The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper by

Richard A. Musgrave
recipient of the 1981 award

Fiscal Functions: Order and Politics

delivered September 17, 1981

Southwestern At Memphis
host college of the Award

THE FRANK E. SEIDMAN DISTINGUISHED AWARD IN POLITICAL ECONOMY

The Frank E. Seidman Distinguished Award in Political Economy was established in memory of Frank E. Seidman by Mr. and Mrs. P.K. Seidman. The host college for the Award is Southwestern At Memphis, a liberal arts college established in 1848. An honorarium of ten thousand dollars will be given to an economist who has distinguished himself or herself internationally by contributing, in the judgment of his or her peers, to the advancement of economic thought along interdisciplinary lines and to its implementation through public policy.

The purpose of the Award is to recognize and encourage economists who are attempting to extend their work into the interdependent areas of the other social sciences. The Award is established with the expectation that social welfare will be advanced when proper cognizance is given to environmental and institutional influences upon the economic behavior of individuals and groups. The basis for evaluation will encompass both the synthesis of existing thought in political economy and the pathbreaking development of new concepts.

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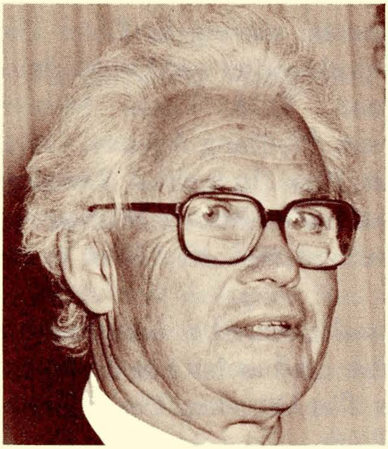

RICHARD A. MUSGRAVE
Recipient of the Eighth Annual Frank E. Seidman Distinguished Award in Political Economy

Memphis, Tennessee, September 17, 1981

Dr. Musgrave has had a career which embraces the academic, publishing and government arenas.

Among his many positions, Dr. Musgrave was an economist, Division of Research Board of Governors of the Federal Reserve System; and a professor of economics, political economics and public affairs at the University of Michigan, Johns Hopkins University, Princeton University and the University of California, Berkeley.

Dr. Musgrave was a Fulbright Professor in Frankfurt, Germany and visiting Professor, Massachusetts Institute of Technology.

A native of Koenigstein, Germany, Dr. Musgrave studied at Munich University, Exeter College, England, Heidelberg University, the University of Rochester and Harvard University. He received his Diplom Volkswirt from Heidelberg in 1933 and both his M.A. and Ph.D. degrees in Economics from Harvard University in 1936 and 1937 respectively.

Over the years, he has been an economic adviser to a number of foreign governments, serving as Chief Economist, International Bank for Reconstruction and Development Mission to Colombia; Co-chairman, ECA Fiscal Mission to Germany; Economic Consultant, Planning Agency, Government of Japan; Consultant, Puerto Rico Industrial Development Company; Economic Consultant with Robert Nathan Associates in Seoul, Korea, and a consultant with that firm to the Government of Burma.

Dr. Musgrave has also served as consultant to the Tax Reform Commission, Taiwan; and as tax consultant to the Government of Nassau. He was also Director, Fiscal Reform Mission to the Government of Bolivia.

He is also president of the International Seminar in Public Economics.

A distinguished author and contributor to leading international journals and periodicals, Dr. Musgrave was for several years, editor of the influential Quarterly Journal of Economics.

He retired this year as H. H. Burbank Professor of Political Economy at Harvard University and will be adjunct Professor at the University of California, Santa Cruz. He is also presently consultant to the Inter-American Development Bank.

Defining his philosophy of political economy, Dr. Musgrave said, "In the introduction to my book, 'Theory of Public Finance', published in 1958, I wrote, 'Intelligent conduct of government is at the heart of democracy. It requires an understanding of the economic relations involved; and the economist, by aiding in this understanding, may hope to contribute to a better society. This is why the field of public finance has seemed of particular interest to me; and this is why my interest in the field has been motivated by a search for the good society, no less than by scientific curiosity.' That concept continues to motivate my work."

