POLICY REPORT

Volume IV Number 10 | A PUBLICATION OF THE CATO INSTITUTE | October 1982

Summer of '82: The Great Budget Delusion

By William K. MacReynolds

In an unusually skillful exercise of political chicanery, Reagan promoted this summer's tax increase bill of $98.3 billion by promising $3 in spending cuts for every $1 tax increase. As things now stand, we got at best 13¢ on the dollar. More than likely spending will continue to increase at record levels.

You don't have to be either a supply-sider or a Keynesian worrying over the prospects of continued recession to be against the 1982 tax increase. Its supporters claimed it would cure recession by reducing the deficit, reducing interest rates, and restoring growth to the economy. It will do none of those things. As Richard Rahn, chief economist at the U.S. Chamber of Commerce pointed out, "Individuals pay taxes and corporations collect them. This bill will raise the amount taken out of the economy by a projected $99 billion which will raise prices, lower wages, raise the rate of unemployment, and reduce income and growth."[1] This article will examine the faulty economic thinking of the tax bill as well as the political chimera of the current budget process.

Increased taxes always reduce the wealth and income of society by enlarging the difference between what is paid (prices) and what is received (wages, profit, interest, rent, etc.). Prices rise and wages fall initially in industries where new taxes are added. This will eventually result in lower spending and output elsewhere, thereby lowering income, raising prices, and adding to unemployment throughout the economy.

In a lucid *Wall Street Journal* editorial on August 17, 1982, the editors comment on the tax bill.

> The only goal is to raise money, in the fond hope of reducing a huge federal deficit caused by a failure to control federal spending . . . .Ethel the waitress's employer will have a new bookkeeping chore — seeing to it that Ethel's W-2 imputes 8% in the tip income — and a new cost — making up the difference so that Ethel won't give up the rigors of waitressing in favor of some other kind of work.
>
> There is no free lunch in this kind of tax collecting. If the IRS takes more of Ethel's income, restaurant customers will have to make it up. If the IRS extracts more money by forcing banks and commercial companies to withhold interest and dividends, there'll be that much less for building factories and buying farm machines. If the depreciation schedule is tightened, companies will have to raise prices to preserve their cash flow. The same goes for all the other changes that fall on business. The only thing that can be said truthfully about the $98.3 billion in new taxes is that it will be paid by the people, all of them, no matter by what circuitous route the money is collected. If there is any greater "fairness" achieved, it will be mainly accidental.

"By 1985 government expenditures will be 24% of GNP, continuing the all-time high, and taxes can be projected at about 23.6% of GNP, an all-time high."

A tax increase will increase the deficit by reducing income and thus increasing federal spending for the newly employed. The huge Reagan tax increase will have a devastating effect on opportunities for economic recovery.

The Commerce Department estimates that the impact of the 1981 Reagan income tax cut, which went into effect in July of this year, was to increase savings by 50% of the increased disposable income. Increased funds available for loans contribute to falling interest rates; this will result from tax cuts, not tax increases. The next set in the recovery would be an increase in private spending, leading to rising interest rates and lower federal deficits from enhanced income. Thus, there is no one-to-one link between deficits and interest rates. The interest rate may fall with reduced taxes.

Unemployment is the direct result of higher taxes and unproductive government spending. Government spending utilizes less of the labor resources and at higher wages than the same amount of expenditure in the private sector. To obtain funds, the government causes a combination of increases in prices, taxes, unemployment, interest rates, and reductions in wages. Unemployment results from shifts in output away from tax-laden industries. The resulting lower wages throughout the economy attracts fewer workers from unemployment. The double curse of taxation and unproductive government spending is the cause of

(Cont. on p. 3)

William K. MacReynolds is assistant professor of economics at George Mason University.

Privatization: Promise or Peril?

Readers of *Policy Report* are well aware of the increasing cost and declining quality of services provided by the government. Education test scores have dropped for 17 straight years. It can be argued that the cost of a first-class letter has risen to $8, since only Express Mail guarantees timely delivery. *Newsweek* trumpets "The Decaying of America" on its cover, calling for $3 trillion in new public spending to rebuild our infrastructure of roads, bridges, and water projects.

The response to all this has varied widely — from "economic democracy" to tax revolts — but rarely do the proposed solutions question the fundamental idea that needed services should be provided by government in a traditional way. Rather, they propose only to spend more, spend less, or put different people in charge of the spending.

Within this narrow paradigm, the growing privatization movement would seem to offer a ray of hope. Privatization advocates — notably HUD Assistant Secretary E. S. Savas in his new book *Privatizing the Public Sector* — suggest that some government services could be better provided by private firms. Savas cites evidence that private companies can provide fire protection, mail service, garbage collection, health care, and a host of other services at a lower cost than government agencies.

Unfortunately, however, privatization advocates are still operating within a set of establishment parameters. Government electric utilities cost too much, they say, so let's have government select a private company to supply electric power in the same way to the same customers at a reduced cost.

What the privatization movement ignores is that many services have been shaped by years of government provision or control. In a real free market they might evolve in an entirely different way. Perhaps electric power would no longer be provided in its present form; it might be superseded by cogeneration and other forms of energy that have been stifled by monopoly utilities and restrictive laws. Perhaps there would be no private automobiles in cities if transportation had developed naturally in response to consumer preference and price signals. The point is, we don't know if these services would be provided in a different way or not.

If we removed government from the provision of needed services, the market would begin to evolve in the direction of efficiency and consumer satisfaction. But if we allow government merely to "contract out" the provision of services in a traditional way, we will still be stuck with outdated services and delivery methods.

If government selects only one supplier for a service — a franchise monopoly garbage collection company, bus company, or utility, for instance — and consumers pay a "user fee" to that company instead of a tax to the government, there will be little difference. The profit-maximizing company, not subject to government union contracts and feather-bedding and not eligible for a subsidy to cover its losses, will probably deliver the service for a somewhat lower rate. But a compulsory "user fee" is virtually indistinguishable from a tax, and there will be little efficiency and innovation in such an arrangement. Even if two or more companies are allowed to "compete" in offering a service that consumers must purchase, there will be little of the change and innovation that we expect in the private sector.

