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Derail the Federal Gravy Train: A Normative Audit of America's Economic Policy Debate

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An Analysis of America's Economic Policy Debate

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There is a saying going around these days in Washington, D.C. that ". . . *all the king's horses and all the king's men will never be able to cut government spending again.*" The legacy of fiscal irresponsibility is that runaway, big spending government is out of control. And it's a bipartisan problem. Neither political party seems to know what to do about it. That's what this monograph is all about.

As we read the handwriting on the President's lips, we sense that even leaders with relatively clear sets of principles find it politically difficult to make those tough policy decisions that are required to turn the state of our economy around.

At the heart of the current debate is this question, *"Are we under-taxed or overspent?"* In the 1980's, federal revenue, taxed at significantly lower rates, rose approximately six percent annually. Federal spending grew through the decade at an annual rate of nearly eight percent. The question answers itself. We are a nation of people who, individually and collectively, can't balance our checkbooks. And we want more from government than we are willing to pay for in taxes.

The problems with the American economy are not the result of malicious actions by mean people. Rather, the problems are the cumulative toll of well-intentioned folks who either have not done their homework or have not considered the long run consequences of short run, quick fix policies. As I tell my students *"it's not just the crook in business you have to worry about -- it's also the honest fellow who doesn't know what he's doing. He can hurt you, too."*

The basic economic truth is that, in the long run, far from "creating new jobs," deficit spending actually throws people out of work. By hogging the supply of credit, the government elbows private firms out of the market. Strapped for funds, businesses languish. And unemployment soars. With the federal budget well over one trillion dollars, and triple digit deficits, isn't it imperative that stronger fiscal controls be exercised?

Stimulating demand through Federal spending has spawned evergrowing numbers of special interest groups. And should it be a surprise that each of these groups has vigorously guarded "its" so-called share of the Federal government's budget? After all, we now call them "entitlements." We need better control of government spending.

Do we really think we can all continue to stand in a large circle with our hands in each other's pockets and all expect to get rich? Certainly not. Do we need a safety net to catch those unfortunate individuals who have fallen through the cracks? Yes, however, we certainly shouldn't turn it into a bed for those who refuse to climb up and out.

Politicians will always be politicians. They survive by catering to special interest groups throughout the land. As long as we allow it, our politicians will literally spend money as if there were no tomorrow. When the day of reckoning does come, their track record indicates a propensity to raise taxes or borrow the money to cover their fiscal folly.

Proof positive is that it doesn't matter who is president nor which party controls Congress. We have lost our requisite self-discipline to resist voting ourselves more and more benefits from the public trough. One real hope is to change the system's rules, so that politicians can still be politicians without dragging an insolvent economy over the edge.

A Line Item Veto?

Our Founding Fathers, as delegates to the Constitutional Convention, felt strongly that the chief executive must have the power to veto legislation, if checks and balances were to operate. Presidential veto power, however, was to be qualified; and it could be overridden by a two-thirds majority of both houses of Congress. The question of granting an American president the power to veto each item in appropriations bills was not dealt with at that time.

However, nothing is so powerful as an idea whose time has come. The president should, therefore, send a proposed constitutional amendment to Congress, requesting presidential power to veto individual items in the U.S. budget. If and when such an amendment clears both houses of Congress, it will have up seven years to win state ratification. Such an amendment provides the necessary balance between realism and idealism. It should be adopted.

If Congress can't be convinced to sanction an amendment for a presidential item veto, are there other options? Two-thirds or more of the state legislatures can ask Congress to call a constitutional convention for the singular purpose of drafting and submitting an item-veto amendment. Congress would be obligated to comply.

With the item veto, the chief executive can disapprove a provision of an appropriations bill without having to disapprove the entire bill. He can designate the provisions which are unacceptable to him and return it to the Congress with his comments.

Congress can subsequently practice the same procedure for the item veto as it does for any other veto by putting together a two-thirds majority to override the veto. The discipline of the line item veto should help to reduce extravagance in public expenditures cut back on pork barrel appropriations.