With regard to the current economic scene Dr. Musgrave stated, "The President has said that government cannot solve our problems, but the government is our problem. I disagree. Ours is a mixed economy, with essential inputs from both the public and private sectors. Of course, public policy, like all other activities, should be improved. But to discredit the public sector is to undermine our democratic society."

FISCAL FUNCTIONS: ORDER AND POLITICS

Address by

Richard A. Musgrave

It is not surprising and is indeed appropriate that fiscal policy, on both its tax and expenditure sides, should be among the most controversial of policy issues. The fiscal process, as much as any other democratic institution occupies the middle ground between anarchy and absolute rule. It provides the forum on which interest groups and ideologies may clash without resort to the barricades, and on which compromise and cooperation may be sought. Located at the center of dispute, the budget process can hardly be expected to function neatly and without error if only because it is created by the same conflicting interests which it must reconcile. Yet, an orderly working of that process is essential to the conduct of public affairs and for this its multiple objectives must be understood.

Over the years, these objectives and their interaction have been central to my thinking on fiscal policy. My essential proposition, first made 25 years ago, was that budget policy involves multiple goals, including provision for social goods, adjustment in the distribution of income and stability with growth.[1] I then argued that policy mixes may be developed which can meet these objectives together and without conflict, while failure to separate them involves conflict and poor policy design. At a time when there is a flood of proposals, frequently arbitrary, for constraining fiscal action, it may be well to review these propositions and to see what remedies emerge.

Provision for Social Goods

The classical and still central function of budget policy is to provide for certain goods and services which, by their very nature, cannot be provided for efficiently through the market.

[1] See R.A. Musgrave, *The Theory of Public Finance*, New York: McGraw-Hill, 1959, Chapters 1 and 2.

The very logic of the market system requires that benefits and costs are internalized and accounted for by what buyers pay and suppliers charge. Where these conditions are not met and externalities occur, market failure results. The extreme case is that of social goods, i.e. goods which once provided are available to all potential consumers in equal amount and can be used by A and B without interfering with their use by C and D. Because of this it is efficient to make benefits available to all and free of direct charge. But given free availability, the individual consumer has no occasion to purchase such services. Rather, the individual will act as a free rider and rely on what is provided to all. This becomes a zero-sum game since without buyers there will be no sellers either. A political process is needed to provide for such goods.[2]

Let us look closely at what this process does or does not imply. The issue, to begin with, is not one of public versus private production or ownership of resources. National defense is provided for through the budget, but military hardware may be purchased from private industry. Street cleaning is paid for by the town, but may be contracted out to a private firm. The issue of public provision, therefore, is not one of private enterprise versus socialist organization. Moreover, the provision of public goods is useful to consumers in the same way as is their purchase of private goods. Peoples' preference maps include backyards as well as public parks and there is no deep psychological difference in their wanting one or the other. Provision for social goods, therefore, fits perfectly well into an individualistic view of consumer demand. The efficient scope of their provision thus becomes a function of factors such as consumer tastes, demography, technology and the level of income. It should not be set by political ideology. Invention of the automobile, to illustrate, called for road construction, thereby expanding the need for budgetary provision. This side effect may have seemed

[2]My concern is with the issues involved in the practical provision of social goods and not with the implications of their non-rivalness characteristics for the efficiency conditions of theoretical welfare economics. I also pass over another reason for public provision, i.e. a situation where exclusion, though desirable, is not feasible. For further discussion, see R.A. and P.B. Musgrave, *Public Finance in Theory and Practice*, 3d ed., New York: McGraw-Hill, 1980, Chapter 3.

pleasing to liberals and unfortunate to conservatives, but their preferences for driving should have nothing to do with this. The conservative may love to travel while the liberal may like to stay at home.

What is involved in public provision is the need for a mechanism by which individual preferences for social goods come to be revealed and payments are made to defray the cost. For private goods, this dual objective is met by forcing consumers to bid for what they want, thereby revealing their preferences; and by paying in line with their bids, thereby refunding the suppliers for their costs. The market serves as an auction system and thus accomplishes both objectives. The problem is how to create an analogue for social goods in the form of a political process. Ideally, government would solicit taxpayers to enquire what social goods they are willing to pay for, invite corresponding payments, and then provide accordingly. This, however, would be self-defeating since, acting as free riders, taxpayers would tend to understate their true evaluation. The essential problem, therefore, is to find a mechanism by which taxpayers are induced to reveal their true preferences. This is accomplished, albeit in an imperfect fashion, by using a voting system. Knowing that the outcome of the vote will be mandatory, taxpayers will find it in their interest to vote so as to have the outcome conform with their desires.

