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## INDUSTRIALIZED COUNTRIES

# Alternative Methods of Reducing Government Expenditure

by Roland Vaubel, Kiel\*

**In recent years spectacular attempts by various major industrialized countries to reduce government expenditure have met with limited success and given rise to heavy controversies. What are the lessons to be learnt? What are the principles to be followed in cutting government expenditure?**

The rapid and persistent increase of government expenditure relative to GNP which has been observed in the industrialized countries in this century, has led to many suggestions for fiscal containment. In the sixties and most of the seventies, their focus was on constitutional reform. The aim was to remove the institutional biases which make for excessive government growth. The question addressed was: how can decisions in favour of fiscal retrenchment (best) be generated? The proposals concentrated on decentralisation, more restrictive voting procedures (such as qualified majority requirements and referenda in case of public spending increases), the establishment of an additional, politically independent parliamentary assembly, as well as direct limits on budgetary outcomes (such as constitutional spending or taxation limits and balanced budget rules).

In the meantime, new governments that are committed to fiscal retrenchment have been elected in the United Kingdom (1979) and the United States (1980), and several other European governments are moving in the same direction. With this new situation, the focus of attention has shifted. The question is no longer: how can the political process be reformed so as to generate decisions in favour of expenditure cuts, but: how can public expenditure best be cut when the government in power is committed to cuts? It is

surprising that very little has been written about this issue, the more so as attempts at expenditure cutting are not an entirely new phenomenon. What are the principles to be followed in reducing government expenditure? What are the lessons to be learnt?

### **The Size of Expenditure Cuts**

In September 1981, the German government and the Bundestag voted to reduce the nominal growth of federal expenditure in 1982 by about DM 13 bn or 5.6 % of 1981 expenditure. The remaining 4.2 % increase of nominal federal expenditure would have been approximately equal to expected inflation<sup>1</sup>. Federal government employment (excluding the armed forces) was to be reduced by one per cent over the same period. Several Länder (provincial) governments have decided on public employment cuts of 1/2 to 2 % as well. In October, under the impression of more pessimistic economic forecasts, the government agreed on additional federal expenditure cuts in the order of DM 1 bn, thus reducing the planned nominal increase of total federal spending in 1982 by another DM 300 mn or 0.1 % of the originally planned expenditure in 1981. In both instances, it was extremely difficult to obtain a consensus; the name "operation 82" was to convey the impression that something very painful had been undertaken.

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<sup>1</sup> The most recent common forecast of the five leading German economic research institutes predicts an inflation rate of 4.5 % for 1982.

In March 1981, President Reagan called for federal public expenditure reductions of \$ 48.6 bn in fiscal year 1982; this was equivalent to 7.4 % of the then estimated outlays in 1981. With an official inflation forecast of 8.3 % for the calendar year 1982, the remaining nominal increase in federal spending of 6.1 % from FY 1981 to FY 1982 implied a real reduction of 2.5 to 3 %. By 1984, the share of federal spending in GNP was to be reduced by 2.7 percentage points to 19.3 %. The cuts approved by Congress in July amounted to only \$ 35 bn for 1982 but in September, with more pessimistic economic forecasts, the President asked for further cuts of \$ 13 bn in 1982. Federal government employment is to be reduced by 75,000 or 6.5 % in three years.

In Britain, the first budget of the new Conservative government in March 1980 called for a 4 % reduction of real government expenditure in four years. This included a 4 % cut in current local government expenditure and a 14 % cut in local government capital expenditure. The size of the British civil service was to be reduced by 60,000 or 8 %. By March 1981, the staff of the civil service had been reduced by 37,000 (more than 5 %); this encouraged the government to raise the total target reduction to 65,000 or 9 %, which would

leave a staff of 630,000, the smallest civil service since the end of the Second World War.

In 1980, decisions were announced which will lead to the abolition of over 430 non-departmental public bodies. In local government, manpower was reduced by 50,000; real current expenditure by local authorities diminished by 3.5 %, their real capital outlays by 21 %. Nevertheless, owing to the severe recession and a backlog in public sector wage settlements and social security adjustments, the government did not manage to reduce total public expenditure in volume terms; it increased by almost 2 % from FY 1979/80 to FY 1980/81. The public expenditure/GNP ratio rose even more because of the sharp reduction of real GNP. In response to this development, the government announced additional expenditure cuts in November 1980, amounting to 1.9 % of the expenditure previously estimated. By now, it is clear that public spending continues to rise in real terms in 1981 and 1982, but new decisions are being taken to limit the increase through further cuts.