The line item veto could help to restore to the office of the president the balance of power that was intended to work. By mandating that bonafide political horsetrading take place on Capitol Hill, it would boost the sagging image of Congress. It would send a signal that Washington is also serious about dealing with the record deficits.

A president, armed with a line item veto, could focus the attention of Congress and the country on particular items of spending that he deems wasteful or inappropriate. The present veto is too general a weapon. Presently, he may face the choice of having to veto major legislation to get at the one or two items in a bill that are genuinely contentious.

Recapture the Mandate

Chief executives and Congressmen readily offer lame explanations that the Federal budget can't be cut much because social welfare program spending is "uncontrollable", that is, mandated by law. Certainly, whatever laws previous Congresses and presidents have enacted, any future Congress and president can repeal. Perhaps what is really uncontrollable is the instinct for political survival among our public servants. Repeatedly, our leaders have shown their unwillingness to balance the books.

The governor of every major state in the Union has line item veto power, which permits the Executive to veto individual items in the legislature's budget. Nearly every president since Ulysses S. Grant -- Democrat and Republican -- has requested it. President Roosevelt, in his annual budget message of Jan. 3, 1939 put it this way:

> *A respectable difference of opinion exists as to whether a similar item veto power could be given to the President by legislation or whether a constitutional amendment would be necessary. I strongly recommend that the present Congress adopt whichever course it may deem to be the correct one.*

In forty-three of the fifty states, the governor has been granted such a line item veto. It should also be a necessary part of presidential power. A recent Gallup survey reported that seventy percent of Americans favored granting line item veto power to our presidents.

What about those who believe that the only response to the present budgetary crisis is election of "responsible" representatives? Have we forgotten that the Congress presently consists of such well-intentioned individuals? Justification for the amendment lies directly in the Congressional fiscal irresponsibility that has plagued our economy for at least the last several decades.

As with the first ten amendments, a line item budget amendment limits the power of Congress to bind the people with excessive taxation and deficit-caused inflation which acts as a tax. The amendment would force members of Congress to identify themselves, by their votes, as deliberate budget busters, if they desire to commit funds that will have to be borrowed.

Critics contend that fiscal theory should not be in the Constitution. However, the 16th Amendment authorized the income tax; that was not in the Constitution originally. Currently, the Constitution contemplates revenue raising, but it doesn't deal with how much can be spent.

It is probable that if a president held the power to veto individual spending items, Congress would then be constrained to decide what is justifiable spending and what is not. If Congress refused to be a good steward in managing the peoples' tax payments, those taxpayer-voters who elect presidents should also grant them the sanctions to use the item veto authority to restore budget control.

Certainly it is logical that once politics-as-usual has operated in the budgetary process, that overall responsibility should rest with the president. This has proved true in those forty-three states in which their chief executive retains the line item veto power.

No Free Lunch

The question before the house is this: *"Do we want to risk a speedup of inflation and the destruction of our currency by boosting government deficit spending and hampering savings and production, or are we really determined to cut Federal expenditures, curb the growth of the money supply and thus preserve our currency and our economy?"*

Office seekers know that many voters realize that increased Federal spending, without corresponding increases in taxation, will cause an inflationary bias. Candidates and voters alike also know that such a practice can lead to recession and unemployment. And so, politicians, whose actual policies and programs would oblige a significantly larger Federal budget, are apt to camouflage this fact.

Alas, there is not a free lunch. Everything has a cost that must be paid by someone. In the past three decades, the Federal government has been doling out money for many programs that had never been part of its responsibility earlier. If such money, heretofore thought of as "free," could potentially be reduced through a line item veto amendment, the "victims" would be complaining about economic and social injustice.

If those programs are in fact important, then couldn't the would-be casualties petition their state legislatures for similar programs? Some of the programs might no longer be so important, if the citizens were asked to pay for them directly.

Nearly a decade ago, the governor of Illinois said he would put off a line item veto of funds for a mental-health center if the legislature found equal savings somewhere else in the budget. This give-and-take process is certainly helped along by the stark reality that states cannot legally resort to printing press money to cover their deficits.

