Real Government Reform

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Politicians have an incentive to run large deficits since increasing spending is politically desirable for them while increasing taxes is not. Additionally, politicians have incentives to promote expenditures that benefit *them* but that are not in the interests of the general voters, special interest abuses being of particular concern. Public choice theorists, such as Buchanan (1962) and Olsen (1965), as classic sources among many, have long been aware of the flawed incentives facing politicians.

The preceding problems are also well known to those developing models of government (e.g., Becker 1983, Brennan and Buchanan 1979, Niskanen 1975, Peltzman 1976, and Stigler 1971). In models of widely varying types, equilibrium spending is predicted to be non-optimally large and budget rules are seen as needed constraints on politicians' tax and spending behavior.

The predictions of the various models of government are borne out in data showing a steady growth in the size of government in our society. Averaging over decades, to smooth the impact of business cycles, the percent of GDP (national output or, equivalently, income) spent by all levels of government was 22.8 (1950s), 25.1 (1960s), 28.2 (1970s), 30.6 (1980s), and 30.5 (1990-1998). It is likely that this growth was not desired by American voters, as suggested by the various models of government cited above. However, the mechanism proposed here to reform government allows for the possibility that government spending is a superior good.

The large deficits of the 1980s and early 1990s resulted in the various Balanced Budget Amendment (hereafter BBA) proposals as attempts to control the behavior of our elected politicians. If a BBA constitutional amendment had been enacted it would have required that the federal budget be annually balanced, except in times of war or national emergency. In such extreme cases, deficits may be run if both the House and Senate vote to do so with a super-majority. The weak form of BBA would allow taxes to be increased to balance the budget if both chambers voted to do so with a simple majority and deficits could be run with a three-fifths majority. The strong form of BBA would require a two-thirds majority to either raise taxes or run a deficit. The presumption, particularly in the strong form of BBA, is that this amendment would work, over time, to reduce the size of government expenditure as a percentage of GDP.

The BBA proposals have passionate defenders and critics. Many economists are concerned that the BBA proposals would worsen recessions. In a recession, some categories of expenditure *automatically* increase (e.g., food stamps, unemployment insurance), at the same time that lower incomes reduce tax revenue. Requiring a balanced budget would necessitate either spending cuts or increases in taxes, either of which would lower demands for goods in an already depressed economy. This could deepen a recession.

Another objection to BBA proposals stems from variation in voter desires about the size of government: any BBA would have the practical result of cutting the growth of spending. Some people may actually want bigger governments or believe that large overall levels of government spending are necessary to reflect the diversity of opinion about which things should be funded. Hence, while one might suspect that a majority of the voting population supports smaller government, some may believe that a large government doing many things reduces the tyranny of the majority over the minority.

The baby-boomer demographic phenomenon along with improvements in productivity growth in the 1990s led most observers to expect the surpluses of those years to continue for decades. Hence, interest waned in efforts to pass a constitutional amendment requiring budget balance. The large recent deficits associated with war and homeland security have again raised concerns about budget balance. And, the power of special interest groups remains, with politicians still not doing what voters wish.

A Coase-like mechanism in the presence of political competition

An alternative approach is advanced here to achieve the benefits of a BBA, along with many other benefits, without the drawbacks that are emphasized by its detractors. To motivate this alternative approach, it is useful to examine more closely the basic flaw in the current governmental system that has led many to advocate a BBA. This flaw exists at all levels of government, foreign and domestic, although the discussion will emphasize the U.S. federal government to parallel the BBA proposals.

The flaw, well known to public choice economists, is that politicians, once elected, make decisions to spend that do not accurately reflect the social benefits and costs of that expenditure. In particular, regardless of the spending platforms the candidates of parties vying for the presidency run on, once they are, in fact, elected decision-makers have incentives to take actions with benefits greater than costs *to them and their Party*. Hence, projects that provide concentrated benefits for special interest groups but greater costs to the general tax-paying populace are enacted into law, despite the fact that such projects lower the value of our nation's scarce resources.

Illustrating, under the current system, the overall budget might grow due to funding a project having concentrated benefits of $60 million and costs of $100 million. This project could get funded because a portion of the benefits could be allocated to the politicians (e.g. $10 million in PAC contributions), while the American people will be paying for the project. With more than 100 million households, the cost to each household would be less than a dollar, hence it would not be in the interest of voters to even *know* about such projects, much less attempt to resist them. Thus, upon being elected and becoming the decision-makers, politicians (netting $10 million) in concert with special interests (netting $50 million) would pass legislation funding this project and perhaps many other projects having costs greater than benefits to typical voters. Note that many special interest policies are enacted (e.g. milk price supports) with near-unanimous support, since both Parties are receiving political contributions in case the Awrong@ party gets elected!