The question is how best to implement this process of choice. Two major issues are involved, one being the voting rule and the other how issues are defined. Regarding voting rules, I only note that any practicable system with mandatory acceptance of the outcome will fail to satisfy everyone concerned. Short of the extreme case of an unanimity rule, a dissatisfied minority will remain. As protection of minority interests is strengthened by requiring a larger majority, its extension also blocks the extent to which majority wishes can be served. The problem is one of balance and I see little reason for deviating from the customary use of a simple majority rule. While some have argued that this rule is inherently biased towards over-expansion of social goods, I question this proposition.[3] Nor do the events of 1981 seem to

[3]See R.A. Musgrave, "Leviathan Cometh: Or Does He?", in H. Ladd and N. Tideman (eds.), *Tax and Expenditure Limitations*, Washington: Urban Institute, 1981.

support it. If there is to be reform of voting rules, the use of plurality as distinct from majority would seem the better direction.

However this may be, let me turn to the second and more fruitful issue of how the voting agenda should be arranged. Common sense tells us that for efficient decisions to be made, tax and expenditure issues should be decided jointly. How can a person decide whether to vote for or against a particular expenditure project without knowing what it will cost him or her? This linkage was recognized long ago by the great Swedish economist, Knut Wicksell, who first addressed this problem almost a hundred years ago.[4] He suggested that tax and expenditure decisions be made jointly, so that voters can decide whether any particular project is worth the tax price which they are asked to pay. This is an eminently sensible proposition but not one that is followed. In practice actual procedure is at the other extreme. Expenditure decisions are made independent of tax votes, or are related only vaguely thereto. As a result, expenditure votes are not cost-conscious, nor are revenue votes benefit-conscious. The composition of the tax structure is determined without reference to the expenditure pattern and new expenditures are voted without specifying who pays. Such is still the case though the Budget Reform Act of 1974 made some progress by requiring an overall budget limit to be set before dealing with specific appropriations.

The key question is how to establish a better nexus between tax and expenditure decisions. The answer clearly is not in earmarking of the traditional type, which assigns a particular tax to a particular expenditure function and lets expenditures vary with whatever that tax may yield. Rather, expenditure votes should be linked to their matching revenue votes when initially made. This may be done by tying various expenditure proposals to the same tax base, such as income, but different slabs of income tax would go to pay for different projects. Since various programs are valued differently by different groups of the population, they would contribute different amount of tax.

[4]See Knut Wicksell, Excerpts of Writings in R.A. Musgrave and A. Peacock (eds.), *Classics in the Theory of Public Finance*, New York: Macmillan, 1958.

To permit such differentiation, suppose that appropriations were reorganized into a small number of committees, say five or so, with each responsible for public provision in a major program area, including both the expenditure and tax sides of their programs. Each committee might then determine its claim on the income base, or it might be given a base suitable as a proxy for the benefits generated by the particular service area. Thus defense might be financed by a wealth tax, transportation by a gasoline tax, development by a value-added tax and so forth. In this way only those concerned with the potential benefit would enter into the vote, e.g. drivers would vote on an automotive tax to finance highways, while non-drivers would be indifferent. If instead the tax was assessed in line with income, non-drivers would vote nay, thereby blocking the wishes of the drivers.

I am aware that these thoughts involve a drastic departure from accepted standards of fiscal procedure. Breaking up the budget into components would seem to contradict the central principle of good budgeting, i.e. that there should be a simultaneous equating at the margin of the return obtained from <u>all</u> projects. True enough, but on closer consideration this principle — as indeed most accepted fiscal theory — applies to a setting in which preferences and the valuation of projects are known to the budgeteer.[5] But it is of little use in a setting where preferences are unknown and must be determined before an allocation can occur. Similarly, my suggestions run counter to the widely accepted view (reflected also in my own writings on the good tax system) that there should be an equitable, ability-to-pay based distribution of the <u>entire</u> tax bill, and not of its fragments. Once more, this equity rule is appropriate to the financing of public services in a setting in which expenditures are determined independent of the revenue pattern. Outlays are treated as if they were reparation payments to the moon and taxation is viewed simply as a necessary reduction in the income left for private use. At the same time, this equity rule does not meet a situation in which the need for preference revelation necessitates a linkage between both sides of the budget, i.e. where revenue

[5]This observation holds for modern social good theory as well as for that based on the older view of welfare economics.

needed to finance public services must be drawn from consumers in line with the benefits which they receive.