In addition, there is no evidence that governments cut taxes when they reduce their costs. Rather, they regard that as an opportunity to spend more money on some other "need." The level of taxes is not set by how much government needs, but by how much it can get. A reduction in the government's costs will thus not lead to tax reduction.

One noted author has written an article depicting the glorious future under privatization. His mythical city began contracting out various city services, and after 20 years the city government consisted of just three employees who selected contractors and oversaw the provision of services. It sounded like paradise, and for some people — the favored firms, for example — it may have been. What it was not was free enterprise. Rather, it could be compared more accurately to the old practice of tax farming, whereby the state sold off the right to collect a particular tax. In this city, the government transferred to a particular company the right to collect payments for fire protection, for garbage collection, for electric power, and so on. It did not simply say, "These services will no longer be provided by government. Consumers are free to make their own arrangements." And the suggestion that the government lowered its taxes to virtually nothing is, we fear, naively optimistic.

If the privatization advocates can break out of the narrow parameters of establishment debate, if they can recognize that services can only be provided efficiently where there is complete freedom of choice and that there is nothing inherently good about present types of services, they may provide us with some original and creative ideas. Until then, however, they are only tinkering with a system that is increasingly unworkable. ■

Budget Delusion (Cont. from p. 1)

today's economic problems, not the solution.

Government deficits from overspending drain savings from the productive sector of the economy. Instead of converting productive savings into potentially productive investment, deficits turn savings into current consumption of already produced goods and services. Such a transformation makes the use of resources for current production appear much more important than enhancing future production — reflecting behavior that causes a rise in the real interest rate. In this way, deficits alter behavior. They discourage resource use for future enhanced output. While the intention of savers is to save for use in the future, because of deficits, little of this savings is turned into greater future output. Savings is then discouraged. As the economy has shifted away from long-term productive expenditure toward expenditure on current goods favored by government, growth has been retarded.

To reduce the federal deficit, the government must reduce expenditures. Writing about the Reagan tax bill, Thomas Humbert says:

> Budget deficits, of course, do mean that the federal government will claim, through increased borrowing, a larger share of the private sector's capital. But tax increases also claim a larger share of the capital. When that capital pool shrinks, interest rates are likely to rise. Thus lowering the deficit by hiking taxes is not going to do much to bring down interest rates. For that to happen, the deficit has to be lowered by reducing government spending. Milton Friedman points out that the debate over whether to finance government spending by taxes or deficits is pretty much irrelevant. Both sources of funds represent a loss to the private sector.[2]

Government spending is the real tax on Americans.

The Politics of the Tax Bill

Spending in excess of the means to pay is common practice for elected officials. Deficits reflect the political incentives of overspending. Incumbents are rewarded handsomely by lobbyists who represent the people who benefit from government spending. Under current restrictive statutes on campaign contributions, lobbyists and their associated PACs wield tremendous power in a re-election bid. Higher taxes are not politically popular. One important political victory this summer was to turn the focus of debate from record spending to a "mid-course correction" of the overzealous tax cuts passed in 1981. Economic theory aside, it was a victory for older, centrist incumbents whose long association with special interest groups would have been jeopardized by rampant budget cutting. The variety of "tax reforms" passed were nothing new. They had been advocated for years.

Political arguments over the deficit were successful in diverting attention away from the bread-and-butter issue of spending. One of the original supply-siders, Jude Wanniski, stated clearly the workings of the political budget process.

> Nor is it necessary that the budget ever be balanced. As a corporation or a nation grows more productive, its debt can grow as long as its proportion does not outpace production. And a nation has to be able to run deficits to get through bad times the same way we expect families to borrow when the breadwinner is out of work. Those who have resources to lend will do so as long as they see the family or nation having the potential and prospect of getting back to work.[3]

With the power to tax, politicians know that deficits can continue forever. The problem of recession is one of unproductive spending. Consider what would happen with a $200 billion federal deficit but with one-half of today's government spending. Much less would be taken from the economy. Prices would be lower, wages higher, wealth and income greater, interest rates probably at low levels, and unemployment quite

(Cont. on p. 4)

In This Issue

- Summer of '82: The Great Budget Delusion — 1
- Privatization: Promise or Peril? (Editorial) — 2
- Briefs — 5
- PR Reviews — 6
- Is Campaigning Profitable? The Economics of Electioneering — 7
- Washington Update — 8
- Regulatory Watch — Department of Education — 9
- Government Receipts Monitor — 10
- "To be governed . . ." — 12

POLICY REPORT
ISSN: 0190-325X

Published by the Cato Institute, *Policy Report* is a monthly review that provides in-depth evaluations of public policies and discusses appropriate solutions to current economic problems.

David Boaz . . . . Executive Editor
Richard H. Fink . . . . Managing Editor
Tyler Cowen, Daniel Klein . . . . . Research

EDITORIAL BOARD

Yale Brozen . . . . . . University of Chicago
Karl Brunner . . . . University of Rochester
Friedrich A. Hayek . . . . University of Freiburg
Israel M. Kirzner . . . New York University
Gerald P. O'Driscoll, Jr. . . . . . . New York University
Edwin G. West . . . . . Carleton University
Leland B. Yeager . . . . University of Virginia

Subscriptions and correspondence should be addressed to: *Policy Report*, P.O. Box 693, Englewood, CO 80151. The annual subscription rate is $15.00 (12 issues). Single issues are $2.00 per copy. *Policy Report* is published monthly by the Cato Institute, 224 Second Street SE, Washington, D.C. 20003. Second-class postage paid at Washington, D.C.
POSTMASTER: Send address corrections to P.O. Box 693, Englewood, CO 81501.

Copyright © 1982 by the Cato Institute

Budget Delusion (Cont. from p. 3)

low. There is now no political accountability for the excessive use of government power nor has Ronald Reagan gotten government "off our backs."

Reagan and Dole sold the tax bill as a tax compliance measure with few actual tax increases (about $17 billion) as tax reform to eliminate tax advantages already voted in by Congress, and as added revenue from increased enforcement. They called the bill "fair," a term that always means increasing taxes in Washington, or sometimes spreading the tax burden around. Most of the compliance provisions focus on interest and dividend income. The bulk of the people who do not report accurately interest and dividend income are fairly poor, often retired, old, and forgetful, and a large group of noncompliers are children with relatively small savings accounts.

