MERCATUS CENTER
George Mason University
Bridging the gap between academic ideas and real-world problems

ECONOMIC PERSPECTIVES

REFORMS TO BOOST ECONOMIC GROWTH

Prepared by Matthew D. Mitchell, Nita Ghei, and Benjamin Klutsey

Economic growth and job creation are top policy objectives in Washington. Yet repeated attempts to achieve these aims—including hundreds of billions spent in the name of economic "stimulus" and a host of ostensibly pro-growth tax breaks—have all had disappointing outcomes. The recovery remains slow and halting, in great part because of government-created impediments, including regulation, favoritism, taxes, and increasing government spending and debt.

It is time for Washington policymakers to shift strategies and focus on identifying—and eliminating—the policies that stifle the economy's performance.

KEYS TO ECONOMIC GROWTH

Most previous government attempts to promote growth have proven costly, misguided, and ineffective. But Washington need not fly blind in pursuit of policies that support economic growth. Economic research has identified a number of policies that tend to correlate with faster growth. Policymakers interested in fostering an environment conducive to growth would do well to:

Reform regulatory policy. The continuous accumulation of regulation creates byzantine barriers that stifle innovation, disregard consumer priorities, and inhibit economic growth.

Remove market distortions. Federal programs misdirect resources to inefficient, government-approved "investments" rather than to growth-generating activities.

Eliminate disincentives to work, save, and invest. Many of the largest federal programs are riddled with provisions that discourage work and invite greater dependence on the government

Reduce the government's fiscal burden. Higher debt levels inhibit economic competitiveness and are associated with slower economic growth. They also limit the government's ability to respond to adverse economic conditions.

Rethink framework for achieving monetary stability. The current monetary policy approach contributes to other counterproductive government policies while failing to achieve its goal to ameliorate the swings of the business cycle.

POLICY REFORM TO SUPPORT ECONOMIC GROWTH AND INNOVATION

Reform Regulatory Policy

The current regulatory system piles new regulations on top of old, resulting in more than 175,000 pages of repetitive requirements that are often burdensome and ineffective in achieving their stated goals and are effectively a tax. A modern system of results-based regulatory policy would cut red tape and unleash existing potential to both boost economic growth and improve public health and safety.

- *Improve the entire regulatory system.* Any growth-oriented regulatory reform efforts must include an evaluation of both current and future regulations. Limiting reform to new regulations without including retrospective review will miss the significant opportunity to improve the economy via regulatory cleanup. "Large-scale retrospective analysis, coupled with a streamlined mechanism for eliminating obsolete or otherwise undesirable regulations, can dramatically improve economic performance."
  Patrick A. McLaughlin and Richard Williams, "The Consequences of Regulatory Accumulation and a Proposed Solution," Mercatus Working Paper, February 2014.[1]

- *Conduct economic analyses of proposed regulations.* In addition to retrospective analyses, reform of regulatory policy should include efforts to perform thorough economic analyses on all proposed regulations, including financial regulations. Essentially, "regardless of their legal obligations, all of the regulators should strive to conduct economic analysis of contemplated regulatory actions as a matter of good rulemaking practice."
  Hester Peirce, "Economic Analysis by Federal Financial Regulators," Journal of Law, Economics & Policy *9, no. 4 (2013).*[2]

- *Regulation should support innovation.* Government policies aimed at reducing risks often end up merely stifling innovation and privileging some industries and businesses over others. Regulators can promote entrepreneurial creativity by embracing a culture of "permissionless innovation," and encouraging risk-taking that challenges existing business models and traditional methods. Permissionless innovation "refers to the notion that experimentation with new technologies and business models should generally be permitted by default."
  Adam Thierer, Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom*, Mercatus Center at George Mason University, 2016.*[3]

