Abstract: The current federal budget process lacks the singular element that gives meaning and motivation to budgeting and economic analysis: the concept of scarcity. The effective operating assumption of the activity we now call federal “budgeting” is that investors will provide the government with unlimited resources in exchange for US Treasury debt. Accordingly, for federal budget decisions, choice is unnecessary, opportunity costs approach zero, and allocative efficiency is passé. Even those analysts who warn of harm from a national budget process without scarcity usually focus on its adverse effects on economic growth and an elevated risk of fiscal, economic, social, and political instability. In fact, the continuous loss from suboptimal resource allocation is arguably as great. This paper offers an outline of events leading to the political end of scarcity for government and revisits a long-standing proposal to restore the missing element and improve federal budget decisions. (146 words)

I. INTRODUCTION

With economics and budgeting: it’s all about scarcity.

Microeconomics is the study of how people do the best they can with resources that are scarce in relation to their beneficial uses, i.e. engage in the process of “constrained optimization.” Budgeting is a means of disciplining and informing necessary choice consistent with the goal of maximizing benefits from limited

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1 I thank the participants in the 2020 SEA Session, especially my discussant, Barry Poulson, and Tracy Gordon, John Merrifield, Roy T. Meyers, Justin Ross, Eugene Steuerle, and David Torregrosa for helpful comments and corrections.
resources. Addressing scarcity is the general activity, budgeting a specific instance.

Markets and government are social institutions commonly used to minimize the adverse consequences of scarcity. Microeconomics provides a conceptual solution to the optimization problem for both: allocate scarce resources to alternative uses until the marginal benefit from each alternative is equal, or until marginal opportunity cost equals marginal benefit.

Given universal scarcity and the unique power to compel, governments must make two distinct types of allocative decisions: among alternative governmental uses of resources and between public and private choice, i.e. between market and government allocation. For intra-governmental allocative decisions, policy makers must compare the costs and benefits of alternative public uses of funds. For public-private trade-offs and settling on the “right size” of government, the median voter is assumed to approve increased spending until the marginal value of government services is equal to its opportunity cost or the highest value alternative private use of funds. Thus, government’s claim on resources is limited to the inferred value of government services. That is, to amounts constituents are willing to pay.

For the first 150 years of so, US government budgeting was governed by the “balanced budget norm,”: spending more than current revenues was acceptable especially during wartime, conditional on retirement of the debt issued after the emergency had passed. (Figure 1). Beginning in the Great Depression, however, the balanced budget norm was gradually replaced by a new orthodoxy: when resources are unemployed, borrowing (issuing Treasury debt) is a long-term alternative to increasing taxes or reducing other spending to finance new government spending. The underlying rationale, part of the new Keynesian macro-economic paradigm, was that increased total spending, without increasing tax rates, would increase aggregate demand for goods and services, thereby

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2 Both, of course, are imperfect. Much of economics is aimed at improving the performance by criteria of both.
3 Government’s power to compel payment of taxes and to impose other restrictions on private choice creates the potential for government to increase the efficiency of private choice in the presence of “market failures,” e.g. externalities, public goods, insufficiently competitive markets, asymmetric information, assignment and enforcement of property rights and contracts, and to promote a socially desired distribution of resources among constituents. However, net gains from those intervention result only so long as marginal social benefits exceed social cost.
increasing the demand for idle resources including unemployed labor. The increase in employment and income would raise tax revenues and reduce outlays for public assistance. In prospect, the increase in spending could be self-financing and “pay for itself.”

The existence of unemployed resources thus seems to offer relief from the “dismal” implication of scarcity: we can have more of one good or service only if we give up something else of value, or if we bear its opportunity cost. In its vernacular form: “there ain’t no such thing as a free lunch.” Under the new paradigm, additional government spending in the presence of unemployed resources could provide benefits to the public at zero cost, i.e. without giving up anything else of value. Moreover, for policymakers, some resources almost always seem to be unemployed, but for reasons that may have nothing to do with weak aggregate demand.4

The new view eventually proved popular with policymakers and their constituents because the prospect of providing and receiving benefits at no cost to anyone was politically irresistible. It remains the dominant policy heuristic for federal budgeting and finance today. Nonetheless, the new norm—in the presence of a seemingly inexhaustible demand for US Treasury debt—has had the adverse effect of seeming to obviate the need to allocate resources based on their respective costs and benefits when resources are effectively fully employed in beneficial activity.

This paper offers an explication of how a strictly limited but correct macroeconomic insight became the gateway to a transformation of federal budgeting into its enduring antithesis. It also offers a proposal for a budget process change that could restore the gains from policies that increase allocative efficiency, while retaining use of the insight that fiscal policy has the potential to add social value by reducing cyclical unemployment.

