Governing the $5 Trillion Economy
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Governing the $5 Trillion Economy

Herbert Stein

Discussion of federal budget policy in the United States has fallen to an abysmally low level. It consists wholly of bumper-sticker slogans, sound bites, lip reading. It finds public expression in shibboleths like no new taxes, balance the budget, don't raid Social Security. Prescriptions for dealing with the budget evade the central problem, which is making choices. Instead the nation is treated to the arbitrariness of balanced-budget amendments, constitutional limits on spending, Gramm-Rudman-Hollings formulas, freezes, flexible freezes, and across-the-board cuts.

None of these supposed cure-alls takes into account the consequences of budget policy. Budget decisions have three kinds of effects. One is on the allocation of government expenditures among the hundreds of agencies and thousands of programs of the government, which I call the micro-allocation function. A second consequence of budget policy is its effect on the stability of the economy — the fluctuations of total output, employment, and the price level. This effect is the one that preoccupied the generation after the Great Depression of the 1930s. It is still important. But the effect that I am most concerned about is the effect budget policy has on the allocation of the national output.

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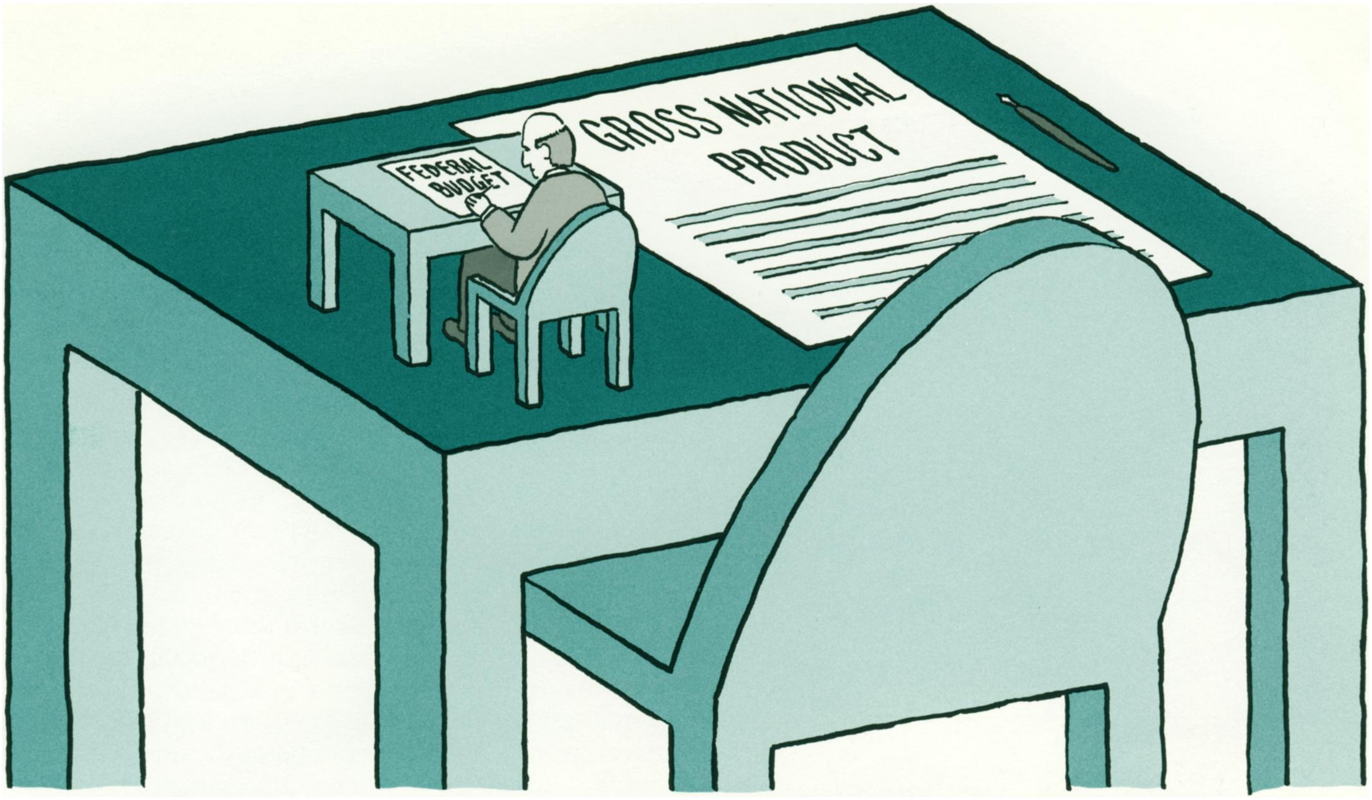
It is this effect that determines whether we further our national objectives; it is this effect that is most neglected and that needs attention.

