The Roots of the Public Sector Fiscal Crisis

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Introduction

The news is filled with stories of fiscal crises in state and local governments. Large tax increases and public service cuts are being reluctantly adopted by governors and legislators who are required to balance their budgets. Meanwhile, domestic spending by the national government continues to be constrained in the face of high budget deficits, the 1990-91 recession, and the general stagnation of the economy.

The public sector is in "crisis" on at least two levels. On the surface, there is a financial crisis in the need for governments to make large, painful budgetary adjustments in a brief period of time. There is also a deeper crisis in the sense that we are not getting what many people expect from governments as a result of how they are coping with the financial crisis.

This report takes the view that government has three jobs: 1) to provide households with an adequate supply of high quality goods and services which cannot easily be obtained otherwise: 2) to promote economic growth, and 3) to take steps to alleviate growing income inequality. From the standpoint of this report, the fiscal crisis stems from major setbacks to the fulfillment of these objectives. The nation faces an undersupply of public services, government efforts to promote economic growth have withered, and income inequality is growing.

This report rebuts the common view that the public sector's current difficulty in reconciling revenue and expenditure is a consequence of the recession -- thus this difficulty will disappear with recovery -- or of uncontrolled spending increases. To the contrary, the roots of the crisis can be found in long-term economic trends, federal policy bungling in the 1980s, be found in long-term economic trends, federal policy bungling in the 1980s, and other developments extraneous to the limited extent of growth in domestic spending.[1] While improvements in public sector efficiency and in setting priorities are feasible and would be of major assistance in alleviating current difficulties, substantial room for expansion in the role of government can also be found. More specifically, our main findings are:

1. In general the U.S. domestic public sector is small in comparison to those in other advanced industrial countries.
2. Federal taxes increased in the 1980s but federal spending increased to a greater extent, giving rise to high federal budget deficits. The relatively higher rate of spending was concentrated in <u>military</u> outlays and interest payments. There is no parallel growth in the domestic area. (The growth of Social Security spending was matched by payroll tax revenue, so Social Security and the taxes which finance it did not increase the deficit; they reduced it.[2])
3. In the 1980s federal deficits gave rise to inefficient and arbitrary constraints on federal domestic spending, including cuts in grants-in-aid and the passing-along of domestic responsibilities (without funds) to state and local governments. No real budget discipline or considered reform of federal-state-local relations was accomplished.[3]

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[1] A statement of this view is in Pierce (1991). Documentation can be found in Gold (1990).

[2] A similar view was put forward in McIntyre (1990. 1991).

[3] "New Federalism" is the name applied by President Ronald Reagan, and ten years earlier by President Richard Nixon. to proposals for radical decentralization of government. See Sawicky (1991).

4. At the state and local level, the fiscal crisis was brought on by federal policy and by outside pressures on states such. as the stagnation of the general economy, rapidly-rising health care costs, and poverty.
5. The public sector needs a major overhaul and expansion for it to fulfill its proper role in meeting the nation's needs today and in the future. Its proper role goes beyond bringing traditional public services up to adequate levels. Deliberate steps must be taken to improve the productivity of our private sector workforce and to augment our ability to compete in international markets.

Where Are We?

As this is being written, most state and local governments were finishing up their most difficult budget deliberations since the recession-ridden early 1980s. In the midst of the current recession, they have been forced to cut public services or increase taxes. Appeals to the federal government were met with silence and inaction.

The Federal Government: Dead in the Water

Last fall's budget deal between the Democratic-dominated Congress and the Republican President culminated seven years of supposed efforts to control the federal deficit. The new arrangements reflect an agreement to ignore domestic problems in the U.S. for the next five years.

Actual reduction of the deficit accomplished by the deal is modest. The Congressional Budget Office projects this year's (Fiscal 1991) budget deficit, excluding the savings and loan bailout and the Gulf War contributions, at $250 billion. Five years from now, in Fiscal Year 1996, that same number is projected to be $200 billion.[4] So the reward for five years of paralysis and austerity under the latest, relatively optimistic economic assumptions (given our weak economy) will be persistent deficits in excess of $200 billion that hang over the budget process and stifle any new initiatives for meeting the nation's needs.

[4] Clearly the 1996 figure will be a much smaller share of GNP than the 1991 figure. However, for this to have any significance, you must believe that deficit reduction increases private investment in the U.S. by reducing the rate of interest. The latter proposition is highly debatable. with evidence providing a very mixed picture (Eisner. 1990). From this standpoint, the deficit is a political problem, not an economic problem.

If the budget deal fails to eliminate the deficit, then what is its real purpose? "Deficit Reduction" is really a pretext for placing limits on taxes and spending. Such limits are unnecessary: one can have high deficits with low levels of spending if the gap between revenue and spending is great, whereas one can have low deficits with high spending levels if we pay as we go. These limits on taxes and spending block national initiatives aimed at doing anything more or new in the domestic arena -- a strait-jacket which Congress bought and put on voluntarily, and which Congress can remove at any time.

The actual irrelevance of deficit reduction becomes clear if we look at the rules governing the budget. Under the new rules, if something causes the projected deficits to increase, such as an economic downturn or another special U.S. military operation, nothing else happens. There is no mandatory measure to offset the increase in the deficit.

On the other hand, if Congress determines that a new problem or an emergency requires action which causes spending to exceed agreed-upon "baseline" levels -- such as a move to provide extended benefits under unemployment insurance -- a mandatory measure is triggered: Congress must find something else to cut, or some tax to raise. For many kinds of spending, moreover, the tax option is absolutely forbidden. Any spending increase must be offset by a decrease somewhere else.[5]

[5]To some extent, there are effective political walls between shifts in spending because Congressional committees are customarily accorded an almost proprietary control over "their" money. If the committee's jurisdiction is limited to space exploration and housing, for instance, then an improvement in one area comes at the cost of a cut in the other. For a microscopic examination of the budget process over the past ten years, see White and Wildavsky (1989).

<u>The States and Cities: Treading Water</u>

The paralysis of the federal government creates collateral damage in state and local governments. National needs that are neglected or ignored fall into the laps of the states. Unlike almost all other central governments in major industrialized countries, the U.S. federal government has marked out for itself a particularly limited role in the nation's affairs. Just as the problems of international economic competition grow more acute for the U.S., the costs of neglect of public needs are starting to hit home.

Besides fulfilling traditionally local responsibilities in the fields of law enforcement, sanitation, recreation, public education, and local transportation, state and local governments have been forced to venture into areas typically served by central governments in other countries. These include industrial policy, economic development, certain forms of infrastructure,[6] poverty and inequality, health care, and the environment. Meanwhile, the nations of Western Europe are moving in the other direction: forming a federation that will be able to deal with common problems more effectively than each country could on its own.

[6]Infrastructure refers to such public facilities as roads; bridges, sewer systems, electric utility networks, mass transit. etc. Infrastructure is the most tangible type of public capital. Other types include the level of education attained by of the workforce or the extent of scientific knowledge attained.

How Did We Get Here?

Trends in Total Public Spending

We are constantly bombarded with explosive numbers purporting to describe what has happened in the public sector. These data always seem to suggest that government growth is out of control; everything seems to have been growing since time immemorial. But frequently these numbers only reflect the parallel growth of the population, the economy, the workforce, etc.

Spending by all governments in the U.S. has indeed increased throughout the 20th Century.[7] If we are going to look at the size of government we should include all governments in the U.S. -- federal, state, and local. All governments are related parts of a system: money flows from one government to another, one government issues orders which another government must carry out, and what one government does in the area of programs affects what another might do. Most domestic government functions are shared in some measure by multiple levels of government in the U.S. From 1929 to 1989, level of spending on domestic government functions has increased from $142 billion to over $2,115 billion (both in 1990 dollars). Of what does this growth consist? The pie chart in Figure 1 shows the composition of spending in 1989.[8]

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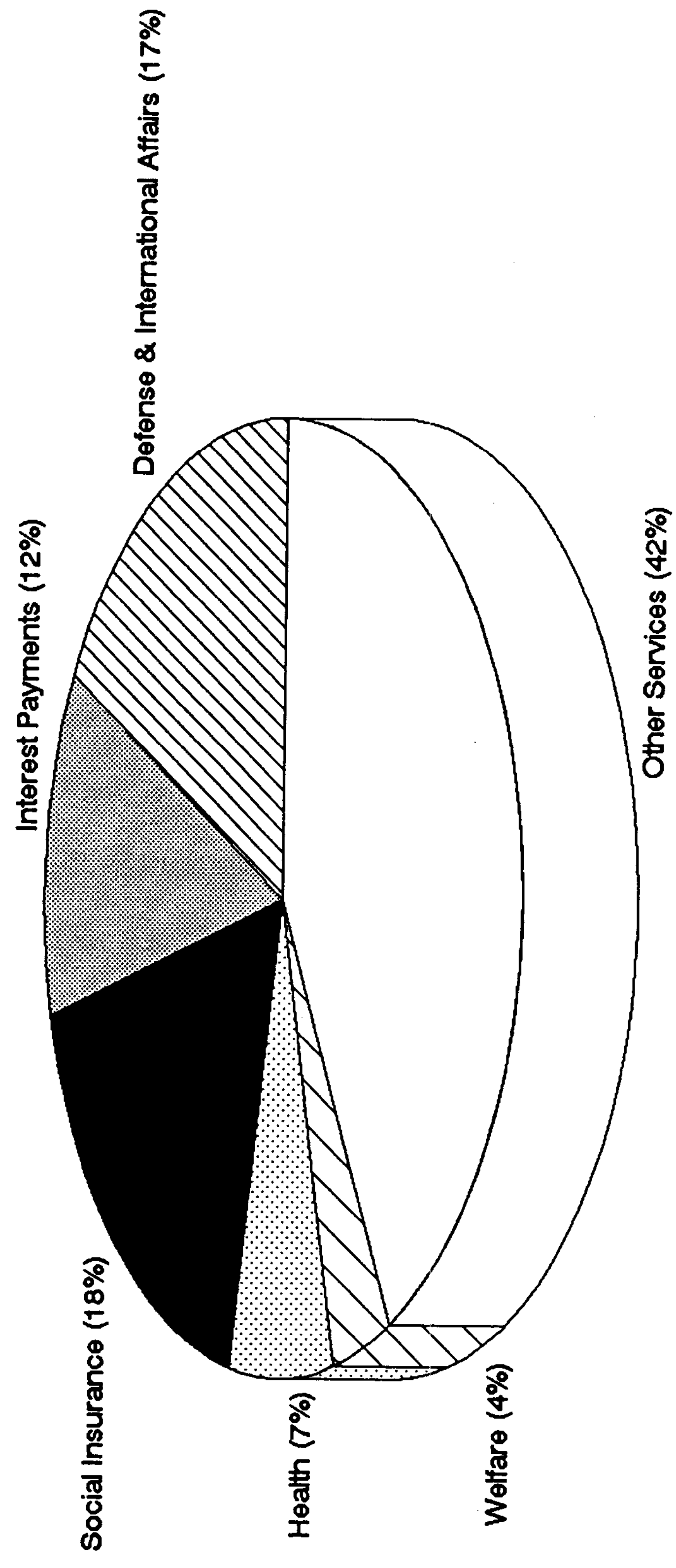
[7]To draw an accurate picture of spending. one must reckon with inflation. Spending increases to some extent purely because the prices of all things in the economy increase. It doesn't mean that we are getting more services or paying more taxes. If we are interested in spending from the standpoint of what citizens receive. then spending needs to be adjusted for inflation in the cost of providing the service(s) in question. For instance. if health care spending increases by 100 percent and the cost of health care increases by 100 percent, the real increase in health care received by taxpayers is zero.

[8]Some minor alterations in Bureau of the Census categories of spending are employed in this study. Total spending as discussed here does not include the operating expenditures of state and local enterprises that generally run a profit -- utilities and liquor stores. On the

Figure 1
The Composition of Total Government Spending, 1989



Source: Census of Governments.

other hand, because transit utilities are identical in functional terms to other "on-budget" transportation spending by state and local governments, and because in aggregate they run deficits, subsidies to these enterprises are included as general state and local expenditure. For the same reason, all Federal subsidies to enterprises are counted as spending. Insofar as the operating expenditures of enterprises at any level are offset by receipts from customers of such enterprises, these expenditures are not included in spending totals.

Similarly, on the revenue side it is only the profits of enterprises that is counted as revenue, not the extent of revenues which offset operating expenditures.

For government functions not classified as enterprises, but which do entail fees and charges, customary Census procedure is observed: operating expenditures are counted in full as spending, and all receipts are counted as revenue.

Starting on the right and moving counter-clockwise, the first slice of the pie to be noted is spending on defense and international affairs, which is almost entirely contained in the federal government. After a great decrease over the twenty-five years following World War II, defense spending leveled off for much of the 1970s, and then enjoyed a large increase of over 60 percent in the 1980s. By 1989 defense and international affairs comprised 17 percent of spending by all governments.

Then we have interest payments on debt owed by all governments. Federal interest payments alone increased even more than defense over the past decade, almost doubling in real terms, and reaching 9 percent of all government spending.

Next we have programs which are classified by the Census Bureau as "social insurance": these include Social Security, Medicare, Workers' Compensation, unemployment insurance, public employees' retirement, and veterans life insurance. Social insurance spending has increased steadily since World War II. In the 1980s, it grew by almost 37 percent, after adjusting for inflation. Some social insurance programs cover risks associated with working, such as unemployment, disability, or injury on the job, so it is natural that they should grow in proportion to the size of the workforce. Social Security provides insurance for workers' retirements and for their survivors in the event of death. Thus as the number of retirees grows, so too should these programs.

The next area on the graph is health spending which excludes Medicare but includes Medicaid[9] and other programs supporting health care provision and hospital operations. Most of the health care spending category benefits people who are not well-insured on the job or by Medicare against health care costs. In terms of the value of benefits, this spending increased in the 1980s by only 5 percent. The very large increase in revenues devoted to this category was due to the skyrocketing prices in the health care industry. That is, more money is being spent to pay health care providers and insurance companies rather than more health care services being provided to households.

Next we have one of the most misunderstood parts of the public budget: welfare. The category represented in the graph includes spending on such social services as day care, foster children, and adoption assistance. It increased slowly over the entire post-war period. The programs subject to greatest criticism -- Food Stamps and AFDC -- enjoyed their greatest growth between 1968 and 1972. Since then these two have not increased from the standpoint of family benefits. Benefits provided under the Food Stamp Program and Aid to Families with Dependent Children was 2 percent of all federal spending in 1990.[10] Spending on other components increased to a greater extent, contributing to an overall 16 percent real growth in this area over 1980-89.

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[9] Medicare is a social insurance program financed by the Federal "FICA" tax. Eligibility for Medicare and Social Security's Old Age, Survivors, and Disability Insurance (OASDI) are linked by the individual's labor earnings history. Medicaid is available for those with little or no income or earnings history who are beneficiaries of the Aid to Families with Dependent Children or Supplemental Security Income program The former is for low-income families with able-bodied parents of working age (usually one-pare& families) with children. The latter is for the blind, disabled, or aged with low income.

[10] Office of Management and Budget (1991): U.S. House of Representatives, (1991).

Finally, the large bottom area is the remainder of public spending for such functions as transportation, parks and recreation, sanitation, housing, community development, education, environmental protection, public safety, social services, the Post Office, etc. The common thread here is that these are resources largely devoted to non-military public goods and services, as opposed to transfer programs." They are the most prominent part of what the public perceives to be the direct and widely-available benefits of paying general taxes.

This final category is central to our analysis. The level of this category relative to GNP remained within one percentage point of its 1961 level of 16.6 percent for the succeeding twenty-eight years. Over the 1980s it increased at close to the same rate as the economy as a whole -- 31.6 percent. Although governments are spending more, the change in composition of spending has meant that the taxpayer has not reaped equivalent tangible benefits from the growth in spending. This is because the addition to general revenues has been devoted to interest payments on the federal debt and to defense. In principle, interest payments are the price for having public spending sooner rather than later, but in the case of the federal government in the U.S., the public spending that was obtained was defense, not additional civilian public services. Thus any perceived increase in tax burden is not accompanied by new spending which makes people better off.

"A "transfer program" is defined as a program whose purpose is to make payments in cash, vouchers (e.g. Food Stamps), or actual goods (e.g., free cheese). The payment differs from a wage in that it is not made in return for any services rendered. Obviously some transfer programs have more political support than others. Social Security is an example Of **one of the most popular transfer programs.**

Social insurance programs enjoy the support of a broad political consensus. Attempts by the Reagan Administration and the Republican Senate Majority in the early 1980s to cut back in this area were met with a sharp political rebuff. Most of the concern over social insurance lies in two issues: a) some dedicated taxes[12] are siphoned off into general revenue: and b) social insurance in the U.S. is too limited -- people are not well-insured against certain risks they face: a good example is the limited extent of protection against catastrophic health care expenses.

The social insurance category may inspire some discontent among younger workers because the future payoff from onerous payroll taxes seems distant and uncertain. So there is some perceived mismatch here between what you pay and what you get at a given point in time. Such sentiments would clearly be aggravated by the increase in income inequality in the 1980s. (For all that, as noted above, the size and growth of these programs and the taxes that finance them do not seem to generate political controversy on the whole. [13])

Any way we measure it, welfare outside of the health care area is too small a portion of total government spending to be the source of the public sector's fiscal crisis. Much more important is the impoverishment of basic

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[12]Dedicated revenues or taxes are earmarked for some specific spending purpose.

[13]Although social insurance is typically financed by such devices as payroll taxes and these taxes are regressive when considered in isolation, such programs generally maintain a benefits/payment ratio which is progressive. Therefore, the expansion of such programs. besides providing a valuable insurance policy which could not be purchased from a private insurance company, reduces general after-tax income equality. The real crime associated with the payroll tax arises because it is diverted to uses outside the social insurance field. as has been the case in the federal budget for the past few years.

civilian functions which drives a wedge between taxes paid and benefits received. Indeed, the political obsession with welfare has obscured the fact that many civilian public services are essential to the health of the private sector, to the productivity of workers, to the profitability of business firms, and to the commitment to investment and economic growth.[14] If public services are perceived to be primarily about redistribution and not also about growth, then voter discontent with government will persist.

