America's Second Fiscal Revolution
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America's Second Fiscal Revolution

The government eventually will be responsible for allocating the entire national output, not just the federal budget. Expenditures, taxes, and deficits will be viewed more and more as instruments for achieving our national goals.

The Great Depression of the 1930s, with an assist from John Maynard Keynes, created a fiscal revolution in America, a new way of thinking and acting about the budget. Before the revolution, the budget problem was how to provide and pay for a limited list of uniquely government functions absorbing a small fraction of the national income. Calvin Coolidge, for example, presided over a budget equal to about 3 percent of GNP and devoted almost entirely to defense, interest, care of veterans, the post office, and the administration of justice.

The depression focused attention on the role of the budget as a stabilizer of the economy. It brought us "functional finance," in which the function of the budget was to affect aggregate demand in a way that would yield full employment and, it was hoped, price level stability.

This new way of thinking led to several specific developments. One was the Employment Act of 1946, assigning new responsibilities to the government, with the clear implication that the budget was to be the major instrument for carrying out these reponsibilities. From the Employment Act we got the Council of Economic Advisers (CEA) and the Joint Economic Committee. A natural consequence was the emergence of the Troika as the central body for making economic policy in the executive branch of the government. Comprised of the treasury secretary, the budget director, and the CEA chairman, it reflected the assumed interaction of the budget and the aggregate performance of the economy.

The view of stabilization as the critical economic function of the budget gave rise to new ways of measuring the budget—the unified budget, the national income accounts budget, and the high employment budget—and to much research by economists on the relations between the budget, total output, employment, and the price level. And, to a considerable de-

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gree, this view of the budget function affected the policy that was actually followed.

I described the history of this first fiscal revolution, up to about 1965, in my book, *The Fiscal Revolution in America* (see For Further Reading). But now we need, and I believe we are in the process of getting, a second fiscal revolution. It is not a revolution counter to the one that began fifty years ago. That revolution already has been subject to much revision. What I am talking about is something entirely different. It deals with the role of the budget as an allocator of the national output, a subject that needs new consideration regardless of how the budget is to be managed in relation to the stabilization problem.

This new revolution will address four basic facts:

(1) The federal budget now directly absorbs, through its expenditures, over 20 percent of GNP.

(2) Probably half of federal budget expenditures goes to nonfederal sectors—private, state, or local—and covers health, education, investment, and most of all, personal consumption.

(3) The federal government strongly influences the direction of uses of the national output that are not ordinarily considered "federal," not only through expenditures, but also through taxes, borrowing, and regulations. Federal borrowing affects private investment. Federal tax provisions affect private spending for health. Federal regulations affect private spending for protecting the environment, and so on.

(4) There is a national interest, justifying government concern, with many of the private uses of the national output that federal policy affects.

Given these facts, it would appear that the government ought to be responsible for the allocation of the entire national output, not just the federal budget. It should use the budget and other policies of government as instruments for effectuating the desired allocation of the national output. It should make the decisions about the desired allocation of the national output as self-consciously, as explicitly, and with as much information as possible. The main object of my new book, *Governing the $5 Trillion Economy* (see For Further Reading) is to explain the importance of this approach and to suggest ways of implementing it.

Using our national output

This way of looking at the budget, this second fiscal revolution, is necessary not only because it would be neat and logical, but also because it addresses today's

Stein's long and distinguished career

Herbert Stein, a senior fellow of the Washington-based American Enterprise Institute (AEI) and editor of *The AEI Economist,* attended Williams College during the Great Depression when he found only one day's work during all of his vacations from school. The state of the economy during those years was what initially propelled him into his long and distinguished career as an economist.

He went on to the University of Chicago for his Ph.D., not because of the growing reputation of its free market Chicago school of economic thinking, but rather because "it was recommended to me by a professor to whom I was close." Later he was instrumental in applying and popularizing the Chicago school as an economist in a series of Washington jobs, including the Committee for Economic Development, where he remained for twenty-two years.

Stein was chairman of the Council of Economic Advisers (CEA) under Presidents Nixon and Ford, and served on President Reagan's Economic Policy Advisory Board (PEPAB). Stein told *Challenge* that the CEA job was the highlight of his career.

"Being inside the White House orbit was very exciting," he said. "In the Nixon Administration, everything could be freely discussed. It was a freer environment than, for instance, the Reagan Administration where some things, taxes especially, were considered taboo subjects for discussion."

When he was on Reagan's PEPAB, he "grumbled and dissented" about the absence of "any logical foundation for the administration's whole budget policy." But his dissatisfaction did not make him any happier with the loyal opposition which he considered "too protectionist, too dovish, too inflationist, too redistributionist, and too tempted by grandiose ideas of economic planning . . ."

