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The Way Out of the Budget Quandary: The Need for Spending Cuts

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The prospect of wall-to-wall $200 billion deficits for the next several years is one of the few dark clouds in an otherwise upbeat economic environment. Yet these outsized budget deficits do not mean, as some observers seem to fear, that the end of the world is approaching.

Polar alternatives and dramatic extremes are always more likely to attract public attention. The federal budget is no exception. On the one hand, there are many economists and others who contend that deficits do not matter at all. They cite as evidence the current robust recovery in the face of $200 billion of annual Treasury borrowing.

On the other hand, there is no shortage of financial and economic authorities who point to the same deficit as the source of high interest rates, large foreign trade deficits, and sluggish business investment in new facilities. Because of these factors, they expect the recovery to lose steam early in 1984.

The more likely result—as is so frequently the case in economic disputations—falls in that dull middle area. When the government runs a deficit, that does make a difference, in both financial markets and in the pace of business activity. But surely deficits are not the only factor that matters. The underlying strength of the private sector is a far more

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basic determinant. In that regard, a strong recovery in the private economy is underway.

According to my foggy crystal ball—and that of most experienced forecasters—this recovery will last at least until the polls close that Tuesday in November in George Orwell's year. But the current expansion may not be as strong or as long-lasting as we would like. There are two major clouds on the economic horizon. The first is the possibility that monetary policy will veer either to excessive tightness or to excessive ease. The second danger is that fiscal or budget policy will continue to generate unusually large deficits even as the economy continues to expand.

With reference to the first problem area, my standard advice to the Federal Reserve Board is straightforward and hardly novel. It is to follow a path of moderate, stable, and predictable growth of the money supply. One such sensible path is the middle of the Fed's own target range for growth in M1, which is a bit above where monetary growth is now.

Source of the Quandary

The second problem area is the more difficult one. Let us turn to the genesis of the budget quandary facing the United States.

To put it in a nutshell, the fiscal problem arises because the 1981 tax cuts have not been matched by the reductions in federal spending which were anticipated when the tax cuts were proposed in early 1981. In effect, we still have not earned the tax cuts. Surely, the view that cutting taxes was the fundamental way to control spending has proven incorrect. The events of recent years have underscored the old truth, that the only way to reduce or slow down the growth of federal outlays is to get the Congress to appropriate less.

I will note in passing that another possibility for deficit reduction is to broaden the tax base. This is, of course, the basis for the various "flat tax" proposals. However, their proponents find it more convenient to stress the pleasant or benefit side of their proposals—tax rate reductions— rather than the painful or cost side represented by increasing the proportion of income which is taxed. Although the idea may be superior on equity grounds, raising revenues from broadening the tax base is as much a tax increase as raising the rates on the existing base.

The events of recent years have underscored the old truth—the only way to reduce federal outlays is to get Congress to appropriate less

But what about all the spending cuts that have been made? On the surface, the growth in federal spending has been slowed down in the past several years—in nominal terms. The substantial progress in bringing down inflation has kept nominal spending down, but it has had a larger downward effect on the flow of revenues from the progressive federal income tax.

In real terms, government spending is continuing to rise. The estimates of real budget outlays for fiscal years 1982-86 contained in President Carter's swansong budget were lower than the estimates for the same period contained in the Reagan Administration's most recent budget report (see Table 1). Another way of looking at the budget situation is to note that federal outlays in fiscal 1980 were 22 percent of GNP and in 1983 they were 25 percent (see Table 2).

To be sure, tens of billions of dollars of reductions have occurred in proposed Federal expenditures. Yet those unprecedented cuts (mainly reductions in proposed increases) have been made entirely in a few civilian areas, such as grants to state and

TABLE 1
Comparison of the Carter and Reagan Administrations' Projected Budget Outlays for Fiscal Years 1982 to 1986
(in billions of dollars)

	1982	1983	1984	1985	1986
From President Carter's Last Budget:					
Nominal Outlays	$739.3	$817.3	$890.3	$967.9	$1050.3
Real Outlays (1972 Dollars)	345.0	351.7	355.4	361.2	368.8
From President Reagan's Latest Budget Review:					
Nominal Outlays	$728.4	$809.8	$848.1	$918.3	$990.9
Real Outlays (1972 Dollars)	351.7	373.7	373.6	385.7	397.8

Source: *Budget of the United States Government, Fiscal Year 1982* (Washington, D.C.: Government Printing Office, January 15, 1981); Office of Management and Budget, *Mid-Session Review of the 1984 Budget* (Washington, D.C., July 25, 1983).

