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The Heritage Foundation

October 23, 1990

Mr. Ted Garmey
Speechwriting Office
The White House

Dear Ted:

Here are all The Heritage Foundation's papers on the budget, taxes and the economy for 1990 to date. I hope you find them helpful. If you need further information, please let me know.

Very truly yours,

Joel Rosenberg

Joel C. Rosenberg
Assistant to the Senior Vice President

The Heritage Foundation
Backgrounder
UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/18/90 Number 149

THE CONGRESSIONAL BUDGET PROCESS: THE REAL CULPRIT IN WASHINGTON'S FISCAL CRISIS

(Updating Gordon S. Jones and John Marini, eds., *The Imperial Congress: Crisis in the Separation of Powers* [New York: Pharos Books, 1989].)

Washington's latest fiscal crisis is one in a series of budget nightmares that have plagued the capital for nearly two decades. They are the result of a Congress-dominated budget process that is out of control and in desperate need of wide-scale reform. As noted in the 1989 book *The Imperial Congress*:

> ... the current budget process has evolved into a procedure which promotes confrontation rather than negotiation between the executive and legislative branches. The Congress largely dominates budget decisions, leading to higher spending and larger deficits that in the period preceding the enactment of the Congressional Budget Act.[1]

The current federal budget process was established by the 1974 Congressional Budget and Impoundment Control Act. Passed by an assertive Congress in the wake of the Watergate scandal, the Act expanded congressional control over the budget process while limiting the President's ability to curb congressional spending and otherwise set national budget policy. As the sponsors of the Act explained at the time, its purpose was to "assure congressional budget control; provide for congressional determination of the appropriate level of federal revenues and expenditures...[and]...establish national budget priorities."

Everyone to Blame. Although the Act achieved its goal of increasing Congress's control over spending, it created an unwieldy budget process in which 535 Congressmen and Congresswomen each can secure funding for pet projects while avoiding responsibility for the resulting deficits. By curtailing the President's power to check congressional spending, the Act obliterated political accountability for the bottom line. Thus, while 535 politicians in Washington are empowered under the Budget Act to spend money, no one is responsible for cutting spending. The result has been spiraling federal deficits accompanied by higher taxes and partisan finger-pointing. The tragedy of the system is that because everyone is to blame, no one is to blame.

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1 Gordon S. Jones and John Marini, eds., *The Imperial Congress: Crisis in the Separation of Powers* (New York: Pharos Books and The Heritage Foundation, 1989), p. 181.

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Lack of Discipline. As a body of legislators, each representing separate and diverse constituencies, Congress inherently lacks the fiscal discipline needed to balance the budget. This was demonstrated during fiscal year 1976, the first year of budgeting under the new Act. Then Congress produced a budget with a deficit $22 billion higher than that proposed by President Gerald Ford. Since then, federal spending has increased at a pace double the rate of inflation, and federal revenues have nearly doubled. In inflation adjusted dollars, federal spending has grown by more than one-half trillion dollars in the fifteen years of budgeting under the Act, compared to an increase of $220 billion during the fifteen years of Great Society spending prior to passage of the Budget Act. Even during the Reagan years, when federal revenues grew by a record $474 billion, spending increased by $606 billion, including a 60 percent increase in domestic spending. And to feed its spending addiction, Congress since 1982 has passed fourteen separate tax increases.

Congress's lack of fiscal discipline also is demonstrated by its consistent failure to abide by the provisions of its own budget law. Lawmakers routinely have ignored the budget deadlines set forth in the Act. For thirteen of the sixteen years under the Act, Congress has failed to pass its First Budget Resolution on time, and for seven of the last eight years it has failed to complete its budget before the start of the new fiscal year. Instead, Congress stalls, avoiding spending cuts that may alienate constituents until a "budget crisis" ensues that will create a political environment more conducive to raising taxes. In recent years, such congressional inaction has resulted in the need for frequent emergency stop-gap spending measures passed in lieu of a budget. Often the President is faced with a choice of signing such emergency spending measures or shutting down the federal government. Since 1975, Congress has passed 46 emergency stop-gap spending bills, and in six of the last ten years the federal government has run out of funds.[2]

Ignoring Promises. When Congress does reach a budget agreement it routinely ignores its promises to cut spending. Perhaps the most troubling case of congressional budget chicanery occurred after the 1982 "budget summit agreement" between Congress and Ronald Reagan. In exchange for a record $98 billion tax increase, Congress pledged to cut $3 in spending for every $1 raised in new taxes. Instead, Congress spent an additional $200 billion. In fact, Congress has reneged on each of the five "budget summit agreements" reached between 1982 and 1989, failing to reduce spending to agreed-upon levels, even though tax increases were included in four of the agreements.[3] The failed 1990 budget agreement and the proposed alternative are no different. In each case Congress will receive higher revenues in exchange for future unspecified cuts to be determined by congressional committees. Yet as previous budget agreements have shown, these committees are incapable of cutting spending.

In recognition of its inability to enforce its own budget laws, Congress in 1985 passed the Gramm-Rudman-Hollings (GRH) Balanced Budget and Emergency Deficit Control Act. Its purpose was to ensure automatic across the board spending cuts if Congress failed to cut on its own. Yet as with the Budget Act itself, Congress simply ignores or modifies the GRH law to avoid spending cuts. One way it does this is by waiving the law's provision that spending increases must be accompanied by offsetting cuts elsewhere. Since 1985 Congress has voted sixteen times to waive the law, and thus increase spending freely. Congress also sidesteps the law by underestimating the deficit and thus, the

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2 *Congressional Quarterly Almanacs*, 1975 - 1989.

3 Paul G. Merski, "A Decade of Budget Summitry," Tax Foundation *Issue Brief*, June 1990.

level of spending cuts necessary to meet GRH deficit reduction targets. The result: Congress has failed to meet GRH deficit ceilings every year since the law was enacted, exceeding the deficit limits by an average of $25 billion per year.[4]

Congress's lack of budget discipline is fueled by a pro-spending bias that inevitably dominates the congressional budget process. Driven by special interest demands for increased funding and an overriding hunger for reelection, Congressmen simply cannot say "no" to more federal spending. Nowhere is this more clearly illustrated than in Congress's spending record so far this year. While Congress on one hand was negotiating with the White House over a deficit reduction package, on the other hand it was passing record spending increases. Appropriation bills passed by the House amid budget negotiations this year call for increasing federal spending by $59 billion next year, or 17 percent more than last year. Even the bipartisan 1990 budget agreement rejected by the House on October 4 called for increasing spending by $222 billion over five years.

Return to Discipline. No deficit solution is possible without reforms that return discipline to the federal budget process. And such discipline will exist only when it becomes possible to hold policy makers accountable to the bottom line: the deficit. Yet no Congressman alone can be held accountable for the deficit. Rather, Congressmen primarily are accountable to their own state or district interests, which generally demand a greater return of their federal tax dollars – or more spending. Only the President represents a national constituency and the national interest that primarily is served by saying "no" to more spending. Yet the 1974 Budget Act stripped from the President that power.

Prior to the 1974 Budget Act, Presidents had the authority to refuse to spend funds appropriated by Congress. Examples: Thomas Jefferson in 1801 refused to spend funds Congress had appropriated for gunboats. Franklin Roosevelt in 1941 refused to spend funds for flood control projects that Congress had included in the War Department appropriations bill. And Lyndon Johnson, the father of the Great Society, refused to spend large amounts of funds appropriated by Congress for domestic programs, including public housing and highway construction. In 1967 Johnson impounded $10.6 billion, or 6.7 percent of the federal budget.[5] Yet under the 1974 Budget Act, a President's decision to rescind appropriated funds has no effect unless Congress votes to accept the rescission. Since passage of the Act, Presidents have requested from Congress 894 spending rescissions, yet Congress has approved only 315. All told, Congress has rejected $37.4 billion in rescissions requested by Presidents since the Budget Act was passed.[6]

Line-Item Veto. One way to check congressional spending and restore accountability to the budget process is to grant to the President line-item veto authority that currently is enjoyed by governors in 43 states.*[7] This reform will restore to the budget process a practice available to every President from George Washington until 1974: the power to rescind particular items of congressional spending that the President deems incompatible with the national interest.

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4 Stephen Moore, "Congress vs. America: How Congress Raises Its Own Pay," Heritage Foundation *Backgrounder* No. 744, December 14, 1989.

5 Jones and Marini, *op. cit.*, pp. 155-156.

6 General Accounting Office report, March 6, 1989.

7 Daniel J. Mitchell, "Eleven Conditions for a Budget Summit," Heritage Foundation *Backgrounder* No. 779, July 23, 1990.

False Spending Cuts. Another necessary budget reform is eliminating Congress's "baseline" approach to federal budgeting. Under the 1974 Budget Act, a "current services" budget must be established. This budget projects to future years the level of increased spending necessary to continue existing government policies by factoring in such considerations as changing demographics, program growth in previous congressional budgets, and inflation. Once established, this baseline locks in higher federal spending and treats as budget "cuts" any reduction in the planned increases in spending. This is how Congress routinely can decry massive spending cuts that in fact are not actual reductions in federal spending, but reductions in the rate of increase of federal spending. It allows Congress to increase spending while claiming that spending is cut.

Congress and the press, for example, have claimed with much success that Ronald Reagan cut domestic spending to the bone. In fact, however, Reagan only reduced the rate of spending growth, as domestic spending increased every year of his administration for a total increase of $240 billion. So too is the case with the 1990 budget resolution currently moving through Congress. Although described as "painful" budget cuts, the deficit reduction plan, passed by the House October 16 and currently before the Senate, does not actually cut spending from previous year levels. Instead, it would increase domestic spending by $245 billion, which excludes costs of the Savings and Loan bailout and interest payments on the national debt.[8] If Congress did not use the deceiving "baseline" approach to budgeting, it could not count such spending hikes as spending cuts.