Now Stein has written *The $5 Trillion Economy,* in which he outlines a plan for allocating the nation's GNP that seems to endorse a planned economy. "Not so," says Stein. "I don't recommend price controls. I don't recommend controlling entry to industry." Nevertheless he would "like to take the curse off the word 'planning' because in general there's nothing wrong with it. The question is what decisions are you planning to make? Are they legitimate or not?"

In addition to his work at the AEI, Stein is a contributor to The Wall Street Journal and a Congressional Budget Office consultant. Otherwise there is no major project on his immediate agenda. "I'm just resting up," he said. "I'm entitled."

most important economic problem: we are not using our national output wisely. Although we are enormously rich, with a real national output previously undreamed of, we seem unable to do many of the things we expect we should be able to do. We find ourselves lacking in our ability to defend ourselves, educate our children, take care of the poor, and provide for the future. Others might describe our deficiencies differently, but that doesn't change the basic point.

Table 1 **Use of National Output**

	Percent of 1986 GNP
Investment owned by Americans, including government investment	14.3
Defense	6.6
Health care	10.3
Education	6.2
Other consumption of the very poor	1.9
Other private consumption	54.7
Other federal uses of output	1.3
Other state and local uses of output	3.8
Government transfers and interest payments abroad	0.9
	100.0

Source: All data except consumption by the poor from Bureau of Economic Analysis, Department of Commerce, National Income and Product Accounts, and Survey of Current Business. Consumption by the poor based on author's estimates.

What I am saying no doubt immediately raises in some minds the specter of "national economic planning"—a subject on which I have written my share of scandalized criticism. Some imagine a federal czar squeezing the entire national output into the cells of a giant 1,000-by-1,000 matrix of the economy. This is not what I am talking about at all. I am talking about the allocation of the national output among a few—say, ten—uses where the federal influence is large and inevitable, where there is a strong national interest in the allocation, and where the federal influence is exerted without serious discrimination among individuals or power over them.

Table 1 shows the categories I am thinking of, together with an estimate of the share of the national output they absorbed in 1986, the latest year for which necessary data are available.

Others might construct a different list. Some might want to add housing and research, or drop the distinction between consumption of the very poor and other consumption. Such differences are not critical to my proposal. What is important is that the list should exhaust the national output, so that if there is to be more of something on the list there has to be less of something else. The list should carry out the basic principle that the cost of something is the other things that must be foregone to get it.

I can illustrate the meaning of my proposal by referring to the very real issue that first made me think of it. In 1969, when I became a member of President Nixon's Council of Economic Advisers, I was made head of a task force to study the economic consequences of decisions about the size of the defense program. We very quickly realized that the most obvious cost of an increase or decrease of the defense program was that less or more of the national output would be left for nondefense uses.

Moreover, the effect would not be on nondefense uses "in general." Which of several major categories of defense uses would be affected would depend upon policy decisions about finance that would inevitably accompany the defense decision. If a larger defense program were financed by borrowing, there would be less investment, which, in the conditions of 1969, we thought mainly would translate into less housing. If taxes were raised, there would be less private consumption. If federal grants-in-aid were cut, there would be fewer state and local services.

Furthermore, we thought that the question of whether an increase of the defense program was worthwhile could not be separated from the question of which share of the national output would be sacrificed to achieve it. So we were already in the process of thinking about making a budgetary decision within the context of a decision about allocation of the national output among a few major categories.

Being superficial or being explicit

My continuing interest in this subject has been fueled by what has seemed to me the dangerously superficial way in which we have been thinking about the defense program to this day. People keep talking about being unable to "afford" a larger defense program. I think they should be saying that they prefer some other use of the national output, such as private consumption or investment. If people could be induced to be explicit about these preferences, they would make better decisions.

The same superficiality is apparent in the talk about the federal deficit. We have gotten over saying that a deficit of a certain size is necessary to achieve high employment or is dangerous because it will cause inflation. So we are left with no anchor for considering the proper size of the deficit or surplus—no national objective for which that decision is consequential. We therefore rely on totally arbitrary targets, like Gramm-Rudman-Hollings.

I propose that we look upon the deficit or surplus as an instrument for influencing the amount of investment owned by Americans and determine the size of the deficit or surplus by deciding how much of the national output should go for that rather than for consumption or defense or the other major purposes I would distinguish.

I am trying to demythologize the talk about the budget and deficits and taxes and spending. I want to promote talk about the budget in which expenditures and taxes and deficits are not considered totems, or ends-in-themselves, but are looked upon as instruments for achieving certain uses of the national output. Decisions about these instruments should be made by reference to the character and magnitude of their effects on the allocation of national output.

