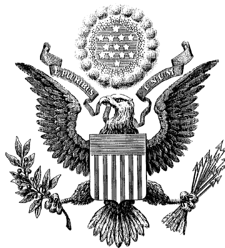
BUDGET PROCESS REFORM

A JOINT ECONOMIC COMMITTEE REPORT



Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

May 1997

Abstract

The excessive size of the Federal Government is due in part to biases in the budget process. In order to have a government that is of a more appropriate size and that responds to the needs of the general public rather than to special-interest groups, reforms should be instituted which improve the transparency of the budget process and thereby increase accountability to the voters and the taxpayers.

Joint Economic Committee
G-01 Dirksen Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240

Internet Address:
http://www.house.gov/jec/

BUDGET PROCESS REFORM

EXECUTIVE SUMMARY

This staff study reviews problems with the Federal budget process that lead to excessive levels of government and describes how the excessive size and complexity of government can produce a bias toward additional special-interest spending. It makes recommendations for improving the transparency of the process and the accountability of policy makers.

Government can be a determining factor in the performance of the economy, because it provides a basic property-rights framework to permit the functioning of a market economy. After a point, however, increasing government size can hinder economic growth by becoming a fiscal burden and by creating special-interest programs which are a deadweight loss. For example, after the optimal level is exceeded, budget growth is due in large part to programs which substitute inefficient government spending for more efficient, market-driven activities. Empirical evidence suggests that a Federal spending level of about 17 percent of gross domestic product (GDP) would be optimal for economic growth in the United States.

Budget growth and the excessive size of government has been aided by a pattern of deficit spending which separates spending decisions from full recognition of their cost. Further exacerbating the problem is the complexity of the budgetary process, which reduces the accountability of individual policy makers. The complexity, duplication, and drawn-out nature of the formulation of budget policy make the public's understanding of policy, and policy makers' accountability for decisions, less clear.

With the passage of the Congressional Budget and Impoundment Control Act of 1974 and subsequent amendments, the Congress has tended to increase the ambiguity of the budget process. Two layers of budget process have become three; committee spending records have been replaced by functional targets identifiable with no committee or member; and staff technical specialists have gained a larger role. These trends reduce transparency and accountability.

Among the steps for improving the transparency of the process, this report recommends a Balanced Budget Amendment to the Constitution, giving the President more of a role, and defining congressional spending targets on a committee-by-committee basis. The Constitutional Amendment is particularly useful in improving transparency because it requires the President to submit a balanced budget. As the most visible budgetary official, the President's participation in this manner would improve accountability. The committee spending targets would improve accountability in the Congress.

BUDGET PROCESS REFORM

INTRODUCTION

This paper reviews problems in the Federal budget process and the reasons that make some procedures and institutional structures counterproductive in helping to control the size of government, resulting in increased spending to levels higher than necessary. As a prescription for a healthier economy, this study recommends improvements in the budget process to reduce the bias toward spending and excessive government.

OVERSPENDING AND EXCESSIVE GOVERNMENT

The size of government can be a major determinant of the growth rate of the economy. Up to a point, contributions by government are essential to healthy growth, since government provides the basic framework of a property-rights system and enforcement of those rights, both of which permit a sophisticated economy to function. In addition, government usually provides physical infrastructure like transportation systems, public safety and health protection, and other public goods necessary for a complex economy.

There is a point, however, after which the size of government and the type of expenditures it makes become a hindrance to economic growth and the well-being of the nation. The hindrance occurs not only because of the large size of government and the burden of paying for its activities, but also because a large and overly complex government makes the public's understanding of the decision-making process more difficult. This permits special-interest groups to seek benefits for themselves behind a veil of confusion. The problem of special-interest influences is not new; in fact, Madison warned the Nation of this problem even before the adoption of our Constitution.[1]

In the United States, growth in government has been significant since the 1930s. In 1930, Federal expenditures constituted 3.3 percent of gross domestic product (GDP); the estimate for 1997 is 20.8 percent. Much of the increased spending has been facilitated by the accumulation of debt and inflationary increases in the money supply. The size of the Federal Government has exceeded the point at which it makes a constructive contribution to economic growth, and current budgetary processes do not appear helpful in controlling this spending.

---

[1] James Madison, *Federalist Paper No. 10*, November 1787.