Real Reform Proposal. Representative Christopher Cox, the California Republican, has introduced a comprehensive package of budget reforms that would amend the 1974 Budget Act to inject discipline into the congressional budget process and empower the President to enforce federal spending limits. The Cox bill would require Congress to pass a binding budget law each year, rather than the current nonbinding budget resolution. The budget law would establish legal ceilings on spending rather than the unenforceable "targets" under the Budget Act. If Congress fails to pass a budget, the President may rescind any spending Congress passes that exceeds previous year levels. Once Congress passes its budget law, it cannot exceed the law's spending ceilings without two-thirds approval from each house and the President's agreement. Should Congress exceed the ceilings in an appropriations bill, the President may sign the bill and rescind any spending above the ceilings. And in a reversal of the current practice under the 1974 Budget Act, the President's rescissions would stand unless Congress voted to restore the funding, subject to a presidential veto. Finally, the Cox plan would eliminate the need for emergency spending bills by providing for automatic funding of government at previous year levels should Congress and the President fail to reach a budget agreement.

The 1990 budget debacle should persuade Congress and the President to scrap the 1974 Budget Act and adopt reforms that will distribute more evenly between the President and Congress responsibility and accountability for the federal budget. Immediately upon completion of this year's budget, George Bush should begin drafting a comprehensive reform plan to be submitted to the next Congress. The plan should include a line-item veto, an end to baseline budgeting, and elements of the Cox reform package. Bush should make budget reform his top domestic priority for the remainder of his term.

Mark. B. Liedl
Director, U.S. Congress Assessment Project

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8 Scott A. Hodge, "The 'New' Budget Agreement: Part II, Back to Carternomics," Heritage Foundation *Backgrounder Update* No. 147, October 12, 1990.

The Heritage Foundation
Backgrounder UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/18/90 Number 150

THE FOUR BIG LIES OF THE "NEW" BUDGET AGREEMENT

(Updating *Backgrounder Update* No. 148, "The 'New' Budget Agreement: Part III, The Fairness Issue - Trojan Horse for Taxing the Middle Class, October 18, 1990; *Backgrounder Update* No. 147, "The 'New' Budget Agreement: Part II, Back to Carternomics," October 12, 1990; and *Executive Memorandum* No. 289, "The 'New' Budget Agreement: Part I, From Bad to Worse," October 9, 1990.)

The House of Representatives enacted the largest tax increase in America's history October 16, raising taxes by at least $170 billion over five years. The Senate is poised to follow suit today with a tax hike of equivalent proportions. Neither bill cuts one cent of spending except for defense. The two bills will then go to a House-Senate conference committee to iron out differences. If the conference commettee's changes are approved by each chamber, the legislation goes to the White House for the President's signature or veto.

While the House and Senate bills differ to some degree, both are based on lies repeated apparently unashamedly by the White House and top Republican and Democratic congressional leaders. Both bills return to the tax-and-spend policies of the 1970s. Higher taxes would be used to finance more than $245 billion of additional federal spending. If either bill, or any possible combination of the two, is signed into law by the President, the economy almost certainly will fall into a recession.

Administration officials consistently have claimed that the President must capitulate since failure to sign a tax bill results in a stalemate with Congress. The deficit, this argument goes, then would remain unacceptably large, and the Federal Reserve Board would not adopt an easy money policy to lower interest rates. The White House, led by Office of Management and Budget Director Richard Darman, is deliberately misleading America when it puts the choices this way. George Bush need not choose between higher taxes and higher deficits. The President instead can achieve the largest deficit reduction in history without one penny of new taxes by using the automatic Gramm-Rudman-Hollings spending restraint mechanism known as sequestration.

The first step is a veto of the tax increase being prepared by Congress. The President should then demand, and responsible lawmakers should then produce, a full year spending bill, or Continuing Resolution, that funds the government at a level consistent with a partial $40.1 billion sequester. While politicians in Congress would not be inclined to support this request, their other alternatives

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This is Part 4 in a series of Heritage Foundation studies on the "new" budget agreement. Parts I, II, and II are listed at the beginning of this study.

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would be either to shut the government by failing to pass any spending bill or to allow a current law sequestration to go into effect, automatically reducing fiscal year 1991 spending – and the deficit – by an estimated $85.3 billion.

The choice is therefore not between higher taxes and higher deficits, each of which drains resources out of the economy's productive sector. The honest choice is between the record-high tax increases proposed in Congress, all the revenues from which are used to fund higher spending, and a partial sequester, which reduces the deficit by addressing the true problem – excessive federal spending.

Many politicians would characterize a $40.1 billion partial sequester as an excessive "cut" in government spending, even though total federal spending in 1991 after sequestration would still be more than $30 billion higher than 1990 spending, even if the costs of the Deposit Insurance Bailout are not counted. An attempt to repeal, waive, or suspend Gramm-Rudman-Hollings would certainly be forthcoming if the White House adopted a pro-growth partial sequester strategy. The President, however, can veto any legislation attempting to gut the deficit reduction law. Congress would have trouble overriding this veto. An amendment to fund a temporary spending bill at a level consistent with a $40.1 billion sequester received 186 votes in the House of Representatives, well beyond the 145 votes needed to sustain a veto.

With the economy facing a possible recession, one of the major advantages of a sequester is that taxes are not raised. Instead of taking money out of the hands of consumers, workers, investors, savers, farmers, the elderly, the poor, and others who would see their tax burdens increase, a sequester makes across-the-board cuts in projected spending levels for affected programs. An equally important benefit of sequestration is deficit reduction. As the following table demonstrates, not only does a sequester produce real savings in the first year, it also generates considerable savings over five years. And unlike the supposed $500 billion of deficit reduction in the tax bills before Congress, the sequester savings are real. With a sequester, there are no budget gimmicks, no "user fees" masquerading as spending cuts, and no phantom savings that never materialize.

FIVE-YEAR SAVINGS FROM $40.1 BILLION SEQUESTER
($ billions)

Year	1991	1992	1993	1994	1995
Savings	$40.1	$58	$70	$79	$88

Source: Congressional Budget Office.

Administration advisors continuously have rejected a sequester strategy without ever explaining why it would not work. Along with most of the leadership in Congress, the Bush White House and Treasury continue to lie to the nation. They know the truth, yet they continue to insist that: 1) a budget agreement will lower the deficit; 2) the pending budget agreement includes substantial cuts in spending on federal programs; 3) no agreement means the deficit will not be reduced; and 4) the Federal Reserve Board can reduce interest rates and will only do so if taxes are raised. These are all lies that would embarrass even a big-city machine ward-heeler.

LIE # 1: A budget deal with Congress will reduce the deficit.

TRUTH: Bipartisan budget agreements containing significant tax increases were enacted in 1982, 1984, 1987, and 1989. In each case, promises were made to restrain spending growth and assurances

were given that the new revenues would be used to reduce the deficit. In every single case, Congress simply spent the additional money and the deficit was higher the following year. There is no eveidence that this year would be any different. Based on how many of the spending "cuts" in the original agreement have already disappeared or been exposed as budget gimmicks, it is almost certain that the deficit will rise next year if any of the packages under consideration become law.

LIE # 2: A budget deal balances tax increases with courageous spending cuts.

TRUTH: Politicians from both Congress and the White House are telling the American public that the budget agreement cuts spending by more than $300 billion. In reality, however, spending will rise by a minimum of $245 billion over the next five years. The only part of the budget which

1991 Budget Proposed Spending Levels Compared to 1990 Levels

	Fiscal 1990	Fiscal 1991	Change 1990-1991 (billions)	
(050) National Defense	$299.9	$297.0	- $2.9	-0.96%
(150) International Affairs	$15.5	$17.4	$1.9	12.3%
(250) General Science, Space and Technology	$14.2	$15.2	$1.0	7.0%
(270) Energy	$3.3	$4.0	$0.7	21.2%
(300) Natural Resources and Environment	$17.8	$18.9	$1.1	6.2%
(350) Agriculture	$12.5	$14.1	$1.6	12.8%
(370) Commerce and Housing Credit	$75.7	$87.0	$11.3	15.0%
(400) Transportation	$29.5	$30.7	$1.2	4.1%
(450) Community and Regional Development	$8.3	$8.6	$0.3	3.6%
(500) Education	$38.3	$41.8	$3.5	9.1%
(550) Health	$58.2	$65.5	$7.3	12.5%
(570) Medicare	$96.9	$104.9	$8.0	8.3%
(600) Income Security	$148.5	$160.5	$12.0	8.1%
(650) Social Security	$248.7	$266.3	$17.6	7.1%
(700) Veterans Benefits and Services	$29.4	$31.7	$2.3	7.8%
(750) Administration of Justice	$10.5	$12.3	$1.8	17.1%
(800) General Government	$10.6	$11.7	$1.1	10.4%

Note: Numbers are known as budget subfunction numbers and indicate the order in which programs appear in the President's budget.

will have less money to spend in future years than today is defense. Pentagon spending will decline from $300 billion in 1990 to $291 billion in 1993, a reduction of $9 billion. Domestic discretionary spending, by contrast, will rise by at least $36 billion in the next three years, and domestic entitlement spending will jump by nearly $200 billion by 1995.