The allocation problem has changed greatly since 60 years ago. In Calvin Coolidge's time, the budget problem was how to allocate a tiny fraction of the national output — about 3 percent — among a number of uniquely federal uses, such as national defense, administration of justice, care for veterans, and the post office. The federal government did not much affect — and did not have much interest in — how the other 97 percent of the output was used.

Today the federal government uses a much larger share of the national output, more than 20 percent of the gross national product (GNP). It also affects much more profoundly and intimately how the rest of the national output is used — and it does so intentionally. Most of the government's expenditures are for purposes that it did not serve 60 years ago and that are also served by the private sector and by state and local governments. Sensible decisions about those expenditures can only be made after considering the total national provision for those purposes, and not just the federal provision. Much federal action is designed to affect the nonfederal allocation of the GNP by incentives of various kinds. The government's taxes, transfers, and borrowing significantly influence the division of private income between consumption and investment. Tax treatment of fringe benefits affects how much private income is spent for medical care. Tax treatment of mortgage interest affects private expenditures for housing. These effects are recognized in a special analysis of the budget,



called "tax expenditures," but they are not integrated into the decisionmaking process about the budget. Moreover, other government policies, such as various regulations and loans, also affect substantially the allocation of the national output but receive no systematic attention in the budget process.

To correct these serious omissions in federal budget-making, I suggest that the process begin with decisions about the allocation of the national output among the major uses of it. Federal decisions about taxes, expenditures, borrowing, regulation, and loans should be regarded as means for achieving the desired allocation of the national output and should be consistent with that allocation. In other words, we should budget the $5 trillion GNP before we start budgeting the $1 trillion that the federal government spends.

The deficit is *not* the heart of the budget problem. But it can illustrate what I mean by budgeting the GNP. Almost everyone says that the budget deficit must be reduced, yet can rarely say why or explain what difference it makes. The deficit does make a difference; it absorbs saving that would otherwise be productively invested and so reduces future levels of output. The deficit is important because it affects a certain real use of the GNP. If we want the deficit to be smaller, it is because we want that particular use, which is investment, to be larger. But if we want investment to be larger, some other use of the GNP has to be smaller. At any moment there is a limited amount of available national output; increasing some use of that output therefore requires decreasing some other use. As the Communists used to say, whoever says A must also say B. Or as the conservatives say, there is no free lunch. Once we recognize the logical implication of a reasoned desire to reduce the deficit, we are in the domain of budgeting the GNP, of thinking about how the GNP should be allocated.

At this point it becomes clear the decisions about the conventional federal budget are only instruments for affecting the allocation of the GNP. Raising or lowering the deficit is a means of affecting investment. Raising or lowering taxes is a means of doing something about consumption. Changing the rules for reimbursement under Medicare is a means of doing something about that share of the GNP devoted to health care. My proposal is that we should make these instrumental decisions so that they are consistent with explicit decisions about how the GNP should be allocated among major uses.

I am not suggesting that the government should be making detailed decisions about the allocation of the national output. I only want the government to make explicit decisions about the "grand divisions" of the national output with which it is inevitably involved and in which there is generally agreed to be a national interest.

In my view, the uses it is appropriate to consider are defense; education; health; consumption by the very poor, excluding health care; consumption by the nonpoor, excluding health care; investment by Americans, including government capital not included elsewhere; and other government functions. Other people would have different views of what the appropriate categories should be. Some

Illustration by Robert Wiser

"To correct these serious omissions in federal budget-making, I suggest that the process begin with decisions about the allocation of the national output among the major uses of it . . . . In other words, we should budget the $5 trillion GNP before we start budgeting the $1 trillion that the federal government spends."

might want to include housing or net exports or research as separate categories, which would require rearrangement of the others. The classification is not important. What is important is that people who talk about the budget should be explicit about their priorities for the uses of the GNP, according to their own standards, that the categories should be exhaustive, and that the number of categories should not be too large for a single mind to grasp and compare.