The compliance costs on interest withholding born by private markets may be substantial. They are estimated at over $3 billion for the next three years. Add to that lost interest of $1 billion per year and the individual's time involved in figuring out how to comply with the new law, and the private sector ends up spending more than the government gains in revenue.

In the bill drafting states, banking and credit union lobbyists opposed the withholding of taxes on interest and dividends, citing these high compliance costs. Working with the Senate Finance Committee, the Treasury Department promoted a provision allowing banks to keep the withheld funds in a float account for two weeks before depositing them in Treasury accounts. The banks could then earn interest sufficient to cover their compliance costs. Opposition by the ABA and other lobbyists became moot in the last few weeks of discussion on the bill.

Many taxpayers will overpay taxes through withholding, lose interest, and come to decide that other assets may be preferable to liquid savings accounts. Even complying taxpayers will be looking anxiously over their shoulders, though. There are 5,200 new IRS agents funded by this tax bill. IRS agents gain new power to issue and enforce administrative summons and have new access to confidential financial information. Taxpayers who file are easier to locate than those who do not and will be subjected to the unfair game of negotiating with the IRS where the burden of proof of honesty is on the citizen.

Passage of the tax bill was the next to last step in the drama to reduce federal deficits before the November elections. Sen. Robert Dole, author of the bill, likened the struggle to a true test of leadership, a process of governing by doing the "painful thing." Almost without exception, the media hailed the bipartisan efforts of the older, centrist elected officials, led by Reagan, who provided backbone support for the slim margin of victory.

> **"Political arguments over the deficit were successful in diverting attention away from the bread-and-butter issue of spending."**

Economic Assumptions

This political tale of deception in the budget process has yet to be played out to completion. The last step to come was set up earlier this year with varying predictions of record deficits in the next three years. News reports were appearing almost daily on the high interest rates that had prevailed for the past two years. In the conventional power politics vernacular, "something had to be done." That something was to reduce projected deficits to lower "the pressure" on interest rates.

The Reagan administration then traveled to Capitol Hill with numbers projecting economic growth of 5½% with commensurate growth in government spending. By 1985, that outsized projection showed a budget of over $1.1 trillion and continued record deficits. Financial markets ignored the estimate as interest rates held their course. Congress, using the theory that cuts from high budgets are easier than cuts from low budgets, accepted the Reagan projection and passed a Budget Resolution in June calling for spending reductions of $280 billion and tax increases of $99 billion over three years. Before you could blink, $154.3 billion in "spending cuts" were made. From where, you ask? From the overstated 1985 budget total. That was the first step. Next, Congress reduced the approved spending increase for 1983 by about $27.2 billion. This was accomplished by spending "cuts" in the tax bill and other "cuts" in a separate bill. Mitigated somewhat by an emergency spending bill increase for this year of over $14 billion, in one week spending was said to have declined by about $13 billion.

The last step will be for the committees to cut, again from the outsized projections, appropriations for 1984 and 1985. Some cuts may be made before the November elections. The cuts are phantom cuts, though, and easier to make for all of us.

To all of this must be added the current fiscal climate. The other largest tax increase in history, the Carter Social Security tax, is now in effect alongside the new tax bill and the Reagan tax cut of 1981. Government spending is roaring ahead at an 8 to 10% annual rate of growth.

Altogether, the New York Federal Reserve Bank estimates that by 1985, government expenditures will be 24% of GNP, continuing the all-time high, and taxes, with bracket creep, can be projected at about 23.6% of GNP, an all-time high. Ronald Reagan in 1980 promised us 20.5% for both these figures. Yet now, in a deep recession, we can safely predict massive growth of the federal government. As the *Washington Times* commented sarcastically, this is truly "a new beginning."[4]

Playing the numbers game is a time-honored Washington tradition. In the week of the tax bill gambit, only about $13 billion in net cuts were approved, giving 13¢ on the dollar. There are no *real* cuts, and spending is actually rising quite rapidly. What we saw was a tax increase sold as tax reform to try to stave off Republican defeats in November. As many have asked, if this was tax reform, who is paying less taxes as reforms generally call for?

Prodding the tax bill through his party, Reagan, however, sold the $3 to $1 ratio as a fair price to pay. To many this may be a telling argument. But some will ask why there was a tax increase at all? If the idea was to reduce the deficit, why not do it with a spending reduction of $180 billion instead of tax increases of $99 billion. Politicians have a method for everything. Most Democrats voted for the bill because they clearly saw it as a tax increase and nothing else — a renunciation of Reagan policy. They could not make actual spending cuts in an election year so the tax increase became a "mid-course correction" of debilitating tax cuts.

Key business groups supported the tax bill: the Business Roundtable, National Association of Manufacturers, American Business Conference, American Automobile Association, American Retail Federation, National Association of Realtors, Small Business Legislative Council, the heads of over 50 major corporations including Chrysler Corporation, and at the eleventh hour, a majority of the Board of Directors of the U.S. Chamber of Commerce, seeming to reverse the Chamber's original opposition to the bill. The Chamber's switch placed economist Richard Rahn and President Richard Lesher, who vehemently denounced the bill, in an awkward public posture. A multitude of labor groups also supported the bill. All supporters hailed the effort to reduce interest rates.

Opposition to the bill came from a variety of sources. On the political right in the House, Newt Gingrich and Jack Kemp were flabbergasted at taking $100 billion out of the economy, particularly during a recession. On the left, young black congressmen doubted the sincerity of the Reagan approach. They viewed the bill as a fraud setting up unprecedented defense spending increases, knowing full well that what follows tax increases are spending increases. Many others opposed the bill because as polls indicated, the public wanted spending cuts and not tax increases by an overwhelming margin. Many congressmen voted nay out of a fear for their reelection.