Politicians are able to mislead the American people on the issue of spending cuts because they have redefined the meaning of the word "cut." In the real world, a spending cut means spending less next year than this year. In Washington, however, the process has been rigged to ensure more spending. A spending cut in the Washington vernacular, therefore, occurs when spending does not increase as fast as politicians had previously planned. When OMB Director Darman says the budget agreement contains genuine spending cuts, he is not telling the truth. When Senate Majority Leader George Mitchell say the budget package makes significant budget cuts, he is not telling the truth. The chart on the preceding page demonstrates this.

LIE # 3: Failure to enact a bipartisan agreement will leave the deficit at unbearable levels.

TRUTH: Proponents of the budget agreement privately admit that neither the House nor Senate bills will reduce the deficit nearly as much as is publicly claimed. They say, however, that this approach is the only alternative to no deficit reduction at all. They ignore the obvious fact that the Gramm-Rudman-Hollings Deficit Reduction Act is still the law of the land. As such, failure to approve a budget agreement will trigger a sequester that cuts the deficit more than twice as much as does the budget agreement. Defeat of tax increase legislation puts the President in an enviable position. He can demand that Congress either enact a full year spending bill containing a $40.1 billion sequester or let lawmakers endure the political fallout of the $85.3 billion sequester which would automatically occur.

The choice thus is not between accepting taxes or doing nothing about the budget deficit. The honest choice is between a record tax increase which will not reduce the deficit and could trigger a recession or a sequester that unambiguously extinguishes government spending authority and permanently lowers the trend line of future outlays.

LIE # 4: The Federal Reserve Board will not lower interest rates in the absence of an agreement.

TRUTH: The Administration's argument for higher taxes quickly boils down to the belief that the nation's central bank will respond by engineering a drop in interest rates which will head off a recession. This argument assumes that the Fed controls credit markets sufficiently to lower interest rates significantly. The Fed's primary tool for lowering interest rates is injecting money into the banking system, thus creating the illusion of more savings. Financial markets, however, have become increasingly sensitive to Fed policies that put upward pressure on prices. At best, an inflationary monetary policy can lead to a temporary drop in short-term interest rates. The more enduring effect of an easy money policy would be higher interest rates since investors would demand a greater "inflation premium" because of rising prices, much as occurred in the late 1970s following the Carter Administration's easy money policy. Advocates of higher taxes portray Federal Reserve Board Chairman Alan Greenspan's tepid endorsement of the budget agreement as "proof" that higher taxes will lower interest rates. Not only does this assertion misinterpret the Chairman's comments, it also overlooks Greenspan's endorsement of sequestration over higher taxes when he testified before the Senate Budget Committee last year.

Senate and House Tax Bills: Two Sides of the Same Coin.

Much attention has been given to the minor differences between the two tax bills in Congress, leading some to assert that the Senate legislation is somehow preferable to the House version. The House bill does contain several provisions which will depress economic growth and reduce incentives to work, save, and invest. Income tax rates are explicitly raised, violating the promise of the 1986 Tax Reform Act. As bad, the House bill also raises income taxes on low - and middle-income individuals by suspending the indexing provision which protects taxpayers from "bracket creep." This allows a return to the 1970s policy of hidden tax hikes every year as inflation pushes taxpayers into higher tax brackets even though they experience no increase in their inflation-adjusted income.

The Senate bill is no better. Instead of raising income tax rates openly, it boosts them by reducing the value of deductions. The Senate bill also doubles the gas tax, adding a special burden to America's working men and women and legislating an across-the-board increase in the cost of all products and services that require energy to produce and transport.

Tax theorists can debate which bill, the House or Senate version, damages the economy the most. Either bill, however, or any combination of the two that might emerge from a conference committee, will take America in the wrong direction. Sucking $170 billion out of the economy while growth is faltering is irresponsible. Choosing between two record tax hikes guarantees economic decline. The only responsible alternative at this point is a sequester.

♦ ♦ ♦

George Bush has an opportunity to rescue the economy from the tax increase juggernaut moving through Congress. It is completely within his power to stop recession-inducing tax hikes and instead to choose the honest deficit reduction which is generated by a partial sequester. The President has to choose which is more important, the federal budget or the family budget.

The consequences are enormous. Higher taxes would bring back the economic stagnation and declining living standards of the 1970s. And whenever the economy weakens, the most vulnerable in society are the first ones to suffer. As the U.S. Civil Rights Commission stated October 16, "In bad economic times, black and Hispanic unemployment rates rise the fastest. In good times, a tight labor market encourages employers to cast a wider net when hiring, thus breaking barriers that have traditionally prevented minorities, women, and persons with disabilities from gaining better paying jobs.... We therefore call on the President and Congress to adopt only those deficit-reducing proposals consistent with economic growth. Specifically, we recommend freezing real total government expenditure at the fiscal 1990 level."

The President and other policy makers should heed those words. The White House and Senate and House leaders should stop lying to the nation. What America needs is a budget that really cuts spending and that measures its effect in terms of jobs preserved and created, the businesses that do not fail, and the families that do not suffer.

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John M. Olin Fellow in Political Economy

The Heritage Foundation

Backgrounder UPDATE

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Number

10/18/90 148

THE "NEW" BUDGET AGREEMENT: PART III THE FAIRNESS ISSUE – TROJAN HORSE FOR TAXING THE MIDDLE CLASS

(Updating *Backgrounder Update* No. 147, "The 'New' Budget Agreement: Part II, Back to Carternomics," October 12, 1990, and *Executive Memorandum* No. 289, "The 'New' Budget Agreement: Part I, From Bad to Worse," October 9, 1990.)

An outcry from the American people led to the defeat in the House of Representatives several weeks ago of the President's budget summit package that would have raised taxes by $134 billion over five years. But rather than develop a new package that reduces the deficit by restraining the growth of federal spending, congressional leaders put together an even larger tax increase. They hope to pass this record tax hike by stirring up class hatred. Since almost no American wants to send more of his paycheck to Washington, and since very few people consider themselves wealthy, lawmakers assume that calls to "tax the rich" will appeal to most Americans.

This shrill rhetoric of class warfare masks the truth. With the new package, it is ordinary workers and consumers who will be the ultimate victims of higher taxes. The reason: as Famous Thief Willie Sutton responded when asked why he robbed banks, "that is where the money is." Most income in America is earned by the middle class and any tax increase designed to raise significant revenues inevitably must tax the middle class and add to the average family's tax burden. Advocates of higher taxes assert, incorrectly, that the 1980s saw the rich get richer and the poor get poorer. They also say, again incorrectly, that the deficit exists because revenues from higher taxes on lower- and middle-income workers were offset by huge tax breaks for the rich. In reality, economic growth in the 1980s produced significant income gains for all Americans. Moreover, wealthy Americans today are paying a greater percentage of the total tax burden than ever before. Indeed, the clamor to tax the rich is based on a series of myths, and these myths are used to justify what lawmakers really want – not fairness, but a return to the tax-and-spend policies of the 1970s.

Myth #1: The economic situation of most American families declined during the 1980s.

Fact: The well-being of the average American family, as measured by either family income or household income, illustrates that the 1980s were good years. After declining sharply from 1979 to 1982, median family income and median household income started growing and both now are at all-time highs. Table 1 shows the dramatic turnaround in income trends once the high-tax economic policies of the 1970s were replaced with pro-growth policies in the 1980s.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Table 1 Trends in Family and Household Income (constant 1989 dollars)				
Year	Family Income	Yearly Change	Household Income	Yearly Change
1976	31,225	955	26,483	447
1977	31,410	185	26,629	146
1978	32,405	995	27,673	1044
1979	32,821	416	27,583	-90
1980	31,675	-1146	26,683	-900
1981	31,811	-864	26,251	-432
1982	30,394	-417	26,163	-88
1983	30,719	325	26,167	4
1984	31,547	828	26,751	584
1985	31,962	415	27,218	467
1986	33,328	1366	28,168	950
1987	33,805	477	28,447	279
1988	33,742	-63	28,537	90
1989	34,213	471	28,906	369

Source: Census Bureau.
CPI-U-XI used for inflation adjustment.

Table 2 Percent Change in Income by Class (constant 1989 dollars)					
Years	Bottom Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973-1980	-5.1	-2.3	0.7	2.2	2
1979-1980	-5.3	-3.6	-3.3	-2.5	-3.7
1981-1989	5.9	9.3	10.6	13.4	24.5
1982-1989	11.9	11	12.6	14.2	22.1

Source: United States Senate Staff Report.

Myth #2: The rich have grown richer at the expense of the poor.

Fact: Confronted by the facts from Table 1, those who would raise taxes go on to argue that the numbers are distorted because large income gains for the wealthy mask the declining income levels among lower- and middle-income Americans. They are half right. The top 20 percent of income-earners did indeed see their inflation-adjusted incomes rise by more than 22 percent between 1982 and 1989. But the bottom 20 percent of income-earners also benefited from Reaganomics, with their inflation-adjusted incomes rising by 11.9 percent between 1982 and 1989. By contrast, between 1973 and 1980, the average incomes for the lowest 20 percent declined by 5.1 percent. Table 2 reveals the percentage change in inflation-adjusted incomes by each income quintile. The figures demonstrate conclusively that poor Americans suffered throughout the 1970s and all Americans suffered during the late 1970s, while all classes of Americans saw their incomes increase during the 1980s.

Myth #3: The budget deficit exists because the rich received huge tax cuts during the 1980s.

Fact: Tax revenues more than doubled during the 1980s, climbing from $517 billion in 1980 to an estimated $1.044 trillion in 1990. Federal taxes rose from an average of 18.3 percent of gross national product in the 1970s to more than 19 percent in the 1980s. The budget deficit exists because federal spending climbed by an even greater amount. If federal spending had "only" grown by the rate

of inflation during the 1980s, the nation today would enjoy a budget surplus of more than $125 billion.