How does one prevent special interest dominance of political life? The solution involves property rights (see Coase 1960), where the assignment of those rights affects transactions costs. Politicians currently have no incentive to tell the truth in campaign speeches; they can say anything they want and later behave differently without consequences. They have, in other words, *property rights* in political promises. The incentive-correcting mechanism advanced here reassigns those property rights from politicians to voters, with profound consequences, as will been seen. The mechanism might be worded as follows:

> AAny Party wishing to place a candidate on the ballot for an impending election, must (in addition to existing requirements) indicate the total spending, S, that it will incur over the four-year term of election. If the elected officials of the Party spend more than S, the Party is *itself* liable to pay any amount exceeding S into a fund that will be used to retire the national debt, except under specific circumstances discussed below.@

The overall spending limit, S, is all they need indicate. In particular, politicians in the elected Party can spend that budget in any way they want and they can even talk in the speeches prior to the election about spending it one way and, in fact, spend it in another way after being elected, although that might be reputationally risky. Moreover, they can have complete flexibility as to how they allocate their promised total spending among the four years. After all, the future cannot be predicted and flexibility would be desirable.

Incidentally, it would be irrational for a Party to exceed its own stated S since it would either go bankrupt or be replaced at the next election (or both). Since parties aren't irrational, it is exceedingly unlikely that there will ever *in fact* be any money in the Afund.@ The political Party that wins the election will likely wish, as at present, to indicate the amount that they will spend in each of their years of office, but only as the years roll around. The timing of the announcement of S could be debated.

What would this mechanism accomplish? Programs with costs exceeding benefits that would exceed S, will have costs that are born by the decision making Party, rather than by the American people. Hence, no amount that the special interest group would be *willing* to pay to increase spending above S would be accepted by the political decision-makers. In the illustrative example above, the most that would be offered to politicians by special interests would be $60 million for an increment to the budget favoring them while politicians would be liable for the full $100 million cost.

One might argue that too many projects, efficient and inefficient, would still be included in overly large S's offered by the Parties vying for office. This is, of course, a problem in the current system and remains so, perhaps to a somewhat lesser degree, under a BBA. Under the proposed mechanism, however, *political competition* will tend to give Americans the overall level of government expenditure they wish over time. Note that this eliminates one of the criticisms of BBAs: it is commonly felt that a BBA is just a ruse to halt spending growth, while some people really want more, not less, spending. Under the mechanism here, if Americans want bigger government they can vote for the Party offering a larger S. But, one must strongly suspect that most voters would, in fact, like to have smaller more efficient government.

As noted, there have been dramatic increases in the percentage of income being spent by government. The 1990s were a period of unprecedented expansion in GDP, or the share of income being spent by government would likely have continued its upward trend. The early years of the new millennium seem likely to continue the upward trend. It should be noted that the observed growth in total spending has occurred regardless of which Party is in power. This is as expected given the faulty incentives currently facing politicians, differences being merely a matter of what groups are receiving the largesse. It would seem likely, under the mechanism advanced here, that the Party whose candidates ultimately win the national election would propose at least modest expenditure cuts, say an initial rollback to 19.2% of GDP (19.7% was the actual figure for federal spending in 1998). Political competition would be likely to force percentages lower in future elections.

Since overall governmental spending will be limited by the S of the elected Party, focus would be likely to shift to the efficiency and equity implications of the composition of that spending. This does not, of itself, necessarily imply that programs would become more efficient. People, in virtually any country rich enough, appear to have an affinity for agricultural policies, for example, that are resource wasting. Moreover, it is difficult to measure benefits and costs for many government programs, so increases in efficiency (within an overall S) might be expected to be slow in emerging.

But, many inefficient programs are quite easy to analyze (e.g. the agricultural policies). Efficiency gains from agricultural program reform could be combined with transfers to make all farmers better off, if that were deemed fair. If the political concern were with poor farmers being forced from family farms, a means-based test could be applied and more of the efficiency gains could be returned to the American people in the form of lower prices for food.

Exceptions to the mechanism: three cases

It might be argued that the elected political Party can only Atry@ to deliver its promises, but there may be cases in which it is unable to do so. Indeed, a *New York Times*/CBS News Poll indicated that only Atwo in 10 voters said they thought it was possible for presidents to fulfill their promises.@ The article reporting the poll results went further, indicating that Avoters were overwhelmingly pessimistic about the likelihood that either candidate would accomplish much as president...(being) inevitably hamstrung by the whims and desires of Congress and special interest groups@ (Berke and Elder, Nov. 6, 2000).