Moderation won out, with support from former tax cutters such as Rep. Phil Gramm (D-Tex.) and Bob Dole. With the dubious rationale that higher taxes would, in lockstep, reduce deficits and that deficits made incumbents look bad,

(Cont. on p. 6)

Briefs

☐ The National Taxpayers Union has recently announced that the true federal debt is closer to $1.6 trillion than the official figure of $1.1 trillion. NTU's total includes $7.3 billion worth of unfunded liability for pension and annuity plans and $2.2 billion for such insurance commitments as war risks, flood insurance, and student loans.

☐ Reagan administration officials have admitted that federal borrowing this year will soak up more than half of all the credit available in the United States this year. According to the Office of Management and Budget, federal borrowing took $142 billion, or 35% of all U.S. credit raised in 1981. Even if the 1982 deficit is held to $119 billion, federal borrowing will amount to $206 billion, 56% of the $368 billion expected to be raised in American credit markets in fiscal 1982. As high as this figure may seem, it does not come close to the record set in 1944 when wartime borrowing drove this figure up to 99%.

☐ Murray Weidenbaum, former chairman of President Reagan's Council of Economic Advisers, now says that the President's insistence on record military spending increases has defeated his efforts to control government spending. "On balance, we really haven't cut the budget," Weidenbaum said in an interview with Associated Press. "What worries me [about the military spending] is that these crash efforts rarely increase national security. They strain resources, create bottlenecks."

☐ A draft audit report from the inspector general of the Labor Department has revealed that officers of one of the largest anti-poverty agencies in America have systematically used agency funds for personal purposes. The East Los Angeles Community Union (TELACU) and its subsidiaries are estimated to have spent more than $46 million in questionable or undocumented expenses from 1976 to 1979. Agency officials used the money to make themselves personal loans, take trips to Europe, take their wives to Lake Tahoe, employ relatives, and finance their political activities. TELACU companies also lost nearly $4 million on bad investments in this period, many of which were far from the Los Angeles neighborhoods they were supposedly trying to help. These investments included $210,000 in an aquarium manufacturing company that went bankrupt and $443,000 in a New York publications firm. Not included in the $4 million figure is the purchase of a $300,000 townhouse in Washington that is used by executives when they visit the capital.

☐ Not only are there plans to print money and collect taxes in the aftermath of a nuclear war but now there are plans to continue mail delivery. Post office officials recently appeared before a House subcommittee to outline a 400-page plan for delivering mail after a holocaust. When one congressman asked what would happen if there were not many people left to send and receive letters, a postal official replied, "Those who are left will get their mail." Another official added, "If something is left, we'll be able to respond." Part of the plan calls for fallout protection for top postal officials and postal workers. ■

Budget Delusion (Cont. from p. 5)

they supported what was called the largest tax increase in history. Dole called the president on the night the bill passed. Flanked by other Senators he told Reagan, "I'm standing here with a group of happy taxpayers who want to congratulate you, Mr. President."

The tax bill was a direct result of the failure of Reaganomics to reduce the growth of government spending by any substantial degree. Ronald Reagan champions the cause of reduced government, but, in practice, he promotes fat-skimming assaults on social programs which inevitably lead to increased funding of those programs to mollify growing opposition to those cuts. No amount of fat-skimming will reduce the demand for band-aid social programs. The root causes of poverty — minimum wage laws, discretionary tax and spending policies, occupational licensing, and other sacred cows — are left untouched by Reagan's cosmetic approach. Reagan also supports increased defense spending with the simple notion that a massive defense build-up is a significant deterrent to war rather than a threat to peace.

Illustrative of the only type of cuts that Reagan will push and Congress will pass, was a bill passed just before the tax bill came up to reduce agricultural price supports. The *Wall Street Journal* on August 13 summed up the new approach to budget-saving cuts:

> Moreover, these "savings" are being achieved in ways that sometimes border on the outrageous. A projected cut in dairy price supports, for example, will be attained by giving the industry what amounts to a cartel, letting it make up for lost budget money by charging consumers higher prices. And "savings" in Medicare are arrived at by requiring employers to continue health insurance coverage for retirees — in other words a hidden tax. We're told that Dan Rostenkowski's House Ways and Means Committee wants to count this large sum as both a "savings" and a tax to get credit for deficit trimming on both sides of the ledger. "If I tried to do that in a bank, I'd be arrested," says one congressional aide.

Reagan's record on overall federal spending nowhere nearly matches his rhetoric. The budget process is so convoluted that very few Americans can tell what is going on. What Reagan had achieved in 1981 was to cut $20 billion in fiscal year 1982 from the then-projected government expenditures. That is a cut of $20 billion from a more than 10% spending increase assumed by the White House and Congress if nothing was changed. Spending reduction is an illusion, but is perpetuated by the media.

"Before you could blink, $154.3 billion in 'spending cuts' were made from the overstated 1985 total."

The summer of '82 may influence the fall elections, but only by obscuring what really happened. It started as a political power struggle for campaign bragging rights and ended as high camp delusion. Ex-Reagan aide Lyn Nofziger applied the proper commentary to the effort to go against his conservative principles. After a meeting with Reagan, he said, "I was opposed to this thing, but they finally done explained it to me." How it was explained and the rating on the laugh meter that ensued were not revealed.

Recession can be avoided by shunning inflation. The end result of inflationary government financing is disappointment and retrenchment. And to avoid inflation, it helps to avoid recession. Profligate federal spending to end recession has been tried and it fails. Yet we remain on that course to this day. As George Mason University economist Jack High concludes, "The most important economic effect of the Reagan tax increase is this: It hands politicians more money, and leaves honest working men with less." ■

---

[1] "MacNeil-Lehrer Report," PBS Television, August 10, 1982.

[2] Thomas M. Humbert, "The Tax Package: It's Unfair," Heritage Foundation, August 18, 1982.

[3] Jude Wanniski, "The Balanced Budget Amendment," *Washington Post*, August 1, 1982.

[4] "A New Beginning," *Washington Times*, August 20, 1982.

PR *Reviews*

Elites in American History: The New Deal to the Carter Administration, by Philip H. Burch, Jr. Holmes and Meier Publishers, Inc., New York, 1980. 544 pp. $19.95.