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4 Walter Oi, famed Professor of Economics at the University of Rochester and major contributor to the case for an all-volunteer military force is said to have replied to a reporter’s question as to whether the US had finally reached full employment with: “No, I don’t think so,” while gesturing toward acres of lawn outside his office. “Look at all that grass, and no sheep.”
II. PUBLIC BUDGETING: An Economic Perspective

Budgeting and economics exist because of the scarcity of resources relative to their beneficial uses; without scarcity both lack purpose and function. Absent scarcity, benefits are free of opportunity cost. More can be had of everything without giving up something else of value. If resources are available at no cost only to sovereign governments, people rationally demand every service provided by government to satiety, until marginal benefit is zero (Buchanan and Wagner 1977). In fact, the absence of scarcity appears to be the only condition in which, when uncertain, it is always better to err on the side of getting too much in benefits from government, rather than too little, i.e. “go big or go home.” Without scarcity in public choice, Medicare for all dominates Medicare for those who require assistance. Universal, complete student loan forgiveness is preferred.

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5 An economic interpretation of budgeting is sometimes dismissed as irrelevant to the design of effective budget processes because budgeting has many other purposes of equal social importance to scarcity-constrained optimization. (Khan and Hildreth. 2002 provide a summary.) Principal among those multiple functions is to resolve conflict among important constituencies. However, scarcity is the principal source of that conflict. One failing of the current budget process is that it resolves conflict in large part by shifting costs to the future rather than by weighing the trade-offs and benefits of alternative resolutions.
to anything less. Expanded Social Security benefits, paid leave, and a living wage for all is the rational, preferred choice over more limited policies. If additional spending for defense provides any social benefit, it should be undertaken. Tax cuts are always to be favored over current or higher levies.  

Instead of scarcity and the associated search for efficiency in the allocation of resources, the current federal budget process starts with a focus on “stimulus,” the increase in aggregate demand from debt-financed spending increases and tax cuts needed to maintain high employment. To be sure, the pace of economic activity and resource use is subject to cyclical variation in aggregate demand, which may be dampened by offsetting changes in monetary and fiscal policy. But intensity of resource use at any time is also subject to variation for reasons—adjustment to changes in tastes, technology, relative prices, taxes, or the appearance of pandemics, which directly increase the cost of in-person commercial transactions—other than changes in aggregate demand. The persistent use of aggregate demand stimulus to eliminate unemployment from all causes reduces the ability of the economy to adjust productively to change and imposes inefficiency and dead weight losses on society. In the process, it can contribute to secular stagnation in economic growth by retarding the movement of resources to higher value uses. (Merrifield and Poulson 2021).

The notion that borrowing is a costless alternative to tax increases and spending reductions as a means of financing new spending is an example of F. Bastiat’s well-known (to economics students) Broken Window Fallacy. In his 1850 essay, he uses the incident of an errant stone breaking a window in a baker’s shop to debunk the false view that destruction of existing assets can produce net benefits because it leads to an increase in the demand for labor and goods required for its repair or replacement. This in turn increases the number of jobs, income, and additional spending and creates a virtuous spiral of greater prosperity for all. Bastiat emphasizes, however, that the claim of net gain ignores the (unseen) net value that would have been obtained if the requisite resources had been

6 To be completely clear, the embrace of unconstrained budgeting is bipartisan. We live in an era of the Two-Santas (Wanniski 1976) with each providing “gifts” of increased government spending or reduced taxes that are more accurately characterized as “loans.” (Steuerle 2018)

7 “Ce qu’on voit et ce qu’on ne voit pas” (“What is seen and what is not seen”). In this essay, Bastiat introduced through the parable of the broken window, the concept of opportunity cost in all but name.” Wikipedia.
employed in alternative, more productive uses. That is, the fallacy arises from the unrecognized opportunity cost of replacing the broken window. Borrowing to finance an increase in consumption today similarly produces obvious, immediate benefits, but at a distant, uncertain, “unseen” and deeply discounted cost today. In fact, the cost amounts to a sacrifice of equal future value. Borrowing merely defers the recognition of cost to another time.\(^8\)

Nonetheless, the past 50 years of US fiscal policy have been characterized by the gradual disappearance of fiscal limits, scarcity, and opportunity cost as budgetary considerations of US federal policymakers. This development has been documented by others, including Merrifield and Poulson 2017, Chapter IV. Historians generally attribute this change to the Keynesian Revolution which swept away the balanced budget norm and replaced it with a focus on using government budget deficits to maintain high employment in market economies.

For our purposes, it is important to note that the revolutionary contribution of the new Keynesian paradigm was not merely that debt-financed spending could be useful in addressing scarcity during recessions. Rather, a critical political effect was the popular belief that debt financing of spending could produce social gains in good times as well as bad times, if some resources appear to be idle. A secondary, but also key, implication of that finding was that repaying debt is not necessary,\(^9\) except when all resources are employed, and excess demand is only increasing the prices of produced goods and services. Thus, under the new norm, the “right” level of budget deficit/surplus—and change in the amount of outstanding public debt—is determined by the perceived state of the economy with respect to the goals of full employment and stable prices.

In providing policymakers with a new, potentially costless, tool for addressing scarcity, the new macroeconomics affected federal financial decisions at three allocative margins: present-future, public-private, and public-public.

**Present-Future.** Under the balanced budget norm, intergeneration redistribution was not a significant consideration in federal budgeting. Each generation paid for

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\(^8\) Behavioral studies use a different term for the same fallacy: What you see is all there is, or WYSIATI (Kahneman 2011).

