

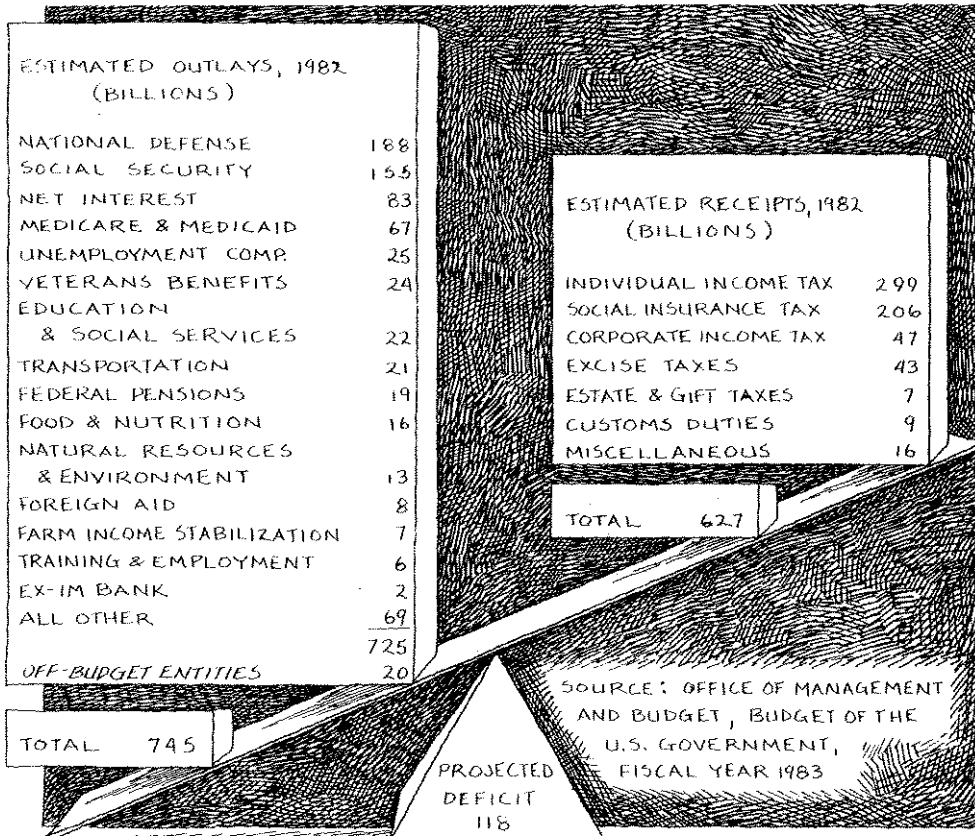
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The Balancing Act: Rethinking the Federal Budget Process



Despite the Budget Reform Act of 1974, Congress has been unable to discipline its spending habit. Although the Reagan Administration last year waged a highly publicized and politically risky campaign to get Congress to lower government spending, federal outlays in 1982 still rose 10.4 percent. Combine this spending momentum with the severe recession, and the results are whopping deficits, which may top \$100 billion for each of the next several years.

Where must future spending cuts be made if we are to regain control of our economic destiny? Can the Congress control itself, or must measures like the balanced budget amendment be imposed on it? To help answer these questions, the Institute for Contemporary Studies of San Francisco recently published *The Federal Budget: Economics and Politics*, in which fifteen economists and political scientists explore the political, institutional, and economic aspects of the federal budget.

The Manhattan Institute, with the cooperation of the Institute for Contemporary Studies, invited three contributors to this volume to discuss federal budget reform options for the short and long run. The panelists were Michael Boskin, Professor of Economics at Stanford University and a recognized expert on the Social Security system; Rudolph Penner, Director of Tax Policy Studies at the American Enterprise Institute and a senior staff economist in the Council of Economic Advisers during the Ford Administration; and Alvin Rabushka, Senior Fellow at the Hoover Institution and a coauthor of the Hall-Rabushka flat rate tax proposal. Leif Olsen, Chairman of the Economic Policy Committee at Citibank, N.A., moderated the discussion, an edited transcript of which follows.

The Balancing Act: Rethinking the Federal Budget Process

Leif Olsen—This gathering is jointly sponsored by the Institute for Contemporary Studies and the Manhattan Institute for Policy Research; my thanks to Bill Hammett, President of the Manhattan Institute, for making it possible.

The Institute for Contemporary Studies is releasing a book today on *The Federal Budget: Economics and Politics*. Three contributors have come to discuss the budgeting process. Mike Boskin is director of the Palo Alto Office, National Bureau of Economic Research, and of the NBER program on social research.

In addition, he is a Senior Fellow at the Hoover Institution and a Professor of Economics at Stanford University.

Michael Boskin—Winston Churchill described Russia as a riddle wrapped up in a mystery inside an enigma. I would characterize the federal budget in the same way.