Much of the spending problem lies in human nature and the political process. The rational self-interest of people in and outside of government often causes the steering of benefits to small, well-organized interest groups at the expense of taxpayers and the electorate at-large.[2] Policy makers expand budgets to fund programs of questionable public value in order to gain the support of these groups, while the taxpayers remain largely ignorant of the cost to themselves of these political rewards. Within the government bureaucracy, self-interest takes the form of agencies expanding their own budgets and responsibilities beyond the point of effective execution of their programs. One estimate, for example, puts the potential output of a government bureaucracy at twice the level of a competitive industry facing similar demand and cost parameters.[3] The large size and complexity of programs not only prohibit the public from understanding the real decision process with its rewards to special-interest groups, but they also reduce the quality of the services to those who are the putative beneficiaries.

Economists use the term "deadweight burden" to refer to the net losses resulting from the imposition of some government policies. The deadweight burden of government spending is found in the actions of individuals who respond to the incentives created by government interference in the market economy. For example, individuals expend resources competing for the purely redistributional opportunities created by government programs. These resources are not spent on producing wealth, but on the seeking of government license to conduct some activity. The resources could have been employed to produce goods and services demanded by the economy rather than lost on non-productive competition.

Recent studies have begun to evaluate the aggregate effects of government size on economic growth. One statistical evaluation suggests that the optimal size of the Federal Government is in the range of 17 percent of GDP, roughly four percentage points lower than current levels, the equivalent of about $280 billion in expenditures.[4] Another study, focusing on the period 1949-1989, concluded that, in order to achieve maximum economic growth rates, total government taxes--federal, state, and local-- should have been in the 21.5 to 22.9 percent range, and that such levels would have produced growth rates for the economy of 5.56 percent per annum instead of the 3.50 percent rates actually achieved.[5]

---

[2] Economic theory predicts that there is a rational self-interest in bearing the cost of organizing a small group to pressure government to adopt policies by which small per capita costs are apportioned among a large group in order to provide large per capita benefits to the small group.

[3] William A. Niskanen, *Bureaucracy and Representative Government*, Aldine Publishing, Chicago, 1971.

[4] Lowell Gallaway and Richard Vedder, *The Impact of the Welfare State on the American Economy*, Joint Economic Committee, 1995.

[5] Gerald W. Scully, *What Is the Optimal Size of Government in the United States?* National Center for Policy Analysis, November 1994.

An understanding of the real problem behind the numbers requires a look at the types of programs supported as the size of the budget increases. At lower levels of spending, programs tend to include those which facilitate the functioning of the economy and provide a foundation for work, saving, and investment. But those programs expanding most rapidly as government size increases beyond a certain point tend to be those that substitute inefficient government spending for private-sector activities, thereby generating deadweight losses.

THE FISCAL PROCESS AND GOVERNMENT GROWTH

THE FISCAL ILLUSION

The ability of special interests to drive government size beyond effective levels, and much of its energy to the production of narrowly focused benefits, has been made possible by the relatively new tradition of persistent deficit financing. Deficit financing, as an alternative to reducing spending or raising taxes, is attractive in a representative democracy, because it defers the cost to taxpayers of the associated spending. But while the potential penalties are hidden from the electorate, they are no less burdensome from a macroeconomic viewpoint than those generated by direct taxation.

From the fiscal-discipline perspective, the chief procedural problem with deficit financing is the bifurcation of the spending and finance decisions. The ability to obscure the real cost makes the decision to approve spending easier and reduces the pain of analyzing the real need for, or quality of, the expenditure in question. Only when the deficit level reaches significant proportions does the cost of this process become apparent. Reducing a large deficit, however, has the unattractive feature of putting decision makers in the position of cutting programs, all of which now have established constituencies, or raising taxes. On the other hand, by combining spending and tax increase decisions, the responsibility for the cost is placed on the political leaders who are taking credit for program benefits. This is the deficit bias in a representative democracy.[6]

One economic penalty of deficit financing, as well as tax financing, is the alternatives foregone in the more efficient private sector. Instead of taking funds from taxpayers who are consumers and savers, debt financing takes funds directly from capital markets and reduces investment in the economy. Even though we know that demand by the Federal Government will "crowd-out" private investment opportunities, this effect is difficult to measure. The "fiscal illusion," or overrating benefits vis-a-vis costs, is promoted because debt financing hinders a

---

[6] The seminal work in this area is James M. Buchanan and Richard E. Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes*, Academic Press, 1977.

comparison between the quality of the spending program and the quality of the forgone alternatives. Not only is dollar cost separated from the decision, but the real cost, the private sector projects that go unaccomplished, is also not identified, even in the most remote manner. This is not the case when individuals can see the taxes withheld from their paychecks, and the cost to them is clear.