In any case, higher taxes on the rich would barely dent the budget deficit. Even if lawmakers confiscated every dollar of individual taxable income above $1 million, they could only run the government for a little more than twelve days.

Myth #4: The rich are not paying their fair share of taxes.

Fact: The share of the income tax burden paid by the top one percent of income-earners has climbed from 18 percent in 1981 to 25 percent in 1987, the latest year for which official figures are available. The Congressional Budget Office estimates that the wealthiest five percent have seen their share of the income tax burden climb from 36 percent in 1980 to 44 percent in 1990. The rise in income tax payments by the wealthy is, in part, a result of higher incomes and confirms the supply-side hypothesis that lower income tax rates encourage individuals to remove money from tax shelters and report it as taxable income.

Taxing the Poor

One element of the unfairness issue is true: higher Social Security taxes have disproportionately hurt poor and middle-income Americans. Social Security payroll taxes have risen considerably in the last ten years, largely thanks to legislation enacted in the 1970s. Many lower-income Americans pay no income taxes, mostly due to the 1986 Tax Reform Act. Payroll taxes, by contrast, are levied against the first dollar of income, so they fall particularly hard on those with lower incomes. The question of fairness thus requires reducing the excessive burden of payroll taxes on lower- and middle-income citizens. Senators Robert Kasten, the Wisconsin Republican, and Daniel Patrick Moynihan, the New York Democrat, have introduced legislation to reduce the payroll tax and prevent politicians from spending surplus Social Security tax revenues on other government programs. Lower payroll taxes would spur job creation and increase after-tax income for tens of millions of Americans. The alternative, raising taxes on middle- and upper- income taxpayers to "balance" high payroll taxes on lower income taxpayers, simply means all taxpayers lose.

The point that higher taxes ultimately hurt poor blacks, Hispanics, and other minorities was made this week by the U.S. Civil Rights Commission. The Commission noted that in bad economic times, black and Hispanic unemployment rates rise the fastest. In good times, a tight labor market encourages employers to cast a wider net when hiring, thus breaking barriers that have prevented minorities, women, and persons with disabilities from gaining better-paying jobs. Civil rights laws can do little to expand opportunities for members of historically disadvantaged groups when opportunities for all Americans shrink.

Commissioner Russell G. Redenbaugh warns that "It's becoming increasingly clear that the U.S. is now in an economic recession." Therefore he concludes that "To raise taxes when an economy is already weak and in a recession is like throwing a drowning man a rock." Redenbaugh adds that "A zero capital gains tax rate would be a magnet to draw and hold the wealth that is produced in" the inner cities. Commissioner Carl A. Anderson adds that "To me, this is quite a strong statement on implementation of civil rights policy and the need for a strong growth economy." These commissioners understand that a high-tax policy which transfers money from the productive sector of the economy to the government will stifle economic growth and thus harm minorities all Americans.

The 1970s and 1980s proved that low taxes trigger strong economic growth and thus higher income levels and living standards for all Americans. More than other citizens, it is the poor who

most depend on a healthy economy. The high-tax decade of the 1970s culminated in prolonged economic stagnation. Inflation-adjusted gross national product was smaller in 1982 than it was in 1979, and it was the poor who suffered most during this period. Once the economic policy changes of the early 1980s took effect, however, Americans saw their incomes and living standards rise. The question policy makers face today is whether to retreat to the policy mistakes of the 1970s by raising taxes or to continue America's longest-ever period of peacetime economic growth by limiting the size of government.

A tax hike based on the politics of envy is little more than a Trojan Horse. Once the tax-increasers breach the taxpayers' defenses, economic policy will degenerate to the failed tax-and-spend policies of the 1970s. Today it is tax hike for the "rich": tomorrow it will be pink slips for the poor.

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The Heritage Foundation

Backgrounder UPDATE

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

Number

10/12/90 147

THE "NEW" BUDGET AGREEMENT PART II BACK TO CARTERNOMICS

(Updating *Executive Memorandum* No. 289, "The 'New' Budget Agreement: Part I, From Bad to Worse," October 9, 1990.)

Congressional committees are working feverishly to put meat on the bones of the budget resolution passed last Monday. If Congress sticks to its timetable, and George Bush signs into law on October 19 the budget package being drafted by congressional Democratic leaders, he may well be remembered as the President responsible for not just the largest first-year tax increase in American history, but also the nation's largest ever domestic spending increase. The spending proposals outlined in the budget resolution will increase overall federal spending on average by 6 percent per year, leaving domestic spending $245 billion higher in fiscal 1995 than in fiscal 1990. This means that for every dollar in new taxes raised by this budget, federal spending will rise by $1.90.

During the past six months of budget discussions, Bush and congressional negotiators have told Americans that deep and painful spending cuts would be needed to solve the deficit crisis. Yet, they added, spending cuts alone would not solve the problem; taxes too would have to be raised. Given such talk of deep cuts, Americans naturally would expect the fiscal 1991 spending levels agreed by summiteers to be less than last year's levels. In fact, runaway spending will continue.

Hefty Non-Defense Increases. Only one spending area – defense – will receive less money in 1991 than it did in fiscal 1990: $2.9 billion less in the first year and $9 billion less by 1995. Every other program area in the $1.3 trillion budget package will receive billions of dollars more in fiscal 1991 than in fiscal 1990. Not one bit of pork, waste, fraud, and unnecessary spending will be cut out of the budget. Instead, each non-defense program area will receive hefty increases next year. Moreover, this new spending comes on top of the $73 billion, or 11 percent, hike in domestic spending between fiscal 1989 and fiscal 1990. Under this new budget package, for instance, energy programs receive 20 percent more funds in 1991 than in 1990; the Justice Department is given 17.1 percent more; agriculture grows by 12.8 percent; health programs rise 12.5 percent; and general government expenses, including funds for huge increases in congressional salaries, jump by 10.4 percent (See table on page 2.)

The budgetary technique allowing politicians to spend more while talking incessantly of cuts is called "current services" or "baseline" budgeting. Under this accounting device, introduced in the 1974 Budget Act, spending for each program is assumed to increase by the projected rate of inflation and the expansion of services authorized under current law. This automatic increase creates the new baseline for the program. Example: a program that costs $100 million in one year might be

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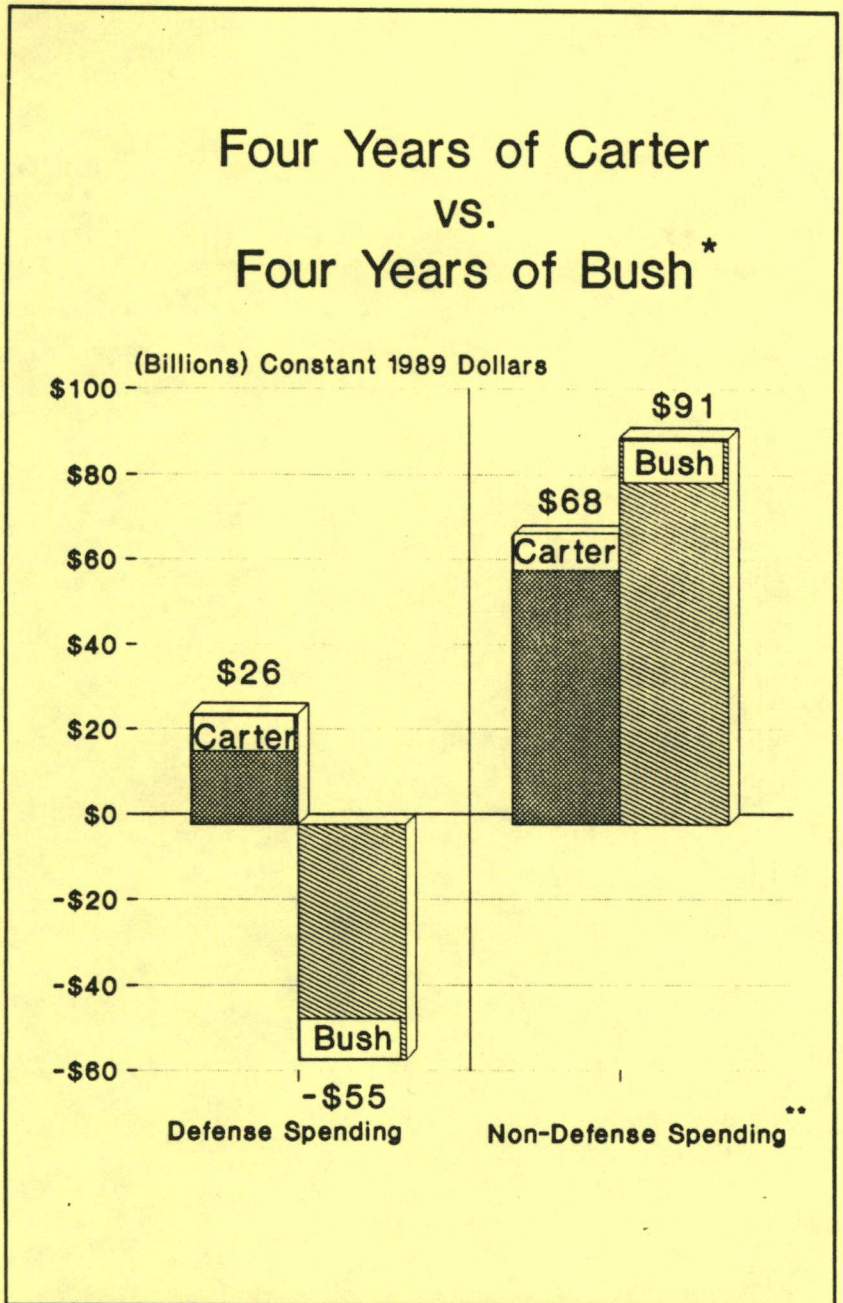
1991 Budget Proposed Spending Levels Compared to 1990 Levels