What we call the federal budget is not a budget in the true sense—not if you think of a budget as an accounting device, as a control device, as a planning procedure, or as a priority-setting device. It is less and less relevant as a measure of the Federal government's economic activity; nor does the several percentage point rise in federal government outlays as a proportion of Gross National Product (GNP) really capture the full impact of government activity on the economy.

We do not, for instance, have a separate capital account, despite the major shift in budgeting priorities towards the substantial acquisition of military capital. More generally, if you compared budgets and deficits over the next several years with those in the late 1970s, the federal government just stopped investing. By my own estimate, it wasn't even covering the depreciation and obsolescence of its capital stock. I don't suggest the federal government should sell the White House for capital. But a more realistic understanding of asset valuation is necessary, and, indeed, is begin-

ning to arrive—witness the current discussion of federal land acquisition and sales policies. [See *Manhattan Report*, Volume II, No. 3]

The difference between the political process of budget making and the reality of budgetary outlays must be emphasized. There was a huge sigh of relief for about one day in financial markets after the House passed a "budget." What it did do was pass a budget *resolution*.

I'm sure Rudy and Alvin will have things to say about the economic assumptions embodied in those estimates presented for fiscal 1983 and beyond. I would emphasize that historically, budget resolutions are honored more in the breach than in the observance. Actual spending, revenue, and total deficits—on or off the books—bear little resemblance to the estimates of the administration presented in January, or for that matter to those of the Congressional Budget Office (CBO).

But these are the tip of the iceberg. There is, for instance, the great debate about restructuring federal government priorities and budget processes. Can structural revisions within the congressional and administrative budget making process do the trick? Is the line-item veto the answer? Can more binding internal restrictions within Congress control spending? Are constitutional restrictions the answer?

Finally, there are problems in the programs themselves. In the area of national security, for instance, several of the essays in our new book discuss the weaknesses of current planning and procurement processes. The Defense Department needs long lead times, and it is important to develop a budgeting procedure that allows the Pentagon to rely upon a certain level of spending over more than a year at a time. We will all quibble about the proper amount that should be spent, and the desirability of this or that weapons system. But if whole systems are approved and then with-

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drawn, waste and inefficiencies are guaranteed.

Another big problem area is social expenditure, particularly Social Security. Social Security is the second largest and most rapidly growing item on the expenditure and tax sides of the budget. It is absolutely clear that sensible, cost effective, and target effective government spending is impossible *unless a major restructuring of Social Security, gradually phased in after a grace period, is implemented—and soon.* The basic problem is the enormous long term financing problem of the retirement program that dwarfs its short term cash flow problems. These problems require rethinking what we want those programs to accomplish. But because some people are heavily dependent on them now, any sensible restructuring requires a grace period, and a gradual phase-in.

The public is now far from understanding the true dimensions of the problem. Moreover, for about fifteen years in the late 1980s and 1990s, demographic trends will turn very favorable for our pay-as-you-go Social Security system, blunting the immediate need for reform. If nothing is done in the next two or three or four years, we will miss a major opportunity to establish a very different and more realistic set of social expectations and economic possibilities. The same is true for health care. The consequences of our choices, or non-choices, in the next few years will be momentous. They will affect everything, even our immigration policy in the next century.

There are also enormous subsidies for the rich involved in our government policies. We have various commodity support programs, foreign export subsidies, regulation policies, trade policies, subsidized loans, etc., that often go to very wealthy individuals. I am sure that there are a variety of people in this room who either now or in a previous time were beneficiaries of some of those programs. I certainly was. I had a substantially subsidized student loan. I took out the maximum amount, and paid it back as slowly as I was allowed. However, I did not default. Others did, and do, yet we do not have a sensible notion of bad debt reserves for the *half trillion* (and rapidly growing) in loans guaranteed by the federal government.

We have been getting further and further into subsidies, further and further into ill understood redistribution policies through complex indexing formulae, off-the-books programs, and conversion of government agency loans into off-budget activity. All the while, we have been drifting further and further away from cost effective, target effective government.

There are many people who view the situation with alarm, and I share this view. I don't think people want to get government out of the business of insuring individuals against destitution. But they want it done in the most cost effective



Michael Boskin, National Bureau of Economic Research
Photo by Craig Terry

way possible. With that in mind let me give you some guarded reasons for optimism.

Amidst all the confusion of the last year—and even while the House of Representatives resembled the Fourth Republic of France—it is clear that some signals were being sent out. Did you think you would ever hear, in the midst of what is supposedly the worst economic times since the Great Depression, that the liberal Democrat alternative to the Republican budget would include only \$2 billion for public works and jobs and training? For this reason and others, I am guardedly optimistic about a return to federal fiscal sensibility.

Leif Olsen—Our next speaker is Rudolph G. Penner, the Director of Tax Policy Studies and a Resident Scholar at the American Enterprise Institute.