Thinking about the budget *initially* as an instrument for allocating the national output has three main advantages:

(1) It gets us closer to the goals we are really interested in rather than just thinking about variables like deficits and taxes. Of course, categories like investment, private consumption, and total health expenditures are not the *ultimate* objects of policy either. But they are much closer to the ultimate objects—''welfare'' or ''social solidarity'' or whatever—than the numbers we usually talk about.

(2) Allocating the national output brings home the point that decision-making involves choice and that if you want more of something you have to have less of something else. The national output is, in the short run at least, a given total, and you cannot allocate more than 100 percent of it. But the size of the federal budget is not a given, and you can always make it appear that more is being given to one purpose without less to another by making the total larger.

(3) Allocating the national output eliminates the possibility and temptation to evade the constraints of the budget by recourse to other policies, such as regulations, that have similar effects. The most notable current instance is the proposal to establish national health insurance by requiring employers to provide insurance for their workers. If one looks only at the federal budget, that seems devoid of cost. But it does involve devotion of more of the national output to medical care and consequently less to something else. A ''GNP budget'' would reveal that.

A less obvious case would be an effort by the president, as is sometimes suggested, to use his ''bully pulpit'' to induce states, localities, and private parties to spend more for education. This would also involve a shift in the use of resources, which would have its costs, and, if the amounts were large enough, they would show up in the ''GNP budget.''

Of course, I am not suggesting a law enacting the ''GNP budget'' and saying how much of the national income should go for investment or for consumption or for others of the grand categories that would be identified. I am only talking about a framework for thinking about and discussing the budget and for proposing and evaluating the specific tax, expenditure, borrowing, lending, and regulating programs of the government.

Setting priorities

I visualize a president some day saying, in his state of the union message, what he thinks the country's main priorities are. He would tell us what he thinks we most need—whether it is more economic growth to provide for the future, or a higher standard of living for the great mass of Americans, or strengthened national security, or whatever it may be. He would indicate what changes in the allocation of the national output would conform to those priorities—what changes in the proportions of the national output should go to investment, or to private consumption, or to defense. And, if he suggests that some uses should be increased, he would have to suggest which uses should be reduced.

All of this would be preliminary and explanatory, but the president would base upon it a set of specific proposals for taxes, expenditures, lending, borrowing, and regulations intended to conform to those priorities. The statement of priorities and desired allocations of the national output, at the level of generality that I am suggesting, would not uniquely determine the specific proposals.

For example, if the desire is to reduce the share of the national output going to consumption by Americans who are not poor, there still remain many questions about how to do that. Should taxes be raised? If so, which ones? Should social security benefits, or farm subsidies, or other transfer payments be reduced? Similar questions would be raised about the means for implementing other goals for the allocation of the national output. At this point all the usual questions about equity and efficiency would arise, but they would arise within the context of some objectives that had been explicitly stated.

Many of the proposals made these days for reforming the budget process would fit comfortably with the suggestions I have made. We need, for example, a longer-run—four- or five-year—budget to guide the major expenditure and revenue decisions. We need two-year appropriations. We need to reduce drastically the number of appropriation items into which the budget is divided, in order to focus the attention of Congress on the big issues and cut down on micromanagement. We need cooperation between the White House and the congressional leadership in the early stages of budget development. My proposal would put another level of decision-making on top of all that in order to relate the usual tax and expenditure actions to the grand allocations of the national output and through that to the grand national priorities.

Two complaints

Aside from the worry about "planning," which I have already discussed, the proposal to "budget the GNP" has elicited two main complaints. One is whether we know enough to do what is proposed. The idea assumes that we know that if we reduce the deficit, savings and investment will increase, and by how much. It assumes that we know that if we raise taxes, consumption will be decreased, and by how much. It assumes that we know how national expenditures on medical care will be affected if we alter the tax treatment of employers' contributions for health insurance.

We do not, however, "know" such things, if knowing means knowing precisely and with a high degree of reliability. No one is more aware of this than I am, or, at least, no economist has written about our ignorance so much. Though this ignorance is a problem, it is not, in my opinion, a serious objection to my proposal.

The decisions we are now making, and cannot escape making, already imply some answers to questions that we cannot answer precisely and reliably. When these implied answers are exposed to the light of day, we may discover that they contradict what little we do know. Perhaps we will find that the implied answers assume that we know with confidence something that we do not really know at all.

For example, policy about taxation assumes that we *know* that a tax increase will be fully matched by an expenditure increase, or that it will depress the economy, or that it will reduce saving by an equal amount, or that it will reduce the revenue. The possibility of prudent decisions would be enhanced by a revelation of the true state of our knowledge about these questions. As Artemas Ward said, "It ain't what we don't know that hurts us, it's the things we know that ain't so."

Allocating the GNP would be a step toward revealing what we need to know anyway in order to make intelligent decisions and toward exposing what we do and do not know. One consequence would be to direct attention to trying to learn more. The second fiscal revolution provides a research agenda for economists, just as the first revolution did, although I hope no one will think that is the motive for it.