	Fiscal 1990	Fiscal 1991	Change 1990-1991 (billions)	
(050) National Defense	$299.9	$297.0	-$2.9	-0.96%
(150) International Affairs	$15.5	$17.4	$1.9	12.30%
(250) General Science, Space and Technology	$14.2	$15.2	$1.0	7.00%
(270) Energy	$3.3	$4.0	$0.7	21.20%
(300) Natural Resources and Environment	$17.8	$18.9	$1.1	6.20%
(350) Agriculture	$12.5	$14.1	$1.6	12.80%
(370) Commerce and Housing Credit	$75.7	$87.0	$11.3	15.00%
(400) Transportation	$29.5	$30.7	$1.2	4.10%
(450) Community and Regional Development	$8.3	$8.6	$0.3	3.60%
(500) Education	$38.3	$41.8	$3.5	9.10%
(550) Health	$58.2	$65.5	$7.3	12.50%
(570) Medicare	$96.9	$104.9	$8.0	8.30%
(600) Income Security	$148.5	$160.5	$12.0	8.10%
(650) Social Security	$248.7	$266.3	$17.6	7.10%
(700) Veterans Benefits and Services	$29.4	$31.7	$2.3	7.80%
(750) Administration of Justice	$10.5	$12.3	$1.8	17.10%
(800) General Government	$10.6	$11.7	$1.1	10.40%

Note: Program areas are identified by their budget function numbers, which indicate the order in which programs appear in the President's budget.

projected by the baseline budgeting method to receive $110 million the next year. If Congress appropriates $105 million for the program, this is recorded as a $5 million "cut." To any average American, of course, this would be a $5 million increase.

By resorting to the "current services" charade and by cutting $55 billion in real (inflation adjusted) dollars from defense, the liberal leadership in Congress can claim that the new budget package slows the growth of federal spending. In fact, non-defense domestic spending goes up by $245 billion, or 34 percent, during the five-year life of this package – excluding net interest payments on the federal debt and the "off budget" cost of the savings and loan bailout. This increase in non-defense spending exceeds the total increase in non-defense spending during the entire 1980s. In other words, George Bush and the congressional leadership will increase domestic spending faster



*Excluding interest payment and deposit insurance.

** Carter fiscal years 1978-1981.
Bush fiscal years 1990-1993.
(Bush years based upon the most recent budget agreement)

in the first five years of this decade than was achieved during the full ten years of the previous decade.

Outdoing Carter. Bush is well on the road to breaking the spending records set by Jimmy Carter. The spending levels established in the budget package will mean a real increase in domestic spending of at least $91 billion. This is close on the heels of the $94 billion real increase in total federal spending during the four years of the Carter Administration. If the Bush Administration fails to exceed the Carter Administration in its spending, it will only be because defense spending will decrease in real terms by over $55 billion under Bush. Defense spending under Carter increased by $26 billion in real terms.

Coupled with the huge tax increases scheduled in the budget resolution, and calls from the Administration for the Federal Reserve Board to ease monetary policy, the President thus seems set to bring back the economic disasters of escalating taxes, economic stagnation, and inflation that characterized the Carter Administration.

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Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/09/90 Number 289

THE "NEW" BUDGET AGREEMENT: PART I FROM BAD TO WORSE

Angry protests from American taxpayers forced the House of Representatives last week to reject the original tax-laden budget agreement worked out behind closed doors by the summit negotiators. As they sifted through the fine print, lawmakers realized that not only did the package rely on phony spending cuts and unrealistic economic assumptions, it also would have caused a deep recession by burdening the faltering economy with the largest tax increase in American history.

Unfortunately, the Washington "insiders" who produced the original agreement responded to taxpayer protests with a new package that is even worse. It would produce less in savings on the spending side and more in growth-destroying new taxes. Even specific spending reductions in the package turn out to be only advisory, leaving congressional committees with a penchant for creative accounting in charge of producing the "savings" using whatever policies they wish. Taking advantage of the limited public awareness of the agreement, the new budget resolution was enacted swiftly by both chambers.

The original summit package would have been a disaster for the economy. Not only is the revised agreement even worse, but by including an open invitation for committees to further modify the package, it all but guarantees that the final budget legislation will mean the end of the economic growth America has enjoyed since the early 1980s.

Record Tax Increase Gets Even Bigger. Economists disagree on many issues, but they are almost completely united in their belief that it is folly to raise taxes with the economy perched on the edge of a recession. Instead of reducing the record $133.8 billion tax hike in the original package, however, the new budget agreement increases the tax burden by as much as $15.2 billion, with the added revenues to come from $20 billion of "unspecified" deficit reduction assigned to the tax-writing committees.

Many legislators are concerned that the new agreement permits greater tax increases. Proponents deny this point, claiming that "gross" revenues in the new agreement will be no greater than the $162.9 billion in the original package. But the original agreement contained approximately $25 billion of revenue-losing provisions, meaning the net increase in the tax burden was $133.8 billion. The new budget agreement likely will eliminate these, resulting in the net tax burden jumping to $149 billion.

The distinction between "net" and "gross" tax increases, moreover, is highly significant. The Tax Reform Act of 1986, for instance, included gross tax increases of more than $100 billion. But these

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revenue-raising provisions were almost exactly offset by revenue-losing provisions, leaving the important figure – net taxes – largely unchanged. The budget resolution passed by the House and Senate, by contrast, increases net taxes by far more than the original agreement.

Green Light for More Spending. The original package did little to limit federal spending. The revised agreement does even less. The few positive spending proposals in the initial package, including reforms of Medicare and unemployment compensation, either are missing from the new package or are reduced in scope. Under the initial agreement, Medicare spending was supposed to be $55 billion higher in 1995 than in 1990 – characterized in Washington parlance as a "cut," since it reduced the rate of increase in Medicare spending. Under the new agreement, Medicare spending will climb faster. The foregone deficit reduction will be made up by higher taxes on working Americans.

In many ways, however, the new agreement simply replicates the bad features of the old one. For example, the only genuine cuts are in the defense budget. The other supposed cuts actually are no more than reductions in previously planned increases. Other "cuts" in both the new and old proposals in fact are thinly-disguised tax increases or "fees." Remaining spending savings are either unspecified or budget gimmicks, such as the provision transferring nearly $5.4 billion of revenue from the Postal Service to the general budget, and the provision changing the point in time when certain federal employee retirement benefits are paid.

Rosy Scenario. The new agreement also continues to use the same discredited economic assumptions contained in the initial package. The largest tax increase in history is assumed to cause the annual rate of economic growth to double in 1991 and triple in 1992. Today's rising inflation and interest rates are supposed to fall magically, with long-term interest rates somehow dropping to their lowest level in a quarter century. Of course, if inflation and interest rates do not behave as projected, spending will be much higher than the agreement estimates since so many federal programs are tied to increases in the price level.

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The newly enacted budget resolution is a victory for politics as usual and the status quo. Budget summit agreements in 1982, 1984, 1987, and 1989 all were enacted with the solemn promise that spending would be restrained, new taxes would be used for deficit reduction, and government borrowing would be reduced. In every single instance, however, the deficit rose in the year following summit agreements as Congress spent every penny of the additional tax revenue and then some. There is no reason to believe that the result will be any different if Congress and the Bush Administration enact the latest "solution" to the federal deficit.

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John M. Olin Fellow in Political Economy

For further information:

Scott A. Hodge and Robert Rector, "The Budget Summit Agreement: Part III, No New Taxes Needed," Heritage Foundation *Backgrounder Update* No. 142, October 3, 1990.

Daniel J. Mitchell, "The Budget Summit Agreement: Part VIII, Hidden Time Bombs," Heritage Foundation *Backgrounder Update* No. 146, October 3, 1990.

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Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/5/90

Number 287

THE BUDGET SUMMIT AGREEMENT: PART IX WHAT NEXT?

Several hours ago the House of Representatives rejected the budget summit agreement – and with good reason. Yet the debate revealed a fundamental misunderstanding about the package. The proposed budget would not have cut the deficit by cutting spending and raising taxes. It would have increased both spending and taxes. And then it would have opened the door for even larger increases in the future. Further, the economic damage wrought by such a package would have reduced revenues to Treasury. The result: The budget deficit would have increased.

The vote against the budget summit agreement was not a major defeat for George Bush. The agreement itself was a defeat for Bush's central campaign promises: continued economic growth and no new taxes. The repudiation of the summit budget is a victory for Bush because it offers him an opportunity to resolve the budget problem while keeping his promises intact.

The question now is, what next?

There are a number of approaches vastly better than the summit agreement. The best is the so-called "Four Percent Solution." This plan involves no new taxes. It calls for no program cuts. It would allow spending to increase by 4 percent over the previous year, that is, at the approximate rate of inflation. This would balance the budget by 1994. For greater deficit reduction, defense spending could be frozen at the levels agreed to by the budget summiteers.

If Congress and the Administration find that a 4 percent annual growth in spending pinches too tight, then they may consider a 6.5 percent solution. This allows non-defense spending to climb 6.5 percent per year; this roughly is the level agreed upon by summiteers. This would balance the federal deficit by 1995. The only thing that would sabotage these budget-balancing schedules would be a tax increase which strangles economic growth: A 6.5 percent solution would allow non-defense spending to grow greatly in excess of the rate of inflation. It would not be a cut at all.