The sensible strategy is to free up resources for both redistribution and investment in economic growth by changing the composition of spending -- reducing military spending, getting rid of transfer programs which benefit the wealthy, and reducing federal interest payments through genuine deficit reduction. Moreover, within the domestic arena it should be possible to increase efficiency and thus to lower costs. A prime example is restructuring health care, which if properly done would provide coverage to all Americans at a lower cost than borne presently. It should also be possible to enhance the efficiency of the public sector by reallocating resources within the domestic budget to more desirable uses. It is implausible that every existing program is equally beneficial; the good ought to be allowed to drive out the bad.

Spending and the Economy

As the absolute level of total government spending has grown, so has the nation's economy itself. This brings us to the question of how public spending

[14]For a survey of research on this question. see Aschauer (1991). Proceedings of a conference held on this subject are in Munnell (1990).

has grown relative to the ability of the economy to support such spending. In other words, how does spending compare to the Gross National Product? Government spending and GNP are properly compared by considering the ratio of public purchases of all governments to GNP[15]. This is shown in Figure 2.

The bottom area is federal civilian purchases and net subsidies to enterprises. This has clearly been virtually flat since the mid-1960s. In 1989 it was less than 3 percent of GNP. The glory days for this item were in 1964, when it reached the very modest height of 3.75 percent of GNP. The middle area is state-local purchases. Here again we do not see expansion. Combined federal-state-local civilian purchases have roughly the same profile over time as federal civilian purchases: flat or declining slightly over time. The peak for the period shown is 1975, when the total level of purchases of goods and services for non-military purposes was almost 16 percent: by 1980 (marked with a vertical line on the graph) it was 14.4 percent, and by 1989 it was just 13.7 percent.

Finally on top we have defense spending, which is much lower relative to GNP than it was in the late 1960s (during the Vietnam War), but higher now

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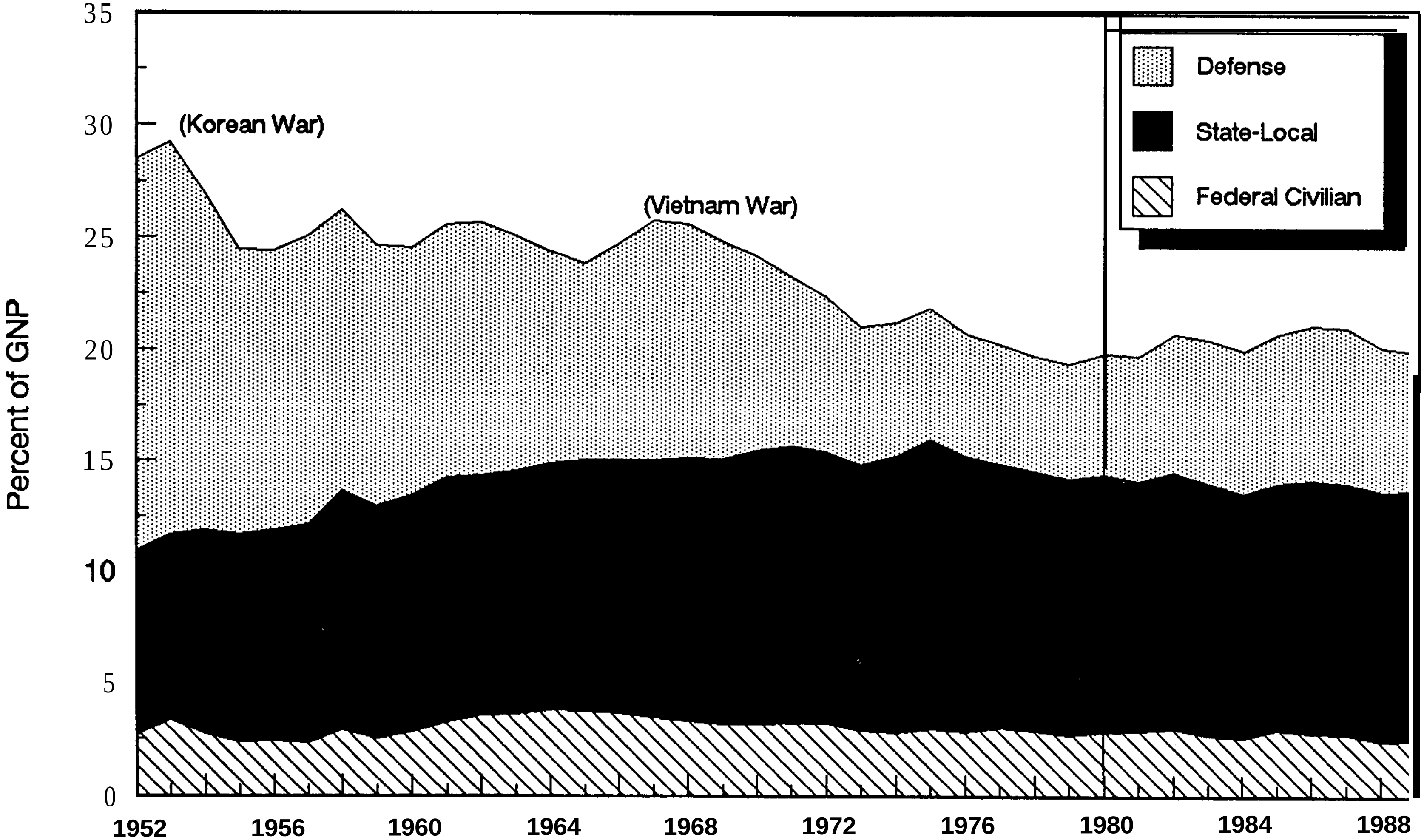
[15]One type of public spending draws resources from uses in the private economy. This type is called government purchases of goods and services. A. related item is government subsidies to public enterprises such as transit utilities or the Post Office. Purchases include all goods and services bought by a government in the course of providing public services, including the wages of public employees and the purchase of equipment. materials, or structures (e.g.. buildings) used to provide services.

A second type of spending consists of transfer programs and interest payments. This type does not exhaust resources in the way purchases do. Rather, it simply redistributes purchasing power among persons. Transfer programs redistribute income from taxpayers to transfer program beneficiaries. whereas interest payments redistribute income from taxpayers to holders of government bonds.

GNP is a measure of the total wealth produced in an economy in a year: it does not include the extent to which this wealth is transferred among persons. Therefore the comparison of transfers to GNP can be misleading. See Musgrave (1980).

Figure 2
The Public Sector's Claim on National Output,
1952-1989



Source: NIPA, Bureau of Economic Analysis.

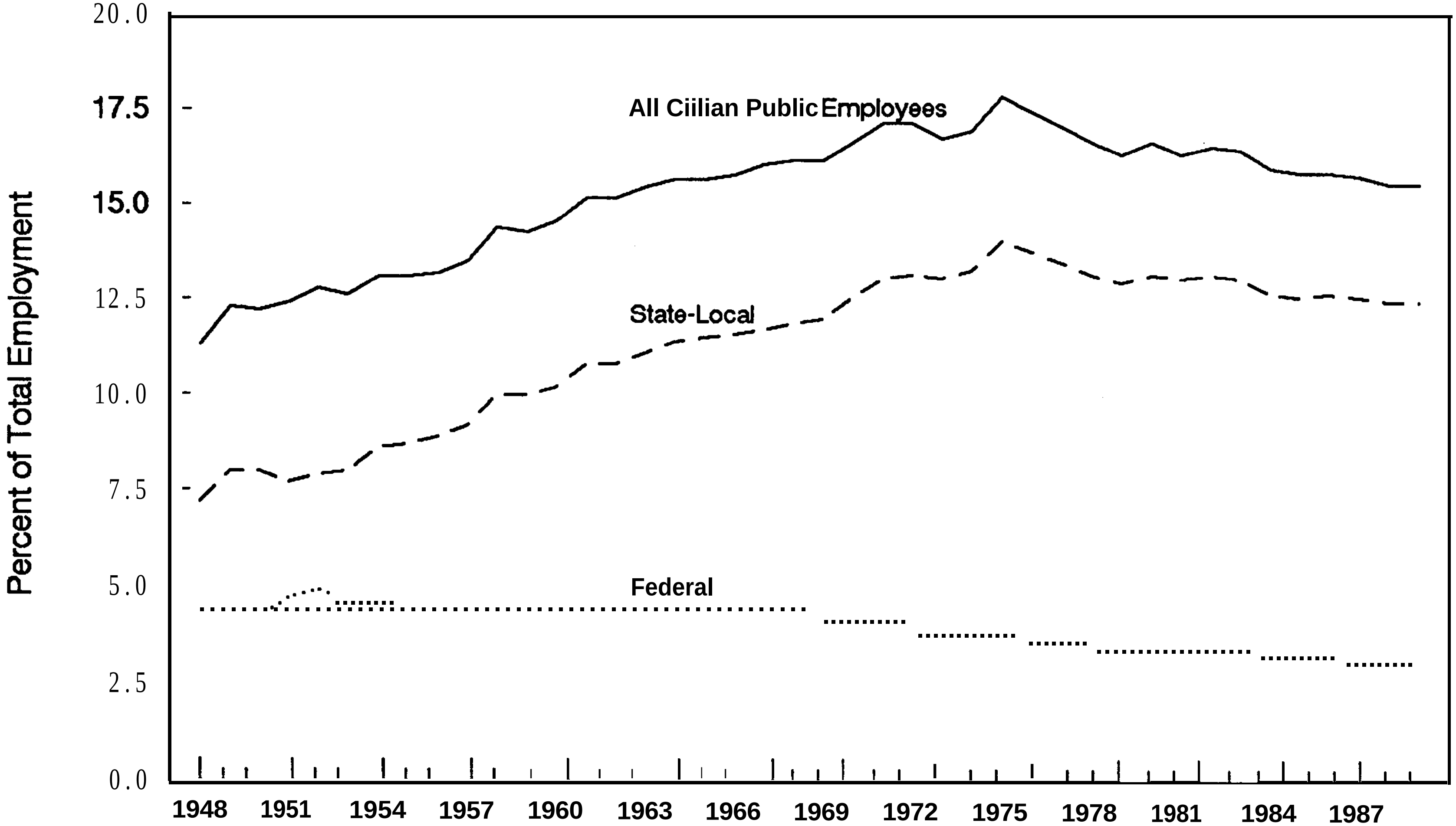
than in the late 1970s. 'The maximum range between the low point in 1978 of 5.1 percent and the high point in 1987 of 6.9 percent is admittedly small, but this differential understates the extent of waste associated with this trend. As noted elsewhere in this study, insofar as defense spending was financed by borrowing, it increased the national debt and the extent of future interest payment obligations for the taxpayer. Secondly, while civilian government spending should bear some relation to GNP, since the demand for it grows as the economy becomes larger and more complex, the same need not hold true for defense. In the latter case, what matters is the absolute level of defense spending in light of outside military threats to our national security.

The more pertinent perspective from which to judge the burden of defense spending is not its share of GNP, but rather in terms of other public spending that was foregone. In 1989, for example, one percentage point of GNP devoted to defense in 1989 exceeded $50 billion; this could have supplemented the total domestic spending of all governments[16] by 5 percent, and it would have increased the federal contribution in this area by 13 percent. Thus the defense buildup diverted significant resources form domestic spending priorities. As Figure 2 shows, the composition of total spending on purchases began shifting against the civilian category in the late 1970s.

Another sign of the stagnation of the civilian side of the budget can be found in the recent trends in civilian public employment. Like GNP, total U.S.

[16]The percentages do not include social insurance expenditure or Federal interest payments in the domestic total.

Figure 3
Public Shares of Total Employment: Full-Time Equivalent, 1948-I 989



Source: NIPA, Bureau of Economic Analysis.

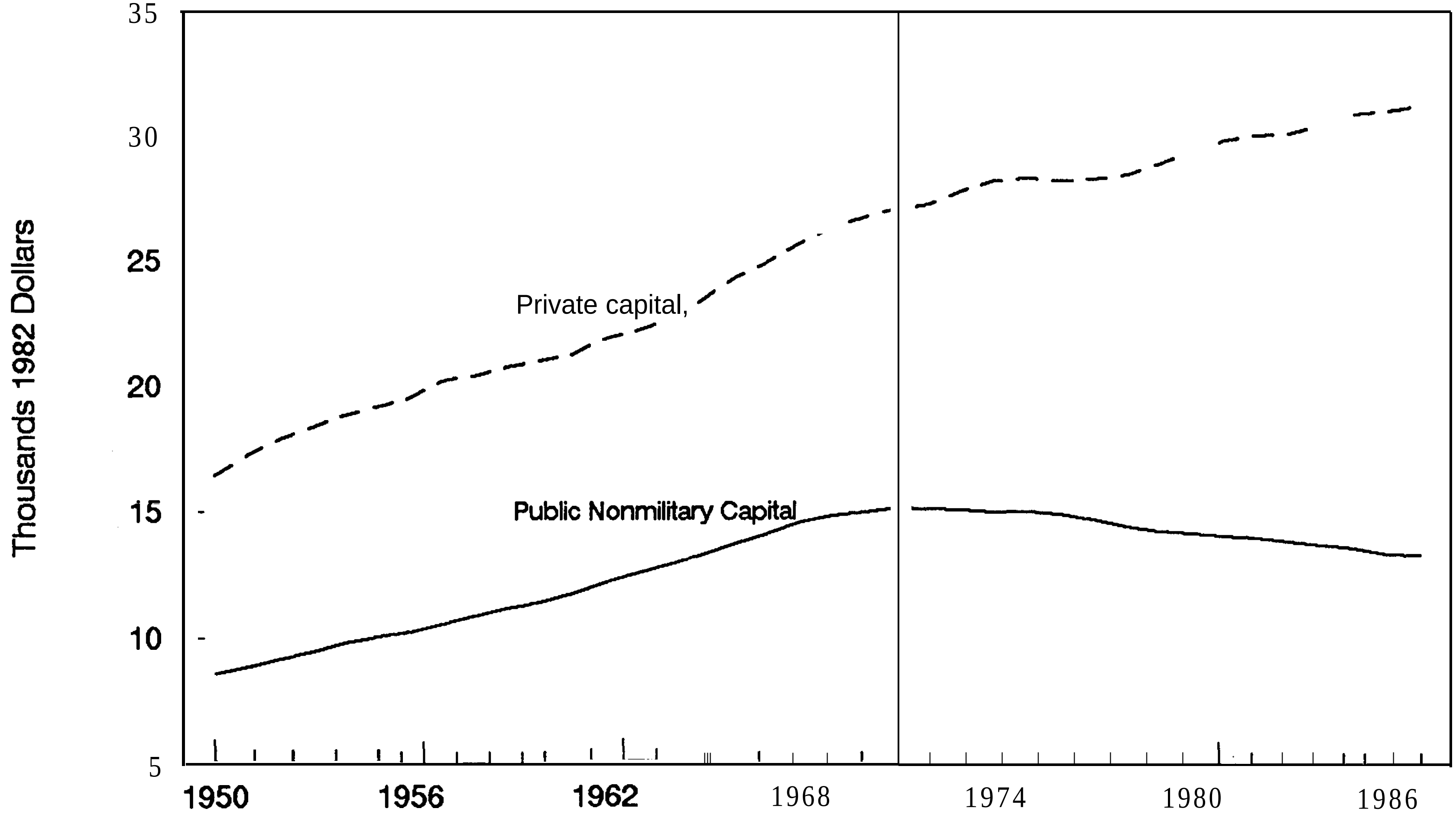
employment and public employment have grown since 1948. But absolute growth in public employment halted in the final years of the 1970s -- Jimmy Carter's Administration. After a pause of a few years, growth recommenced. Most of this growth was in the state and local sector, not the federal, and a good part of the state-local growth was in education.[17]

The top line in Figure 3 is total civilian public employment as a share of all civilian employment in the economy as a whole. The relative level of civilian public employment peaked in 1975 at 18 percent of the workforce and fell to 15.5 percent by 1989. From this standpoint, the civilian public sector has been shrinking for fifteen years. The source of the reversal of growth is clear from the next line: total state and local employment follows the same trend, peaking at 14 percent in 1975 and falling to 12.5 percent by 1989.

Contrary to recent political rhetoric, Figure 3 also shows that federal civilian employment has been gradually but steadily declining as a share of total employment for forty years. In 1951 federal civilian employment was almost 5 percent of the workforce. By 1989 it was close to 3 percent. This shrinking share of federal employment has gone on under liberal Democratic and conservative Republican presidents. The widespread notion that the federal government is engulfing the rest of the economy is patently absurd. Along with the relative decline in government employment, there has also been

[17]Since there are an increasing number of part-time workers in the economy, we need to adopt a comrnon unit of measurement to see how much work is being done in different sectors. Thus for this discussion we employ a measure of the number of full-time equivalent employees, where two half-time workers equal one full-time worker, and so forth. Data is published by the Bureau of Economic Analysis. Department of Commerce. See Tilly (1991) on trends in the workforce concerning part-time workers.

Figure 4
Private & Public Nonmilitary Capital Per Worker
1950 to 1987



Source: **NIPA,** Bureau of Economic Analysis.

a dramatic decrease in government investment in equipment and structures -- also known as public or capital infrastructure.

What is the state of our civilian public infrastructure? **Not very good.** Figure 4 shows the amount of public capital per worker? As with public employment, it increased until 1973 to $15,143 (marked with a vertical line on the graph), and then declined to $13,297 by 1989. By this comparison, government in the U.S. has been investing much less in infrastructure for the past twenty years then it did in the 1950s and 1960s.