Other examples of cutback management are provided by local governments in the US. Proposition 13

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in California which reduced local government revenue by 23 % (by about 10 %, if the "bail out" by the state is taken into account) led to a fall of total public employment by 103,000 or 8 % within one year. Wages were frozen, expenditure was cut in real terms. Several other US cities had to drastically cut their personnel: for example, Cincinnati by 14 % in five years, Cleveland by 16 % in three years, Pittsburgh by 20 % in three years, and most spectacularly, New York by 20.8 % in two years (1975-77). In many of these cases, even firefighters and teachers were laid off (in New York 16.5 % of all city teachers lost their jobs), several schools and hospitals were permanently closed, and real wages were reduced.

The most drastic cuts of public sector manpower ever to be executed in a modern democracy are probably the German cuts of 1923/24: within five months, personnel in the central government and its agencies (notably the post office and the railways, both of which ceased to receive further subsidies) was reduced by more than 20 %; 318,000 officials, employees and workers were dismissed or retired. That was even more than the 15 % which the Personnel Reduction Decree ("Personalabbauverordnung") of October 27, 1923 had required for this period. Further cuts were made between April and December 1924. In addition, public servants were discharged by the lower level governments (79,000 by April 1, 1924). Those public servants who were not laid off suffered an average loss in real salary of 30 %. Administrative expenditure in 1924, as a quarterly average, was only half of what it had been in the last quarter of 1923. Total central

government expenditure fell much less because additional reparation and compensation payments were due in 1924; nevertheless, total public expenditure in 1924 was 24 % lower than in 1923 in real terms, and its share in NNP fell from 47 to 31 per cent<sup>2</sup>.

The Personnel Reduction Decree had been adopted by the second Stresemann cabinet which was supported by a grand coalition of Deutsche Volkspartei, Demokraten, Zentrum and Vereinigte Sozialdemokratische Partei. The Minister of Finance, Hans Luther, who was not a member of any party, received the power to veto any central government expenditure; his veto could only be overridden by a cabinet majority including the Chancellor<sup>3</sup>. Parliament had abdicated its control in the "Ermächtigungsgesetz" which was adopted with the required two-thirds majority on October 13. It empowered the government "to take all steps which it considers necessary and urgent in the financial, economic and social fields" and to set aside the fundamental rights of the constitution<sup>4</sup>. The implementation of the austerity measures was largely left to a bourgeois minority government under Wilhelm Marx (Zentrum) which took office on November 30, after Stresemann's cabinet had been overthrown by the Social Democratic Party over a non-economic dispute. Nevertheless, the Social Democrats accepted another, somewhat weaker "Ermächtigungsgesetz" (December 8), and Hans Luther remained Minister of Finance in various minority cabinets until January 1925 when he succeeded as Chancellor.

### Gradualism?

The purpose of this account is not to suggest that fiscal retrenchment must always be dramatic and sudden. However, these episodes illustrate that much of what seems unthinkable in Germany today is perfectly possible if the emergency is regarded as sufficiently serious. Cutback management in declining industries is an analogous case<sup>5</sup>.

The drastic cutbacks listed above were due to exogenous forces beyond the government's control. The Weimar cuts were almost inevitable if hyperinflation, and thus the government's resorting to the printing press, were to be ended at all. The cuts in New York City were triggered by the banks' refusal to continue buying short-term city notes. The local government cuts in California, Cincinnati and several other cities were imposed by a majority of voters in tax limitation referenda. In the absence of an inescapable crisis, gradualism seems to be preferred, even in the US. According to the US Congressional Budget Office, "the possibility of achieving a reduced level of federal

<sup>2</sup> For further details on the 1923/24 cuts cf. Karl-Bernhard Netzband, Hans-Peter Widmaier: *Währungs- und Finanzpolitik der Ära Luther* (Monetary and fiscal policy in the Luther era), 1923-25, Basle and Tübingen 1964; Claus-Dieter Krohn: *Stabilisierung und ökonomische Interessen. Die Finanzpolitik des Deutschen Reiches 1923-27* (Stabilization and economic interests. Fiscal policy in Germany 1923-27), Düsseldorf 1974; Peter-Christian Witt: *Finanzpolitik und Sozialer Wandel in Krieg und Inflation, 1918-24* (Fiscal policy and social change in war and inflation, 1918-24), in: Hans Mommsen et al. (eds.): *Industrielles System und Politische Entwicklung in der Weimarer Republik*, Düsseldorf 1974.