The decisions about the grand divisions of the national output would have to be implemented by policy — by taxing, spending, borrowing and lending, subsidies, regulations, exhortations, or possibly other policies. The budgeting of the GNP cannot supplant the budget process that now goes on but should guide and discipline that process. We would understand better the consequences of a particular tax policy if that policy flowed from a prior decision about the allocation of the national output. We convey more information if we say we will not reduce private consumption than if we say "Read my lips: No new taxes."

If we decide that we want to divert some of the national output from consumption to defense, we still have to decide how to restrict the consumption and how to spend for defense, and the usual questions of equity and efficiency will remain to be solved. But we will make better decisions about the means if we have considered the ends of policy.

Looking at the budgetary problem as one of budgeting the GNP has three major advantages.

First, the allocations of the GNP come closer to defining our ultimate national interests than the allocations of the federal budget do. If a national objective is to improve the educational attainment of the American people, total expenditures for education — private, state, and local as well as federal — must be considered. Sensible decisions about the adequacy of federal expenditures can be made only in the context of total expenditures for education goals. If future economic growth is a goal, the totality of growth-promoting uses of the national output, which are predominantly private expenditures, must be considered before deciding on federal policies, including the federal deficit or surplus, that affect that totality. Budgeting the GNP can create a bridge between national objectives and budget decisions.

Second, budgeting the GNP helps to bring home the basic fact that if the nation wants more of something, it must take less of something else. It always seems possible to meet more of everyone's claims on the federal budget, without sacrificing any, just by increasing the budget. That is not true of the GNP; it cannot simply be made bigger.

Third, allocation of the GNP also shows the nonbudgetary ways in which the federal government influences the allocation of the national output. These influences are of growing importance. As policymakers feel more constrained by the budget situation, they are more tempted to achieve the same objectives by nonbudgetary means — thereby concealing the costs that would have been evident if the budget had been used. For example, one widely discussed idea would institute national health insurance by requiring employers to provide their workers with health coverage. These expenditures would not appear in the budget, and the population would pay through higher prices or lower wages rather than through taxes. This device, and others like it, would not, however, take the costs or benefits of the program outside the GNP.

How the Process Would Work

To carry out the approach to budget decisionmaking that I propose, I suggest the following steps.

First, the president, within a year after taking office, should set out his view of the national priorities. This statement should identify not only the purposes to which he thinks more resources should be devoted, but also those

Breaking with Tradition

I was raised on the belief that while rules for policy might not give the best of all conceivable results, they would give results vastly superior to the product of ignorant, self-interested and short-sighted politicians. At the same time, I have been greatly impressed by how little we know about anything and have always thought that the chief problem in formulating economic policy is deciding what to do when we don't know what to do.

So how does a person who has always believed in the superiority of rules come to propose a process that relies heavily on the discretionary judgment of politicians about matters for which objective evidence is very limited? There are several explanations for my present position.

First, I doubt that the commonly proposed rules for remedying our budget problems, namely, the balanced budget and spending limitation amendments, would yield better results than the politically based process we now follow. The basic rationale underlying these proposed rules is that politicians spend too much; therefore, a rule that limits government spending, directly or indirectly, would be an improvement.

But once you recognize the possibility that a given government expenditure could be lower than you would like, you must also recognize that tightening the limits on total spending will increase the possibility that the expenditure you care about will suffer. In that case, the rule might lead to an inferior result even though it restricts total spending. Less spending may be worse than more spending if it involves cutting the spending that you think is terribly important.

This conclusion is borne in on me by consideration of defense spending. I think that concern with the deficit and with limiting total spending has resulted in greater danger to the national security than would have occurred with more spending and a bigger deficit. And once I recognize that result for the expenditures that seem vital to me, I have to recognize that others may feel the same way about other expenditures.