While the importance of vested interests in American politics is well-known, there is little research in this area that is relevant to current public policy debate. Philip Burch's masterful treatment is a major step in the right direction. *Elites in American History* is the most comprehensive work to date to detail the role of special interest groups in American government. It is part of a three-volume set spanning the Federalist years to the Carter administration, with one volume not yet published.

A good example of Burch's method is the chapter on the Kennedy-Johnson years. There are sections on John Kennedy's major administrative and diplomatic appointments; important policy actions of his administration; Johnson and his informal inner circle, top officials, and important policy actions; and Supreme Court appointments and actions. The book's back cover notes that "Philip Burch's rigorous analysis of the socioeconomic background and affiliations of America's top appointed officials challenges the widely held view that government has been one 'of the people, by the people, and for the people.' "

Elites in American History is a magnificent piece of scholarship and is essential for anyone researching the origins of legislation over the last 50 years.

(Cont. on p. 11)

Is Campaigning Profitable? The Economics of Electioneering

By W. Mark Crain and David N. Laband

It is common knowledge that political campaigns are expensive. Less well known is the fact that campaigning is a revenue-generating activity that can be profitable. In fact, reports on file at the Federal Election Commission for recent U.S. congressional elections suggest that most of the time candidates come out ahead on their campaigns, win or lose.

Consider for the moment the final balances after the 1978 U.S. House races. Of some 1,121 major party candidates, just over 75% ended their campaigns in the black. The average final balance was $3,671, with the winners netting $9,463 on average and the losers, a paltry $85. The post-election balances of 148 candidates exceeded $10,000, and 72 campaigns closed out above the $20,000 mark. This is roughly equivalent to the outside earnings limit from other sources that Congress has created for itself. The gainers list was topped by Rep. Jim Collins (D-Tex.) with $145,523. Rep. Bob Stump (D-Ariz.) bottomed out the field with a $44,635 campaign debt. In short, the expense of running for office is not a deterrent and, if anything, campaigning is an additional source of outside earnings to supplement politicians' personal expense accounts. Numerous examples of incumbent senators and congressmen converting their residual campaign funds to personal uses have recently been documented.[1] Surely no candidate wants to incur campaign debts, but there is more to campaign financing activity than simply breaking even.

Campaigns profits are an important determinant in the overall behavior of politicians. Like private entrepreneurs, politicians attempt to maximize their net wealth over time. This involves profits from campaigning as well as from "political income," broadly defined, from holding office. This is, of course, an analytical abstraction that will not describe all politicians. It serves, however, as a useful conceptual framework that explains certain growing trends in American elections.

"The possibilities for generating income out of the election and re-election cycle add a new dimension to the politician's decision on when to retire."

In this article we examine the notion of legislators as net wealth maximizers, particularly in terms of a candidate's campaign revenues and expenditures. We then analyze the influence of incumbency and party affiliation on campaign profits as well as a politician's legislative "marginal product"; that is, his ability to pass or otherwise influence legislative proposals.

Several public policy issues are raised by this analysis. These will be taken up later within the more general framework of the competition for public office.

The Determinants of Campaign Profitability

A casual glance at the data on campaign receipts and expenditures provides evidence that politicians are frequently making money off their campaigns, in addition to whatever benefits they derive from actually holding office. Surely both aspects are important to office-seekers but in the present paper we focus on the behavioral implications of campaign profits. Campaign profits are defined here as simply the difference between campaign receipts and campaign expenditures.

The ability of the candidate to raise campaign revenues is a function of his party affiliation, tenure or seniority, closeness of his race, the particular office he is running for, and other factors. The amount he spends to get elected is determined generally by these same variables. We discuss the two sides of the campaign profit relationship below.

Campaign Revenues

Contributors have a variety of motives for contributing to candidates. These motives can be classified broadly in three categories:

(1) the expected impact that the candidate will have in the current legislative session;

(2) the expected impact of the candidate in future legislative sessions; and

(3) the likelihood that the contribution will make a difference in the outcome of the election.

If the candidate wins, his ability to influence current legislation depends on his tenure and his party affiliation. The legislative impact that a candidate will have in the future depends on how long he is expected to remain in office; that is, the candidate's political time horizon. A political time horizon is determined by the candidate's age, tenure, party affiliations, and the certainty of his election in the current and all future elections. This certainty can be estimated by contributors by looking at how well the candidate appears to be doing in the current election, as well as the percent of the vote the candidate received in the past few elections. The likelihood that a contribution will make a difference in

(Cont. on p. 9)

W. Mark Crain is associate professor of economics and program coordinator for the Center for Study of Public Choice at George Mason University. David N. Laband is assistant professor of economics at the University of Maryland, Baltimore County.

✓ Washington Update

✓ Members of the Senate Finance Committee have indicated that they wish to amend the Reagan administration's proposed tuition tax credit by paring down its cost from $1.25 billion to $900 million over the next three years. The committee is also preparing several other amendments which would reduce the maximum tax credit to $300 per child rather than $500, start phasing out credit at income levels of $40,000 rather than $50,000, and add a refundability clause so that poor families who owe no taxes could take advantage of the credit.

✓ The Federal Communications Commission has proposed an extension of the authorized hours of operation for daytime-only AM radio stations. If the proposal is implemented as expected, it would allow more than 2,000 of the nation's 2,300 daytime-only AM stations to continue broadcasting after local sunset. In a separate notice of inquiry, the FCC also solicited comments on a proposal to give daytime-only broadcasters preference in applying for a full-time FM station.

✓ In an unexpected turnabout, the House of Representatives approved a two-year extension of the basic federal pesticide control law and defeated a series of pro-industry amendments. The amendments that were adopted will now allow private citizens access to federal courts to seek relief from pesticide damage and will erase recent limits that were placed on the power of the states to restrict the use of pesticides.

✓ The Federal Trade Commission has approved regulations that will require funeral directors to offer their customers a greater choice in the types and costs of funerals available. The regulations also provide for industry-wide price disclosure rules in order to protect consumers from "unscrupulous" undertakers. Under the rule, funeral directors would be required to provide a comprehensive, item-by-item list of all services and prices. This information would also be available over the phone by request. Although the Commission approved these proposals by a 3-to-1 margin, it was necessary to override the chairman, James Miller. Miller opposed the new rules because he feared they would raise the cost of funerals without necessarily benefiting the consumers.