<sup>3</sup> Luther's success seems to suggest that decisions about spending cuts should never be taken in meetings of the full cabinet. Instead of confronting a whole phalanx of budget-busting ministers in a cabinet meeting, the Minister(s) of Finance and Economics and the Chancellor could combine to deal with each of their colleagues separately.

<sup>4</sup> Only a lengthening of working time and social pension cuts were excluded at the request of the Social Democratic Party. Stresemann had advocated longer working hours.

<sup>5</sup> Cf. the case studies in Oliver E. Williamson: *The Economics of Discretionary Behaviour: Managerial Objectives in a Theory of the Firm*, Englewood Cliffs 1964, Ch. 6. For example, he analyzes the fate of the Midwest Processing Company which cut personnel by 10 % in one year, and of Chemical Products, Inc., which reduced its manpower by 20 % in nine months and by 25 % in two years. More recently, the Dutch-German synthetics producer Enka reduced its total personnel by 15 % in four years, and the German company AEG-Telefunken eliminated 20,000, or 13 %, of its jobs in two years.

activity would be enhanced if proposed changes were phased in gradually rather than implemented abruptly"<sup>6</sup>.

In the same spirit the federal administration declared its willingness, under certain conditions, to ease New York's financial squeeze through loan guarantees; and the State of California cushioned the impact of Proposition 13 by transferring part of its surplus, with strings attached, to its local authorities. What arguments are there in favour of gradualism?

The traditional argument, for instance in the context of monetary deceleration and disinflation, is that gradualism facilitates expectation adjustment. If change proceeds gradually, it can be extrapolated so that part of the total change can be anticipated. An alternative method of adjusting expectations may, of course, be by announcement beforehand. However, announcement of change beforehand, whether gradual or not, may not be credible unless part of the change is already taking place, and credibility is likely to benefit more when the initial changes are large.

### Attrition

The most forceful argument in favour of gradualism is probably that it helps to avoid lay-offs and austerity-induced frictional unemployment. If the personnel reductions are sufficiently gradual, they can be accomplished through a hiring freeze and natural attrition<sup>7</sup>. This may explain why lay-offs are only given a minor role in fiscal retrenchment in Germany, the UK and the US even where dismissals are legally feasible. However, retrenchment through attrition has the obvious disadvantage that both the speed and distribution of personnel reductions are random variables<sup>8</sup>. Since its allocative effects within the public sector are arbitrary, attrition is likely to reduce public sector output by more than a predetermined personnel reduction of the same size would do. The question then is how and to what extent the government can offset the haphazard allocative effects of attrition by reassigning part of the remaining personnel within the public sector.

To base the case for gradualism on the need to rely on attrition is not entirely convincing; for the speed of attrition is a variable which depends on public sector wages relative to private sector wages. Attrition can be

made to be highly abrupt by drastically reducing relative wages in the public sector<sup>9</sup>. Only if sizeable relative wage changes are considered politically impossible (which, according to our examples, they must not be!), or if excessive real wages in the private sector prevent the creation of new private-sector jobs, does gradualism follow from the attrition postulate.

While retrenchment in the Weimar Republic and in New York brought substantial cuts in nominal public-sector wages, nominal and later real wages were frozen in California. In the Californian case, the reduction of manpower by 8 % in one year required virtually no lay-offs of full-time personnel. Is wage-induced attrition the optimal method of reducing manpower?

A frequent objection is that public sector wage restraint induces the best to leave<sup>10</sup>. There is, it is argued, an "adverse selection problem", for the fact that a public servant receives an offer from the private sector proves that he is being underpaid in the public sector and that the public sector would gain by keeping him at the market wage. The objection need not be valid. If the public-sector wage structure is in equilibrium, each civil servant receives a salary equal to his marginal product. If he is offered a higher salary in the private sector, this indicates that he is (considered to be) more productive in a private-sector activity than in the public sector. Since both the budgetary and the opportunity cost of keeping him in the public sector exceed his public-sector marginal product, it is in the interest of both the fisc and the national economy to let him go. Only if his offer from the private sector is interpreted as a sign of disequilibrium within the public sector is there reason to fear that the best (in terms of marginal productivity relative to their wage) are leaving – to the government's detriment. In that case, the solution lies in adjusting relative wages within the public sector, but not necessarily in permitting an increase of the public-sector wage bill.

