an upward climb since the federal government began its War on Poverty in the 1960s. Adjusting for inflation, welfare spending has increased by 16-fold since then, and today means-tested welfare costs taxpayers nearly $1 trillion annually. Means-tested welfare is the second largest category of spending in the United States government, exceeded only by old-age entitlements.[1] Despite tens of trillions of dollars in spending on the War on Poverty over the last half century, self-sufficiency rates have languished and unwed childbearing has steadily increased. Yet for decades, liberals have continued to advocate for this broken system.

Conservatives can and should take the lead on fighting poverty, encouraging anti-poverty policy that helps rather than hinders thriving. Rather than allowing the liberals to dominate the discussion, they must address how the current means-tested welfare system has failed the poor. Instead of simply providing a one-way handout that encourages a culture of dependency and too often traps individuals at the margins of society, conservatives should advance policy that respects the dignity of the person by emphasizing the significance of work and marriage to fight poverty and promote self-sufficiency.

WELFARE REFORM: MUCH WORK LEFT TO DO

Conservatives have a strong policy model for success in lifting up those in need. The 1996 welfare reform accomplished something historic. For the first time, able-bodied adult recipients of a welfare program were required to work, prepare for work, or look for work in exchange for receiving welfare benefits. It changed the old Aid to Families with Dependent Children (AFDC) program into the Temporary Assistance for Needy Families (TANF) program. Within about five years of implementing the reform, welfare rolls dropped by half, child poverty declined, and employment rates among low-income individuals grew.[2]

The 1996 welfare reform is a story of successful policy. However, the story of welfare reform shouldn't have ended in 1996. The welfare system in the United States is not limited to merely one program. Far from it. Today, the welfare system includes roughly 80 means-tested programs that provide cash, food, housing, medical care, and social services to poor and lower-income Americans.[3] The 1996 welfare reform touched just one of those programs. The vast majority of welfare programs fail to include any type of work requirement. Furthermore, even TANF's work requirement has been weakened, due to the exploitation of loopholes by state bureaucrats and by the failure of Congress to reauthorize the law.

Rather than abandoning the issue of welfare reform after 1996, conservatives should have used the momentum to propel reform forward. Too many assumed the work of welfare reform was finished, neglecting the fact that the welfare system consists of dozens of other programs that undermine self-sufficiency.

Moreover, the ensuing years have brought attempts to roll back the 1996 reforms. The most direct of these attacks came in July 2012, when the Obama Administration issued a directive from the Department of Health and Human Services that attempted to gut the 1996 welfare reform of its work requirement. This directive went against Congressional authority, quietly and unlawfully trying to do away with the heart of the welfare reform law. Beyond that, this action went against what most Americans believe: able-bodied adults should be required to work or prepare for work in exchange for receiving welfare assistance.[4]

Some conservatives went to great effort to push back. While commendable, it was a difficult task. Policymakers had ignored the issue for so long that the specifics of the reform debate—the nature of the work requirement and the principles underlying it—were ancient history to members of the press covering the change. The White House made the most of the ignorance of a media eager to offer it positive press, convincing many reporters and so-called media "fact-checkers" that the president had actually strengthened the work requirement—an argument debunked by Heritage at the time.[5]

Conservative policymakers must do more to educate themselves and the public on the mechanics of welfare to prevent proponents of the failed system from making further efforts to undermine current reforms and obstruct additional ones. The best way to do so is to open a new conversation about the broader efforts needed to make the entirety of the means-tested welfare system point toward self-sufficiency.

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1 Robert Rector, "Examining the Means-Tested Welfare State: 79 Programs and $927 Billion in Annual Spending," testimony before the Committee on the Budget, U.S. House of Representatives, May 3, 2012, http://www.heritage.org/research/testimony/2012/05/examining-the-means-tested-welfare-state.

2 Robert Rector and Patrick F. Fagan, "The Continuing Good News of Welfare Reform," Heritage Foundation *Backgrounder* No. 1620, http://www.heritage.org/research/reports/2003/02/the-continuing-good-news.

3 Rector, "Examining the Means-Tested Welfare State: 79 Programs and $927 Billion in Annual Spending."

4 "83% Favor Work Requirement for Welfare Recipients," Rasmussen Reports, July 18, 2012, http://www.rasmussenreports.com/public_content/business/jobs_employment/july_2012/83_favor_work_requirement_for_welfare_recipients.

5 Mark Hemingway, "Obama's Palace Guard," *The Weekly Standard*, October 1, 2012, http://www.weeklystandard.com/print/articles/obama-s-palace-guard_652895.html.

Research shows that Americans continue to support the undergirding principle of the 1996 welfare reform: self-sufficiency through work.[6] This principle should be strengthened in the TANF program and expanded to other means-tested welfare programs. Additionally, policymakers should better prioritize means-tested welfare spending, rather than allowing costs to keep ballooning. Finally, the breakdown of marriage must be addressed if the nation hopes to see a reduction in poverty and an increase in self-sufficiency. Too many children are born outside of the institution that research continually shows will best help them thrive. The decline in marriage is leading to a divided society, where some children are born into a stable family and greater resources and others have fewer resources and also lack the stability and benefits of being raised by their married mother and father.

The 1996 welfare reform accomplished something historic. For the first time, able-bodied adult recipients of a welfare program were required to work, prepare for work, or look for work in exchange for receiving welfare benefits.

THE SCOPE OF TODAY'S WELFARE SYSTEM

Today's welfare system is massive. Means-tested welfare spending has soared since the War on Poverty began and is, today, the second largest category of government spending, exceeded only be the combined costs of Social Security and medicare.[7] Back in 1993, means-tested welfare spending surpassed the cost of defense spending, and the chasm between the two categories has grown steadily.[8] The roughly $22 trillion spent on welfare since the beginning of the War on Poverty is three times the amount the government has spent on all military wars combined since the beginning of the nation's history.[9]

Despite the massive amount of taxpayer money going towards means-tested welfare, the Obama Administration has only increased the size of the welfare state. Means-tested welfare spending jumped by one-third during President Obama's first term in office. Under President Obama's budgets, this disparity would grow even larger. Over the next decade alone, President Obama plans to spend $13 trillion on means-tested welfare programs.[10]

6 Rasmussen Reports, "83% Favor Work Requirement for Welfare Recipients."

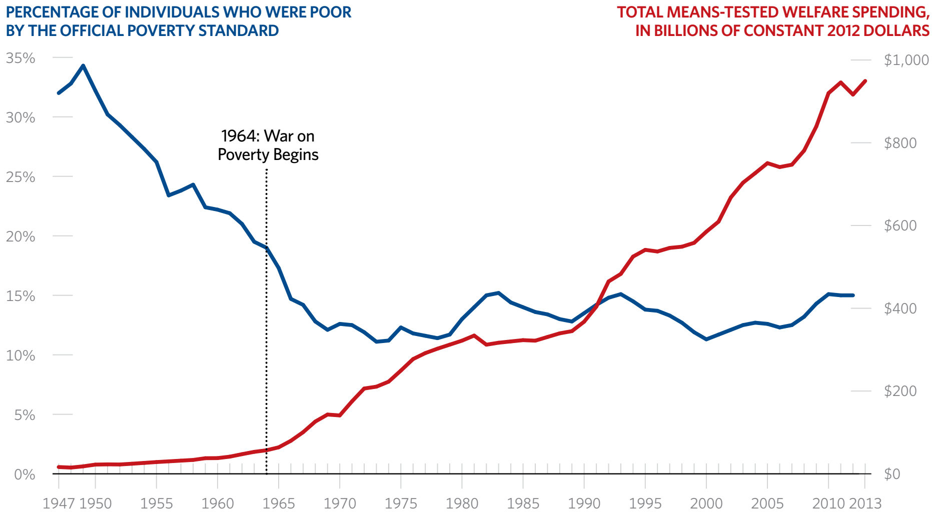
7 Robert Rector and Rachel Sheffield, "The War on Poverty After 50 Years," Heritage Foundation *Backgrounder* No. 2955, September 15, 2014, http://www.heritage.org/research/reports/2014/09/the-war-on-poverty-after-50-years.

8 *Ibid.*

9 Rector, "Examining the Means-Tested Welfare State: 79 Programs and $927 Billion in Annual Spending."

10 *Ibid.*

Total Means-Tested Welfare Spending and Official Poverty Rate, 1947–2012



Sources: Poverty figures for 1947–1958: Gordon Fisher, "Estimates of the Poverty Population Under the Current Official Definition for Years Before 1959," U.S. Department of Health and Human Services, Office of the Assistant Secretary for Planning and Evaluation, 1986. Poverty figures for 1959–2012: U.S. Census Bureau, Current Population Survey, Annual Social and Economic Supplements, "Historical Poverty Tables—People," Table 2, https://www.census.gov/hhes/www/poverty/data/historical/people.html (accessed September 10, 2014). Means-tested welfare spending figures: Heritage Foundation research, U.S. Office of Management and Budget.

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The federal government operates roughly 80 means-tested welfare programs that provide cash, food, housing, medical care, and social services to poor and lower-income Americans. Federal and state spending on these programs costs taxpayers nearly $1 trillion annually ($943 billion in FY 2013). Approximately one third of Americans, or about 100 million individuals, receive benefits from at least one of these programs. If the cost of total government welfare spending were divided equally among the recipients, it would amount to about $9,000 per person or $36,000 per family of four.[11] While this doesn't mean that every individual currently receives this exact amount, it demonstrates the high cost of welfare spending as compared to the number of lower-income Americans.

Although means-tested welfare spending accounts for one of the greatest costs to the American taxpayer, many Americans, including policymakers, don't realize this. Welfare programs are spread across multiple government agencies, and the numerous welfare programs are not viewed as one large whole. In discussions surrounding poverty and welfare, policymakers and the media discuss the means-tested system in a piecemeal fashion, as if food stamps or the school lunch program was the only welfare program. This piecemeal perspective provides a distorted view of the size of the means-tested welfare system.

11 Rector and Sheffield, "The War on Poverty After 50 Years."

WAR ON POVERTY HAS FAILED

The $22 trillion War on Poverty has not led to a decrease in the official poverty rate. The latest Census Bureau report shows that 14.5 percent of Americans live below the poverty line.[12] This is roughly the same amount as were below poverty when the War on Poverty began. While the poverty rate has fluctuated some over the past five decades, it has always hovered around this level.[13]

However, it's important to note that part of the reason the poverty rate has not declined is due to the way poverty is measured. Census identifies a household as poor if its "income" falls below certain thresholds. But in counting "income" Census excludes nearly all of the $943 billion in means-tested welfare aid that is given to low-income Americans. Even if a household received welfare benefits that valued $50,000, for example, it would still be considered poor if its non-welfare income was below the poverty threshold. Because the poverty measure fails to account for most benefits, it is a bad measure of real poverty. It provides very little information about the actual living conditions of poor households.

Although the Census Bureau continues to report each year that roughly 45 million Americans are poor, the actual living of the households that Census defines as poor would be counter-intuitive to most Americans.

Government surveys show that:

- Eighty percent of poor households have air conditioning.
- Nearly three-quarters have a car or truck.
- Nearly two-thirds have cable or satellite television.
- Two-thirds have at least one DVD player, and a quarter have two or more.
- Half have a personal computer; one in seven has two or more computers.
- More than half of poor families with children have a video game system such as an Xbox or PlayStation.
- Forty-three percent have Internet access.
- Forty percent have a wide-screen plasma or LCD TV.
- A quarter have a digital video recorder system such as a TIVO.
- Ninety-two percent of poor households have a microwave.

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12 U.S. Census Bureau, *Income and Poverty in the United States: 2013*, September 2014, http://www.census.gov/content/dam/Census/library/publications/2014/demo/p60-249.pdf.

13 Rector and Sheffield, "The War on Poverty After 50 Years."

Most poor Americans live in comfortable housing that is in good repair and is not over-crowded. In fact, the typical poor American has more living space than the average non-poor person in France, Germany or England. The over-whelming majority of poor persons are neither malnourished nor hungry. For example, in 2009, during the height of the recession, 96 percent of poor parents reported that their child never went hungry at any time during the year because they couldn't afford food.[14]

After the work requirement was put into place, the welfare caseload began to decline rapidly. Within about five years, welfare rolls dropped by half.

Do the surprising living conditions of poor Americans mean that the government's War on Poverty was a success? No, not really. It is true that means-tested welfare assistance does prop up the living standards of many Americans. After all, even the government cannot spend nearly a trillion dollars on welfare without having some impact of living standards. But to properly assess the War on Poverty it's important to remember President Johnson's original goal in launching it. In Lyndon B. Johnson's own words, the War on Poverty was to address not simply the "consequences of poverty" but also the causes. He stated the "aim is not only to relieve the symptom of poverty, but to cure it and, above all, to prevent it."[15] He claimed that the War on Poverty would shrink future welfare rolls and transform the poor from "taxeaters" into "taxpayers."[16] In other words, President Johnson's original aim was to make the poor self-sufficient: able to support themselves above poverty without reliance on welfare.

To assess the War on Poverty's progress in achieving this goal, we can turn to Census's official poverty figures. As noted, because these figures exclude nearly all welfare assistance, they are a very inaccurate measure of actual living conditions. However, Census does accurately count households' earned income; this means that the official poverty figures are, paradoxically, a very good measure of Johnson's original goal for promoting self-sufficiency. The figures show that while there were dramatic improvements in self-sufficiency in the decades before the War on Poverty began in 1964, since the mid-sixties, there has been virtually no improvement.

Judged by Johnson's original goal, the War on Poverty has been a colossal flop. Today many parts of the population are less capable of self-sufficiency than when the War on

14 Rector and Sheffield, "The War on Poverty After 50 Years."

15 Lyndon B. Johnson, "Annual Message to the Congress on the State of the Union," January 8, 1964, http://www.presidency.ucsb.edu/ws/index.php?pid=26787.

16 Lyndon B. Johnson, quoted in David Zaretsky, *President Johnson's War on Poverty: Rhetoric and History* (Tuscaloosa: University of Alabama Press, 1986), p. 49.

Poverty began. Labor force participation rates of prime-age males have dropped, and unwed childbearing has skyrocketed.[17]

WHAT HAS WORKED IN WELFARE REFORM

The current welfare state harms the poor because it rewards non-work and discourages marriage. A properly designed welfare system should be based on reciprocal moral obligation: society should provide aid to those who truly need it because they have nowhere else to turn, but able-bodied recipients should be expected to contribute back to society and to take steps toward self-sufficiency in return. Contrary to the actions of the Obama Administration, the vast majority of Americans believe that welfare should include that type of work requirement. A Rasmussen survey from 2012 shows that 83 percent of Americans agree that welfare recipients should be required to work in exchange for receiving benefits.[18] Other polling data indicate that more than 90 percent of Americans, on both sides of the political aisle, believe that able-bodied adults should work, prepare for work, or at least look for work in exchange for receiving means-tested benefits.[19] Nonetheless, very few welfare programs have work or training requirements.

Work requirements were the core of the successful 1996 welfare reform. The reform law inserted a mandatory work requirement into what became the Temporary Assistance for Needy Families (TANF) program. States were forced to require that at least 30 to 40 percent of their work-eligible caseloads would work or participate in some type of work preparation or training for 20 to 30 hours a week in order to qualify for welfare. Rather than a one-way handout, TANF became a program founded on reciprocal obligation.[20]

The work requirement served as a gatekeeper. Welfare assistance was still available to those who were truly in need, but the policy took those who did not truly need assistance off the rolls. Ultimately, the work requirement pointed individuals towards work first, thus encouraging self-sufficiency.

After the work requirement was put into place, the welfare caseload began to decline rapidly. Within about five years, welfare rolls dropped by half. Employment rates among lower-income people also increased. Although skeptics on the left claimed that the welfare

17 Charles Murray, *Coming Apart: The State of White America, 1960-2010* (New York: Crown Forum, 2012).

18 "83% Favor Work Requirement for Welfare Recipients," Rasmussen Reports.

19 Robert Rector, "Obama's End Run on Welfare Reform, Part One: Understanding Workfare," Heritage Foundation *Backgrounder* No. 2730, September 19, 2012, http://www.heritage.org/research/reports/2012/09/obamas-end-run-on-welfare-reform-part-one-understanding-workfare.

20 *Ibid*.

reform would lead to a growth in child poverty, the opposite occurred: child poverty dropped, and African American child poverty fell to its lowest level in U.S. history.[21]

The reform also changed the funding structure of the program from an open-ended entitlement to states into a fixed funding stream. Under the old structure, states received more federal funding as their caseloads increased. Under the 1996 reform, states were allocated a fixed amount of funding from the federal government. If a state's caseload fell, states could keep the excess funding for other projects. Fixed federal funds were not adjusted for inflation. This has meant that, over time, if a state wished to maintain high welfare caseloads, the cost would have to be borne by state revenues. State governments have been reluctant to take on those costs.