✓ The Labor Department has proposed significant changes in federal child labor regulations that would allow 14- and 15-year-olds to work longer hours and accept more hazardous jobs. DOL also proposed relaxing the red tape involved in hiring full-time students at less than the minimum wage. 14-and 15-year olds would now be allowed to work until 9 p.m. on school days and until 10 p.m. during the summer. Teenagers would also be allowed to work 24 hours a week when school is in session instead of the current 18-hour limit. Among the jobs that would be opened up would be certain cooking and baking jobs, operating switchboards and typewriters, certain laundry jobs, filling orders in warehouses, and operating data processing equipment. If these proposals are enacted, they would be the first major revisions in child labor rules since 1938.

✓ In a unanimous vote, the FTC has decided to challenge Gulf Oil's $5.13 billion bid for Cities Service Co., on the grounds that such a merger would decrease competition in the oil industry. Although FTC lawyers are currently trying to negotiate a settlement with Gulf attorneys, a preliminary injunction against the merger has been sought. If completed, it would be the third largest merger in American history.

✓ The Environmental Protection Agency has proposed exempting nearly half of all newly developed chemicals from a detailed agency review. This plan, which was based on a suggestion from the Chemical Manufacturing Association, would exempt from review about 400 of the approximately 900 new chemicals developed each year. The decision as to which chemicals will be exempted will be left to a "qualified expert" paid by the manufacturer. All decisions will be subject to EPA veto.

✓ The Interior Department has proposed a reorganization of the Bureau of Indian Affairs, which would cut the number of regional BIA offices from 12 to 6. Such a plan is estimated to save about $16 million annually and would cut staff levels by about 500. BIA officials also noted that the reorganization itself would cost between $6 and 8.5 million this year.

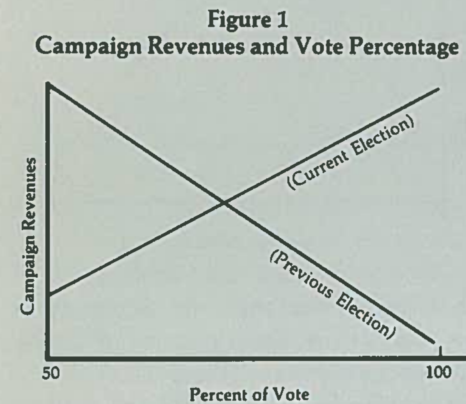
✓ The Reagan administration is drawing up legislation that would sharply curtail claims for legal fees in cases that are brought by private citizens and public interest groups against state, local, or federal governments. If this bill passes Congress, 25% of all legal fees would be paid out of any monetary damages awarded the plaintiff. In addition, many cases would no longer be eligible for any awards at all. In many cases, judges would now be allowed to require the plaintiff to pay the government's legal fees. The administration has reportedly had trouble finding any congressman willing to sponsor such a bill. ■

Campaigning (Cont. from p. 7)

the race depends on the closeness of the current and recent elections.

The relationships that determine a candidate's campaign revenues are illustrated in Figure 1.[2]

Figure 1
Campaign Revenues and Vote Percentage



Basically it depicts the dilemma the candidate who is attempting to raise more campaign revenues finds himself in. On the one hand, a higher vote percentage sends the signal that he is a winner and the message to interest groups that he is going to be a political force to deal with in the future. On the other hand, higher margins of victory signal contributors that additional contributions are not likely to make any difference in the outcome of the election, thus diminishing one of their motives for giving. The relationship between a candidate's ability to raise revenues and the percentage of the vote in the previous election is negative. Stated in the reverse, a narrow winning margin in the previous election means that a candidate can go to contributors with the argument that donations will make a substantial difference in the outcome of the current election.

The major implication here is straightforward. If a candidate seeks to generate higher campaign revenues, it may not pay to be a vote-maximizer. While it is true that increasing your margin of victory in the current election boosts contributions to your campaign, it has the effect of reducing donations for future elections. Thus, it may pay, in terms of your ability to raise campaign contributions over a political lifetime, to "fine-tune" your margin of victory in the current election campaign.

(Cont. on p. 10)

Regulatory Watch

DEPARTMENT OF EDUCATION

The Department of Education has issued final rules revoking a previous regulation that allowed students to file federal complaints about local school dress codes. The regulation had prohibited discrimination "against any person in application of any rules of appearance," which effectively prevented any rules specifically directed at either males or females. Although Education Secretary Terrel Bell had proposed the change 15 months ago, he met with opposition from women's groups who claimed it would foster sex discrimination by allowing dress codes that prescribed "stereotyped" clothing for male and female students. Bell's action is the third time this rule has been changed. Former HEW Secretary Califano proposed withdrawing the rule in 1978 but his decision was reversed in 1979 by his successor, Patricia Harris.

Major revisions are proposed in the rules governing handicapped education, including regulations that would allow schools to remove "disruptive" handicapped children from regular classrooms. These students would be returned to institutions and special classes for the mentally and physically handicapped. The proposed changes are in direct opposition to the Education for all Handicapped Children Act of 1975, which requires schools to keep handicapped children in regular classrooms as much as possible. Bell claims that these revisions would streamline federal policy and reduce costs and administrative burdens on local school districts. Congress is already on record as opposing these changes.

Congress and Education Department officials are embroiled in an ongoing feud over congressional power to veto the Department's regulations. Several new education regulations are in danger because many congressmen are claiming they are incompatible with the General Education Provisions Act (GEPA), a law which sets out certain administrative rules and safeguards that educational institutions must follow. On the other hand, the Reagan administration claims that GEPA does not apply to new rules because Congress did not specify such an application when it passed last year's budget reconciliation bill. In addition, it is argued that Congress can't veto any regulatory rules because its veto authority comes from GEPA, the law that does not apply. These disputes arose when the Department published new rules for aid to disadvantaged children and block grants to the states. The issue over legislative veto power is now before the Supreme Court in the form of an immigration case.