Second, I doubt that rules can keep the majority of politicians — and a majority of citizens — from doing something they want to do. Despite all the hue and cry, the politicians have not enacted these proposed budget rules. And there is widespread, if tacit, acknowledgement that if the rules were enacted, real adherence to them would be almost impossible to ensure. The rules will not be established and observed unless there is greater awareness of the practical reasons for doing so than now exists. And if there were such awareness, the rules would not be as necessary as their proponents claim them to be.

Third, I don't think we have to despair about the possibility of improving the rationality of the present budget process. Thinking and talking about the process has already led to some improvement in our lifetimes.

Fourth, even if the rules were established and observed, they would not answer most of the questions. At most, they might determine the size of the deficit, presumably zero, and the total amount of spending. They could not determine the direction of expenditure or the nature of taxation, issues that could be more important than the size of the deficit or total spending.

Finally, even the most rigorous formulation of budget rules leaves open the possibility of departing from them or changing them, decisions that are a matter of someone's discretion. In short, I do not think we can avoid the challenge to try to learn more and make goal-oriented, functional decisions about the budget.

purposes to which he thinks fewer resources should be devoted. He should recognize that the nation cannot have and do everything and that he is expressing a set of choices. The statement might read like this:

> The United States faces a powerful enemy, whose conventional military forces outstrip ours and threaten our security. The United States is very rich, with the highest per capita income in history. But per capita income is growing more slowly than it did in the recent past. However rich we are, the loss of the expectation of rapid, visible improvement in living standards removes an invigorating and encouraging aspect of life in America. Also, even though we are on the average very rich, a relatively small number of people have incomes so low and living conditions so miserable that improvement is a high national priority. Finally, the quality of life in America is worsened, and the survival of a free society itself endangered, by the illiteracy of too many Americans, by their ignorance and their lack of understanding of our society's values. Thus, the nation's most important goals at this time are to strengthen our defenses, to raise the rate of economic growth, to improve the lot of the poorest among us, and to elevate the understanding of the population. To say that these are the most important objectives is to say that some other things, although valuable, are less important. The chief among these is to sustain the level of consumption of people who are not poor.

I offer this statement because it happens to describe my priorities. But it is only an illustration. The president may have different priorities. He could think that the national security threat has passed, that Americans in general are rich enough and do not need to save much for the future, that the purpose of economic activity is consumption, and that the highest priority is to divert some of the national output to consumption from defense and investment. Whatever his priorities, his statement of them should be as explicit as possible and recognize the existence of limits — something presidents dislike doing.

Second, the president should submit a four-year plan for the allocation of the GNP that he considers consistent with these priorities. The form of this plan will depend on what his priorities are. For example, an allocation plan related to the preceding statement of priorities might read like this:

> Investment owned by Americans, which has been running at about 14 percent of GNP, should be restored to close to the 1973 level of 20 percent of GNP. Real defense expenditures should increase by 3 percent a year, instead of being frozen as recent legislation implies. A study of national security experts concluded that this rate of increase is necessary for the adequate modernization of our forces. To improve the condition of the poor, we will increase the share of the national output going to their consumption by 10 percent during the next four years, from about 2 percent to about 2.2 percent. We will also devote another two-tenths of a percent of the GNP to education. To achieve all of this, we will hold constant for the next four years real per capita income of people who are not poor, and we will slow down the growth of national health expenditures so that their share of the GNP does not rise.

All of these numbers will reflect the president's judgments. They will reveal what he intends to do and will be the basis for a national debate about the desirability of the ends and the effectiveness of the means. I should emphasize that I do not expect this plan for the allocation of the national output to be legislated. I look upon it as an explanation for and discipline upon the specific appropriation and revenue proposals that are to be legislated.

Third, the president should submit a four-year program, including but not limited to a comprehensive budget plan, to implement the desired allocation of the national output. On the expenditure side the program would run at about the level of generality of the 20 major functional classifications presently in the budget. Revenue changes and regulations the president considers appropriate to the GNP allocation plan would also be included.

