Follow the Money

Checks Unbalanced: The Quiet Side of Public Spending, by Herman B. Leonard (Basic Books, 1986), 289 pp.

Reviewed by Michael J. Boskin

Debates about the appropriate role of government in the economy span the centuries, and today are alive and well in virtually every society, whether democratic or totalitarian, advanced or developing. Such debates properly engender strong emotion, as they concern not only the performance of the economy and the distribution of income and wealth, but also the boundaries of personal freedoms and responsibilities.

Beyond the philosophical and ideological debates about the role of government lie a set of practical empirical questions about the size and impact of government. Just how large is it? Is it growing or contracting? How effectively is it achieving its goals? Remarkably, the answers to these questions are far from clear. A small but growing number of economists, accountants, and statisticians have been hard at work for some years documenting an unfortunate fact of life in the United States: as conventionally measured, government spending is a poor guide to the size and impact of our government.

The accounting system traditionally used to record government spending, revenues, and deficits can be highly misleading—due partly to historical happenstance, and partly to political expedience. Mandated private activities are ignored in federal budget accounts, even though they are close substitutes for government spending and taxes. No distinction is made between capital accounts and current accounts, leading to immense confusion (and real gimmickry). Accruing contingent liabilities, such as loans and loan guarantees, are ignored for years. Net spending—the difference between spending and revenues—is frequently recorded rather than a program's contribution to total spending and total revenues. (This procedure accounts for the finding that spending on deposit insurance was *negative* in 1982, a year in which accrued liabilities increased by tens of billions of dollars in expected present value terms.) Potential accrued liabilities, such as the unfunded deficit in social security and other pension programs, are also ignored. Increasingly, the budget process is a political renegotiation of accounting conventions and assumptions as much as a renegotiation of spending decisions.

Much has been made recently of the difficulty of forecasting deficits, let alone achieving meaningful reductions in the deficit. But what do we know about the current state of the budget or where it has been? The accounting problems are so fundamental and pervasive that federal budget figures can not be used to compile an accurate representation of our fiscal history.

To many these issues may seem arcane and irrelevant, but they are important to our understanding of the role of government in society—too important to be left solely to academic treatises, appendices to the budget, or little-noticed government reports. In *Checks Unbalanced: The Quiet Side of Public Spending*, Professor Herman (Dutch) Leonard of the Kennedy School of Government, Harvard University does a splendid job of illuminating, in broad outline, the real magnitude of government spending. The book is a superbly crafted blend of history, politics, economics, and accounting. It is addressed to the citizens who ought to be concerned about the public's business and ought to be expressing that concern to our elected officials. Leonard incisively discusses various options to raise the profile of the quiet side of public spending for Congress and the general public.

While Leonard's book is enlightening and entertaining, it contains little that is new for those already familiar with the details of federal budgeting. My familiarity with the subject occasionally made me wish that Leonard had delved somewhat deeper into the conceptual and empirical issues at hand and their economic implications. For example, how should we conceive of—let alone measure—the unfunded liabilities in social security and deposit insurance? If a closed group concept is used for social security, the liability is measured as the present value of benefits in excess of taxes yet to be paid. Do we really believe that this is a sensible measure of what it would cost to buy out current participants if the system were privatized? Would participants demand more than this because social security provides inflation-adjusted joint survi-

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vor annuities, typically unavailable in private markets? Or would they demand less because of the considerable uncertainty surrounding the future of social security and the possibility that they will receive far less in benefits than currently promised?

Or consider the potential liabilities of the deposit insurance system. In Leonard's otherwise excellent discussion of federal credit activities, deposit insurance is ignored. Yet this is by far the most important credit activity of the federal government. How do we define the potential liabilities of the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation? Total insured deposits at banks and thrifts were over $2 trillion in 1986. Is this the extent of the insuring agencies' maximum possible exposure? The history of the FDIC seems to indicate that the agency effectively insures the "uninsured" deposits at insured banks as well, either by waiting for them to be withdrawn before closing the bank or by arranging a merger of the failed bank with a profitable one. The assets of the FDIC amount to about $15 billion, plus some standby borrowing authority at the Treasury. Is this the maximum exposure? What happens if three or four major banks fail, the FDIC assets are exhausted, and the Federal Reserve must step in as the lender of last resort? The outcome of this complex interplay of legal rules, regulatory institutions, and accounting conventions is beyond our ability to forecast, particularly if we factor in the (small) possibility of a major financial crisis.

Leonard's chapter on federal tax expenditures raises yet another set of interesting questions that beg to be answered. The chapter contains a tremendous amount of information on the development of the tax expenditure concept and the occasional interagency bickering over the items to be included. Data are presented on the size of the tax expenditure budget, the estimated revenue loss, the (apparent) distribution of tax expenditures by functional spending category, and the (alleged) distribution of tax expenditure benefits relative to income tax liabilities by income categories. All of this is valuable information. Leonard appropriately digs further into some of the limitations of the tax expenditure budget.