TABLE 2
Federal Spending and the GNP

Fiscal Year	Federal Outlays as a Percentage of GNP
1980	22.4%
1981	22.9
1982	24.0
1983	25.2

Source: *Budget of the United States Government, Fiscal Year 1984* (Washington, D.C.: Government Printing Office, January 1983).

local governments and selected social welfare programs. But those decreases have been more than offset by the simultaneous rapid expansion in military outlays, farm subsidies, interest payments, and the continuing and almost inexorable rise in "entitlement" outlays. The initial budget report of the new Administration (issued in March 1981) had a line for "unspecified savings," a large amount of budget cuts presumably to be specified at a future date. What ensued reminds me of the words of the old song, "Tomorrow, I'll be leaving, but tomorrow never comes." I am not attempting to identify culpability, but surely substantial responsibility for the diminished ardor for

In real terms, government spending is continuing to rise. Federal outlays in fiscal 1980 were 22 percent of GNP, and in 1983 they were 25 percent

budget cutting can be placed at both ends of Pennsylvania Avenue and on both sides of the aisle.

In any event, the 1981 tax cuts have not been accompanied by comparable spending cuts. That is the basic fault—a sort of San Andreas Fault—in our current budget policy. It is the fundamental reason for the large budget deficits that are in prospect.

When we include off-budget financing—that portion of government spending which Congress arbitrarily has moved out of the budget but which must be covered by Treasury borrowing—most public and private forecasts show a continuing level of deficit financing in the neighborhood of $200 billion. In terms of the economic impact in the next several years, that is a rough neighborhood.

Tax cuts unaccompanied by comparable spending cuts are the "San Andreas fault" of our current budget policy

What should be done about those deficits? As seen from a distance, there are two contending viewpoints in Washington, D.C. One downplays the significance of the deficits, while the other urges tax increases to bridge the financing gap. While neither approach is devoid of merit, both possess basic shortcomings. My fundamental objection to them is that they both divert attention from the third alternative that I will develop in a moment.

With reference to these first of these two views, deficits will not bring the end of the world, but they do matter. The U.S. economy would be much healthier if the deficits were half their present size. Lower deficits would help achieve lower interest rates, a more competitive dollar in world markets, and, thus, an improved outlook for the basic industries that have been so hard-hit by foreign competition. Less federal borrowing would also free up more funds for housing and business expansion. Although I cannot pinpoint the exact amounts involved, the direction of change seems clear.

On the other hand, with reference to the second viewpoint, I believe that a general tax increase would be misguided. To state the matter bluntly, deficits are not so undesirable that we should ignore the economic costs of proposals to reduce them. There are ways of curbing the deficit that would do more economic harm than good. Tax increases that reduce saving and investment are prime examples. Such actions would signal to the advocates of more government spending that they now have a clear field. But, more basically, such tax increases would reverse the beneficial effects of the 1981 tax cuts on saving, investment, and economic growth.

A more satisfying—although more difficult—response to the budget problem is to move ahead with a comprehensive round of budget cutting

There is a third and more satisfying—although more difficult—response to the budget problem facing the nation. That is to move ahead with a comprehensive round of budget cutting. I take as my inspiration the old motto of the budget office, "Good budgeting is the uniform distribution of dissatisfaction." The truth of the matter is that not enough of the spending agencies are dissatisfied. Far too frequently, pleas for additional spending cuts are brushed aside by pointing out that defense is too important to cut, entitlements are too difficult to change, and the "all other" category is not big enough to bother with. Anyone who has participated in budget reviews must be convinced, as I am, that opportunities for serious and careful budget pruning abound in every department, military and civilian, social and economic. I would like to illustrate that key point.