Here we encounter the fact that in many respects the relations between budget actions and the allocation of the GNP are not fully understood. We do not know, for example, whether increased expenditures for Medicare increase total health provision for the aged, substitute for expenditures the aged would have made anyway, or increase the incomes of physicians — or in what proportions they do any of the three. But some beliefs or hunches about such connections are implicit in budgets and programs already in place, and these beliefs should be brought out in the open. If those connections become an integral part of the way we think about the budget, incentives to learn more about them will strengthen. If the connections between an activity and its presumed effects are truly unknown and unknowable, the government probably should not be engaging in the activity in the first place.

Before he submits his four-year program, the president should discuss it with the congressional leadership and try hard to reach maximum agreement on it. The four-year program, unlike the GNP plan, should be enacted. It could be modeled on the present congressional budget resolution, except that it would be a law, signed by the president. It also would contain aspects of the Gramm-Rudman-Hollings law, in that it would be a binding multi-year plan. But unlike Gramm-Rudman-Hollings, its deficit path would not be arbitrarily decided but deliberately chosen because of its desired effect on investment. Nor would the expenditure composition be arbitrarily decided but would instead reflect explicit priorities. The program, once enacted, would permit a point of order to be raised against legislative proposals that are inconsistent with it. It would also require the president to submit budgets consistent with the program, but he could also propose other budgets and so request amendment to the plan.

Fourth, the president should request and Congress should enact two-year appropriations bills. The president and Congress should also work together to revise the appropriation structure so that Congress no longer acts upon the 1,000 line items, many of them of trivial size, and the 5,000 items reflected in report language. Dealing with so many small items is a diversion from the major questions that require congressional attention.

Undoubtedly, neither the president nor Congress will like this proposal very much. It would require them to be more explicit about their aims, to argue about the connection between the ends they espouse and the means they propose, and to recognize the limits of what the economy can stand. It is an attempt to expose the whole process to information and analysis, which limits the ability of presidents and legislators to ignore or conceal what they are doing.

Despite the understandable resistance of presidents and lawmakers to ceding power and accepting discipline, there have been movements in my direction in the past 15 years. The Budget Reform Act, Gramm-Rudman-Hollings, the 1987 budget summit, the current consideration being given to two-year budgeting, all are steps toward thinking about the budget at a higher level of generality, accepting commitments for a longer term, and seeking more constructive relations between the president and Congress. These steps fall far short of our needs and contain too many arbitrary features. But they signal the possibility of change.

In any case, I do not think of the president and Congress as the leaders of budgetary reform. In the past budgetary reform has been initiated outside the regular political process. The contributions of the Taft Commission of 1911, the predecessors of Brookings in the early 1920s, the Committee for Economic Development and others in the early postwar period, and the commission on the definition of the budget come quickly to mind. Less inhibited by political considerations, private leaders can speak more freely. If private people who talk about the budget, and there are many of them, will talk about it in what I consider rational and functional, well-informed terms, politicians will have to adapt.

What the Budget Might Look Like

I have tried to distinguish clearly between my thoughts about how to make better decisions and my thoughts about what the decisions should be. I am proposing a way to think about the budget, not what to do about it. Even if my procedure were followed, the content of the budget would still depend on values that would have to emerge from the citizens and the politicians, who may not share my values, and from information that I do not have. To give a concrete illustration of what I am suggesting, however, I have produced some budgets that might emerge in the 1990s if my suggestions were followed.

My research assistant, Glenn Follette, and I first estimated how the GNP had been divided in the past 15 years among investment, education, health care, provision for the poor, and consumption by the rest of the population. The official GNP figures published by the Department of Commerce are not broken down functionally. One cannot get from those figures a clean number for what is spent for health by governments, households, businesses, nonprofit institutions, for example. The same is true for education, for consumption by the poor, or for government capital expenditures. We estimated those things as well as we could, but it will be important for the Department of Commerce to develop accurate figures.

We then used the baseline budget prepared by the Congressional Budget Office (CBO) and some other information and assumptions to project how the GNP would be allocated in 1993 if the baseline budget were followed.