Although not the main subject of this publication, it might have been better for all Americans if our leaders of those past decades had the resolve to go even farther and start the process toward an honest-to-goodness balanced budget amendment. The typical version of a balanced budget amendment would require Congress to enact each year a budget whose outlays did not exceed expected revenues. Peacetime deficits would be allowed only with the consent of three-fifths of both houses.

Wartime deficits could be approved by a simple majority. Congress would increase spending substantially from year to year--but only if it were willing to vote for higher taxes. Without such a vote, revenue increases would be held to a pace no greater than the nation's rate of economic growth.

"Trickle Down" vs. "Siphon Off"

Have the chickens come home to roost? At odds today are the neo-classical supply-side economics and the Keynesian demand-side economics, sometimes alluded to as "trickle down" and "siphon off" approaches respectively.

Five decades of education based on demand-side economics have understandably caused this approach to be deeply imbedded in the thinking of our elected leaders, scholars, and the media. Therefore, an understanding of supply-side economics is still beyond the grasp of many today, even though it is pure, vintage Adam Smith.

The ideas of John Maynard Keynes have dominated the last five decades, and his theories have been imposed on western democracies. What were his basic premises? He preached that prosperity would be the result of increased consumer demand and increased government spending through an inflated currency.

Keynesian "siphon off" policies have drained away the private sector's vitality. The notion was that we could continually prod the economy into prosperity through force feeding it with annual budget deficits. That created a noxious mixture of slow growth and chronic price increases that we call "stagflation."

Those results should have knocked Keynesian economics off its pedestal. But it hasn't happened. Why? Another type of deficit, this in our export/import trade, is the prime reason that those chronic, triple digit Federal budget deficits have not spawned more inflation during the last decade. Those trade deficit dollars have flowed back into the American economy as foreigners have been purchasing our government and corporate debt.

Supply-side economics, in its simplest form, is the application of incentive-based price theory to the economy. It has its foundation in the belief that the free market is stable and, if the government keeps its hands off, the result will be an efficient allocation of goods, services, resources, and income.

Far from being new and unsound, the basic principles of supply-side economics have been standard operating policy through most of America's history. Its legacy has been the phenomenal development of American capitalism.

One needs only to contrast that early American record, and Great Britain's wonderful achievements in the 19th Century, to the Keynesian legacy of falling productivity, persistent inflation, relatively high tax burdens and the quantum leap in the size and scope of government and its debt in the past 50 years and ask which policy was the fluke, which one was unsound, and which one failed?

Nothing Heals Like a Tax Cut

Supply-side economics is as ancient as that five thousand year old *"Aesop's Fables"* about *"The Goose That Laid the Golden Egg."* In the fable, some well-intention folks want to catch and kill the golden goose to get the rest of those golden eggs. However, sounder minds prevailed. The people in that tale learned that it was in their long run interest to nurture and stroke that golden goose. The result would be more golden eggs in perpetuity.

Adam Smith, author of The Wealth of Nations, in 1776, was one of the first to propose a supply-side theory that stood apart from mercantilist protectionist economics. His principles were not followed by government leaders until Britain's Prime Minister Gladstone formally embraced them in the latter half of the 19th century. History was to then record that his program was indeed highly successful.

Prime Minister Gladstone's program did involve sizeable tax reductions, rapid economic growth and the elimination of budget deficits. Recognized as the dominant view of fiscal macroeconomic policy of its day, this approach can hardly be indicted today of being radical or new. Supply-side economic principles are rooted in classical macroeconomics.

So, here is supply-side economics in a nutshell. A reduction in tax rates is like a raise in pay which results in higher savings, lower interest rates and higher investment. Corporate tax rate cuts and/or increases in the investment tax credit, combined with accelerated depreciation allowances, improve business investment by increasing average after-tax rates of return.

Higher business investment results in productivity increases, more output per unit of input. The transfer of resources from the government sector to the private sector increases productivity rates still further, since productivity gains in the government sector are usually nominal.