If politicians are forced by circumstances beyond their control to exceed their S limit, it might be widely viewed as unfair to require that the elected Party be liable for the excess spending. Three important cases of this problem come to mind. First, a national disaster (e.g. a major earthquake on the West Coast or the September 11 terrorist attacks) or a large war in some future year might occur after a party, promising to spend S, has been elected. In such cases, a Congressional vote could be taken as to whether a temporary supplement to S would be warranted, that would not count against the Party's S, using the same super-majority rules as advocated under a BBA. This extraordinary event will not go unnoticed by the American people, hence will be reserved for true emergencies, and will not be commonly available as a means of exceeding S.

Note that for minor disasters, wars, and the like, funds can be moved among different expenditure classifications within the overall S. For example, money could be moved from social programs to defense should a small, unanticipated war break out. Or, conversely, a minor disaster might involve transfers from military accounts to FEMA or other aid agencies.

Second, what of spending that is beyond the control of politicians, being built into the system and dependent on the level of income? If a recession were to occur after election, spending automatically increases and tax revenue automatically decreases (the Abuilt-in stabilizers@ of the old Keynesian macroeconomic models). Indeed, as already mentioned, this is one of the common criticisms of the BBA. In that context, the potential pro-cyclical implications might indeed be a problem, since the focus of the BBA is on deficits, rather than the truly important concern, the level of S. These spending variations may indeed be desirable, and these too need not count toward S, under the proposed mechanism. Spending that is either increased or decreased automatically (e.g. unemployment insurance, food stamps) over the business cycle need not be applied to S. The critical thing is that *politician increased* spending that ultimately violates S not be allowed; this is guaranteed by the proposed mechanism. It is also possible that recessions could be handled as with major disasters, leaving the Party in power responsible for minor fluctuations, turning to Congress only in major downturns. This would be less pro-cyclical than the BBA proposals since the loss in revenue would not need to be offset by tax increases during depressed economic times.

Indeed, by focusing on deficits, the BBA only indirectly focuses on the share of our resources being devoted to government goods. Ricardian equivalence clarifies that the level of spending is of central importance, with financing being a secondary concern. This is easy to see in the present context. If taxes are raised to prevent a deficit, the assets cashed to pay the taxes fail to earn the interest that would have enabled payment of the future tax burden. Alternatively, if a deficit is run, the assets retained by the taxpayers earn interest, allowing payment of the higher future tax burden. Whether a budget is balanced is of much less importance than its magnitude.

Finally, what if a candidate of Party A, promising to spend S, is elected to the presidency, while another Party B controls one or both of the House of Representatives or Senate? This is a particularly important difficulty with the implementation of the mechanism advocated here in political systems like those in America. The mechanism advocated here might most easily be first adopted in a parliamentary system, since the majority party appoints the Prime Minister, eliminating this problem. Should the executive and legislative branches be split, the Party of the president would not be liable for any spending mandated by Congress upon it in excess of S. That is, the mechanism would not be operational in this case. However, it should be pointed out that it would generally be irrational to elect a Congress controlled by a Party that differed from the President's Party if the mechanism were available. With the mechanism available, voters who vote a split ticket would be thwarting their own desires to obtain the S that they themselves prefer! Voters would quickly recognize that voting a split ticket would create unnecessary problems in getting what they want. Over time, a majority would certainly be expected to vote for the Party of the president for control of Congress in any event.

Indeed, recent trends toward splitting control of the Executive and Legislative branches, are likely due to voters desires to have less Aaccomplished,@ a motivation eliminated by the proposed mechanism. This was clearly expressed in William Safire's November 7, 2000 *New York Times* column entitled ABe Sure to Split that Ticket, Because Gridlock is Good.@ Fewer pork-barrel projects are approved if the branches are split, but the S limitation under the proposed mechanism better accomplishes this goal without splitting tickets. The Party in power will be able to spend what they said they would and will wish to spend no more under the proposed mechanism. Many existing Achecks and balances@ become both unnecessary and actually obstructive when politicians become responsible for their promises under the mechanism.

Verifying the spending of the Party in office is not difficult. The spending to be compared to S is the actual dollar amount of spending over the time until the next election. Auditors can calculate the expenditures, where Afuture promises@ to spend are, on the whole, valueless if they are to occur in an election period further out than the present four-year period. The auditing function is quite important and might be conducted by the nonpartisan General Accounting Office. One might, alternatively, argue for setting up an independent agency, analogous to the Federal Reserve, for this purpose. Or, a major accounting firm could be employed, as is the case with large corporations, in the context of smaller state and local governmental units.