<sup>8</sup> For example, since libraries tend to have a senior workforce, libraries contract relative to other services simply because of the hiring freeze. Cf. Mark David Menchik, Anthony H. Pascal: The Equity Effects of Restraints on Taxing and Spending, Rand Corporation, Santa Monica, Rand Note P-6469, May 1980, p. 18.

<sup>9</sup> Of course, any such change in relative wages can only be temporary. In the new equilibrium, there will have been enough migration from the public to the private sector to reduce marginal labour productivity and wages in the private sector to those in the public sector. See Ronald G. Ehrenberg: The Effect of Tax Limitation Legislation on Public Sector Labour Markets: A Comment, in: National Tax Journal, 1979, Supplement, p. 264.

<sup>10</sup> Cf. for example, Anthony H. Pascal et al.: Fiscal Containment of Local and State Government, Rand Corporation, Rand Report R-2494-FF/RC, Sept. 1979, p. 92; Charles H. Levine: More on Cutback Management: Hard Questions for Hard Times, in: Public Administration Review, March/April 1979, p. 180; and Leonard Greenhalgh, Robert B. McKersie, op. cit., p. 577, who quote an unpublished empirical study by Greenhalgh and Jick.

<sup>6</sup> Congressional Budget Office: Reducing the Federal Budget: Strategies and Examples, The Congress of the United States, Febr. 1980, p. 7.

<sup>7</sup> In the US public sector, attrition amounts to about 5 % per annum; in Europe, it is probably lower. Cf. Leonard Greenhalgh, Robert B. McKersie: Cost-Effectiveness of Alternative Strategies for Cutback Management, in: Public Administration Review, Nov./Dec. 1980. The authors come out very strongly in favour of the attrition method.

Thus, the arguments in favour of gradualism may not hold in every instance. Sometimes, there may be powerful reasons for a "big bang". Most obviously, there are cases in which the "crisis theory of history" applies: unless forced to make drastic cuts, governments will not achieve major changes because all gradual reductions are likely to be reversed before the next election. Indeed, examples of gradual cutbacks sustained over many years are difficult to come by.

If retrenchment goes beyond attrition, the case for substantial cuts can also be based on the existence of large fixed costs incurred as a result of the cutting itself. This is what Levine has called the paradoxes of cutback management<sup>11</sup>. The adoption and implementation of cutbacks requires additional expenditure for management planning, information and control, for rationalisation incentives and for productivity-increasing investment. If total expenditure is to fall at all, these costs of transition have to be offset by even larger permanent cost reductions through cutbacks. To raise expenditure in order to make it fall is a strategy which no electorate would consider credible. Moreover, it would fail to impress precisely those who have to implement the cuts: the civil servants. Bureaucrats are not easily impressed by governments which may not be re-elected (nor by budget deficits which may turn out to be merely cyclical).

The work of Yeager, Levine et al. and Walker et al. shows how important it is that the civil service considers cutback management permanent rather than transitory<sup>12</sup>. Yeager demonstrates in a comparative empirical study of defense cutbacks how a politically induced permanent-transitory confusion lengthened the unemployment of those who were laid off. Levine et al. analyse cutback implementation in several US cities and test a three-stage model of retrenchment. They find that long-range cutback planning is usually preceded by a phase of denial and delay (borrowing, use of one-time revenues, depletion of contingency funds, deferral of

maintenance and capital expenditure) and a stretching phase (hiring and purchase freeze, tighter controls over sick leave and overtime, service rationing, minor cuts). Walker et al. summarize their study of retrenchment in the Californian criminal justice system: "We did not find local government grappling with resource allocation problems. . . Instead we found attempts to apply short-term solutions to long-term problems". In the context of German fiscal containment in 1981/82, the use of temporary central bank profits to reduce a *structural* budget deficit seems to be a case in point.

