THE POLITICAL ECONOMY OF MANDATED SPENDING

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Introduction

It is widely acknowledged that government spending and taxation are not the sole sources of government influence on resource allocation and the distribution of income. Modern governments also wield vast regulatory powers and, in many circumstances, direct regulation of private sector entities is an alternative to government taxing or spending. Richard Wagner, for example, asserts that "a central principle of public finance is that any statute or regulation can be translated into a budgetary equivalent" (Wagner 1989, p. 108). Harvey Rosen, in his best-selling public finance text, refers to the " 'hidden' costs of government," in pointing out that many regulations have important and large effects even though they require minimal government outlays (Rosen 1988, p. 17).

The failure of the budget document to reflect the economic impact of regulation is potentially more than a pure measurement issue. There is a perennial debate in the United States over the desirability and feasibility of imposing constitutional limits on the activities of the public sector, particularly at the national level. To the extent that the most commonly proposed constraints, spending limits, and balanced budget requirements are expressed in terms of fiscal variables alone, concern has been expressed that the availability of regulation will provide a means for the political process to circumvent those constraints. At a 1980 conference, for example, no fewer than three of the participants expressed concern that increased regulation would provide an avenue for the political process to subvert any constitutional limits on its spending or borrowing authority (Moore and Penner 1980, pp. 48, 54, and 60). Similarly, Aaron Wildavsky

raised the issue of regulation as an "end run" around a constitution-
ally imposed spending limit.[1]

This paper takes a critical look at the public choice aspects of
the choice between direct government spending and government
mandated private expenditures.[2] Some similar issues arise with
respect to intergovernmental relations when one level of government
imposes mandates on the spending levels and patterns of a jurisdic-
tion or jurisdictions below it in the federal hierarchy. These issues
will not be considered in this paper. Under what circumstances is
the government likely to require that private sector entities, either
firms or consumers, spend their own after tax resources to achieve
some publicly (i.e. politically) determined objective and what are
the implications of this choice for imposing constitutional fiscal con-
straints? The following propositions will be developed.

1. A necessary condition for government intervention is the exis-
   tence of some constituency that favors it. However, supporters
   of intervention may have preferences regarding the form of
   such intervention and only in a limited number of cases will
   direct government spending and mandated private spending be
   regarded as substitutes in the achievement of the constituents'
   goals. Rarely, if ever, will the two forms of intervention be
   regarded as perfect substitutes. Fiscal limits will not influence
   these preferences.
2. A balanced budget amendment may have little impact on public
   sector size in general, and probably does not, in and of itself,
   create a stronger constituency in favor of mandated private
   spending.

The Demand for Intervention

Much of the discussion of propositions (1) and (2) above will be
based on the simple example presented in Figure 1. That figure
depicts the market for some good produced by a competitive, industry.
The market is initially in equilibrium with output Q^* and price P^*.
Suppose that the government is considering a policy of requiring
some safety provision in the industry. This provision will raise mar-
ginal cost by some amount, A. If the government mandates that the

[1]Wildavsky argued that the substitution of regulation for direct spending was not a
likely outcome. His reasons were very different from the ones examined in this paper,
however.

[2]Some similar issues arise with respect to intergovernmental relations when one level
of government imposes mandates on the spending levels and patterns of a jurisdiction
or jurisdictions below it in the federal hierarchy. These issues will not be considered
in this paper.