The subsequent increased rates of economic growth provide the needed factory capacity to create additional goods and services demanded because of the tax cut. The result is balanced economic growth with neither shortages nor surpluses. Reduced tax rates result in lower demands for wage increases, because real income has risen as a result of the tax cut. With the wage-price spiral somewhat broken, lower inflation results in an increase in real income.

Consumer spending, output and employment, will subsequently be on the rise. Lower tax rates give individuals more incentive to work, and quite naturally the result is more and better work being performed. The private sector's productive capacity is further increased, and the underlying inflation rate is reduced further.

Law of Diminishing Returns

It was controversial West Coast economist, Arthur Laffer, who said it was insufficient supply that resulted in inflation and economic stagnation. The prime cause was a governmental wedge that interfered with the free market's incentives to work, invest and produce, and produced ever-increasing level of taxation, government regulation and spending. The cure: cut tax rates frequently, irrespective of the size and scope of inflation, business fluctuations, and federal budget imbalances.

The "Laffer Curve" is basically a bullet-shaped graph which compares the relationship between tax revenues and tax rates. The curve shows that when tax rates are low, tax revenues are low. As tax rates rise, revenues increase at a reduced rate. At some optimum point on the curve, tax revenues are maximized. If tax rates are raised further, fewer dollars will flow into the Federal coffers. It's the law of diminishing returns in it purest form.

Supply-siders correctly say that inflation is the result of too much money chasing too few goods. By stimulating the supply-side of our economy, a sizeable step could be taken to reduce price inflation. Personal and business-tax cuts combined with deregulation are designed to restore conditions that would produce long-run growth.

Cuts in Federal spending and stable money supply growth are both vital to their success. So, another cornerstone to it all is a central bank policy that holds the line on money supply increases. This, in tandem with more goods available for purchase, would throttle the inflationary problem of too much money chasing too few goods.

In large measure, the remarkable resurgence of Japan and West Germany to become the third and fourth largest economic powers can be attributed to tax policies which encouraged growth. Japan and the former West Germany have fairly low rates of tax on earnings and profits. It is supply-side economics personified: a narrow tax base and low rates of direct taxation promote rapid economic growth which results in high and ever-increasing tax revenues.

These low tax rates bring about high rates of real economic growth, resulting in rising revenues which can be made available for public sector spending for well-run social programs. At the same time, welfare states like Sweden rely on high tax rates, and continue to labor under serious economic difficulties.

Critics of tax cut plans still say that it will be making 250 million Americans the guinea pigs for an untested economic theory. That hardly seems to be the case, in light of economic history. Pay your money, and take your choice.

A Republican–Democrat Connection

Supply-siders enjoy pointing out that prior to former President Reagan, the last real growth-oriented politician in the United States was President Kennedy. Mr. Kennedy launched a very abrupt change in economic policies in the United States, cutting taxes the most on those who earned the most. Mr. Kennedy believed that no person has ever truly prospered by trying to pull down another.

His point was that we don't work just to pay taxes; we work to have what is left after taxes. Furthermore, entrepreneurs don't look at factories with humanitarian motives; they are looking for rate of return on investment. Nobody saves to go bankrupt; we save to augment our wealth.

Mr. President Reagan told the nation that federal tax reductions will not be held hostage to spending reductions. In fact, Mr. Reagan clearly said that *"government revenues will increase as the economy grows. . .because the economic base will have been expanded by reason of the reduced (tax) rates."*

Mr. Kennedy in his 1963 Economic Report of the President made the same point as follows: *"Tax reduction thus sets off a process that can bring gains for everyone"*. . .and explained why *"reducing taxes is the best way open to us to increase revenues."*

What about the issue of helping the poor to cope with the hardships of life? Here, Reagan and Kennedy share sharply different views from the Keynesian redistributionists. Time and again, Kennedy remarked that the best form of welfare was still a good, high-paying job. This notion was characterized by the phrase that *"A rising tide raises all boats"* and that a growing economy elevates the standard of living of the poor, along with the more affluent.