Revenues

Government spending is financed primarily through taxes, contributions to social insurance, and user charges.[19] Figure 5 shows the composition of government revenues in 1989. The first slice is personal and corporate income tax proceeds collected by all governments in the U.S. Next are other "indirect" taxes[20] supporting general revenue, which excludes payroll taxes for social insurance.[21] Next are user charges. Then we have miscellaneous receipts,[22] which includes such things as interest earnings and dividends received from

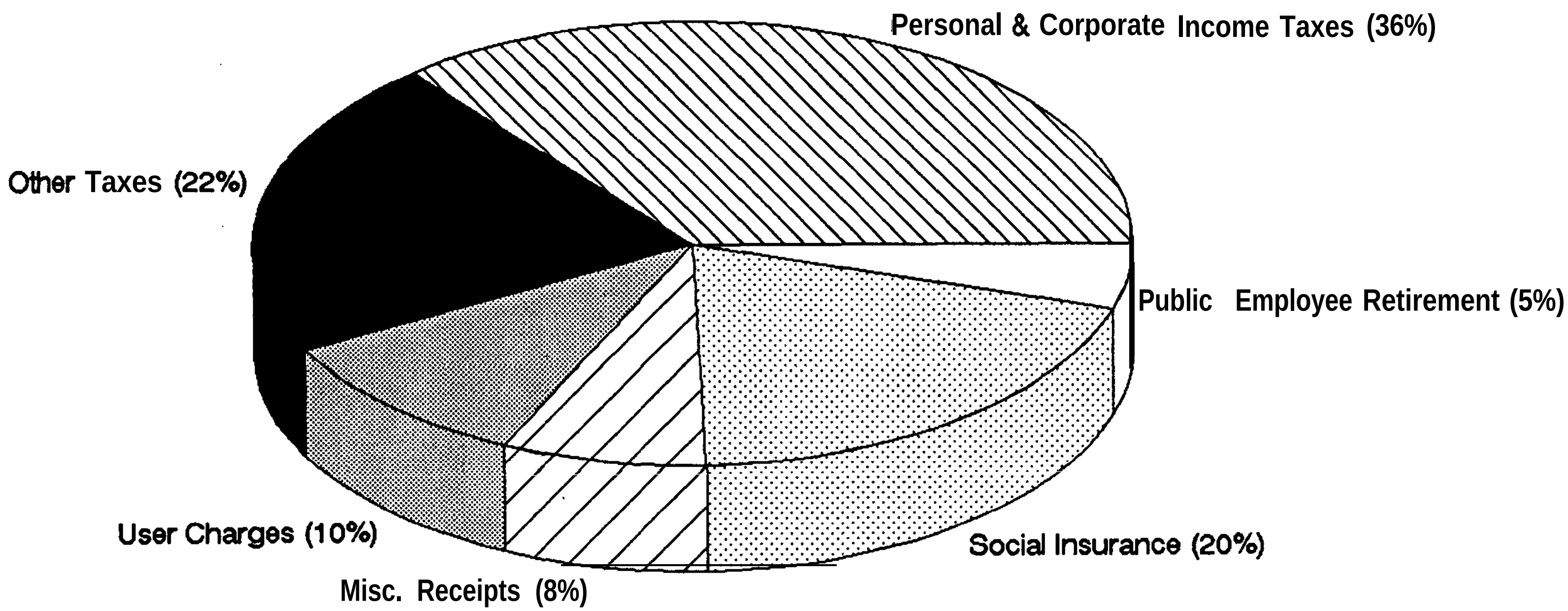
[18]Aschauer (199 1).

[19]A user charge is defined as a payment made by a consumer for some specific good or service provided by government. just like a price paid by a consumer for a good sold by a business firm.

[20]The terminology "indirect taxes" stems from the fact such. taxes are not directly applied to income. but are levied on such things as sales. property, or production costs. Thus they reduce income "indirectly."

[21]It is acknowledged that a portion of payroll taxes are being improperly diverted into general revenue.

Figure 5
Sources of Public Revenue in 1989



Source: Census of Governments.

state and local pension funds, lottery revenues, the profits of state and local enterprises, etc. Then we have contributions to social insurance and public employee retirement funds -- also known as payroll taxes.

Government Revenues and the Economy

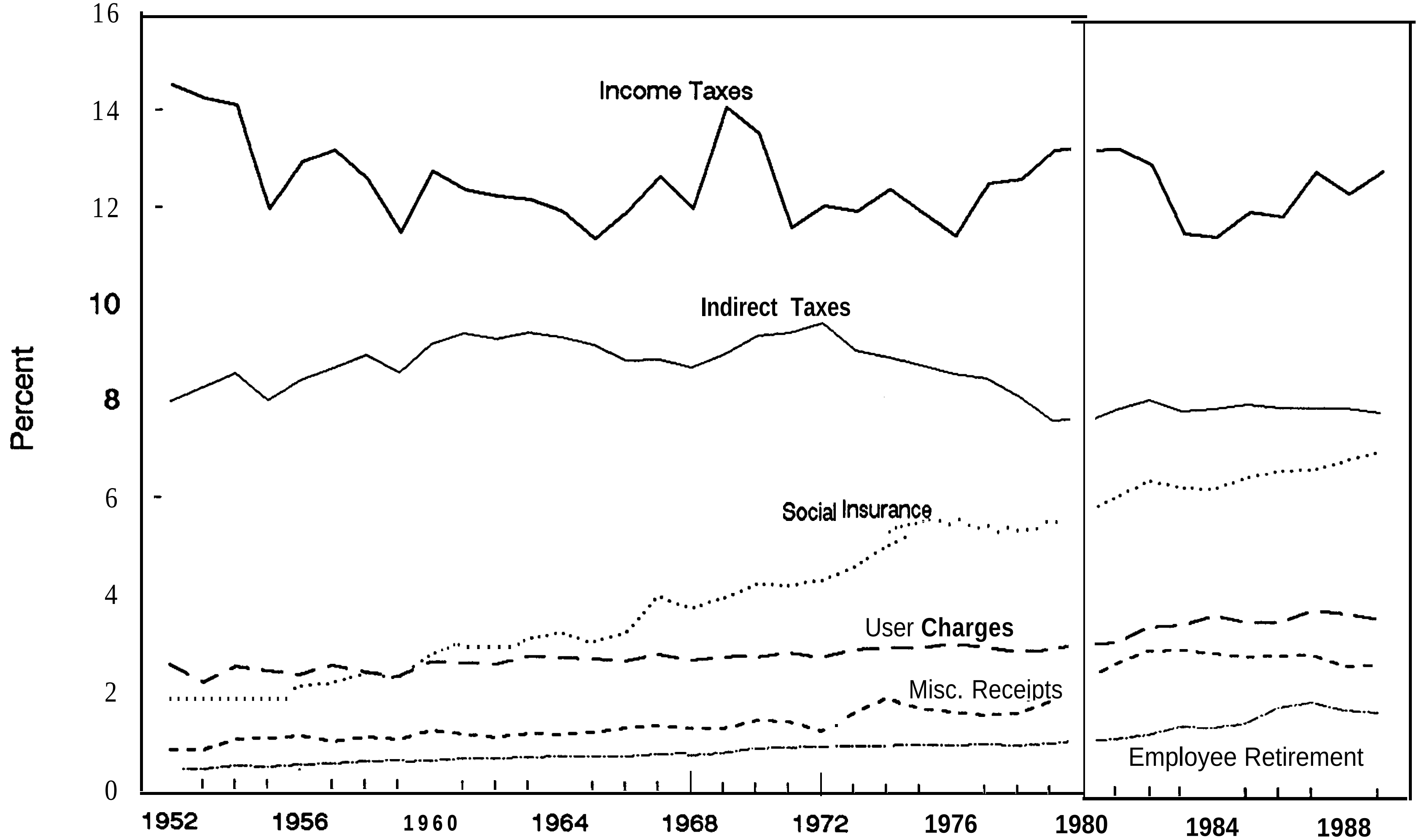
Do the trends in revenues suggest anything about the effect of taxes on the economy? Figure 6 compares the revenue sources enumerated above to the size of the economy, as measured by GNP.

The top line is federal, state, and local taxes on the incomes of persons and corporations. We can see that income taxes have fluctuated within the same narrow band (roughly 12 to 14 percent of GNI?) for over forty years, so there is no tidal wave of income tax revenue relative to GNP. Next we have all other taxes (again excluding contributions to social insurance) -- known as "indirect taxes" -- which have fluctuated within an almost equally narrow, lower band (7 to 10 percent of GNP) over the same period: these other taxes declined relative to GNP between 1972 and 1978 and have stayed roughly constant since then.

Next we have contributions to social insurance [payroll taxes), which have climbed steadily over the entire period. Part of this growth is due to increases in program benefits and associated tax rates. Part is due to the increase in the number of retired workers.[23] But as a result of the financial squeeze on governments, some of this revenue is being diverted from its

[23]Since Social Security is a "pay-as-you-go" system, those currently working finance the benefits currently paid to retired workers.

Figure 6
Trends in Sources of Public Revenue, as Shares of GNP, 19524989



Source: Census of Governments.

earmarked destination, the Social Security Trust Fund, to pay for general government and is to that extent indistinguishable from general tax revenue.

Next we have fees and charges, miscellaneous receipts, and contributions to public employee retirement funds. The first two items increased in the 1980s, partly because anti-tax politics stimulated voter resistance to income and sales taxes, and partly due to cuts in federal programs and cuts in federal aid to state and local governments.

Some fear that taxes have contributed to the sluggishness of the U.S. economy. But from Figure 6 we can see that general taxes as a share of GNP (the sum of taxes shown in the top two lines) have not risen on average for 40 years[24]; for the economy these years have been fat and lean, but there is no visible upward trend to which the economic troubles of the past twenty years can be attributed.[25] The only relevant qualification here concerns the diversion of the federal payroll tax from the Social Security trust fund to general federal spending. This has become an important political issue because the tax is regressive and because the diversion constitutes a violation of the implicit agreement underlying the Social Security system. But the extent of the diversion has not been large relative to GNP. The diverted funds supplemented total general tax revenue by almost 5 percent in 1989. (The

[24]The amount of revenue collected does not necessarily indicate the extent to which taxes distort economic decision-making. The latter depends on the extent to which marginal tax rates are high. and on the extent to which the tax base is narrowed by various exemptions, deductions. and other preferences. One virtue of the tax reform of 1986 and of similar actions at the state level is that the economic costs of income taxation were probably reduced.

[25]Of course. changes in the structure of taxation could have a myriad of good and bad effects on the economy. Such considerations are beyond the scope of this paper.

surplus is projected to double in nominal terms by 1995.[26])

An important source of revenue growth, mostly for state and local governments, has been in the categories of fees and charges and miscellaneous items. User charges are simply prices charged for goods and services provided by government. In this way they are analogous to payments for private goods. Incorrectly set charges contribute to economic in efficiency. Most economists would expect that governments characteristically set user charges at too low a level, either due to political pressure or perhaps out of a concern for their burden on the poor. In either case, public institutions which rely on charges (in particular, hospitals, universities, and mass transit systems) labor under chronic operating deficits. So the growth of revenues' from charges could reflect an improvement in efficiency, since scarce public dollars which cover those deficits could be made available for more desirable alternatives. It would remain appropriate to keep equity concerns in mind;; devices for alleviating costs for the poor which do not preclude the use of charges are feasible.

The Birth of Structural Federal Budget Deficits

Before 1980 the federal government had run deficits, but these were either due to wartime military spending, were short-lived, or were deliberately run at moderate levels to stimulate the economy. The modem deficit of the 1980s is "structural" in the sense that it was not caused by any of these factors: it was not run for the purpose of macroeconomic stimulation, it was not associated with any war, and it will remain with us for the foreseeable future. To the contrary, the deficit was engineered for the purpose of financing

[26]Office of Management and Budget (1991).

a peacetime defense build-up and of paralyzing the federal government in non-defense endeavors.[27]

Figure 7 displays the relevant factors in understanding the deficits of the 1980s. The top line compares the trend in federal debt? relative to GNP. You can see that we spent about thirty years paying off the enormous costs of World War II. In 1952, federal debt exceeded 60 percent of GNP. By 1969 it was less than 30 percent. It remained less than 30 percent throughout the 1970s, during which time federal spending increased in the ways discussed above. In the 1980s, the Reagan-Bush era saw the rise of debt relative to GNP to over 40 percent, back to its level in the early 1960s, thus reversing about twenty years of progress in reducing the federal debt.

Why did this happen? A number of categories of public spending clearly cannot be a source of higher deficits. We have already shown that non-defense governmental purchases relative to GNP did not increase in the 1980s: in fact, they decreased. Social insurance and employee retirement spending is entirely defrayed by dedicated taxes and the investment earnings of public employee pension funds, so there was no parallel deficit in the social insurance area that could have contributed to the general deficit.

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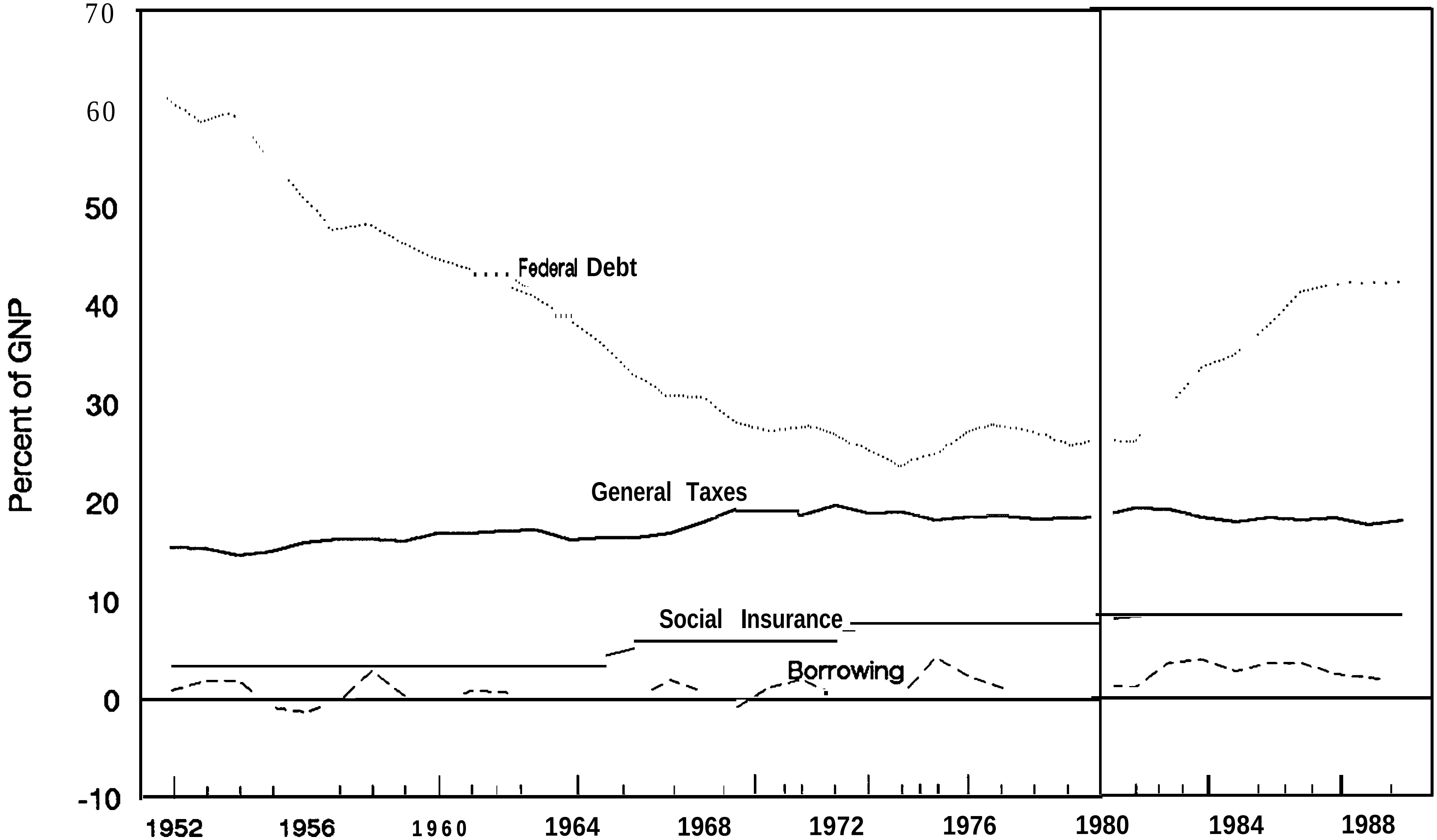
[27]The deficit as a deliberate act of budgetary sabotage (my phrase -- M.S.) is amply documented in White and Wildavsky (1989). Senator Daniel Moynihan has called the Reagan deficits "strategic."

Deficits applied less pressure to defense than to other types of spending because the former was commonly held to be a matter of life or death for the nation.

[28]This is federal debt held by the public, as opposed to gross federal debt. The latter includes debts owed by one part of the Federal government to another: in such cases one agency's debt is another agency's asset, so the two wash out in consideration of the actual debt burden on the American taxpayer through the intermediary of the federal government.

Figure 7
Public Revenues of All Governments as a Share of GNP, Selected Items, 1952-1989



Source: Census of Governments, and Office of Management and Budget.

Figure 8 shows that the deficit cannot be attributed to grants-in-aid to state and local governments or to transfer payments,, Clearly, defense spending and net interest are culprits.

Another suspect not found on the graph is the Economic Recovery Tax Act (ERTA) of 1981 -- Reagan's famous tax cut. Less well known is that after this tax act, the President and Congress increased taxes six times throughout the remainder of the 1980s.[29] Taking all federal tax changes between 1977 and 1989 into account, average effective tax rates increased for all but the richest 10 percent of families.[30] On balance then, for the vast majority of people, there was no federal tax cut. In addition, there were increases in state and local taxes and user charges occasioned by, as previously mentioned, Reagan's cuts in federal aid to state and local governments.