The principle that the cost of expenditures should be assigned when the project is voted upon, by its very nature also suggests the requirement of a balanced budget. Deficit finance tends to understate the cost while surplus finance tends to overstate it. There is however an important exception to this rule. Where the expenditures in question involve the provision of capital goods, loan finance is in order, as this permits future beneficiaries to share in the cost. This is an important consideration since a substantial part of public outlays on goods and services are in this group. A further qualification will be noted presently when the stabilization aspect of budget policy is considered.

While these thoughts fall short of offering a workable solution, they at least point in the direction of constructive budget reform. This must be a reform designed to secure a better reflection of taxpayer preferences, with emphasis on the composition as well as the level of the budget, and without prejudice as to whether the budget is too large or too small. This view of reform differs sharply from current drives for constitutional limitation and other arbitrary barriers to free fiscal choice. These proposals are based on the contention that there is an inherent flaw in the democratic process, a flaw which causes the budget to be over-expanded and calls for correction by wiser minds. I find this a questionable hypothesis and insufficiently proven to provide an unbiased basis for budgetary reform.[6] Once more, recent events show that the democratic process may involve a budget policy which, though jerky, is by no means unidirectional.

Adjusting Income Distribution

My preceding argument has been that taxation, used as an instrument for preference revelation, leads to a concept of taxation in line with benefits received. Such taxes may be expected to rise with income as higher-income consumers will value a common level of public services, say defense, more highly than low-income consumers. But this leaves open the question

[6] See note 3 above.

whether the benefit tax will rise less, as, or more rapidly than income. As a result, the burden distribution may prove regressive, proportional or progressive, depending on the price- and income-elasticity of demand for public services. But even if the tax turns out to be progressive, this should not be viewed as reflecting income redistribution. Rather, the benefit tax reflects the prevailing state of distribution and may thus be viewed as distributionally neutral.

At the same time, a benefit approach to the financing of public services is in no way incompatible with supplementation by a distinct set of tax-transfer measures designed to adjust the prevailing state of distribution. Indeed, it may well be argued — as Wicksell did from the outset — that benefit taxation can be considered just and equitable (in addition to being efficient) only if imposed on a just and equitable distribution of income. The argument here is precisely the same as for the pricing of private goods. While a competitive market results in efficient pricing, the outcome is equitable only if the pattern of effective demand which gives rise to such pricing is generated by an equitable distribution of income.

This takes me to the second concern of fiscal policy, which is the state of income distribution. While it is difficult to design an efficient mechanism for the provision of social goods, economic analysis at least offers some guidance in this undertaking. Such is not the case, or less so, when it comes to determining what constitutes the proper state of distribution. Philosophies regarding distributive justice differ, and so do views on the appropriate scope of redistributive policy. On one end of the scale there is John Locke's proposition, grounded in the philosophy of natural law that one is entitled to the fruits of one's labor and that the state must not interfere therewith. Accordingly, no taking by taxation is permitted. Only those taxes are permitted which follow the benefit rule, providing a quid pro quo to the payee. Nozick, in his extension of the Lockean doctrine, even likens redistributive taxation to slavery since the payee is forced to work for the recipient.[7] On the other end of the scale, there is the proposition as recently argued by Rawls, that the accident

[7]See Robert Nozick, *Anarchy, State and Utopia*, New York: Basic Books, 1974.

of birth with its differential endowment of talent, wealth and position, does not establish a legitimate claim of desert.[8] The fruits of superior talent are subject to communal claim and not to personal entitlement, a view also expounded in Edward Bellamy's 19th century vision of an American Utopia.[9] Entitlement rather is to fair and equal treatment, a right held equally by all members of the community. In this setting, the distribution of earnings which results in the market must be adjusted to meet the standard of fairness, so that some degree of redistribution is required. Benefit taxes retain their place in the finance of social goods but the benefit principle ceases to reign as the universal rule of tax equity.