Price-level inflation is another potential consequence of debt financing. If the Nation's central bank, the Federal Reserve System, rapidly increases the money supply to offset borrowing in capital markets, inflation will result. There is a fair amount of evidence that the Federal Reserve System responds to the political needs of the moment, leaving the potentially negative consequences to fall beyond the political time horizon of policy makers. For example, during the Kennedy Administration, economic growth, not price stability, was the overriding concern. The Fed responded accordingly, helping to expand the economy more rapidly, but inflation followed soon thereafter.[7]

KEYNESIAN THEORY AND RESULTING SPENDING INCREASES

The chief philosophical change in U.S. fiscal policy came as a result of the introduction of Keynesian economic theory, which suggested that the Federal Government's fiscal process could be used to influence the level of economic activity. According to this theory, deficit financing could be used to stimulate economic growth and increase employment. The new philosophy was dominant in academic circles following World War II, but it did not find effective support within the Federal Government until the 1960s. Then the new philosophy was welcomed by fiscal activists in government as an economic justification for increased spending without the need to vote for tax increases. This produced a deficit spending pattern which is with us today.

As a percent of GDP, the deficit itself has increased sharply since 1971, and according to General Accounting Office (GAO) and Congressional Budget Office (CBO) estimates, it will increase at an even greater pace when the baby-boom generation begins to retire around 2010.[8] The Federal debt has already become so large that interest payments have quadrupled over the last 25 years. In 1997 interest payments are estimated to be $357 billion, which is 23 percent of outlays. Longer term trends reveal a more difficult time ahead for the U.S. economy, if deficit spending is not reduced and a surplus restored. Today's deficits are less than 3 percent of GDP, but current spending policies will lead to deficits at the 23 percent level by the year 2025. As the deficit increases to this level, the economy will stagnate as interest rates rise, confidence in the Federal Government weakens, and incentives to invest decrease.

---

[7] The shift in Fed policy in response to changes in administrations is documented in Robert E. Weintraub, "Congressional Supervision of Monetary Policy," *Journal of Monetary Economics* 4 (1978), pp. 341-362.

[8] United States General Accounting Office, *Federal Fiscal Trends*: *Fiscal Years 1971-1995,* November 1996.

PAST EFFORTS AND NEW PROPOSALS FOR PROCESS REFORM

Since 1974, several initiatives have been taken to change the budget process, but their impact on controlling deficits and spending levels has been negligible for various reasons. Some of the measures have actually thwarted efforts to control spending, because they have reduced the understanding of the process and ignored the value to a representative democracy of keeping decision making visible. Such measures should keep fiscal issues within the political arena and make this venue a more accurate reflection of the will of the people.

TRANSPARENCY AND ACCOUNTABILITY

There are several proposals which improve fiscal discipline by increasing the clarity of the decision-making process, fixing responsibility for decisions, and increasing accountability for those decisions. The "transparency" theory suggests that too complex a decision-making process will reduce the ability of taxpayers and voters to hold budget policy makers accountable. If voluminous and byzantine documents are employed or lengthy, repetitious, and overlapping procedures are part of the budget decision-making process, the public's understanding of the process suffers, and this damages accountability. Policy makers might even promote confusion as part of a plan to assist special interests. In the making of budget policy, this type of intentional ambiguity is evidenced by creative accounting, hiding tax burdens, overestimating program benefits, and providing overly optimistic economic forecasts.[9]

In light of the transparency theory, it is interesting to look at the complaints from congressional observers as they review the current budgetary process. The chief complaints revolve around the complexity, duplication, and time-consuming nature of the budgetary process. For example, spending policy is now made in three distinct phases: budget, authorization, and appropriation. Each requires a separate set of hearings, reports, votes, and procedures, and the Congress must act several times on each spending proposal. The result is a system so confusing that it is difficult to identify responsible individuals, key votes, or actual policy direction. Adding to the complexity are stop-gap measures intended to plug various process loopholes which have permitted evasion of budgetary discipline. The high level of technical detail required in following these rules and calculating fiscal implications resulting from these measures not only complicates decision making, but also pushes the process even further into the hands of unelected technical specialists, both of which reduce transparency.