Table 1. Recent Uses of the GNP
(percent distribution)

Use	1973	1980	1986
Defense	5.7%	5.2%	6.6%
Education	6.4	6.2	6.2
Health care	7.5	8.7	10.3
Consumption by the poor	1.6	2.0	1.9
Consumption by the nonpoor	53.4	53.6	54.7
Investment owned by Americans*	20.1	18.5	14.3
Other government spending	4.7	5.1	5.2
Government transfers and interest abroad	0.6	0.7	0.9
Total	**100.0**	**100.0**	**100.0**

Sources: All data except consumption by the poor from Bureau of Economic Analysis, Department of Commerce, *The National Income and Product Accounts of the United States, 1929–82* (GPO, 1986) and *Survey of Current Business* (July 1987). Consumption by the poor estimated by the author using U.S. Bureau of the Census, *Money Income and Poverty Status of Families and Persons in the U.S.:* 1986 (GPO, 1987); *Characteristics of Households and Persons Receiving Selected Noncash Benefits: 1984* (GPO, 1986); and *The Budget of the United States Government* for fiscal years 1973, 1980, and 1986 (GPO, 1972, 1979, and 1985).

*Investment owned by Americans is gross private domestic investment plus federal, state, and local capital expenditures not included in other categories less net foreign capital inflow.

Table 2. Alternative Uses of the GNP in 1993
(percent distribution)

Use	Baseline	Case A	Case B	Case C
Defense	5.5%	6.4%	5.5%	4.5%
Education	6.4	6.5	6.4	6.7
Health care	12.5	11.2	11.2	12.7
Consumption by the poor	2.0	2.1	2.0	2.3
Consumption by the nonpoor	51.5	49.5	49.6	50.6
Investment owned by Americans*	16.8	19.0	20.2	18.0
Other government spending	4.5	4.5	4.5	4.5
Government transfers and interest abroad	0.8	0.8	0.8	0.8
Total**	**100.0**	**100.0**	**100.0**	**100.0**

Sources: Author's calculations based on Bureau of Economic Analysis, Department of Commerce, *The National Income and Product Accounts.*

*Investment owned by Americans is gross private domestic investment plus federal, state, and local capital expenditures not included in other categories less net foreign capital inflow.

**Estimated total GNP in 1993 is $6.5 trillion.

Table 3. Possible Spending Cuts, Revenue Increases
(in billions of dollars)

Source	Estimated Effect in 1993
Raise premiums to cover 50% of cost of Medicare Supplementary Medical Insurance (SMI)	$ 18.6
Establish new physicians' fee schedule under SMI	10.0
Increase Medicare deductible	3.6
Tax employer-paid health insurance as income	25.1
Eliminate agricultural income supports	15.0
Tax 60% of all Social Security benefits as income	11.3
Eliminate deductibility of state and local taxes	32.1
Limit the mortgage interest deduction to 15% of interest	14.5
Tax capital gains at death	5.8
Tax 30% of capital gains from home sales	7.5
Raise tax on distilled spirits by 20%; raise beer and wine tax to that level	4.8
Double the cigarette tax	3.0
Increase motor fuel tax by 12 cents a gallon	11.7
Lower amount of contributions to pension and profit-sharing funds that can be deducted	3.4
Reduce miscellaneous subsidies (to Export-Import Bank, Rural Electrification Administration, and others)	3.6
Total	**$170.0**

Source: Congressional Budget Office, "Reducing the Deficit: Spending and Revenue Options," 1988.

(These projections were derived from the baseline budget published by CBO in February 1988. Subsequent revisions of the baseline budget would change these figures somewhat but would not affect the process of thinking being illustrated.) This exercise also involved a number of assumptions about the relations between policies and GNP outcomes that we could only make crudely but that would have to be the subject of study and argument if my proposal to budget the GNP were to be implemented. But I do not think that the knowledge we would attain about these relations would be below the standards of reliability that we regularly count on in managing our economic and social affairs.

What stands out from these estimates is that the share of the GNP going to investment owned by Americans has declined substantially, from 20 percent in 1973 to 14 percent in 1986 (*see table 1*). This decline was closely matched by an increase in the total share going to consumption and health care, and the largest share of that was for health. The defense share increased a little. Education and provision for the poor stayed about the same. It also appeared that the shift from investment to health care and consumption was greatly affected by public policy, although a decline in the private saving rate was also important. The rise of the federal deficit relative to GNP was a factor in the decline of the investment share, and the decline of net taxes — taxes net of transfer payments — contributed to the rise of the consumption share.