Although average tax rates for most went up, the cuts in rates for the wealthy were sufficiently extreme to reduce yearly federal tax revenue by an average of $63 billion per year in the 1980s. In other words, although taxes were raised subsequent to the 1981 tax cut, in effect $63 billion of these increases were "spent" to pay for previous tax cuts for the wealthy. Had we not cut taxes for the rich in 198 1, the deficits of the 1980s would have been lower. Deficits would have been further reduced because smaller deficits decrease

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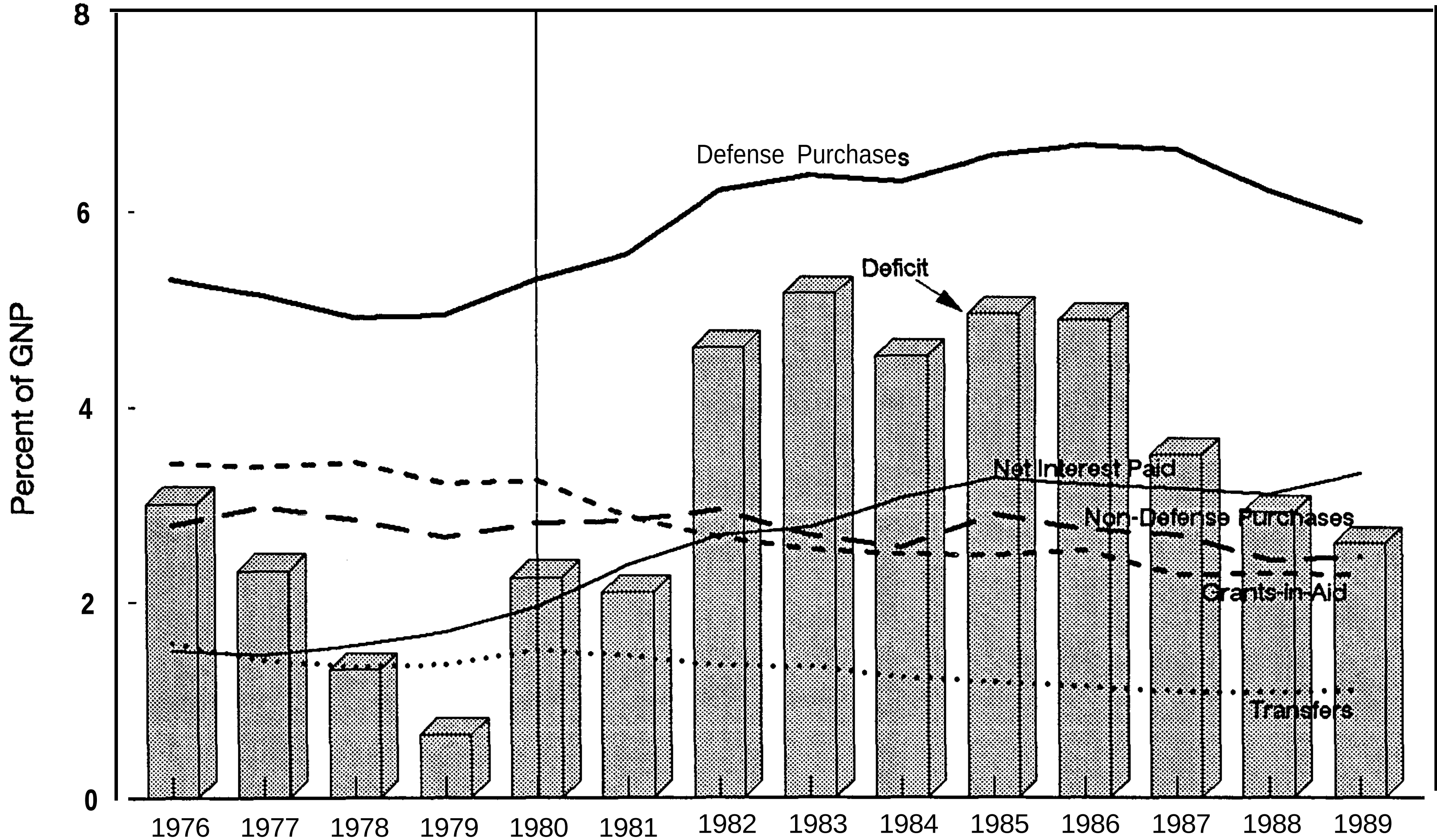
[29] Stein (1989). Tax legislation signed by Ronald Reagan which increased the amount of revenue collected by the federal government included the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. amendments to the Social Security Act in 1983. the Deficit Reduction Act (DEFRA) of 1984. the Budget Reconciliation Act of 1987. the Tax Reform Act of 1986. and other miscellaneous measures. The measures accounted for a combined revenue increase of $120 billion in fiscal 1989: the increases came from changes in. the three primary federal revenue sources: the personal income tax, the corporate income tax, and the payroll tax.

[30] McIntyre (1991).

Figure 8
What Made the Federal Deficit?
Selected Factors, 1976-l 989



Sources: Census of Governments, and Office of Management and Budget.

interest payment obligations in subsequent years. By fiscal year 1991 (putting aside the savings and loan bailout costs and future revenue receipts) the ERTA tax cut obliged the federal government to borrow an extra $84 billion, or 30 percent of the current year deficit.[31]

For those who claim that federal deficits rose not because taxes were too low but because spending was too high, we simply need to point to where this is true and where it is not. Since 1976, federal spending on transfer payments (excluding social insurance), non-defense purchases, grants to state and local governments, and subsidies to enterprises declined relative to GNP. So transfer payments, whether worthwhile or not, cannot be said to have increased the deficit. On the other hand, defense purchases and net interest did increase. In point of fact, relative to GNP there was no growth in federal spending outside the categories of social insurance, defense, and net interest. As noted above, social insurance is not in deficit in the federal budget and seldom has been[32]; in recent years it has amassed healthy surpluses which have been diverted to general expenditures.

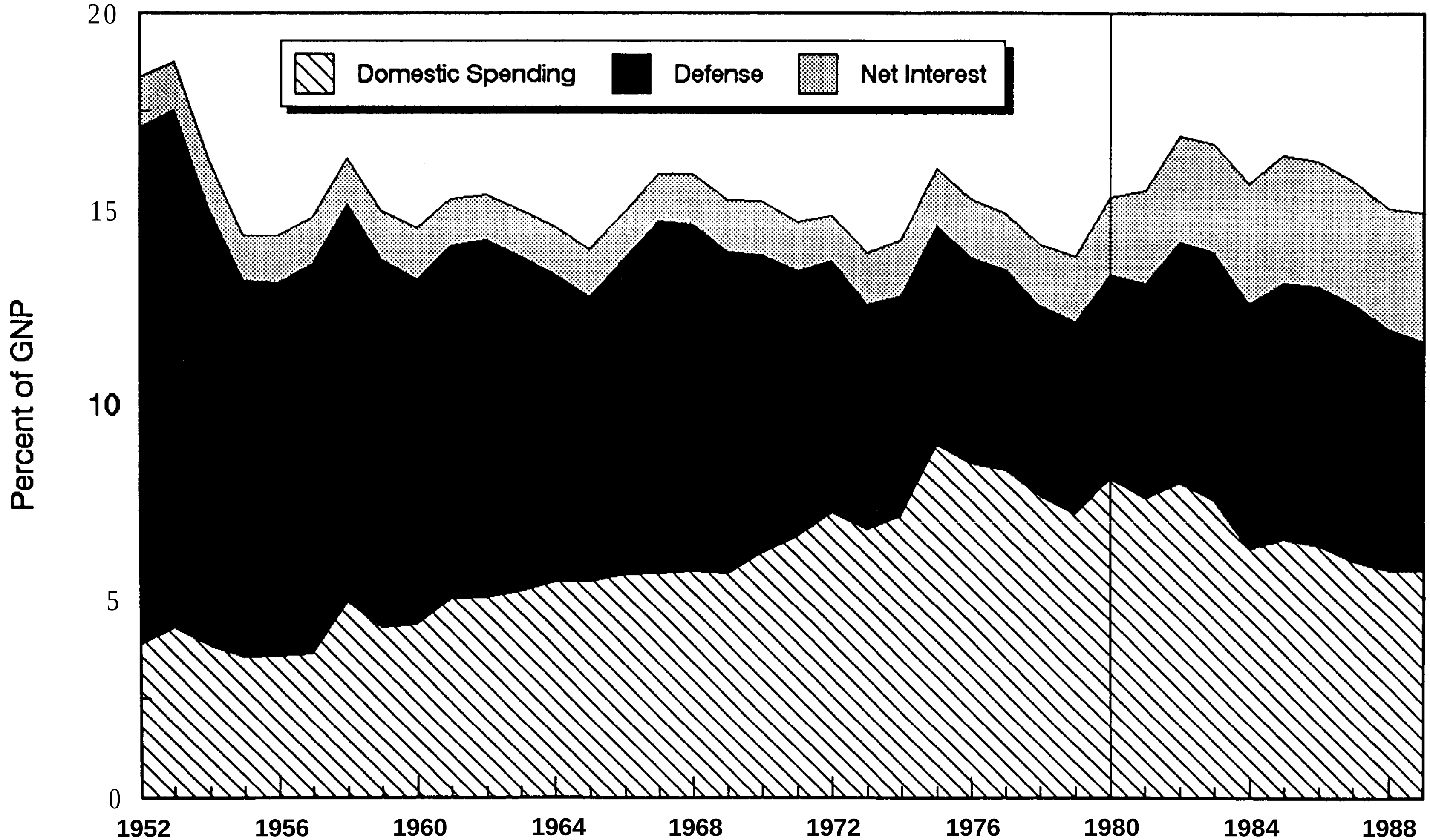
In light of the revenue-losing effects of tax policy in the 1980s and the spending trends cited above, Reagan's defense build-up was unfunded, and the lack of funding resulted in the increase in federal debt and thus in the interest reauired to service that debt.

The picture is confirmed in Figure 9. The bottom region is all domestic spending outside of the social insurance category, plus any deficits in the

[31] McIntyre (1991).

[32] All statements here on social insurance hold true if the definition is narrowed to Social Security and Medicare (OASDHI), as in McIntyre (1991).

Figure 9
What Made the Federal Deficit II, Selected Federal Receipts and Outlays, 19524989



Source: Census of Governments.

social insurance budget.[33] Clearly civilian spending peaked in 1975 and has been falling on average ever since. Thus, to reiterate: domestic spending cannot be held accountable for the deficit.

Some would object that no particular expenditure or tax can "cause" the deficit, which is simply the difference between total receipts and total expenditures. But this view neglects the fact that some receipts and expenditures are linked, so if one decreases, the other is likely to follow. In particular, the growth of social insurance transfers is tied to the growth of contributions to social insurance: if the former decreased, so would the latter. If we had less social insurance, the deficit would probably not be any lower: in fact, it could be higher if the Social Security trust fund surplus were smaller.

It is true that if domestic spending had decreased <u>more</u> than it did, the deficit would be lower (other things being equal). But there is no reason why we should have expected these expenditures to fall to such an extent. In any case, they did fall relative to GNP. Every advanced industrial nation has kept its public expenditures (which are mostly civilian) even with or ahead of the growth of their economies, and as it was, the U.S. brought up the rear in this regard. Why should we have lagged further behind?

<u>The Shift Between Governments</u>

We have seen that appropriate measures of civilian public sector activity, in other words, taxes and spending by all governments in the U.S., show either

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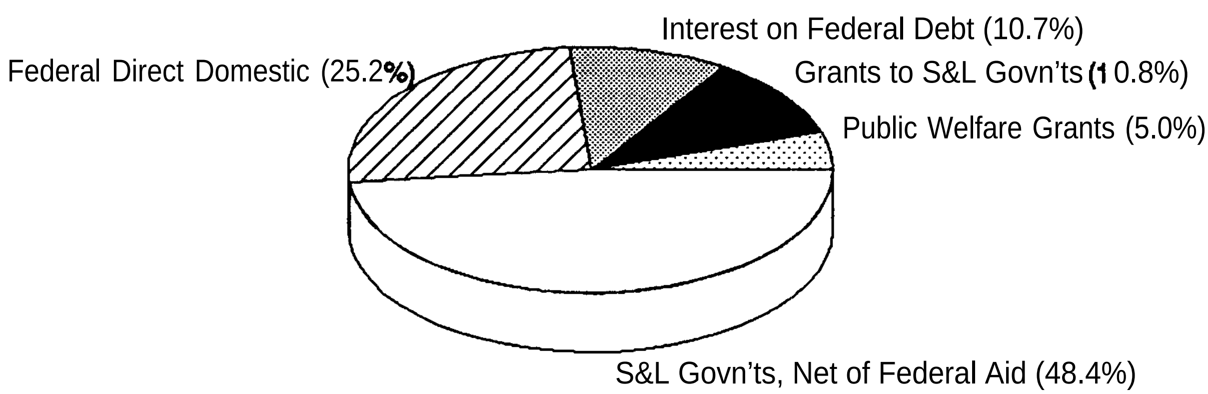
[33]When we characterize the social insurance category as "in deficit," we mean that general revenue was used to support Social Security -- the reverse of the current state of affairs. To keep the terms of this discussion consistent, a diversion of general revenue to social insurance spending should count as an addition to general spending.

no increase or some decline. Within the civilian public sector, however, there were some significant changes in terms of which governments (federal, state, or local) took on the responsibility for financing programs, both those they operated directly and those they supported through the provision of grants-in-aid to other governments. The financing of civilian public services has been shifted from the federal government to state governments, and from state governments to local governments. The consequence of this shift is increased inequality in after-tax income and well-being. After-tax income is more unequal because the overall U.S. tax system is less progressive; well-being is more unequal because reductions in public services are greatest for those with low incomes.

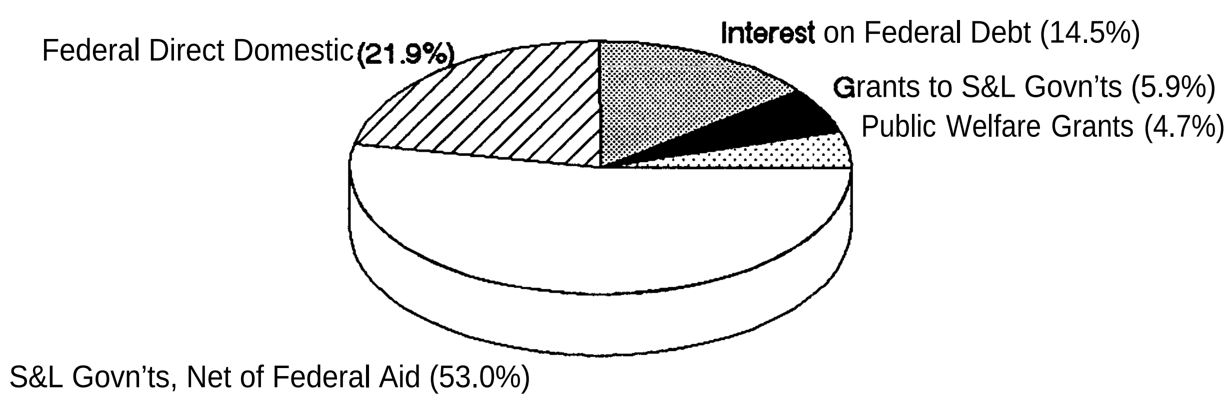
The nature of the shifts can be seen in the two pie charts in Figure 10. The top pie shows the breakdown in total civilian public spending in 1980, in terms of how it was funded, The entire pie represents all spending outside the military and social insurance categories; it includes the non-military purchases of goods and services shown in Figure 2 and transfer payments (including welfare, farm subsidies, veterans benefits, etc.) outside of social insurance programs.

The federal government financed some public welfare spending through grants to the states: this amounted to 5 percent of all spending (including Medicaid grants) in 1980. Other federal grants to state and local governments financed non-transfer programs, amounting to almost 11 percent of the total. Federal interest payments were also close to 11 percent. Then there were federal domestic programs, which were 25.2 percent. Thus more than half the

Figure 10
Domestic Public Services in 1980 and 1989, Where the Spending Originated



1980



1989

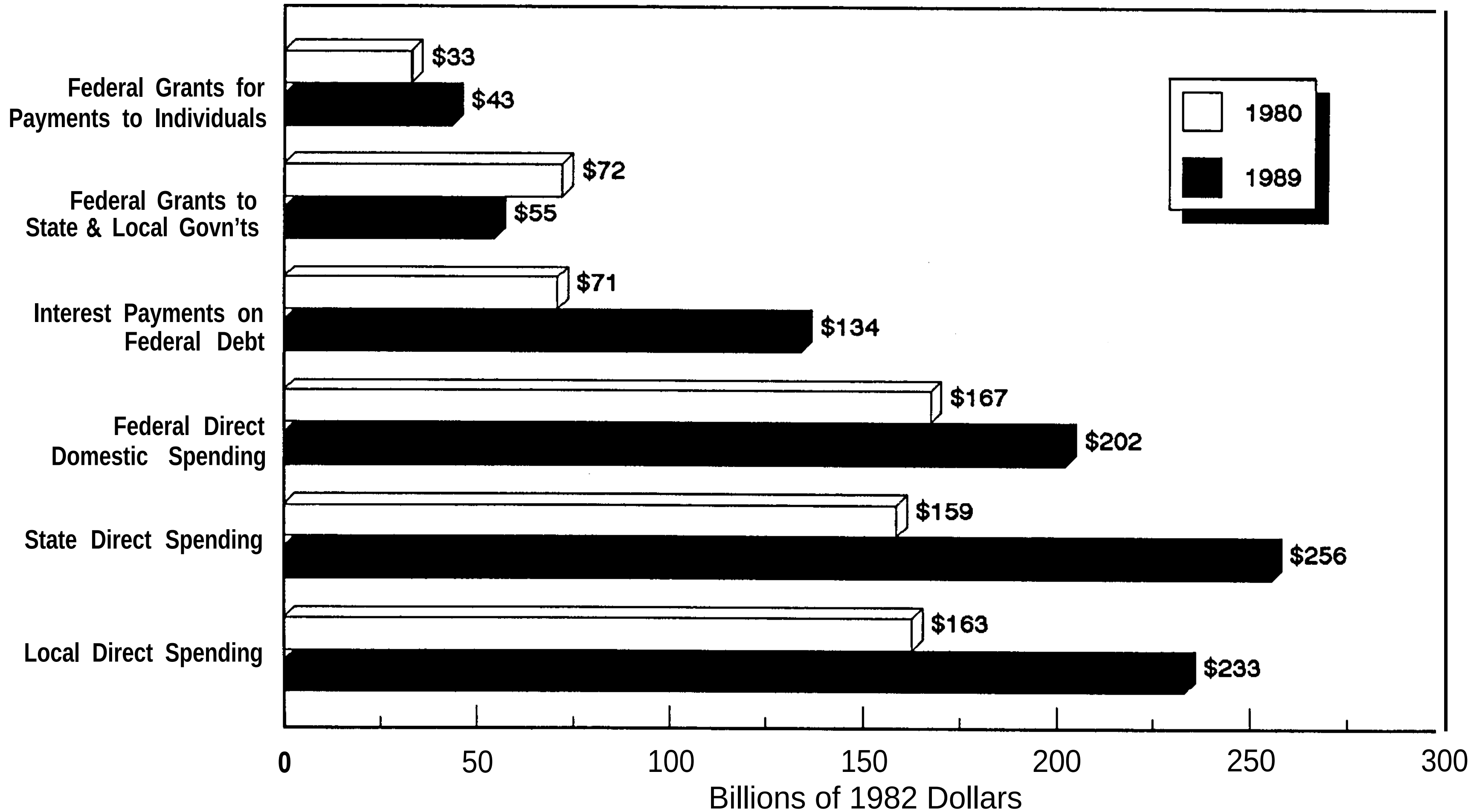
Source: Census of Governments.
Note: State & Local Governments abbreviated to 'S&L Govn'ts'.

pie, or about 52 percent, consisting of grants, interest on the federal debt, and direct federal domestic spending, was financed by the federal government, although the grants were actually spent by state and local governments who administered the aided programs. The other half of the pie is state and local spending financed by state and local "own-source" (non-federal) revenues.