In matters of distributive justice, as elsewhere, polar positions are helpful to clarify issues but soon give way to qualification. Among those who start out with a Lockean view, few would prohibit all redistribution through the political process. While preferring reliance on charity or beneficence, as Adam Smith put it, most will accept governmental support in situations of severe poverty. At some point, appeal to charity yields to minimal rights. Those who begin with the opposite view of common entitlement must accept the fact that the size of the pie varies with the slicing. Short of compulsory labor, the transferor can substitute leisure for income; and since only income can be transferred but not leisure, redistribution in the last resort is conditioned by consent. Society, to paraphrase Karl Marx, may choose to give according to need; but it cannot assure contribution according to ability. Given this fact, even those who would divide a constant pie equally, will accept inequality if the pie is variable. The question is how much. John Rawls in his rule of maxi-min suggests that inequality be accepted to the extent that it permits a higher level of transfers to the bottom of the scale. Taxing the rich according to his rule is appropriate up to the point of maximum revenue but not beyond. A less stringent and more widely held view assigns some social weight to the transferor's loss, thus further limiting the appropriate scope of redistribution.

[8]See John Rawls, *A Theory of Justice*, Cambridge: Harvard University Press, 1972.

[9]See Edward Bellamy, *Looking Backward*, New York: New American Library, 1960, p. 76.

The degree of redistribution which a society chooses to undertake at a given time is conditioned by the prevailing distribution of income and the average income level. But distribution policy also reflects social attitudes and the balance of political power. Attitudes change and so does their legislative outcome. "What they will call the spirit of the time", as Goethe put it "is but the peoples' own design in which the time reflects its image".[10] Much of the growth of the public sector in recent decades has thus taken the form of distribution-oriented programs, reflecting a liberal mood and the power of low-middle income coalitions. Whether this era of the welfare state has now come to an end remains to be seen, but one would not be surprised to find it a self-terminating process. After all, as the level of redistribution rises, so does the number of losers relative to that of gainers, so that the majority available for further action falls. This change in voting balance may be delayed as voting participation at the lower end of the scale rises, but once more this is a terminal process. Moreover, pro and con votes will not divide neatly in line with positions below and above the median income level. Low-income voters who aspire to move up will hesitate to lower their prospects, and demands for redistribution will be dampened by concern, real and induced, for adverse productivity effects.

For any given redistribution target, there is the further question of what instruments should be used to implement it. In the longer run, the most attractive approach is not through redistribution at all, but through labor-market and training policies aimed at raising earning power of the poor. But beyond this, some degree of redistribution is called for and here a tax-transfer scheme offers the most direct approach. Discussed widely in the context of welfare reform a decade ago, this scheme has the advantage of securing the redistribution without interfering with how the funds are used by the recipient.[11]

[10] Author's translation, *Faust*, Part I. "Was ihr den Geist der Zeiten heisst, das ist im Grund der Herren eigner Geist in dem die Zeiten sich bespiegeln."

[11] Recent discussion in the optimal theory of taxation holds that deadweight loss may be reduced by using an optimal mix of commodity taxes and subsidies, rather than a mechanism of income taxes and transfers. This, however, does not at this stage appear to be a practical scheme.

The combination of a positive-negative income tax has the further advantage that distributional adjustments are made without interfering with the provision of social goods. People who favor redistribution and prefer private goods would not have to vote for social goods, hoping that their financing will be more progressive than justified on benefit grounds. Others, who like public goods but not redistribution, would not have to oppose a larger budget fearing that it would involve such finance. In the historical perspective the first of these distortions reigned in the earlier stages of the welfare state. A levelling of income, which could not have been achieved politically via a tax-transfer scheme, could be achieved via progressive financing of an expanded provision for social goods. Under changed conditions, the second distortion now moves into action, with reduction of public services an excuse for cutting back on progressive taxation. Clearly, elimination of both biases would make for a more efficient conduct of fiscal affairs, and separation of the tax-transfer scheme from benefit-financed provision of social goods would contribute thereto. There would, in short, be two sets of taxes, one to finance public services and the other (in the form of a positive-negative income tax) to adjust distribution. Their collection could be coordinated, especially if assessed on the same base, but they would differ in pattern.