FIGURE 1
MARKET RESPONSE TO MANDATES
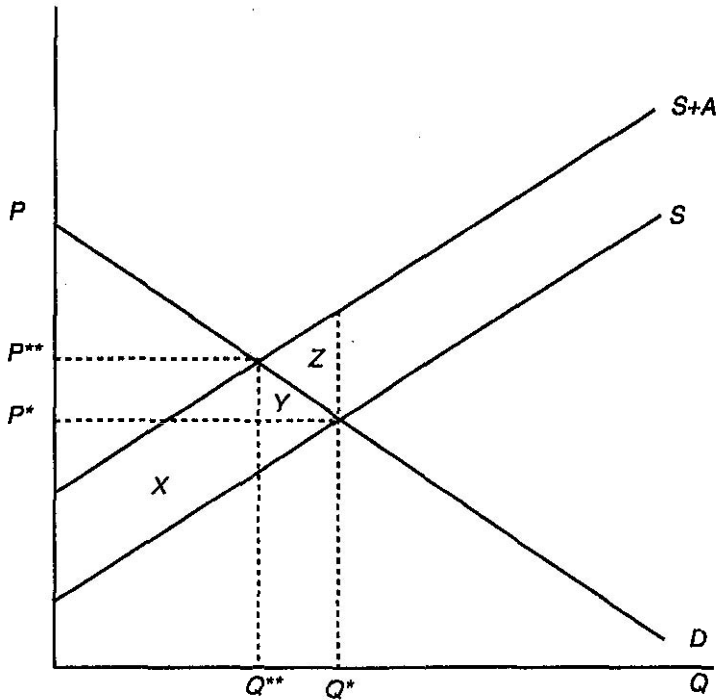
industry pay for the safety provision, the industry supply curve will
shift up by A to the curve labeled $S+A$, and equilibrium price and
output in the industry will rise and decline to the levels P^{**}
and Q^{**}, respectively. Note that the cost of the safety provision is
the sum of the area labeled X, representing the resource costs of
implementing the provision, and the triangle Y that represents addi-
tional losses in consumer and producer surplus.

An alternative policy option would have the government bear the
cost of the safety provision out of public funds. The goverment could
either purchase the safety device or, more plausibly, require that
firms buy it, but provide a subsidy to cover the cost of purchase.
This policy has very different implications for price and output in
the industry. Because cost is unaffected at the firm level, there is no
increase in price and corresponding decline in industry output.[3]

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[3]There is the possibility that the extra taxes may somewhat reduce the demand for the
good. This effect seems sufficiently small to be safely ignored.

Because the safety provision now affects Q^* units of output, the total cost of the provision is the area X plus the two triangles labeled Y and Z. The cost of the safety provision in the direct government expenditure case exceeds cost in the mandated private expenditure case by the area of triangle Z.[4]

The example thus far is contrived in that no source of demand for the safety provision is identified. It is difficult to understand why the government would be involved at all under such circumstances. The next step in the analysis is to consider some alternative sources of demand for the safety provision and to ask whether the potential demanders would have any preference between direct government expenditures and mandated private expenditures. In the discussion that follows, three examples will be considered. In each of the examples, the constituency with a demand for intervention has a distinct preference for the *nature* of the intervention. In only one of the examples do the supporters of intervention regard direct government spending and mandated private spending as substitutes. Even in that case, the two policy options are imperfect substitutes.

Two assumptions should be made explicit before proceeding with development of the specific models below. First, it will be assumed that consumers and producers are aware of the differential implications for market equilibrium of direct government spending and mandated private spending. Second, although some subset of taxpayers must constitute the potential demanders for intervention, for purposes of simplification, a general distinction will be made between taxpayers at large and individuals with a positive preference for intervention. Thus, taxpayers can be characterized as opposed to intervention via the direct government expenditure route and neutral with respect to the choice between no intervention and intervention via mandated expenditures. Any constituency with a demand for direct spending, on the other hand, can be simply characterized as a group for whom the benefits of the spending exceed their own share of the tax costs.

Example I: Demand for Direct Government Spending

The first example to be considered is one in which the safety provision is of some value to consumers but not of sufficient value to lead to market provision. Suppose consumers place a value of B

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[4]In addition to the added cost represented by triangle Z, the government spending option also should include the excess burden associated with the marginal taxation required to finance that option. This point is made by Summers (1989) in his comparison of the relative efficiency of mandates and direct government spending.

per unit on the safety provision. Referring to Figure 2, the presence of the *safety provision shifts the demand curve up vertically* by that amount. The safety provision increases marginal cost by A as was the case in the original example. If $B>A$, the market process will provide the safety without government intervention. If, on the other hand, $B<A$ as depicted in Figure 1, the safety provision will only be provided if the government intervenes.