[9] Alberto Alesina, Ricardo Hausmann, Rudolf Hommes, and Ernesto Stein, *Budget Institutions and Fiscal Performance in Latin America*, Working Paper Series, Number 5586, National Bureau of Economic Research, May 1996.

THE 1974 BUDGET ACT AND OTHER MEASURES

A relatively recent reform in the budget process was the passage of the 1974 Congressional Budget and Impoundment Control Act. Its enactment, according to its legislative history, was intended to gain "control" of the budget. A practical interpretation of this goal was to provide the Congress with additional resources and procedures so that the Legislative Branch could compete with the Executive Branch in the battle of the budget. The Act created a Budget Committee in each House of the Congress to act as a focal point for the consideration of targets for spending in broad functional categories. It also established the Congressional Budget Office to provide technical support and advice independent of the Executive Branch. However, as a fiscal discipline measure, the Act, in its original version, was not effective. Federal spending rates increased following enactment, and deficits were still a problem.

Continued high levels of spending and increased deficits in the 1980s led to the passage of two additional key budget reform laws, the Balanced Budget and Emergency Deficit Control Act of 1985, also known as Gramm-Rudman-Hollings (GRH), and the Budget Enforcement Act (BEA) of 1990. GRH's goal was the elimination of the deficit, and it included the unusual disciplinary measure of automatic across-the-board cuts in the budget, "sequestrations," in the event that predetermined targets were not met through the normal budgetary process. The GRH approach was eventually abandoned in the face of massive deficit increases caused by the savings and loan bailout. BEA, on the other hand, was passed in order to enforce the budget agreements concluded by the Congress and the Bush Administration. It provided for pay-as-you-go (PAYGO) rules to ensure that future mandatory spending policy changes were "deficit-neutral" and included spending caps for discretionary programs. BEA remains in force through fiscal year 1998.

The 1974 Congressional Budget and Impoundment Control Act further weakened budgetary discipline. First, it added a third layer of budgetary action, the congressional budget process. Despite the fact that it gave some sense of order to congressional budgeting, the new Act included procedures that actually diminished the ability to understand what direction fiscal policy was taking at the program or committee level. This confusion was created by setting spending targets in functional areas for which no committee or individual felt responsibility. The new process also made more ambiguous the direction of a member's votes on spending policy, making it possible to vote for spending control in the budget phase and to vote later for increased spending in the appropriations process.

Second, this ambiguity was increased by the Act's requirement that "current policy" baselines be used as the starting point for consideration of a new budget. Current policy includes increases for program growth from inflation, increased numbers of program beneficiaries, and increased use of services by incumbent beneficiaries. Confusion was generated by the perception

that any proposed spending levels below current policy were program reductions, allowing some policy makers to claim savings while permitting others to claim increases. In any case, these automatic increases biased spending upward.

The 1974 Act was intended as a vehicle for increased congressional control and budgetary initiative, and in accomplishing that purpose, it wrested control at the expense of the Executive Branch. As a process for maintaining fiscal discipline, however, shifting power from the more centralized executive to a decentralized legislature is a move in the wrong direction. Competition among committees for available revenues under a decentralized budget process will lead to increased spending. For example, there are currently 15 spending committees in the House and 16 in the Senate. These committees have no responsibility for overall budget levels, so they tend to focus their efforts on providing program resources for their individual constituencies.[10] An analogy often employed to make the incentives in this type of situation clear is that of the communal apple tree. The absence of clear ownership leads to overuse as members of the communal group compete to get their share of apples before they disappear. Spending committees are likewise in competition to take advantage of budgetary resources for expanding programs.