Rudolph Penner—Last summer the Reagan Administration got Congress to pass a badly mismatched set of spending and tax policies, in no small measure because they were able to promise Congress and the American people a balanced budget in 1984. That claim in turn was based on a logically inconsistent set of economic assumptions. My own experience as an economist at the Office of Management and Budget (OMB) prepared me for this type of outcome. I was constantly buffeted about by the extraordinary asymmetry between the political implications of changing budget outlay totals for economic forecasting reasons, and changing them for policy reasons.

I remember very vividly wandering into Jim Lynn's office one day. He was the OMB Director under Ford. I told him that I was sorry but we economists had made a bit of a rounding error and the Consumer Price Index (CPI) had to be

*"We can't spend more than we can produce forever,
and we can't continually try to circumvent the
basic choices in government budgeting."
—Michael Boskin*

raised by a tenth. We would have to raise all the totals about \$100,000. I didn't know he had just spent hours sweating blood with the director of the Economic Development Agency (EDA) squeezing \$100,000 out of his budget, and here I was coming in with a computer error that wiped out his afternoon's work. Well, he was very articulate about where economists could go, and where we could put our computers.

The point is that budget totals are enormously sensitive to economic assumptions. A one percentage point change in the unemployment rate can mean about a \$25 to \$30 billion change in the deficit! And it's not only the economic assumptions that are the problem. There are an extraordinary number of non-economic assumptions that play a role. How fast can the Pentagon spend its appropriations? What about the weather? Crop yields, after all, determine agricultural subsidies. Natural disasters can have a big impact on the budget. When God had the foresight to put Mount St. Helens in the same state as the Chairman of the Senate Appropriations Committee, it cost us an enormous amount of money. One might say that more cash than ash fell on the state of Washington.

The ability to confuse the effects of assumptions with the effects of program design gives the politician extraordinary latitude to obfuscate the issues. A perfect example occurred last year. One Democratic alternative to Reagan's program had a different set of spending priorities, but under the same economic assumptions, it would have called for the same total expenditures. But Jim Jones made a fatal error. He chose to use a more realistic set of assumptions. This made total federal outlays seem very much higher; and the President successfully accused him of being a big time spender, a "deficit monger" and so on. Poor Jim could never explain to the public that the difference in totals depended upon assumptions.

How do we improve the process? We need a mechanism to separate arguments about forecasts from arguments about program design. Forecasts should be depoliticized. Forecasting should be based on mechanical rules, even at the cost of some arbitrariness. Nevertheless, I don't believe we should do away with forecasting altogether. Surprisingly, given the low reputation of economists, the January forecasts various administrations made for the year ahead are awfully good.

Needless to say, the January forecast for each succeeding year gets a lot worse, and the long run projections that various administrations made have been totally absurd. That's really where the problem has been—with those longer run projections. My proposed solution, which I explain in greater detail in the book, amounts to this; there should be at least one occasion when *all* of the

various program proposals are evaluated using one set of economic and other assumptions, so that you could compare the Administration's policies, the House's policies, the Senate's policies—on one base line.

Oddly enough, I had thought this might be difficult to arrange. But I got scooped because this year that is essentially what happened. The "gang of seventeen" got so tired arguing over assumptions that they all did agree at the beginning to use the same economic assumptions.

Generally, I plead for more truth in budgeting. However, with some embarrassment I stand here and say that maybe this year it's important to lie. The system is so fragile at the moment, I'm not sure it can stand to work with realistic numbers. What has been going on is theater, but the system is in such jeopardy, and the truth so unpleasant, that we may be able to contend with nothing else. We economists may have to put on our blindfolds and let the politicians make up a lot of numbers in the next few weeks.

Leif Olsen—Our next speaker is Alvin Rabushka, Senior Fellow at the Hoover Institution.

Alvin Rabushka—Thanks to the current chaos of the federal budget, we dare to think bold thoughts about a low flat tax system, such as the proposal I and Robert Hall of Stanford's Economics Department are championing.

How did I get into this business? In 1963, I took my first trip to Hong Kong to learn the Chinese language. I got married there as well; and in the years since then, after many trips back, I watched a relatively poor country become a relatively rich one. If you go to Hong Kong and talk to a banker, a butcher, a baker, or a candlestick maker, and you ask them why they are prosperous, the answer is always and everywhere low taxes. It's repeated by anybody and everybody. The maximum marginal rate of personal income tax is 15 percent. The corporate rate is 16 percent. The capital gains tax is a big flat zero. In the last six years Hong Kong has enjoyed the world's highest economic growth rate, running 10 percent per year. And over the last thirty years, the growth rate has been first or second in the world.

They continue to grow while the rest of us stagnate. Not only do they have low taxes, they have the world's largest budget surpluses. These run somewhere in the neighborhood of 10 to 15 percent of annual expenditures; and they have an accumulated surplus reserve equal to something like 40 percent of annual spending. They earn a tremendous amount of interest on these reserves, and it helps keep taxes low as well.