Welfare reform was ultimately successful because the change in the funding stream was coupled with a strong work requirement. Typically, states have little incentive to keep their rolls from growing, since most welfare benefits are funded by the federal government. State bureaucracies historically have also had little interest in creating work programs for welfare beneficiaries. Administering a work program is much more difficult than simply distributing checks.[22]

REFORMING THE SYSTEM THE RIGHT WAY

The 1996 welfare reform should serve as the model for future efforts. Unfortunately, some well-intended reformers have proposed ideas that would fail to replicate the mechanisms key to its success. Policymakers must correctly reform the incentive structure of the welfare system.

First, policymakers must understand the massive size of the means-tested welfare system and make it a key point of discussion. If policymakers and the American people were aware of the size of the welfare system, there would be greater accountability for policymakers to better prioritize means-tested welfare spending and to work towards getting spending under control. Policymakers should make more transparent in the budget process the nearly $1 trillion in federal and state funds annually spent on 80 means-tested programs that provide a variety of benefits and services, including cash, food, housing, medical care and social services. They should also take steps to rein in this ever increasing amount.

Second, policymakers must understand what makes a work requirement work. The 1996 welfare reform made it mandatory for states to engage a portion of their work eligible

21 Rector and Fagan, "The Continuing Good News About Welfare Reform."

22 The 1996 reform also placed five year time limit on TANF benefits. And while the five-year time limit is a well-known aspect of welfare reform, it actually has had little impact. The time limit has many loopholes, and very few people ultimately have left the welfare rolls because of the time limit. See Robert Rector, "Obama's End Run on Welfare Reform, Part One: Understanding Workfare."

TANF caseload in work or a work activity. It was not optional for states to participate in the work program, and the elements of the work requirement were clearly defined for the states. If states failed to fully meet the work requirement, they did not receive their full TANF funding amount from the federal government.

Work or enrollment in some type of work-related activity was required of able-bodied adults at the point of entry into welfare. Welfare applicants were expected up front to demonstrate that they were working. If not, they were expected to begin working or participating in some type of work-related activity (such as training, job search, or community service) for 20 to 30 hours per week.[23]

The unique way the TANF work requirement was structured was fundamental to its success. Weaker work provisions, such as those that make it optional for states to have a work requirement or those that measure "success" in loose or meaningless terms are not likely to promote self-sufficiency. The 1996 work requirement is a model that policymakers can look to in making reforms today. The vast majority of welfare programs do not include a work requirement, and the TANF program's work requirement has been weakened substantially. There is much to be done to ensure that the welfare system is founded on the principle of work.

Third, policymakers should avoid the assumption that simply giving states greater flexibility is the answer to welfare reform. Some assume that the 1996 welfare reform was successful because it gave states greater flexibility with federal dollars via "block grants." In reality, the 1996 welfare reform worked because for the first time the federal government mandated that state welfare bureaucracies impose work requirements on able-bodied welfare recipients. The reform also cut federal welfare spending and insisted state governments bear a greater share of the welfare costs. These fiscal changes further incentivized states to reduce welfare caseloads.

It is true that the reform did give states greater flexibility in spending federal money, but it did so within a clearly defined policy of workfare. States could allow welfare recipients to fulfill the work requirement in a variety of different ways, including paid employment, job search, or job training, but there were clearly defined targets states had to meet.

TANF was not a "block grant" in the sense the term is ordinarily understood, that is, as a fixed sum of money handed down from the federal government to the states to be spent with few if any requirements. This is definitely not what the 1996 welfare reform did. TANF's funding stream would more appropriately be defined as a "work activation grant." States began receiving federal welfare dollars in a fixed amount, but receipt of those dollars was contingent upon a state's compliance with the work requirement.

23 *Ibid.*

Contrary to the conservative principle of federalism, proposals to block grant federal welfare programs would more aptly be called "faux-federalism": taxes are collected at one level of government to be spent by politicians at another level of government. Rather than being a catalyst for efficiency and innovation, faux federalism historically has been a formula for unaccountability, inefficiency, and policy stagnation. Considering that the vast majority of welfare spending, approximately 75 percent, is federal funding, faux-federalism is a particularly poor way of reforming welfare programs. True federalism would not mean giving states flexibility in spending federal funds but rather would entail returning financial responsibility for welfare to the states.[24]

Fourth, policymakers must also highlight the importance of marriage in addressing poverty, self-sufficiency, and child well-being. Children in single-parent homes are over 80 percent more likely to be officially poor compared to their peers in married-parent homes. Of the families with children on welfare, three quarters are headed by a single parent.[25] Marriage connects parents, particularly fathers, to their children, making it more likely that a father and the resources that he provides, both financially and otherwise, will remain in a child's life.

Marriage is the institution that best protects against child poverty. Unfortunately, it has declined drastically since the war on poverty began.[26] Consequently, the rate of unwed childbearing has soared. Today, over 40 percent of children are born outside of marriage annually, compared to less than 10 percent in the 1960s.

Unwed childbearing is particularly common among those women who have the hardest time going it alone. Over half of children born to women with a high school education or less are born outside marriage. By contrast, among college educated women the rate of unwed childbearing is less than 10 percent.[27] The decline in marriage is increasingly dividing society into two castes. In the top income half of society children are typically raised by married parents with a college education; in the lower-income half of society children are increasingly raised by single mothers with a high school degree or less.

Despite the shocking growth in unwed births and the link between unwed births and poverty, policymakers rarely include marriage in discussions of anti-poverty policy. Furthermore, all welfare programs actually have marriage penalties.

Three of the four primary legislative goals of the 1996 welfare reform law involved strengthening marriage and reducing unwed births. However, in contrast, to the work

24 Robert Rector and Katherine Bradley, "Reforming the Food Stamp Program," Heritage Foundation *Backgrounder* No. 2708, July 25, 2012, http://www.heritage.org/research/reports/2012/07/reforming-the-food-stamp-program.

25 Robert Rector, "Marriage: America's Greatest Weapon Against Child Poverty," Heritage Foundation *Special Report* No. 117, September 5, 2012, http://www.heritage.org/research/reports/2012/09/marriage-americas-greatest-weapon-against-child-poverty.

26 *Ibid.*

27 *Ibid.*

provisions of the TANF law, the marriage provisions lacked teeth. States were not financially penalized if they failed to address these goals. As a consequence, state welfare bureaucrats simply ignored the law. Twenty years after the reform was enacted, few states have bothered to run even token pro-marriage programs. Future reforms must address this failure and revive the original TANF goals of reducing marital breakdown and unwed childbearing in low-income communities.

POLICY RECOMMENDATIONS

Effective welfare reform should consist of a few key components. First, it must get out-of-control welfare spending under control. Second, it must ensure that welfare programs require work for able-bodied adults. Third, it should address marital decline and the high rate of unwed childbearing.

- **Getting welfare spending under control.** Approximately 80 federal means-tested welfare programs are spread across multiple government agencies. To improve accountability for means-tested welfare spending, policymakers should require the president's annual budget to clearly state the aggregate annual cost of means-tested welfare spending as well as projections of aggregate means-tested welfare spending for the next ten years. Explicitly stating the total cost of means-tested welfare spending in this manner would help shed light on the size of the welfare system and better inform discussions of anti-poverty policy. It would also emphasize the importance of reforming a swelling welfare system.

  Furthermore, total means-tested welfare spending should be gradually rolled back to pre-recession (FY 2007) levels and allowed to grow only at the rate of inflation going forward. Capping aggregate welfare spending would require policymakers to prioritize moving recipients off the rolls in order to meet their budgets rather than allowing them to continuously increase the size of the welfare system.

  Senator Mike Lee and Representative Jim Jordan both introduced legislation in the 113th Congress that included this type of cap. These welfare reform bills also included details of a work requirement for the food stamps program.

- **Encouraging work.** Welfare should be founded on the principle of self-sufficiency through work. Unfortunately, this is not the case with the majority of welfare programs. Welfare reform should restore and strengthen the work requirements of the Temporary Assistance for Needy Families (TANF) program that have been weakened due to exploitation of loopholes over the years, as well as by actions of the Obama Administration.

Furthermore, welfare reform should add work requirements to more of the approximately 80 welfare programs. Food stamps would be a prime candidate.[28] The food stamps program is one of the largest of the means-tested welfare programs and has grown rapidly over the last decade. Costs doubled from roughly $20 billion in FY 2000 to approximately $40 billion in FY 2008. By 2012, the costs had doubled again to about $80 billion. Part of the increase in cost was due to the recession, but it was also due to policies that made it easier for people to get on the rolls and remain there. As welfare reform did with TANF, welfare reform should make it mandatory that states require a portion of their able-bodied adult caseload to work, prepare for work, or at least look for work for a specified amount of hours each month in order to receive food stamps. Particularly, able-bodied adults without dependents (ABAWDs) should have to fulfill such a work requirement to be eligible to receive food stamp assistance. Roughly 3.5 million "ABAWDs" receive food stamps from the federal government every month. A federal work requirement would help ensure that money goes only to those who truly need it.

Food stamps are not the only obvious candidate; policymakers would also be wise to consider adding work requirements to public housing programs in the next round of welfare reform.

- **Strengthening marriage.** The absence of married fathers in the home is the greatest driver of child poverty today. The large increase in unwed childbearing puts children at high risk for official poverty, and it also increases their risk for other negative outcomes, such as dropping out of high school, being involved in drug and alcohol abuse, engaging in delinquent behaviors, and becoming a single-parent.[29]

  Unfortunately, all welfare programs include marriage penalties. Policymakers should look for fiscally responsible ways to reduce these marriage penalties, thus ensuring that welfare programs do no harm to marriage. Eliminating or reducing marriage penalties would be costly to do all at once, however. A good first step would be to reform the Earned Income Tax Credit (EITC) for married couples. EITC, a refundable tax credit, helps ease the transition from welfare to work by allowing individuals to keep more of their earnings. To help ease the current marriage penalty, EITC should be expanded for married couples with children where both spouses have income.

  Additionally, leaders at every level should look for ways to strengthen marriage. The TANF program included in its goals the strengthening of marriage and the reduction of unwed births. States were to use much of their federal TANF funding in pursuit

28 Rector and Bradley, "Reforming the Food Stamp Program."

29 Rector, "Marriage: America's Greatest Weapon Against Child Poverty."

of those objectives. Unfortunately, nearly all states ignored this aspect of the law. Welfare reform should revitalize efforts to encourage and sustain healthy marriages in order to reduce unwed births, which undermine self-sufficiency and put more children at risk of poverty.

CONCLUSION

At $943 billion per year, combined federal and state means-tested welfare spending is the second largest category of government spending in the United States. Today government spends more on means-tested welfare than it spends on public education or national defense. Only the combined costs of Social Security and Medicare top welfare spending. Means-tested welfare has cost taxpayers a total of $22 trillion over the past five decades. Under President Obama's plans, it will cost taxpayers another $13 trillion over the next decade. But the high cost of government welfare spending is unknown to most Americans. Massive welfare spending over five decades has not led to an increase in self-sufficiency among Americans. Since the War on Poverty began fifty years ago, official poverty rates have remained virtually stagnant and the institutions that protect against poverty—work and marriage—have declined. Although the War on Poverty has failed the poor, government continues to pour more taxpayer dollars into this system every year, costing Americans trillions while failing to address the causes of poverty and in some cases exacerbating them.

Fortunately, there is a model of successful welfare reform. The 1996 reform, which restructured the largest cash assistance welfare program from a one-way handout to a program founded on the principle of work and self-sufficiency, led to decreased welfare rolls, higher employment among low-income parents, and a decrease in child poverty. Rather than ending in 1996, welfare reform should have continued. Instead, in the interim that historic reform has been weakened and the total means-tested welfare system has continued to grow.

Policymakers must focus on reforming welfare. This important area of policy and massive cost to taxpayers can no longer be overlooked. Successful welfare reform must focus on getting the cost of welfare under control, instituting work and self-sufficiency as the founding principles of welfare, and strengthening the vital institution of marriage.

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* This essay is drawn in part from Robert Rector and Rachel Sheffield, "The War on Poverty After 50 Years," Heritage Foundation *Backgrounder* No. 2955, September 15, 2014, http://www.heritage.org/research/reports/2014/09/the-war-on-poverty-after-50-years.

ELIMINATING WASTE AND CONTROLLING GOVERNMENT SPENDING

Romina Boccia

If one asks Americans how many cents of every dollar that the federal government spends they believe is wasted, their answer reflects a belief that Washington is vastly incompetent when it comes to managing taxpayer money. A 2014 Gallup poll reported that Americans think the federal government wastes 51 cents of every dollar they pay in taxes.[1]

This year's figure is tied for the highest since Gallup began asking the question in 1979, when Americans thought their government wasted about 40 cents of every tax dollar it spent.[2] Except for a low point of 38 percent in the midst of Ronald Reagan's presidency, American perception of government waste has gone the same direction as the size of the federal budget—up.

While a narrow definition of government waste might include such boondoggles as a bridge to nowhere or the infamous RoboSquirrel, any attempt to control government spending and eliminate waste is best served by a broader definition based in economic principles.[3]

The federal government does too many things that would be done better by individuals or businesses in the private sector, or by state and local governments, or that should not be done at all. Moreover, unnecessary taxing, spending, and regulating distorts economic activity in numerous ways, leading to less growth and prosperity than if the government refrained from acting outside its proper constitutional domain.

Ultimately, succeeding in eliminating waste and controlling government spending requires reducing the size and scope of the federal government.

WHAT COUNTS AS GOVERNMENT WASTE?

Every year, countless news articles highlight wasteful spending by government. Waste in that sense often means lavish conferences, use-it-or-lose-it purchases made by agencies before the end of the fiscal year (FY), subsidies to dead farmers, or scratch-your-head programs, such as paying for a reality TV show in India.[4]

Economists use a broader definition of waste. They characterize the misallocation of resources as waste. When higher-valued resources are used for lower-valued activities, that is waste. The federal misallocation of resources takes various shapes, including:

- Spending on projects that cost more than the benefits they create;
- Government intervention in the form of subsidies or regulations that cause individuals and businesses to reduce their productive efforts or to engage in unproductive activities. A direct example is lobbying for additional government favors ("rent seeking") instead of seeking profit from serving consumers to the best of their ability;
- Federal spending on functions that could be better performed by the private sector, or by state and local governments;
- Mis-targeted programs whose recipients should not be entitled to government benefits;
- Spending on outdated, unnecessary, or duplicative programs; and
- Inefficiency, mismanagement, and fraud.

A definition of government waste based in economic principles encompasses a much broader spectrum of government activities and is helpful as a guide to evaluating existing and new spending programs from a principled vantage point. An economic perspective should by no means be the only guide to defining the proper role of government, as other considerations, first and foremost the consent of the governed, play the most important role in the American constitutional form of government. The consent of the governed is substantively distinct from "the will of the majority." As explained in *The Heritage Guide to the Constitution*:

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1 Rebecca Rifkin, "Americans Say Federal Gov't Wastes 51 Cents on the Dollar," Gallup, September 17, 2014, http://www.gallup.com/poll/176102/americans-say-federal-gov-wastes-cents-dollar.aspx.

2 Romina Boccia, Alison Acosta Fraser, and Emily Goff, "Federal Spending by the Numbers, 2013: Government Spending Trends in Graphics, Tables, and Key Points," Heritage Foundation *Special Report* No. 140, August 20, 2013, http://www.heritage.org/research/reports/2013/08/federal-spending-by-the-numbers-2013.

3 Emily Goff, "Top 10 Examples of Wasteful Federal Spending in 2012," The Daily Signal, October 16, 2012, http://dailysignal.com/2012/10/16/top-10-examples-of-wasteful-federal-spending-in-2012/.

4 Matthew Sabas, "'Use It or Lose It' Shows There's More Room to Cut Spending," The Daily Signal, November 14, 2013, http://dailysignal.com/2013/11/14/use-lose-shows-theres-room-cut-spending/, Alexis Levinson, "Waste Report: Tax Dollars Going to Indian Reality TV, Overseas Advertising," *The Daily Caller*, June 16, 2012, http://dailycaller.com/2012/06/16/waste-report-tax-dollars-going-to-indian-reality-tv-overseas-advertising/, and Diane Katz, "6,300 Reasons the Government Is Dead Wrong on Farm Subsidies," The Daily Signal, August 9, 2013, http://dailysignal.com/2013/08/09/usda-dead-wrong-on-farm-subsidies/.

> Any political powers not derived from the consent of the governed are, by the laws of nature, illegitimate and hence unjust. … The "consent of the governed" describes a situation where the people are self-governing in their communities, religions, and social institutions, and into which the government may intrude only with the people's consent. … In Europe, the "will of the majority" signals an idea that all decisions are ultimately political and are routed through the government. Thus, limited government is not just a desirable objective; it is the essential bedrock of the American polity.[5]

By both standards of measure, the federal government has overextended itself into areas that fall outside its proper domain. Eliminating government waste and controlling spending is necessary to return America to its constitutional form of government.