The record of Federal budget deficits over the last 200 years provides evidence that a decentralized spending process leads to more spending and greater deficits than a process which is centralized. In testimony before the House Budget Committee, one expert contrasted two periods of centralized spending authority in the Congress with two period of decentralized authority. As a percent of gross national product (GNP), the centralized periods produced deficits of .26 and -.77 percent (a surplus), while the decentralized periods produced deficits of .69 and 3.67 percent of GNP.[11]

In summary, the 1974 Act not only shifted budgeting initiative and power away from the centralized executive to a decentralized legislature, but it also further decentralized the legislative budgetary process, and along with amendments for such controls as PAYGO, made the congressional process more complex and less transparent, and it made individual members and committees less accountable. The PAYGO rules also limit policy options with respect to reducing taxes because they preclude using spending cuts in discretionary programs to offset revenue reductions. This in itself is a bias toward bigger government. To improve the discipline of the spending process, the Congress will need to consider reforms which maintain the advantages of an organized process, but which improve clarity and accountability. This might include allowing the expiration of the PAYGO rules in 1998.

---

[10] Prepared Statement of John F. Cogan, in *How Did We Get Here from There: Reform of the Federal Budget Process,* Hearings before the Committee on the Budget, U.S. House of Representatives, Report No. 104-28.

[11] The centralized periods were 1799-1885 and 1922-1931; the decentralized periods were 1866-1921 and 1931-1995. *Ibid.*

A CONSTITUTIONAL AMENDMENT REQUIRING A BALANCED BUDGET

Given the continuing problems of high spending levels and large deficits, a balanced budget amendment to the Constitution is an important component of a national policy for achieving and maintaining a healthy, growing economy. As one key fiscal-control measure in a strategy for controlling government spending, such an amendment has the potential of reversing a trend of excessive expenditures which have long been a drag on the productive elements of our society. The fiscal illusion would diminish, because policy makers would be dealing with current costs as well as current benefits in their decision calculus. Such comparison of costs and benefits would produce more careful analysis of the need for and quality of the benefits, leading to higher quality programs and lower spending levels.

Experience at the state level shows that balanced-budget requirements do have an effect in producing balanced budgets. Forty-eight of the 50 states have some type of balanced-budget requirement, and, in general, that requirement plays a significant role in forcing policy makers to act with more fiscal discipline. A survey of 49 states by the U.S. General Accounting Office (GAO) suggests that such a requirement, along with a tradition of balanced budgets and concerns over the impact on bond ratings, has been a primary motivation in fiscal discipline.[12]

The chief objection to the current version of the amendment under consideration has been the lack of a tax limitation provision in the amendment, a proviso which requires a supermajority vote to increase revenues, thereby focusing budget-balancing activity on the spending reduction side of the equation. Such a disciplinary measure might be particularly important during the initial transition stage under the amendment, when existing programs with their established constituencies would fight hard to avoid program reductions and encourage policy makers to increase taxes instead. At the national level, recent fiscal history shows that pressure for tax increases can be significant. Experience at the state level suggests, however, that revenue increases are not the chief mechanism for achieving balance. GAO notes in a study of 25 states that half of projected current-year budget deficits were achieved by spending reductions.[13] Only a few states have a tax-limitation provision.

An objection to an amendment also has been made on the grounds that capital expenditures should not be subject to a balanced-budget discipline, because payment for investment projects should be made along with their consumption (they should be amortized) and not made out of current revenues. State governments typically use separate capital accounts for long-term investment spending. To create a separate undisciplined account, however, would provide a major loophole for enabling every policy maker to hide favorite programs under the label of

[12] U.S. General Accounting Office, *Balanced Budget Requirements: State Experiences and Implications for the Federal Government,* March 1993, pp. 38-39.

[13] *Ibid.*, p. 27.

"investment." The operative reason to avoid financing large capital projects out of current revenues at the state level is the spike created in revenues to accommodate the investment under a balanced-budget scenario. While spikes may sometimes occur at the state level, at the national level, the aggregated total of investments in infrastructure, research and development, and other capital projects averages out into a smoother pattern and tends not to produce spending spikes. The use of accumulated amounts in trust funds also reduces this problem.