Let me give you a second reason for my interest in this issue. There's a whole class of people who thought Ronald Reagan was going to ruthlessly slash taxes, but it hasn't happened. The orig-

inal Kemp-Roth proposal was postponed and delayed, and the 1.25 percent tax rate reduction of last year really didn't even accommodate inflationary bracket creep and previously mandated Social Security tax increases. Tax receipts for calendar year 1981 went up 16.5 percent. Net out the inflation rate, and you'll see that we didn't have a tax cut; we had a massive tax increase of near record proportion. This is not the tax cut supply-siders wanted.

Putting my knowledge of Hong Kong together with the failure of last year's tax reduction crusade, I and my colleague Robert Hall met over a series of lunches and worked out a flat rate tax proposal. The following principles underlie our tax reform. The first principle is to tax *all* income, but to tax it only once. We don't do that now. Lots of income is taxed twice, and some income we don't tax at all. The second is to tax all income at *the same rate*, and that meant weaving together the business and the compensation taxes, so people don't, among other things, shift income back and forth. The third principle is to exempt the very poorest from the income tax net. In Hong Kong, for example, a family of four doesn't pay its first dollar of income tax until they earn the equivalent of U.S. \$15,000. Our tax kicks in at a lower income level; Hong Kong, after all, has a much more robust economy. The fourth principle is what we call "postcard" simplicity. The standard return should fit the back of a postcard. Finally, we do not look to maximize any one of the four principles, but to introduce all four simultaneously. If you want pure simplicity and nothing else, that will produce one

tax form. If you're going for low flat rates and nothing else, that may produce another. So we tried to blend a number of things together.

Let me explain two other guidelines that went into the construction of the Hall-Rabushka tax proposal. The first is that we *did not* want to mingle together questions about the size of government with the issue of a restructured tax system. If I had my druthers, I'd cut government way back. But, in the interest of seeing what kind of tax reform would sustain the *same* composition of revenues, we attempted to reproduce the existing revenues of the federal government with very different income tax rules. I firmly believe, incidentally, that this kind of static comparison is absolutely wrong. We would get a rather dramatic real growth in GNP over our current system if we went to a low flat rate; the actual rate could be lower than what comparative static analysis implies. But in order not to ruffle anyone's feathers, we didn't introduce a dynamic consideration. Finally, to encourage saving and investment, we "expense" all capital recovery allowances, i.e., do away with depreciation allowances.

Let me explain some of our motives. First, on simplicity. Just filling out the 87 million forms last year took roughly 182 million hours—not counting the enormous preparation and consulting time.

One hundred eighty two million hours at \$10 an hour is \$1.8 billion. That's conservative; it's probably a lot more. There are in the United States today about 60,000 tax lawyers—not tax accountants or CPAs, just lawyers. And that's only the high priced, fancy stuff. There's well over 100,000 in the shelter business, the accounting business, the record keeping business, etc.

The Internal Revenue Service has graciously told us that \$300 billion in income goes unreported, implying \$90 billion of uncollected taxes, which would help close the deficit. Incidentally, the IRS estimates that only \$10 billion of unreported income was earned through illegal drug trafficking, prostitution, and gambling. The rest of it consists of you and me arranging our affairs to avoid paying taxes.

Finally, we consider equity. There is a good deal of unfairness in the system. Today's *Wall Street Journal*, for instance, reveals that in 1979, 2.3 million households filed returns reporting adjusted gross income exceeding \$50,000. That's between 2.5 and 2.75 percent of all taxpaying households. But 9,000 of these households paid no taxes whatsoever. So the upper two percentile of the country includes many whom we know don't pay taxes. What good is progressivity if the rich don't pay?

Now let me introduce some political observations. Hall and I assumed the first three months of



Photo by Craig Terry

Rudolph Penner, American Enterprise Institute

"When special interests steal from us through absurd programs, the very absurdity of those programs limits their impact."
—Rudolph Penner



Photo by Craig Terry

Alvin Rabushka, Hoover Institution

calendar year 1982 would produce all kinds of interesting political commentary on our proposal, and indeed it did. Indeed, to my absolute wonderment and astonishment, on April 15 both the *Washington Post* and *The New York Times* endorsed us. Wonders of wonders!

"Right wing" publications have endorsed us all along, but when the two pillars of the Eastern establishment gave us approval I felt that maybe there's something to all this. Since our first article appeared on December 10 of last year, we have had an uninterrupted flow of correspondence, phone calls, and queries. It's continued to this day, and the most astonishing part is that it has accelerated since April 15; it hasn't wound down. The number of people who have been writing about it, or plan to, is greater since April 15, rather than before April 15. There has been, to put it bluntly, a virtual intellectual transformation of the tax landscape, producing the elements favorable to a political coalition running from the far Left to the far Right. Fairness is one reason for the dissatisfaction with the code; complexity is another.

Finally, the systematic economic distortions and economically counterproductive behavior introduced by high marginal rates is finally beginning to sink into public awareness.