As part of an attempt to depoliticize the funding of its grants and contracts, the Education Department is considering new rules for grant applicants who are involved in lobbying or other forms of "propaganda." These "high-risk" applicants would have to undergo special approval procedures in order to obtain money from the Department, including supplying information such as the organization's constitution, by-laws, and a list of its lobbying and litigation activities. Critics of the proposal charge it is part of the New Right's attempt to de-fund the left. ■

Campaigning (Cont. from p. 9)

Campaign Expenditures

The amount that a candidate spends in his election effort depends on several factors:

(1) the closeness of his race;
(2) the amount of time the candidate is able to spend campaigning in the district;
(3) his tenure and seniority; and
(4) federal pork-barrel spending in his district.

This relationship is depicted in Figure 2.

GOVERNMENT RECEIPTS MONITOR

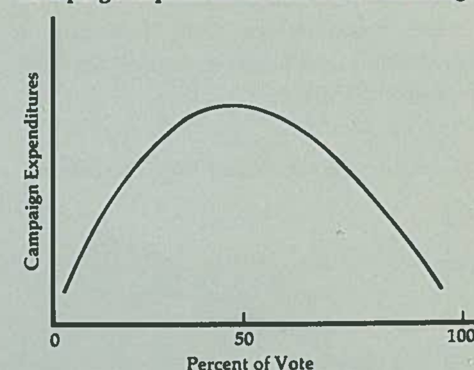
On a quarterly basis, *Policy Report* presents three monitors of economic activity: "Government Spending," "Government Receipts," and "Inflation." The "Government Receipts Monitor" summarizes the latest levels and sources of the federal government's income.

RECEIPTS (annual rate in millions of $ unless otherwise indicated)

	1982 2nd Quarter	1982 1st Quarter	1981 4th Quarter	Average for Last Year
Total Receipts	715,532	569,596	588,764	625,185
Surplus or Deficit	−10,012	−25,658	−207,148	−75,400
Total Individual Taxes	455,328	343,800	286,104	351,376
Gross Corporate Income Taxes	92,536	58,808	63,592	68,892
Employment Taxes and Contributions	205,128	179,476	165,712	179,379
Social Insurance Taxes and Contributions	240,164	188,936	183,224	200,993
Unemployment Trust Fund	29,364	9,872	8,892	16,164
Excise Taxes	33,392	36,708	41,808	39,622
Highway Trust Fund	7,144	6,484	6,816	6,808
Estate and Gift Taxes	7,760	9,072	7,532	7,949
Customs Duties	6,412	8,608	9,344	8,415
Miscellaneous	16,540	15,396	17,536	16,424
Holding of Public Debt Securities (current total)	1,079,630	1,061,299	1,028,727	1,041,873
Holding of Agency Securities (c.t.)	5,029	5,094	5,987	5,549
Federal Securities Held by Public (c.t.)	871,783	862,809	830,055	839,770

SOURCE: *Monthly Treasury Statement of Receipts and Outlays of the United States Government.*

Figure 2
Campaign Expenditures and Vote Percentage



At one extreme the candidate is a shoo-in (100% of the vote); at the other, he has no realistic chance of being elected. In either case there is little incentive to spend. As the candidate's election margin edges toward 50% (assuming only two candidates), marginal expenditures are likely to be the decisive factor in the outcome. Thus, spending should rise to a maximum in close races and be relatively low in runaway contests.

The amount of time a candidate can spend campaigning and federal funds spent in the district also are important in the campaign expenditure decision. In effect, the politician can influence election outcomes with each of these factors. For any given vote percentage, the more the candidate advertises (private campaign spending), the less time he must spend traveling and campaigning in the home district. This is especially important for committee chairmen and members of the leadership due to the heavy legislative demands on their time.

Effects of Tenure and Party Affiliation on Campaign Expenditures

A candidate's ability to influence the legislative process depends largely on his committee assignments and seniority. For the most part, committee membership status depends on length of congressional service. Not surprisingly, then, donors contribute more to senior legislators than to junior legislators, *ceteris paribus.*

Party affiliation decidedly influences a politician's legislative impact. With tenure constant, the ability of a majority party member to influence outcomes is generally much greater than his minority party counterpart. Obviously, this stems once again from the committee system where the majority party controls the chairmanship positions and the proportionate representation.

Public Spending

As more federal funds go to his district, a legislator can substitute public spending for spending his private funds. The ability to use public money for pork-barrel projects back home serves much the same purpose in the reelection effort; namely to publicize his legislative efforts for the voters. Over a political lifetime, then, the level of campaign spending required by an incumbent to obtain a given percentage of the vote declines. For this reason, the longer a candidate's time in office the less he will have to spend to get reelected.

Time Spent Campaigning

A candidate's tenure has a negative effect, though. The longer his tenure the greater his role in the legislative process, which makes it more difficult to spend campaign time back in his district. It seems likely that, at some point, the wealth-maximizing legislator will substitute campaign advertising for home trips as long as the cost of advertising is less than the value of his time spent away from legislative business. The more tenure, the more we can expect incumbents to spend relatively less time in their home districts, and relatively more campaign funds on advertising. The case of Al Ullman, former House Ways and Means Committee chairman, illustrates the nature of this trade-off. As chairman of one of the most powerful committees in the House, the value of his time in Washington was extremely high. In light of this fact, it is not surprising that in the 1980 elections, his was one of the most expensive campaigns ever.[3]

Policy Implications

The proposition that competition at the polls may materially benefit candidates is important in understanding the behavior of politicians. Vote-maximizing may not be in his best interest.

With this in mind we can evaluate the impact of Public Law No. 96-187, which permits national political candidates to convert campaign funds to private use. (Note that PL 94-283 had previously permitted the conversion of campaign receipts to private use but only upon retirement from public office).

Since there is a range over which closer races tend to be more profitable for politicians, an incentive is created for candidates to slack off in the campaign effort. The candidate who "destroys" his opponent with 90% of the vote will attract fewer contributions the next time around than he could expect with a more modest victory, say, with 65% of the vote. This means that, over all, national elections in the United States may be much less competitive than they appear to be. If candidates could not use campaign funds other than for elections, the average winning margin would very likely increase.