THE GROWTH IN GOVERNMENT SPENDING

Federal spending is divided into three broad categories: discretionary, mandatory, and net interest. Discretionary spending is provided through appropriations acts and is subject to congressional debate every year. This category covers the costs of most government agencies, including federal salaries, and includes spending on defense and domestic programs, such as transportation, education, and the enforcement of environmental regulation. Mandatory spending is authorized by laws other than appropriations acts, either on a permanent or multi-year basis. Mandatory funding becomes available automatically each year, without further legislative action by Congress. Net interest is what the government pays to service the national debt.

Over the past 20 years total federal spending grew by nearly two-thirds after inflation.[6] Although spending has increased across the board, the share of the budget dedicated to mandatory spending has expanded most significantly.[7] Mandatory spending, including Social Security and means-tested spending, doubled since 1993, while discretionary spending grew by half.

The expansion of mandatory spending as a share of the budget has proceeded steadily over the past 50 years. Whereas discretionary spending made up two-thirds of the budget in 1963 and mandatory spending consumed about one-fourth, by 2013 these shares had

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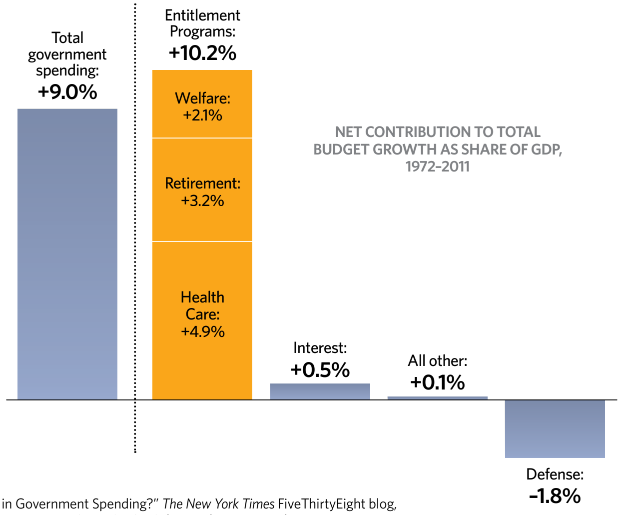
5 David Forte and Matthew Spalding, *The Heritage Guide to the Constitution: Fully Revised Second Edition* (Washington, DC: The Heritage Foundation, 2012), http://www.heritage.org/constitution.

6 Boccia, Fraser, and Goff, "Federal Spending by the Numbers, 2013: Government Spending Trends in Graphics, Tables, and Key Points."

7 *Ibid*.

Entitlement Programs Primary Cause for Rise in Government Spending

Nearly all the growth in government spending over the past 40 years is due to growth in entitlement programs. In fact, government spending would be even higher were it not for reductions in defense spending.



Source: Nate Silver, "What Is Driving Growth in Government Spending?" *The New York Times* FiveThirtyEight blog, January 16, 2013, http://fivethirtyeight.blogs.nytimes.com/2013/01/16/what-is-driving-growth-in- government-spending/ (accessed September 23, 2014).

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almost perfectly flipped with mandatory spending consuming nearly two-thirds of the budget and discretionary spending falling to about one-fourth.

The growth in mandatory spending can particularly be traced to policies enacted between 1965 and 1972. Both Medicare and Medicaid were enacted in 1965, and they and Social Security were significantly expanded in 1972. Other programs targeting the poor and disabled, like the Earned Income Tax Credit (EITC) and Supplemental Security Income (SSI), were added in the 1970s, further increasing the population eligible for federal benefits.

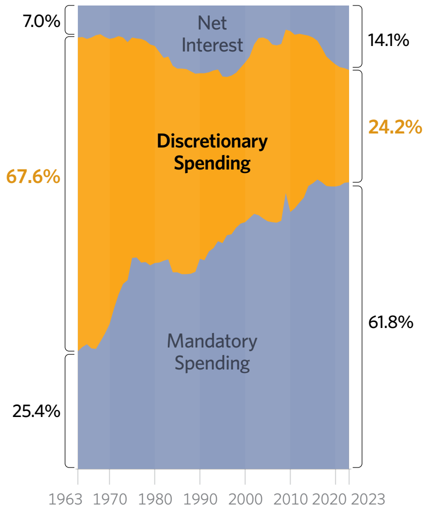
Additionally, health care costs per person have been on the rise, fueling the growth in federal health care spending in large part due to poor incentive structures provided by third-party payment. Moreover, the increase in American life-expectancy over this period is contributing to a large degree to the rising cost of Medicare and Social Security as more beneficiaries draw benefits from both programs for longer periods of time.

Nate Silver, statistician and journalist, analyzed the increase in government spending over the past 40 years by grouping spending into four broad categories: (1) entitlement; (2) military; (3) infrastructure and government services (such as education and the criminal justice system); and (4) interest on the debt.

Silver identified that entitlement spending increased sixfold from about $0.5 trillion in 1972 to $2.9 trillion in 2011, faster than gross domestic product (GDP) and all other government spending. Entitlement spending even increased by more than the overall increase in government spending, meaning that spending on other categories remained

As Entitlements Grow, the Discretionary Share of the Budget Falls to Below One Quarter

SHARE OF TOTAL OUTLAYS



Sources: Office of Management and Budget, *Historical Tables: Budget of the U.S. Government, FY 2014*, Table 8.5, April 2013, http://www.whitehouse.gov/omb/budget/Historicals (accessed May 8, 2013); and Congressional Budget Office, *Updated Budget Projections: Fiscal Years 2013 to 2023*, May 2013, http://www.cbo.gov/publication/44172 (accessed May 15, 2013).

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flat or decreased relative to the size of the economy.

Silver concludes that "essentially all of the increase in spending relative to economic growth, and the potential tax base, has come from entitlement programs, and about half of that has come from health care entitlements specifically."[8]

Looking forward, entitlement programs will continue to be the major drivers of spending and debt. Social Security, Medicare, and Medicaid (including Obamacare's expansion) are all projected to grow faster than the economy and revenues. By current Congressional Budget Office (CBO) projections, Social Security, Medicare, and Medicaid, and what Americans pay in interest to service the public debt, will consume all tax revenues by 2030.[9] This means that the federal government could cease all other operations, including its core constitutional duty to provide for the national defense, and would still end up in a fiscal hole within one generation.

Overspending on entitlement programs is the biggest driver of future debt. In its *2014 Long-Term Budget Outlook*, the CBO highlights that the current debt trajectory is unsustainable. In the CBO's own assessment,

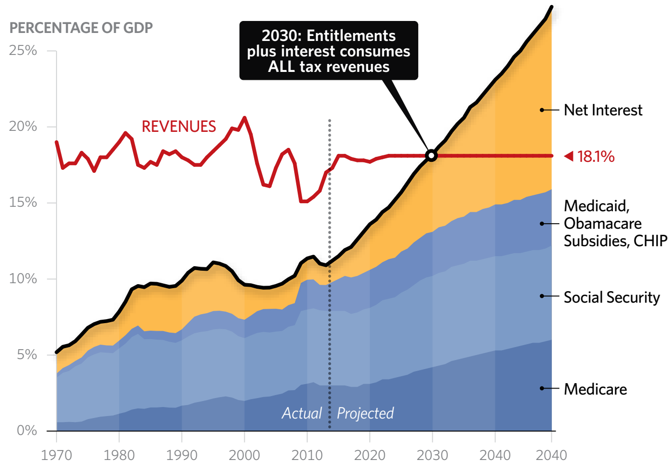
> [T]he high and rising amount of federal debt that CBO projects under the extended baseline would have significant negative consequences for both the economy and the federal budget. … The large amount of debt could also compromise national security by constraining defense

8 Nate Silver, "What Is Driving Growth in Government Spending?," *The New York Times* FiveThirtyEight blog, January 16, 2013, http://fivethirtyeight.blogs.nytimes.com/2013/01/16/what-is-driving-growth-in-government-spending/?_php=true&_type=blogs&_php=true&_type=blogs&_r=1&.

9 "Medicaid Is the Fastest-Growing Major Entitlement," The Heritage Foundation, August 20, 2013, http://www.heritage.org/multimedia/infographic/2013/08/federalspendingbynumbers2013/page-7-chart-2.

All Tax Revenue Spent on Entitlements and Net Interest by 2030

In less than two decades, all projected tax revenues will be consumed by three federal programs (Medicare, Social Security, and Medicaid, which includes CHIP and Obamacare) and net interest on the debt. Entitlement reform is a must.



Sources: Congressional Budget Office, *The 2013 Long-Term Budget Outlook*, September 17, 2013, http://cbo.gov/publication/44521 (accessed September 30, 2013), and Office of Management and Budget, *Historical Tables: Budget of the U.S. Government, Fiscal Year 2014*, April 10, 2013, http://www.whitehouse.gov/omb/budget/Historicals (accessed October 9, 2013).

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> spending in times of international crisis or by limiting the country's ability to prepare for such a crisis.[10]

In sum, doing nothing to address the growth in entitlement spending is simply not an option.

With the overall majority of spending going toward, essentially, federal insurance programs (for health, retirement, and unemployment) and with these entitlement programs growing at a disproportionate rate, eliminating waste and controlling spending in entitlements is an absolute necessity. A better understanding of the meaning of a minimal safety net should guide this process.

SOCIAL INSURANCE VERSUS EGALITARIAN REDISTRIBUTION

Austrian economist Friedrich von Hayek laid out his case for a minimal safety net in an industrialized world where labor mobility dissolved community ties in *The Constitution of Liberty*:

> All modern governments have made provisions for the indigent, unfortunate, and disabled. ... [T]he necessity of some such arrangement in an

10 Congressional Budget Office, *The 2014 Long-Term Budget Outlook*, July 15, 2014, http://www.cbo.gov/publication/45471.

> industrial society is unquestioned—be it only in the interest of those who require protection against acts of desperation on the part of the needy.[11]

Providing for those in need does not mean that the government should nationalize the provision of retirement income, health care, and other social services. For the government to become the sole provider of these services and for it to require that everyone participate in them, regardless of ability to provide for oneself, turns a system conceived to relieve poverty into one in which the government redistributes income above and beyond what is necessary to care for the poor. As Hayek describes the situation:

> Seen as an alternative to the now discredited method of directly steering production, the technique of the welfare state, which attempts to bring about a "just distribution" by handing out income in such proportions and forms as it sees fit, is indeed merely a new method of pursuing the old aims of socialism. … It is essential that we become clearly aware of the line that separates a state of affairs in which the community accepts the duty of preventing destitution and of providing a minimum level of welfare from that in which it assumes the power to determine the "just" position of everybody and allocates to each what it thinks he deserves.[12]

Social Security and Medicare, the two largest federal government programs, redistribute money from younger working generations to older and on-average wealthier generations, regardless of need. Although many program beneficiaries argue that they paid for their own benefits, the programs are structured on a pay-as-you-go basis in which current workers finance the benefits of current retirees. Moreover, past and current retirees receive much more in benefits from Social Security and Medicare than they ever paid into the programs.[13]

Most Americans support the idea of providing a minimal safety net to prevent poverty in retirement.[14] But Social Security and Medicare go far beyond that. More than 47,000 millionaires receive federal retirement benefits, including some wealthy lawmakers' children.[15]

Overall, when it comes to net wealth, older Americans are faring much better as a group than younger Americans. A 2009 Pew study revealed that the typical household headed by

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11 Friedrich A. Hayek, *The Constitution of Liberty* (Chicago: The University of Chicago Press, 1960).

12 *Ibid*.

13 Romina Boccia, "Washington Post Op-Ed: You Didn't Pay For That (And She's Right)," The Daily Signal, April 11, 2014, http://dailysignal.com/2014/04/11/washington-post-op-ed-didnt-pay-shes-right/.

14 Rich Morin, Paul Taylor, and Eileen Patten, "A Bipartisan Nation of Beneficiaries," Pew Research: Social & Demographic Trends, December 18, 2012, http://www.pewsocialtrends.org/2012/12/18/a-bipartisan-nation-of-beneficiaries/.

15 Romina Boccia, "Social Security Turns 78: What Was It Meant to Do?" The Daily Signal, August 13, 2013, http://dailysignal.com/2013/08/13/social-security-turns-78-what-was-it-meant-to-do/, and David C. John, "Social Security Pays Benefits to Millionaires' Children," The Daily Signal, August 24, 2012, http://dailysignal.com/2012/08/24/social-security-pays-benefits-to-millionaires-children/.

someone 65 or older had *47 times* as much net wealth as the typical household headed by someone below the age of 35.[16]

Means-tested welfare programs have expanded beyond their purported aims. The government runs over 80 means-tested welfare programs that provide cash, food, housing, medical care, and social services to poor and lower-income Americans.[17] Since the War on Poverty began back in the 1960s, means-tested welfare spending has grown sixteen-fold, adjusted for inflation. Total government welfare spending was $943 billion in FY 2013. Since 1960, taxpayers have spent $22 trillion on means-tested welfare programs.[18] Today, roughly one-third of the population receives benefits from a means-tested welfare program. Tragically, these programs have failed to promote self-sufficiency.

POLICY RECOMMENDATIONS

The need to eliminate waste and control government spending is clear. Less clear is how such a feat can be accomplished. Most spending decisions are not made within the context of thorough congressional deliberation. Rather, special interests are driving politics in America at the expense of the interests of the general public and the American taxpayer. The challenge then becomes to convince lawmakers to bind themselves to rules that, if violated, carry painful consequences. Rules should be simple so they can be understood by a watchful public to help hold lawmakers accountable.

The other, perhaps bigger, challenge is to help the American public understand that the most popular programs, Social Security and Medicare, also pose the biggest challenge to eliminating waste and controlling government spending. Reducing the government's role in the provision of health care services and retirement income does not by any means indicate that Americans would not enjoy the same or better benefits in retirement. Rather, freeing up resources that are today being diverted to government programs would allow them to produce more opportunity for Americans to enjoy greater retirement security. Eliminating waste and controlling government spending requires the support of the electorate.

16 Richard Fry, D'Vera Cohn, Gretchen Livingston, and Paul Taylor, "The Rising Age Gap in Economic Well-Being," Pew Research Social & Demographic Trends, November 7, 2011, http://www.pewsocialtrends.org/2011/11/07/the-rising-age-gap-in-economic-well-being/.

17 Robert Rector and Rachel Sheffield, "Welfare Spending at All-Time High…and Growing," Heritage Foundation *Commentary*, October 22, 2012, http://www.heritage.org/research/commentary/2012/10/welfare-is-at-an-all-time-high, and David B. Muhlhausen, "Do Federal Social Programs Work?" Heritage Foundation *Backgrounder* No. 2884, March 19, 2014, http://www.heritage.org/research/reports/2014/03/do-federal-social-programs-work.

18 Robert Rector and Rachel Sheffield, "The War on Poverty After 50 Years," Heritage Foundation *Backgrounder* No. 2955, September 15, 2014, http://www.heritage.org/research/reports/2014/09/the-war-on-poverty-after-50-years#_ftnref6.

The following agenda corrects course in America by eliminating waste where possible and by controlling government spending by cutting it down in both size and scope. Congress should:

- **Refocus entitlement programs and end government provision where feasible.** The massive increase in entitlement spending is a direct consequence of mis-targeted programs that provide benefits to recipients that should not be receiving them, and that provide them inefficiently. Assuming a basic social safety net as proper in an industrialized society, government should provide for those in need in the least harmful way possible. This means limiting benefits to those who actually need them and providing them in the most economical way possible.

  Social Security should focus benefits on those least able to prevent destitution in old age or those with disabilities, while encouraging others to save for their own nest egg.[19]

  Medicare and Medicaid spending, other than for the needy disabled and elderly who may require additional administrative support, should be targeted to those individuals who need support the most, in the form of a premium support payment that enables beneficiaries to choose their own health care plans.[20] Other federal means-tested social programs that are measurably more costly than the benefits they provide for their recipients should be eliminated.[21] The most efficient method of providing insurance against poverty is through direct cash benefits, tied to specific purposes where deemed necessary, such as health care. Convoluted social programs have a tendency to provide greater benefits to the bureaucracies who administer them than to the needy they are supposed to help.

  With the right reforms, Congress can better protect America's most vulnerable populations by providing a durable safety net, without burdening younger generations with economically harmful debt levels or higher taxes.

- **Reform welfare programs.** Welfare reform should begin with taking account of the vast expanse of the welfare state. Total annual welfare costs as well as cost projections should be included in the President's annual budget. Means-tested welfare

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19 Rachel Greszler and Romina Boccia, "Social Security Trustees Report: Unfunded Liability Increased $1.1 Trillion and Projected Insolvency in 2033," Heritage Foundation *Backgrounder* No. 2936, August 4, 2014, http://www.heritage.org/research/reports/2014/08/social-security-trustees-report-unfunded-liability-increased-11-trillion-and-projected-insolvency-in-2033.