\(^9\) In fact, investors, consumers, and firms value and demand near-riskless, highly liquid financial assets to hold, which sovereign governments are able to provide with Treasury debt at very low-cost. The optimum level of public debt is neither zero nor unbounded.
the value it assigned to current services and, in the process, bequeathed some long-lived assets to future generations, even though benefits-based arguments could have been used to support debt financing of capital investment. Under the new budget norm, each generation can be expected to leave some debt to future generations, if “stimulus” does not pay for itself and if periods of inflation are insufficiently severe and frequent to make up the difference. In any case, the new permanency of debt means that each future generation only bears the carrying cost of debt rather than the cost of its retirement.

The key feature of the new regime, however, is that while the issue of new debt finances immediate, highly visible benefits comparable to those financed by equal tax increases and spending reduction, its perceived opportunity cost to the current generation approaches zero, perhaps amounting only to the amount of bequest needed to offset service costs of living heirs. Thus, the new fiscal norm reduced the cost of debt relative to alternative forms of public finance and reallocated net benefits from future to the present generations.

**Public-Private.** Under the balanced budget norm, the size of government spending was limited to the amount of taxes the electorate was willing to pay in good times, when the debt issued in bad times was to be repaid. Government-provided goods and services had opportunity costs equal to those of private suppliers. The new norm’s acceptance of perpetual debt financing by government abolished the old constraint and shifted some current cost of government to future generations. This change reduced the cost of government services to the current generation but left private costs unchanged. This change in perceived relative prices increased the share of goods and services provided by government relative to those produced privately, even though actual opportunity costs and social benefits of alternative provision remained unchanged.

**Public-Public.** Under the balance budget norm, choices about the allocation of scarce resources for public use were necessary and required the same difficult comparisons of costs and benefits as alternatives faced in private decisions. The use of government debt to relieve the resource constraint reduced the need to make those choices because additional resources could be obtained at near zero
cost. Without scarcity, the search for more effective and efficient alternatives is pointless.\textsuperscript{10}

In sum, the loss of the intertemporal constraint provided by the balanced budget norm created the fiscal illusion that government resources were no longer limited by current tax revenues; that public debt offered a long-term escape from scarcity and the necessity of choice. That illusion encouraged errors in the perception of opportunity cost and created bias in public choice between efficient present and future consumption; public and private provision of goods and services; and in the allocation of resources among public uses of resources.\textsuperscript{11} Choices among alternatives based on incomplete measures of costs or benefits are inefficient and impose deadweight losses on society. Because those losses are “unseen,” there is little constituency for remedy.

Further, elected policy makers choose their agendas and are their own decision process architects; that is, which decisions they will make and the basis on which they will make them (Meyers 1994, 1999). The Keynesian Revolution offered democratic policymakers an opportunity to redefine their role in budgeting in a manner that enabled them to make easier decisions, consistent with their own re-electability.

III. LOSING, REVIVING, and AVOIDING a BUDGET PROCESS CONSTRAINT: Key Steps in the Evolution of Current Budget Practice

Despite the current absence of a binding budget constraint in the budget process, the Congress appears to be of two minds about the desirability of such a restriction. On the one hand they appear to aspire to fiscal balance, but on the other hand, find it extraordinarily difficult to make the policy changes necessary to that result, possibly because the economy appears too weak and in need of additional stimulus or because of “unmet needs” of important constituencies. Whatever the cause, this conflict is evident in the pattern of enacted fiscally

\textsuperscript{10} For a detailed discussion of weak incentives to choose more efficient mitigation policies with “free” replacement and recovery funding under an “emergency” designation, see House Rules Subcommittee on Legislative and Budget Process hearing September 24, 2019. Building Resilient Communities for America’s Future - YouTube https://republicans-rules.house.gov/video/subcommittee-hearing-building-resilient-communities-america-s-future

\textsuperscript{11} Related budgetary distortions from misstated costs have been observed with tax expenditures (Burman and Phaup, 2010) and federal direct loans and loan guarantees (Phaup, 2019b)
restrictive budget process rules, followed by the development of procedural workarounds when those rules become effective or constrain choices.

This on-off behavior has been especially evident in the last 50 years or so. However, the Budget and Accounting Act of 1921 is usually considered to be the beginning of the modern federal budget process because it introduced the concept of making all individual budget decisions simultaneously rather than sequentially. Prompted by the surge in the federal debt during World War I and the 1918-19 influenza pandemic, the Act required the President to develop and send to Congress a comprehensive budget for the upcoming fiscal year to include the fiscal activities of all federal agencies (Schick 2007). The motivating idea was that total budget spending, deficits, and debt could be better managed by the Executive with responsibility for all budget activity than by an amorphous, parochial legislature.