The baseline budget projected out to 1993 would change this allocation in certain respects. The investment share would rise, as the ratio of deficit to GNP declines, but the share would not return to the 1973 level of 20.1 percent or even to the 1980 rate of 18.5 percent. The share devoted to health care would continue to rise. The defense share would decline, as real defense expenditures are kept constant in the baseline budget, and the share of miscellaneous government services would also decline. The share of consumption other than health would remain about constant.

What effects on the budget would result if it were decided to allocate the GNP in 1993 differently? To illustrate, I describe three possible sets of priorities.

The first case gives high priority to defense, raising real defense expenditures by 3 percent a year. It gives low priority to consumption by the nonpoor and to health care, freezing real per capita consumption of the nonpoor, other than health care, until 1993, and freezing the share of health care in the GNP. Most of the resources thus released, after providing for defense, would go to investment, although education and assistance to the poor could be increased a bit. The investment share would increase significantly, but would not return to the 1973 or 1980 level.

The second case, which I suppose is more conventional, would accept the baseline projection of no real increase in defense, thus cutting its share of GNP. But it would aim to restore investment to its earlier, higher share. Health care and consumption by the nonpoor would be treated as they were in the first case.

The third case, which I pattern after some of the proposals Jesse Jackson made during the primaries, goes in a different direction. It freezes defense in nominal terms, substantially reducing its share of GNP, and cuts consumption by the nonpoor, or, more precisely, the rich. It increases expenditures for health, education, and assistance to the poor. It also increases somewhat the share of the GNP going to investment but less than in either the first or second case (*see table* 2).

In budget terms, the first and second cases are more difficult than the third to achieve, because they require more shifts from the distribution of output projected by CBO's baseline budget. In a nutshell, both the first and second cases require shifting a little more than 3 percent of GNP from health care and consumption by the nonpoor to defense and investment. Because of its emphasis on investment, the second case requires a federal budget surplus equal to 1.3 percent of GNP in 1993, compared with a deficit of 1.9 percent projected in the baseline budget. Even the first case, which also calls for greater defense spending, requires a surplus equal to 0.3 percent of GNP.

If we translate these percentages into 1993 dollars, the numbers look terribly forbidding. That is because we are not used to thinking about an economy whose GNP will probably be about $6.5 trillion by then.

Basically, the first and second cases require that about $200 billion of 1993 dollars be diverted from health care and consumption by the nonpoor to defense and investment. If we don't know how to increase private saving — and I don't think we do — this amount of money has to be raised from tax increases and expenditure cuts that do not impinge on the high-priority items, which are defense, education, provision for the poor, and federal investment. Two questions will be raised immediately — one economic, the other political.

The economic question is whether this amount of tax increase and revenue reduction could be achieved without seriously damaging incentive and efficiency. I believe that the answer is "yes," and I have tested that by drawing up a list of steps that would yield the $200 billion with economic effects that are probably good rather than bad. The steps include taxing employer-paid health insurance as income, eliminating the deductibility of state and local taxes in the federal income tax, raising premiums to cover 50 percent of the cost of Medicare Supplementary Medical Insurance, eliminating agricultural price supports, increasing the motor fuel tax, and similar items (*see table* 3). The point to recognize about the claims that taxes cannot be raised without adverse effects is that the tax code now contains many exclusions that are economically distorting.

"Undoubtedly, neither the president nor Congress will like this proposal very much. It would require them to be more explicit about their aims, to argue about the connection between the ends they espouse and the means they propose, and to recognize the limits of what the economy can stand."

Merely to list such items, however, is to draw the response that their enactment is politically impossible. The tax privileges and subsidies are there because someone wants them quite badly. As things stand, the chance of removing them is slight. But the point of this whole exercise is to change the way things stand and the way people look at them. Decisionmakers and the public must be made to confront their real choices.

Would you rather retain the last 3 percent of GNP that an already affluent and abundantly doctored and dosed majority of the American population consumes or devote that 3 percent to improving the national defense and future economic growth? That is a legitimate and debatable question. If the politicians and the people, having faced and debated such questions, give answers different from mine, I cannot complain. My purpose is not to answer such questions but to get them raised and discussed. Talking about them head-on is the only way we will learn to make good use of the enormous income the American economy generates.