### Structural Distortions

Permanent-transitory confusions increase the cost of adjusting to lower levels of government spending just as they raise the cost of adjusting to a lower rate of monetary expansion and inflation. In the fiscal context, they are dangerous not only because they lead to avoidable unemployment and delays but also because the allocative pattern of public expenditure tends to be distorted in the process.

First of all, the administrative decision makers are induced to cut primarily where the consequences will be felt in the long term rather than in the short term: public investment, maintenance, research, management planning and information, data processing. The evidence on this point is overwhelming.

Secondly, among the projects to be cut, those which involve the largest initial costs are hit hardest.

Thirdly, there is the impression that cuts concentrate on external government services rather than on administrative overhead staff, and especially on genuine public goods for which private substitutes are not easily available (e. g. police, fire protection, sanitation).

In Buchanan's words, "If the bureaucracy retains power to allocate general spending cuts among functions, it will, of course, direct the cuts to those areas that are most sensitive, those most in demand by the people. . . Blunderbuss attempts to cut back on public spending programs. . . may be subverted by the bureaucracy"<sup>13</sup>. The suspicion is that by cutting where it hurts most, bureaucrats may try to mobilize public opinion against the political decisions makers who impose the expenditure reductions upon the bureaucracy.

The subversion hypothesis is difficult to evaluate. There is no systematic evidence that cuts tend to concentrate on the most sensitive expenditures. There are some spectacular examples, reported in the American and British press, which tend to support the

<sup>11</sup> Charles H. Levine: Organisational Decline and Cutback Management, *Public Administration Review*, July/Aug. 1978, p. 317, and op. cit., 1979, p. 180.

<sup>12</sup> James H. Yeager: Budgetary Cutbacks, Political Promises and the Unemployment Problem, *Public Choice*, Fall 1975; Charles H. Levine, 1978, op. cit., p. 317; 1979, op. cit., p. 181; Charles H. Levine, Irene S. Rubin, George G. Wolohojian: Fiscal Stress and Local Government Adaptations: Toward a Multi-Stage Theory of Retrenchment, paper presented at the Conference of the Committee on Urban Public Economics, New Orleans, Oct. 1980; Warren E. Walker, Jan Michael Chaiken, Anthony P. Jiga, Sandra Segal Polin: The Impact of Proposition 13 on Local Criminal Justice Agencies: Emerging Patterns, Rand Corporation, Rand Note N-1521-DOS, June 1980, p. 3.

<sup>13</sup> James M. Buchanan: Why does Government Grow?, in: Thomas E. Borcherding (ed.): *Budgets and Bureaucrats*, Durham, N. C., 1977, pp. 6-7.

hypothesis. It is sometimes called the "Washington Monument Syndrome", for, when faced with cuts, the National Park Service threatened to close the Washington Monument, its most popular site. The evidence from New York and California is mixed: for police and fire protection, for example, expenditure cuts tended to be above average, but manpower cuts were below average.<sup>14</sup>

There is also the example of Cincinnati where "the council sought to avoid cuts in areas easily visible to citizens (and) reversed service reductions in the face of citizen complaints"<sup>15</sup>.

The problem is not only that the behaviour to be explained by the subversion hypothesis does not always prevail; even where it does prevail, there are competing explanatory hypotheses. One is that bureaucrats act like corporate managers who are faced with an apparently temporary fall in demand for their product: they first lay off on-the-line workers rather than administrative personnel because the information and transaction costs of dismissing and rehiring workers are lower<sup>16</sup>. A possible difficulty with this view is that not all companies behave in this way<sup>17</sup> and that, in some cases, public sector cuts concentrated on salaried employees rather than blue-collar workers.<sup>18</sup>

Another competing hypothesis is that political decision-makers and bureaucrats cut where it hurts most in order to increase the probability and size of grants-in-aid from higher-level government<sup>19</sup>. On this view, cutback management is a typical moral hazard

problem. In the case of New York City and Proposition 13 in California, aid from higher-level government was indeed obtained. However, since the evidence on the pattern of cuts is quite mixed in these cases, moral hazard seems to fare better as an explanation of such fiscal crises themselves than of their effects on expenditure composition.

