

## PRINCIPLES OF BUDGET DETERMINATION

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The people of the United States are generally agreed that the economy is to be organized on the premise of free consumer choice, that production is to be carried on by privately owned and operated firms, and that the market should be relied upon where possible to transmit the desires of the consumer to these firms. This being our basic form of organization, why is it that a substantial part of the economy's output is provided for through the budget? This question must be answered to begin with, if we wish to say something about the "proper" scope or composition of the budget.

The budgetary activity of the Government is needed because the pricing system of the market cannot deal with all the tasks that must be met in order to operate a sound economy and a healthy society. Certain tasks must be performed by government. Some may deplore this fact and dream of a setting where everyone could live in peace without any kind of governmental activity; others may feel that the necessity of social and economic policy at the governmental level enriches the challenge of social life and makes for a more balanced society. Whatever one's values in this respect, the nature of things is such that budgetary activity is needed. The question then is under what circumstances and why this need arises.

The answer to this question is too complex to permit a simple and uniform solution. In my own thinking I have found it useful to distinguish between three major functions of budget policy, including—

1. The provision for social wants, which requires the Government to impose taxes and make expenditures for goods and services, to be supplied free of direct charge to the consumer;

2. The application of certain corrections to the distribution of income as determined in the market requiring the Government to add to the income of some by transfers while reducing the income of others by taxes; and

3. The use of budget policy for purposes of economic stabilization, rendering it necessary under some conditions to raise the level of demand by a deficit policy and under others to curtail demand by a surplus policy.

I shall comment briefly on the nature of each of these three functions, and on how they are interrelated.

### PROVISION FOR SOCIAL WANTS

When I say that the Government must provide for the satisfaction of social wants, it does not follow that the Government itself must carry on the production of the goods and services which are needed to satisfy these wants. This may be necessary in some cases, as for in-

stance with the provision for police protection, which can hardly be left to a private agent, but this is the exception rather than the rule. In most cases there is no such need. If new planes or government buildings are to be provided for, they may be purchased from private firms. The essence of budgetary provision for the satisfaction of social wants, therefore, is not production by government. It is payment for goods and services through budgetary finance, and supply of such services free of direct charge to the consumer.

What, then, are the social wants which must be provided for in this fashion? Some people have argued that they are wants which in a mysterious fashion are experienced by the Nation as a whole, and thus reflect the desires of the collective entity. This makes little sense in our setting. The desire for the satisfaction of social wants is experienced by individuals, no less than that for the satisfaction of private wants. This is not where the difference lies. The basic problem of social wants arises because their satisfaction, by their very nature, requires that the goods and services in question must be consumed in equal amounts by all. Social wants differ in this important respect from private wants, where each consumer may arrange his personal pattern of consumption such as to satisfy his own personal tastes. Thus, I may go to the market and purchase whatever amounts and type of clothing, housing, or food may suit my tastes and resources; but I must be satisfied with the same municipal services as are received by my neighbors, or with the same degree and type of foreign protection as is granted to all other citizens of the United States. This crucial fact, that certain services must be consumed in equal amounts by all, has important consequences.

One consequence is that you cannot apply what I like to refer to as the exclusion principle.<sup>1</sup> Since all people must consume the same amounts, no one can be excluded from the enjoyment of services aimed at the satisfaction of social wants. Everyone benefits, whether he contributes little or heavily to their cost. Now you might say that this is not too difficult a problem. Let the tax collector see to it that everyone pays. Unfortunately this overlooks the real difficulty. The real difficulty is not that people are unwilling to pay unless forced to; it is that of determining just how much various people should be called upon to contribute.

This difficulty does not arise with the satisfaction of private wants in the market. Here the individual consumer is forced to bid against others in order to get what he wants. The pricing mechanism, as it were, is an auctioning device by which things go to those who value them most, as evidenced by what they are willing to pay. People must bid to get what they want, and thereby provide the producer with the necessary signal of what to produce. In the case of social wants this signal is not forthcoming. Consumers know that they cannot be excluded and that their own contribution will weigh very lightly in the total picture. Thus they will not reveal their true preferences on a voluntary basis and offer to pay accordingly. Therefore it is no easy task to determine just what social wants should be recognized and how much each should be called upon to contribute.

<sup>1</sup> A second consequence, which has been pointed out by Professor Samuelson, is that there would be no single best solution to the budget problem, applying the usual criterion of economic efficiency, even if the preferences of all individuals were known. This aspect is omitted from the present discussion.

A further difference is this: For goods supplied in the satisfaction of private wants, competition sets a uniform price in the market. Individual consumers, depending on their personal tastes, can buy different amounts at that price. For goods supplied in the satisfaction of social wants, all must consume the same amount, and those who value public services more highly must pay a higher unit price.