One of the most elementary things we need is a more reliable classification of the national output by uses or functions. For example, we cannot now tell very well how much of the national output goes for education or medical care because in the national income accounts much of the expenditure for these functions is included in the costs of producing other goods and services.

Another major complaint about my proposal is that "It may be good economics, logical and rational, but it isn't politically realistic." Politicians, it is said, have no interest in good economics, logic, or rationality. They do not want to expose the consequences of their actions any more than they have to and they are certainly not looking out for something called "the national objectives."

I have lived in Washington, in and around government, for 51 years and have heard this argument repeatedly. (I also have been in Washington long enough to learn that politicians, political scientists, and political journalists do not know very much about what is "good politics.") I appreciate the force of the argument, but I do not think it is an insuperable objection to trying to introduce more information and rationality into the process, for several reasons:

(1) There really is no alternative. Some people think there is an alternative, which is to impose upon "uninformed and unprincipled politicians" a set of rules devised by "outsiders" who are both "informed and principled." Balanced-budget amendments and expenditure-limitation amendments are examples of such rules. But we now see how difficult it is to get the politicians to put those blinkers on, and Gramm-Rudman-Hollings shows how adept the politicians are at evading the rules if they do not accept the reasons for them.

In any case, such rules at best can only deal with the big aggregates, such as the size of the deficit or total spending. They can not deal with questions of the direction of expenditures, which may be more important.

(2) The utility of my proposal does not depend upon politicians becoming "good," in the sense of more public-spirited and honest. I assume that the politicians will strive to serve their own interests, with as high or as low ethical standards as ever. I only want to transfer the struggle to a better-illuminated playing field. I want the participants to be better informed about the consequences of what they are doing and, especially, of what is being done to them.

The errors of policy, from the standpoint of the national interest, are partly due to the difference between the interest of the decisionmakers and the national interest. But policy errors are also, and to a considerable degree, due to ignorance all around. It is this second cause of error that I hope to correct. I do not know what to do about the first.

(3) The budget reform movement that has been going on in the United States for at least seventy-five years has always been an effort to inject more information about the ultimate consequences of decisions into the decision-making process. This movement has had considerable success over that period.

Even in recent years there has been progress. The Budget Reform Act of 1974, the increased emphasis on broad categories and long periods in making decisions, the "budget summits" between the White House and the congressional leadership, the general agreement on the need for two-year appropriations, even Gramm-Rudman-Hollings, for all its faults, are steps forward. The proposal to put the decisions in the framework of the allocation of the national output is a logical step in this process and there is no reason to despair of achieving it.

(4) In my opinion, movement toward this new way of looking at the budget and other government policies is not only possible but also highly probable, simply because some participants in the struggle will find this movement in their interest. Proponents of higher defense spending, whatever their motives, will not be content with the answer that we cannot afford it. They will want to know why a 10 percent increase in defense spending is less valuable to the nation than a 1 percent increase in private consumption.

Opponents of mandated national health insurance will ask why we should increase the share of the national output going to medical care—even if it doesn't show in the budget—when the already-high share shows little benefit. The argument about the size of the budget deficit already is becoming an argument about the share of the national output going to investment, and the consequent effects on economic growth. The competition of claims on the national output will be forced into the arena of real effects because some of the claimants will find their strongest case there and others will have to join them.

I do not count upon politicians alone for improvement of the policy-making process. Much of the leadership in this direction has always come from the private sector, where there are some people with broader and longer interests than politicians may think they can afford. If the public discussion of budget policy focuses on real affects, rather than on symbols and shibboleths, the politicians will have to follow.

ROBERT L. HEILBRONER

Examining Stein's Proposals

"Having made plain my admiration for Herbert Stein's book, I have two serious criticisms: The first concerns Stein's failure to explain the deficit, and the second concerns his almost offhand treatment of the Federal Reserve."

Herbert Stein's peculiar gift to economics is his ability to see everyday realities behind its jargon: he once described the gross national product as what happens when 100 million Americans get up in the morning and go to work. *Governing the $5 Trillion Economy* applies this deceptively simple talent to the question that occupies center stage these days—namely, the federal budget.

Stein has many interesting things to say about this vexed issue, but his book is ultimately about something much more important than "the deficit." It is about how a large and rich industrial state should manage its economic affairs. From this perspective, as Stein puts it, "Balancing the budget is not the name of the game. The name of the game is making good use of the national output, which may or may not involve balancing the budget."

Stein's concern with "governing" the economy sets him apart from much conservative theorizing, which starts from the assumption that the economy does not need to be governed and that attempts to do so will only come to nothing against the natural forces of economic life. Stein derives his much more positive view partly from his own active participation in gov-

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