To assist the President, the Act created the Bureau of the Budget, predecessor of the Office of Management and Budget (OMB). In addition, the Act established the General Accounting Office (GAO) to audit the financial performance of agencies and provide assurance to the Congress and the public of agency adherence to statute and Congressional direction. The legislation significantly increased the ability of the President to affect budget decisions through the acquisition and use of information and in shaping the budget policy agenda.\(^{12}\) For 40 years following the 1921 Act, the Balanced Budget norm continued to govern aggregate fiscal policy.\(^ {13}\)

The Kennedy Administration in 1961 was the first to embrace the new Keynesian orthodoxy and argue that reductions in taxes, increases in federal spending, and larger deficits could increase employment, production, income, and economic growth, even in the absence of a recession. When Lyndon Johnson succeeded Kennedy in 1963, he continued the push for expansive aggregate demand policies, launched the War on Poverty, and escalated the Viet-Nam War.

Professional concerns about the potential for inflation in a booming economy and the inadequacies of current budgetary accounting for effective macro-

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12 Schick 2007 refers to the period 1921-74 as an era of “presidential dominance.”
13 De Long 1998 provides engaging details on the intellectual history of the balanced budget norm, the political efforts to defend it during the Great Depression and the intellectual effort to replace it with a broader fiscal policy in the post-World War II era.
management of the economy led President Johnson to appoint a Commission on Budget Concepts to make recommendations for improving the government’s ability to manage the macro-economy through the budget. The Commission focused especially on 1) reducing prevailing confusion among the public and policymakers arising from three different federal “budgets”: Administrative, Consolidated Cash, and National Income Accounts budgets, each with different spending and deficit measures of stimulus; 2) adopting accrual accounting for federal orders of durable goods, especially military hardware, to match budget recognition with obligatory stimulus; and 3) creating fiscal “space” for two Wars by reducing the overstated, cash-basis cost of direct federal lending.

The Commission’s Report addressed its key issues with the following recommendations:

- **Multiple “budgets”:** adopt a single, unified budget display, comprehensive of the use of federal fiscal resources, to measure the total federal effect on aggregate demand in the current year.
- **Cash-basis accounting:** replace the cash measure of the G component of aggregate demand, especially for military hardware and transportation equipment with an obligational, accrual basis of budgetary accounting. Similarly, reject proposals for adoption of a capital budget on grounds that it would further delay the recognition of budget spending past its effect on aggregate demand.
- **Fiscal “space”:** move Fannie Mae and its cash-basis direct lending off-budget by converting it to a privately-owned GSE (government sponsored enterprise), following the example of the Federal Land Bank, Farm Credit System. This accounting treatment was also adopted for Freddie Mac at its creation in 1970. Also replace cash-basis of accounting with accrual accounting for the budget subsidy cost of direct loans advanced by remaining on-budget credit agencies.

OMB adopted the Commission’s recommendations for a single, consolidated budget, against a capital budget, and for moving Fannie Mae off-budget. It increased the visibility of “unfilled orders” for durable equipment but retained
cash-basis accounting for purchases of goods and services and for on-budget federal loan programs.\footnote{Federal direct loans and loan guarantees were converted to an accrual-basis of accounting for subsidy costs in the Federal Credit Reform Act, a title of the Budget Enforcement Act of 1990. That change was made to improve the comparability of budget costs for cash and credit programs, rather than to facilitate aggregate demand management (CBO 1989.) The Act reduced the overstatement of direct loan cost and the understatement of guarantee cost but resulted in the understatement of cost for both direct and guaranteed loans because it omitted administrative, servicing cost and the cost of market risk. (Lucas and Phaup 2008) (CBO 2019).}

In accounting, form must follow and support function. By basing its accounting recommendations on the new federal function of managing the pace of economic activity, the 1967 Budget Concepts Commission confirmed its preeminence. The Commission’s Report remains an authoritative reference and guide for budgetary accounting standards among federal budget practitioners today. For example, aggregate demand management can be used to justify a cash-basis of accounting for deferred payment programs with upfront earmarked taxes such as Social Security on grounds that taxes reduce spending when collected and benefits stimulate the economy when paid (Phaup 2019a).

Continuing deficits in the late 1960s required frequent, discomforting Congressional approval of increases in the federal debt ceiling.\footnote{The federal debt ceiling was established in the Second Liberty Bond Act of 1917, which gave Treasury authority to issue specified types and amounts of debt up the ceiling amount without further legislative action.} Escalating debt also enabled President Nixon to tar the Congress as “fiscally irresponsible,” and thereby justify his practice of impounding, or refusing to spend, amounts appropriated for programs he opposed. He also challenged the Congress to honor the ceiling on total federal spending in his annual budget proposal. Joyce (2011) identifies the budget for FY 1973 as pivotal in the inter-branch struggle for control of federal spending. In that year, the President demanded that the Congress adopt a $250 billion cap on federal outlays. Both houses passed legislation to establish that limit, but the effort failed in conference. That failure highlighted the absence of a process for controlling total spending by the Congress, despite the constitutional grant of power of the purse to the legislative branch.