A comparison to the second pie shows what changed between 1980 and 1989. Welfare grants decreased slightly as a share of the total, and grants for other purposes were almost cut in half. At the same time, the share for interest on the federal debt increased by almost half, and federal domestic spending decreased by more than three percentage points. The federal government thus contributed less to the pie in terms of grants-in-aid and its own domestic programs, and took more away in the form of increased interest payments. In contrast, state and local governments increased their responsibilities for domestic public services.

Another view of these same numbers is provided in Figure 11, which' shows the amounts of different types of spending. Starting from the top, the first bar is all federal grants for payments to individuals under welfare programs (as noted above, this does not include social insurance programs): this category increased slightly, but since the pie got bigger it accounted for a smaller slice by 1989. On the other hand, grants to state and local governments for non-transfer programs decreased in constant dollar terms as well as in terms of its share. Next we have interest payments on the federal debt, which almost doubled in real terms. Federal domestic spending increased at the moderate rate of 21 percent (more slowly than GNP, as

Figure 11
Which Governments Increased Domestic Spending?
1980-89



Source: Census of Governments.

reflected in Figures 2, 3, 4, 8, and 9), while state "direct" spending (spending exclusive of grants to other governments) increased by 61 percent and local government spending increased by 43 percent.

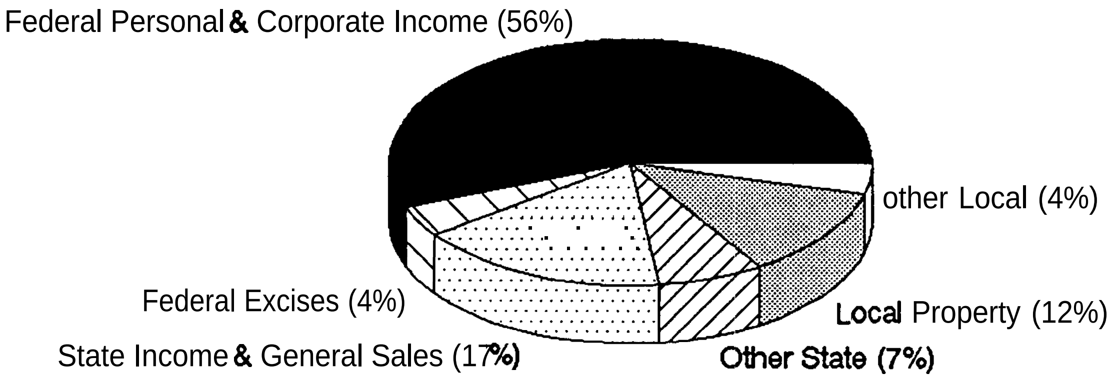
A similar picture of federal government shirking of domestic responsibilities emerges in Figure 12 by examining the split in taxes according to the government collecting the taxes. Here again we exclude contributions to social insurance, except insofar as the surplus or deficit in this category either adds to or detracts from the federal government's contribution to non-social insurance spending.

The federal income taxes share shrunk between 1980 and 1989. State government taxes on income and general sales increased, partly offsetting decreases in other state taxes. Both categories of local revenues -- property taxes and other local taxes -- increased. Not shown on the chart are increases in fees and charges at all levels of government. So we see again that the federal contribution diminished in comparison to the state and local roles.

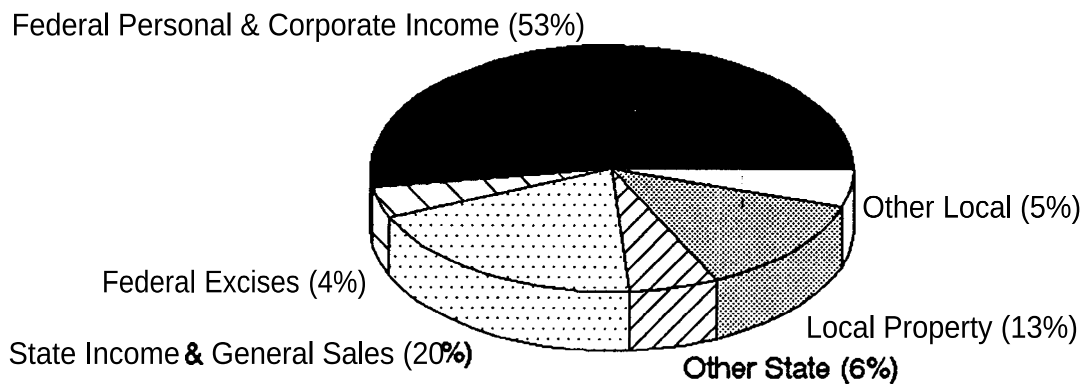
What is the difference whether the federal government or the states collect your taxes? It depends on your income bracket and your place of residence. In general, the lower your income, the more likely you are to be hurt when federal taxes are replaced by state taxes, or if state taxes give way to local taxes.

For example, suppose your family receives the median level of income in your state, and you live in the state of Nevada. You pay an average of 5.7 percent of your income to the state government, while the richest persons in Nevada pay less than 2 percent. Your state tax rate is 318 percent of that for

Figure 12
Contributions to General Tax Revenue, by Level of Government, 1980 and 1988



1980



1988

Source: Census of Governments.

the richest residents of Nevada. On the other hand, your federal taxes on average are a lower percentage of income than those paid by wealthier taxpayers (although not lower than they used to be before the tax reforms of the 1980s).

It turns out that Nevada is one of the "terrible ten" identified in the Citizens for Tax Justice ("CTJ") study on tax fairness in the states, where taxes are among the most unfair in the nation.[34] But taxes in everv state in the nation are regressive in absolute terms and in comparison to federal taxes. (Nevada simply happens to be one of the worst cases.) So any shift in revenue-raising responsibilities from federal to state or from state to local government will result in an increase in after-tax income inequality.

State government taxes will typically be more progressive than local taxes because states rely to a relatively greater extent on income taxes, whereas local governments' primary sources of revenue are property taxes and user charges. So income inequality is heightened in any shift from state to local taxation.

Decentralization of public spending also entails increased inequality of public services -- education is the most flagrant example -- because neither costs nor ability to pay are equal. The cause is the extent of economic residential segregation in the U.S. A rich community can raise a given amount of tax revenue with relatively low tax rates, compared to a poor community. A rich community can also reduce its public service costs by excluding low-income people through restrictive zoning laws which make it impossible to

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[34] McIntyre et al. 1991.

build low-cost housing. A relatively well-off community also typically has fewer social problems with which to contend, so it can dedicate itself to such public services as education and environmental protection, rather than be obliged to deal with the poor, the homeless, or the medically uninsured.

Because Reagan's "New Federalism" and President Bush's "New Paradigm"[35] are based on decentralization for its own sake, without regard to efficiency considerations or needed services, such policies are likely to increase income inequality without any offsetting gains in efficiency.

The U.S. Public Sector in International Comparisons

The U.S. system of government is quite different from those in most industrialized countries. It has the smallest public sector, among the lowest rates of growth of public spending, and generally a government which is reluctant to address problems in the economy. This can be seen from Figure 13, which compares nations of the Organization for Economic Cooperation and Development (OECD), which consists of the world's advanced, industrial nations.[36]

The length of the bars reflect the ratio of total tax revenue to Gross Domestic Product (GDP).[37] The U.S. is the lowest at 27.9 percent. We also show spending by all governments relative to GDP. Once again, the U.S.

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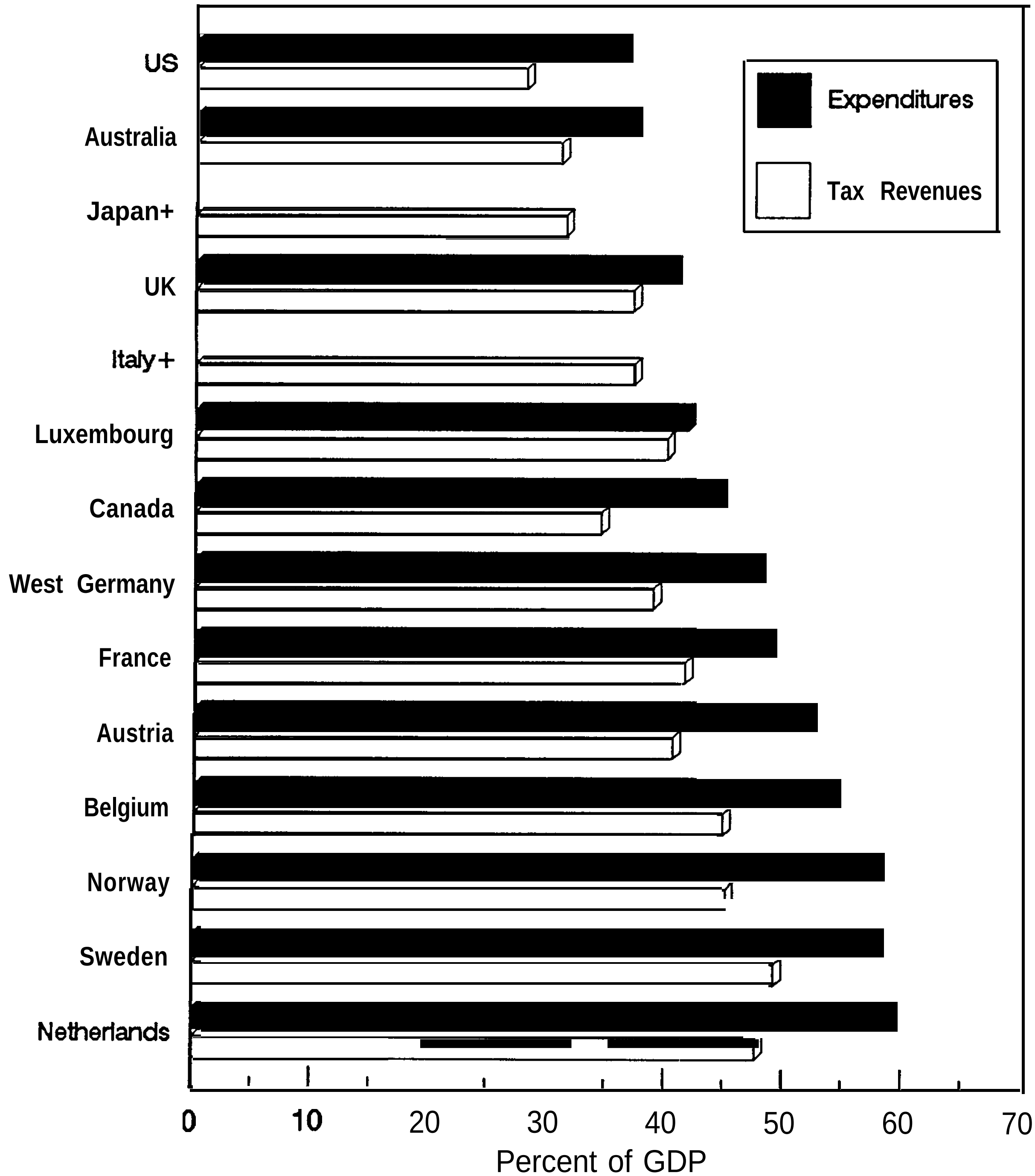
[35] See Sawicky (1991).

[36] This data is organized so that it is comparable over countries, thus U.S. figures may not be precisely consistent with other sources of U.S. data.

[37] Gross Domestic Product is the value of all goods and services produced in the U.S. proper. It does not include the earnings of U.S. corporations resulting from operations abroad. and it does include the output of foreign corporations' affiliates in the U.S.

Figure 13
International Comparisons of Government Expenditures and Tax Revenues As Percent of Total Output*, 1988



Source: International Monetary Fund and OECD.
Notes: *Gross Domestic Product. +Data for general government expenditures N/A. Expenditures for general government include lending minus repayments.

brings up the rear, at 36.4 percent. Keep in mind that as low as the U.S. is in this ranking, its level of domestic spending is overstated insofar as our military spending grossly exceeds that of all other countries shown (not excluding those countries we have been protecting).

By comparison, the countries with the best growth rates and improvements in quality of life all have larger civilian governments.[38] West Germany (prior to unification; with unification, its public sector has grown), for example, collected 39 percent of its total output (GDP) as taxes in 1988.[39] Italy, which has enjoyed rapid growth, taxed 37 percent of its output. On the evidence of taxes collected (which is very close to the U.S. level relative to GDP), Japan's civilian public sector (not shown on graph) is likely to be notably larger than ours[40] because we spent nearly 5.5 percent of our GDP on defense in 1990 and they spent about 1 percent.

An increase in U.S. taxes of just 1 percent of GDP would have raised over $50 billion in 1990. $50 billion dollars per year would be a very significant increase in domestic spending. Clearly a few extra percentage points of GNP would mean a very different public sector in the U.S., while for lack of such an advance the U.S. position on the bottom of the totem pole forecloses a myriad of possibilities for public sector initiatives to deal with

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[38] Gorham (1987).

[39] 1988 is the latest year for which comparative data are available. See International Monetary Fund (1990) and Organization for Economic Cooperation and Development (1988).

[40] Comparable data on Japanese public spending was not available. If Japan's reliance on non-tax revenues is roughly the same as that of the U.S., than because taxes relative to GDP are almost identical. a larger U.S. defense sector implies a smaller non-defense sector. all in comparison to GDP.

domestic problems.

This consideration of taxes and spending leaves out an important activity of government: industrial policy. In many countries the central government operates some industries directly and influences others indirectly. These activities are geared in general to keeping good jobs in the country, whereas U.S. policy is based on the notion that such matters are best left to the so-called free market. At worse, this can have the consequence of driving jobs out of the domestic economy. (The current U.S.-Mexico trade negotiations will substantially add to such problems.)

Such policies do not necessarily show up as large net expenditure items in a country's government budget because industries can be run on a for-profit basis: tax subsidies are not necessarily required and much of industrial policy is carried out through loan guarantees or regulation. While it has a small public sector (compared to advanced industrial nations other than the U.S.), Japan has a very active industrial policy. European countries have both larger public sectors and more active industrial measures than the U.S. industrial policy and ample public sectors have been associated with vibrant private sectors.

Industrial policy is crucial to the health of the public sector for the same reason that a strong economy is. As wages for private sector jobs fall, so does tax revenue. The ability of governments to finance public services and to pay the wages of public employees is diminished.

The U.S. also lags behind its commercial rivals in the traditional area of public investment. An efficient transportation network, adequate water resources and sanitation, electrical utilities, other types of infrastructure, and. a healthy,. well-educated workforce are all essential to the private economy.

Therefore, to the extent there is a bias in the U.S. against government, it is not serving us well in the new world of international economic competition: anti-government sentiment is an obstacle to the rehabilitation of infrastructure which is required for a growing economy. Rather than the question, how did government spending in the U.S. get so high, one might more appropriately ask, "Why is it so low?" in light of the levels and rates of growth of public spending in other industrialized countries.

How Much Public Spending Do We Need?

What we need depends on what we can afford, what kinds and levels of problems we are confronting, what it costs to act, and finally what our inclinations are in the face of all these material factors.

Polls repeatedly showed that although Ronald Reagan was personally popular, voters disagreed with him on most matters of domestic policy pertaining to public services and spending. Reagan voters repeatedly elected Democrats to federal, state, and local office in great numbers. And finally, Reagan himself made fewer efforts to cut total spending then was reflected in his rhetoric. Rather, Reagan's main contribution was to shift the composition of spending away from non-military purposes and towards defense and interest payments on the national debt. Under the Reagan Presidency, federal spending, relative to GNP, was higher than that of any other President in history except Jimmy Carter. President Bush, for his part, has surpassed Reagan and Carter.[41] These facts attest to the political durability of the consensus favoring public service provision.

Although it is clear that citizens who voted Republican in recent Presidential elections were not necessarily advocates of Reaganomics, it remains useful to examine the underlying relation between what voters want and how the government responds.

The government provides goods and services to consumers that they could not purchase on their own. But the same is true for business. Much public spending supports the profitability of business firms and promotes

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[41]Moore (1991a).

economic growth, which means more jobs and income for workers in general. Therefore, the demand for public services goes beyond the direct needs of households.

Polling Data and Preferences for Public Services

Because public services are not, for the most part, purchased piece by piece from the government, our first indicator of people's desires for public services is the decisions made by politicians, who presumably want to keep their voters happy, in the form of actual trends in public spending. The problem is that the decisions do not depend only on preferences but also on costs and the ability to pay. A great desire for public action can be limited by high costs and meager resources. First we focus on preferences.

One question which was asked in a recent poll. was citizens' general assessment of governments.[42] Respecting each basic level of government -- federal, state, and local -- over 70 percent of poll respondents said they regarded the performance of government as either satisfactory, good, or excellent. 23 percent or less felt government's performance was either unsatisfactory or a failure. it is difficult to find a strong anti-government sentiment toward any level of government in these poll results. Comparing contemporary political rhetoric to what voters say, it. would appear that politicians are more anti-government than their constituents.