20 Nina Owcharenko, "Medicaid Reform: More than a Block Grant Is Needed," Heritage Foundation *Issue Brief* No. 3590, May 4, 2012, http://www.heritage.org/research/reports/2012/05/three-steps-to-medicaid-reform.

21 Muhlhausen, "Do Federal Social Programs Work?"

programs are spread across multiple government agencies and are approached in a piecemeal fashion rather than viewed as a whole. Policymakers should place a cap on total welfare spending, adjusting for inflation, which would require policymakers to prioritize among welfare spending categories. Welfare programs should first and foremost promote self-sufficiency, requiring all able-bodied adults to work, prepare for work, or look for work in exchange for receiving assistance.

- **End corporate welfare.** Corporate welfare or the provision of financial and other benefits to businesses distorts markets and directs productive activities toward unproductive rent-seeking. It also breeds corruption. According to analysis by the Cato Institute's Ted DeHaven, the federal government spends $100 billion a year on corporate welfare.[22] Ending corporate welfare in practice means, for instance, shutting down the Export-Import Bank, and ending energy mandates, loan programs, and agriculture subsidies. Taxpayers would be better off if government stopped doling out favors to special interests.

- **Eliminate waste, duplication, and inappropriate federal spending.** Undoubtedly, there is a great deal of waste that can be cut from the federal budget. From $5 million spent on fancy crystal in the State Department, to a single $1 million bus stop in the Washington area, the federal government knows how to spend money irresponsibly. Greater congressional oversight and financial transparency would go a long way toward reining in lavish agency spending. To allow Congress to conduct proper oversight, however, government must be cut in size and scope. The government has simply grown too big for members of Congress to keep pace. Case in point: There are 2,283 federal domestic-assistance programs.[23]

  Each year, the Government Accountability Office (GAO) releases a report detailing duplication among federal government agencies, along with recommendations on how to fix the problem. Congressional oversight can tie agency funding to improvements in the management of taxpayer resources. Other GAO-identified actions require congressional authorization, such as preventing individuals from double-dipping from unemployment and disability benefits

  Moreover, reducing improper payments through better oversight and management could save billions every year. The federal government wasted more than $100 billion in 2013 alone by making improper payments, such as sending

22 Tad DeHaven, "Corporate Welfare in the Federal Budget," Cato Institute *Policy Analysis* No. 703, July 25, 2012, http://www.cato.org/sites/cato.org/files/pubs/pdf/PA703.pdf.

23 Catalogue of Federal Domestic Assistance, "CFDA Statistics: Programs at a Glance," https://www.cfda.gov/?s=main&mode=list&tab=list.

checks to people who should not receive them, overpaying for medical equipment or paying for goods and services that were never delivered, as well as paying benefits to dead people.[24] The vast bulk of improper payments happen in federal health care programs, where government intervention has grown rapidly.

A specifically dedicated, independent commission with the charge to eliminate waste, cut programs that are outside the proper scope of the federal government, and consolidate duplicative programs, could help Congress eliminate waste and control government spending.[25] Such a commission should also be charged with identifying government programs that unfairly compete with the private sector, or that should be within the purview of state and local government. It should also judge programs based on performance measures, including the outcomes of randomized controlled trial experiments.

Reining in the federal government as it encroaches on more spheres that are not national priorities and reducing its current bloated scope is key to reducing the power of Washington bureaucrats to meddle in affairs better left to individuals, businesses, and state and local government.

- **Enact and enforce firm spending caps.** Firm spending caps would encourage lawmakers to allocate scarce resources toward their greatest uses, by prioritizing federal spending based on constitutional principles. Spending caps enable lawmakers to say no to special interests and protect American taxpayers from wasteful spending burdens. Spending caps could be implemented in a number of different ways. For example:

    - *Spend One Dollar Less.* This rule would require Congress to spend precisely one dollar less next year than it did this year.

    - *Limit Spending Growth to Inflation.* This approach would stop government from growing faster than changes in the cost of living.

    - *Limit Spending Growth to Economic Growth.* Measuring the size of government in terms of the economy, through GDP, shows how big government is compared with measured private-sector activity. This rule would bind government so that it can grow no faster than the economy.

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24 Government Accountability Office, "Improper Payments, Government-Wide Estimates and Reduction Strategies," testimony before the Subcommittee on Government Operations, Committee on Oversight and Government Reform, U.S. House of Representatives, July 9, 2014, http://www.gao.gov/assets/670/664692.pdf.

25 Romina Boccia, "How Congress Can Improve Government Programs and Save Taxpayer Dollars," Heritage Foundation *Backgrounder* No. 2915, June 10, 2014, http://www.heritage.org/research/reports/2014/06/how-congress-can-improve-government-programs-and-save-taxpayer-dollars.

- **Control the debt.** George Washington, the nation's first President, suggested that Congress should avoid "the accumulation of debt" so as to "not ungenerously [throw] upon posterity the burden which we ourselves ought to bear."[26] The public debt has reached heights not seen since right after World War II and entitlement spending growth threatens to elevate the public debt to levels never before seen in the U.S. Such high levels of debt endanger the nation's economy and its people. Unlike wars or economic crises, which may require the temporary accumulation of debt, the projected increase in the public debt is due to structural spending challenges. Congress should return the debt to below its historical average of 40 percent of GDP and limit the accumulation of debt by keeping spending within its means. Congress should further refrain from suspending the debt limit, as that abdicates its constitutional power to control the borrowing of the federal government.

- **Uphold the earmark ban.** Earmarking is the practice of directing funds to specific projects by bypassing competitive bidding processes and other forms of impersonal allocation of funds. Earmarks contributed to spending on often-inappropriate (beyond the scope of government) and wasteful federal programs. Earmarks have a damaging effect on the budget process beyond their dollar cost. In the transportation area, earmarks are often carved out of each state's formula allocation so that a dollar devoted to an earmark means that this dollar is no longer available to the state's own priority projects. By bypassing competitive bidding processes, moreover, earmarks often allocate funding to lower-quality and higher-cost projects at a loss to the public. Additionally, earmarks breed corruption.[27] Congress should uphold its 2010 rule to ban its own earmarks and seek to eliminate administrative earmarks next.

CONCLUSION

The federal government does too many things that would better be done by individuals and organizations in the private sector, or by state and local governments, or that should not be done at all. A smaller, more limited federal government would focus on providing essential public services, legal services, and a basic social safety net, and would otherwise leave individuals free to determine their own affairs to the maximum extent possible in the defense of liberty. Eliminating waste and controlling government spending is best accomplished by reducing the size and scope of government.

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26 Washington's Farewell Address, September 19, 1796, Heritage Foundation *First Principles Series*, http://www.heritage.org/initiatives/first-principles/primary-sources/washingtons-farewell-address.

27 Spencer S. Hsu, "Visclosky Aide Offered Earmarks for Campaign Donation, Convicted Lobbyist Said," *The Washington Post*, September 18, 2014, http://www.washingtonpost.com/politics/visclosky-aide-offered-earmarks-for-campaign-donation-convicted-lobbyist-said/2014/09/18/7ab7cc6a-3f3f-11e4-b0ea-8141703bbf6f_story.html.

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HOW TAX REFORM WOULD HELP AMERICAN FAMILIES

Curtis S. Dubay

Tax reform is one of the vital policy improvements necessary to revive the laboring economy. Despite widespread agreement on this fact, the prospects of Congress passing and the president signing a tax reform bill are low.

One reason for this mismatch between political will and policy importance is a lack of pressure from American families on lawmakers. This is understandable because the arguments for tax reform are too often made in the context of improving economic efficiency, which means little to families struggling to make ends meet. This leaves families wondering how tax reform could benefit them.

To elicit the public demand that would compel Washington to act, proponents need to make a better-defined argument for why families would benefit from tax reform. That would give them a tangible reason to push tax reform.

If American families believe that tax reform would raise their incomes by thousands of dollars a year and increase opportunities for them and their children, they would push their representatives to support tax reform more strongly.

CONGRESS HAS BEEN MAKING THINGS WORSE INSTEAD OF DOING TAX REFORM

An unfortunate side effect of Congress's inaction on tax reform is that, instead of making tax code less of a burden on families, it has spent recent years making it even worse by heaping unnecessary deductions and credits on top of the already-too-large heap. Those policies almost always benefit narrow special interests with power to sway Congress.

For instance, Congress has become intoxicated with the desire to manipulate the energy market with a variety of targeted deductions and credits that try to change our behavior. At the same time, those policies pick winners and losers in the marketplace to the benefit of businesses that make the products on which Congress bestows special approval. The losers are everyday consumers that pay higher prices and the makers of products that do not receive special government treatment.

Examples of these government-imposed distortions include a credit for buying energy efficient vehicles, like hybrids. People that buy such cars benefit, as do the manufacturers of the cars. Those that prefer other cars experience no benefit, while at the same time they continue to suffer under the auspices of the broken tax code.

Similar credits exist for the purchase of items that improve the energy efficiency of homes, both new and old, and for the purchase of energy efficient appliances. These unfair attempts to change our behavior in a government-approved way have similar damaging impacts.

The government's foray into the energy market goes even deeper with its influence of the market for energy sources. This is a partial list of policies that preference particular Congress-favored alternative energy sources:

- Credits for producing biodiesel and renewable diesel;
- Credits for producing or selling alternative fuel and alternative fuel mixtures;
- Alternative Fuel Vehicle refueling Property credit (for installing alternative-fuel mechanisms); and
- Income tax credits and excise tax credits for producing or using ethanol.

These tax breaks tilt the market in government-chosen directions, distorting how the market allocates resources. This practice hurts families by inflating prices, limiting choice, and empowering special interests—all of which reduce opportunities for families.

Furthermore, targeted tax preferences can make it more difficult for new businesses to enter certain markets. For example, the tax preferences for renewable energy sources make it more difficult for entrepreneurs to develop a type of energy that does not qualify for the tax preferences. This further reduces the opportunities for families by reducing the dynamism of the economy.

Even more troubling, most of these policies expire at regular intervals, which means that Congress must regularly renew them to keep them in place. They become part of what is known as the "tax extenders."

Rather than spend time working to fix the broader tax code to the benefit of all Americans, Congress has spent its time making sure these narrowly beneficial policies remain in place. The tax extenders package contains some policies that Congress should make permanent. But instead of taking the time to make them a permanent part of the tax code, and letting bad policies expire, it has used the threat of their elimination to pass those policies that benefit only special interests time and time again.

This has another, more direct, harmful impact on tax reform. Expiring policies, under arcane Congressional budget rules, require tax reform to raise more revenue than necessary. Settling the tax extenders issue once and for all, by making those necessary policies permanent and allowing all the others to die, is the crucial first step towards tax reform. Yet Congress remains unwilling to take it.

These tax breaks tilt the market in government-chosen directions, distorting how the market allocates resources. This practice hurts families by inflating prices, limiting choice, and empowering special interests—all of which reduce opportunities for families.

In recent years, the tax debate has focused on tax hikes, rather than tax reform. Largely because of President Obama's class warfare inspired tax-hiking agenda, Congress has focused a great deal of its attention on ways to raise taxes on the most successful, and on the middle class as well. Tax increases are antithetical to tax reform since tax reform is about increasing economic growth, while tax hikes slow growth. It is long past time for Congress to stop trying to come up with ways to take more money from the American people, and focus on reforming the code so American families can earn more to provide for their families and their security.

WHY TAX REFORM IS NECESSARY

Before families can understand how tax reform would help them, they need to know how the current tax system is hurting them. Many families are unaware of its damaging effects because they are largely hidden from view.

The tax code imposes tax rates that are too high, is biased against saving and investment, and wrongly picks winners and losers. Each of these problems hurts families because they create sizeable disincentives against working, investing, and taking risks—activities that are central to increasing prosperity and establishing security. These activities are also the building blocks of economic growth.

High tax rates on families discourage work, especially from second workers who may wish to enter the workforce. The extra tax they would pay on the additional income combined with other costs—such as child care, transportation, loss of certain tax benefits, less time at home, and other work-related expenses—makes the benefits of taking a job not worth the effort.

Families use savings to pay for down payments on homes, education, retirement, unexpected bills, or anything else that they may desire to buy in the future. High rates discourage them from saving by making spending today more attractive than spending in the future. High tax rates on interest income, dividends, and capital gains discourage families from saving, thereby reducing the amount they can spend in the future by forgoing spending and saving today. When they save less today, families are less secure in the future.

Pass-through businesses, which pay their taxes on their owners' individual tax returns rather than through the corporate tax system, also pay the high rates that families pay. More than 4 million of them have employees.[1] Those with more than 100 workers employ 20 million Americans.[2] The high tax rates that they pay reduce the amount of earnings that they can reinvest into their businesses. This hurts families because the reduction in investment reduces the number of jobs that the businesses create and the wage increases they give to their workers.

Further reducing investment are the multiple layers of taxes that investors face when contemplating an investment. Much investment is taxed first at the corporate level, where businesses organized as C-corporations pay the U.S. corporate tax rate of 35 percent—the highest corporate tax rate in the world. Investment is then taxed at the investor level through taxes on capital gains and dividends, which are both taxed at 23.8 percent. Combined, these rates mean that investment returns face a tax rate of almost 54 percent, including state taxes.

That high rate raises the hurdle rate that investors require before making certain investments since they are concerned with their after-tax returns for taking the risk. Therefore, many potential investments fall short of meeting the mark and thus go unmade. The effect on families is the same as when pass-throughs invest less: fewer new job opportunities and forgone wage increases.

Entrepreneurship is essential for maintaining the vitality of the economy. The new ventures that succeed create new jobs and new products that enhance families' lives. High tax rates hamper entrepreneurship because they reduce the incentive for taking the risk of launching a new enterprise. They also reduce the start-up capital that potential entrepreneurs could use to get their ideas off the ground since many entrepreneurs are high-earning workers before starting their businesses. Families suffer because the jobs that these businesses would create never materialize, and the chance of a "next big thing" product coming to market is reduced.

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1 Curtis S. Dubay, "Obama's Taxmageddon Tax Increase Would Hurt Job Creation," Heritage Foundation *Issue Brief* No. 3658, July 9, 2013, http://www.heritage.org/research/reports/2012/07/obama-s-taxmageddon-tax-increase-would-hurt-job-creation.

2 Robert Carroll and Gerald Pranted, "Long-Run Macroeconomic Impact of Increasing Tax Rates on High-Income Taxpayers in 2013," Ernst & Young LLP, July 2012, http://www.nfib.com/LinkClick.aspx?fileticket=OMV7uZczVaM%3d&tabid=1083.

The corporate tax system is also a problem for families. The high rate and the worldwide tax system that the U.S. uses to tax the foreign income of businesses headquartered in the United States reduce investment. The high rate reduces domestic investment by both U.S.-headquartered businesses and foreign businesses, stifling job creation and wage growth. The worldwide system suppresses investment by U.S. businesses in new and growing international markets, which are the key to enhancing their global competitiveness.[3] Reduced foreign investment costs jobs and wage increases domestically.[4]

HOW TAX REFORM WOULD FIX THESE PROBLEMS

The central purpose of tax reform is to improve the economy's potential by fixing each of these problems.

RATE AND BASE EQUALLY IMPORTANT

In tax reform vernacular, the fix is described as broadening the tax base and lowering rates. This phrasing gives a simplified and mostly correct explanation of what tax reform does, but like many clichés it does not tell the whole story.

Certainly, lower rates are a key component of a successful tax reform plan. However, to maximize the growth potential of reform, the lower rates must be applied to a correct tax base. In tax policy parlance, the tax base must be neutral, which means that it does not positively or negatively influence economic decision making by families, businesses, investors, and entrepreneurs.

Lower rates on an incorrectly broadened base (i.e., one that included investment in capital) would have minimal growth benefits and could be a net drag on the economy if the tax base is structured poorly. To avoid this undesirable outcome, tax reform must expend as much effort establishing the correct tax base as lowering rates, preferably establishing a flat rate.

The proper tax base is one that taxes what we take out of the economy, not what we put into it. It does this by taxing consumption, not investment. The traditional flat tax, a consumed-income flat tax, a national retail sales tax, or a combination of these methods (a business transfer tax) are all consumption-based taxes that would achieve this objective equally well. Each of them uses the correct consumption tax base, and their economic effects are identical. They vary only in how taxpayers pay them. A useful way to understand their variations is to think of

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3 Curtis S. Dubay, "A Territorial Tax System Would Create Jobs and Raise Wages for U.S. Workers," Heritage Foundation *Backgrounder* No. 2843, September 12, 2013, http://www.heritage.org/research/reports/2013/09/a-territorial-tax-system-would-create-jobs-and-raise-wages-for-us-workers.

4 Mihir A. Desai, C. Fritz Foley, and James R. Hines, Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," *American Economic Journal: Economic Policy*, Vol. 1, No. 1 (February 2009), pp. 181–203.

them as distinct software programs used to execute the same function. They all execute that function equally well, but they interact with their users (i.e., taxpayers) differently.[5]

They all apply one rate to the consumption base, and because they have the proper tax base, they eliminate taxes on saving and investment. They do not tax capital gains or dividends (unless there was no corporate tax and business owners were taxed at the ownership level) or estate tax.