The loss of Congressional control of spending was largely due to the rapid growth in mandatory spending for programs such as Social Security, Medicare, and Medicaid whose spending is not limited by annual appropriations. By 1974, mandatory programs accounted for about half of federal outlays. Thus, the House
and Senate Appropriations Committees, historically seen as the Congressional guardians of federal fiscal resources, had gradually lost control of total federal outlays leaving the legislature without a Committee with jurisdiction over total spending. Together, both political forces and structural weakness in the process set the stage for the development and enactment of the Congressional Budget Act.

A. Congressional Budget and Impoundment Control Act of 1974

This Act created a budget process with a legislatively established constraint, multiple provisions for enforcement, and fiscal flexibility to address economic and defense emergencies. As Philip Joyce documents in his definitive 2011 study of the founding, development, and organization of the Congressional Budget Office, Congress wanted something approaching parity with the President in making national fiscal policy. That meant they needed: a macro-economic analytical support capability equivalent to OMB, an entity to develop policy and enforce it across the decentralized Congressional Committee structure, and a legislative vehicle to specify the Congressional fiscal plan. Their aim was to gain control over fiscal policy, not to change the nature of federal budgeting. The 1974 Act met their objectives with the establishment of the Congressional Budget Office (CBO), the Budget Committees, and the Congressional Budget Resolution, respectively.16

The Budget Act also included procedures for enforcing the budget resolution within the Congress. The two most important were points of order and reconciliation. The first created a procedural point of order against the consideration of a bill that would violate the limits specified in the Budget Resolution. Reconciliation gave the Budget Committees authority to require Committees of jurisdiction to report legislation that would reduce spending or increase revenues sufficient to meet Resolution targets. However, those enforcement measures and the Budget Resolution itself are not law but rather are incorporated into the procedural rules of both Houses, which are themselves subject to change at the discretion of members. Over time, especially in the

16 In one sense, they got more than many in the House wanted, especially from CBO. Joyce (2011), Ch. 2 details the preference of some for a narrowly focused support agency that would 1) project budget and economic conditions under alternative fiscal policies and 2) score legislation against the Budget Resolution. He also explains how Alice Rivlin, CBO’s first Director, with the support of Senator Muskie and the Senate Budget Committee, was able to broaden CBO’s budget mission to include program evaluation or, “program analysis,” as it was then described.
House, it has become routine for points of order to be waived, often by the Rules Committee if the offending legislation has the backing of the majority leadership. Similarly, while Reconciliation, which receives expedited consideration in both Houses, was used during the Reagan Administration to reduce spending, it is now used primarily to adopt policies that increase spending or cut taxes (Gray 2021). Examples include a $1.5 trillion tax cut engineered by the Republican majority for FY 2018 and to enact a $1.9 trillion COVID relief and stimulus package during the early days of the Biden Administration (Hoagland 2021).

B. Legislative Revisions to the 1974 Congressional Budget Act

Continued deficits under the new process led to enactment of Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985 (GRH) which specified sharp reductions in annual deficit limits that were to be enforced by across-the-board reductions in outlays, or sequestration, if the targets were not met through legislated changes in law. The Congress, however, subsequently proved unwilling to make the necessary policy modifications or to permit sequesters that would hit the GRH targets. Consequently, the ratio of debt to GDP continued to rise in the years following the enactment of GRH. (Figure 1)

The failure of GRH to achieve the intended fiscal result, led the Congress and the President to agree on a new approach to fiscal restraint, enacted as the Budget Enforcement Act of 1990 (BEA) which established 5-year caps on discretionary spending and a PAYGO scorecard that capped annual net legislated increases in mandatory spending and reductions in taxes at zero. Both the discretionary ceilings and PAYGO balanced scorecard were to be enforced by sequesters. BEA enjoyed some initial success: the discretionary caps and PAYGO rule were honored, for 5 years, without significant sequestration and modest amounts of “creative” budgetary accounting. But when BEA expired, it was replaced by a new version of PAYGO with many program exemptions. The current version, the Statutory Pay-As-You-Go Act of 2010 excludes Social Security, the Postal Service, Emergency spending, and other programs specified in law (CBO, 2020). It also permits lawmakers to waive or defer sequestration at their discretion. Accordingly, this version of S-PAYGO has had little effect on restraining legislated spending increases or tax cuts. For example, the $2 trillion in the debt-financed

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American Rescue Plan – including the stimulus checks—failed to trigger sequestration.

As a result of this experience, many observers have concluded that adoption and enforcement of a disciplining, controlling fiscal limit will require the involvement of an extraordinary economic or political event. It is not possible to anticipate precisely when a Black Swan might appear and provide this impetus. But given the unsustainable path of the current process and the sage insight of Herbert Stein (“If something cannot go on forever, it will stop”), it seems reasonable to consider the outline of a revised process that might be useful in such an eventuality.

IV. IDENTIFYING A FEASIBLE, EFFECTIVE REFORM: A Stein/CED/Smithies Proposal Redux, or “Lost in the Fifties Tonight”17

The primary “lesson” from both the history of federal budgeting and behavioral science is that people, including voters and policy officials make mistakes, i.e. decisions inconsistent with their authentic goals. Although, this conclusion is not especially surprising, the more valuable insight of this research is those errors are systematic, which has enabled the identification of features of decision processes that are closely related to specific errors (Thaler and Sunstein 2007).