The third competing hypothesis is related to the second. According to this view, expenditure on genuine public goods tends to be cut more than proportionately because the other public services and large parts of welfare expenditure are mandated and/or heavily subsidized by the higher-level government(s)<sup>20</sup>. The hypothesis is convincing to the extent that these expenditures are imposed on local authorities. However, it fails in the case of local expenditures which are not obligatory but merely subsidized through categorical matching grants. There is good reason to believe that the introduction of such matching grants distorts the functional composition of local expenditure. However, once the pattern of local expenditure has adjusted to the grants, why should we expect the proportion of grant-supported voluntary expenditure to increase any further when total local government expenditure has to be reduced?

### Across-the-Board Cuts?

The discussion of structural distortions in the process of expenditure cutting raises the question: should all expenditures be reduced by the same proportion?

Across-the-board cuts are appealing for a number of reasons:

1. They seem to imply an equitable distribution of sacrifices.

<sup>14</sup> Cf., for example, Charles H. Levine, Paul L. Posner: *The Centralizing Effects of Austerity on the Intergovernmental System*, in: *Political Science Quarterly*, Spring 1981, pp. 78-79; Andrew Glassberg: *Organizational Responses to Municipal Budget Decreases*, in: *Public Administration Review*, July/Aug. 1978, p. 327; Albert Lipson: *Political and Legal Responses to Proposition 13 in California*, Rand Corporation, Rand Report R-2483-DOJ, Jan. 1980, p. 52; Perry Shapiro, John Sonstelie: *Representative Voter or Bureaucratic Manipulation: An Examination of Public Finances in California before and after Proposition 13*, paper presented at the Carnegie-Mellon Conference on Political Economy, Pittsburgh, May 1981. In New York, for example, where the city workforce declined by 20.8 % from June 1975 to June 1977, manpower cuts in the field of fire protection and police were only 17.0 % and 16.8 %, respectively, whereas the largest cuts hit probation (28.9 %), higher education (28.6 %) and health (22.4 %). In California the largest cuts were budgeted for recreation and cultural services (31 %), libraries (12 %) and prisons, probation, etc. (5 %), while police and fire protection were exempted from manpower cuts under the bailout arrangement with the State.

<sup>15</sup> Charles H. Levine et al., 1980, p. 31.

<sup>16</sup> This view has been expressed by Thomas Moore, Hoover Institution, Stanford University.

<sup>17</sup> Take, for example, Williamson's (op. cit.) Midwest Processing Company which discharged proportionately more salaried employees than hourly workers, or his Chemical Products, Inc., which reduced its total manpower by 20 % in nine months and its headquarter personnel by 41 %. Also, Enka cut its total manpower by 3.5 % per annum, whereas its non-production personnel declined by 4.9 % per annum (Enka Report, 1981, p. 4). However, it may be argued that these cuts were considered permanent.

<sup>18</sup> In the Weimar Republic from mid-October 1923 to April 1, 1924, the central government and its public corporations discharged 45.1 % of their salaried employees but only 24.7 % of their blue-collar workers. However, owing to legal constraints, the number of public officials (Beamte) discharged was even smaller (13.9 %). Moreover, Luther also used the opportunity to reverse most of the wage equalisation that had taken place under his predecessors in 1921-22.

<sup>19</sup> Roger L. Faith: *Local Fiscal Crises and Intergovernmental Grants: A Suggested Hypothesis*, in: *Public Choice*, 1979, 3/4. Two other studies which view local spending limitation as an attempt to obtain more grants from higher-level government are Eli M. Noam: *Tax Limitations and Fiscal Federalism*, and Arthur Denzau, Robert MacKay, Carolyn Weaver: *Spending Limitations, Agenda Control and Voters' Expectations*, in: *National Tax Journal*, 1979, Supplement.

<sup>20</sup> For this view and supporting empirical evidence cf. Comptroller General of the United States: *Proposed Changes in the Federal Matching and Maintenance of Effort Requirements for State and Local Governments*, General Accounting Office, Washington, 1980; Warren E. Walker et al., op. cit., p. viii. Tendencies towards centralisation in conditions of fiscal austerity may also be due to bureaucrats' attempts to protect their discretionary profits by reducing competition between bureaus. For this view see Mark T. O'Ma, Eugenia Froedje T. O'Ma: *Bureaucratic Responses to Tax Limitation Amendments*, in: *Public Choice*, 1980, pp. 344-345.