Other evidence can be found in polling data on government priorities? In 1990, respondents were asked which problems deserved more attention and

[42]U.S. Advisory Commission on Intergovernmental Relations (1990).

[43]Roper Center for Public Opinion Research (1990).

more spending from the government. Well above 50 percent indicated that "too little" was being done in the areas of protecting the environment, protecting the nation's health. solving problems of the cities, halting the "rising crime rate," dealing with drug addiction, improving the nation's education system, improving roads and bridges, and dealing with Social Security.

Clearly the public expects that if more money is spent, more should be accomplished. Since the poll questions explicitly premised increased action on increased government spending, the poll results indicate a general appreciation that progress depends on increased public spending, and that increased spending will lead to improvements. An exception is in the areas of defense, space, and foreign affairs, where more respondents felt too much was being done rather than too little.[44]

One sign of the lack of political support for squeezing the public sector is the fate of recent proposals for tax and expenditure limitations in state budgets. In the most recent elections (November 1990), such proposals were overwhelmingly defeated in seven states. The only exception was Oregon where voters by a slim margin capped property tax assessments. Other bellwethers include California, where a Republican governor felt obliged to approve substantial tax increases over budget cuts (despite the protests of most Republican state legislators), and Connecticut, where a general income tax was adopted at the urging of Republican-turned-independent Governor Lowell Weicker.

[44] For additional, recent evidence, see Greenberg (1991).

Trends in Spending in Light of Costs and the Ability to Pay

Clearly if incomes rise, people will be able to buy more of whatever they please, including more public services. If we are interested in the change in the public's ability to pay for public services over some period of time, the proper reference point is the change in their real incomes.

For the U.S. economy as a whole, the simplest factor that corresponds to the ability to pay for the population as a whole would be Net National Product (NNP), which is the total amount of income received by persons and governments in the economy, but which does not include income used to replace depreciated capital. Between 1980 and 1989, NNP increased in real terms by almost 30 percent. Historically public spending has tracked income closely, so we could expect 30 percent growth in real public spending in the 1980s.[45]

Another influence on voters' demands for public services is the extent to which they bear the cost of any given amount of spending, which is reflected in their share of total taxes. Defenders of Reaganomics are fond of pointing out that the rich now contribute a greater share of federal taxes than they did before 1981. Of course, the income of the rich increased more than their taxes did, so they bear a diminished tax burden relative to their income. Their income has increased sufficiently, nevertheless, that. they do pay a larger share of taxes. The implication of this for the question under discussion is that

[45]Translating aggregate ability to pay into a prediction of how the electorate will vote on spending requires a theory of how political decisions are made. This requires consideration of the distribution of income among voters, not merely the aggregate or average. Such an analysis is beyond the scope of this survey. See Inman (1979).

because lower-income people have a lower share of taxes, they can be expected to favor higher levels of public spending on that account, even if their incomes failed to increase.

Offsetting the decrease in tax shares of lower-income voters indeed is their stagnant or declining income. Lower income would lead a voter to prefer less public spending in toto, but for any given total, more spending that is geared to improving productivity and economic security. These warring factors -- slow or negative income growth and decreased tax shares -- could help to explain the contradictory responses of some poll respondents who favor lower taxes but more of many types of public spending.

This problem underlines the importance of reassessing the composition of the public budget, moving away from spending on defense and outer space and back to bread-and-butter concerns in the fields of social insurance, education, and infrastructure.

The Public Sector's Workload

Changes have taken place in the general economy or in society which would prompt us to expect an increased desire for public spending in certain areas. A simple way to consider such matters is to use the idea of public sector "workload."[46] A workload measure is a variable or indicator which reflects the magnitude of a given government responsibility. In other words, the workload sheds light on the amount of money, workers, and other inputs needed to perform a certain public function. For example, since the U.S. has a policy of mandatory, universal public education through the secondary school

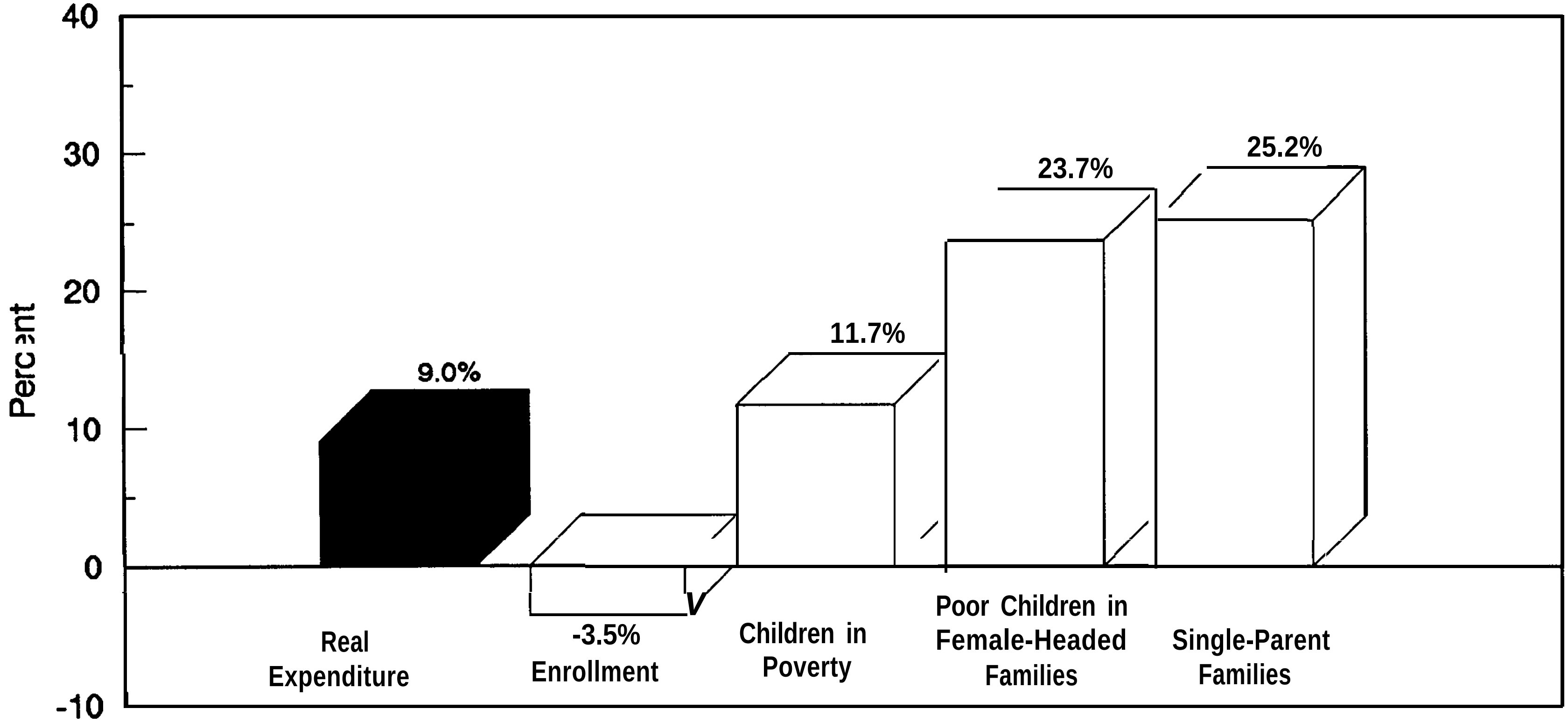
[46] Rafuse (1990).

level, the workload is reflected, as a first approximation, by the number of students who must be educated. The observed change in the workload level provides an indication of the change in the need for spending. Moreover, it can be seen that some students will cost more to educate than others, so they would not all be counted in the same manner. For instance, education for the handicapped or mentally retarded student costs more than education for the average student. In the same vein, students who come from homes which fail to provide sufficient preparation, or even adequate nutrition, will cost more to educate.

How do changes in public spending in the U.S. compare to changes in workload indicators over the previous decade? In the series of figures discussed in the following paragraphs, all percentages reflect changes between 1980 and 1989 in the absolute number of the item reflected. For instance, the poverty percentage refers to the changing number of persons in poverty between 1980 and 1989, not to the poverty rate (the latter is the ratio of the number of persons in poverty to the population).

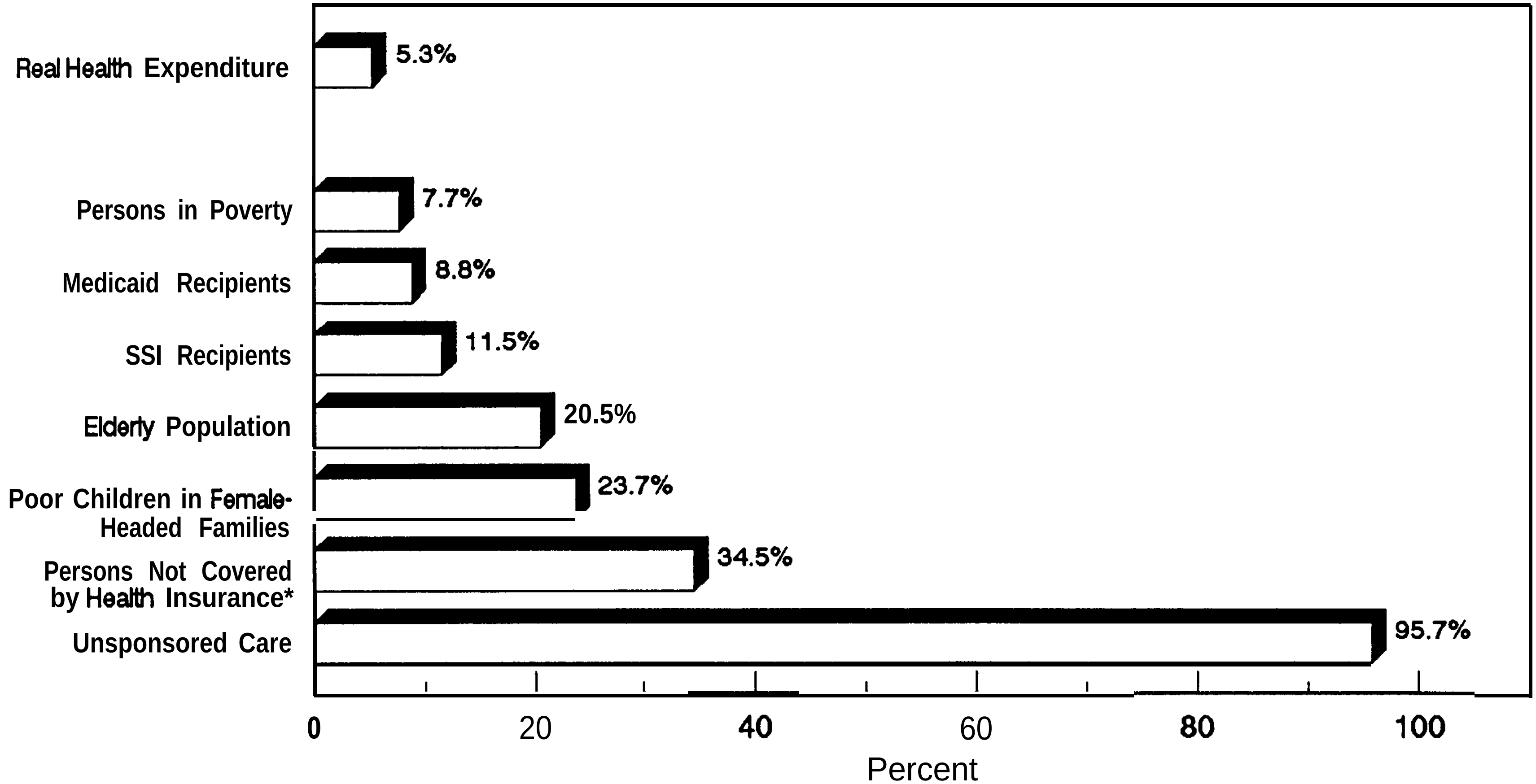
Elementary Education *is the* subject of Figure **14.** Here real spending growth exceeded total enrollment, but it can also be seen that real spending fell short of other factors that push up the cost of education: the number of children living in families below the poverty line, the number of children in poor families with a female head of household, and the number of children in families with a single parent of either gender. (One relevant factor on which data is lacking is the extent of Federally-mandated spending on education of handicapped students.) An ominous sign for the future is that enrollment

Figure 14
Percent Changes in Public K-12 Education Real Expenditure and Other Social Indicators, 1980-89



Sources: Department of Education and Census of Governments.
Note: Public K-l 2 expenditures adjusted for inflation using elementary/secondary education price index.

Figure 15
Percent Changes in Real Health Expenditure and Other Social Indicators, 1980-89



Sources: Department of Health and Human Services, Census of Governments, and American Hospital Association.
Notes: *Includes private insurance, Medicaid, Medicare and military plans.
Expendiires adjusted for inflation using total medical care price index.

growth for the decade of the 1990s is projected at 7.5 percent by the National Center for Education Statistics.[47]

Health Care. Figure 15 shows the change in health spending (including the other major anti-poverty program, Medicaid, but excluding Medicare) over the 1980s. It is exceeded by the poverty population, the clientele of Medicaid and Supplemental Security Income or "SSI" (which serves the blind, the elderly poor, and the permanently and totally disabled), the elderly population, poor children in female-headed families, the number of persons not covered by health insurance of any type, and the extent of "unsponsored care" in hospitals.[48] Clearly the increase in actual health care benefits financed by governments in the 1980s did not keep pace with the social conditions which prompt such spending.

public *Safetu*. Figure 16 shows the change in spending related to public safety, including police, fire, corrections, and judicial costs. This was clearly a big growth area in the 1980s, which makes it something of a paradox. The number of victims of crime decreased by 11 percent over the same period, according to the U.S. Department of Justice survey of households. In contrast, the Federal Bureau of Investigation reported an increase in the number of violent crimes. Experts generally put more stock in the household survey, because the FBI figures are collected from numerous police departments in a relatively haphazard fashion and only reflect crimes reported to the police.

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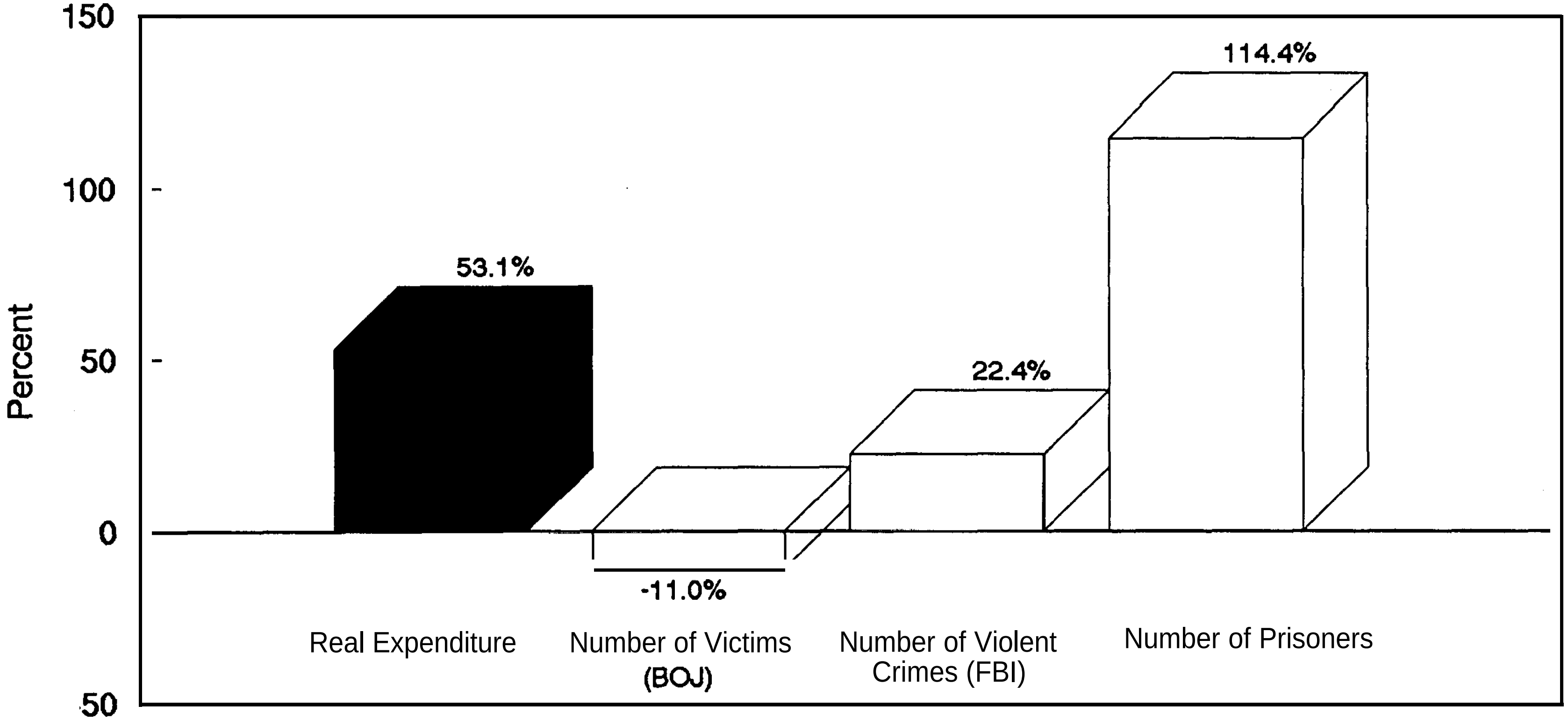
[47] Gold (1990).

[48] Unsponsored care is the level of costs attributable to non-payment of hospitals and failure of government to defray any such expenses. In other words, it is the extent of uncompensated care costs less government subsidies to defray such costs. A better indicator in this context would be the totality of uncompensated care, but this was not available.