With a tax-transfer scheme the most efficient instrument for fiscal redistribution, how can one explain that much of fiscal redistribution over recent decades has been through services in kind, such as health facilities, housing, food stamps or school lunches? Indeed, the only major cash transfers have been AFDC and the redistributive component of social security. In large degree, this prevalence of in-kind redistribution reflects the desire of payors to determine how the funds should be spent by payees. Payors agree to vote for redistributive programs if they retain control but not otherwise. Payees would rather have their funds without constraint but prefer conditional grants to no grants at all. There is nothing wrong with this outcome if seen from a Lockean entitlement position. The charitable donor can set the conditions of his gift and the donee remains free to accept or not. "Einem geschenkten Gaul", so a German saying goes, "sieht man nicht in's Maul". The same holds for a modified Lockean view where entitlement to earnings is valid but subject to modification by majority rule. The transferor remains free to vote yea on conditional but nay on cash grants. Reliance on in-kind transfers, on the other hand, is inappropriate if seen from a common entitlement perspective, where the recipient has a right to support, independent of paternalistic imposition by high earners. But payor preference has not been the only factor in the growth of in-kind support. Such support enjoys the backing of supplying industries, e.g. agricultural support for food stamps or construction industry support for low-cost housing. Such support distorts the decision process since it is not available for cash transfers the outlay of which is diffused more widely.

Given the important role of in-kind transfers, the fiscal process encounters another source of confusion, now between (1) the general provision for public services and their financing by benefit-type taxes, and (2) services provided as transfers in-kind and properly financed as part of a progressive tax-transfer scheme. Indeed, it may not be easy to determine how particular provisions should be classified. Transfers in-kind, to be sure, may involve either social or private goods, while other provision involves social goods only. But social goods may not be equally important to all income groups. Suppose a particular social good is valued more highly by low-income earners so that its benefit finance may call for a regressive rate. Yet, finance by a progressive tax would turn such provision into redistribution in-kind. Once more, we have to recognize that such difficulties remain even though I can offer no ready resolution thereof.

Macro Aspects of Fiscal Policy

I now turn to the final concern of fiscal policy, its relation to employment, inflation and growth. The crucial policy variable in the Keynesian economics of the Great Depression was the magnitude of budget deficit. Full employment would require an adequate level of aggregate demand and, with monetary policy ineffective in the throes of the depression, this would have to be secured through budget policy. More specifically, the necessary increase in demand would have to be generated by a deficit-financed increase in public spending. Powerfully verified by the enormous expansion in economic activity during World War II, the doctrine in the '60s and '70s had to be adjusted to the changed circumstances of inflation. Whereas increased spending had been seen as a means to employment creation, the same logic would now call for reduced spending as a means to cutting demand.

There is a fallacy in both positions. Given the exclusive emphasis of early Keynesian doctrine on government spending, expansionary policy had the by-product of increasing the size of the public sector. This side effect made fiscal expansion attractive to the liberal position, as did the previously noted nexus between budget size and progressive taxation. This linkage between expansionary demand policy and budget expansion once more was a major factor not only in the depression context of the '30s but well into the '60s. Replayed in reverse, the later inflation setting came to call for reliance on expenditure cuts, a reverse bias now appealing to a conservative desire to reduce the size of the public sector.

Efficient conduct of public policy should and could avoid either bias. Measures to expand or restrain aggregate demand should be borne evenly by both the public and private sector and not place a disproportionate share on the former. For this purpose, primary reliance need be placed on tax rather than expenditure adjustments. To illustrate, suppose that federal expenditures account for $20 out of a GNP of $100, taxes take $20 and private outlays are $80. If there is to be a 10 percent reduction in total outlays pro-rated over both sectors, public expenditures should be cut from $20 to $18 and private outlays from $80 to $72. Assuming for simplicity's sake that taxes reduce private expenditures on a one-to-one basis, taxes must be increased from $20 to $28. Thus a 40 percent increase in tax rates is needed, as compared with an expenditure cut of 10 percent. The differential is even larger if we allow for the fact that taxes are not reflected fully in reduced private outlay. A corresponding argument holds for expansionary action with the appropriate expenditure increase substantially below the rate of tax cut.