In summary, let me say that there is evidence to believe that a low flat rate tax would help close the deficit. If we enact it, and enact as well a balanced budget constitutional amendment with tax limits, I feel that our economic prospects would be much brighter than they presently are.

Leif Olsen—I'm going to open this forum now to questions and comments from the audience.

Henry Hughes, Hunter College—What can be done to actually get Congress to present a finished budget to the President? We didn't have a budget last year and it looks like we actually may not have any budget during the entire Reagan Administration. Is the Congress unable to meet the deadlines that were put down for a first resolution or a second resolution?

Rudolph Penner—I think that what we see today simply reflects the fact that the decisions are so hard. The American people desperately want a lower average tax burden. Yet the majority seems to want to rehabilitate our defense while there is no constituency for cutting Social Security. When you put Social Security, defense, and the exploding interest expense of the debt together, you approach 70 percent of the budget by the mid-1980s. There is no way of offsetting the growth in defense, Social Security, and interest by cutting other programs. They are like a Pacman, just gobbling up the other programs. I hope that once the silly season of this election is over, maybe we can get down to real business either in a lame duck session or in the budget resolutions of next year and reexamine defense and Social Security.

Alvin Rabushka—My answer is a balanced budget constitutional amendment. If by September 30 a budget is not adopted, outlays after October 1 would be zero. We shut the government down as Ronald Reagan did for half a day. That is required under the amendment. They will have a budget by September 30. You may not like it, but they would have one under the amendment.

Rudolph Penner—I think that's extraordinarily optimistic. Alvin's flat tax idea is better than his constitutional amendment idea.

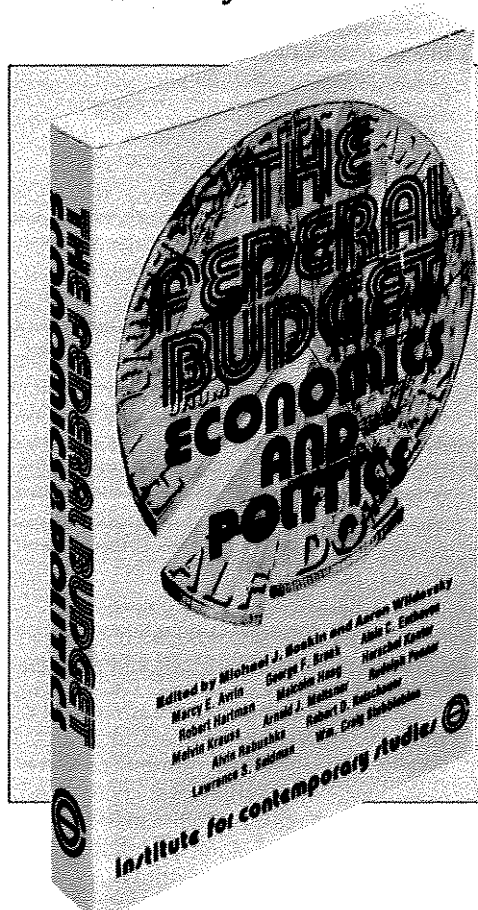
Michael Boskin—I agree with Rudy. I think all three of us would strongly favor a flat tax if careful attention was paid to the transition, because obviously any dramatic changes in the tax system are going to cause very substantial windfall gains and losses.

Richard Hoey, Bache—Mr. Penner, you seem to be telling us that until the elections, the best Congress will be able to scrape together is another set of unrealistic forecasts. What I'd like to do is look beyond the elections. What is a reasonable pros-

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The worst of times . . . or the best of times?

The Federal Budget: Economics and Politics Edited by Michael J. Boskin and Aaron Wildavsky



Fifteen leading economists and political scientists probe the economics and politics of the federal budget. They trace the historical trends of the American economy, including the most recent budget performance, and offer insights into today's most pressing problems. While their report is often grim, the authors see reason for hope as they recommend practical strategies to set the federal budget back on course.

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The Balancing Act

(Continued from page 6)

pect for what Congress will do between November 1982 and the middle of 1983?

Rudolph Penner—The outcome of the election will be of some relevance to the question you are asking. And I should warn you that I'm an incurable optimist. I think the fact that the Congress was able to pass a first resolution is a good sign. The system has not broken down completely yet. It is still very fragile. It could break down. It could break down over the conference. It could break down during reconciliation. It could just break down with fatigue. What I think will happen, in this highly volatile framework, is that Congress will muddle through this year, and they will get a conference report. It will be passed; and it will contain a lot of lies.

We're heading for a 1983 deficit of about \$150 billion or thereabouts. I was going to say give or take \$50 billion, but I can't see taking \$50 billion. It is my guess that while the Democrats will probably gain in the election, it will not be the Tip O'Neill, Jim Wright type of porkbarrel liberalism that will prevail. I think it will rather be the Leon Panetta, Jim Jones type of moderate Democrat that will be successful, because there has been something going on amongst the voters and they have definitely been moving Right. Given this outcome, you will have a Congress fatigued by contending with big deficits. I wish I could tell you they'd come back and take a careful look at defense and a careful look at Social Security. I can't promise that.