Figure 16
Percent Changes in Public Safety Real Expenditure and Other Social Indicators, 1980-89



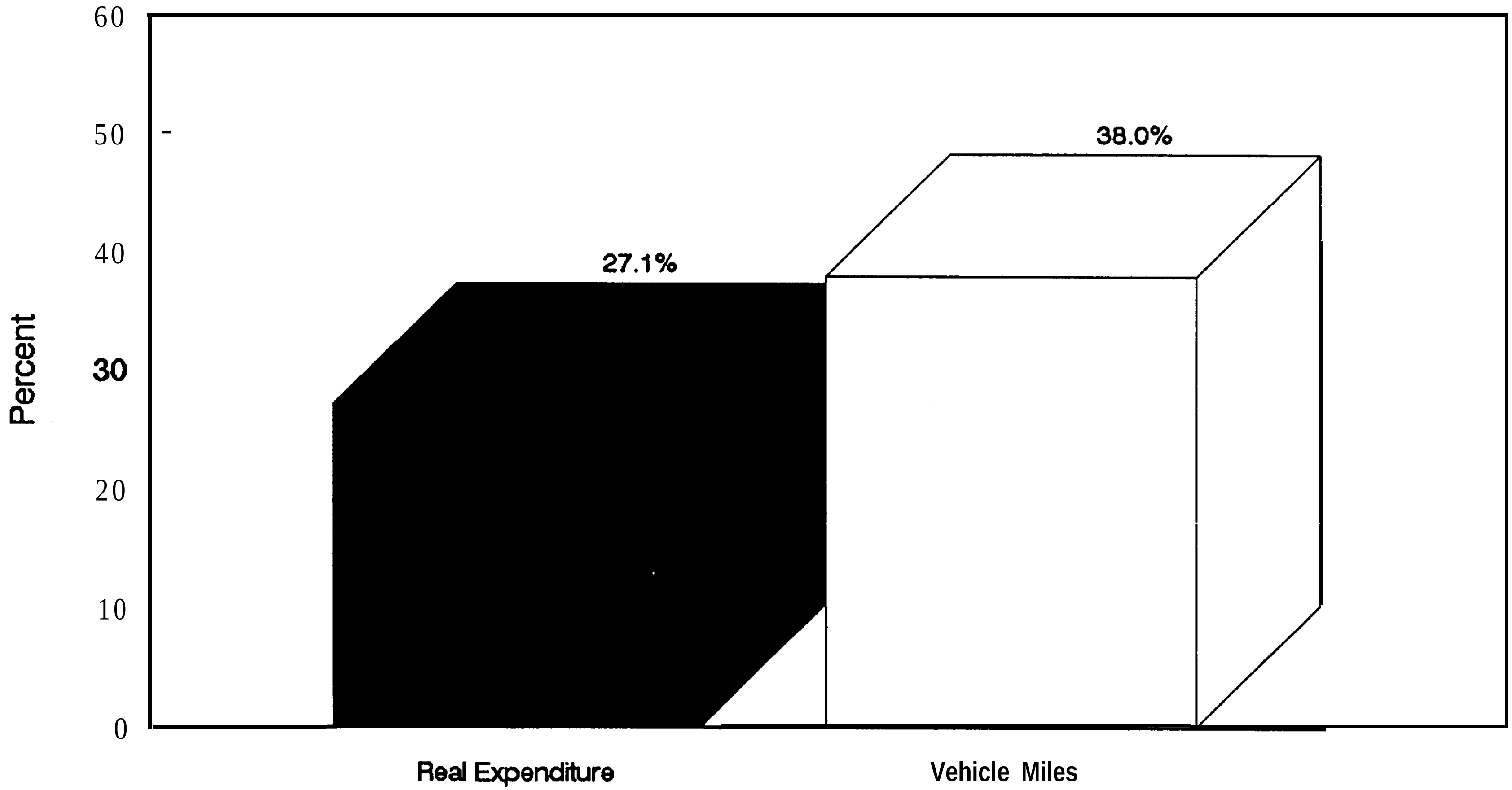
Sources: Census of Governments, Federal Bureau of Investigation, and Bureau of Justice.
Note: Expendiires adjusted for inflation using implicit deflators for state and local government purchases of goods and services.

Wholly apart from whatever the crime rate was in the 1980s, or whatever people felt about crime, federal court decisions forced state governments to spend large sums to alleviate prison overcrowding. Legislators enacted laws increasing the penalties for criminal offenses which included mandatory sentencing provisions. Of course, the public's tolerance for crime or its fear of crime could have increased, irrespective of the actual crime rate. Perhaps the most telling indicator is the number of prisoners, which clearly drives spending in the major growth area of corrections.

Highways. Figure 17 shows the change in highway spending alongside the change in vehicle miles traveled. To some extent, and unlike the previous spending categories mentioned thus far, highway spending need not track the amount of travel because roads can bear some buildl-up of traffic. The point here is that the spending increase was significantly below the workload measure.

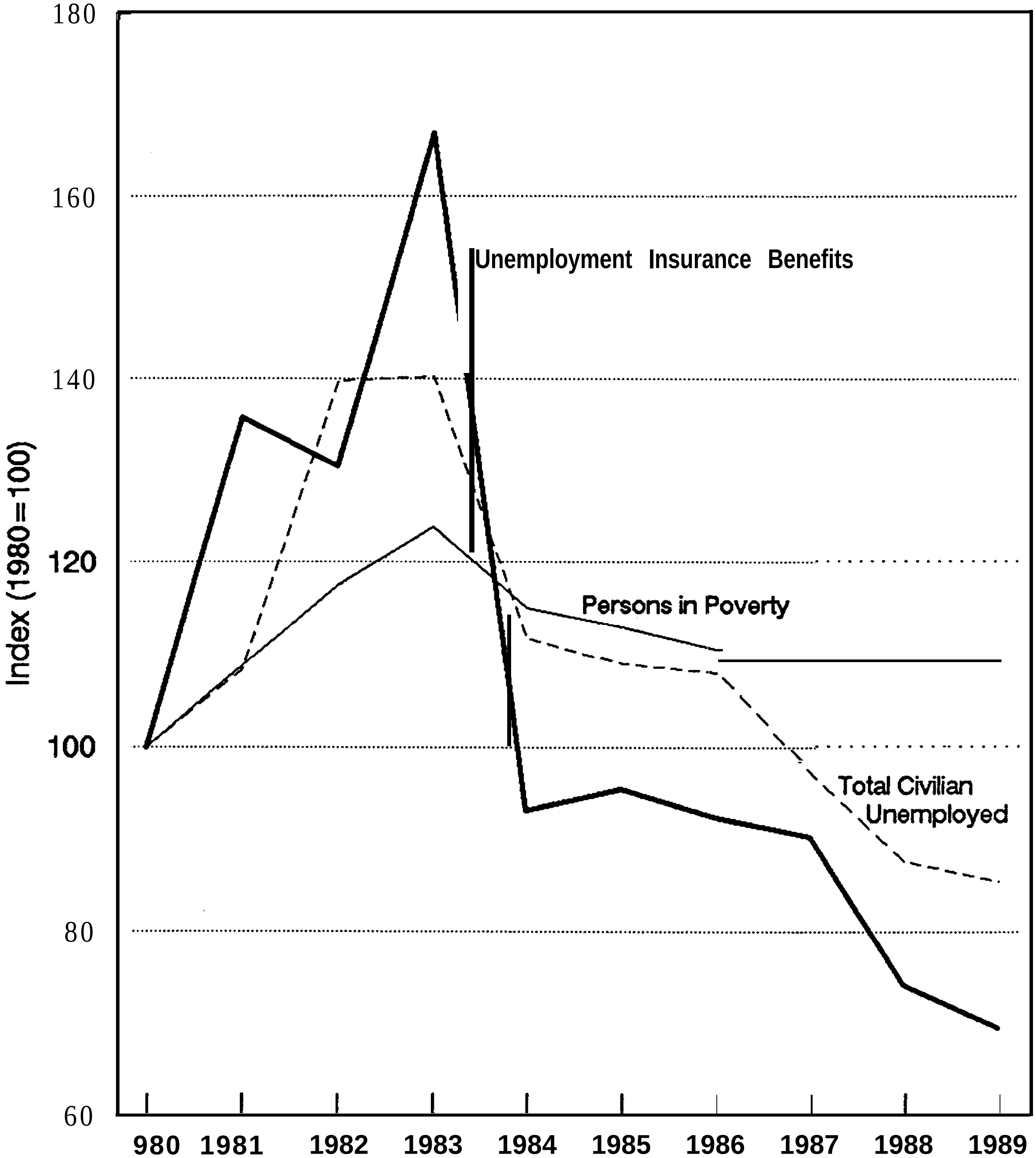
Relief for the Unemployed. Figure 18 shows the trends in the 1980s pertaining to unemployment. The dashed line refers to the actual official number of unemployed workers. The height of each line is expressed here relative to its level in 1980 (a year in which there was a short recession), which is why all lines begin at the same point (100). We see that the number of unemployed persons increased by almost 40 percent by 1982. While unemployed insurance (UI) benefits outpaced the number of unemployed during that recession, after 1984 the reverse has been the case: benefits have remained a lower percentage of the 1980 level then the corresponding number of unemployed. Benefits are also lower relative to the number of persons in

Figure 17
Percent Changes in Real Highway Expenditure Relative to Vehicle Miles Traveled, 1980-89



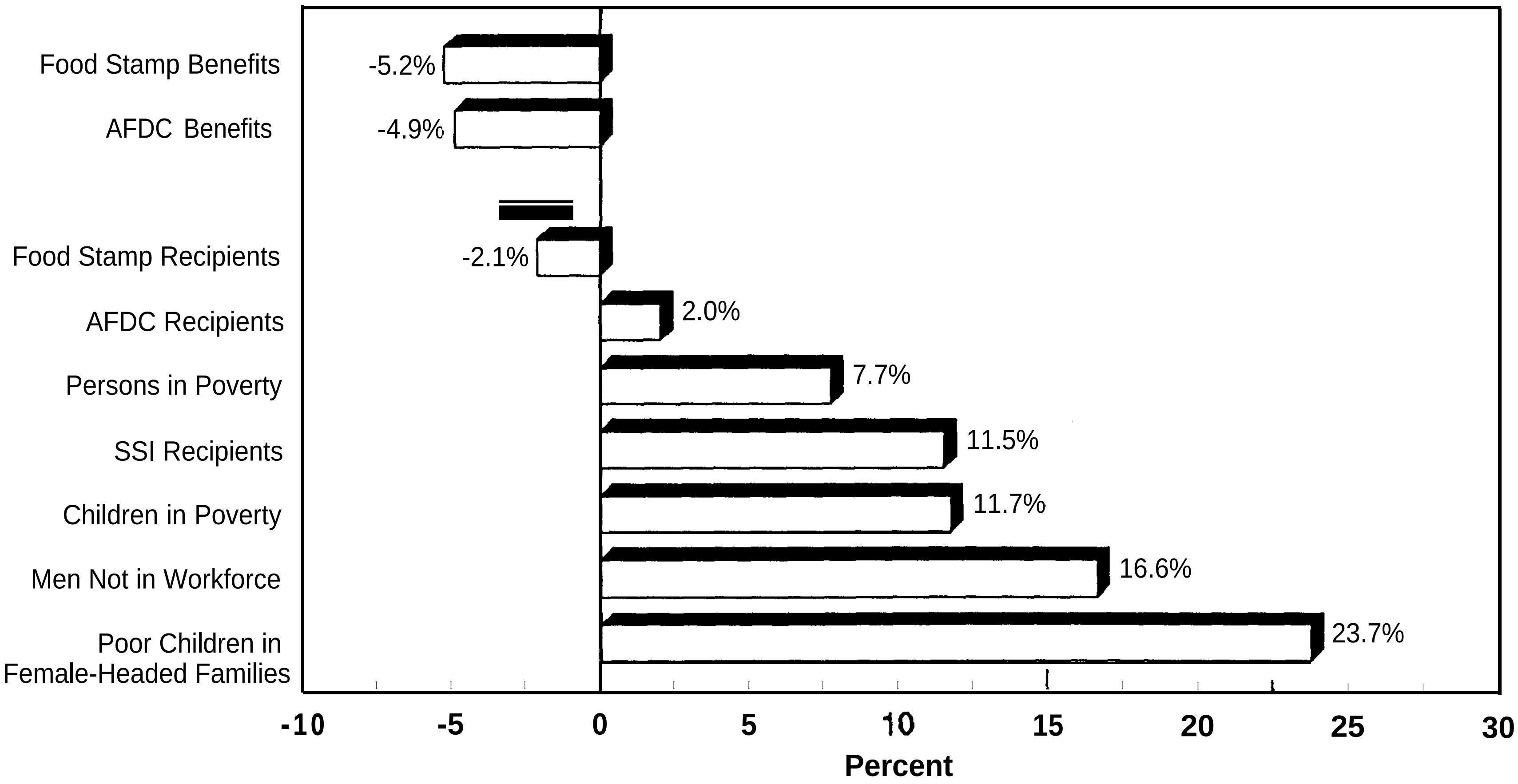
Sources: Census of Governments and Federal Highway Administration.
Note: Expenditures adjusted for inflation using transportation price index.

Figure 18
Trends in Unemployment, Poverty, and Selected Public Spending Relative to 1980



Source: Census of Governments and Bureau of Labor Statistics.
Note: Nominal values adjusted for inflation using fixed-weight personal consumption expenditures (PCE) index.

Figure 19
Percent Changes in Public Welfare Benefits and Other Social Indicators, 1980-89



Sources: Bureau of Labor Statistics, Census of Governments, and Department of Health and Human Services.
Note: Welfare benefits adjusted for inflation using fixed-weight personal consumption expenditures (PCE) index.

poverty, which is also a relevant indicator of the need for unemployment insurance.

Aid to the Poor. Figure 19 shows the change in benefits provided through two of the most important anti-poverty programs: Aid to Families with Dependent Children (AFDC) and Food Stamps. It can be seen here that total real value of benefits in both programs fell in the 1980s, although the number of persons in poverty, the number of children in poverty, the number of working-age males not in the workforce, and the number of poor children in families headed by women all rose by significant rates over the same period. It can also be seen that enrollment in Food Stamps declined; to some extent this reflects tightening up of requirements made by the Reagan Administration in 1981.

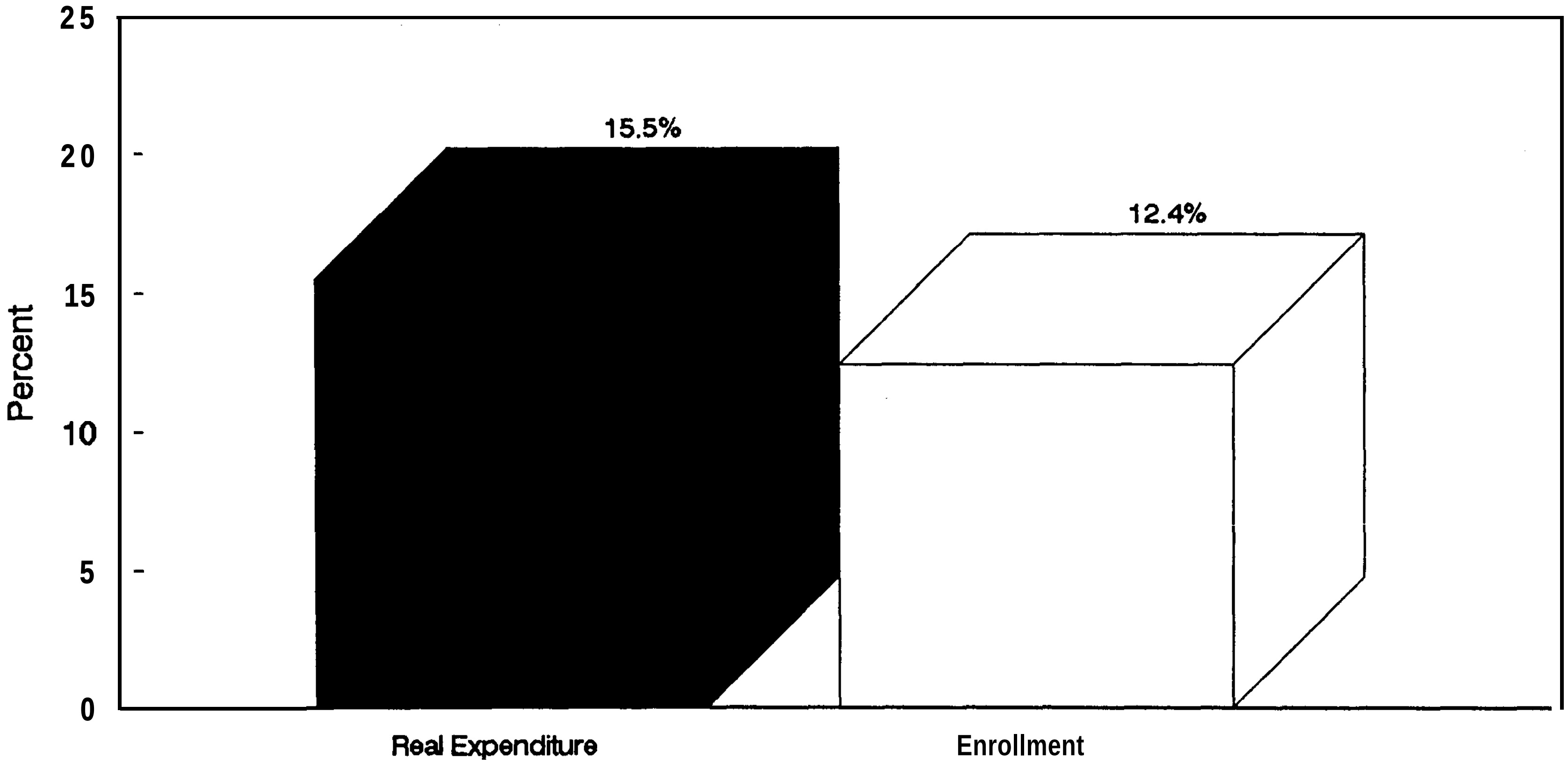
Higher Education. Figure 20 compares growth in spending on public higher education with enrollments. As you can see, spending outpaced enrollments by less than three percentage points. Spending in this case is adjusted for inflation in the costs of providing the particular service.