Attacking Waste. Congress too finally should attack the waste and unnecessary spending in the federal budget. The summit agreement made no attempt to do so. The summit package did not cut funding for programs or shut down programs that serve no national interest. The Heritage Foundation has identified a potential $130 billion in cuts that would lower the budget deficit and eliminate the need for higher taxes.

By raising taxes and pushing the country into a recession, the summit agreement would have resulted in higher outlays for such programs as unemployment and food stamps, less revenues in the Treasury, and therefore a higher budget deficit. A new budget agreement should contain real policy reforms to promote economic growth, which is the best way to generate revenue. One way to do this is to cut the capital gains tax rate. This would not be a break for the wealthy. Economic statistics long have proved that a capital gains tax cut is used mainly by middle class Americans selling their homes

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or their farms or their small businesses. Cutting the capital gains rate, moreover, would trigger business activity that would bring in billions of dollars of new tax revenues. Bush said at a press conference that "if Congress really wants economic growth and increased revenues, the place to start is not with tax increases but with incentives for growth, investment – and jobs."

Vital Programs Secure. If Bush and Congress allow the Gramm-Rudmann-Hollings sequester automatically to cut federal outlays, it need not be a disaster. First, most government programs that directly help people are exempt from the sequester. Social Security, Medicaid, food stamps, and the Women, Infants and Children program are not touched. Second, Congress can shuffle the mix of cuts, for example, fully funding air traffic controllers and health inspectors while cutting back further in less vital programs.

If sequester is distasteful to lawmakers, they could pass what is called a continuing resolution. This continues into next year the current year's spending levels. This would produce significant real savings while allowing the government to continue to operate. While there are, of course, some problems with a continuing resolution, it is much better for the economy than last weekend's budget summit package.

If Congress refuses to cooperate with the President, George Bush can use the 1870 "Antideficiency Act." Carter Administration Attorney General Benjamin Civiletti maintained that this act gives the President the authority to incur obligations in advance of appropriations by Congress for the safety of life and the protection of property. This would mean, for example, that the President could allow air traffic controllers and health inspectors to remain on the job while Congress considers the budget.

The budget summit agreement went down to defeat, as well it should have. The President now has the opportunity to keep his pledge of economic growth and no new taxes. Congress has the opportunity to craft a budget that – unlike the summit agreement – does not increase programs and taxes. It is possible to balance the federal budget in the next half-dozen years without raising taxes and without gutting programs.

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For further information:

Scott A. Hodge and Robert Rector, "The Budget Summit Agreement: Part III, No New Taxes Needed," Heritage Foundation *Backgrounder Update* No. 142, October 3, 1990.

Scott A. Hodge, "Rx for the Federal Deficit: The Four Percent Solution," Heritage Foundation *Backgrounder* No. 787, September 4, 1990.

Scott A. Hodge, "A $130 billion No-Tax Prescription for the Budget Deficit," Heritage Foundation *Backgrounder* No. 772, May 31, 1990.

The Heritage Foundation
Backgrounder UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

Number
10/3/90 146

THE BUDGET SUMMIT AGREEMENT: PART VIII HIDDEN TIME BOMBS

(Updating *Executive Memorandum* No. 286, "The Budget Summit Agreement: Part VII, Economists Speak Out," October 3, 1990; *Backgrounder Update* No. 145, "The Budget Summit Agreement: Part VI, No Real Budget Process Reform," October 3, 1990; *Backgrounder Update* No. 144, "The Budget Summit Agreement: Part V, Faulty Economic Assumptions, " October 3, 1990; *Backgrounder Update* No. 143, "The Budget Summit Agreement: Part IV, The Myth of Entitlement Reform," October 3, 1990; *Backgrounder Update* No. 142, "The Budget Summit Agreement: Part III, No New Taxes Needed" October 3, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part II," October 2, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," October 1, 1990; and *Backgrounder* 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

Budget summiteers claim that the $134 billion tax hike included in their agreement, the largest first-year tax increase in America's history, was a one-time necessity. In the long run, they say, the agreement will limit the growth of government spending and thus eliminate the need for higher taxes in the future. Yet the budget agreement actually includes several provisions which would reshape fundamentally the nation's tax and spending policies. Far from reducing the likelihood of future tax increases, these provisions would open the door to higher taxes and bigger government. Thus, not only does the budget package propose recessionary policies for today, it also virtually guarantees a huge increase in spending and taxation in the future.

Among the many fiscal time bombs hidden in the budget agreement:

- **A National Sales Tax.** Many liberals in Congress have long wanted a value-added tax or some similar national sales tax, knowing that such a national tax would be a cash cow to finance future pet programs. The agreement opens the door to such a tax. The imposition of a ten percent tax on so-called luxury items can easily be expanded to include other products and services. Indeed, because the overall package is sure to fail in its goal of deficit reduction, pressure will be created for more tax increases in future years. Legislators then will be tempted to define more and more goods as "luxury" items. Eventually this revenue-raising "luxury" tax will become the full blown national sales tax that the big spenders have always wanted.
- **Effective Prohibition of Future Tax Cuts.** Many policy makers, concerned that the budget summit agreement may be enacted into law, are developing tax-cut proposals to pull the economy out of the recession which almost certainly will follow the enactment of the budget

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summit package. But the agreement blocks virtually any future legislation that would reduce the tax burden on the American people. The reason is that the agreement requires any tax cut to be accompanied by a provision raising taxes by an equal amount. Furthermore, if higher taxes are not included in the tax cut legislation, the budget agreement requires the appropriate congressional committees to produce legislation raising taxes by the same amount as the tax cut provision.

- **Reduction of Itemized Deductions.** The budget agreement would reduce the value of itemized tax deductions for higher income Americans, opening the door to the gradual erosion of many deductions now available to middle-income Americans. This sets the stage for the elimination of such deductions as home mortgage interest, state and local income and property taxes, and charitable contributions. If the Federal Reserve Board follows an inflationary monetary policy, as advocated currently by the Bush Administration, middle-class taxpayers who receive wage increases just to offset inflation soon will find their deductions are reduced.

- **Gutting the Gramm-Rudman Deficit Reduction Act.** Supporters of the agreement claim that the package strengthens Gramm-Rudman by adding spending caps for domestic, international, and defense discretionary spending. This marginal improvement is overshadowed, however, by the creation of a number of loopholes. Under the proposed agreement, for instance, Gramm-Rudman's fiscal discipline does not apply if the excessive spending is caused by faulty "technical" and "economic" assumptions. Given legislators' proclivity to use inaccurate assumptions and faulty estimates under current law, this provision enables lawmakers to evade the Gramm-Rudman targets simply by adopting phony economic projections. It does not take much imagination to see how this loophole will emasculate Gramm-Rudman.

- **The Raid on Special Funds.** The budget summit agreement raises revenues by misusing taxing authority meant to deal with specific national problems. Example: Revenues from the gasoline tax normally go into a trust fund meant to finance improvements in America's highways. But half of the new money raised by the proposed 12 cent increase in gasoline taxes will go to general revenues, not into the highway fund. Example: The amount of an individual's income subject to the Medicare tax is raised from $51,300 to $73,000, not to help elderly Americans who become sick but to give Congress more money to spend on other programs. With the major trust funds raided in this way, the door is open to future abuses of taxing authority and raids by a spendthrift government on funds set aside in special accounts.

The budget summit agreement, contrary to the claims of its supporters, not only fails to reduce spending but makes it easier in the future for the government to extort further revenues from an already overtaxed American public. Far from being stop-gap measures to reduce the deficit, they are major changes in policy, overturning some of the most basic principles of U.S. tax policy.

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Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/3/90

Number 286

THE BUDGET SUMMIT AGREEMENT: PART VII ECONOMISTS SPEAK OUT

As the facts of this week's budget summit agreement come to light, a consensus is growing that the package contains only real taxes and phony spending cuts that will send the American economy headlong into a recession. Even House Majority Leader Richard Gephardt, the Missouri Democrat, is criticizing the agreement. "I detest it. I think it's wrong . . . . The economy won't do what we think it's going to do now. And probably, in three years, we'll be back into a summit," Gephardt told the St. Louis Post-Dispatch *in a front-page interview published today. Several top economists, many former high-ranking Reagan Administration officials, voiced their own criticisms of the agreement at a Heritage Foundation briefing today.*

Betsy C. Hart
Director of Lectures and Seminars

I oppose this budget agreement... it is a disaster. The ambitious enforcement program is full of loopholes. The package doesn't reduce the deficit, the deficit goes up by $50 billion.

If this agreement is approved, I think it is vitally important that we take the table with the outlays and revenues, and we frame it, put it on the wall, and then every year we compare the numbers and see what they are. I'm willing to bet that those numbers will not comport with reality.

—**James Miller, Ph.D.,** Chairman, Citizens for a Sound Economy, Former Director, Office of Management and Budget

There are four fundamental flaws in the budget: it contains the largest first year tax increase in American history; it is technically flawed in its economic assumptions; it creates the myth of entitlement reform; and there is no enforcement and no real budget reform.

—**Daniel J. Mitchell,** John M. Olin Fellow in Political Economy, The Heritage Foundation

Contrary to what the President asserts, this agreement will exert a strong contractionary influence on the economy... The President should tell us how a whopping tax increase and virtually no cuts in spending other than in defense outlays will help the U.S. economy to grow.

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What we really need are real spending cuts, and we need basic tax reform that will make the economy more efficient, remove impediments to growth, and remove impediments to the competitiveness of American businesses in the world economy.

—**Norman Ture, Ph.D.**, President, Institute for Research on the Economics of Taxation, former Undersecretary of the Treasury

This is the tenth year of budget agreements. Higher taxes have always been permanent, and budget savings have never been realized. If you just reached into a hat and pulled out something it would be better than this.

