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SPENDING RESTRAINT MEASURES BEFORE THE SENATE

The House has passed a reformed version of the line item veto sponsored by Representative Paul Ryan (R-WI). It would allow the President to send the Congress a request that specific spending items and narrowly-targeted tax measures in a newly-enacted law be reconsidered. The President's request would have to be submitted within 45 days of enactment. He would be allowed 5 lists of rescissions for an ordinary bill, and 10 lists for an omnibus appropriation or reconciliation budget bill. The Congress would have to vote on the request, without amendment, within 14 legislative days. The measure now goes to the Senate, which should give it serious consideration.

A previous version of the line item veto was struck down by the Supreme Court in 1998 because it took too much legislative authority away from the Congress. In that version, the President could rescind a portion of an appropriation, and the money would not be spent unless Congress acted to restore the spending. The new measure is expected to pass Court scrutiny because Congressional action will decide the outcome.

The line item veto is aimed mainly at controlling wasteful spending, especially non-cost-effective earmarks that have proliferated in recent years. It may also be used to curb special-interest tax preferences. Such targeted spending items and preferences are often inserted as minor items in large spending or tax measures whose over-all necessity or popularity makes it impractical for a Member of Congress to vote against it, and makes a Presidential veto of the entire bill futile. This version of the line item veto forces a re-vote on such items without their protective cover, one-by-one or in small groups, which makes them much less likely to be re-approved.

Trimming wasteful earmarks is a useful step in bringing some restraint to Federal spending, but it can only do so much. Another measure before the Senate would restore some control over total budget outlays.

Senator Judd Gregg (R-NH) has proposed a new version of the old "PAYGO" rule. Under the old PAYGO rule in the 1990s, discretionary spending hikes had to be offset by tax increases or discretionary spending cuts. Entitlement increases or tax reductions required offsetting entitlement cuts or increases in other taxes. These rules blocked efforts to reduce tax barriers to growth.

The new version would cap discretionary spending growth, and would mandate that overages be offset by an across-the-board spending reduction. It would build a certain amount of emergency spending into the cap, but would end the open-ended "emergency spending" loophole that plagues the current budget rules. It would set targets for the deficit to decline as a share of GDP to achieve virtual balance by 2012. Congress would be required to trim spending to meet these deficit targets; failure to due so would trigger across the board cuts in entitlements. Tax increases would not be required. This formulation would clearly be more effective than the old PAYGO system in trimming the size of government, not just the deficit. There would also be a line-item veto/expedited rescission provision. The bill would establish two commissions, one to end obsolete agencies or programs, and one to put entitlement programs on a sound financial footing.

It is vital to focus on spending restraint to restore budget balance. Government spending has been soaring as a share of GDP, and is the real source of the deficits. Furthermore, government spending frequently reduces national output and welfare. There are two reasons for this.

First, when the government spends, it diverts manpower, land, and materials away from private sector use. Private output declines.[1] Unless the government's use of the resources produces more value than the private sector product that is preempted, welfare falls. Since the government has no market to test the value of its spending, seldom subjects its spending to any cost-benefit test, and often decides to spend based on political rather than economic considerations, there is a strong presumption that the preempted resources yield less value in government use.

Second, government outlays cost more than they appear to do. They must eventually be paid for by taxes. Most taxes create disincentives to produce, or otherwise distort the economy, which reduces private sector output by more than the revenue transferred to the Treasury. The additional loss in GDP from the tax is an extra, hidden cost of the Federal spending. If the tax associated with a dollar of federal spending reduces GDP by an additional dollar, the cost of the spending to the private sector is $2, not $1.[2]

The proposed budget process reforms would help to counter the strong parochial pressures on the Congress to overspend. The reforms should be adopted. A further step would be to subject the federal budget to some form of real cost accounting, recognizing the economic impact of the tax and spending provisions. That, too, would greatly benefit the budget process and the general public.

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President and Executive Director

Endnotes

1. This assumes markets are working, and there are no really idle resources. We are not in a Great Depression — and even that was due mainly to mistakes in federal monetary, tax, tariff, and regulatory policies, not to private sector error. It has been many years since economists have assumed that additional federal spending adds to total real GDP. Federal spending is counted as GDP at cost, on the assumption that it is worth the outlay. This keeps GDP constant in an accounting sense. But if the particular spending project is a less efficient use of resource than the private sector use (or the spending could have been put to better use elsewhere in the government sector), it lowers real welfare.

2. Taxes on labor encourage people to work somewhat less and take somewhat more leisure. The modern economic view is that this effect is modest, but non-negligible. Taxes on capital are far more destructive. They encourage consumption instead of saving and investment, and chase investment abroad. The result is reduced domestic capital formation, labor productivity, wages, and employment. This reduces the revenue take from the tax, and reduces private sector income. The loss to the private sector from a dollar of federal spending is the tax revenue plus the loss of private sector output and income from the distortion. The marginal tax take at the federal level is about 35%. The negative revenue "reflow" from a tax increase (offsetting loss from reduced activity) is widely assumed to be between a third and a half for most taxes. Therefore, these taxes must be reducing private activity by between $1 and $1.50 for each dollar of revenue that is apparently raised on a given level of GDP.