Returning to my theme of multiple policy instruments, a third set of adjustments is thus called for. This takes the form of a tax or transfer which would lower or raise private income in proportional fashion, while being neutral with regard to both the provision for social goods and the distribution of income. A mechanism of this sort is in line with proposals made repeatedly over the years to grant executive authority for countercyclical tax changes to be made in a more or less neutral and across-the-board fashion. By separating stabilization-oriented tax changes from the provision of public services and redistribution, fiscal policy may serve the objectives of stabilization and do so without interference with other aspects of budget. The previously noted rule that the public service budget should be balanced (except for loan finance of capital outlays) is thus rendered compatible with the rule that the budget as a whole may have to be in deficit or surplus, depending on the requirements of stabilization policy. These in turn are set by the condition of the economy and the extent to which the necessary control of aggregate demand can be achieved through the means of monetary policy. Unnecessary to say, both have to work in conjunction, but reliance on monetary policy can hardly be so great as to relieve budget policy of this function. A requirement that the overall budget be in balance, therefore, is not compatible with sound economic management, and it would be most unfortunate to have it enshrined in the constitution.[12]

Apart from discretionary changes in tax and expenditure levels, allowance must be made for automatic responses of the fiscal system to changes in economic activity. Over the years, automatic revenue responses have come to be viewed as a desirable stabilizing factor. As GNP falls, so will tax revenue thereby creating a deficit which in turn cushions the decline. As GNP rises the reverse occurs, thus counteracting inflation. This mechanism fits well into the role of the budget as a stabilization device provided that fluctuations are around a full employment level and that automatic changes in revenue are not translated into corresponding changes in spending. If they result in such changes, as may well be the case, the stabilizing effect is voided and the balance of public and private shares in GNP is disturbed.

These considerations are especially troublesome in the context of inflation, where the automatic revenue response of the

[12] The major constitutional amendment now under consideration by Congress (Senate Joint Resolution 58) requires that planned outlays and receipts be in balance unless a deficit is passed by a three-fifth vote of the whole number of both houses.

income tax is accentuated by bracket creep. Revenue not only rises in proportion to the tax base but at a faster rate, since the nominal increase in incomes pushes given real incomes into higher rate brackets. This has two effects. For one thing, the distribution of the tax burden undergoes hidden and arbitrary change since the degree of bracket creep differs over various parts of the income scale. For another, as revenue increases in real terms so that additional expenditures can be made, over and above what is needed to keep up with prices, without requiring explicit voter consent through raising tax rates. Or, the built-in excess gain permits the legislature to please voters by reducing tax rates while maintaining services at their real level. Both consequences distort efficient policy decisions and may be avoided by indexing rate brackets. With indexing, now scheduled for 1985, revenue will increase in line with prices only, so that tax liabilities and services willl remain constant in real terms. If inflation is to be checked, tax rates will then have to be raised in explicit fashion, or they will have to be reduced when expansion is needed.

All this relates to fiscal policy as an instrument for controlling aggregate demand. This role must be performed in conjunction with monetary policy. Both are important, and the bitter debate between Keynesians and monetarists as to which matters more is not very helpful. But as has become apparent in recent years, the control of aggregate demand, whether through fiscal or monetary tools, is hardly adequate to deal with the problem. In a setting of stagflation, raising aggregate demand may add to inflation rather than increase employment, while reducing demand may lower employment rather than check inflation. An environment must be created in which competing groups, unions and large firms, can be induced to stay within non-inflationary wage and price demands. Such schemes may involve the use of wage-price guidelines or of fiscal tools. These may take the form of income-tax rebates to workers payable if wages are outrun by inflation, or penalty taxes on firms which grant inflationary wage increases. This opens new conflicts with traditional fiscal functions, but we shall not pursue them here.