- *Reform intellectual property law.* The mounting influence of special interests means that patent and copyright laws, meant to foster innovation, are increasingly a cost to those who seek to build on previous work. To maximize the dynamism and productivity of our economy, we should consider a number of reforms to the patent system. We should make patent infringement a civil rather than a criminal offense. We should return to the pre-1982 system in which all circuit courts hear patent appeals. And we should consider greater reliance on other mechanisms to encourage innovation, including prizes, voluntary contributions, and assurance contracts.
  Eli Dourado and Alex Tabarrok, "Public Choice and Bloomington School Perspectives on Intellectual Property," Mercatus Working Paper, November 2013.[4]

- *Increase investments and innovation.* Reducing regulatory accumulation can also spark economic growth by reducing the unintended distortions and disincentives created by the current regulatory environment. "For each new regulation added to the existing pile, there is a greater possibility for interaction, for inefficient company resource allocation, and for reduced ability to invest in innovation. The negative effect on U.S. industry of regulatory accumulation actually compounds on itself for every additional regulation added to the pile."
  Michael Mandel and Diana G. Carew, "Regulatory Improvement Commission: A Politically-Viable Approach to U.S. Regulatory Reform," Progressive Policy Institute Policy Memo, May 2013.[5]

- *Improve GDP growth.* According to World Bank estimates, a country that improves its regulatory environment from among the 25 percent most burdensome to the 25 percent least burdensome in the World Bank's "Doing Business" index can expect a 2.3 percentage point increase in average annual growth in GDP per capita.
  Simeon Djankov, Caralee McLiesh, and Rita Maria Ramalho, "Regulation and Growth," World Bank Research Paper, 2006.[6]

- *Improve productivity.* By affecting the allocation of labor and capital and what economists call total factor productivity, the accumulation of regulation can reduce productivity and lower aggregate output. The accumulation of regulations in the 1970s offers a straightforward explanation for the productivity slowdown of the 1970s—this knowledge should inform our understanding of a similar slowdown in recent years.
  John W. Dawson and John J. Seater, "Federal Regulation and Aggregate Economic Growth," Journal of Economic Growth *18, no. 2 (June 2013).*[7]

Remove Market Distortions

The complex US tax code, with its numerous targeted provisions, distorts market decisions and discourages the efficient allocation of resources. Innovation, a major source of growth, is a victim of the tax code, particularly when combined with an equally complex regulatory regime. The ideal tax code[8]—simple, efficient, equitable, and predictable—could significantly improve the economy's prospects for growth.

- *Eliminate targeted privileges.* Government favoritism of particular firms creates a host of economic and social problems. It undermines competition, leads to the misallocation of resources, encourages wasteful efforts to seek favors, and undermines the legitimacy of both government and business.
  Matthew Mitchell, The Pathology of Privilege: The Economic Consequences of Government Favoritism*, Mercatus Center at George Mason University, 2014.*[9]

- *Eliminate tax expenditures.* The $1 trillion in tax loopholes—commonly called tax expenditures—distort individual and corporate economic decisions by encouraging politically favored activity rather than the most productive activity. Eliminating tax expenditures would increase economic growth and allow for lower tax rates, further increasing growth.
  Jeremy Horpedahl and Brandon Pizzola, "A Trillion Little Subsidies: The Economic Impact of Tax Expenditures in the Federal Income Tax Code," Mercatus Research, October 2012.[10]

- *Lower the US corporate tax rate.* Currently the highest in the industrialized world, the corporate tax rate acts as a drag on US companies' competitiveness in the global marketplace and discourages domestic investment. "If Congress does not overhaul the corporate tax structure, the United States will continue to lose jobs to countries with lower taxes."
  Jason J. Fichtner and Nick Tuszynski, "Why the United States Need to Restructure the Corporate Income Tax," Mercatus Working Paper, November 2011.[11]

Eliminate Disincentives to Work, Save, and Invest

Many of the government's benefit programs create perverse incentives that discourage savings, investment, and work, limiting individuals' personal gains and slowing overall economic growth.