FIGURE 2

## DEMAND FOR DIRECT SPENDING
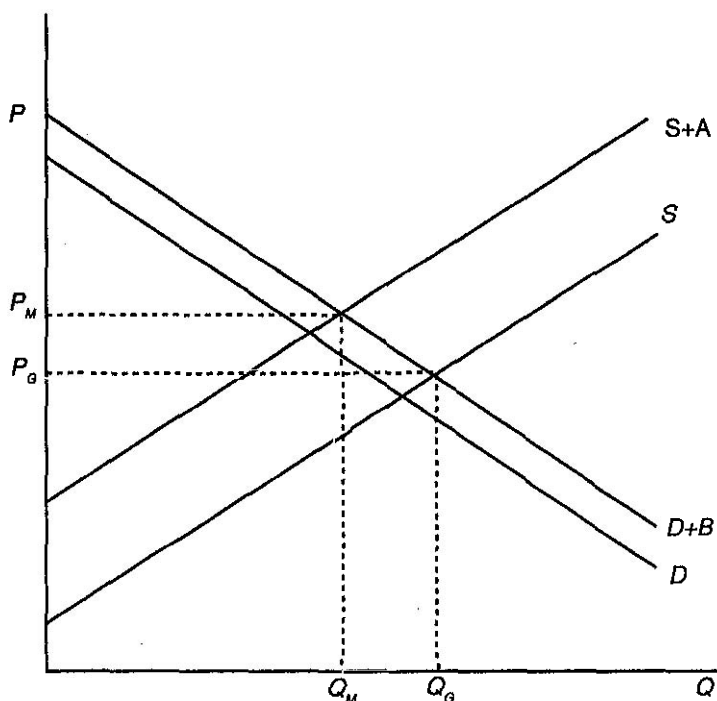
If the safety provision is financed by direct government spending, there will be an increase in both consumer and producer surplus at the new market equilibrium price and quantity of P_G and Q_G respectively. Therefore, both consumer and producer interests should have a demand for intervention via the direct government spending route. However, the situation is very different if the *safety provision is the result of mandated expenditure by the industry.* Market equilibrium in this case is characterized by P_M and Q_M. Both producer and consumer surplus are reduced by this form of intervention and, correspondingly, there is no political demand for interven-

tion of this sort. The two possible political outcomes thus should be no intervention or government intervention via the direct expenditure route with the actual choice reflecting the political balance between the interests of consumers and producers with relatively small total but large per capita benefits and the opposition of taxpayers who have large total but small per capita losses.

Example II: Substitutability between Mandated and Direct Spending

A scenario in which mandated private expenditures acquire some political plausibility exists if the good in question is associated with some externality or third party effects. Suppose, for example, that production of the good generates some risk of harm to third parties who are neither producers nor consumers of the product. In Figure 3, the marginal external cost of that risk as a function of industry size is depicted by the function labeled R if the safety device is not used and by the function labeled T if the safety device is used. Industry