The basic conclusion which is suggested by these simple comparisons, with the exception of corrections, is that in the 1980s taxpayers have not been binging on public services -- they have been on a diet.,

Public Spending and Economic Growth

Most of the workload measures noted above pertain to household needs. There remains the public services needed by business firms. General economic performance in the U.S. underwent an important change beginning roughly in 1970. For the two decades after 1970, the growth rate of

Figure 20
Percent Changes in Public Higher Education Real Expenditure and Enrollment, 1980-89



Sources: Department of Education and Census of Governments.
Note: Public higher education expenditure adjusted for inflation using higher education price index.

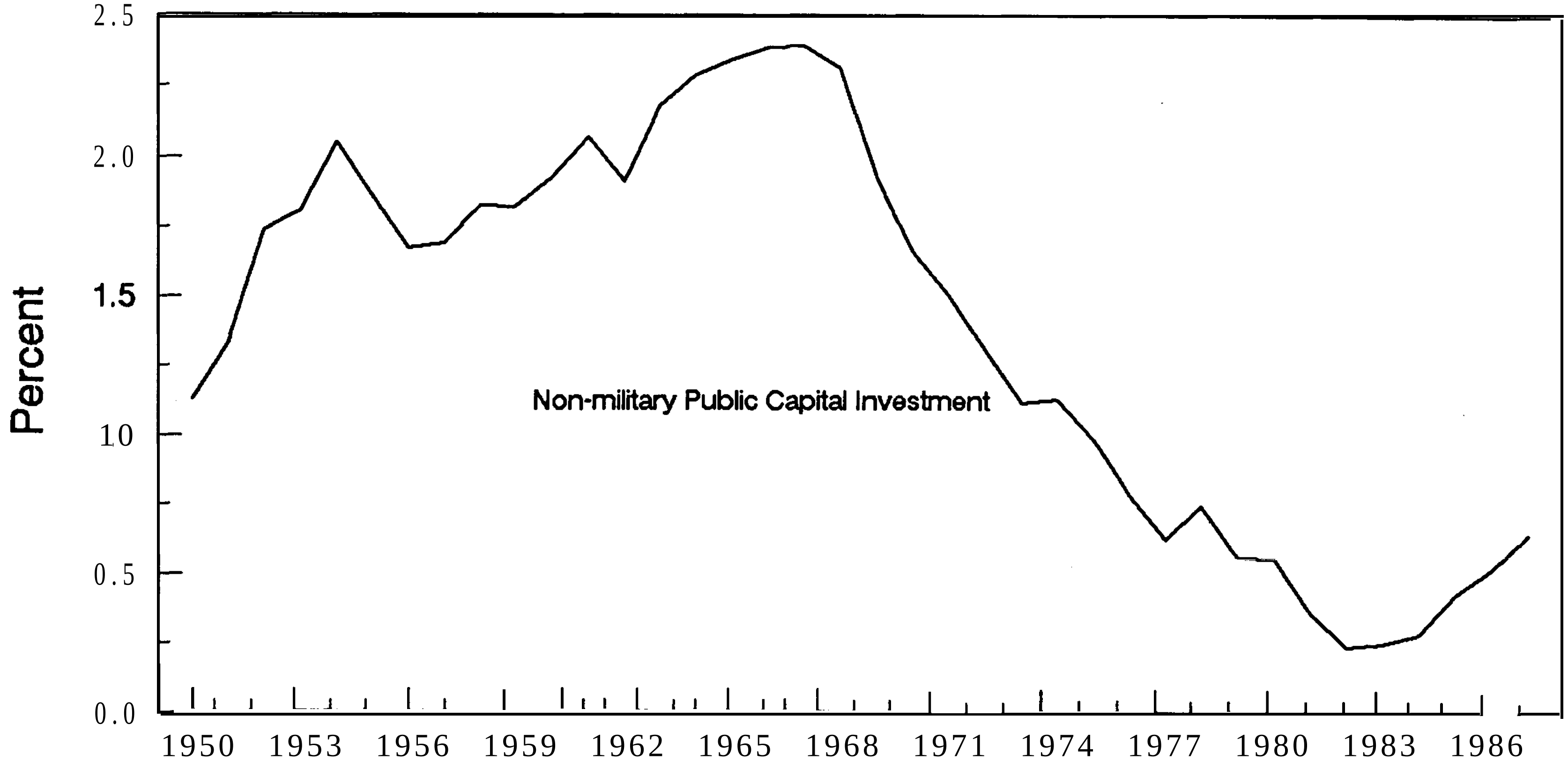
productivity in the U.S. decreased. The consequences of this for the economy were profound. Productivity growth lays the basis for wage increases, and thus for growth in family incomes. It also increases the profits of business firms, which lays the basis for increased private investment and compounded growth in the future.

The stagnation of family income has an important implication for government activity: it means tax revenue growth will be lower and the need for spending will be greater. Spending pressures will be greater in such areas as aid to the poor and unemployed, health care, and public safety.

At about the same time general productivity decreased, so too did public investment in infrastructure, including roads, bridges, canals, mass transit, electric and gas networks, and sanitation systems. Figure 21 shows the trend in public investment relative to GNP. The collapse which began after 1968 is readily apparent. This has prompted some analysts to investigate whether a connection between public capital and private economic growth exists. The logic underlying such a connection is straight-forward: public facilities reduce the costs of private business because they directly augment the productivity of workers and private capital, and they substitute for expenditures firms might otherwise be required to make.

It turns out that public investment follows productivity in the private economy very closely, whether examined for the U.S. as a whole, for individual states, or by comparing industrial nations. Economist David Aschauer, for example, has estimated that had the U.S. maintained the share of GNP devoted to public infrastructure spending of 20 years ago the result would have been

Figure 21
Net Civilian Public Investment* as a Share of GNP,
1950-1987



Source: NIPA, Bureau of Economic Analysis.
Note: *Defined as additions to public capital net of replacement of depreciated capital, for non-military uses only.

increases in private sector productivity profits and investment of 50, 22. and 19 percent respectively.[49] Thus there is noteworthy evidence that additional public investment can lift the U.S. economy out of its long-term stagnation. Such investments would not be limited to traditional infrastructure, but would include attention to education and training, research and development, and new types of infrastructure.

Productivity increases will make possible improvements in family income for the vast majority of families in the U.S. Higher productivity will also increase the returns to private investment, which should encourage additional investment, which means more and better jobs in the future. At the same time, in many cases public investment will benefit households. An example is the time people save commuting to work, when public transportation is provided.

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[49] Aschauer (1991).

How to Reconstruct the Public Budget

Government can be refocused on the central mission summarized at the beginning of this paper: promoting economic growth, improving the well-being of families, and alleviating inequality. This is not the place for a complete alternative public budget for federal, state, and local governments in the U.S. But some general priorities can be proposed, some of which speak to the neglected subject of how we decide to spend tax dollars.

1. Public Investment. The case for improvements in public services which augment economic growth is strong. In particular, this points to infrastructure, education, and worker retraining. With respect to the latter item, "free trade" agreements and big defense cuts will increase the need for a major overhaul of the U.S. employment and training system as thousands of workers and members of the armed services are dismissed. This remains one of the crucial unmet needs in the U.S. Retraining lends itself to substantial state government input in terms of the design and administration of programs, but because some states are less able to finance such programs than others, some federal financial role will be necessary.

   Infrastructure and public education are largely designed and administrated by state and local governments in the U.S., so the federal role in these instances is primarily one of providing financial leverage.

2. Industrial Policy. The most widely agreed-upon priority which falls under the classification of industrial policy is increased support for research and development. There is disagreement on how far to extend

government assistance in the process of industrial reorganization and expansion. In any case this is a task for the national government, since the well-being of entire industries is at issue. A crucial matter here is the disposition of defense plants and laboratories which are no longer needed in their existing capacities.

3. National Health Insurance. The case for national health insurance is compelling in terms of equity and efficiency. Here is one area where reform should end up saving taxpayers a great deal of money and widening access to health care at the same time. The U.S. currently spends about 12 percent of its GNP on health care, compared to other countries which spend well below 10 percent. A very important by-product of health care reforrn could be enormous fiscal relief for state governments, allowing for some combination of spending increases in other areas and tax cuts.

4. Unemnlovment Relief and Action Against Povertv. The top priority here is to increase federal financial responsibility for unemployment relief and income support. Wider availability of extended unemployment benefits would protect workers'families from falling into poverty, and increased federal financial aid for income support would make possible national standards for eligibility and benefit levels. National health insurance would also provide relief to the working poor. Increased efforts in public investment and training would also attack the poverty problem by facilitating the participation of the disadvantaged in the job market, and by reducing the need for income support in the future.

5. Free the States. Recentralization in selected areas of spending, such as health care, income support, and public investment accomplishes the dual tasks of ensuring adequate resources for the given functions and freeing up resources at the state and local level which can be devoted to what is best conceived at those levels of government.

State and local tax capacity is a concern from the standpoint of achieving adequate levels of state-local taxation, but another concern is the distribution of fiscal capacity among states and localities.” Differences in tax capacity encourage economically-unproductive relocation by households and business firms. An additional tool for addressing state differences in fiscal capacity would be a revived revenue sharing program.

There remains a key obstacle to such measures at the federal level: the budget deal. The budget deal forbids net increases in domestic discretionary spending, which means that the federal government is barred from expanding in the vital areas of infrastructure, research and development, education, and industrial policy. Caps on domestic discretionary spending should be removed. Further, the wall between domestic and military spending should be broken down now rather than in 1994, allowing us to transfer funding from military to domestic functions in a deficit-neutral manner. Finally, the federal government and the states should consult on how to develop a unified capital budget that would permit borrowing for new public investment projects.

Even if none of this were done, the current budget deal does permit the

[50] See Office of State and Local Finance (1986).

inauguration of a national health insurance program which would **free up** revenues throughout the rest of the U.S. public sector. The deal also permits greater federal financial participation in income support programs. The catch is that both would have to be financed by new taxes. In the case of health, the new taxes would eliminate payments people currently make for private health insurance, so the overall financial burden on taxpayers ought not to increase as a consequence of a well-designed program for national health insurance. National standards for income support would require additional federal taxes, but they would permit the reduction of state and local taxes.

How Should We Raise the Money?

A Peacetime Defense Budget

The most convenient source for new resources is the defense budget, which is more irrelevant now than at any point in U.S. history. About half of our $300 billion defense spending is devoted to defending Western Europe from a land invasion by the forces of the Warsaw Pact. led by the Union of Soviet Socialist Republics.[51] But neither exists any longer. What remains is the anti-communist Russian Republic, which is surrounded by wary, non-Russian, anti-communist states!

Moreover, the countries we are defending will next year collectively comprise a political federation -- the European Community -- which will easily surpass the U.S. in terms of population and national income.

The anti-Soviet component of the defense budget cited above does not include spending devoted to nuclear weapons, nor does it include U.S. forces in the Pacific. Here as well, significant reductions ought to be possible.

Last ditch defenders of the defense budget are claiming we need "more defense than ever" to ensure "stability" in the world. The fact is that for a fraction of the current budget, the U.S. would be fully equipped to deal with the Saddams and Noriegas of this world. In many cases military forces have proven to be of no use at all: a tragic example was the Reagan Administration's debacle in Lebanon. The best current example is the problem in Yugoslavia, which is fundamentally political in nature -- not military.

[51] See Faux and Sawicky (1989) and Kauffman (1989).

Continued Tax Reform

Additional revenue could be obtained by further reform of the federal and state taxes on personal and corporate income. As noted above, U.S. taxes are the lowest in the world, and this does not seem to have been of much help in international competition, whereas the extent of unmet public needs poses a serious challenge to our economic prospects.

Reform should aim first to strengthen the principle that all types of income are taxed evenly. This precludes capital gains tax preferences and suggests reduction of other tax preferences. For instance, there is no reason why taxpayers should be able to deduct property taxes and mortgage on second homes or vacation homes.

The second principle is that marginal tax rates[52] should increase as income does. A reasonable target for the top rate would be 40 percent: a substantial addition to federal revenue to be realized by this moderate increase in taxes on families currently receiving more than $175,000 in yearly income.

Third, the federal income tax should not penalize families with children, as it increasingly has over the past thirty years. Fourth, diversion of the Social Security Trust Fund to general revenue, financed by the payroll tax, should be stopped. And finally, the corporate income tax and alternative minimum tax should be made more productive through further base broadening and limited rate increases.

[52] A marginal tax rate is the change in the amount of tax owed if the taxpayer's tax base changes. For instance, if the taxpayer earns an extra dollar, the percentage he owes in extra taxes is his marginal tax rate on labor income.

The importance of these sources of revenue is that they would begin to restore the balance of revenue-raising responsibilities that prevailed before 1981 by shifting the emphasis back to the federal government. The fairness of the tax system would also be enhanced by a return towards the status quo before Reagan, although this does not require a resumption of 70 percent marginal income tax rates.

Revenue Elasticity and Fairness

We have described various forces which push up the need for public spending. Because the economy grows in most years in most places, tax revenue and user fees will increase automatically to some extent. The problem is that the increase may not be sufficient to meet public needs, depending on the type of tax system in the state or locality. We say that a tax or tax system is "elastic" if tax revenue automatically increases at least as quickly as personal income (e.g., with no changes in tax rates), and "inelastic" if it does not. Revenues from some taxes, particularly property and excises, increase more slowly than personal income. Revenues from broad-based income taxes or general sales taxes increase more rapidly than income.[53] The balance of taxes in the jurisdiction determines the rate of growth of tax revenue.

If voters anticipate needs for increased spending, it makes sense to build more elastic tax systems employing a set of taxes which are balanced to get the desired growth. High elasticity can be dangerous because it works in both directions -- during a recession, the loss in revenue is greater. In such a period, inelastic taxes provide more steady revenues.

[53] Dye and McGuire (1991).

To expand the civilian public sector, the proper place to begin, in light of the drift towards greater inequality in the 1980s, is through the expansion of broad-based income taxes. For this to be successful, however, state and local governments need one of three things: to establish viable "rainy-day funds" when tax revenues are high, so that when the next recession arrives they are not forced to make rapid, deep cuts in spending: to institute a federal program that provides loans to state and local governments during recessions, to be repaid quickly in the ensuing years[54]; or to establish an anti-recessionary revenue sharing program.

Inveterate opponents of all public spending have three strategies to combat a forward-looking tax policy:

1. They try to overload the tax code with inelastic taxes, and underutilize income and other elastic taxes:

2. They strive to decentralize the financing of public services. Lower-level governments will always have more difficulty raising a given amount of tax revenue, so decentralization is one way to cut spending altogether; and,

3. They strive to place limitations on particular types of taxes, or to increase the number of loopholes and exceptions in tax laws. By restricting the selection of available taxes, the burden on those remaining increases, again making it more costly to finance public services.

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[54]Gramlich (1991).

It is not coincidental that elastic taxes and tax systems are likely to be more progressive. That is, the rich will bear more of the tax burden and the poor less. The simple reason is that taxes whose revenues increase most rapidly are borne by people with rapidly-increasing personal income and consumer purchasing power. In the 1980s in particular, most of the growth in personal income was concentrated in the upper 5 percent of the population. Obviously elastic taxes would have hit these high-income taxpayers harder and brought in more revenue faster.

The most inelastic taxes, in contrast, fall most heavily on average and lower-income people: property taxes, and excises on cigarettes, alcoholic beverages, and motor fuels.

The major change in the composition of all taxes in the U.S. in the 1980s is the decreased reliance on corporate and personal income taxes at the federal level. In response, state governments increased their reliance on the income tax to some extent, but they also increased their receipts from less progressive revenue sources. The upshot is a tax system that is on the whole less well-suited to meet growing public spending needs.

Public Services. Fairness, and Economic Growth: What's the Connection?

We have shown that Reaganomics was not about smaller government for all or tax cuts for most. The size of government and the level of taxes did not decrease: both were shifted around and increased. Federal domestic programs and federal grants to state and local governments for domestic programs were held back, while defense spending and interest payments more than made up for reductions elsewhere. Tax cuts for the wealthy were offset by tax increases for the rest of us. Federal spending cuts were offset by state and local tax increases.

Some recentralization of domestic taxing and spending responsibility would meet the dual goals of fairness and growth in six ways:

1. Federal taxes on personal and corporate income are more progressive than state and local taxes, so if the federal government collects more of total taxes in the U.S., the tax burden will be more equitable.
2. The problems which prompt spending are not equally distributed among states and localities. Because concentration unduly burdens local governments in haphazard fashion, increased federal financial participation in certain programs would provide important relief. Examples include the costs of immigration, care of AIDS patients, and income support for the poor.
3. Federal aid to states can be adjusted to cope with severe cyclical downturns, such as have been experienced this past year, whereas state budget-balancing requirements force them to make hasty, deep cuts in an inefficient manner.
4. Insofar as the federal government can ensure the fiscal solvency of state and local governments, financial markets will benefit from reduced volatility and uncertainty.
5. Since state and local governments provide the bulk of civilian public capital, a rejuvenated state-local sector will be able to get back into the public investment business: private sector productivity, profits, and investrnent will benefit.

6. The expansion of public services to households will improve the well-being of families, an unmeasured but important component of economic growth.

Summary and Conclusion

Government in the U.S. is not part of the problem: it is part of the solution. The problems of the 1980s were not a result of unbridled growth in domestic public spending or related taxation. There was no such growth.

The U.S. system of social insurance increased in size, but this development in and of itself has not met with voter opposition; to the contrary, more discussion has centered around the question of how to make social insurance more comprehensive, such as through the inauguration of national health insurance.

Public spending for other civilian purposes did not increase in the 1980s relative to the size of the economy. Many areas decreased in absolute terms. What did increase was federal spending on defense and interest on the national debt. As a result, at this stage in the Reagan-Bush era, total federal spending and taxes are higher relative to GNP than at any other point in U.S. history excepting World War II. The long-term trend in total taxes relative to GNP in the U.S. is not positive, except for contributions to social insurance programs.

The 1980s also brought a shift in spending and taxing responsibility from the federal government to the states, and from states to localities. The result was a federal budget that was less fair to states and localities, and a system of taxation that was less fair to individuals. Reagan and Bush have cut federal personal income taxes for the rich and raised them for everybody else. They also raised our state and local taxes by cutting back on federal domestic programs and on federal aid to state and local governments.

The result is a public sector that is less focused on the domestic agenda in the U.S., less equitable, and less directed towards enhancing future prosperity. We can do much better.

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