- *Disincentive to save and work*. Social Security's large trust fund creates for many an illusion that they need not save for retirement, and its earnings limitations encourage some to quit the labor force before reaching the full retirement age of 65—even if they could continue working productively. Therefore, reform should "focus on reining in program costs, encouraging personal saving and investment, and rewarding those in middle and early retirement age who make the decision to extend their working careers."
  Charles P. Blahous and Jason J. Fichtner, "Limiting Social Security's Drag on Economic Growth," Mercatus Research, November 2012.[12]

- *Disincentive to employment*. The benefit structure of the Affordable Care Act (ACA) creates major disincentives to employment. The reduction in weekly employment because of these ACA disincentives is estimated to be about 3 percent, or about 4 million fewer full-time-equivalent workers. This impact will arguably be larger than that of any single piece of legislation since World War II.
  Casey B. Mulligan, "The Affordable Care Act and the New Economics of Part-Time Work," Mercatus Working Paper, October 2014.[13]

- *Disincentive to work*. "Families are eligible for a large amount of assistance at very low incomes but then lose that assistance very quickly as they move into moderate income ranges."
  C. Eugene Steuerle, "Labor Force Participation, Taxes, and the Nation's Social Welfare System," Urban Institute, February 2013.[14]

Reduce the Government's Fiscal Burden

Excessive government spending, which drives deficits and mounting debt, is a significant barrier to faster economic growth. High debt levels slow economic growth, as has been shown[15] in a wide swath of academic studies from the European Central Bank, the International Monetary Fund, and the Bank for International Settlements, among others. Research also shows that high levels of debt inhibit economic competitiveness and limit government's ability to respond to adverse economic conditions.

- "While economists can't predict exactly when or how a debt crisis will manifest itself in the United States, such a crisis is inevitable if current spending trends continue."
  Veronique de Rugy and Jason J. Fichtner, "The United States' Debt Crisis: Far from Solved," Mercatus on Policy, August 2014.[16]

- *Entitlements are the drivers of fiscal imbalance.* "The long-term [fiscal] imbalance is driven primarily by growth in Medicare, Medicaid, Social Security, and the new health-insurance exchanges established as part of the 2010 Affordable Care Act." Any strategy that fails to reform these key drivers of projected long-term deficits will inevitably fail to correct the federal government's fiscal imbalance.
  Charles P. Blahous, "Why We Have Federal Deficits: The Policy Decisions that Created Them," Mercatus Research, November 2013.[17]

  Reforming entitlements to control their costs would send a valuable signal to financial markets that Washington is serious about addressing unsustainable levels of spending and debt. This would help improve the economic outlook. Thus, "entitlement reform is [itself] a pro-growth policy move."
  Douglas Holtz-Eakin, "Structural Reforms to Reduce Debt and Restore Growth," Cato Online Forum, November 2014.[18]

- *Spending cuts are best for economic growth.* Research shows that spending restraint without tax increases is the best formula for reducing debt without harming economic growth.

  According to a study of 21 countries over the period of 1970 through 2007, fiscal adjustments based upon spending cuts and no tax increases are more likely to reduce deficits and debt over GDP ratios than those based upon tax increases.
  Alberto F. Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," NBER Working Paper, October 2009.[19]

  A follow-up study reached a similar conclusion: "Fiscal adjustment packages made mostly of spending cuts are more likely to lead to lasting debt reduction than those made of tax increases."
  Alberto F. Alesina and Veronique de Rugy, "Austerity: The Relative Effects of Tax Increases versus Spending Cuts," Mercatus Research, March 2013.[20]

  Research finds Keynesian-based stimulus fails to meet its proponents' own criteria of being timely, targeted, and temporary. In addition to being poorly timed and targeted, stimulus spending has led to permanent increases in the size and scope of government.
  Jason E. Taylor and Andrea Castillo, "'Timely, Targeted, and Temporary?' An Analysis of Government Expansions Over the Past Century," Mercatus Research, January 2015.[21]

Rethink Framework for Achieving Monetary Stability

The ever-expanding mandate of the Federal Reserve is counterproductive to a goal of monetary stability. Reevaluation of the current monetary framework should weigh a range of alternative approaches, including further incorporating private institutions and market mechanisms, rethinking monetary policy targets, and limiting the Federal Reserve's role in financial regulations.