Controlling Defense Spending

Let us turn to the admittedly difficult subject of defense budgeting. At least since the early 1970s, I have written about the need to bolster our defense capabilities. Thus, I strongly support the need for a military buildup. But I do not see the desirability of exempting the defense establishment from the rigorous budget review that civilian agencies undergo. A recent report on the Department of Defense's budget problems by the General Accounting Office (GAO/PLRD-83-62) underscores this point. Here is a typical excerpt from the report; it deals with operations and maintenance spending.

> Last year we also reported that DOD did not have a well-planned strategy and priority system for applying increased funding to O & M programs. As a result, funds were applied to some programs in excess of what could be absorbed efficiently and effectively.
>
> DOD still does not have a well-planned strategy for applying increased funding to O & M programs.

GAO went on to point out specifics:

> —At Fort Lee $2.7 million was received during September 1982 to be obligated before the fiscal year ended on September 30. The money was used to finance projects that had not been validated, were not in the approved backlog, and were not in the 1982 or 1983 work plans.
>
> —At Fort Stewart year-end funding amounting to $92,000 was used to construct a bicycle path while more mission-related projects were not funded.
>
> —At Little Creek Naval Amphibious Base, $300,000 was used to resurface tennis courts, widen sidewalks, and paint signs while roof repair projects went unfinanced.

Here is a sampling of other shortcomings found by GAO:

> —As much as 36 percent of the flying done by Navy tactical and patrol squadrons is for nontraining activities; however, the budget is based on training for primary mission readiness.

> —Each year millions of dollars "migrate" from mission-related programs to real property maintenance. Because much of these budget transfers occur in the last months of the fiscal year, projects of questionable need are sometimes funded in an attempt to spend the money before year-end.

In my own research, I have questioned—not the desirability—but the economic feasibility of the rapid buildup on which the Pentagon has embarked. Studies such as the GAO's confirm this concern. More recently, we have seen reports of the Defense Department's rush to spend all its available money before the fiscal year ran out on September 30, 1983. Hasty procurement moves included buying 57,600 softballs, a 14-month supply of paper, and piles of ice-cube makers and video-cassette players.

I suggest that tighter reins on defense spending will do more than contribute to a smaller budget deficit. Such improved managerial controls will solidify the necessary public support for the continued high level of military strength that is required for the dangerous world in which we live. Unfortunately, such public approval has diminished during the last three years, the period during which the Pentagon has received such extraordinarily generous budgetary treatment.

We do not promote the national security by showing the Russians how fast we can spend money

The rationale for shifting from the target of 5 percent annual growth in real military spending, which was presented in the 1980 Presidential campaign, to 10 percent or more has never been convincingly explained. Surely, our military posture has not deteriorated in these last three years. I suggest that a return to the 5 percent figure is now appropriate. Adopting a more measured attitude toward military preparedness avoids crash programs; it opposes the view that every nickle appropriated must be spent at all costs. We do not promote the national security by showing the Russians how fast we can spend money.

Controlling "Entitlement" Outlays

The largest category of federal spending is the "entitlements," which are dominated by Social Security outlays. Here I find it useful to analyze the problem in terms of three generations. The first is represented by that of my father, who is on Social Security. For most of their working life, he and his counterparts were told that they were earning a Social Security pension. In fact, the government set up account numbers to record all of their contributions, and those of their employers. You and I may know that those contributions, including the interest earned, do not begin to cover their monthly Social Security checks. But the recipients do not know that—nor do they want to learn that bad news.

Frankly, I do not have the nerve to tell my own father that each month he is receiving the economic equivalent of welfare, and I do not expect any elected official to be more foolhardy. The inescapable fact is that this nation has made a moral commitment to my father's generation to pay at least the current level of monthly payments and probably some allowance to cover inflation. Advocates of budget restraint must accept that.

But my own generation is very different. We have the opportunity to adjust to changes in future Social Security benefits—provided the shifts are phased in gradually. At least some of us are sophisticated enough to understand that retroactive benefits, by their very nature, must represent a hidden subsidy paid by someone else and, thus, are the economic equivalent of welfare outlays. Key long-term changes in benefits are, therefore, feasible.