This much is clear, but the question is just what should be supplied and just how much each should pay. The market cannot give the solution and a political process is needed to accomplish this task. By choosing among various budget programs, including various expenditure plans and various tax plans to cover the costs, the voters can express their preferences in the matter. Since they know that the law, once decided upon, will apply to each of them, they will find it in their interest to reveal their preferences and to vote for the plan, or the approximation thereto, which is most appealing to them. Thus preferences are revealed through the political process. While the minority might be dissatisfied, and strategies might be used in voting, an acceptable approximation to the preferences of the individual members of the group is reached.

All this is somewhat of an oversimplification. Individuals do not vote personally on each issue. Rather, they elect representatives who vote for them. Thus, the function of the representative is to crystallize public opinion with regard to such issues, budgetary and other, and to find groups of issues on which their constituents can agree. The Member of Congress is a go-between, whose function it is to work out compromises and solutions which are acceptable to the majority. By saying this I do not mean to slight the educational function of political leadership, nor do I wish to underestimate the importance of the contribution to be rendered by the executive branch and by the civil service. All these are important, but the basic process is one of transforming individual preferences into social wants.

In taking this view of social wants, I am thinking in the framework of what since Adam Smith has been referred to as the benefit principle of taxation. In other words, budget policy should provide for goods and services in response to the social wants of individuals, and to make this possible, individuals should contribute as closely as possible in response to their evaluation of these social wants. The great value of this approach, from the point of view of the economist, is that it requires us to determine public expenditures together with the revenue side of the budget. In this basic sense, there can be no theory of public expenditures without a theory of taxation, and vice versa.

What does the benefit approach mean regarding the distribution of the tax bill between people with different levels of income? I will not attempt to answer this in a categorical form, but I can point to the considerations on which the answer should depend: This is whether the goods and services supplied for the satisfaction of social wants are largely in the nature of necessities or luxuries. If they are largely in the nature of necessities, the answer leads to regression; if they are primarily in the nature of luxuries the answer points to progression. If people wish to spend the same fraction at all levels of income the answer leads to proportional taxation.<sup>2</sup> While a moderate degree of

<sup>2</sup> In technical terms, the tax structure will be proportional if the income elasticity of social wants is unity, progressive if it is greater than unity, and regressive if it is smaller than unity.

progression would seem the reasonable answer, this is by no means the only consideration entering into the distribution of the total tax bill.

Finally, a word about the matter of budgetary balance. Insofar as the satisfaction of social wants is concerned, the budget must be balanced, in the sense that goods provided for through the budget must be paid for over their useful life. This merely reflects the fact that resources used for the satisfaction of social wants cannot be used for other purposes, and someone must bear the cost. At the same time, we shall see that this is only one among other considerations. It does not follow that the total budget must be balanced.

I need hardly add that this brief discussion of social wants does not cover the entire picture. Not all public services are supplied in response to the individual preferences of the consumers. There may be instances when the majority decides that certain wants of individuals should be satisfied, even though these individuals would prefer to be given the cash and use it for other purposes. Free education or hospital services may be cited to illustrate this case. This type of public service requires a different explanation. However, note that the benefits derived from such services extend beyond the specific beneficiary, and thus approach what I have described as the central type of social wants.

#### ADJUSTMENTS IN THE DISTRIBUTION OF INCOME

I now turn to the second function of budget policy, which is to provide for adjustments in the distribution of income. We are all agreed that it is the responsibility of society to undertake certain adjustments in the distribution of income, which results from the forces of the market, the laws of inheritance, and differences in abilities to acquire income. Babies must be assured adequate food, the sick and the aged must be given proper care, and so forth. Beyond this, some hold to an idea of the good society which requires a fairly extensive degree of income equalization, others would favor a moderate degree of equalization, while still others might oppose any such measure and favor a high degree of inequality. These are matters of social philosophy and value judgment on which we all have our own views. Moreover, consideration must be given to the interrelation between income distribution and the total income which is available for distribution.

My concern here is not with the question as to which is the best set of values. While I happen to feel that progressive taxation is fair, this is not the point. My point is that if society wishes to make distributional adjustments, it is desirable as a matter of economic policy to make them through the tax-transfer mechanism of the budget. This is preferable to distributional adjustments via manipulation of particular prices, be it of products or of factors of production. Certainly, we cannot accept the stricture that the purpose of taxation is to finance public services and nothing else, and that, therefore, they "must not" be used for distributional adjustments. There is no such law in the order of things. Indeed, where distributional adjustments are to be made, this is the logical way in which to make them.