Furthermore, a well-executed tax reform plan would eliminate economically unjustified tax preferences—those not necessary to maintain neutrality. In fact, it should explicitly seek to abolish policies that Congress intended to benefit particular industries or particular groups.

The best way to ensure that tax reform uses a correct tax base is for Congress to start the process by selecting which of the acceptable tax systems to use. An appropriate tax base, by definition, would not include tax preferences that favor any groups or industries. Congress could then set the rate based on a desired revenue target. Applied to a correct tax base, the rate will most likely be considerably lower than under current law.

ADDITIONAL POLICY IMPROVEMENTS NEEDED FOR BUSINESSES

On the business side, tax reform should go beyond just lowering the corporate tax rate. While a lower rate is essential to increasing investment, other policy changes are needed to fully alleviate the burden that the current code puts on investment.

The key is to move from the worldwide tax system to a territorial tax system, which taxes businesses only on income earned within the borders of the U.S. Another key is allowing businesses to deduct the full cost of their capital expenses when they incur them, known as expensing, rather than over many years using the cumbersome depreciation schedules currently in effect. Expensing is a key part of establishing a consumption tax base. Finally, tax reform should remove taxes on exports so U.S. products compete on an even playing field in foreign markets.

OTHER CONSIDERATIONS

Congress should also keep in mind certain non-economic objectives when undertaking tax reform. Congress should particularly limit the tax system's adverse impact on the core institutions of civil society including the family and voluntary associations, such as religious and educational institutions, charities, and community organizations.

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5 The FairTax is a prominent example of the latter. Regarding traditional flat taxes and consumed-income flat taxes, see Robert Hall and Alvin Rabushka, *The Flat Tax*, 2nd ed. (Stanford, CA: Hoover Institution Press, 2007) and J. D. Foster, "The New Flat Tax: Easy as One, Two, Three," Heritage Foundation *Backgrounder* No. 2631, December 13, 2011, http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.

A complementary aim of tax reform should be to improve simplicity and transparency for families. Tax reform should make it easier for them to file their returns because a consumption-based tax would not be complicated with a maze of credits, deductions, and exemptions that require pages of forms and worksheets to determine eligibility. Enhanced simplicity would also especially help small businesses.

The proper tax base is one that taxes what we take out of the economy, not what we put into it. It does this by taxing consumption, not investment.

Government spending is on track to grow to unsustainable levels that threaten the security of families. Tax reform should work to make it easier to reduce the bloated size of government by making the cost of government more transparent to the American people. Because of income and payroll tax withholding and the hidden costs of corporate, employer payroll, and excise taxes, most Americans have little idea how much they are paying to fund the federal government or how proposed policy changes would affect them. Tax reform should make that cost more explicit to taxpayers. Once taxpayers know how much of their hard-earned income goes to fund the federal government, they will be more willing to reduce the size of government to lessen its cost to them.

WHAT TAX REFORM SHOULD NOT DO

In addition to making the right changes to the tax code, tax reform must refrain from doing some things. For instance, tax reform should not retroactively raise taxes because that is inherently unfair. Often forgotten, however, is that tax reform should not bestow tax windfalls either. Some taxpayers, mostly businesses, accrue deferred tax liabilities and tax assets like unused credits and deductions that they are entitled to use in future tax years. Tax reform should not decrease those liabilities nor increase the value of those assets. Doing so would have little upside for growth since businesses already made planning decisions when they accrued them. Retroactively changing them is an undeserved tax windfall that has no place in tax reform.

In recent years, some lawmakers have devoted a great deal of attention to developing new tax systems that would apply in addition to existing federal corporate and individual income taxes, payroll taxes, capital gains and dividends taxes, and various excise taxes. These additional taxes include a carbon tax, a value-added tax (VAT), and a financial transactions tax. An additional tax would make complying with taxes even more difficult than it already is. Further, despite protestations to the contrary from those that favor adding new tax systems, Congress would undoubtedly spend the revenue from a new tax to expand the government. This has been the experience in Europe when countries added

VATs on top of their income taxes. Tax reform should not add to the already excessive number of federal taxes.

HOW TAX REFORM WOULD HELP FAMILIES

Tax reform that established a consumption base and the other policies outlined above would be a significant boon to American families because it would ease the tremendous burden the current system places on them.

A single, low-rate system would make is easier for second earners to enter the workforce. That would raise family incomes, helping them to pay bills and provide a better future for their children.

A tax system with such a consumption base would remove the disincentives to save because it would not tax savings. Families would save more for all the various reasons that they choose to put money away. This would make it easier to buy a new home, afford a good education for their children, handle unexpected expenses, and provide for their retirement.

Of course, families would see those welcome benefits directly on their bottom lines. Although they might not perceive it as directly, they would also profit from a substantial increase in opportunity that would come from increased investment.

Tax reform would make more investments viable than under the current system. Eliminating taxes on investment, reducing the corporate tax rate, and moving to a territorial system would make that increase in investment possible. American families would see their wages rise as a result. They would also see more chances to take better paying jobs as the economy expands because of the surge of investment.

A new wave of entrepreneurship unleashed by tax reform, coupled with an increase of economic vigor from ending the tax code's practice of picking winners and losers would benefit families, too. More new businesses would open, further increasing opportunities for families, and more new products would enter the market.

Clearly, all of these effects would substantially benefit families. According to the Tax Foundation, the economy could grow as much as 15 percent more over 10 years because of tax reform. After those 10 years, the average American family's wages would be almost 10 percent higher.[6] That would mean an extra $5,000 in the pockets of families making $50,000 per year (roughly the median income in the U.S. today).

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6 Andrew Lundeen, "Slow Economic Growth Does Not Need to Be the New Normal," Tax Foundation, May 15, 2014, http://taxfoundation.org/blog/slow-economic-growth-does-not-need-be-new-normal.

CONCLUSION

Congress has not reformed the tax code for nearly 30 years, and it is long overdue. This is a widely agreed upon premise, yet Congress has failed to act.

The best way to make Members of Congress act is for their constituents to compel them. If the case is made to the American people that their families could benefit by $5,000 each year, they would be more likely to make the case to their representatives that the time to act is now.

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* A version of this essay was published previously as "How Tax Reform Would Help American Families," Heritage Foundation *Backgrounder* No. 2963, October 20, 2014, http://www.heritage.org/research/reports/2014/10/how-tax-reform-would-help-american-families.

INDIVISIBLE: LIFE, MARRIAGE, RELIGIOUS LIBERTY, AND PROSPERITY

Ryan T. Anderson and Sarah Torre

To hear some political commentators talk, economic and social issues should not be discussed in the same breath. If policymakers just focused on lower taxes and job growth, ignoring cultural issues like the breakdown of marriage or assaults on religious freedom, we could move toward a freer society and a more limited government.

But that couldn't be further from the truth. Reducing taxes, freeing businesses to create more jobs, and cutting down on government regulation are all important. It takes a thriving economy and functioning market to help lift families out of poverty and advance human flourishing. But it also takes strong families, a healthy marriage culture, and a robust civil society to provide the sort of social solidarity that serves as a necessary precondition to economic prosperity and limited government.

A policy platform that champions free market policies alongside the preservation of a healthy culture and the institutions of civil society will resonate with Americans. More importantly, however, advancing such a unified governing agenda is the principled thing for conservative public officials to do.

INALIENABLE RIGHTS UNDER ASSAULT

Rightly understood, America exists to defend the unalienable rights articulated in the Declaration of Independence: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness."

Today, however, many of these rights are under assault by cultural pressures and expansive government mandates.

The right to life has been redefined by abortion advocates and sympathetic courts to exclude the youngest and most vulnerable human beings. The right to liberty, particularly the religious liberty to live and work according to one's convictions, is increasingly redefined to a mere "freedom to worship," implying that faith is only acceptable and protected within the four walls of a house of worship.

The right to the pursuit of happiness normally is protected by allowing autonomous adults to act without government interference. But when it comes to non-autonomous children, policy protects their rights to pursue happiness by promoting the truth about marriage—encouraging a man and a woman to commit to each other permanently and exclusively as husband and wife so that any children that their union produces will have access to the love and care of their mother and father. But marriage, too, is being redefined.

Nevertheless, marriage, the fundamental institution of civil society, remains the best protector of the rights of children to pursue happiness. The redefinition of marriage makes the institution more about the desires of adults than the needs—or rights—of children.

The American people recognize that freedom, opportunity, and prosperity are not only supported by job growth, low taxes, and increased choice in education and health care. The American dream is most fully realized when government protects individuals' most fundamental rights and respects and supports the institutions of marriage, family, and communal life.

The tasks of protecting the right to life, promoting marriage, and defending religious liberty are essential. Neglecting these priorities in our law and—more importantly—failing to live them out in our culture will place constitutional self-government increasingly at risk.

DEFENDING THE RIGHT TO LIFE BY LEADING THE ARGUMENT

All human beings have basic, natural rights, the most fundamental of which is the right to life. It is a right that belongs not only to the strong and powerful, the rich and famous. It is for all human beings, including the weak, marginalized and infirm—wanted or unwanted, born or yet to be born.

At the moment of conception, a new human being comes into existence who has inherent value and possesses a natural right to life. Yet, in 1973, the Supreme Court in its opinions in *Roe v. Wade* and *Doe v. Bolton* distorted the Constitution's view of liberty, overturning state abortion laws and sanctioning abortion on demand across the United States.[1] Over the past four decades, advocates for abortion have used those decisions to demand expansion of elective abortion, for any reason, throughout all nine months of pregnancy. Legalized abortion has sentenced countless women to emotional and physical harm and taken the lives of more than 56 million unborn children in the United States.[2]

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1 Clarke D. Forsythe, *Abuse of Discretion: The Inside Story of* Roe v. Wade (New York: 2013).

2 "How to Speak Up for Life: Questions and Answers Driving the Debate," The Heritage Foundation, 2014, https://www.scribd.com/doc/201208788/How-to-Speak-Up-for-Life.

Government has a duty to protect the weakest in society and to recognize the inherent value of every human life. A country founded to protect unalienable human rights should not deny those rights to the most vulnerable children in our society merely because they are small, dependent, disabled, or simply inconvenient.

Today, the United States remains one of only seven countries (in the company of such illustrious human rights supporters as China and North Korea) in which elective, late-term abortions after 20 weeks—five months—of pregnancy are allowed.

We must make a persuasive case for protecting the dignity and worth of every human life—of defending the health and safety of women and the lives of unborn children.

REJECTING ANTI-LIFE EXTREMISM

Some continue to take extreme positions against such principles, and their voices have unfortunately had some influence on Capitol Hill. In 2014, sweeping legislation moved through the U.S. Senate to eliminate many state pro-life laws.[3] During the most recent election cycle, liberal candidates admitted to supporting access to late-term abortions, and one swing-state candidate ran on a platform advocating legal abortion as far as eight months into pregnancy.[4] Such an extreme stance by many liberal policymakers and advocates has left U.S. law on abortion at odds with the majority of Americans and the majority of developed nations. Today, the United States remains one of only seven countries (in the company of such illustrious human rights supporters as China and North Korea) in which elective, late-term abortions after 20 weeks—five months—of pregnancy are allowed.[5] Meanwhile, Obamacare has vastly expanded federal funding for health plans that include coverage of elective abortion and threatens to crush the conscience rights of many pro-life Americans.[6]

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3 Sarah Torre, "Senate Considering Bill that Could Wipe Out Many State Pro-life Laws," The Daily Signal, July 16, 2014, http://dailysignal.com/2014/07/16/senate-considering-bill-wipe-many-state-pro-life-laws/.

4 John McCormack, "In Colorado Debate, Mark Udall Says He Supports Abortion During the Eighth Month of Pregnancy," October 7, 2014, http://www.weeklystandard.com/blogs/colorado-debate-mark-udall-says-he-supports-abortion-during-eighth-month-pregnancy_810785.html, and John McCormack, "Kay Hagan's Extreme Position on Late-Term Abortion Highlighted in New $620k Ad Buy," *The Weekly Standard*, October 7, 2014, http://www.weeklystandard.com/blogs/kay-hagans-extreme-position-late-term-abortion-highlighted-new-620k-ad-buy_810780.html.

5 Sarah Torre, "Report: U.S. Is One of Seven Countries That Allows Late-Term Abortion," The Daily Signal, March 12, 2014, http://dailysignal.com/2014/03/12/report-u-s-one-seven-countries-allows-late-term-abortion/.

6 Sarah Torre, "Obamacare's Many Loopholes: Forcing Individuals and Taxpayers to Fund Abortion Coverage," Heritage Foundation *Backgrounder* No. 2872, January 13, 2014, http://www.heritage.org/research/reports/2014/01/obamacares-many-loopholes-forcing-individuals-and-taxpayers-to-fund-elective-abortion-coverage.

Most Americans reject these extreme and unpopular positions on abortion. Over the past 40 years, the pro-life movement has winsomely and effectively made the case for the humanity of the unborn and provided material and emotional support to women facing difficult situations through thousands of pregnancy centers. During the past decade more pro-life laws have been passed than in the 30 previous years combined. These are commonsense laws that enjoy the support of most Americans.

The simple witness by a tireless pro-life movement in culture and law is largely responsible for reorienting the hearts and minds of an entire generation.

THE APPEAL OF THE PRO-LIFE MESSAGE

Today, polls show that 58 percent of Americans believe that abortion should be illegal in all or most cases. Two-thirds of Americans—including 60 percent of women—believe late-term abortion should generally be illegal. And even more Americans oppose abortions in the third trimester, when women are at greater risk and the unborn child is capable of living outside the womb.[7]

In 2013, American Principles in Action released a report showing a majority of Americans support policies promoted by social conservatives, especially those moving the country in a pro-life direction.[8] The report details:

> [Y]oung voters are the most pro-life generation ever. The May 2013 Gallup poll showed that Millennials (ages 18-34) support making abortion illegal in all or most cases by a margin of 57 percent to 41 percent, a +16 pro-life advantage. … Only 29 percent of Millennials support the Democratic Party's position on abortion.

Millennials aren't the only group receptive to the pro-life message. Regarding legislation that would protect unborn children from abortion after 20 weeks (5 months) of pregnancy, the report notes that "Hispanics are more likely to back the restriction than either blacks or whites, by a 39 point margin." In addition, 24-hour waiting periods, parental-consent requirements and informed-consent laws all garner support from 60 to 70 percent of Americans. This helps explain why pro-life governors who have signed such bills into law enjoy such high approval ratings.

The case for life can be a winning issue. But the surest way to lose the debate over the most fundamental right and to fail to persuade citizens of American values is to abstain from the discussion.

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7 "Historical Trends: Abortion," Gallup, http://www.gallup.com/poll/1576/abortion.aspx.

8 Francis Cannon, Maggie Gallagher, and Rich Danker, "Building a Winning GOP Coalition: The Lessons of 2012," American Principles in Action, October 2013, http://www.americanprinciplesinaction.org/gop-autopsy-report-2013/.

By contrast, speaking up for the dignity and worth of every life is the mark of real leadership. Testifying to the truth of when life begins and advancing policies that protect the lives of women and children will hasten the day when every human being—from the moment of conception—is protected in law and welcomed in life.

PROMOTING MARRIAGE AND LIMITED GOVERNMENT

Marriage and family are the building blocks of human civilization and the primary institutions of civil society. Intact married families are the foundation of a strong and stable culture, a guarantor of individual liberty, and the first engine of economic growth. Preserving the institution of marriage by restoring a culture of marriage and protecting its fundamental definition is integral to promoting a healthy civil society.

Today, however, federal courts are usurping the authority of citizens and their elected representatives to make marriage policy within their own states. Across the country, good laws that reflect the truth about marriage—frequently passed with overwhelming democratic support by millions of citizens—have been struck down by judges without any compelling argument that they are unconstitutional. Recently, the Supreme Court declined to hear many of the challenges to state marriage laws, allowing lower federal courts to continue disregarding the constitutional authority of citizens and their elected representatives to make good marriage policy.[9]

These actions are a serious setback for sound constitutional self-government and a setback for a strong marriage culture. But they shouldn't signal the end of the public debate about the truth about marriage.[10]

Nothing in these legal opinions changes the actual reality of what marriage is or why it matters. They simply codify a faulty vision of marriage in law and make it harder for future generations to understand and live out the truth about the institution.