Thus, modifications more likely to be successful in re-introducing scarcity to budgeting are themselves subject to certain political, economic, and behavioral requirements (Hearn and Phaup 2016). The new process should be acceptable to the Congress so that they enact and live with it. The new constraint should be intuitive, related to scarcity, and easy to understand. Enforcement should be prospective—not ex post—and automatic, without requiring action (heroic or routine) by members or major losses to their important constituencies. Fiscal emergencies should be anticipated and included in budget plans, ex ante.

Although this paper’s emphasis on the loss of scarcity as the key failing of the current process may seem odd or eccentric, the risk that the loss of the balanced budget norm would result in an incoherent and unprincipled fiscal policy was regarded as sufficiently high in the post-War period that it was addressed broadly by academics and public policy associations. For current purposes, it may be

17 Apologies to Ronnie Milsap.
sufficient to note that in 1945 economist Herbert Stein, who previously had published work on policies to maintain high employment after World War II, joined the Staff of the Committee for Economic Development (CED), a progressive, business-sponsored, public policy group interested in promoting a transition to a prosperous, efficient post-war economy. Under Stein’s intellectual leadership (Stein 1969), the CED developed and advocated a proposal for a “stabilizing budget.” The proposal won the support of many economists, including Arthur Smithies, Chair of the Economics Department at Harvard. Subsequently, Smithies (1955) wrote an overview and critique of the existing federal budget process, published by the CED, in which he detailed and provided logical support for the “stabilizing budget.” He argued explicitly that national budgeting could advance efficiency in resource allocation through choices based on the costs and benefits of alternatives, while simultaneously moderating fluctuations in income and employment. To facilitate that result, he endorsed the CED recommendations that 1) federal annual spending be limited to the estimated level of annual federal revenues under current law at high employment and 2) the federal budget be augmented by a “special budget,” essentially a budget stabilization fund, to finance and budget for fiscal responses to economic, defense, and natural emergencies.18 (Smithies 1955: 443-450). The budget process was to be constrained by scarcity, but intertemporal, offsetting imbalances were to be facilitated. For the federal government, those process modifications could have restored the fiscal discipline and increased the budget flexibility of the “balanced budget norm.”

The Stein/CED/Smithies (CED) proposal remains an attractive, if largely neglected option. Its principal advantage is that it reconciles the appearance of conflict between a fiscal constraint to promote efficiency and long-term growth with the flexibility needed for short-term economic stabilization.19 Formulating the constraint in terms of high employment revenues has an advantage over a strict balanced budget rule because it avoids pro-cyclical changes in policy during economic slowdowns and booms. The proposal also relies on the amounts people

18 State experience with balanced budget rules and rainy-day funds also suggests the potential usefulness of that combination of structural elements (Moynihan and Hou 2007, Hou and Duncombe 2008).
19 The 1967 Report of the President’s Commission on Budget Concepts (p. 14) identifies the basic purposes of budgeting as “resource allocation and economic stabilization” and refers to these functions as “interdependencies.”
are willing to pay for government for its services in good times to determine the “right” fiscal size of government. The CED proposal is also consistent with the research finding (Anderson and Minarik 2006; Merrifield and Poulson 2019) and with experience with GRH that spending constraints are more effective than debt limits, even if the objective is to reduce the growth of debt. One reason is that borrowing occurs too late in the process to control directly without also defaulting on existing obligations. (Phaup 2019a). The same reason explains the failure of the debt ceiling to restrain the growth of debt. Effectively, the growth of debt controls the debt ceiling, rather than vice versa (CRFB 2019).

Under current federal budget policy, every major negative shock is treated as an unpredictable shock that could not have been anticipated and for which the only possible course of action is to borrow to finance an essential response. True perhaps for specific instances, but the periodic occurrence of shocks is as predictable as earthquakes or hurricanes. Rational policies in a world of scarcity anticipate those events and act to smooth consumption before the shocks occur. The CED proposal addresses that need with the creation of a budget stabilization fund to isolate the fiscal costs of “extraordinary” policy measures from the rest of the budget. This separation has two advantages: first, to free those responses, temporarily, from the expected revenue constraint but, second, to monitor account balances and report the extent to which extraordinary departures from fiscal balance are offset with surpluses in good times.

Under more recent budgetary accounting practice, the budget process could achieve the desired bifurcation, maintain budget comprehensiveness and discipline by placing the “stabilizing budget” account below-the-deficit line, technically in the “means of financing the deficit other than borrowing from the public.” That accounting would also lend itself to a policy of ex ante accrual budgeting for the expected annual cost of emergencies and create incentives for mitigation and avoidance of losses if doing so would be more efficient and effective than relief and recovery (Phaup and Kirschner 2010). It could also avoid

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20 Accounts in this part of the budget are used for a variety of purposes including showing the effect of changes in Treasury cash balances on the Treasury borrowing requirement, to record federal obligations and claims on an accrual-basis of accounting rather than a cash basis, e.g. interest on Treasury debt is recorded as earned by transfer from Treasury to an interest payable account where it is held until paid to debt holders. Other accounts included in this budget tabulation include expected outlays for loans guaranteed by the federal government, and other amounts payable.
the upward ratchet in debt triggered by repetitive adverse macro-economic shocks, each of which is currently treated as a fiscal “surprise.”