Indeed, the information requirements under the proposed mechanism are less onerous than those of the various BBAs, since the latter require *annual* numbers for *both* expenditures and revenues. For large projects that can only be completed in a longer time frame, only expenditures in the current period count against the current budgetary period, while expenditures in future periods will be included in the S of the current Party running for re-election. If that Party does not get re-elected, it is possible that some such projects would be eliminated. Indeed, voters might wish to vote against the incumbent Party precisely to halt certain projects (e.g. AStar Wars@ defense initiatives, perhaps, or a welfare expansion viewed as overly generous). Should, however, the newly-elected Party wish to continue long-time-frame projects from a prior administration (as might be expected if such projects had benefits greater than costs or if they were popular regardless of efficiency considerations), they must take responsibility for this in *their* S'.

The political Parties running candidates for office might, especially initially, be expected to be risk averse, running on a higher S than they really plan on spending, to offset fears of accidental excess spending that they would be liable for under the proposed mechanism. There is no particular reason to expect that the resulting surpluses would be undesirable, and, with experience, this reason for their existence should diminish, in any event.

Why would political Parties submit to this mechanism? As the implications discussed here become well known, the populace would demand that a law or constitutional amendment enforcing the proposed mechanism be passed, if necessary. Such a law is superior to the BBA that would likely already have been ratified in the 1990s had surpluses not been predicted for many decades. The candidate of any Party unwilling to support such a law would be widely seen as wishing to continue the pork-barrel status quo that has been enlarging the scope of government in America for at least the last half-century.

Passage of a law enforcing the mechanism might not actually be necessary, if verifiable, nonpartisan auditing procedures were agreed upon. If proper auditing is assured, it is possible that competition among the Parties (and pressure from the media) would result, in a few short years, in at least one major Party agreeing to Aput their money where their mouth is,@ subject to the three exceptions discussed above. The Party first agreeing to take responsibility for their spending promises will be very likely to win the election. For example, suppose that the Republicans agreed to abide by the mechanism and ran on a platform of S, where S is five percent smaller than the budget of the prior administration. It seems likely that the Democrats, in order to compete in that or a later election, would be forced to also agree to take financial responsibility for their budget. They might compete by offering a similar S, though with a different pattern of proposed spending, perhaps one with more appeal on equity grounds.

There is great political competition in the present form of government. This is good, and is critical to receiving the long-run benefits of shifting to the mechanism proposed here. Because of that competition, candidates of parties hoping to get, and remain, elected will have incentives to incorporate, within their fixed S, policies that are seen by voters as equitable and efficient insofar as either can be readily determined. Little in the way of enforcement will be needed (assuming the auditing process is relatively unambiguous), because the mechanism is self-policing. Enforcement is analogous to enforcement of any other contract made in society. The assignment of the property rights as indicated under the proposed mechanism largely eliminates the need for policing, apart from the auditing function. In ambiguous cases (which would likely be rare), courts could decide whether the conditions of the Acontract@ had been violated.

Additional benefits of the mechanism

Under the proposed mechanism, there would need to be heightened Ainternal@ policing of politicians in the Party that is in control. Every congressional member has an incentive to deliver the goods to *their* constituents. The overall expenditure level is analogous to the Acommons,@ with each member trying to get as much of the (expandable, under the current system) expenditure delivered to their district as possible. With the overall expenditure constrained under the proposed mechanism, politicians might get to spend in proportion to an historical average, or expenditure might be allocated more nearly in line with taxes paid by districts, or equity concerns might result in more largesse going to poorer districts, etc. The inevitable discussion of such allocation issues is, it would seem, an additional benefit of the proposed mechanism.

One would increasingly expect transfers to the poor to involve means tests. Inefficient policies that are currently rationalized as Ahelping the poor@ (but that, of course, help many special interest groups of means) would be replaced by more efficient and equitable approaches that would enable party candidates to run on smaller S's.

Elected representatives of the party in control will be more likely to seek programs that are efficient or otherwise appeal to a majority of voters under the proposal, since that will make their S more appealing. With parties meaningfully constrained by their spending promises, debate may turn, more than at present, to issues of the regulatory burden.

One might initially suspect that the possibility of a recession could loom large if the mechanism were suddenly introduced. However, significant dislocations are unlikely, since candidates of Parties wishing to be elected, but fearing over-spending, are likely to offer (at least initially) conservative S's akin to recent past spending. Moreover, any dislocations that do occur will present a far less significant problem than is the case with the BBA, since the potential pro-cyclical nature of the latter is eliminated by the mechanism's focus on spending, not on whether the budget is balanced.