FIGURE 3

SUBSTITUTABILITY BETWEEN MANDATES AND SPENDING
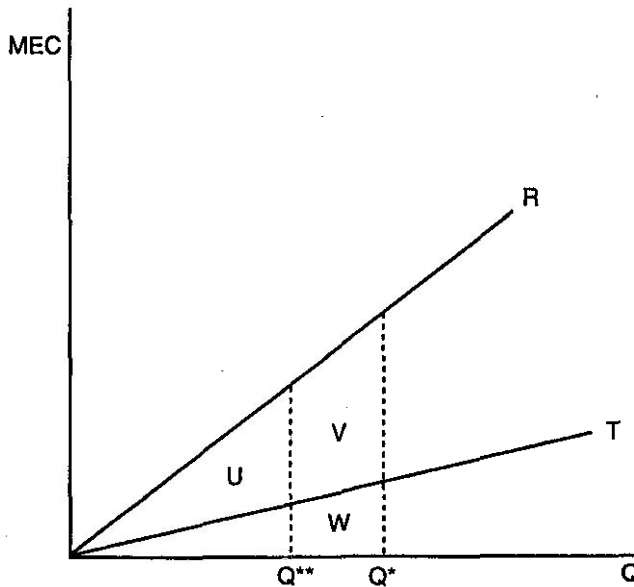
size in the absence of government intervention is Q* as before. If the safety device is implemented as a result of direct government expenditures, cost savings to third parties are represented by the

sum of the areas of the triangle labeled U and the quadrangle labeled V. If, on the other hand, the safety device is implemented as a result of mandated industry expenditure with a corresponding shrinkage of the industry to Q^{**}, cost savings to third parties are increased by the area of the quadrangle labeled W.

In this case, the demanders of intervention have a preference for mandated private spending, but will garner some smaller net gain if the direct government spending policy is adopted. The political choice of the manner of government intervention, assuming it occurs, then should reflect a balance between the greater demand for mandates and the opposition from taxpayers to direct spending and a coalition of producer and consumer interests who prefer direct spending to mandated private spending.

Example III: Demand for Mandated Private Spending

Although regulation is often characterized as a means of imposing the cost of achieving public objectives on the affected industries and their resource suppliers, particularly labor, rather than on the taxpayers at large, various scholars have noted that the opposition from these groups is less vigorous than might be expected and in some cases is almost nonexistent. It is hypothesized that in some cases the regulation is welcomed because it enables a group of firms within an industry or perhaps an entire industry to gain a competitive advantage over another group of firms or another industry.[5] Suppose, for example, that the cost of a worker safety provision was smaller for one group of firms in an industry than for another group. If government policy were to require that all firms provide the added safety, product price must rise to cover the cost of that provision to the marginal (high cost) firms in the industry. This creates inframarginal rents to other firms who are able to satisfy the government requirement at lower cost. This latter group of firms would benefit from the regulatory provision.

In context of the discussion in this paper, the situation described above creates a constituency that would support mandates and oppose direct spending. Simultaneously, an opposing constituency exists that would support direct spending and oppose mandates. A simple example can illustrate how mandated spending can create rents for one group of firms in an industry while direct spending creates rents for another group of firms. Suppose that the industry in question is comprised of two types of firms. Both types hire in a

[5]See, for example, Ackerman and Hassler (1981), Bartel and Lacy (1985, 1987), Fuess and Lowenstein (1990), Maloney and McCormick (1982).

competitive national labor market, but there is a risk to workers which is unique to the industry. The risk can be eliminated at a cost of CI per worker in type I firms and CII per worker in type II firms. Workers place a value of A on elimination of the risk. Assume that $CII > A > CI$. This implies type I firms will eliminate the risk even in the absence of government intervention, but that type II firms will not. Given a national wage of W, employees of type I firms will receive that wage, and the labor cost per worker to those firms will be $W + CI$. Employees of type II firms will receive a wage of $W + A$. In the absence of government intervention, the market price of the product will adjust to a level consistent with positive economic rent for type I firms reflecting their lower labor costs and zero rent for type II firms.

If the government mandates that all firms provide a safe workplace, the rent earned by type I firms will increase. The mandate will have no effect on labor costs of those firms, but labor costs will increase, to $W + CII$ per worker, for type II firms. This increase in marginal cost of production will lead to an increase in product price and a corresponding increase in the economic rent accruing to type I firms. In contrast, type II firms will gain and type I firms lose if the government finances the safety provision directly. Relative to the no-intervention equilibrium, government provision will cause labor costs to fall by CI for type I firms and by A for type II firms. Type II firms will now be the low cost firms and correspondingly recipients of positive economic rent.