Redistributionists turn the Kennedy *"rising tide"* phrase on its head and refer to the same policies as *"trickle down"* economics. A better term would be *"flow through."* Reagan, remaking Kennedy's point stated: *"Our aim is to increase our national wealth so all will have more, not just redistribute what we already have which is just a sharing of scarcity."*

So-called *"trickle down economics,"* can be a sound economics. In a market economy, taxable revenues are created by the deployment of capital. If we don't penalize those who have the capital by high tax rates, the benefits do *"flow through"* the economy. Such has been the very positive heritage of our American Industrial Revolution.

In the 1963 Economic Report of the President, Mr. Kennedy put it this way:

> *Tax reduction thus sets off a process that can bring gains for everyone, gains won by marshalling resources that would otherwise stand idle--workers without jobs and farm and factory capacity without markets. Yet many taxpayers seem prepared to deny the nation the fruits of tax reduction because they question the financial soundness of*

reducing tax when the federal budget is already in deficit. Let me make clear why, in today's economy, fiscal prudence and responsibility call for tax reduction even if it temporarily enlarged the federal deficit--why reducing taxes is the best way open to us to increase revenues.

It looks as if we need another strong R & D effort to get us back on track. By R & D we mean "Republican and Democrat." After all, there is plenty of blame to go around both parties.

Derail The Federal Gravy Train?

It has been said that our redistributive society has evolved through three stages. First, we taxed the wealthy, stealing from the rich. Second, through deficit spending and inflation, we used unbalanced red ink budgets to steal purchasing power from the middle class. Third, through overconsumption caused by producing less and demanding more, we stole from our children by providing insufficient capital for economic growth.

It all comes back to that old saw, *"What the difference between Christmas and the deficit?"* Answer: *"With Christmas, kids tell Santa what they want, and the adults pay for it. . .With the deficit, adults tell the government what they want, and their kids pay for it."* This has undoubtedly been a sure way to discourage ancestor worship.

The notion that we could continually prod the economy into prosperity, through force feeding it with annual budget deficits, has created "stagflation." We cannot spend ourselves rich. Attempting to do so has drained away the private sector's vitality and has caused scary combinations of budget deficits, chronic inflation, and volatile interest rates.

The real argument about the budget deficits and the quantum leap in the Federal debt centers on their effect on the size of government. The liberal likes the deficits, because he favors big government. The conservative opposes it, because he is four-square against big government. Many of the contentions regarding budget deficits have been contrived out of a desire either to expand or contract the Federal government.

If there were any one prescription that would do the American economy an enormous amount of good, it would be a healthy dose of the 4-D's: De-tax, de-spend, de-regulate, and downsize government. A Constitutional line item veto budget amendment appears to be one means of bringing Congress' excessive spending under control.

Thomas Jefferson said it best: *". . .let no more be heard of confidence in man, but bind him down from mischief by the claims of the Constitution."* It is indeed regrettable that this approach was not tried decades ago, before the numbers go so downright scary. This is open-heart surgery we're talking about. But after all, capitalism, as we know it could be in the oxygen tent if we wait too long.

Summary

Alexander Tytler, professor at Edinburgh University, writing at the time of the American Revolution, was right on the money with this:

> *A democracy cannot exist as a permanent form of government. It can only exist until the voters discover that they can vote themselves largesse from the public treasury. From that moment on, the majority always votes for the candidates promising them the most benefits from the public treasury, with the result that a democracy always collapses over loose fiscal policy, always followed by a dictatorship.*
>
> *The average age of the world's great civilizations has been 200 years. These nations have progressed through this sequence: From bondage to spiritual faith; from spiritual faith to great courage; from courage to liberty; from liberty to abundance; from abundance to selfishness; from selfishness to complacency; from complacency to apathy; from apathy to dependence; from dependence back into bondage.*

All in all, probably no clearer message has been sent since Noah said, *"It looks like rain."* To demand a painless way out of our situation is being like the young man who, as he was about to be sentenced by the judge for bumping off his parents, pleaded, "*Your Honor, I need mercy, because I'm an orphan, you know.*"

Elected officials enjoy delivering benefits to the voting public. It involves no small pain for them to be the messengers when programs and benefits are cut. We might react by throwing the rascals out and getting a new set of rascals. A bit of schizophrenia exists here: we are uncomfortable with big government, and yet we expect so much (and then more) from it.