—**Paul Craig Roberts, Ph.D.**, William E. Simon Chair in Political Economy, Center for Strategic and International Studies, Former Assistant Secretary of the Treasury for Economic Policy

This budget package is an economic mistake and a political disaster... and it is shifting part of the deficit burden to our children and our grandchildren. Increasing taxes given Gramm-Rudman rules doesn't reduce the deficit, it increases allowed spending... Mr. Bush's claim that the tax package does not increase marginal tax rates is wrong.

—**William Niskanen, Ph.D.**, Chairman, Cato Institute, former member and Acting Chairman, Council of Economic Advisors

If you believe the economic assumptions about the outyear budget surplus numbers, then you don't need tax increases. If you put the tax increases in, then you don't get the economic assumptions.

Here we are in the 1990s raising taxes, increasing regulation, and calling on the Federal Reserve Board to print more money. This is a reenactment of the 1970s. It didn't work then and it won't work now.

—**Stephen Entin, Ph.D.**, Resident Scholar, Institute for Research on the Economics of Taxation, former Deputy Assistant Secretary of the Treasury for Economic Policy

You just don't embark on a large tax increase in a recessionary setting. What we have now is the most blatant visible discussion of not only raising taxes but raising all manner of taxes we thought were locked up... the summiteers will be back and they'll be back to raise taxes again. This weighs heavily on the minds of business and investment people... I don't see how the President and Congressional leaders can get up and talk proudly about austerity and pain because that is not leadership and that will not help the economy.

I am very annoyed at the inflated nature of the new current services baseline. I think it is deceptive, I think it disinforms the public and undermines government credibility. The discretionary, non-mandatory domestic programs have gotten off once-again scot free, and this is a phenomenal area of waste, fraud, and abuse.

—**Lawrence Kudlow, Ph.D.**, Chief Economist, Bear, Stearns, former Chief Economist, Office of Management and Budget

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Backgrounder UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/3/90 Number 145

THE BUDGET SUMMIT AGREEMENT: PART VI NO REAL BUDGET PROCESS REFORM

(Updating *Backgrounder Update* No. 144, "The Budget Summit Agreement: Part V, Faulty Economic Assumptions," October 3, 1990; *Backgrounder Update* No. 143, "The Budget Summit Agreement: Part IV, The Myth of Entitlement Reform," October 3, 1990; *Backgrounder Update* No. 142, "The Budget Summit Agreement: Part III, No New Taxes Needed" October 3, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part II," October 2, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," October 1, 1990; and *Backgrounder* 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

When the Bush Administration and congressional leaders began budget negotiations five months ago, it was expected that any deficit reduction agreement would include long-overdue reforms of the budget process. Previous experience showed that without a tightening of the process, lawmakers soon would begin to evade spending controls, under pressure from interest groups. The Administration specifically declared that substantive reforms were a necessary condition for an agreement.

The summit agreement includes no serious reform. Not only are much-needed changes completely ignored, it appears that the marginal changes included in the package may actually weaken what little discipline currently exists.

The agreement was most notable for the absence of key budget process reforms needed to make spending control a reality. The package failed to include any of the following:

- **A Tax Limitation/Balanced Budget Amendment.** Even though a balanced budget amendment came within seven votes in July of the two-thirds needed in the House of Representatives, the negotiators did not include the amendment in the package. As a result, a package which is supposedly designed to eliminate the budget deficit does not include the one reform designed to guarantee that result.
- **A Line-Item Veto.** One of the major causes of deficit spending is the inclusion of wasteful and unnecessary spending in legislation which has broad appeal. The President then is faced with choice of vetoing the entire bill in order to express his opposition to pork barrel provisions or signing the legislation. A line-item veto, which would allow the President to veto individual spending provisions, would produce billions of dollars in savings. Not only did the summit negotiators reject the line-item veto, they also turned down much more modest proposals to give the President enhanced rescission powers.

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- **Eliminating the Current Services Budget.** In the real world outside Washington, American families and businesses understand that a spending cut means that spending next year will be less than it is this year. Washington lawmakers, however, have redefined a spending cut to be the difference between how fast they wanted to increase spending and how much they actually increase spending. If a store owner advertised a "10 percent off" sale because he only raised his prices by 15 percent instead of the 25 percent hike he would have preferred, he would accused of fraud. When legislators do the same thing, they are rewarded with support from the special interest groups who get the additional spending. Repeal of the current services budget, which would restore honesty to the budget process, was rejected by the negotiators.
- **Gramm-Rudman Outlay Targets.** Establishing specific federal spending targets, and requiring sequestration if spending increased above those targets, would ensure that promised fiscal restraint actually materialized. Such an approach, as included in the "Four Percent Solution" (S. 3136) legislation introduced in the Senate and with supporters in the House, was rejected by the negotiators.

POROUS SPENDING LIMITS

Supporters of the budget summit agreement would like to portray the "caps" on domestic, international, and defense appropriations spending as ironclad limits on total spending. In theory, the caps in these three categories are enforced by automatic budget cuts within each category whenever spending rises above the allowable level. This is in principle a step in the right direction. Unfortunately, the agreement contains many exceptions and limitations on this new procedure. Examples:

- Spending requests declared to deal with an "emergency" would not count against the spending caps.
- Excessive spending due to faulty economic assumptions does not count against the caps.
- If spending is higher than originally projected for "technical" reasons, it would not count against the spending caps at all in 1991. Such spending would count after 1991 only if technical reestimates boosted spending by more than $2.5 billion for domestic spending, $1.5 billion for foreign aid programs, and $2.5 billion for defense.
- The current Gramm-Rudman law is weakened by increasing the amount by which Congress can miss the target from $10 billion to $15 billion.
- A special budget summit is mandated for 1993 to "adjust" technical and economic estimates. Higher spending exposed by these changes would be exempt from spending caps.

THE AUTOMATIC TAX INCREASE PROVISION

In addition to undermining already existing limits on spending growth, the budget agreement creates an automatic tax increase mechanism. Under this provision, any measure which loses revenue according to the congressional Joint Tax Committee's static analysis would have to be accompanied by an offsetting tax increase. Failure to do so would result in automatic tax increase instructions to the House Ways and Means Committee and to the Senate Finance Committee. A number of points illustrate the folly of the approach:

- Had this provision been in effect in 1981, Ronald Reagan's Economic Recovery Tax Act could not have been enacted.
- This provision effectively kills any future consideration of a reduction in the capital gains tax.

- Reductions in the payroll tax would also effectively be prohibited by this provision.

Real budget process reform might have done something to salvage an otherwise deplorable budget agreement. At least it would have forced lawmakers to stick by their own agreement. But not only was real budget reform rejected – it appears that the changes agreed upon actually may make it even easier to circumvent controls on spending.

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10/3/90 Number 144

THE BUDGET SUMMIT AGREEMENT: PART V FAULTY ECONOMIC ASSUMPTIONS

(Updating *Backgrounder Update* No. 143, "The Budget Summit Agreement: Part IV, The Myth of Entitlement Reform," October 3, 1990; *Backgrounder Update* No. 142, "The Budget Summit Agreement: Part III, No New Taxes Needed" October 3, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part II," October 2, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," October 1, 1990; and *Backgrounder* 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

Supporters of the budget summit agreement contend that the package will bring spending down below 18.5 percent of Gross National Product (GNP) by 1995. This compares with the Administration's mid-session and pre-summit estimate that federal spending consumed nearly 22 percent of GNP in the recently-completed 1990 fiscal year. By allegedly holding down spending in this way, and enacting the largest first-year tax increase in American history, advocates of the agreement can claim that the overall package would balance the budget by 1995.

Their own economic assumptions show this to be a hollow claim. Achievement of the goal is based largely on unrealistic and dubious economic assumptions. Moreover, the proposed tax increase would certainly destroy the whole basis of these wildly optimistic projections. Yet without the spurious assumptions, the promised spending restraint evaporates and the goal of a balanced budget by 1995 collapses.

The "success" of the budget agreement hinges on the credibility of these economic assumptions. Sound and objective analysis, however, suggests that the assumptions are grossly optimistic and that the spending and revenue estimates are almost meaningless.

Among the economic realities likely to torpedo the summiteers' economic assumptions:

- The annual rate of economic growth is assumed to nearly double between 1990 and 1991, and almost triple between 1991 and 1992. Not only is this dramatic pickup in growth extremely unlikely, but it is supposed to occur on the heels of the largest first-year tax increase in American history.
- If economic growth does not meet the summit's rosy assumptions, the economic projections used in the agreement become invalid. That means a huge increase in the deficit. The Congressional Budget Office (CBO) estimated in January that a one percentage point reduction in the

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SUMMIT ECONOMIC ASSUMPTIONS (calendar years)						
	1990	1991	1992	1993	1994	1995
Nominal GNP (billions)	5486	5807	6199	6670	7141	7607
Real GNP % change	0.7	1.3	3.8	4.1	3.7	3.5
Inflation % (GNP Deflator)	5.2	4.6	3.4	3.2	3.0	2.8
Short-term Interest Rate (%) (3 months)	7.7	7.2	5.7	4.9	4.4	4.2
Long-term Interest Rate (10 years)(%)	8.7	8.3	7.1	6.1	5.6	5.3

projected annual rate of real economic growth beginning in January 1990 would increase the expected deficit by $143 billion in 1995. The CBO also estimated that a one percentage point increase in the projected unemployment rate would boost the deficit by $81 billion in 1995.