The preceding example is illustrative of a situation in which there are competing constituencies for mandates and direct public spending. This is in contrast to example I, in which there is a constituency only for direct public spending, and example II in which a single constituency favoring government action regards mandates and direct spending as gross substitutes. In example III, neither of the competing constituencies regards mandates and direct spending as substitutes. Each will prefer one form of intervention but oppose the other.

Constitutional Constraints and Mandated Spending

As noted in the introduction, concern has been expressed that attempts to limit the size and influence of the public sector via imposition of fiscal constraints may be of limited effectiveness if political actors are able to circumvent such rules by use of the government's regulatory authority. However, for this to occur, there must be a constituency that would support regulation as an alternative to

direct expenditure by the government. The preceding discussion suggests that the circumstances in which such a situation could occur are somewhat limited. In examples II and III above, such constituencies exist. However, two additional conditions must be met if increased regulation is to be a *consequence* of the imposition of fiscal constraints. First, it must be the case, prior to imposition of the constraints, that either the spending or the nonintervention option had been chosen in the relevant markets. The *second condition is* that imposition of fiscal constraints strengthen the political support for regulation relative to either of those options.

A weakening of the political influence of constituencies that favor government spending would occur if the imposition of fiscal constraints were to strengthen the influence of the taxpayers at large who are the primary opponents of the spending option.[6] In the case of a balanced budget constraint, a presumed source of such a change might be stronger taxpayer opposition to government spending when that spending must be financed by taxation than would be the case if public debt were available as the marginal source of government finance. Do taxpayers regard deficit finance as a means of reducing the marginal cost to them of public spending? If public borrowing is a legitimate way of shifting burden onto future generations, it might appear that the answer to this question would be yes. However, when couched in a proper framework of the opportunity cost of government spending, this proposition can be challenged. Generally speaking, there are two ways in which the government might increase the size of the annual deficit. The first is to increase public spending; the second is to hold spending constant but reduce taxes. Viewed from this perspective, the representative taxpayer should evaluate the marginal cost of government spending on the basis of his or her marginal tax share as determined by the prevailing tax structure.

Public debt, in the absence of Ricardian behavior, is an intergenerational transfer of wealth. The beneficiaries of the transfer have the option to consume their added wealth in the form of an increase in either public or private consumption. The marginal opportunity cost of increased public spending remains reduced private spending. There remains a wealth effect, of course. Assuming that both public and private consumption are normal goods, imposition of a balanced budget rule can be predicted to reduce demand for both with a

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[6]This model of the political process follows Becker, who, in a seminal paper, developed the argument that "increased influence by some groups decreases the influence of others by equal amounts" (Becker 1983, p. 376).

corresponding increase in domestic saving and investment. How-
ever, this does not suggest that proponents of the type of spending
discussed here will be weakened relative to proponents of other
government spending programs. Nor does it suggest a relative weak-
ening of the political influence of the constituencies that oppose
mandated expenditures.

Conclusion

The indisputable incompleteness of the government budget docu-
ment in reflecting the economic cost of the public sector has made
enforceability a key issue in discussions of the feasibility of imposing
meaningful fiscal limits. The presumed justification for imposing
such limits is that important ramifications of the aggregate outcome of
the budgeting process are not adequately reflected in the piecemeal
issue by issue process by which the individual components of the
budget are determined. An overall fiscal constraint, by itself, does
not alter underlying incentives to ignore aggregate implications, but
rather is an attempt to arbitrarily limit the ability of the system
to respond to those incentives. Because the incentives remain, the
constraint will be ignored if its terms are unenforceable. However,
concern with enforceability must also reflect a careful understanding
of the nature of the incentives that lie behind particular hypothesized
avenues of escape. The analysis in this paper suggests that one com-
monly expressed source of concern, direct regulation of private sector
activity, may well be overstated.

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