Most political leaders are, in fact, followers of public opinion. Accordingly, they will only pass laws to balance revenue and spending when it becomes politically profitable to do so. We should especially keep the pressure on newly elected members of Congress, because they are the ones who generally are more responsive to the folks back home. Then, they unwittingly act in behalf of our long-range economic well being.

One productive way to reduce the deficit is to slow the rate of growth of government spending, perhaps through an honest-to-goodness budget freeze. On the contrary, a tax rate increase would slow down economic growth. If we raise tax rates, there will be perverse results on spending, saving, investment, and federal revenues, as Americans become poorer.

If we could keep the deficit down to no more than $200 billion for each of the next six years, and if at the same time we had nominal Gross National Product growth of 8% compounded (which means perhaps 4% inflation and 4% real growth), then in that six-year time frame we would reduce the ratio of budget deficit to GNP by 50%. At that point, a $200 billion deficit would not look all that imposing compared to our annual output of goods and services.

Finally, it was America's first great economist, Pelatiah Webster (1726-1795), who stated the following in an essay in opposition to the Continental currency inflation: "*An error in finances, like a leak in a ship, may be obvious in the fact, alarming in its effects, but difficult to find.*" We in the United States seem unwilling or unable to spot the leaks and seepages leaks in our twin ships of monetary and fiscal policy.

But as Webster also said: "*The first thing necessary to correcting an error is to discover it. The next thing is to confess it, and the last to avoid it.*" It's a tough job, and we have to do it. Let's get started.

Write to your elected representatives; tell them what not to do for us and what not to give us. Tell them that we expect a solvent economy and a government that lives within its means. Cast your vote to remove from office those who would have public sector spending go beyond the we the people's ability to pay of "we the people." Do that, and then coming generations, who become the true judges of what we do today, will find us worthy of our task.

The *ENTREPRENEUR* is a quarterly journal and newsletter addressing contemporary economic issues from a moral perspective. One may not agree with every word printed in the *ENTREPRENEUR* series, nor should one feel he needs to do so. It is hoped that the reader will think about the points laid out in the publication, and then decide for himself.

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Dr. Don Diffiné is currently Professor of Economics at Harding University in Searcy, Arkansas and Director of the Belden Center for Private Enterprise Education. He is also the Director of Economics Teams that have won First Place in national Students in Free Enterprise competitions on six occasions.

Listed in the Heritage Foundation's **Guide to Public Policy Experts**, Dr. Diffine is the author of a 200-page **Facts Book for Business and Industry** and compiler of the **American Incentive System Calendar--A Daily Chronicle of Enterprise**. He has been published frequently in the **Journal of Private Enterprise**.

Dr. Diffine is the recipient of the Freedoms Foundation George Washington Honor Medal in the category of Published Works, for his article "All American Economics--Made in the U.S.A." He is the editor of the ENTREPRENEUR, a newsletter that has received five Freedoms Foundation awards in the category of Non-profit Publications. In 1990, the National Flag Foundation presented their "New Constellation Award" to Dr. Diffiné for his patriotic booklet, **"TO THE FLAG--Our Banner of Liberty"**.

The recipient of the $7,500 Freedoms Foundation Principle Award for Excellence in Private Enterprise Education, Dr. Diffiné has received 8 other Freedoms Foundation awards, in the categories of Economic Education, Public Affairs-Advertising, Public Address, and Published Works. He is also the faculty winner of a $1,000 First Place prize in a National Essay contest judged by Nobel Economist Milton Friedman.

In 1988, the First Annual Distinguished Scholar Award was presented to Dr. Diffiné by the Association of Private Enterprise Education. Dr. Diffiné is listed in **Personalities of the South** and **Outstanding Educators of America**. The Wal-Mart Foundation has designated him as a Free Enterprise Fellow.

Dr. Diffiné has provided Congressional testimony on business problems, economic impact statements, and inflation-recession dilemmas. Also an economic humorist, Dr. Diffiné is a frequent speaker for conventions, trade associations, chambers of commerce, and commencements.

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