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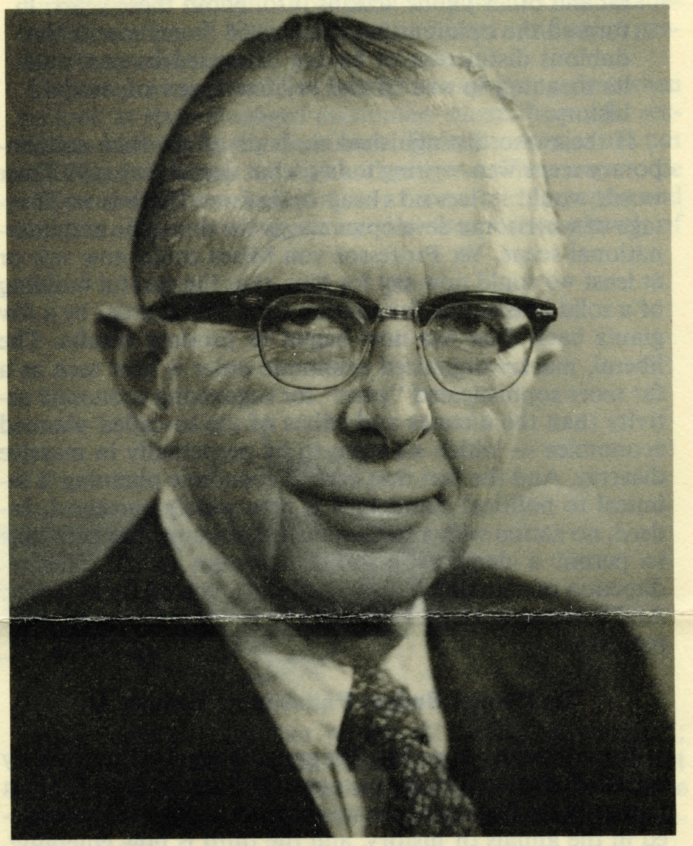
The Meaning of the Budget in the American Political Process

by Paul W. McCracken



Editor's Preview: In March of 1986, Hillsdale College's Ludwig von Mises Lecture Series presented "The Federal Budget: The Economic, Political, and Moral Implications for a Free Society." James M. Buchanan, Nobel laureate and general director of the Center for Study of Public Choice; Thomas J. DiLorenzo, professor of economics, George Mason University; Catherine England, senior fellow, Hoover Institution; Martha Seger, governor, U.S. Federal Reserve Board; and Richard Wagner, professor of economics, Florida State University, joined this month's IMPRIMIS author, Paul W. McCracken, past chairman of the president's Council of Economic Advisers, for the program. *Champions of Freedom, Vol. 13,* featuring their essays, is available from the Hillsdale College Press.

In this abridged version of his essay, Professor McCracken claims that an older form of economic budget theory espoused by classical liberal economists like Adam Smith and Ludwig von Mises is finally reasserting itself in America. The public concern for a balanced budget is but one sign of this trend. "While in the immediate sense the issue is the budget," Professor McCracken asserts, "in the larger sense it is nothing less than the fate of the liberal political and economic order."

Introduction

In this introduction to *Champions of Freedom,* Vol. XI, *The International Economic Order,* published in 1985, President Roche quoted the famous economist Ludwig von Mises, whom the *Champions* series honors, as follows:

> Occasionally, I entertained the hope that my writings would bear practical fruit and show the way for policy. Constantly I have been looking for evidence of a change in ideology. But I have never allowed myself to be deceived. I have come to realize that my theories explain the degeneration of a great civilization; they do not prevent it. I set out to be a reformer, but only became the historian of decline.