I think we're gradually putting our feet in concrete with defense. I'm surprised there hasn't been more effort to look carefully at some of the big, expensive weapons procurement systems like the two nuclear carriers, the B-1, and so on, that will really boost spending in 1986 and 1987, and beyond.

Social Security is also an extraordinarily difficult issue. I made the mistake of devoting my column in *The New York Times* three weeks ago to that subject. I just can't believe the mail I got of the "shame, shame, shame—don't you have a mother and a father?" nature. That topic is just death to the politician. So I'm afraid that if you're asking me for my forecast—not what I want, but my forecast—the issue will be resolved by raising taxes, probably quite substantially in 1983 and beyond.

Leif Olsen—I'm going to make a comment here. Rudy told me during lunch that, on the eve of the vote in the House, a rumor, which later proved false, swept through the House that the postage subsidy for the blind had been omitted from the budget. And it caused some fear to be raised that

the budget would not be passed without the subsidy in it!

One of my observations is that we live with a lot of illusions. One of the illusions we live is that the government has money. In fact, the Press always refers to a federally-funded program, or to the idea that federal funds are sought for this, that, or the other program. To be accurate, the reference should be to taxpayer money.

Congress, of course, is shielded by the illusion that the government has money. When a person is elected to Congress, one of the first things that happens is that he or she is appointed to a Committee in which he or she already has some vested interest or some intellectual interest. And when he or she goes on that Committee, if that Committee's responsibility is to have jurisdiction over an agency that pays out some largesse, the congressman or senator will of course take a very paternalistic attitude towards that agency and seek to enlarge its budget and its programs, because he or she identifies it with his or her political future. And so you may have a process under way in which there is no one in Washington who is essentially representing the taxpayer. No one sees his political future in terms of cutting taxes, and this is very clearly demonstrated in the process that's under way right now.

I find this rather discouraging; and it's one of the reasons for the headway made by the proposed constitutional amendment to restrict spending. I'm not thoroughly convinced that it is free of loopholes, but ultimately something very drastic has to be done to break with this syndrome, where there are enormous vested interests to boost spending, and no countervailing representation for the taxpayer.

Michael Boskin—When opinion pollsters ask people about spending and tax aggregates, they conclude that people would like less taxes and lower spending. But when it comes to specific programs, there's much less agreement that we ought to cut any particular program, unless, of course, it is the fraud, waste, and abuse. However, when you ask where most of that occurs, you find it's in spending programs that, in the big picture, amount to almost nothing.

Secondly, we have on the tax side of the budget an analogue to vested interest groups who promote spending. We have seen the growth of very special tax legislation substituting for direct outlays, and the concentration of interests which view this or that particular exemption as sacrosanct. This is one of the appeals of a comprehensive, deduction-free flat rate tax.

On the balanced budget amendment, I am not sanguine. True, the current proposals include what are called "off-budget" expenditures as part

"Whenever you have a tax system with an explicitly progressive rate structure, you can kiss goodbye the idea of keeping those rates low."

—Alvin Rabushka

of the deficit calculation. But even these are not the sum of *all* the borrowing the federal government does outside the budget. It is only one particular, and rather modest, category. So there are many, many potential loopholes.

I think, in the very short run, the enormous advantage to the balanced budget amendment idea would be to force choices by priority. We need something so that Agency X or Agency Y, or Congressional Committee X or Y, realizes that more spent here means less spent somewhere else in the government; or more taxes now or in the future—or some other process to generate revenue.

The disadvantage would arise simultaneously, as the creative imagination of the congressional process was unleashed. Until we adjudicated what was an outlay, what was revenue, and what was a deficit; until we knew how to treat capital gains and losses on the government's gold and land and the decline in the value of its previously-issued liabilities—until all those things were adjudicated somewhere (God forbid in the Supreme Court, even though two-ninths of it is Stanford), I think that there would be an enormous incentive to make what the government does even less efficient in order to avoid these restrictions.

Leif Olsen—I'd like to ask Rudy Penner if the underreporting of revenues in the underground economy is a significant problem for the federal budget process?

Rudolph Penner—There is some competition

these days to exaggerate the extent of the problem—economists compete by throwing out higher and higher estimates of the underground economy. Given the nature of the subject, there's no way of checking those estimates. But nevertheless, it is a serious problem. In my judgment, the kind of flat tax system that Alvin and others propose might alleviate it considerably.

It is often said you could close the deficit if you could get back all evaded taxes. I think that is absolutely silly. There will be evasion even under a flat tax system. It costs money to enforce the system. As you began to whittle away at the evasion, at some point it would cost you two billion to get the next one billion in tax evasion. And, when I say cost two billion, the major cost is not the budget of the IRS, but the enormous costs of audits to the taxpayer. In other words, the biggest cost is the extent to which you have to burden the innocent!