MARRIAGE: AN INSTITUTION WITH A PURPOSE

Some people argue that marriage is simply a committed relationship of two people. But this fundamentally misunderstands what marriage is and why government policy recognizes marital union.[11]

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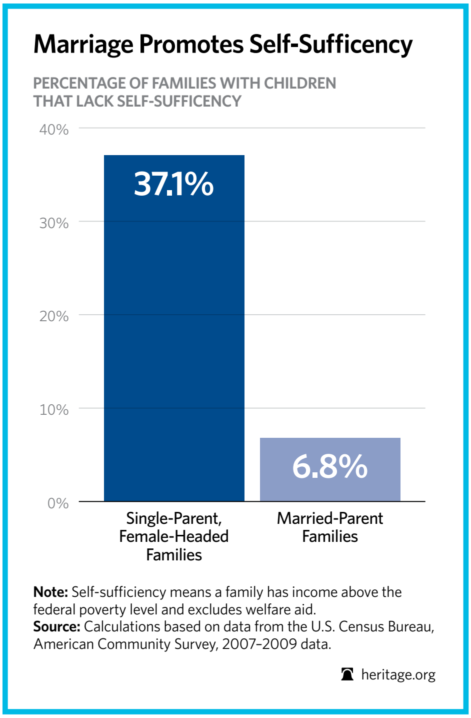
9 Ryan T. Anderson, "Supreme Court Decision Will Lead to Gay Marriage in Five States. Why That's Wrong.," The Daily Signal, October 6, 2014, http://dailysignal.com/2014/10/06/supreme-court-decision-will-lead-gay-marriage-five-states-thats-wrong/.

10 Ryan T. Anderson, "The Defense of Marriage Isn't Over," The Daily Signal, October 7, 2014 http://dailysignal.com/2014/10/07/defense-marriage-isnt/

11 Ryan T. Anderson, "Marriage: What it is, Why it Matters, and the Consequences of Redefining it," Heritage Foundation *Backgrounder* No. 2775, March 11, 2013, http://www.heritage.org/research/reports/2013/03/marriage-what-it-is-why-it-matters-and-the-consequences-of-redefining-it.



Marriage exists to bring a man and a woman together as husband and wife to be father and mother to any children their union produces. It is based on the truth that men and women are sexually complementary, the biological fact that reproduction depends on a man and a woman, and the reality that children need a mother and a father.[12]

Marriage is a unique institution that benefits society in a way that no other relationship does. Government recognizes marriage because it is society's least restrictive means of ensuring the well-being of children. State recognition of marriage protects children by encouraging men and women to commit to each other and take responsibility for their children.

MARRIAGE UNDER ASSAULT

In recent decades, marriage has been weakened by a revisionist view that is more about adults' desires than children's needs. This reduces marriage to a system to approve emotional bonds or distribute legal privileges.

Redefining marriage would further distance marriage from the needs of children and would deny, as a matter of policy, the ideal that a child deserves both a mom and a dad. Decades of social science show that children tend to do best when raised by a mother and a father. The confusion resulting from further delinking childbearing from marriage would force the state to intervene more often in family life and expand welfare programs. After all, redefining marriage would establish a new principle that marriage is whatever emotional bond the government says it is.

Promoting marriage as the union of one man and one woman does not ban any type of relationship. Adults remain free to make choices about their relationships and do not need government permission to do so.

The state's interest in marriage is not that it cares about citizens' love lives for the sake of romance. The state's interest in marriage is ensuring that children have fathers and

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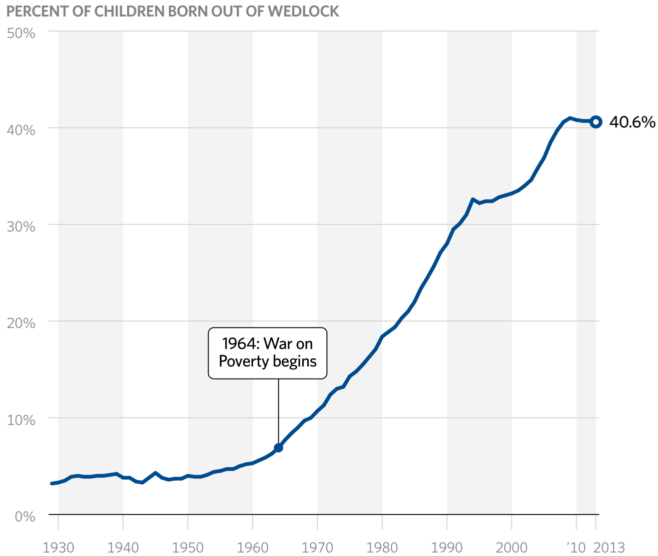
12 Sherif Girgis, Ryan T. Anderson, Robert P. George, *What is Marriage? Man and Woman: A Defense*, (New York: Encounter Books, 2012).

Growth of Unwed Childbearing in the United States, 1929–2013



Sources: U.S. Government, U.S. Census Bureau, and National Center for Health Statistics.

heritage.org

mothers who are involved in their lives, for when this doesn't happen, social costs run high. As the marriage culture has collapsed, child poverty has increased and welfare spending has exploded. Those concerned about social justice and caring for the poor cannot ignore the marriage debate. Those who seek limited government and strive to advance freedom must also see their stake in the future of the institution.

Enacting same-sex marriage does not expand the institution of marriage, but redefines it. It replaces the historic understanding with a revisionist view that marriage is fundamentally an emotional union. This only multiplies the marriage revolution's harms.

While laws that distort the nature of marriage will have an effect on people's lives, conservatives have never thought that law or government is the primary vehicle for social and cultural transformation. Even with bad laws about marriage on the books, citizens and national leaders still have a duty to speak the truth and live out the truth.

Despite losses in courtrooms, the truth about marriage still resonates with American voters. In the 2012 election, for example, in all four states that had marriage on the ballot, traditional marriage outperformed the Republican presidential ticket. In liberal Maryland, presidential candidate Mitt Romney got 36 percent of the vote while marriage got 48 percent.[13]

13 Ryan T. Anderson and Andrew Walker, "How Marriage Fared in the 2012 Election," The Daily Signal, http://dailysignal.com/2012/11/08/how-marriage-fared-in-the-2012-election/ and Francis Cannon, Maggie Gallagher, and Rich Danker, "Building a Winning GOP Coalition: The Lessons of 2012."

If marriage is redefined, pressure will mount to characterize the belief that virtually every human society has held about marriage—that it is the union of a man and a woman ordered to procreation and family life—as an irrational prejudice that ought to be driven to the margins of our culture. The consequences for religious believers are becoming apparent, as discussed below.

The future of this country depends on the future of marriage. The future of marriage depends on citizens understanding what it is and why it matters and demanding that government policies support, not undermine, the institution.[14]

PROTECTING THE RIGHT TO RELIGIOUS LIBERTY

Americans remain a deeply religious people. The vast majority of Americans believe in God or a higher being, and many say that they pray daily. By providing education, health care, and countless social services, religious groups contribute mightily to the health of civil society.

Citizens, the groups they form, and the businesses they run should be free to act in the public square according to their conscientious beliefs. As Michelle Obama put it, religious faith "isn't just about showing up on Sunday for a good sermon and good music and a good meal. It's about what we do Monday through Saturday as well."[15]

The right to live, work, and worship according to one's faith is a freedom foundational to the United States. Many of the first settlers, having faced religious persecution in Europe, sought a place where they could freely worship and live according to their conscience without interference from the government. The Founders were clear, and the Bill of Rights makes it fundamental to our constitutional order, that the government should not infringe on the free exercise of religion.

THE ASSAULT ON CONSCIENCE RIGHTS

In recent years, however, liberals have attempted to water down robust understandings of religious freedom envisioned by the Founders and enshrined in the Constitution to a mere "freedom to worship."

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14 Ryan T. Anderson, "Marriage: What it is, Why it Matters, and the Consequences of Redefining it," Heritage Foundation *Backgrounder* No. 2775, March 11, 2013, http://www.heritage.org/research/reports/2013/03/marriage-what-it-is-why-it-matters-and-the-consequences-of-redefining-it.

15 News release, "Remarks by the First Lady at the African Methodist Episcopal Church Conference," The White House, Office of the First Lady, June 28, 2012, http://www.whitehouse.gov/the-press-office/2012/06/28/remarks-first-lady-african-methodist-episcopal-church-conference.

Through expansive government mandates and cultural pressures, this incorrect view of religious liberty argues that faith should remain a private affair—relegated to personal activities or weekend worship services. Step outside the four walls of a house of worship and robust protection of religious freedom ends.

The case for life can be a winning issue. But the surest way to lose the debate over the most fundamental right and to fail to persuade citizens of American values is to abstain from the discussion.

Perhaps the most egregious example of this whittling away of religious liberty is Obamacare's anti-conscience mandate. The rule requiring employers to cover abortion-inducing drugs and devices, contraception, and sterilization in their employees' health plans has spurred over 100 lawsuits, with the majority of federal courts ruling against the coercive mandate. While the Supreme Court stopped enforcement of the mandate against some family businesses in June 2014, non-profit religious organizations and schools such as the Little Sisters of the Poor and Wheaton College remain in danger of devastating fines of up to $100 per employee per day for not complying with the rule.

Americans are also facing new threats to their freedom to work in accordance with their beliefs about marriage. With the redefinition of marriage has come increasing intolerance in both culture and law toward those who believe marriage is the union of one man and one woman.

In the summer of 2014, a couple running a farm in upstate New York was fined $13,000 for declining to rent their family farm for a same-sex wedding ceremony.[16] Others involved in the wedding industry, such as photographers, florists and cake makers, have been hauled into court for declining to use their artistic talents to participate in same-sex weddings.[17] Facing coercion by state governments to place children with same-sex couples, some Christian adoption agencies have even been forced to end foster care and adoption services rather than abandon their belief that children do best with a married mother and father.[18]

16 Leslie Ford and Ryan T. Anderson, "Government to Farmers: Host Same-Sex Wedding or Pay a $13,000 Fine," The Daily Signal, August 19, 2014, http://dailysignal.com/2014/08/19/government-farmers-host-sex-wedding-pay-13000-fine/.

17 Ryan T. Anderson and Leslie Ford, "Protecting Religious Liberty in the State Marriage Debate," Heritage Foundation *Backgrounder* No. 2891, April 10, 2014, http://www.heritage.org/research/reports/2014/04/protecting-religious-liberty-in-the-state-marriage-debate.

18 Sarah Torre and Ryan T. Anderson, "Adoption, Foster Care, and Conscience Protection," Heritage Foundation *Backgrounder* No. 2869, January 15, 2014, http://www.heritage.org/research/reports/2014/01/adoption-foster-care-and-conscience-protection.

Part of the genius of the American system of government is its commitment to protecting the liberty and First Amendment freedoms of all citizens while respecting their equality before the law. The government protects the freedom of citizens to seek the truth about God, to worship according to their conscience, and to live out their convictions in public life. Likewise, citizens are free to form contracts and other associations according to their own values.

One need not hold the same beliefs as the photographers, cake makers, or Little Sisters of the Poor to recognize that they should have the freedom to run their charities and businesses in accordance with their values—and without fear of reprisal from the government.

Americans should be free to earn a living and free to care for the poor, heal the sick and serve their communities in accordance with their faith without unnecessary government interference.

POLICY RECOMMENDATIONS

Life, marriage, and freedom of conscience are under assault. Our civil society needs champions in Washington now more than ever. Policymakers eager to impact these debates should do the following:

- **Protect women and unborn children by limiting late-term abortions.** Specifically, Congress can protect women and children from late-term abortions by limiting the procedure after 20 weeks of pregnancy. At that stage, the child is capable of feeling pain and women are at increased risk for the negative effects of abortion. In 2013, the House of Representatives passed legislation that would limit abortions in the U.S. after 5 months of pregnancy. Congressional leaders have indicated their intent to consider such legislation in the 114th Congress.

- **End taxpayer funding of abortion.** Regardless of one's personal views on abortion, Americans agree that taxpayer funding shouldn't support the procedure. Policymakers should permanently end all federal funding of abortion and health plans that include elective abortions across all federal law, including the entirety of the Affordable Care Act. The "No Taxpayer Funding for Abortion Act" would do just that, closing the seams in the patchwork of federal laws prohibiting abortion funding. The legislation would also end federal subsidies to Obamacare plans that include coverage of elective abortions.[19] Relatedly, the "Abortion Insurance Full Disclosure Act" would amend the Affordable Care Act to require issuers that include elective abortion coverage on exchange plans to

19 No Taxpayer Funding for Abortion Act, H.R. 3, 113th Cong. 1st Sess.

prominently display in marketing and enrollment materials the existence of such coverage. It would also require health plans to reveal that enrollees will pay a separate premium, right out of their own pockets, for abortion coverage.[20]

- **Protect conscience rights in healthcare.** Policy should protect the conscience rights of medical professionals, patients, and all pro-life Americans to not be forced to perform or pay for abortion procedures. The "Abortion Non-Discrimination Act" would clarify and codify existing federal conscience protections for individuals and organizations that decline to participate in, perform, pay for, or provide coverage of abortions. Policymakers should also enact permanent protections of the freedom of individuals, families, and employers to find and provide health care coverage that aligns with their values.[21]

- **Continue the legal battles and defend constitutional self-government.** Marriage is too important to allow unelected judges to redefine it without a fight. Governors and state attorneys general should continue the legal battles to defend laws defining marriage as the union of a man and woman, many of which were passed with overwhelming democratic support. In a system of limited constitutional self-government, the people and their elected representatives should make decisions about marriage policy. National leaders and policymakers should continue to denounce judicial rulings that usurp the authority of citizens to make good marriage policy.

- **Make the case for marriage.** These legal fights provide opportunities to make the case for marriage in the court of public opinion. Now is the time for national leaders and institutions of civil society to redouble their efforts to teach their own members the truth about marriage and encourage their own members to live out that truth. We must vigorously advance the arguments for a classically liberal form of limited government and highlight the importance of religious liberty. Governmental recognition of same-sex relationships as marriages need not and should not require any third party to recognize a same-sex relationship as a marriage. Regardless of what the future holds, policymakers should protect the freedom of individuals and institutions to continue to speak and to act in the public square based on their belief that marriage is the union of a man and a woman.

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20 Abortion Insurance Full Disclosure Act, H.R. 3279, 113 Cong. 1st Sess.; Sarah Torre, "House Bill Would Address Obamacare's Abortion Secrecy Clause," The Daily Signal, October 18, 2013, http://dailysignal.com/2013/10/18/house-bill-would-address-obamacares-abortion-secrecy-clause/.

21 The Healthcare Conscience Rights Act, introduced in the 113 Congress as H.R. 940, S. 1204 includes both protections for conscience under Obamacare and language similar to the Abortion Non-Discrimination Act.

- **Protect the freedom to speak and act on the truth about marriage.** Even in jurisdictions that have redefined marriage, individuals and businesses that believe marriage is between a man and a woman should be free to live in accord with their moral and religious convictions. Congress has an opportunity to protect religious liberty and the rights of conscience. Policy should prohibit the government from discriminating against any individual or group, whether nonprofit or for-profit, based on their beliefs that marriage is the union of a man and woman or that sexual relations are reserved for marriage. The government should be prohibited from discriminating against such groups or individuals in tax policy, employment, licensing, accreditation, or contracting. The Marriage and Religious Freedom Act would prevent the federal government from taking such adverse actions. Protecting religious liberty and the rights of conscience fosters a more diverse civil sphere. Indeed, tolerance is essential to promoting peaceful coexistence even amid disagreement.[22]

CONCLUSION

A properly limited government requires more than just a robust economy, supported by free market principles. Markets themselves depend on a robust civil society where the institutions of marriage, family, and community thrive. Only by reinvigorating those institutions and the mores that support them can we maintain a society where all Americans have an opportunity to achieve human flourishing.

Conservatives should not be afraid to speak up about the necessity of protecting the most basic, natural right to life, promoting the institution of marriage as a good for society, and defending the right to live out one's beliefs. These causes are rooted in the fundamental principles that have made this nation great, and thoughtful advocacy on their behalf will resonate with the American people.

The erosion of public understanding of the nature of marriage and why it matters for public policy have made the challenge of protecting the institution more difficult. But the urgency of repairing marriage given its interconnectedness to the myriad social and economic challenges we face is too great to resign ourselves to defeat. After all, the only way to guarantee a political loss is to sit idly by.

We believe in an America in which all our fellow citizens can flourish. And for that reason we stand for life, for religious liberty, for marriage, for economic freedom, for low taxes, for markets in health care, for parental choice in education. After all, economic well-being

22 Marriage and Religious Freedom Act, H.R. 3133, S. 1808, 113th Cong. 1st Sess.

and social flourishing spring from the same source. They are grounded in the same principles of natural right and natural law that informed our Founding and continue to sustain our nation.

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A NEW FOREIGN POLICY AGENDA

Kim R. Holmes and William Inboden

It is a little over two years before the next presidential election, but foreign policy might figure more prominently in the 2016 cycle than it has in recent elections. World events are deteriorating rapidly, and national security is more on people's minds. There is widespread popular discontent with the current Administration's foreign policies. Even prominent Democrats are raising significant questions about the direction of U.S. strategy. Republicans are searching for a consistent foreign policy vision. The time is ripe to start thinking about what an alternative foreign policy should be.