For example, what is the appropriate tax base against which deviations should be thought of as tax expenditures? Leonard notes that in 1984 the Office of Management and Budget changed its definition of the tax base, incorporating about 10 percent, or $34 billion, of what were formerly considered tax expenditures. The single most important item incorporated into the tax base was accelerated depreciation. This was at odds with the original conception of a tax expenditure budget, developed at the Department of Treasury and elsewhere, which assumed that the appropriate tax base was real economic income—what public finance economists call the Haig-Simons definition of income. In this case, only true economic depreciation would be considered part of the baseline tax system, and faster depreciation should be considered a tax expenditure.

But there are other ways to define the tax base and appropriate tax expenditures. Suppose one believes that consumption is a more desirable tax base than income, whether on grounds of economic efficiency, fairness, or administrative simplicity? Then accelerated depreciation—on *equity* investment—is really *de*celerated depreciation relative to a consumption tax, which expenses equity investment. What had been a tax expenditure would now look like a surtax.

Thus, in the rush to identify and highlight features of the tax code disapproved of, the framers of the tax expenditure budget assumed a tax base that has *never* formed the basis for the U.S. tax system. Personal and corporate income taxes have always blended components of income and consumption taxation. Defining tax expenditures before deriving some notion of a desirable tax base from underlying principles seems to put the cart before the horse.

As a related matter, it is necessary to take into account the revenue side of the budget in order to really understand the spending side. In part this is because of tax expenditures; in part it is because the optimal size and composition of government spending generally depends upon the nature of financing. For example, with high marginal tax rates the social opportunity cost of financing a dollar of government spending might really be $1.30. With a broader-based, lower-rate tax (lower rates on work effort, *new* saving and investment, etc.), this extra resource cost would be smaller, and more public projects might display positive net benefits.

Indeed, to match the quiet side of government spending and liabilities, there is a quiet side of government revenues and assets—a side which Leonard does not address. For example, the U.S. budget fails to account for deferred tax liabilities. This results in a systematic bias in rev-

enue cost estimates against saving incentives, such as those for individual retirement accounts. For each dollar of revenue the Treasury currently loses because of an IRA deduction, some fraction will be recouped in additional tax collections in later years (in real present value terms).

I raise these conceptual and measurement problems not to expose weaknesses in the book so much as to highlight the nature of the ongoing debate among academics on the underlying issues. Including a discussion of these in any serious detail would have made this a very different volume, accessible to a much smaller audience.

Leonard clearly went out of his way to raise an important subject and to do so in a way that would be read and appreciated by a broad audience. This is one of the book's strengths. Another is the way information, analysis, and prescription are blended on several programs that are not recorded—at least not recorded properly—in the spending figures wending their way through the appropriations and budget processes.

Leonard's work deserves to be read and digested by every citizen concerned with the role of government in economic affairs. As the size of the public sector grows, so too does the importance of understanding its hidden dimensions.

Health Care Diagnosis

Charting the Future of Health Care: Policy, Politics, and Public Health, eds. Jack A. Meyer and Marion Ein Lewin (American Enterprise Institute, 1987), 190 pp.

Reviewed by Rita Ricardo-Campbell

Charting the Future of Health Care: Policy, Politics, and Public Health is a collection of essays on various aspects of national health policy. Written for the general public by a group of professors, researchers, physicians, and individuals with government experience, this book stresses the importance of prevention, consumer education, and self care in containing the rising cost of medical care. Although developments in these areas have been well documented elsewhere, their importance certainly bears repeating.

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The volume begins with an introduction by editors Jack A. Meyer and Marion Ein Lewin that serves primarily to summarize the chapters; it does not weave them into an integrated whole. This is unfortunate because two issues of real importance are largely overlooked. Neither AIDS nor the regulation of new drugs and medical devices by the Food and Drug Administration (FDA) is given adequate attention.

The AIDS epidemic is likely to be the largest single influence on the future of health care. I estimate that by 1991 cumulative medical care costs resulting from AIDS will total $100 billion. This estimate is higher than earlier estimates because of the discovery of AZT therapy, which currently costs about $10,000 per person per year and may extend life but does not cure AIDS. Also, earlier estimates failed to account for patients with AIDS-related complex.

A high estimate of future medical costs associated with AIDS is supported by physician Mervyn Silverman's essay on AIDS. As he notes, "it is . . . reasonable to assume that the number of infected persons in many areas of the United States exceeds by a hundredfold those who have been reported as having AIDS." Based on his review of available studies, he estimates that only 1 or 2 percent of those infected will be diagnosed with classic AIDS during the next year. Of those infected he estimates that 10 percent will develop AIDS-related complex, a condition that "proceeds to AIDS in 25 percent of the cases and can be extremely debilitating and even fatal."

The demand for inpatient and outpatient medical care by AIDS patients will continue to put upward pressure on prices for medical care resources and this, in turn, will increase the cost of medical care for all consumers. This and other secondary effects of AIDS on health care costs have not generally been recognized. For example, to avoid contact with AIDS patients, some new interns are leaving medicine; hence AIDS could dampen the supply of physicians.

Silverman, who was San Francisco's director of public health from 1977 to 1985, describes the conflict between the public health issues posed by AIDS—the need to control the spread of the disease—and the privacy issues raised by those suffering from the disease. He recommends policies that promote education and counseling. Silverman concludes that, "If everyone understood and followed the preventive