It is significant that until very recently it was always the property tax that was considered the most unfair tax. Now polls reveal that the most unfair tax is considered to be the personal income tax. That really raises a danger because our system does depend absolutely on voluntary compliance. Once that breaks down, we face a disaster similar to what you see in Italy or Liberia or countries like that. If people decide suddenly there's no reason for paying the income tax, there is no way the government will be able to enforce it.

Michael Levy, Conference Board—I have two comments rather than a question. The first one is



Photo by Craig Terry

on the flat tax. I'm not surprised that the *Washington Post* and *The New York Times* seem to be endorsing it, since it has been a favorite proposal of one of the leading liberals in this country. Joe Pechman of Brookings, as far back as the 1960s, suggested broadening the base of the income tax and substantially reducing the rate and degree of pseudo-progressivity as a way to simplify and increase the effectiveness and efficiency of the tax systems.

The other comment concerns the constitutional amendment to balance the budget. The idea that you could force Congress to pass a budget, if necessary by closing down the government, is extremely naive and misguided. Financing tricks will continue to abound and proliferate, and would sabotage the process.

Alvin Rabushka—I would alert the audience to the dangers of the Pechman, et al., view of progressivity in the flat tax. If you examine every postwar tax reform you discover that the chief recipients of tax relief have been those who use the standard deduction or disproportionately depend on the personal allowance. And so, thanks to inflation, the real marginal rates have risen year-in, year-out, year-in, year-out, on upper income earners and have fallen to virtually no tax liabilities on lower income earners. If we go the Pechman or the Bradley/ Gephardt route we'll find that the three quarters or more low income, flat rate beneficiaries will gang up on the one quarter high income beneficiaries with a "slight" progressive surcharge. I'm happy to hear that all you in New York now get your surcharge thanks to the machinations of your state legislature and your local government. There's talk about a local surcharge, and the local surcharge will be higher of course for higher incomes. Whenever you have a tax system with an explicitly progressive rate structure, you can kiss goodbye the idea of keeping those rates low.

The criticism of the constitutional amendment is a serious one. Those of us who support it try to deal as rigorously as we can with your objections. For openers, the present system is so bad and unthinkable that if we allow it to function as is, budgetary and economic catastrophe is not too far distant. We *must* change it. But let me be very, very clear about what this amendment does, and what it does not do.

It does not impose economic policy on the government. It does not necessarily determine the structure, level, or amount of taxes or spending. It *does* remove from the budget process two incentives that bias the mechanism toward spending: the unlimited access to deficits presently enjoyed by Congress; and the recourse to higher revenues enjoyed through inflationary bracket creep.



Photo by Craig Terry

Richard Hoey, *Bache Halsey Stuart Shields*

So long as spending and taxes rise automatically, our democratic process is distorted; they occur without an explicit vote. The amendment seeks to eliminate those biases by forcing, on the record, in a publicly accountable way, explicit votes of a majority of the whole membership of both Houses to raise taxes or approve deficits. It's not a panacea or a cure-all, but I think it will be a major stride forward. Ask yourself, if we didn't have the first amendment to the Constitution, whether Congress in all likelihood would have curtailed many areas of free speech. A constitutional rule does impose greater discipline on our legislators.

Michael Boskin—Rudy and I, while sympathetic to the goals of these amendments, feel there are some extremely important potential problems, such as altering the definition of an expenditure or an outlay. That's why I see it as absolutely necessary, as a precondition, to alter the structure of taxes or debt financing.

But I think the deeper question is that we as a society can no longer afford all we thought we could. No outrageously optimistic economic assumptions, budgetary tricks, or tax reform can or should permit us to evade some fundamental truths. We have on line a program of projected potential benefits in Social Security, health care, defense, and interest costs that dominate virtually everything else in the budget. We have so far failed as a society to come to grips with these. In the late 1960s and the early 1970s we increased

"The possibility of the majority exploiting the minority threatens the whole basis of our democratic system."

—Rudolph Penner

Social Security benefits by 25 percent and then indexed them (actually over-indexed them), thinking that the high productivity growth we had for the quarter century after World War II was going to continue, and that these benefits then would be easily financed out of the continued economic improvement of the overwhelming bulk of taxpayers and voters. And then, lo and behold, we see that virtually all the growth in income comes from second earners in the family, a large increase in government spending, increases in social transfer payments on the user side of GNP, etc. Meanwhile defense spending declined. Now we find we live in a more dangerous world, and yet we still refuse to face the guns - and - butter trade off. Time is running out.

I think Alvin is very much convinced that the kinds of things he is proposing will hasten the day when we will come to grips with these issues. I have some sympathy, but I am not yet prepared to go that route. I think inevitably we will come to grips with them, either *de jure* or *de facto*. Nevertheless, if we push this off inevitably, the demands on world credit markets made by our insatiable borrowing demands will eventuate in enormous changes in monetary policy. We really have to get our house in order in the next several years, or we are going to see a major, major blowup in the United States. We can't spend more than we can produce forever, and we can't continually try to circumvent the basic choices in government budgeting.