But the most basic changes can be made

in the generation of which my children are a part. Only recently have they left college and entered the workforce. Retirement benefits are very far from their minds. Provided taxes are not increased in the process, these younger people will likely go along with a variety of reasonable changes in the entitlement programs. This represents the long-term opportunity to reduce the welfare (or intergenerational transfer) aspect of these outlays.

Controlling Other Spending Programs

It has become fashionable to deduct defense and entitlement spending from the budget total and show that the remainder is either too small to fuss with or already declining. I find such an approach far too gross for a satisfactory analysis of the budget quandary. It ignores the important cross-currents that are occurring within the "all other" category. Despite the highly publicized cuts in some social programs, many other Federal activities are candidates for budget pruning.

The fastest growing area of federal spending in recent years has been subsidies to farmers. This category rose from $3 billion in 1981 to $21 billion in 1983. Moreover, recent Congressional action on the dairy program ensures that the U.S. Department of Agriculture will continue subsidizing some of the wealthiest farmers at the expense of taxpayers and consumers. I fail to see why such programs are enacted at a time of great concern with budget deficits.

But sacred cows are not limited to the dairy industry. Consider also the National Endowment for the Humanities. To urge a cut in that agency surely sets you up as a "heavy" who cares not a whit for culture. But an examination of the details is revealing. When I looked at how such money was to be spent in my own state, I found a portion going to finance a history of each of the fourteen branches of a municipal library. I do not believe that one has to be a Philistine to have the gumption to say that such expenditures show that we have not cut too much from civilian budgets, but far too little.

By no means do I intend to let the Congress off the hook. After all, each Federal outlay is made pursuant to an appropriation enacted by Congress. According to a recent report, the House Rules Committee took action to eliminate a supposed inequity: the members of the Committee were approving trips by members of other committees, but had not gone on any themselves. The chairman proposed to remedy this discriminatory state of affairs—at the expense of the taxpayers, of course—by a bus tour across the Potomac to Alexandria, Virginia. That suggestion failed to win sufficient support, but he persevered and succeeded in gaining approval for a trip to South America, Costa Rica, and Jamaica.

I do not mean to ignore the tax-writing committees either. In late 1982, the *New York Times* reported that the Congress had adopted the "love-boat" bill. Professionals who like sunbathing and shuffleboard while attending floating "seminars in the Caribbean" can now write off those so-called business expenses—provided they take one of the four cruise ships that fly under the American flag. Such displays of patriotism are truly touching.

New public works projects show a very marginal cost/benefit ratio. In plain English, the Congress is scraping the bottom of the pork barrel

Some may discount the last few examples of waste in government because of the relatively small amounts of money involved, at least by Federal Government standards. But a far larger example of low-priority expenditure is the list of new public works projects recently approved by the Senate Committee

TABLE 3
Proposed Corps of Engineers Projects, Water Resources Development Act of 1983

Project	Cost (millions)	B/C Ratio*
Rock River, Rockford, Ill.	$27.9	1.1
Green Bay Levee, Iowa	6.3	1.1
Perry Creek, Iowa	40.9	1.1
Halstead, Kansas	7.5	1.1
Bushley Bayou, La.	42.8	1.1
Quincy Coastal Streams, Mass.	25.3	1.1
South Fork Zumbro River, Minn.	87.7	1.1
Robinson's Branch, Rahway, NJ	18.0	1.1
Mamaroneck and Sheldrake Rivers Basin, New York and Connecticut	58.8	1.0
Saw Mill Run, Pa.	7.3	1.1
James River Basin, Va.	93.8	1.1
St. Johns County, Fla.	9.0	1.1
Atlantic Coast of NYC, New York	6.6	1.0
Gulfport Harbor, Miss.	73.8	1.1
White River, Batesville, Ark.	26.5	1.1

*Benefit/Cost ratio at 7⅞% discount rate.
Source: Senate Committee on Environment and Public Works, November 1983.

on Environment and Public Works. At a time when the Treasury is paying approximately 12 percent for its long-term money, the Committee and the Corps of Engineers are using the unrealistically low interest rate of 7¾ percent in evaluating these projects. The practical effect is to show a higher ratio of benefits to cost than would result from using a more realistic interest rate. Nevertheless, even with the subsidized interest rate, 31 of the projects show a very marginal benefit/cost ratio, such as 1.1, and even 1.0. The estimated cost of these uneconomical undertakings exceeds $1 billion (see Table 3).