The appeal of this proposal can be further enhanced by adding operational detail consistent with subsequent, successful budget process innovations and with advances in understanding the crucial role of process in affecting decisions. (Kahneman 2007; Thayer and Sunstein 2008; Thayer 2015; and sources cited therein).

One finding of behavioral research particularly relevant to budget process reform is that making better decisions cognitively easier will increase the frequency of better decisions—those more consistent with long-term preferences and well-being. 21 Recent experience demonstrates that ease of decision making can be facilitated by simplifying the process, delegating the task of analysis to analysts, providing relevant information in a salient form, using no-decision default options consistent with social objectives, and planning routinely for adverse events (Phaup 2019b). For instance, adopting expected high employment revenues as a budget constraint would shift the current technical burden of determining “how much” to spend each fiscal year consistent with fiscal sustainability from policymakers to analysts at OMB and CBO, a task for which the former are poorly suited. That change would significantly simplify the task of budgeting for elected officials, who would retain the functionally appropriate task of deciding “on-what” to spend. That shift in focus could also increase the demand for performance information useful in identifying policies most effective and efficient in achieving social goals.

Stein, Smithies and the CED also advocated increased use of automatic stabilizers such as the progressive income tax and mandatory public assistance programs to reduce lags in stabilizing fiscal policy by avoiding additional discrete budget decisions. From a behavioral perspective, those policy instruments also harness the power of pre-commitment and permit balanced responses to be devised and enacted prior to loss and in the absence of an emotional inclination to deliver assistance to those in need, without regard to its cost. Use of these policies could be substantially increased. One current proposal to create an additional,

21 This concept contrasts with an alternative strategy of advising policymakers to “just do it!” A similar “solution,” electing officials willing to make “hard choices,” is wishing for super-human heroes, who are already fully occupied saving other imaginary worlds.
automatic, targeted macro-policy response to economic downturns would create a federal fiscal insurance program for states (Burman, Gordon, and Airi 2021).22

Perhaps the biggest obstacle to the addition of an effective federal budget constraint is the difficulty of assuring its enforcement. The CED proposal, as supplemented with the operational detail described here, has some potential to reduce this hurdle via automatic and prospective adjustment in funds available for new spending. The key to this advantage is the treatment of the budget stabilization fund as the federal government’s self-insurance fund against adverse fiscal events (Bhatti and Phaup 2015). The technical task of calculating annual premiums for stabilization insurance would be the natural province of a semi-independent fiscal authority such as CBO. Estimates of resources necessary to offset expected losses could be protected from Congressional “time inconsistency” by statutory classification of fiscal insurance premiums as mandatory; that is, obligated annually without further legislative action.23 Treasury could be authorized to transfer those sums annually from the general fund to the stabilization fund. Consistent with the classification of the budget stabilization fund as below-the-deficit-line, those transfers would be scored in the budget as outlays and available to finance anticipated fiscal shortfalls that would otherwise necessitate an equal amount of borrowing from the public. As with any other expenditure, government’s insurance premiums would count against the annual expected revenue cap on spending.

For financial adequacy, annual insurance payments would need to be adjusted for actual annual budget shortfalls. Systematic overspending of expected annual revenues, from all causes, would trigger increases in estimated premiums and tighten the constraint prospectively in future budgets. The estimated expected annual cost might also be expected to rise with such variables as climate change, population growth, and increased international instability.

23 Technically these could be treated as either direct spending authorized in the enabling statute or as funded with permanent, indefinite budget authority.
V. PLANNING A TRANSITION

The current financial condition of the US government is the result of more than 50 years of unconstrained fiscal policy and untold numbers of unanticipated fiscal emergencies. In COVID-free FY 2019, the federal deficit was just short of $1 trillion, meaning that Treasury had to borrow 22 cents for every dollar the government spent that year. Further, more than 90 percent of the revenues collected in the fiscal year were already obligated for mandatory programs and interest expense.\(^{24}\) The FY 2020 policy response to the unanticipated pandemic raised outlays $1.75 trillion above planned levels and pushed the deficit to more than $3 trillion. Outstanding debt rose from 79 percent to 100 percent of GDP.

It is unlikely and probably undesirable that policymakers would adopt and adjust quickly to the CED constraint. Instead, reform might do better to plan for a significant transition period that can be sustained until an efficient fiscal balance is restored. That might entail 10 years or so of gradual adjustment, but with initial, small, painful, “down payments” that could be described as “wasted sacrifice” to restrain the impulse to abandon the transition plan.

Successful transition also might be facilitated through policy changes that are adopted immediately but become effective in the future in small increments. Examples include monthly increases in eligibility age for retirement benefits and others that require commitment now to increase retirement contributions in the future, coincident with increases in income, or “Save More Tomorrow” (Thaler 2015).