Everything argued here applies with equal force for state and local governments which spend two-thirds as much as the federal government and where spending as a percent of GDP has doubled from 7% in 1953 to about 14% today. Indeed, one mechanism by which the proposed mechanism might spread is for states to implement it first. Nebraska, in particular, has but one house, reducing the potential for splits among house, senate, and executive branch. The benefits discussed here would result in the mechanism=s acceptance among the states, ultimately to be adopted at the federal level.

Much is made of the low voter turnouts in American elections, with half of the eligible voters not voting, even in national elections. Part of this apparent apathy doubtlessly stems from suspicion on the part of the voters that they can have no impact on what happens. They realize that, once elected, the representatives of the Party in control (often in concert with the opposition party, since they may also receive special interest benefits) will do whatever they wish, regardless of promises made to the American people in the big public debates. Under the proposed mechanism, the voter turnout is likely to be much higher than in the past, since the voter will be assured of getting the S that they vote for.

The implementation of the proposed mechanism is likely to have several additional benefits. First, it should allow real incomes to grow more rapidly than otherwise if political competition results in the S of the elected party being a smaller percentage of GDP, presuming the rate of return to investment is higher in the private sector. Second, it is likely to encourage privatization of things that should never have been centrally planned in the first place. Third, there will be more incentive to find low-cost suppliers (e.g. $600 coffeepot anecdotes would become less likely). Fourth, the tendency for agencies to spend heavily prior to the end of a fiscal year (the Ause it or lose it@ syndrome) would be discouraged by the party in charge. This is so since the party could save these resources for either future contingencies or for advertising that they Adid what they said they would and came in under budget.@ These effects will be enhanced to the extent that political competition also results in the elimination of inefficient projects in the scrambling to deliver lower S's.

There will be fewer non-salary inducements to seek elected office as the special interest group grip on politics wanes. It is likely, then, that the salaries of our elected officials will have to be increased to lure competent candidates from other pursuits, this surely being preferred to the Abackroom compensations@ of the present system.

Many of the longer-run benefits stemming from the mechanism are a result of political competition. That competition has been very intense, since so much special interest largesse is involved. However, competition will remain high under the proposed mechanism, only the competition will be for best pleasing the voter rather than best pleasing politicians and special interest groups.

It should be noted, however, that even the special interest groups, collectively, might be better off under the proposed mechanism. Much lobbying expense is Adefensive@ in nature, being undertaken to offset lobbying efforts of broadly defined competitors in the political arena. And it is, moreover, likely that much lobbying is undertaken for projects that have, in fact, benefits greater than costs; such projects would likely be undertaken in any event, rendering special interest expenditures unnecessary. Lobbying expenses to be the Achosen@ contractor for a demanded project should be at least somewhat reduced under the proposed mechanism because the political pressure to keep S low will tend to result in the lowest bidding contractor being selected. Under the proposed mechanism, more resources will be put into activities in which firms have expertise and fewer into political manipulation, raising the welfare of the American people.

Indeed, the only groups much harmed by the proposed mechanism are the political parties themselves. Having the ability to deceive voters about spending makes the party winning the election much better off. If this damage to the political parties is viewed as unfair, government could provide a fixed amount of funding to all parties receiving more than some minimal percent of the popular vote. Campaign finance reform would be much less of an issue under the proposed mechanism, in any event.

Conclusions

Politicians have incentives to over-spend, with government spending having the properties of an Aexpandable commons.@ Required budget balance, as a means of correcting the faulty incentives facing politicians, has numerous drawbacks, however. A mechanism is proposed here that more directly reduces the incentives to over-spend and that is in many other ways superior to required budget balance. Indeed, a balanced budget requirement is only of value to the extent that it forces spending to be lower. Illustrating, a federal budget could be balanced at thirty five percent of GDP or unbalanced, say with spending at twenty percent of GDP and revenue at fifteen percent of GDP. In the first case, government acquires thirty-five percent of private sector resources each period. In the second case, government only has yearly command over twenty percent of private sector resources. The second case is likely to be much preferred by voters, in light of Ricardian equivalenceCthe predominant concern is with the spending level, not how that spending level is financed.

Political competition is critical to the benefits of the proposed mechanism. In fact, while it might be determined that the proposed mechanism would require a constitutional amendment, it is not obvious that this is necessary. Political competition might result in strong pressures for a party to take responsibility for its level of spending. The party first agreeing to accept financial responsibility for their promises would likely be regarded very favorably, possibly staying in power until competing parties also agreed to do so. The pressure of the American media, properly focused, should not be under-emphasized. If Awe, the people@ clamor for it, the parties *will* eventually adopt voluntarily or be forced by legislation to adopt a mechanism of the general type advocated here.

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