FOREIGN POLICY ADRIFT

Under the Obama Administration, the United States has undertaken a provisional experiment: How would the world look if the United States pulled back from its traditional role as guarantor of global stability and underwriter of the international liberal order? The reasons for this change in U.S. policy are well known. The Administration came into office vowing to undo a strategy of overreach it believed was the root cause of America's foreign policy problems. But in doing so it has created the opposite problem. By going too far in the opposite direction—by *underreaching*, if you will—it has contributed to shifts in the strategic environment that are quite dangerous for American security. As Senator Marco Rubio observed in an important speech on defense policy in September 2014, "the trend of declining American strength had been largely incidental among previous administrations, but now it is an active priority. Previous presidents had merely taken their foot off the gas pedal of American strength, but President Obama has stomped on the brake."[1]

The first most obvious shift in the strategic environment is that the world is becoming highly disordered. What Henry Kissinger, in his new book *World Order*, calls "zones of non-governance or jihad" now span Africa, the Middle East, and South Asia, and include Afghanistan, Egypt, Gaza, Iraq, Lebanon, Libya, Syria, Mali, Nigeria, Pakistan, Somalia, Sudan, and Yemen.[2] Not included in this inventory of disorder are central Africa's wars and drug cartel–driven violence in Central America and Mexico. Failing states and large swaths of ungovernable lands are beyond not only the control of responsible governments but, increasingly, the influence of U.S. policy and the international community. They are breeding grounds for terrorism, armed conflict, human rights violations, and atrocities committed against civilians.

It is no accident that world disorder is on the rise at the same time that American power and influence are waning. The inconstancy (sometimes verging on incoherence) of U.S. policy and the widely held perception that America is walking away from its responsibilities contribute to instability in the Middle East. U.S. diplomatic clout there has suffered substantial erosion, exemplified by fraying relations with Egypt, Israel, Saudi Arabia, Turkey, the UAE, and Qatar, and by repeated failures of U.S.-led diplomatic initiatives on Syria, Iran, and the Palestinian-Israeli conflict. The Administration's strategy to defeat the Islamic State (IS, also known as ISIS or ISIL) is at best uncertain, at worst hopelessly confused. The Administration has been forced to face a host of bad options partly of its own making; the failure to create a Syrian rebel force earlier on left the road wide open for ISIS to emerge, and the abandonment of Iraq caused IS's rise there directly. As a result, the United States is left between a rock and a hard place. It is unable to degrade IS without bolstering Syrian president Bashar al-Assad, but reluctant to take direct action against him for fear of widening the war. The result is a half-hearted strategy of limited bombings and a slow-motion plan to create a Syrian opposition that offers little hope of success.

The most dangerous shift has been caused by the resurgence of terrorism. Terrorists which we thought were vanquished are back with a vengeance, reversing our hard-fought gains in Iraq and once again threatening the American homeland. Despite the Administration's claims that the threat of terrorism was receding, the number of global terrorist attacks and fatalities has soared in recent years, reaching a record high in 2013 according to the National Consortium for the Study of Terrorism and Responses of Terrorism at the University of Maryland.[3] The State Department, using the same study, reports that the number of terrorist attacks in the world increased 40 percent in 2013 (from 6,771 in 2012 to 11,952).[4]

Not only are the numbers up, but the global threat of terrorism is changing its shape and character. It is metastasizing into strains that are more violent, better armed, better funded, and more difficult to counter. According to official foreign terrorist organization lists posted by the United States, Britain, Canada, and the Global Terrorism Database, there are at least 74 militant Islamist groups conducting terror around the world.[5] Over 30 of them

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1 News release, "Rubio Delivers Speech On Rebuilding American Defense," Office of Senator Marco Rubio, September 17, 2014, http://www.rubio.senate.gov/public/index.cfm/press-releases?ID=82ca57f5-c05e-4d75-b53a-bcb98b390139.

2 Henry Kissinger, *World Order* (New York, NY: Penguin Press, 2014), pp. 143-44, 368.

3 Jessica Rivinius, "Majority of 2013 terrorist attacks occurred in just a few countries," University of Maryland National Consortium for the Study of Terrorism and Responses to Terrorism, August 18, 2014, http://www.start.umd.edu/news/majority-2013-terrorist-attacks-occurred-just-few-countries.

4 "State Department Report Says Terrorism Increased 40% Last Year," *Security Magazine*, May 1, 2014, http://www.securitymagazine.com/articles/85488-state-department-report-says-terrorism-increased-40-last-year.

5 "Foreign Terrorist Organizations," U.S. State Department, Bureau of Counterterrorism, http://www.state.gov/j/ct/rls/other/des/123085.htm, "Proscribed Terrorist Organisations," Home Office, Government of the United Kingdom, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/380939/ProscribedOrganisations.pdf, "Currently listed entities," Public Safety Canada, Government of Canada, http://www.publicsafety.gc.ca/cnt/ntnl-scrt/cntr-trrrsm/lstd-ntts/crrnt-lstd-ntts-eng.aspx, and University of Maryland National Cons ortium for the Study of Terrorism and Responses to Terrorism, Global Terrorism Database, http://www.start.umd.edu/gtd/search/Results.aspx?search=Islamist&sa.x=20&sa.y=15.

were added to those lists since 2008, demonstrating the proliferation of jihadist franchises and increasing risk to U.S. interests despite the "end" of the Afghan and Iraq wars and the Administration's previous (and premature) declarations of victory over al-Qaeda.

Not only are the numbers up, but the global threat of terrorism is changing its shape and character. It is metastasizing into strains that are more violent, better armed, better funded, and more difficult to counter.

The Obama Administration at first continued many of the counterterrorist policies of the George W. Bush Administration with respect to detention and intelligence-gathering. Its drone and targeting policies were anything but shy about killing terrorists, and it has launched air strikes against the Islamic State. At the same time, the Administration made no secret of its desire to move away from a "long war" footing strategy against terrorism, treating it more as a law enforcement problem, as witnessed by attempts to bring accused terrorists into U.S. civilian courts.

Besides the law enforcement strategy, which was haphazard at best (the Guantanamo Bay facility remains open), the strategy had two other components. One was to target as narrowly as possible "core" al-Qaeda and affiliate leaders and infrastructure in places like Yemen, Somalia, and Pakistan. The other was to downplay the strategy of denying terrorists territorial-based safe havens.

It did not work. The fear is that the Islamic State and other terrorist groups will use safe havens and chaos in Iraq and Syria to plan attacks on the U.S. homeland. Indeed, the al-Qaeda–linked group called Khorasan in Syria was struck with U.S. forces precisely because of intelligence that it was "nearing the execution phase" of a planned terror attack on the U.S. or Europe.

As the U.S. prepares to leave Afghanistan, the Taliban may make a comeback as well. Whereas prior to September 11, 2001, al-Qaeda was largely concentrated in one country, Afghanistan, today Islamist terrorist groups operate in or control territory in numerous countries in the Middle East and Africa. Even the "core" al-Qaeda is trying to make a comeback, as witnessed not only by the activities of Khorasan but by the attempts by its newest franchise, al-Qaeda in the Indian Subcontinent (AQIS), to hijack a Pakistani Navy frigate on September 6, 2014.

Another strategic shift has been in America's "great power" relations with Russia and China. The Russian "reset" policy did not result in a hoped-for new strategic partnership of cooperation; it resulted instead in a bitter new rivalry with an emboldened and hostile

Russia. Vladimir Putin is using force not only to nullify international (and Russian) recognition of Ukraine's independence, as codified in the Budapest Memorandum of 1994. He's also challenging the post–Cold War settlement in Europe, trying to reintroduce ethnic irredentist claims as an international norm to European affairs.[6] His position that an independent country like Ukraine is not fully sovereign is a lesson not lost on other East European countries like Poland and the Baltic states. They understand full well that Russia has positioned itself as a revisionist power to challenge the West geopolitically and even ideologically (in terms of authoritarian versus liberal values).

An authoritarian China is also pursuing a revanchist policy, in a similar, albeit more subtle, manner than Russia. In fairness, the White House does not bear all the blame for the relative change in the balance of power between China and the United States in East Asia. China is an economic powerhouse, and its growing military strength and political influence are facts of international life and consistent with historical patterns. The question is: to what end does China seek to deploy its new power, and will it deviate from the path of peaceful rise? Its recent and ongoing aggressions in the region make it appear that it aims to overturn the open regional order the U.S. has maintained to the benefit of all, including China, over the past 70 years. Some conclude that we simply must get used to it and accommodate Beijing's demands. Others, including us, believe a more resolute policy backing U.S. allies and standing steadfast against China's expansionist territorial claims is needed.

Either way, a major challenge to American leadership is underway in East Asia, and any U.S. policy that does not respond vigorously is bound to fail American interests. This Administration is too deeply invested in tranquil U.S.-China relations, however unproductive they may be, to risk the discomfort of challenging Beijing's geopolitical claims.

The bottom line is that the strategy of retrenchment has unwittingly left U.S. interests behind and contributed to more global disorder and instability, not less as intended. The more the United States withdrew from its traditional role as a guarantor of stability, the more unstable the world became. We are less able than before to influence world events. We are less able to deter war and keep the peace. And we are more exposed to direct threats to the security of the United States.

Nor are multilateral institutions any stronger despite the many attempts to engage them. After gaining United Nations Security Council support for the Libya campaign, the Administration has either ignored or been stymied by the U.N. in Syria and Ukraine. While it is true that the U.N. General Assembly now votes more often with the United States than it has in previous years—mainly because the Obama Administration became more U.N.

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6 Anna Dolgov, "Russia Sees Need to Protect Russian Speakers in NATO Baltic States," *The Moscow Times*, September 16, 2014, http://www.themoscowtimes.com/news/article/russia-sees-need-to-protect-russian-speakers-in-nato-baltic-states/507188.html.

friendly—it also is true that doing so is not easing the strains on U.S. relations with the U.N. The Administration was forced to cut off funding to UNESCO over the Palestinian issue, and progress in the U.N. Security Council continues to be stymied by veto threats from Russia and China.[7]

The mistake of the Administration is not in trying to work with multilateral organizations; it is in expecting that doing so is a substitute for American leadership. It is often assumed that if the U.N. does more we can do less, and as such can be a substitute for U.S. leadership, influence, and power. It cannot be those things. Multilateralism works best, indeed only works at all, with American leadership.

REVERSING THESE TRENDS

Having looked at these strategic threats, let's take an inventory of America's capacities and capabilities in order to discern what resources our nation can marshal to reverse these trends.

Let's start with the economy. Without sustained economic growth, America would be out of the leadership business. It's not only the capital to fund the armed forces but the economic and political clout provided by a robust economy that undergirds all elements of national power. In this respect we are severely underperforming: The recovery from the recession is the slowest in 70 years. Nearly 7 million fewer Americans are working or searching for work since the recession technically ended in 2009—it may have ended on economists' charts five years ago, but it continues to be a reality in the lives of too many Americans.

The unemployment rate still remains too high primarily because businesses are not creating new jobs fast enough.[8] That rate also masks the gravity of the jobs crisis, as untold numbers of despondent Americans have exited the workforce entirely. Businesses are slow to take risks and expand because of the unstable economic environment and growing regulatory burden.

The problem is not only slow economic growth but fiscal imbalances. The deficit may have improved recently, but the Congressional Budget Office's August 2014 update to its "Budget and Economic Outlook" report projects that, unless current laws are changed, budget deficits will increase and public debt will exceed 77 percent of GDP in just ten

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7 Brett D. Schaefer and Anthony B. Kim, "Congress Should Link U.N. General Assembly Voting and Foreign Aid," Heritage Foundation *Issue Brief* No. 4270, September 2, 2014, http://www.heritage.org/research/reports/2014/09/congress-should-link-un-general-assembly-voting-and-foreign-aid.

8 James Sherk, "Not Looking for Work: Why Labor Force Participation Has Fallen During the Recovery," Heritage Foundation *Backgrounder* No. 2722, September 4, 2014, http://www.heritage.org/research/reports/2014/09/not-looking-for-work-why-labor-force-participation-has-fallen-during-the-recovery.

years.[9] Spending on all entitlements will grow by at least 80 percent. And according to White House budget office estimates, spending on defense will shrink to under 3 percent of GDP by 2018, its lowest level since 1940.[10]

Unless something is done, mandatory spending on burgeoning entitlement programs and interest on the debt will grow to such an extent that, by 2030, no tax revenues will be left over to fund national defense—or diplomacy, intelligence, or other vital national security functions.[11] Without getting our fiscal house in order and returning to long, sustained economic growth, America's ability to return to its historical position of global leadership is in jeopardy.

The good news is that we still have significant economic potential which can be realized with the right economic policies. Pursuing ambitious reforms in the areas of taxes, regulations, and entitlements could break America's economic malaise and unleash the dynamism of our free enterprise system.

The economic story is not all bad news. Some of the traditional pillars of American economic strength such as manufacturing, innovation, entrepreneurship, technology, and natural resources have in recent years combined to produce an energy boom in oil and gas. The shale revolution is positioning the United States to be a net energy exporter and the leading energy producer in the world—a position inconceivable just ten years ago. The implications of this will be felt across many sectors, from increased job creation and growth at home to more freedom of action and leverage in our foreign policy abroad.

The negative impact of fiscal problems is most felt on our declining defense capabilities. In 2012, Army Chief of Staff General Raymond Odierno warned that sequestration would force the Army to reevaluate its defense strategy and cause a reduction in both active and reserve troop levels. "I think," he said, "it would put us beyond the fringes of what I consider to be acceptable risk, for us to be able to respond to this broad variety of threats. So, to me, I think it's dangerous."[12]

Because of deep budget cuts, some now estimate the Army will be reduced from an Iraq-Afghanistan peak of 566,000 troops to 450,000; under sequestration caps it could

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9 Congressional Budget Office, "An Update to the Budget and Economic Outlook: 2014 to 2024," August 27, 2014, http://www.cbo.gov/publication/45653.

10 U.S. Office of Management and Budget, *Budget of the United States Government, Fiscal Year 2014, Historical Tables* (Washington, DC: U.S. Government Printing Office, 2013), p. 142, Table 6.1, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2014/assets/hist.pdf.

11 "All Tax Revenue Will Go Toward Entitlements and Net Interest by 2030," 2014 Federal Budget in Pictures, The Heritage Foundation, http://www.heritage.org/federalbudget/entitlements-historical-tax-levels.

12 Katie Nelson and William Garbe, "Odierno addresses Army's future, budget cuts," *Army News Service*, June 22, 2012, http://www.army.mil/article/82391/.

shrink further to 420,000.[13] The *Navy Times* reported Defense Secretary Chuck Hagel saying that "under a worst-case-scenario, the Navy would reduce its fleet of aircraft carrier strike groups to eight or nine if the cuts lasted for the next decade. That would be the fewest number of carrier strike groups for the nation since World War II."[14] A congressionally mandated National Defense Panel report on the Pentagon's 2014 Quadrennial Defense Review said the Air Force already has "the smallest and oldest force of combat aircraft in history."[15]

Just as today's defense capabilities suffer dramatic cuts, tomorrow's force structure is being eroded by underinvestment in modernization, development, and acquisition of new weapons platforms. The Navy is patrolling less and increasingly will find itself unable to meet combatant commander requests. Combat readiness has suffered to the point where, as many critics say, only "a handful of Army brigades" are ready for crisis response.[16]

At the same time that capabilities are declining, new missions are being added, like the new war in Iraq and the Ebola virus deployment, which will worsen the strain on the armed forces. This mismatch between capabilities and the demands placed on them greatly increases risk. The result could be a failure to perform the tasks assigned to them, an unnecessary loss of life, or both.

The United States Institute of Peace summed up the problem this way: "The consensus conclusion of the [National Defense Panel] report is that there is a growing gap between the strategic objectives the U.S. military is expected to achieve and the resources required to do so."[17] The consequences of these cuts shackle American strength across the board. Not only does a diminished military undermine our deterrent capability, it also diminishes our diplomatic strength and intelligence effectiveness. American diplomats sit with their foreign counterparts at the negotiating table representing a weakened nation. Our intelligence community identifies threats and opportunities, yet serves a customer less able or willing to do anything about them.

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13 Robert J. Samuelson, "America's neglected defense," *The Washington Post*, September 7, 2014, http://www.washingtonpost.com/opinions/robert-samuelson-americas-neglected-defense/2014/09/07/3acd5de4-3518-11e4-9e92-0899b306bbea_story.html.

14 "CNO expects more deferred maintenance as budget strain continues," *The Navy Times*, August 13, 2013, http://www.navytimes.com/article/20130813/NEWS/308130002/CNO-expects-more-deferred-maintenance-budget-strain-continues.

15 William J. Perry and John P. Abizaid, *Ensuring a Strong U.S. Defense for the Future: The National Defense Panel Review of the 2014 Quadrennial Defense Review*, July 31, 2014, p. x, http://www.usip.org/sites/default/files/Ensuring-a-Strong-U.S.-Defense-for-the-Future-NDP-Review-of-the-QDR.pdf.