It is clear that if a current market rate of interest were used, these projects would be shown to fail the benefit-cost test; the B/C ratio would be substantially less than the minimum 1.0 required by law. In plain English, the Congress is scraping the bottom of the pork barrel. Why raise taxes to finance such uneconomical types of spending?

As long as Congress keeps taking actions like these, it is hard to expect the executive branch to adopt a parsimonious attitude. Far more depressing, such actions make it hard for the public to take our government and its budget problems seriously.

Conclusion

There is plenty of blame to go around. It is the President who submitted the $200 billion deficit budgets, and it is the Congress that is going along with them. Yet, it is the average citizen who generates the pressure for more government spending—when he or she says "I'm all for economy in government... but don't cut the special project in my area or the one benefiting my industry, because that is different." I vividly recall my meeting with an interest group pleading for a bailout from the government. When I said, "That's just a form of welfare," the group protested vehemently: "Welfare is for poor people."

As I stated at the outset, this is no forecast of doom or gloom. With an expanding economy and a rising pool of saving, the budget deficits will, over time, shrink in importance. But meanwhile, if they force the Federal Reserve System to maintain excessive monetary stimulus, the deficits will contribute to another round of inflation. If the Fed does not so monetize the deficits, the resultant Treasury borrowing will keep interest rates unduly high. Housing and business investment will increase more slowly than would otherwise be the case, and our trade deficit will be larger. Thus, economic growth and the rise in living standards will be more modest—unless we

take the necessary course of engaging in another round of comprehensive budget cuts.

In the current environment, an increase in taxes is a confession of failure to control spending. Effective expenditure control truly requires a bipartisan approach. When the conservatives want to cut the social programs in the budget, we should support them. The public must understand the realities of the entitlement programs: the beneficiaries are receiving far more than they are "entitled" to under any insurance concept that links benefit payments to contributions (including employer contributions and earnings on both). These programs contain a major component of subsidy—from working people to retirees.

When the liberals want to limit the rapid defense buildup to the generous rate that candidate Reagan campaigned on (5 percent a year in real terms), we should support them, too. But we should part company with both groups when each tries to use its budget savings to restore the budget cuts made by the other. The budget quandary is no arcane matter. It simply represents our unwillingness as a nation to make hard choices. We can earn the 1981 tax cuts by matching them with spending cuts—or continue to suffer the consequences.

Recommendation

Not only is the budget unbalanced, but the current public dialogue on the budget is also unbalanced. In Congressional hearings as well as in professional publications, a great deal of attention is given to proposals for new taxes and increases in existing taxes. Very little consideration is given to ideas for reducing government spending. Just compare how much time the tax committees spend examining suggestions for increases in taxes with how little time the appropriations committees devote to considering proposals for reductions in expenditures. It may be an underestimate to say that 99 percent of the time spent at appropriation hearings is devoted to listening to agency representatives defend their requests for higher budgets.

The Congress now has one of those rare opportunities to redress this imbalance. A blue ribbon commission of private citizens has just completed a detailed analysis of possibilities for reducing federal spending. I am referring to the reports of the thirty-six or so task forces of the President's Private Sector Survey on Cost Control. To be sure, I am not now urging adoption of the Survey's proposals, but merely a public examination.

Public support for budget cuts will be forthcoming only if the public gets the opportunity to learn about specific alternatives for achieving budget savings.

I suggest that Congress devote one day of open hearings for each department of government, during which the proponents of budget cuts could advise the Congress—and in the process the American public.

Frankly, I do not know whether each of the Survey's proposals is necessary, but I do believe that a systematic examination of proposed budget cuts—department by department—is long overdue. The Congress might wish to expand the hearings to cover other suggestions for budget savings, such as those that have been compiled by the Congressional Budget Office.

Advocates for economy in government often bemoan the lack of public support for specific budget cuts. That should not be surprising. Such support will be forthcoming only if the public gets the opportunity to learn about, consider, and debate specific alternatives for achieving budget savings. The Congress now has the opportunity to exercise bipartisan leadership in launching this vital educational effort.