Leif Olsen—Congress by and large has not had to worry too much about deficits over the last fifteen or twenty years. When we had large deficits, they emerged because we had a recession in the economy. Subsequently, monetary policy would become more expansionary, bringing about economic recovery. Bracket creep would take over as inflation accelerated. And in fact, government revenues grew very comfortably, reducing the deficit to something regarded as relatively manageable—sufficiently manageable, in fact, that Congress was able to substantially increase a number of spending programs in the process. Nominal national income increased by about 5 to 6 percent in the early 1960s, and in the 1970s it increased by about 11 to 12 percent. All of the increase in the rate of increase was inflation, and people have become more and more exasperated with the money illusion of inflation.

When Rudy Penner spoke before about the personal income tax becoming regarded as the most disliked, inequitable, or unfair tax, it may be because in 1970 you could buy for \$20,000 what it took \$40,000 to buy in 1981. The marginal tax rate on an income of \$20,000 was 28 percent, the marginal tax rate on \$40,000 is now somewhere

around 40 percent. And the process would go on as inflation continued to accelerate, so it's no surprise that the income tax has become regarded as a very unfair and inequitable tax.

James Capra, *Federal Reserve Bank of New York*—Most of the forecasts on Social Security talk about a short-term problem followed by a twenty year breathing space, followed by a very serious situation around the year 2010. That is the optimists' scenario. Over in the pessimistic camp, the problem never really goes away. It gets worse and worse in the 1990s and continues on. Is the pessimistic projection more realistic? And if it is, are gradual changes in Social Security like changing the retirement age by a month a year over the next thirty years sufficient, or are more dramatic changes such as freezing cost of living increases once or twice, or doing some extra work on Medicare, necessary?

Michael Boskin—The pessimistic, intermediate and optimistic forecasts for the Social Security Administration (SSA) refer to sets of assumptions about the growth of the economy, inflation rates, unemployment, fertility, mortality, life expectancy in old age, retirement patterns, etc. There has been a kind of inflationary mechanism at work here; what used to be called the intermediate assumptions have become the optimistic assumptions. And I've played some role in that process through my own interaction with the SSA and their actuaries.

Extrapolations are sometimes foolish. I don't think we'll be at a zero rate of economic growth with people living to 130 and no births or anything of that sort. My own best estimate is somewhere



Leif Olsen, *Citibank*

Photo by Craig Terry

between the pessimistic and intermediate one. I do not believe that we will have a real cash flow crisis in the 1990s in Social Security. However, I do believe that the *long term funding problem* early in the next century will be even more dramatic than the intermediate estimates of the SSA. The present value of the net *implicit* debt is much larger than the regular *national* debt. As that becomes better known and people try to evaluate their own future retirement plans, there's going to be extreme havoc created if nothing is changed. Reforms must be in place by 2000 or 2005.

In the shorter run, a lot of other changes ought to be made, not because I'm worried about 1994 through 1997, but because what we were trying to accomplish with Social Security must be rethought in general, fundamental terms. Quick fixes like a one shot elimination of the cost of living adjustment, even if desirable on other grounds, prevent reconsideration of structural reform.

A. Lawrence Chikering, *Institute for Contemporary Studies*—It is true there is great disagreement in our society about whether to spend on defense or to spend for domestic priorities. But there's a very fundamental political tension that occurs, not on the macro level but on the micro level within each individual taxpayer. All of us wear two hats. All of us want spending and all of us want reduced taxes. The discussion by people who advocate amendments will appeal to people in their taxpayer's hat to reduce spending. Will it work; or will people remember their other hat?

Rudolph Penner—Public choice literature tells us

how politicians find it easy to confer concentrated benefits as long as the costs can be diffused. I am convinced that there is a bias in the system toward excessive spending and excessive taxes, and that this whole general pattern of biases could be referred to as well-organized minorities exploiting the majority. But that is not the whole problem.

When special interests steal from us through absurd programs, the very absurdity of those programs limits their impact. They cannot become too noticeable. So while we may spend too much on agriculture, on the merchant marine, etc., the real budget crisis is not caused by minorities exploiting the majority. On the contrary, the crisis arises from the big ticket items, like defense, where there is a widespread consensus that we need more, or like Social Security, whose recipients constitute a majority of the electorate. The Social Security problem gives the clearest picture of the intractability of these problems. There are 36 million beneficiaries of that system out there. Some of them are dependents, granted, but the old ones vote in great numbers and most have children who otherwise would have to support them. These children are also strong, strong proponents of the Social Security system. Given that only 80 million people voted in the last election, the structural problem posed here is much more serious than that posed by very narrow special interests.

The possibility of the majority exploiting the minority threatens the whole basis of our democratic system. □

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