This was a plausible evaluation of the economic and political environment of Mises' era, the early and mid-twentieth century. Defense of the fundamentally liberal economic order in intellectual circles was greeted with bemusement. It was dismissed as classical nineteenth-century liberalism — old-fashioned, obsolete liberalism — in favor of the day's new and modern view which has usurped the label of "liberalism." The patron saint of modern liberalism would be Louis XIV's Minister of Finance, Jean Baptiste Colbert, who insisted on detailed controls of businesses, all for "the good order of the economy," rather than the Scottish political economist and philosopher Adam Smith, renowned for his championing of the free market in *The Wealth of Nations* (1776). But since it was Adam Smith's England and not Colbert's France that became the dominant economic power in the world, it is liberalism which in the literal sense must be called the historical throwback. It is this kind of theory which would have us blueprint the desired social and economic order, and through the State (with greater scope and power than that implied by eighteenth or nineteenth-century liberalism, but which Colbert of the seventeenth century would have understood), the blueprint would be implemented. That people might not want their lives thus blueprinted is not a concern.

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For those deeply concerned about a fundamentally liberal order, the embrace of Colbert rather than Smith in our century has been deeply disturbing. Arthur Krock, whose perceptive columns appeared in the *New York Times* into the postwar years, shared Mises' deep foreboding as he summed things up in his *Memoirs,* published in 1968:

> Historians will differ on whether the political philosophy and the economic and military direction of any nation have changed more fundamentally than those of the United States in a comparable period of time — 1933-1967. But as an eyewitness of governmental and other public actions throughout these years, I formed the opinion that the United States merits the dubious distinction of having discarded its past and its meaning in one of the briefest spans of modern history.

If these two distinguished students of the then contemporary scene were writing today, what would they say? Their words would reflect no cheap optimism. There is no shortage of worrisome developments on the domestic and international scene. Yet Professor von Mises could now say, or at least we could now say for him, that the careful building of a solid intellectual foundation for a liberal order by a few giants back then has now begun to produce results. The liberal, market-organized economic order is now seen as a far more sophisticated "plan" for organizing economic activity than the dictates and edicts of the so-called planned economies — which all seem to be perpetually in massive disarray. And the fact that central economic planning is inimical to political democracy is now widely perceived. Indeed, no nation with a state-managed economy has been able to permit a democratic political system at all. This redirection of thinking has reached the arena of fiscal policy. And that, as it happens, brings us to the subject of these remarks.

Traditional Budget Philosophy: Balance It

No revelation from Mt. Olympus is required to identify certain budget eras in the history of the nation — or for that matter in the history of the western world. Two are ensconced in the annals of history, and the third is now emerging. For 140 years, from the nation's beginning in 1789 to the onset of the Great Depression in 1929, there was little disagreement about the guiding principle in budget strategy. One of the contenders for the White House over a half-century ago summarized it all in a way with which few then would have disagreed: "Any government, like any family, can for a year spend a little more than it earns. But you and I know that a continuance of that habit means the poorhouse."

This was a statement made by Governor Franklin Roosevelt in July, 1932. Some of you unreconstructed Republicans will probably suspect darkly that this represented intellectual disingenuity on the part of the governor. There is a more straightforward explanation. When he came to the budget paragraph in his speech, it would not have occurred to him or anyone else that there was much to say except: "Balance it." Roosevelt's political adversary, President Hoover, would probably have lent his name to the same comment. When Roosevelt became president, he first launched some draconian actions to trim the deficit, even though he rather quickly lost interest in going down that path.

Historically, the balance-the-budget rule was not a principle honored in rhetoric and ignored in practice. During the history of the nation up to the Great Depression, black-ink years outnumbered red-ink years three-to-one if war periods are excluded. Moreover, after every war in our history, except for World War II, the nation went seriously about the task of reducing if not paying off the public debt. A decade after the end of World War II, however, the public debt was slightly higher than in 1946, and from 1980 to 1985 (with a Republican tenant in the White House) the public debt has doubled again.

A Shift in Thinking: Tax and Spend

The first great shift in our thinking about the philosophy of budget policy came, of course, with the Great Depression. Or more accurately, the rationale for the changed philosophy took shape during the latter part of the 1930s with the emergence of the theory of "compensatory fiscal policy." The logic seemed reasonable enough: If the economy was weak, tax reduction or additional expenditures would be justified, even if it were to mean a deficit, in order to strengthen the economy. And if the problem was an overheated economy, tax increases or expenditure reductions would be in order, even if the budget were already in the black, in order to cool things off.