The determination of the desired degree and type of distributional adjustment is again a matter of political process, and I will not discuss it here. Let us suppose that some degree of income equalization is to be accomplished. This calls for taxes on some people with incomes

above the average and for transfer payments to some people with incomes below the average. Insofar as distributional adjustments are concerned, the budget must again be balanced. Now you may argue that such a general tax-transfer scheme does not appear in the budget, except perhaps in the social-security programs, and that our budget does not engage in distributional adjustments. This is not the case. The distributional adjustments are implicit in a distribution of the overall tax bill in a way which is more progressive than would be justified on the basis of assigning the cost of social wants on a benefit basis. In other words, the budget as we know it and as it is enacted reflects the net result of various component policies. More about this in a moment.

Just as my discussion of allocating the cost of social wants moved in the context of a benefit approach to taxation, so does the problem of distributional adjustment belong in the sphere of ability to pay and equal sacrifice doctrines. The two approaches are wholly compatible if each is viewed in its own context. The argument that the cost of public services should be allocated in accordance with ability to pay sounds nice, but it gives us no foundation on which to decide what public services should be rendered. This can be done only in relation to individual preferences and implies the spirit of benefit taxation. I can see no other approach that leads to a sensible solution. At the same time, it is non sequitur to argue that progressive taxation is out of order because (assuming this to be the case) benefit taxation requires proportional rates. The element of progression may be called for in order to implement distributional adjustments, which is quite a different matter.

Failure to distinguish between the problem of distributional adjustment and the problem of providing for the satisfaction of social wants leads to confusion on both counts. If the degree of distributional adjustment is tied to the level of the budget, some may favor an increase in the level of public services as a means of extending distributional adjustments, even though they do not support budget expansion on the basis of benefit taxation; and others, who would favor an expansion of the budget on this basis will oppose it because in practice it is related to an extension of distributional adjustments. Moreover, these relationships change with the level of taxation and the existing tax structure. While there was a time when the marginal taxpayer was the fellow with the large income, we are now in a situation where increased levels of public services largely involve increased tax contributions from (or exclude tax reductions for) people in the middle or middle to lower income groups. Thus the politics of the fiscal problem are changed and essential public services will go begging in the process.

#### BUDGET POLICY AND STABILIZATION

I now turn to my third function of budget policy, which is the use of tax and expenditure measures as a means of economic stabilization. The great achievement of the fiscal-policy discussion of the last 25 years is the by now fairly general recognition that fiscal policy must play an important role in economic stabilization. The old view that the budget should be balanced is applicable only if we consider our first and second functions of budget policy, and even here some temporary exceptions may arise. Once the stabilization function is intro-

duced, deficit finance is called for under conditions of potential depression, and surplus finance is called for under conditions of potential inflation. The point to be noted here is that the stabilization objective of budget policy can be achieved without contradicting the other requirements of budget policy, namely, efficient provision for social wants and the application of distributional adjustments.

Regarding the proper level of public services, this means that there is no excuse for make-work expenditures during a depression, just as there is no excuse for cutting essential public services during periods of high activity. Precisely the same fallacy is involved in both cases. An increase in public services during the depression is in order, only to the extent that the decline in private expenditures for some purposes (such as investment) frees resources which people may wish to allocate in part to the satisfaction of social wants; and a decrease in public services is in order during the boom only to the extent that people wish to divert resources from public use to meet an increased demand for resources for other uses. This sets the limits of the permissible adjustment: There is no justification for raising the level of public services merely to increase aggregate demand, since this can be done also by lowering taxes; and there is no justification for cutting public services merely to curtail demand since this can be done also by raising taxes.

Moreover, there is no need for permitting considerations of stabilization policy to interfere with desired distributional adjustments. Thus it was argued frequently during the thirties and forties that taxes on lower incomes should be avoided because this would undermine demand and that therefore a more progressive tax structure was needed; and vice versa for the current case of inflation where it is held that progression should be reduced to secure a shift of resources from consumption to investment, thus providing for increased capacity in order to check inflation. The argument makes sense in both cases if we assume that the total level of tax yield is given, but it breaks down if we allow for adjustments in the level of taxation. The level of taxation which is required for purposes of stabilization should depend upon the distribution of the tax bill, and not the other way round.

#### NET BUDGET AND SEPARATION OF ISSUES

To bring my point into focus, let me exaggerate a little and assume that there are actually 3 different budgets, pursuing respectively my 3 functions of budget policy. First, there is the budget to provide for the satisfaction of social wants, where taxes are allocated in line with a benefit principle of taxation. By its nature, this budget is balanced over the useful life of the services which are supplied. Secondly, there is the budget to provide for distributional adjustments, involving tax and transfer payments. By its nature, this budget is balanced as well. Then there is the budget designed to stabilize the level of demand. By its nature, this budget involves either taxes or transfer payments, proportional to what is considered the proper state of income distribution.