Another reservation about the amendment is generated by viewing the Federal budget as a macroeconomic stabilizer, automatically going into deficit by spending more and receiving less revenue during an economic downturn.[14] This concept is a holdover from the Keynesian activist philosophy which asserts that deficits can help generate recovery. Proponents of this view ignore the negative incentives generated by increased transfer payments during recessions or the drain of increased borrowing on capital markets and the economy. Spending that causes delay in the response of resource markets, regardless of how well-intentioned, slows economic recovery. Also, by increasing the fiscal burden of government, regardless of how it is financed, the rate of economic recovery from recessions is reduced.

The larger portion of the increased deficit during recessions is produced by revenue loss, which may be handled by waiving the balanced budget requirement or reducing spending. If these options are not in order, rather than failing to adopt a balanced-budget requirement, which would entail a far more costly economic burden, policy makers could always elect to change the mix of spending, reducing some programs in order to permit an increase in others. Raising taxes during a recession would not promote recovery, as it may signal a lack of fiscal discipline and an intention to increase spending in the long run, as has often been the result with previous tax increases.[15]

FURTHER PROPOSALS TO INCREASE TRANSPARENCY

Some proposed rules for enforcing fiscal discipline may be only marginally successful. The additional complexity of these rules may be matched only by the tenacity shown in circumventing them, and, if the transparency theory is correct, more complicated rules only permit additional opportunities to shrink from accountability. If accountability is missing from the process, it would probably make little difference to fiscal discipline whether the rule at issue is a constitutional rule or something less; accountability would be circumvented with little political cost. Most analysts would agree that the most effective way for budget issues to be addressed under a democratic system is to keep the decision making a part of the political

[14] A stable monetary policy will be a much more effective mechanism for reducing excessive amplitude in the business cycle.

[15] Richard Vedder, Lowell Gallaway and Christopher Frenze, *Taxes and Deficits: New Evidence*, Joint Economic Committee, October 1991.

process. Keeping a representative form of government focused on promoting the general welfare requires an understanding by the represented as to how budgets are made. Improving transparency and accountability should decrease the influence of narrow special-interest constituencies seeking benefits at the expense of the general public.

Several possible reforms are suggested by this analysis, among them changes in congressional rules which would strengthen control of the spending process. Concentrating the spending power in the hands of one committee in each House may seem extreme, but this has been the practice in the past. Alternatively, the Congress may choose to follow its own lead and provide more power to the Executive Branch, as it has in granting line-item veto authority to the President. Centralized power improves accountability in this case because one representative and one party must lead and take responsibility. The record becomes easier to read.

Given the President's visibility, a larger role for him may prove constructive from a transparency perspective. The Senate version of the Balanced Budget Amendment to the Constitution, for example, includes a provision which improves transparency and accountability. Section 3 requires the President to submit a budget that is in balance. This provision may be more important than any requirement imposed on the Congress, because it makes a President and his party's position clearer on tax and spending levels.

A similar argument could be made for the substitution of a joint resolution on the budget for the concurrent resolution instituted by the 1974 Budget Act. A concurrent resolution, one which is a vehicle between the House and Senate only, is employed to finalize their agreement on the budget for the upcoming fiscal year. A joint resolution would require presidential approval, and, thereby, raise the visibility of the President as a politically accountable budgetary official. In the absence of the constitutional amendment with a requirement for the President to submit a balanced-budget provision, a joint budget resolution would be an improvement over the current process. At least one budget reform bill before the Congress includes this feature.

As a further option to improve the budget targeting process by fixing responsibility, the Congress may choose to define spending targets on a committee-by-committee basis, rather than the current functional approach. In doing so, the Congress would establish "ownership" of a spending record and relevant disciplinary successes or failures.

Finally, in the spirit of improving the understanding of actions taken in the budget-making process, the Congress should adopt the previous year's spending level as the baseline for considering the budget. This will provide every member with an opportunity to vote explicitly for increases or decreases in spending, regardless of their programmatic origin.

CONCLUSION

One of the biggest criticisms of proposals to improve transparency in the fiscal process has been that greater understanding of the process is no guarantee that some President, Congress, or political party will not increase taxes, spending, or deficits. This is a possibility. The issue behind improved transparency, however, is not the final course of fiscal policy; it is whether budgets reflect the public will and promote the public welfare, or whether they are fashioned behind a smokescreen which facilitates special-interest goals. Comprehensive reform to improve this accountability is urgently required.

Hayden G. Bryan
Senior Economist
Joint Economic Committee