- *Limit the Fed's regulatory role.* In addition to the dual mandate of price stability and reducing unemployment, the Dodd-Frank Wall Street Reform and Consumer Protection Act "significantly expanded the regulatory authority of the Federal Reserve Board of Governors (the Board) over banking institutions, financial firms, and their subsidiaries. . . . This approach not only displaces market discipline, it also displaces other regulators. In the process, it may undermine financial stability by ensuring that regulatory mistakes by the Board reverberate through the entire financial system."
  Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Authority Initiated by Dodd-Frank," Mercatus Center at George Mason University, November 2013.[22]

- *Cost-effective pro-growth reform*. While many other reforms may require a higher level of both energy and resources, reforming monetary policy is relatively inexpensive. "There are other policy reforms that would do more. But it does offer one of the cheapest ways of boosting growth. Unlike fiscal programs such as infrastructure, there is virtually no cost to improving monetary policy. And unlike supply-side tax cuts, there are no significant political barriers."
Scott Sumner, "More Bang for the Buck: A Surprisingly Cost-Effective Way to Boost Growth," Cato Online Forum, December 2014.[23]

- *Rules-based monetary policy is better*. Simplifying monetary policy to a rules-based system would, at the minimum, increase certainty, reduce costs, and lower the probability of counterproductive government policies like taxpayer-funded bailouts for failing businesses. "A firm and clear rule dictating the range of policy options can help the public coordinate its expectations based on credible commitment, limit the knowledge burden facing monetary policymakers, and help insulate the central bank from undue influence."
Alexander Salter, "An Introduction to Monetary Policy Rules," Mercatus Working Paper, December 2014.[24]

LINKS

1. http://mercatus.org/publication/consequences-regulatory-accumulation-and-proposed-solution

2. http://jlep.net/home/wp-content/uploads/2013/10/JLEP-Issue-9.4.pdf

3. http://mercatus.org/publication/permissionless-innovation-continuing-case-comprehensive-technological-freedom

4. http://mercatus.org/publication/public-choice-and-bloomington-school-perspectives-intellectual-property-0

5. http://www.progressivepolicy.org/issues/economy/regulatory-improvement-commission-a-politically-viable-approach-to-u-s-regulatory-reform/

6. http://www.enterprisesurveys.org/research/researchpapers/topic/regulations-and-taxes

7. http://link.springer.com/article/10.1007%2Fs10887-013-9088-y

8. http://mercatus.org/publication/fixing-tax-code-key-principles-successful-sustainable-reform

9. http://mercatus.org/publication/pathology-privilege-economic-consequences-government-favoritism

10. http://mercatus.org/publication/trillion-little-subsidies-economic-impact-tax-expenditures-federal-income-tax-code

11. http://mercatus.org/publication/why-united-states-needs-restructure-corporate-income-tax

12. http://mercatus.org/publication/limiting-social-securitys-drag-economic-growth

13. http://mercatus.org/publication/affordable-care-act-and-new-economics-part-time-work

14. http://www.urban.org/research/publication/labor-force-participation-taxes-and-nations-social-welfare-system

15. http://mercatus.org/publication/united-states-debt-crisis-far-solved

16. http://mercatus.org/publication/united-states-debt-crisis-far-solved

17. http://mercatus.org/publication/why-we-have-federal-deficits-policy-decisions-created-them

18. http://www.cato.org/publications/conference-paper/structural-reforms-reduce-debt-restore-growth

19. http://www.nber.org/papers/w15438

20. http://mercatus.org/publication/austerity-relative-effects-tax-increases-versus-spending-cuts

21. http://mercatus.org/publication/timely-targeted-and-temporary-analysis-government-expansions-over-past-century

22. http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank

23. http://www.cato.org/publications/cato-online-forum/more-bang-buck-surprisingly-cost-effective-way-boost-growth

24. http://mercatus.org/publication/introduction-monetary-policy-rules

CONTACT

Robin Walker, 202-550-9246, rwalker@mercatus.gmu.edu
Mercatus Center at George Mason University
3434 Washington Blvd., 4th Floor, Arlington, VA 22201
www.mercatus.org

ABOUT THE MERCATUS CENTER