16 Michèle Flournoy and Eric Edelman, "Cuts to defense spending are hurting our national security," *The Washington Post*, September 19, 2014, http://www.washingtonpost.com/opinions/cuts-to-us-military-spending-are-hurting-our-national-security/2014/09/18/6db9600c-3abf-11e4-9c9f-ebb47272e40e_story.html.

17 News release, "National Defense Panel Releases Assessment of 2014 Quadrennial Defense Review," United States Institute for Peace, July 31, 2014, http://www.usip.org/publications/national-defense-panel-releases-assessment-of-2014-quadrennial-defense-review.

The intelligence community is perpetually bedeviled by the occupational hazard that its successes can rarely be shared publicly while its failures receive high visibility and wide attention. More recently, the intelligence community not only has been buffeted by a series of high profile lapses—think Edward Snowden's treachery, the un-forecast Arab Spring, or underestimation of the Islamic State's will to fight—but it has also been weighed down by an Administration that does very little to provide it political support, and by a Democrat-led Senate that was a bitter critic of its interrogation techniques under President Bush.

Yet scratch the surface and one finds an intelligence community brimming with advanced capabilities and dedicated professionals. Though originally beset by flawed legislation and a turbulent start, the Office of the Director of National Intelligence is now much better at overseeing resources and integrating intelligence collection and analysis.

At the tactical level, the hard years of front-line combat in Iraq and Afghanistan also spurred remarkable innovations in the field, including various forms of fusion cells composed of intelligence collectors and special operations forces. These fusion cells collect, analyze, and disseminate intelligence in real time and make it immediately available to the warfighters, whose aggressive operational tempo in turn generates more raw intelligence.

At the strategic level, America's technological prowess has made our signals intelligence capabilities second to none, and our human intelligence collectors have rebounded from the budget and bureaucratic strictures of the 1990s to become among the world's leaders. For all of the internal and external challenges facing the intelligence community, it is still on balance an underappreciated national resource.

In the realm of diplomacy, the problem is partly one of diminished capacity, but the more fundamental deficiency has been the misdirection of U.S. policy. Yes, we do ask the State Department to do too much with too little. Yet our bigger failure has been inadequately integrating our diplomacy with hard power. Diplomacy is far more effective when it is backed up by and in harmony with U.S. military policy; indeed it often fails when it is divorced from the realities of military power—as it was, for example, amid the hasty retreat from Iraq, the inconstant threats of force against Syria, our conciliatory policy towards Iran, or our ineffective protests against Russian and Chinese territorial aggression.

Another trait of a sound diplomatic strategy is that it works best when it conforms to strategic realities, rather than being based on wishful thinking. For example, much of the world does not buy into President Obama's progressive view of the global order inevitably marching toward liberal international norms. This is why the Administration's talking points about being on the "right side of history" or its dismissals of "19th century" policies appear so feckless. History does not progress inexorably. If "history" shows anything, it is that positive international change comes from strong U.S. leadership, not from America pulling back and letting others take the lead. In this respect, our enemies and rivals are more impressed by clarity and consistent firmness than by ambiguities or declarations of sympathy and understanding.

Just as America's adversaries have taken our measure and found us wanting, we have also neglected another source of diplomatic strength: our allies and partners. The United States sits at the fulcrum of an alliance system that should be the envy of the world, one that vastly multiplies our global strength. Yet from Asia to Europe to the Middle East, the strength of our alliances is being diminished by a combination of American neglect and allied passivity.

The European alliance has largely underperformed over the past few years, hobbled by declining defense budgets and differences of opinion over the nature of threats. That weakness continues as Europe has proven to be a drag on imposing tough sanctions against Russia over Ukraine. And West European nations inside NATO are reluctant to beef up defenses in the East against Russia, let alone project power further abroad.

But there are positive developments as well. The Europeans did impose sanctions on Russia after all, despite the undertow of economic and energy interests against doing so. Even more important has been the positive response to the growing threat of IS in Iraq and Syria, which shows how resilient the NATO alliance can be. France, the U.K., Belgium, and Denmark will send fighter jets to the fight against IS, and countries like Germany will provide arms and training. Moreover, the European allies are starting to get their act together on energy, building interconnector gas pipelines and starting to make preparations for imports of liquefied natural gas.

Our alliances in Asia are strong. The rise of China and doubts about the staying power of the United States in that region generated anxiety among some allies—principally Japan—but overall we are in good shape in Asia. It could be argued that Japan's incremental relaxation of constitutional restraints on its self-defense forces can be traced in part to hedging its long-term bets against a potential American decline, but these moves have been long debated in Japan, and in fact, they make Japan a better ally.

Our alliances with South Korea, the Philippines, and Australia are quite strong. After 60 years, the United States and Korea remain tightly aligned against potential North Korean aggression. The Philippines and Australia increasingly share American strategic interest in the management of China's rise, and are facilitating a greater U.S. presence. Rising middle powers in Asia such as Indonesia and Vietnam have proven to be willing partners with the United States. Perhaps most significant, despite some setbacks and continued challenges, our burgeoning strategic partnership with India has the potential to fundamentally transform the international order of the Indo-Pacific region.

As for the United Nations and other international organizations, the problems include disappointed expectations born of a misalignment between intentions and capabilities. The

Obama Administration came into office promising more cooperation with a reinvigorated U.N., but international organizations remain ineffective and highly politicized against U.S. interests and values.

Rejoining the Human Rights Council in Geneva, for example, forced the Administration to go along with the charade that the U.N. cares about human rights and effectively advances them. Yet the Council, which includes such known abusers as China, Cuba, Russia, Saudi Arabia, and Venezuela, has with a few notable exceptions been largely ineffective at best and mischievous at worst, the latter illustrated by its wildly disproportionate fulminations against Israel.

The Obama Administration came into office promising more cooperation with a reinvigorated U.N., but international organizations remain ineffective and highly politicized against U.S. interests and values.

Nor is the United Nations Security Council necessarily any more effective. During the intervention against Libya, it looked as if the United States had embraced the "responsibility to protect" doctrine. But it became very clear that the Administration would not apply this doctrine for Syria and Ukraine. Moreover, while President Obama did get Security Council approval to restrict the travel of terrorists, he was unable to enlist its support for the broader combat campaign against IS in Iraq and Syria. The result is that the Security Council remains what it has always been, a political body controlled by the interests and whims of its permanent members, of whom China and Russia are frequently the most obstreperous.

In conclusion, our inventory of capabilities shows much potential, but it also shows that we are dreadfully underperforming. Our economy is weaker than it should be. Our armed forces are in a state of decline. Our diplomacy is often misdirected to achieve ideological goals rather than advance American interests. Our alliances have potential, but they are only as strong as U.S. leadership allows them to be. And international organizations work more often against U.S. interests and values than for them.

PRINCIPLES FOR A NEW FOREIGN POLICY STRATEGY

These are America's capacities and capabilities, which have been underutilized and neglected by the current Administration. Our purpose should be to restore these capabilities but also to better utilize them in order to turn America's position in the world around. Thus we should:

- **Restore America's economic dynamism.** To regain our national confidence, provide more resources for national security, and increase our economic power on the global stage, we need nothing short of an economic revival. This will require: instituting a rational tax policy that spurs economic growth, eliminating regulations and restrictions that hamper economic growth and stifle energy production, reforming entitlement programs and reining in runaway entitlement spending, and ending the regulatory capture of government by corporate special interests and market-distorting subsidies that stifle economic growth.

- **Reinvigorate international economic policy.** In tandem with restoring economic growth we must boost our economic engagement abroad. America's postwar global leadership included spurring the creation of international economic institutions, such as the World Trade Organization and International Monetary Fund, and establishing the dollar as the global reserve currency. That international economic order has served our nation and the world well, yet in recent years the United States drifted from these commitments, diminishing our influence. We must recapture the centrality of international economic policy for our global strategy. Specifically, this means ensuring that the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) advance free markets and liberalize trade, and that Congress approve Trade Promotion Authority ("Fast Track"). International energy policy also presents tremendous opportunities. Approving the Keystone XL pipeline is an obvious step, but the United States should take advantage of other developments such as the shale revolution and Mexico's ongoing liberalization of its energy sector to promote a North American–wide energy initiative that would simultaneously improve bilateral relations with our northern and southern neighbors. Additionally, we should ease the onerous restrictions on exports of petroleum and natural gas. Taken together, these energy reform steps would bolster our domestic economy and strengthen our global leverage. They could also provide our European allies with more energy resources to help wean them off their dependence on Russia.

- **Restore deterrence and peace through strength as strategic principles.** U.S. national strategy and military policy should rest on the principle of deterrence—specifically, deterring our adversaries from threatening us and our interests. We are never interested in a "fair fight" with our enemies. Rather we should possess such overwhelming strength that our enemies choose not to challenge us. To this end we need to restore our defense budget to a minimum of pre-sequestration levels. Just as urgently, we must reprioritize the development and acquisition of new weapons platforms, including the next-generation strategic bomber and an expanded navy, as well as modernizing our nuclear force. Our military strategy should be premised on a multiple-conflict planning construct to prepare for the conventional and unconventional threats we face today.

- **Regain the initiative in the war on terrorists**. The best way to combat terrorists is to understand we are in a "war" and to fight it on all fronts with the full spectrum of national power. This was the strategy of the Bush Administration, and to the extent that the Obama Administration continued it further progress was made in in degrading al-Qaeda, culminating in the killing of Osama bin Laden. However, the narrow focus only on "core" al-Qaeda let the terrorist threat metastasize, proliferate, and escalate. The President has spoken of the war against the Islamic State as "generational" in length, and he is correct. But to have any hope of winning it we need a comprehensive global strategy that deals with the threat in all of its dimensions. It means not allowing weak and failed states to turn into safe havens for terrorists, treating the terrorist conflict as a war and not merely a law enforcement matter, and paying much greater attention to the ideological and propaganda dimensions of the conflict. Over the long term we need to win the war of ideas particularly in terms of information strategy and public diplomacy. The goal should be defeating the jihadists of today and neutralizing the radicalization of a new generation.

- **Repair and strengthen our alliances**. America's alliances are an underappreciated dimension of our national strength. They help us protect our interests and security by helping to preserve order and security in key regions of the world, and by multiplying our power projection, intelligence gathering, and diplomatic influence. But their strength depends directly on the credibility of our commitments and on our constant attention to alliance needs. Our job is not to "lead from behind" but from ahead, which means never letting any doubt arise as to whether the U.S. will make good on its alliance commitments. If our allies have confidence in American credibility, they will increase their own commitments and resources to defense and diplomacy. Specifically, we should bolster our standing military forces in Europe, reinvigorate the special relationships with the United Kingdom and other valuable allies, repair damaged relationships with our main partner nations in the Middle East, and put more military resources behind our rhetorical commitments to our Asian allies. Steps will have to be taken as well to restore the confidence of our friends and our allies in intelligence-sharing and other covert cooperation in the wake of the damaging Senate report on U.S. interrogation techniques.

- **Reintegrate diplomacy with the threat of force**. It should be axiomatic that diplomacy should never be divorced from the threat of military power. And yet the Obama experiment has done just that. Repeatedly the Administration talked and acted as if diplomacy were separate from, even superior to, military capability—that they somehow were alternatives. Diplomacy and military policy should be part of a continuum of strategy and policy. U.S. diplomacy works best not only when it is backed up by resolve and consistency, but when it is consciously based on an appreciation of both the limits and the potential of military force. We should never threaten war unless we mean it, but at the same time we should not pretend as if conflicts have only "political" solutions—i.e., that the U.S. has no military options at all. Repeatedly downplaying the possibility of the use of force, as the Obama Administration has done with respect to Iran, actually hardened Iran's position in the nuclear talks. This does not mean reckless saber rattling or rash displays of military action; any possible use of force must be rare, tempered by prudence and caution. Our diplomacy will be more effective—and conflict will be less frequent—when our diplomats sit at the negotiating table representing the full strength and credibility of the United States.

- **Restore values to foreign policy.** American leadership rests on the perception that the U.S. stands not only for hard power but also the values of freedom, democracy, and the rule of law. Not just our alliances but American public support depend on and demand it. While the past century brought tremendous advances of liberty around the world, more recent years have seen setbacks for freedom, especially in autocracies like Russia and China and in failed transitions from the erstwhile Arab Spring. American policy has not kept pace with these challenges. It is no accident that oppressive governments more often pose security threats while democracies more often are our best strategic partners. Support for liberty and human rights is a strategic advantage for the United States, and democracy and human rights advocates in repressive societies are our natural allies. We must reengage the world on values, not by pushing narrow, ideologically motivated social agendas but by standing whenever possible for freedom and the rule of law. Thus at economic summits we should press an agenda of economic freedom, and in our public and private diplomacy we should stand up for political and religious liberty, and for those courageous dissidents in closed societies.

- **Reintegrate economic growth and political progress for weak and failing states.** Failing states contribute to global disorder and the growing threats to American security. To counter the rise of weak and failing states the United States needs not only an economic strategy but a political one. Through aid and diplomacy we should do everything in our power to help countries liberalize their economies, practice the rule of law, combat corruption and crony capitalism, embrace financial transparency, support free trade and open foreign investment policies, and liberalize labor regulations. At the same time the U.S. should work with weak and failing states to make progress toward stable democratic governments. Doing so should not be about punishing governments that are not sufficiently democratic—strategically cooperating with less than savory partners is unavoidable—but about providing assistance to certain civil societies to help create the conditions for democratic self-government. This should not be seen as nation-building, since that idea assumes total U.S. responsibility, which is unrealistic. Rather, it should be seen as a much more limited goal of civil society assistance for countries that could someday join the family of free nations and thus possibly become U.S. friends and allies.

- **Recover our ability to work with regional forces.** One of the lessons of the failure of our Syria policy is that supporting and shaping a friendly resistance to Assad's regime in Syria could have obstructed and perhaps even prevented the rise of the Islamic State. Now that we are in a major fight against IS, we need to work with a wide variety of regional forces. In the past we successfully used the provision of arms as an effective instrument to strengthen our partners and advance our interests, whether for the Afghan resistance to the Soviets in the 1980s, for Colombia's war on the FARC guerillas over the past decade, or for the Israeli military over the past several decades. Yet in recent years we have neglected the provision of materiel as a policy tool, to the detriment of our interests in places like Syria and Ukraine. We need to not only improve our vetting, training, and coordination of regional groups, but also enhance the capabilities of our conventional and special operations forces to provide support. U.S. special operations forces are overstretched.

CONCLUSION

For most of the Cold War and afterwards, most of what is proposed here was remarkably uncontroversial and embraced by Republicans and Democrats alike. The principles of leadership, strength, and deterrence were hallmarks of U.S. strategy from the time of Harry Truman and Dwight Eisenhower to John F. Kennedy to Bill Clinton and George W. Bush. The current Administration consciously broke with this strategy. Believing the world had so completely changed and that American capabilities were so diminished, it tried to supplant tried and true strategies with a new experiment of retrenchment and withdrawal. Many Democrats and most Republicans agree that experiment has failed.

Our principles add up to this: The United States must reengage as a world leader and embrace the principles of strength and deterrence and the values of stability and liberty. We must face the world as it is and not as we would wish it would be. We must be careful not to rise in anger but be absolutely resolute in seeing a chosen fight to a successful end. We must back allies rather than undermine them, and we must be far more imaginative and flexible not only in fighting wars but in shaping the world economy and the structure of peace in the world.

For over six decades in the postwar era the United States embraced a successful strategy of international leadership. We can do so again.

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* Kim R. Holmes and William Inboden, "The U.S. Needs a New Foreign Policy Agenda for 2016," *Foreign Policy Magazine* Shadow Government blog, August 28, 2014, http://foreignpolicy.com/2014/08/28/the-u-s-needs-a-new-foreign-policy-agenda-for-2016-a-four-part-series/, Kim R. Holmes and William Inboden, "The U.S. Needs a New Foreign Policy Agenda for 2016 (Part Two of Four)," *Foreign Policy Magazine* Shadow Government blog, September 23, 2014, http://foreignpolicy.com/2014/09/23/the-u-s-needs-a-new-foreign-policy-agenda-for-2016-part-two-of-four/, Kim R. Holmes and William Inboden, "The U.S. Needs a New Foreign Policy Agenda for 2016 (Part Three of Four)," *Foreign Policy Magazine* Shadow Government blog, October 8, 2014, http://foreignpolicy.com/2014/10/08/the-united-states-needs-a-new-foreign-policy-agenda-for-2016-part-three-of-four/, and Kim R. Holmes and William Inboden, "The U.S. Needs a New Foreign Policy Agenda for 2016 (Part Four)," *Foreign Policy Magazine* Shadow Government blog, October 17, 2014, http://foreignpolicy.com/2014/10/17/the-u-s-needs-a-new-foreign-policy-agenda-for-2016-part-four/.

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