VI. CONCLUDING COMMENTS

The current federal budget process lacks a functionally essential element for allocative choice and constrained optimization: scarcity. Without scarcity, the opportunity cost of every beneficial policy is zero; we can have it all. Seeking more efficient or effective budget options is pointless.

\(^{24}\) The unobligated and available 10% is the Steuerle-Roeper Fiscal Democracy Index, which measures the fiscal freedom of current policymakers to allocate resources to current priorities (Steuerle. 2014).
Scarcity began to fade from public fiscal consciousness in the 1960s during the Kennedy-Johnson Administration with the rise of aggregate demand management, especially “stimulus” as the economic elixir of choice. Concurrently, federal budget deficits became more persistent. Today, with unlimited, “free” financing available from investors around the world, scarcity has no more presence in federal fiscal or budget decisions, than the smile of a Cheshire Cat.

Because budgeting without scarcity is the antithesis of budgeting, describing its condition as “broken” suggests a blindness to the pervasive ambient. Currently proposed budget process reforms may increase budget “activity,” but are unlikely to have much social benefit until this essential element is restored. Although there are numerous process changes that could contribute to that result, this paper offers a reconsideration of a 1955 proposal, which is consistent with both macro stabilization and micro efficiency.

Successful reintroduction of the concept of scarcity into federal budgeting is necessary, but likely not sufficient, to significantly improve budget decisions. Current cash-basis budgetary cost accounting, incomplete coverage including tax expenditures, and inadequate measures of performance are inconsistent with the objectives of efficiency, stability, and equity. But adding a constraint would be a useful step.

Finally, in budget reform, as in all else, perfection is almost never optimal. Or, to paraphrase George Will, bad policy is the price we pay for democracy, and it’s worth it! Our conceit is that better may be within our grasp.

Appendix A: An Alternative View

An alternative view of national budgeting is that under conditions of low interest rates and deep recessions, optimal fiscal policy must give priority to assuring that aggregate demand is sufficiently high to maximize employment, even if government debt as a share of GDP is high, relative to historical levels (Furman and Summers 2020). That is, under those specified conditions, large increases deficits and debts are necessary to maximize production and likely pose small risks of triggering a fiscal crisis.

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25 “The fish will be the last to discover water.” Anonymous.
One of the most effective paths to understanding that policy recommendation is to read the case developed by two of its most articulate and well-known champions: Professors Jason Furman and Lawrence Summers’ 2020 Brookings Discussion Draft, “A Reconsideration of Fiscal Policy in the Era of Low Interest Rates” (link included in references below.) However, for purposes of this paper, I offer a brief summary of that alternative sufficient to explain why it applies only to a special case and has not displaced the necessity of fiscal balance in a world characterized by scarcity and the related value of efficient choice in the allocation of limited resources.

The alternative view is based on the downward trend since 2000 in interest rates on sovereign debt toward the lower bound of zero, which reduces the ability of monetary policy to address recessions and reduces the cost of expansive fiscal policy. Assuming that expansive monetary policy increases aggregate demand primarily through lower interest rates, rather than through other channels, including quantitative easing which directly increases the flow of credit to targeted users, interest rates near zero severely limit the Federal Reserve’s scope for offsetting economic recessions. Simultaneously, however, lower rates reduce the cost of expansive fiscal policy of debt-financed increases in spending and reductions in tax rates. Moreover, if interest rates on government debt \( (r) \) are less than the rate of growth of the economy \( (g) \), persistent deficits and growing government debt can be sustainable in the sense that debt as a share of GDP will decline even with continued deficits. Further, fiscal policy can increase aggregate demand through a balanced budget multiplier, especially if increases in spending and taxes are progressive; that is, they redistribute income from higher income to lower income consumers because the latter have a higher marginal propensity to consume and a lower marginal propensity to save.

Thus, with low interest rates and unemployed resources from weakness in aggregate demand, expansive fiscal policy can increase employment, production, and income and potentially improve the government’s financial position as measured by the ratio of public debt to GDP. Or, in different words, a debt-financed, expansive fiscal policy can improve welfare when scarce resources are idle due to weakness in aggregate demand. Expressed this way, however, the alternative view is entirely consistent with the balanced budget norm and the existence of scarcity as a defining feature of economic life and public budgeting.
Inconsistency with the balanced budget norm arises only if the alternative view is understood as a general long-term fiscal rule rather than guidance for a special case in which $r < g$. Lucas (2021), in a related analysis, has shown that in planning for sustainable fiscal policies, $r < g$ is not a useful assumption. Among the disadvantages of this assumption are that: a) if people attempt to smooth consumption over time and the rate of time preference is > zero, $r > g$ in the long-run steady state, b) markets are currently signaling an expectation of an increase in $r$ with high volatility, consistent with historical experience, and c) high volatility in $r$ increases the likelihood of a fiscal crisis in the short and intermediate term on the path to long term stability.

In fact, Furman and Summers suggest that their policy proposal might only be appropriate for 10 years or so and that the growth of the public debt should be constrained to prevent interest on the debt from exceeding 2 percent of GDP. This alternative constraint raises issues, beyond the scope of this paper about the feasibility of managing the debt to conform with that limit.

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