

There's no free lunch when making cuts

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The question of how to balance the state's General Fund has divided Alabama Republicans. Governor Bentley has proposed tax increases to raise over \$500 million in extra revenue, while many Republicans in the House and Senate want to cut spending.

Fiscal conservatives often use government waste as an argument against raising taxes. If we just cut the waste, the thinking goes, we'll have enough money for all of the truly important things. Although immensely appealing, economics suggests that the savings from cutting waste are often a mirage.

Why is cutting waste so challenging? The late William Niskanen, the long-time head of the Cato Institute, once remarked how after 25 years of working in DC, he had yet to find the line item labeled "waste, fraud and abuse" in any agency's budget. Dr. Niskanen did not merely mean that the waste was carefully hidden, but in practice does not look like waste.

To see why, consider seemingly wasteful spending by the Pentagon. A closer look often reveals more complexity. Military transport planes, for instance, typically cost far more than similar sized cargo planes used by businesses like UPS, and we might want to call this waste. Yet because military transport planes may need to fly into combat areas, Pentagon officials demand higher performance standards, rendering a cost comparison to civilian cargo planes invalid. The expensive planes will prove wasteful only if the specifications are unwarranted or the designs used to meet the specifications are excessively costly. Suddenly proving waste just got much harder.

Other times, wasteful spending still creates significant benefits, as when a \$100 million program produces \$70 million in benefits. Seventy million dollars is a lot of value, and consequently some people will believe that such a program is justified. The old saying that one person's trash is another's treasure applies, and suggests that waste will not fit our mental image.

Fraud is often more clear-cut, but we quickly hit diminishing returns in preventing fraud. If we require documentation and justification for each dollar spent by our state, we might spend \$50 to validate a \$20 purchase. The net savings from preventing fraud can be small.

Another way we might hope to proceed presumes that our lawmakers and bureaucrats know what is wasteful. If so, taxpayers might squeeze the waste out by rejecting all new taxes until officials cut waste. But this will not necessarily work for two reasons. First, politicians can respond with the “monuments” strategy. During the 1995 government shutdown, President Clinton made sure that the national monuments closed to maximize the impact on the public of the shutdown. (News reports that passage of the Republican legislature’s budget will force the closing of 15 state parks suggests that the “monuments” strategy is in play in Alabama.) Second, politicians will often also be unable to precisely identify waste, because as discussed above, the more combat-ready military transports might well be worthwhile.

Waste, I think, should be viewed instead as part of the cost of government, like shipping charges for online shopping. Consider the cost of taxes. Economics shows that all taxes distort the behavior of businesses and individuals, and these distortions increase the impact of taxes. For example, payroll taxes lead businesses to hire fewer employees. The cost to the economy of raising \$1 will exceed \$1 due to this deadweight loss of taxation; research shows that the full cost might be \$1.40 or more. This does not mean that we should repeal all taxes, but rather cautions us to ensure that spending is worth the full cost. Waste requires a further adjustment of the calculation.

Fiscal conservatives sometimes seem to suggest that “cutting the waste” offers a painless way to balance budgets. While I think that downsizing government is a better way to address both Montgomery’s and Washington’s budget problems than raising taxes, the downsizing will involve sacrifices. Economists like to say that there are no free lunches in the world. Cutting government spending is no exception to this rule.