

THE NEW MACROECONOMICS AND FEDERAL BUDGET REFORM

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ABSTRACT

This article provides an analysis of government finance and fiscal policy – taxing and spending – from the perspective of what is termed the new macroeconomics, a part of NIE or new institutional economics. It presents a view that is quite different from that of traditional budget-oriented thinking with respect to how we ought to analyze and measure the consequences of federal government fiscal policy and debt. The author suggests that a macroeconomic approach is more appropriate and makes more sense than traditional conceptions in terms of how we should assess the overall impact and consequences of government finance decisions.

INTRODUCTION

Arguably, the most dramatic advances of the past forty years in economic understanding have taken place in financial economics. There are two reasons for this success. First, modern financial markets have characteristics that make them particularly amenable to understanding via the economists' beloved mathematical tools of partial equilibrium analysis: many buyers and sellers and standardized products. Second, financial economics is a highly practical discipline. There is a direct and immediate pecuniary payoff to better understanding of financial markets.

Much of this new understanding has taken the form of appreciation of the consequences of decisions that have future effects in terms of their present values. Since the future is necessarily uncertain, much of this new learning is concerned with modeling risk and uncertainty and with the design of institutional arrangements that allow risks to be precisely formulated and priced. Among the most influential of the new financial theories are the capital asset pricing model, portfolio theory, derivatives pricing models and financial engineering, and the theory of real options.

Eventually these theories will probably come to play a dominant role in public financial management. Indeed these topics are increasingly evident in periodicals such as Public Budgeting and Finance and the Municipal Finance Journal. However, their main influence on the field of public finance has come through macroeconomics, especially monetary economics, where they directly bear upon the formulation of interest rates, both real and nominal, and their meaning. These theories have also influenced the way we think about fiscal policy as well and our understanding of the nature of fiscal stimulus and drag. In turn, those ideas have materially influenced our understanding of how government spending, taxing, and borrowing ought to be measured.

HOW TO THINK ABOUT TAXING AND SPENDING DECISIONS

Most macroeconomists would now agree that the best way to think about taxing and spending decisions that have long-term consequences for the American people is in net

present value (NPV) terms. Many budget pundits have forgotten that the executive branch of the U.S. government adopted a consolidated cash budget in the 1960s primarily for macroeconomic reasons: Keynesians held that the public sector borrowing requirement, the annual cash deficit, was the key to sound fiscal management. Few if any macroeconomists now believe that the annual cash deficit as depicted in the President's budget and in congressional debate on annual appropriations (e.g., trying to reduce the cash deficit or keep the annual cash deficit low as a percentage of GDP) is the key to sound fiscal management.

Indeed, it is well known that there is little if any correlation between the cash deficit and interest rates, savings and investment, or productivity growth. This is not because, as Robert Barro of Harvard once claimed, that fiscal policy does not matter (the basis for that claim, Ricardian equivalence, has been decisively rejected on empirical grounds), but because the deficit has been incorrectly defined. Three of the most influential of the economists taking this position are the late Robert Eisner of Northwestern University, Stanford's Michael Boskin, chairman of the President's Council of Economic Advisers under George H. W. Bush, and Boston University's Laurence Kotlikoff.¹

These respected and experienced observers of federal fiscal and macroeconomic policy make several important points:

1. The government's official debt measures only the government's liabilities. It completely ignores the government's assets. Using the government's debt figures to assess its financial position is, in their view, akin to calling the owner of a \$1 million property a debtor because he has a large mortgage on the property.
2. The conventional deficit measure fails to correct for inflation.
3. The government's official debt ignores government liabilities from transfer programs, such as Social Security, and its implicit commitments to other federal expenditures. The conventional deficit omits changes government's liabilities and assets as a result spending and taxing decisions.

With respect to these points, they indicate that the accepted measure of the deficit is based on arbitrary choices of how to label government receipts and payments. If the government labels receipts as taxes and payments as expenditures, it will report one number for the deficit. If it labels receipts as loans and payments as return of principal and interest, it will report a very different number. As Kotlikoff explains, social security is a good example of this phenomenon. Social Security "contributions" are called taxes, and Social Security benefits are called expenditures. If the government taxes Mr. X by \$1,000 this year and pays him \$1,500 in benefits ten years from now, this year's deficit falls by \$1,000 and the deficit ten years hence will be \$1,500 higher. But the taxes could just as plausibly be labeled as a forced loan to the government, and the benefits could be labeled as repayment of principal plus interest. In that case there would be no consequences for the deficit as it is conventionally measured on a cash basis.