We may think of these budgets as being determined in an interdependent system, where the manager of each of the three branches

takes the action of the other branches as given.<sup>3</sup> Having determined the three budgets, the Government may proceed to administer each budget separately. This would involve various sets of taxes and/or transfers for any one person. To simplify matters, it will be desirable to clear the tax and transfer payments against each other, and thus to administer one net budget policy only.

The actual tax and expenditure plan enacted by the Congress in any one year reflects such a net budget. This is of advantage as a matter of administrative convenience, but it blurs the issues. While it may be difficult as a matter of legislative procedure to determine independently each of the three subbudgets noted in my discussion, some lesser steps may be taken in the organization of the budget process, on both the executive and the legislative side, to move the problem into a better perspective. To say the least, an understanding of the three objectives as distinct issues is prerequisite to efficient budget planning.

The preceding discussion will suffice to show that it is exceedingly difficult to establish a simple set of principles by which to secure an

<sup>3</sup> To illustrate, let me assume that there are two taxpayers only, X and Z. Assume further that the full employment income equals \$100, and that X's earnings are divided such that X receives \$70 while Z receives \$30. Now suppose that the Distribution Branch imposes taxes of \$10 on X and pays \$10 of transfers to Z, the desired distribution being such that X is to receive 60 percent and Z is to receive 40 percent.

Next, let me suppose that with an income of \$100, distributed in this fashion, private expenditure on consumption equals \$60 and that expenditures on investment equal \$30. Moreover, the manager of the Stabilization Branch is informed that expenditures for the satisfaction of social wants equal \$22. This means that total expenditures equal \$112 and are \$12 above the full employment level. To simplify matters, let us hold investment constant. In order to lower consumption by \$12 the Stabilization Branch will impose taxes of \$20, it being assumed that the ratio of consumption to income is constant at 60 percent. In order not to interfere with the distributional adjustment, \$12 will be paid by X and \$8 by Z.

The income of X now equals  $\$70 - \$10 - \$12 = \$48$ , while that of Z equals  $\$30 + \$10 - \$8 = \$32$ . Now suppose that both wish to spend 27.5 percent of their income on the satisfaction of social wants. Thus for the satisfaction of social wants taxes equal \$13.20 for X and \$8.80 for Z, with total expenditures for the satisfaction of social wants equal to \$22.

The three subbudgets involve the following transactions:

	X	Z	Total
Satisfaction of social wants:			
Goods and service expenditures .....			22.0
Taxes .....	13.2	8.8	22.0
Balance .....			00.0
Distributional adjustment:			
Taxes .....	10.0		10.0
Transfers .....		10.0	10.0
Balance .....			00.0
Stabilization adjustment:			
Taxes .....	12.0	8.0	20.0
Transfers .....			
Balance .....			20.0
Net budget:			
Taxes .....	35.2	6.8	42.0
Transfers .....			
Goods and service expenditure .....			22.0
Balance .....			20.0

Instead of collecting 3 separate taxes from X it will be more convenient to collect the total of \$35.20; and instead of collecting 2 taxes for Z and paying 1 transfer, it will be more convenient to collect net taxes of \$6.80. We thus have net tax receipts of \$42 which after allowing for goods and service expenditures of \$22 leave us with a surplus of \$20, equal to the surplus in the stabilization operation. A similar illustration might be given where the stabilization operation involves a deficit, in which case there appears a corresponding deficit in the net budget. Finally note that the distribution of the tax bill in the net budget is more progressive than that for carrying the cost of social wants, but less progressive than that involved in the distributional adjustment only.

efficient determination of public expenditures. This task involves the determination of the total budget plan, including the revenue as well as the expenditure side, and it comprises quite distinct sets of objectives or functions of budget policy. The issues involved are the more difficult as they cannot be solved, or be solved in part only, by the ordinary tools of economic analysis. The political process of decision-making becomes an inherent part of the problem.

At the same time, the complexity of the problem establishes no presumption that the use of resources for the satisfaction of social wants is less efficient than its use for the satisfaction of private wants. This must be kept in mind if we are to see the problem of social-want satisfaction in its proper perspective. While it is obvious that any expenditure objective, once decided upon, should be accomplished at minimum cost, the objective of efficiency in public expenditure planning must not be confused with minimizing the level of such expenditures. By the very nature of the budget as an allocation problem, the danger of inefficiency arises with insufficient as well as with excessive outlays.