What this strategy of budget policy did was to unleash powerful forces tending to increase the proportion of the national income pre-empted by the public sector through taxation or borrowing. Since spending programs once launched are difficult to curb, tax increases tended to be the compensatory action attempted during the ensuing expansion. This new theory meant, of course, that more and more national income would go to the public sector.

The fundamental thing that happened along the way with the new "tax and spend" policy was that an important baby — namely, fiscal discipline — got thrown out with the bath water. When the guiding principle was that the budget should be balanced, a crude cost-benefit calculus was imposed on decisions about the budget. Governments were told that if they want to spend, which governments like to do, they must impose the taxes, which governments do not like to do. With the emergence of the view that there are times when the budget ought not to be balanced, it became easy for parliaments, prime ministers, presidents, and congresses always to conclude that "now" is one of those times. During the 39 years of the postwar period (assuming that it really began in 1948) there have been only seven surplus budgets, and none since the fiscal year 1969. This has been, of course, more than an American phenomenon. Indeed, the growth of the public sector has been even more evident in some of the Western European nations. And the proportion of the *increase* in national income and output pre-empted by the *growth* in government outlays (the incremental ratio) has also been striking and is perhaps a better measure of economic impact.

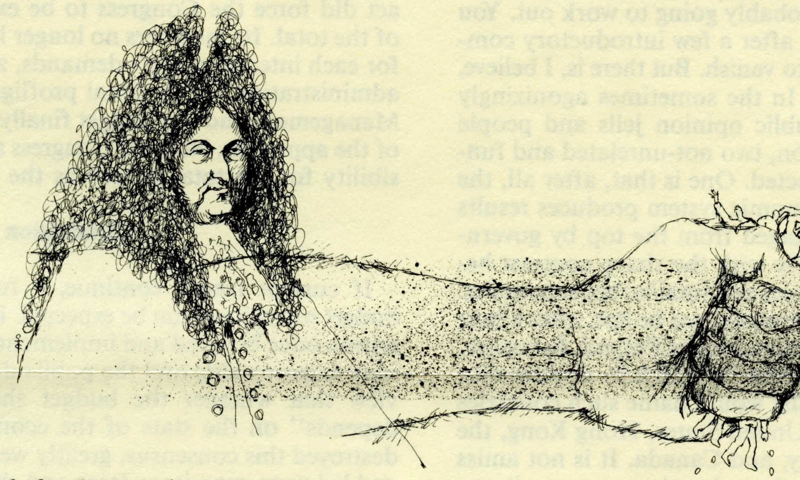
About the Author

Paul W. McCracken, Edmund Ezra Day Distinguished Professor of Business Administration at the University of Michigan, where he has served on the faculty since 1948, is also past chairman of the president's Council of Economic Advisers. Author of numerous books and monographs on economic and financial policy, he is also currently a member of the Economic Policy Advisory Board formed by President Reagan and chairman of the Council of Academic Advisers for the American Enterprise Institute.

Growth of the Public Sector, At the Expense of Our Economy

Now, developments have consequences. Value judgments may lead to differing views about whether the consequences are good or bad, but if the discipline of economics is to claim any analytical capability it ought to be able to identify the consequences. People may differ about whether a minimum wage is good or bad; but economists pretty well agree on the consequences of an increase. (The consequences are that some people's income rises, there is some upward pressure on the cost-price level, and there is some increase in unemployment — with black teenage members of the work force hardest hit.)