GOVERNMENT NET WORTH

Most contemporary macroeconomists would argue that to measure fiscal stimulus or drag properly we must measure the change in government's net worth. That means measuring the value of all current and projected payments and receipts in inflation-adjusted (constant) dollars, which is the equivalent of saying we should measure government's liabilities and assets in terms of the discounted present value of our current commitments to individuals to make future government payments to them and to take receipts from them.

Thinking about fiscal stimulus and drag in terms of the change in net worth from year to year – what might be called the real deficit, leads to a radically different interpretation of postwar economic policy than does reliance on the cash deficit. From this perspective, the fifties, sixties, and seventies were periods of quite loose fiscal policy. The reason was the buildup of our unfunded pay-as-you-go Social Security, civil service, and military retirement programs. The 1980s and 1990s, in contrast, were marked by rather tight fiscal policy. The Reagan tax cuts and military build-up provided considerable fiscal stimulus, but other policies, particularly the 1983 Social Security reform, largely offset them. By raising the retirement age in stages to sixty-seven from sixty-five, and by gradually subjecting retirees' Social Security benefits to income taxation, the 1983 reforms reduced the present value of Social Security benefits to be paid to beneficiaries by about \$1.1 trillion at that time and nearly \$4 trillion now. This perspective, combined with a better understanding of monetary policy and the role of endogenous technological change, allows us to explain most of the variation in economic performance observed over the past 100 years.

Over and above concerns about fiscal stimulus or drag, one theoretical reason contemporary macroeconomists are concerned about the present value of the government's spending and receipts is that policies, which reduce the government's net worth, can increase national consumption, lower savings, lower investment, raise interest rates, and exacerbate trade deficits -- in short, do many of the bad things that have been ascribed to cash deficits. For example, redistribution from younger to older generations will reduce savings and increase consumption because older folks have greater incentives and propensities to consume than do young ones.

CONCLUSIONS

In 2004, the present value of the gap between America's long-term entitlement promises and its expected tax revenues looked to be more than \$70 trillion. Clearly, President Bush's tax cuts made the problem worse. A point demonstrated by the cash deficit. The difference is that the real deficit showed that controlling entitlement spending was the real challenge, not the tax cuts which added only about \$3-\$5 trillion to the fiscal gap. But, when it came to the entitlements issue, the president was largely silent. Although he talked about diverting payroll taxes to individual accounts, he initially said nothing about reducing Social Security benefits. Far from controlling entitlement spending, Bush expanded it, notably by increasing federal spending on prescription drugs for social security recipients, a measure which increased America's long-term fiscal gap by \$17 trillion in 2004 dollars.

President Bush's opponent in the 2004 election, Senator John Kerry, was no better. He was silent on Social Security reform and on health care proposed, if anything, to spend more than Bush. In the end, these concerns must lead to substantial changes in our national income and product accounts and how we measure government spending, taxing,

and borrowing. At a minimum, it should lead to substantial changes in methods of government budgeting and accounting.²

Finally, we must remember that the basic idea of the new economics of organizations is that the comparative advantage of governance mechanisms (e.g., public versus private provision of services to the public) boils down to a question of information or transaction costs, "...and to the ability and willingness of those affected by information costs to recognize and bear them."³ Consequently, the circumstances that create market failures, e.g., public goods, natural monopolies, externalities, moral hazard and adverse selection, etc., those types of problems that justify government action in a capitalist economy, are all fundamentally the result of information failures. Markets could deliver public goods, for example – if information technology existed that would permit free-riders who consume but do not pay to be profitably excluded from enjoying public goods. Monopolies could be compensated to behave like competitors -- if information costs were lower. And bargaining between self-interested individuals could eliminate externalities, without the intervention of government -- if transaction costs were zero. Much the same logic applies to the choice between organizations and markets and the kinds of governance mechanisms used within organizations, e.g., choices on how best to organize work production to gain greatest productivity and what types of management control systems to employ. These observations also have important consequences with respect to governance decisions about which sector to rely upon to provide goods and services to the public, and also on whether and when to contract-out for services delivery. And all of these decisions are important relative to government efforts to achieve cost savings and to budgetary decision making.

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NOTES

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