2. They permit decentralisation of cutback decisions, if desired.
3. They minimize problems with possible interdependencies of expenditures.
4. They satisfy those who object to piecemeal reform on the basis of the theory of the second best.

Nevertheless, across-the-board cuts are the exception rather than the rule and tend to be rejected by public as well as academic opinion. Nor do they seem typical of cutback management in private industry<sup>21</sup>.

Neither the two Thatcher budgets nor the first Reagan budget contained across-the-board cuts. This was to be expected from new governments with new priorities. In the German budget deliberations of September 1981, however, a paradoxical situation arose: the incumbent government decided on selective cuts while the opposition's proposal put the emphasis on a 5 % across-the-board cut. In its revised budget, the government grasped the opportunity and presented additional cuts of reduced selectivity<sup>22</sup>. Similarly, the revised Reagan budget of September 1981 provided for an additional across-the-board cut of 12 % for virtually all non-military appropriations, thus indicating that the adjustment of priorities had been taken care of in the July budget. Similarly, the 1978-79 budget of the State of California contained an across-the-board reduction in operating expenses and equipment. Three out of the four local authorities analysed by Levine et al. favoured across-the-board cuts.

Across-the-board cuts are usually treated with contempt because they are viewed as evasive and cowardly<sup>23</sup>. There are also some technical objections. For example, it is pointed out that some expenditures (e. g. contractual expenditures such as debt service) cannot be cut at all<sup>24</sup>, that in the case of entitlement programmes (Leistungsgesetze) the cost reductions resulting from changes in the law cannot reliably be predicted, or that indivisibilities may require the shutdown of selected facilities (like some hospitals and schools in New York) rather than marginal reductions

everywhere. However, these considerations merely limit the applicability of across-the-board cutting, they do not render it undesirable as such.

Some authors object that across-the-board cuts penalize the efficient departments which have no more slack to eliminate<sup>25</sup>. The objection applies only if the political decision-maker recognizes efficiency differences among departments or sees ways of finding them out. If he does not, the probable existence of efficiency differences cannot be a valid reason to renounce across-the-board cuts, or even spending cuts as such.

If the decision-maker is content with the present pattern of public expenditure but not with its overall volume, should he cut across-the-board? Not necessarily, for at a lower level of expenditure a different composition may be optimal: the marginal benefit curves need not have the same slope for all categories of expenditure. Yet the differences seem to be small<sup>26</sup>. Is there an easy way of determining the required changes of composition? According to Menchik and Pascal, "it can be argued that the last-instituted activity is the least urgent – otherwise it would have been instituted earlier"<sup>27</sup>. If applied to the input side, this last-in, first-out (LIFO) rule would also serve as an efficiency rationale for job seniority as a selection criterion in lay-off decisions. However, the LIFO rule rests squarely on the assumption that the marginal benefit curves have not been affected by intervening events. Are they stable over time?

Modern critics of big government are not likely to favour mere across-the-board cuts. They want to reduce government expenditure mainly because governments are spending increasing amounts of the taxpayer's money on goods, services and transfers that do not meet the welfare-economic criteria of public goods. Genuine public goods, it is true, may also be in excess supply if bureaucrats are interested in increasing public-sector output. However, since the bureaucratic calculus affects public and non-public goods supplied by governments in more or less the same way, the critics will insist that across-the-board cuts must either be confined to government expenditure on non-public goods, or proceed at two speeds, with smaller cuts for public goods proper.

<sup>21</sup> Williamson's case studies (op. cit.) show that the proportionately largest reductions tend to fall on travelling expenses (especially company airplanes and car and chauffeur services), public relations (notably advertising and entertainment expenses), sales expenditure, executive dining services, secretarial staff of middle rank executives, and expenditure on research and development.

<sup>22</sup> Expenditure reductions for research subsidies and high-school student grants were transformed into global cuts for the Ministry of Economics and the Federal Employment Agency.

<sup>23</sup> Cf. Walter Wittmann: Zum Postulat der Ausgabendrosselung im Bunde (On the postulate of expenditure cuts at the federal level), in: *Wirtschaft und Recht*, 1977, 2, p. 70.

<sup>24</sup> The Congressional Budget Office suggests that, for these reasons, "it seems quite unlikely that any sizeable part of the budget could be reduced by an across-the-board cut" (op. cit., p. 7).