The analytical evidence indicates that the growing pre-emption of the national income through some combination of taxes and borrowing does have identifiable consequences. For one thing, the empirical evidence suggests that, internationally, increases in the share of the national income taken by the public sector tend to be inversely correlated with changes in rates of economic growth. In its annual report



issued in 1982, the Bank for International Settlements examined the experience of 11 countries for the period 1973-81 relative to the period 1960-73. All 11 of these countries saw declines in their rate of growth from the first to the second period, and for all of them the share of the national income taken by the public sector was larger in the second period than in the first. It is also clear from the data that there was a tendency for the countries whose share of the national income taken by government rose most rapidly to have experienced the sharpest deterioration in rates of economic growth.

Correlation, as all economists are taught in Basic Statistics, does not prove causation. One could plausibly argue that the public sector's share of the national income will naturally rise more rapidly for countries whose national income has been stagnant. Moreover, differences in rates of economic growth have many and complex causes. The deterioration in the United Kingdom's economy was far more severe than could be explained by the relative growth of the public sector. Other factors were at work. For Sweden the deterioration in its economy was somewhat less than would have been suggested by the growth of its public sector.

There are, however, persuasive reasons for believing that what we see here is the adverse effect on the vitality of an economy from a growing pre-emption of the national income by the public sector. Disincentives are created as the connection is loosened between the individual's own material level of living and what he contributes to the production stream.

Public sectors grow in part because the collective power of well-organized interest groups tends to move public sector spending beyond the tax burdens that the general public will tolerate, and the chronic deficits then divert national savings away from productive investment. This has been a particular problem for the United States. While in 1980 the proportion of our net private savings diverted to finance the budget was about in line with experience in the rest of the industrial world, in 1985 financing this deficit required funds equal to three-quarters of our net savings. This is not unrelated to the low gains in productivity and real earnings during the last decade. Those producing the GNP are inadequately equipped. They lack new and better and more productive capital.

In a way, we see this all as through a magnifying glass when we look at state-managed economies where the public sector has become totally dominant. These economies are not models of economic vitality and progress. They seem to be afflicted with some combination of economic dyspepsia and arthritis. No one is suggesting that the relative growth of public sectors means that we are all "going communist"; fortunately we are probably headed the other way. It is not amiss, however, in evaluating the significance of the relative growth of public sectors to look at this condition in its extreme form.

A second adverse effect of the growth of the public sector has a moral dimension — namely, the enlarging parallel or hidden or underground economy. Large public sectors mean large tax burdens, and historically they have tended also to mean high marginal taxes on increments of earnings. And this creates incentives for channels of economic activity that make an end run around the tax collector. The magnitude of these underground economy activities is by definition not easily measured. Obviously, basic statistical information on the problem is sketchy, but the best indication that it is more than a trivial matter is that it has become the subject of serious discussion in scholarly literature.

In spite of the inevitable paucity of basic information, scholars are using ingenious methodologies to make actual estimates. One study estimates the size of the U.S. underground economy in 1978 at 8.2 percent of GNP, with estimates ranging up to 13.2 percent for Sweden and down to 3.9 percent for Japan. Other estimates can be found suggesting that the parallel economy is much larger, but even 8 percent suggests that over 300 billion dollars of U.S. economic activity occurs in the nether regions. Moveover, when a government bureau's license or permit becomes the route to business success, rather than demonstrated superiority in open and competitive markets, these licenses and permits start to have great value, and history suggests that a price starts to be demanded and paid. But the real cost of our underground economy is not lost tax revenue but the erosion of that public morality so vitally important to a liberal economic and political order.

Finally, this nation's budget strategy has been imposing a high cost on U.S. agriculture and industry. The logic is by now generally understood and needs no elaboration here. The combined needs of the U.S. Treasury to finance large deficits plus the credit requirements of the private economy have been running 12-15 percent in excess of the flow of domestic savings generated (including surpluses of state and local governments). Financial markets are markets. When demand in a market outdistances supply in a market, whether for coffee or copper or credit, prices tend to move upward.