Rather, I turn to the recently prominent concern with "supply-side economics". This new doctrine rejects the view, outlined above, that restriction of inflation should be through increased taxation. Raising taxes, so the argument goes, will reduce incentives thereby lowering output and increasing inflation. On the contrary, taxes should be cut to stimulate output, thereby checking inflation. There are two difficulties with that proposition. Seen in the context of shortrun stabilization, it is unrealistic to expect significant supply-side effects to occur. Such effects take time to develop. Moreover, as J. B. Say once taught us, additional production, whether for consumption or investment goods, also generates additional income. Thus additional output induced by tax reduction leaves excess demand unaffected. What is left is the additional demand due to the tax cut itself. However the Administration's plan also provides for an offsetting budget cut, so that overall expenditures are largely unchanged as is the inflation picture. Responsibility for inflation control is left with monetary policy. As far as fiscal results are concerned, the major outcome is in the cutback of public programs. Civil expenditures in particular are caught in the vise of tax reduction and rising defense outlays. Thus the bias of earlier fiscal policy is being replayed in reverse and with a vengeance.

While the supply-side doctrine has little merit for the short-run control of stabilization, it does bear on the longer run rate of economic growth. As economists have been well aware, growth policy not only calls for a rising level of demand, adequate to sustain a growing full employment output. This is an essential ingredient, but concern must also be with the rate of productivity growth. Such growth is desirable as it provides for a rising standard of living; and by permitting non-inflationary wage increases, it also helps to check inflation. Growth in turn requires capital formation and a mix of stabilization policy which favors it. In line with this, the traditional "neo-classical" recipe has called for a combination of tight budget to restrict consumption with easy money to provide cheap credit for investment. According to our earlier argument, the necessary degree of fiscal tightness could be secured by raising taxes without having to depress the provision of public services unduly. But if higher taxes required by the tight budget rule should depress economic incentives, the growth objective would be frustrated. Allowance for adverse productivity effects could thus shift the burden of fiscal tightness to the expenditure side of the budget, thereby curtailing provision for social goods and for distributional adjustments. With public capital formation, such as investment in human resources, an essential ingredient of growth, the pressure is on social goods of the consumption type. To recognize this problem one need not hold that consumption of social goods is less useful than consumption of private goods. Rather, the difference arises because social goods become available without direct charge and thus does not leave the consumer with an incentive to earn income in order to obtain them.

Resulting effects on economic incentives — work, saving and investment — will depend greatly on what taxes are used.[13] Taxes unrelated to economic activity such as a head tax may increase effort but they are hardly acceptable on other grounds. Disincentives will be greater under a progressive income tax although it may be called for on other grounds. Even benefit-type taxes used to finance social goods will not by-pass the free-rider problem. Potential conflict is sharpened as one turns to the redistribution function of fiscal policy, where the tax pattern is of the essence and progressive rates become unavoidable. Saving and investment decisions in the market economy depend largely on high-income recipients, so that the constraints on budgetary action are even greater.

While the existence of a potential incentive problem is evident, the magnitude of deterring effects are an empirical question and one about which much is to be learned. Recent studies suggest that effects on work effort are slight, especially for primary earners. Effects on saving are controversial and those on investment are even more difficult to measure. Much depends on how taxable income is defined and on how losses are treated. Moreover, the issue is not only one of fiscal economics but also of fiscal politics. Growth considerations not only impose a legitimate constraint on the tax structure but

[13] In line with the supply-side doctrine, the discussion is framed here in terms of deterring effects on factor supply. More precisely, economic theory views the problem in terms of resulting deadweight loss, a loss which may result whether supply falls or rises. According to this more sophisticated view, the problem is not one of encouraging growth but of maintaining neutrality in taxation effects.

may also be used or abused to oppose equity goals of progressive taxation. Constructive tax reform, confronted with this controversy, should be directed at securing growth incentives in a way which will minimize interference with distributional objectives.

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What can we conclude from this review of fiscal objectives, instruments and conflicts? Is it that bringing order out of chaos is an utopian undertaking, a forlorn task which had best be abandoned? I hope not. For one thing, even utopias have their merit especially if accompanied by an awareness of the difficulties that bar their easy realization. For another, much can be gained, even if not all resolved, by setting the framework for an orderly approach. The private sector has its problems and imperfections and so does the public. Both sectors have an essential role in our mixed economic system. Some may view this as an unfortunate necessity given by the exigencies of social affairs; but I would rather suggest that this dualism adds to the richness of social intercourse in a democratic society. A framework for budget policy, both democratic and efficient, is thus well worth reflection. It is so especially at a time when the call is for arbitrary restraint which may well weaken rather than improve the public sector.

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