<sup>25</sup> Charles H. Levine, 1979, op. cit., p. 181; Carol W. Lewis, Anthony T. Logabio: Cutback Principles and Practice: A Checklist for Managers, in: *Public Administration Review*, March/April 1980, p. 186.

<sup>26</sup> This has been shown by Noam (op. cit.) who has calculated the elasticities of demand for budget shares from referendum results in the Swiss Kanton Basle.

<sup>27</sup> Mark David Menchik, Anthony H. Pascal, op. cit., p. 18. For a vehemently different view see Levine, 1978, op. cit., p. 317.



### Spending Cuts and Bureaucratic Efficiency

Since government spending can be reduced by increasing the productive efficiency of bureaucracy, the question as to how this aim can best be attained is of particular interest. Apart from new techniques of management planning and budgetary control, a number of pecuniary and non-pecuniary rewards have been suggested for those civil servants who achieve significant savings in staff and in other expenditures<sup>28</sup>. Unfortunately, such incentive systems cost money. In a period of fiscal austerity, disincentives are likely to be preferred.

A government which prefers decentralised decision-making on where to cut how much, could confine itself to the recommendation of a benchmark rate of reduction. If a civil servant fails to achieve the recommended cut, penalties would be imposed. For example, his amenity funds and the length of his vacation could be cut or overtime work be required; this might enable him to reduce his staff while maintaining output. In addition, his department could be selected for a special audit by the accounting office or by a private consulting firm to search for additional economies.

The opportunity for rationalisation is particularly propitious when a new appointment is made. A new man takes a fresh look at his new department and is less inhibited by personal loyalties. If he suggests savings, he will not be asked why he did not suggest them before. For the same reason, private companies that are forced to contract tend to replace their top management. Government bureaus which practice a high degree of job rotation are likely to benefit in this respect. Any newly appointed civil servant must be asked to suggest economies a few months after taking office.

Where vacancies are filled through promotion within the hierarchy, the chances for economies are particularly favourable as well: since the official is interested in the higher position, he can be asked to agree that his own former position will not be refilled. In this way, promotion can be made conditional upon a reduction of staff and an increase in work effort.

Bureaucratic efficiency is likely to be increased through competition because competitive provision of bureaucratic services facilitates cost comparisons. Regional decentralisation in the provision of public services and tenders to private companies as alternative suppliers are means to this end. The inefficiencies associated with the privileges of public

officials and employees can be reduced by transferring the provision of government services to publicly-owned companies. A more radical proposal is to permit income-tax payers to allocate part of their tax payments to the production of selected public goods or to charitable institutions of their choice.

### Fiscal Retrenchment and Disinflation

The difficulties of expenditure cutting multiply if inflation has to be reduced at the same time. If the spending reductions serve to reduce a budget deficit (rather than taxation), they can contribute to disinflation by reducing the real and nominal rate of interest, thus raising the demand for money. Disinflation, however, regardless of whether it is caused by expectations of a reduced budget deficit or by expectations of monetary deceleration, usually reduces output growth and employment and leads to a recession-induced increase of government expenditure. These expenditure-increasing effects may not be fully anticipated. If Keynesian fix-price assumptions are considered inapplicable, are there allocative reasons to prevent such temporary increases of total government expenditures through additional cuts?

If the demand for public goods (as for private consumption) is a function of permanent income, an unexpected reduction of real growth that is considered temporary and possibly reversible cannot reduce the demand for public goods by much. To the extent that the demand for public goods is also price-elastic, the temporarily lower real interest rates and real wages that are typical of many recessions, would even justify a temporarily higher level of public expenditure. Through intertemporal price arbitrage, government as a producer of public goods may try to act as a stabilizing speculator.

Thus, if in response to a temporarily deteriorating business outlook, a politician proposes additional expenditure cuts, he must make at least one of the following assumptions:

1. Without additional cuts, the government would lose political credibility because the electorate does not regard the recession as temporary.
2. Governments are inherently incapable of stabilizing speculation.
3. The originally planned level of public expenditure was larger than is compatible with allocative optimality.

While the first two assumptions are more likely to be made by the government, the latter better suits the political opposition, or possibly a minority within the government.

<sup>28</sup> A variety of suggestions is presented by William A. Niskanen: *Bureaucracy and Representative Government*, Chicago 1971.