Cause for Optimism

At the outset of this paper I expressed some optimism about the way things were probably going to work out. You may have been thinking that after a few introductory comments, the optimism seemed to vanish. But there is, I believe, a basis for some optimism. In the sometimes agonizingly slow and fitful way that public opinion jells and people decide upon a course of action, two not-unrelated and fundamental themes can be detected. One is that, after all, the liberal market-organized economic system produces results vastly superior to those managed from the top by government. We see this most clearly with the sharp contrast between classical liberal economies and totalitarian economies. A delegation from outer space would not be apt, after a tour of Planet Earth, to list such countries as Poland, Romania, Albania, Czechoslovakia, or even the U.S.S.R. as economic success stories. Instead, the list would name such countries as Japan, South Korea, the United States, Hong Kong, the Federal Republic of Germany, and Canada. It is not amiss for us to remember that only three decades or so ago it was still respectable, even fashionable, in intellectual circles to wonder if, after all, the state-management of economies would not be better than an "unplanned economy." (Admittedly, the thought lingers even today.)

The growing perception about the demonstrated superiority of the classical, liberal, i.e. free market, economic system has already influenced economic policy in the U.S. and elsewhere. When the economic history of this era is finally written, the most significant development may be seen as the de-regulation of major markets. Basic market needs and resources are being more closely fitted together because of airline de-regulation and a major source of wage inflation has been eliminated. Even Europe may be breaking out of its economic *immobilisme* by freeing up her economies from the rigidities imposed by an excessive array of regulations which have contributed to economic stagnation.

This renewed faith in the classical, liberal, i.e. the free market, economic order, rather than Colbert's brand of liberalism, is having its effect right now on public budgets. The International Monetary Fund was even able to report that, in 1984, the latest year for which data is available, government outlays as a percentage of GNP (actually, GDP) declined, and this came after the news that the ratio had risen just over a percentage point per year during the 1980s. IMF data shows declines in central government outlays as percentages of GNP in two-thirds of developing countries in 1983, and for some 60 percent of both developing and industrial countries in 1984. Now one year does not make a trend, but the pervasiveness of this pattern cannot be ignored in view of the changes in fundamental thinking which clearly have occurred.

That stronger fiscal discipline will be a part of the processes of budgetry in the United States in the years ahead seems certain. The Gramm-Rudman-Hollings bill, whatever its fate in the courts, was not an aberration. It must be seen in the context of growing concerns about the implications of a persistent growth in the public sector's share of the national income. Indeed, it is a lineal descendant of the Congressional Budget & Impoundment Act of 1974 which established the current stronger budgetary machinery in the Congress. Whatever its limitations and short falls, this earlier act did force the Congress to be exposed to the discipline of the total. Its members no longer had the luxury of voting for each interest group's demands, and then excoriating the administration for *its* fiscal profligacy when the Office of Management and the Budget finally produced a total for all of the approvals. Now the Congress also must accept responsibility for the total as well as the parts.

Conclusion

If current trends continue, a further strengthening of budget procedures can be expected. By common consent, the nation once believed and implemented the view that deficits were unacceptable and the public debt should be paid. The view that whether the budget should be balanced "all depends" on the state of the economy and desired ends, destroyed this consensus, greatly weakened fiscal discipline, and led us to experience large and chronic deficits. To regain the fiscal discipline required to counter the enormous pressures for excessively rapid increases in public spending, a further strengthening of formal procedures will be necessary and will be implemented (e.g., the line item veto and a constitutional amendment imposing a limit on spending or requiring a balanced budget). The nation has already come far along the road to regaining fiscal discipline, and it is not likely to stop here. Alfred Marshall in his great *Principles of Economics* observed: "The full importance of an epoch-making idea is often not perceived in the generation in which it is made: it starts the thoughts of the world on a new track, but the change of direction is not obvious until the turning point has been left some way behind."

That turning point now seems to be visible. It did not appear in time to reassure Ludwig von Mises or Arthur Krock, but their lonely efforts amount to something more than lamenting history. They and others formed a fundamental intellectual force for new directions which are now beginning to appear. While in the immediate sense the issue is the budget, in the larger sense it is nothing less than fate of the liberal political and economic order.

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