Finally, the possibilities for generating income out of the election and reelection cycle add a new dimension to the politician's decision on when to retire. Deciding to run for one more term may become much more attractive given the remunerative aspect of the campaign trail, and with less concern for the legislative session beyond. ■

[1]See Bill Hogan, Diane Kiesel and Alan Green, "The New Slush Fund Scandal," *New Republic*, August 30, 1982, pp. 21-25.

"Last year, for example, House incumbents used campaign funds for family trips to and from Hawaii, Bermuda, Europe, and China; designer dresses for their wives; expensive silver flatware for their homes; large, unexplained legal fees; tickets to the Kennedy Center, the Super Bowl, and Broadway shows; salaries for spouses and other relatives; bonus payments and cash advances to members of their Congressional staffs; custom-crafted cabinetwork and interior decoration fees for their congressional offices; family moving expenses; home burglar-alarm systems; and even contributions to the church collection plate." Similarly, columnist Jack Anderson wrote on September 8, 1982, that "members of Congress use campaign contributions for expenses that should be paid out of their own pockets."

[2]For a more technical and statistically rigorous development of these relationships, see W. Mark Crain and David N. Laband, "An Empirical Test of the Vote — Maximization Hypothesis," working paper, George Mason University, August 1982.

[3]Of course Ullman's position was also the key determinant of his ability to generate large contributions. The large expenditures were, however, determined independently of the campaign receipts. This is evidenced by the case of the current Ways and Means chairman, Dan Rostenkowski. This spring Rep. Rostenkowski generated $160,000 at a single fund-raiser, although he was unopposed for reelection. See *Wall Street Journal*, March 1, 1982, p. 1.

PR *Reviews* (Cont. from p. 6)

The Ministry of Culture, by Michael M. Mooney, Wyndham Books, New York, 1980. 427 pp. $14.95.

While there are many excellent studies of government regulatory policy, little work has been done on government policy in the arts. In this venture into investigative reporting, novelist Michael Mooney examines the connections between art and money and politics. Mooney contends that the Carter administration created a pervasive national cultural policy under the leadership of Joan Mondale, chairperson of the Federal Council on the Arts and Humanities. By 1980, more than 300 federal agencies were involved and more than $20 billion a year in federal funds was being spent. As the inside cover tells us, "Mooney reveals how these programs overlap, how agencies fund one another, how corporations join in for political advantage, and how a small elite drawn from government, academia, and business are secretly working together to create a radical new national culture."

The Ministry of Culture is a provocative book, full of anecdotes about the influence of the federal government in the arts and humanities. Despite its many excellent points, however, Mooney's case could be bolstered considerably by using economic reasoning; his approach is overly journalistic. In other places, Mooney overstates his case. He has a tendency to fall back upon conspiracy theories and is also obsessed with attributing a perverse brand of secular humanism to this conspiracy. Nevertheless, the book's points of interest outweigh its defects. ■

"To be governed . . ."

Of course, he's not paying it

Using appeals of compromise and fairness, President Reagan sought public approval of the tax-increase bill as "a price worth paying" to return the economy to health.

—*Wall Street Journal,* August 17, 1982

First things first

Not being an economist, I lack the license to predict the effects of a $98 billion deficit cut on interest rates or corporate investment or unemployment. But my political senses tell me that our failure to pass a tax bill would not only lower the nation's confidence in Congress, but also present one of the broadest November targets ever.

—Rep. Dan Rostenkowski, Chairman
House Ways and Means Committee

Holding down spending

The Senate last night approved a $14 billion supplemental appropriations bill for the rest of fiscal 1982 . . .

But the Senate also struck a blow for economy in approving an amendment to prohibit the Internal Revenue Service from spending $85,000 to remodel executive offices at the IRS.

—*Washington Post,* August 12, 1982

It's not a donation

Is the tax-raising bill backed by President Reagan the largest in history? Yes, say Democractic critics. No, says the president. Who is right depends on what one considers to be a tax . . .

Reagan agrees that the bill would raise nearly $100 billion for the Treasury, but he argues that only $18 billion would come from new taxes on individuals and businesses, such as a doubling of excise taxes on cigarettes. The remaining $81 billion, he says, doesn't count as new taxes.

—*Washington Post,* August 12, 1982

Don't worry, you are

Ralph Nader noted that the [administration's] tally [of savings from deregulation] included a weakening of the Transportation Department's bumper standard for cars (savings of $300 million annually, according to the administration) and a decision not to require vehicles to have a device to warn drivers when their tires are improperly inflated ($130 million annually).

"There's no mention of the lives lost," no cost/benefit analysis, Nader said. "If I had a press conference and said we should abolish Exxon because it cost the American public hundreds of thousands of dollars, and I never mentioned that the American people got oil in return, I'd be a laughingstock."

—*Washington Post,* August 9, 1982

It's a tough life

Senate Majority Leader Baker urges senators to wrap up business in time for an August 20 recess. His reasons: "August is a sticky, humid, miserable month. Cars overheat, tempers flare, air conditioners break." The only solution, he says, is to spend time "in one's home state, with one's family and friends."

—*Wall Street Journal,* August 13, 1982

Now if only somebody will dump Parmesan cheese

Pasta is straining trade relations between the United States and the European Economic Community. Last year the National Pasta Association complained to the Office of the U.S. Trade Representative that EEC subsidies of pasta products violate international trade agreements and pose a threat to American manufacturers. Spaghetti dumping began in 1980, the association charged, when a severe draught damaged the U.S. durum-wheat crop and boosted pasta prices. "That opened the floodgates for Italian imports," says industry spokesman Robert Green.

—*Newsweek,* August 16, 1982

The importance of experts

Does current Fed policy rest on solid empirical ground? In a recent issue of their *Weekly Credit Market Bulletin,* Donald E. Maude and Robert A. Schwartz, economists at Merrill Lynch, Pierce, Fenner & Smith Inc., note that two recent studies of monetary policy by the staffs of different Fed banks drew essentially opposite conclusions from the same basic data.

—*Business Week,* August 30, 1982

POLICY REPORT
224 Second Street SE
Washington, D.C. 20003

SECOND CLASS
POSTAGE PAID
AT WASHINGTON, D.C.

CATO
INSTITUTE