- The Bush Adminstration is urging the Federal Reserve Board to adopt an easy money monetary policy to soften the effect of higher taxes. But a loose monetary policy, while perhaps temporarily lowering interest rates by creating the illusion of greater savings, ultimately results in higher inflation and interest rates. Thus, inflation is likely to rise, not fall, if the agreement is enacted and monetary policy loosened. The summit's economic assumptions show inflation, as measured by the GNP deflator, falling to 2.8 percent by 1995. This is hardly a realistic estimate if the Federal Reserve Board follows an inflationary policy. The last "pro-growth" easy-money period in American history, during the Carter Adminstration, resulted in inflation reaching 18 percent.

- Much of the supposed spending "savings" in the budget agreement are contingent on the inflation projection. Specifically, these savings assume lower cost of living adjustment (COLAs) payments to retired federal workers and smaller inflation adjustments in discretionary spending. These savings disappear when realistic inflation estimates are incorporated.

- The summit assumes long-term interest rates will fall to 5.3 percent. This would be the lowest level since 1967.

- The summit assumes that the short-term interest rate will plummet to 4.2 percent, a level not seen since 1972. The easy-money policies pursued during the Carter Administration led to the

prime interest rate climbing above 20 percent, long-term interest rates hitting 13.9 percent, and short-term interest rates peaking at 14.0 percent.

- The budget agreement claims to "save" more than $64 billion over five years because lower interest rates will reduce government borrowing costs. If realistic interest rate projections are used, these savings vanish. The potential magnitude of an error in projected interest rates is indicated in the CBO's analysis earlier this year, which estimated that a one percentage point increase in interest rates beginning in January 1990 would alone have increased the deficit by $31 billion in 1995.
- The Administration is attempting to sell the agreement by asserting that enactment of the package will result in a large drop in interest rates. But the most comprehensive analysis of the relationship between the deficit and interest rates, conducted by the Treasury Department during the Reagan Adminstration, found that the size of the deficit does not have a significant effect on interest rates. In seven out of the last nine years, the deficit as a percent of GNP and the prime interest rate have moved in opposite directions, completely contrary to conventional wisdom.

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A budget agreement that assumes higher taxes will spur economic growth is not credible. A budget agreement that assumes an easy money policy will lower the inflation rate is not realistic. A budget agreement which assumes that interest rates will reverse historical patterns of behavior will not produce promised savings. And without these assumptions, the entire justification for a huge increase in taxes simply collapses.

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10/3/90 Number 143

THE BUDGET SUMMIT AGREEMENT: PART IV THE MYTH OF ENTITLEMENT REFORM

(Updating *Backgrounder Update* No. 142, "The Budget Summit Agreement: Part III, No New Taxes Needed" October 3, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part II," October 2, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," October 1, 1990; and *Backgrounder* 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

George Bush and congressional leaders are urging proponents of fiscal responsibility to support the budget summit agreement. Their reason: the benefits of alleged savings in entitlement spending outweigh the economic cost associated with the largest first-year tax increase in America's history. The entitlement savings, however, turn out to be a mirage, while the tax hike is very real. The few genuine savings in the agreement are more than outweighed by tax increases and budget gimmicks masquerading as entitlement reforms.

Among the provisions spuriously claimed to be entitlement savings:

- Medicare savings are said to produce $4.6 billion of savings in 1991 and $60 billion savings over the five year period. In reality, these "cuts" are simply reductions in already projected increases. Actual Medicare spending will still climb by at least $15 billion between 1990 and 1995.
- A large portion of the Medicare "savings" are not savings in outlays at all. They are accomplished by raising the monthly premium that senior citizens must pay into the Medicare system. This would rise from less than $29 today to more than $54 in 1995. The billions of dollars in new revenue from this provision are counted as a "spending cut."
- The agreement eliminates the lump sum civil service retirement option, which allows retirees to withdraw part of their pension in a lump sum payment disbursed over two years. Doing away with this option "saves" $1 billion in the first year and $8.1 billion over five years. But total spending on these pensions remains unchanged over time. Thus while the Administration portrays this provision as a fundamental reform in entitlement spending, there are no permanent savings as a result of this change. All that changes in the entitlement is the timing of the payoff.
- A budget gimmick enacted last year moved the U.S. Postal Service (USPS) off-budget because the USPS annual operating deficits were raising the overall budget deficit. This year's budget agreement adds to the gimmickry by requiring the Postal Service to transfer to the Treasury nearly $700 million in 1991 and almost $5.4 billion over the next five years. Since the Postal Service is now off-budget, this provision generates a paper savings even though the ac-

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tual overall financial obligations of the federal government are unchanged. Thus, the summiteers would take money from a loss-making government institution and pretend that doing so would reduce the deficit. Postmaster General Anthony Frank correctly referred to this sleight-of-hand as a "stamp tax," since the Postal Service would have to raise stamp prices by five cents to make up for the lost funds. To add insult to injury, these revenues transferred into the Treasury are counted as a "cut" in entitlement spending.

- Unspecified changes in veterans programs are assumed to yield $500 million in savings in 1991 and $2.7 billion in savings over five years. Specific policies are not listed, however, raising serious doubts as to whether the savings will actually be forthcoming.
- The $13 billion savings, over five years, supposedly coming from farm subsidy programs is similarly vague. The agreement "presume[s] that these savings would be achieved through a combination of target price and/or base acre reduction programs." If past agreements are any guide, these savings will fail to materialize.
- The agreement claims $600 million in 1991 savings and $3 billion in savings over the next five years from "Miscellaneous Other Mandatory – Entitlements/Fees." There is no suggestion as to how these phantom savings will be realized other than asserting the negotiators will present them at some later point.
- It turns out that $14.2 billion of the five-year "savings in entitlements" actually comes from new revenue generated by establishing or increasing 17 different "user fees." A large number of these provisions are of course little more than hidden tax increases.

All told, at least $36.5 billion of the supposed "real savings" from entitlement programs actually come from either new revenues or budget gimmicks. Another $23.8 billion of the total is unspecified, optimistically relying on congressional committees to produce real savings.

Even if the negotiators were truthful in claiming that their proposed changes did affect entitlements, the misleading current services budget that is used as the benchmark in the budget agreement means almost all the entitlement "cuts" would be no more than reductions in projected increases. Under the agreement, actual entitlement spending will jump from $523 billion in 1990 to more than $715 billion in 1995, increasing at an annual rate of 6.5 percent. Thus once the phony reforms and hidden taxes are eliminated from the calculation, it is clear that the budget agreement completely fails to rein in the expansion of entitlement programs.

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10/3/90 Number 142

THE BUDGET SUMMIT AGREEMENT: PART III NO NEW TAXES NEEDED

(Updating *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part II," October 2, 1990; *Backgrounder Update* No. 141, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," October 1, 1990; and *Backgrounder* 787,"Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

George Bush and congressional budget negotiators are telling the American people that the only way to deal with the budget deficit is to raise taxes by $134 billion over the next five years. Yet their own calculations show just the opposite – that deficit reduction can be achieved with no new taxes simply by a reasonable slowdown in the overall growth of federal spending. If the aggregate outlay targets agreed to by the summit negotiators are enforced, the budget deficit will be reduced significantly without the new taxes which threaten to send the economy into a recession.

Even greater deficit reduction could be achieved with a "Four Percent Solution," which would limit to four percent the annual increases in non-defense spending. The Four Percent Solution in fact would result in a large budget surplus by 1994.

Bush and the negotiators claim that they have instituted real spending cuts as well as long-term spending restraint in exchange for the $134 billion in new taxes. Yet the dirty little secret of the agreement is that domestic discretionary spending and domestic entitlement spending still will increase by an average of 6.5 percent per year – not even including the Savings and Loan (S&L) bailout. Thus, the cumulative spending increases in non-defense spending accounts will total $724.6 billion over the five years of the agreement. What this means is that the agreement increases non-defense spending by $5.40 for every new dollar of tax revenues.

So-called cuts in non-defense spending, moreover, are largely illusory. Example: the agreement does not cut Medicare spending, despite the protests from lobbyists for the elderly, but merely reduces the annual rate of increase from 12.6 percent to 11.0 percent. In fact, non-defense spending will increase under the agreement during the first three years at the same rate as that projected under current law.

Only the large real cuts in defense spending made in the budget agreement allow the summiteers to claim a reduced rate of annual spending growth. This would help achieve a spending growth rate significantly below the 6.6 percent annual growth rate of tax revenues projected under current law without any new tax increases. Indeed, under current law, total tax revenues are projected to increase by $397 billion over the next five years.

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The lesson of the budget summiteers' own calculations: No new taxes are needed.

THE OLD DEFICIT CALCULATION METHOD

The budget summiteers' own data show that with continued modest economic growth, in addition to the freeze in defense spending outlined in the budget agreement, the deficit will be cut to $8.4 billion without any increases in taxes. Table 1 shows the pre-budget summit method for calculating the Gramm-Rudman deficit targets: the cost of the savings and loan (S&L) bailout is excluded from the spending levels, and the surpluses generated in the Social Security accounts are included in the revenue levels.

TABLE I
DEFICIT REDUCTION WITHOUT TAX INCREASES
(OLD GRAMM-RUDMAN CALCULATION METHOD)

(Outlays in billions)	1991	1992	1993	1994	1995
Agreed Summit Outlay Levels: S&L Costs Excluded	1263.5	1312.2	1359.6	1396.3	1430.2
Tax Revenues Without A Tax Increase	1121.4	1194.2	1278.6	1363.0	1441.1
Summiteers' Economic Assumptions	30.4	58.4	54.4	35.8	19.3

Lawmakers should note that the budget summiteers show a higher deficit than their calculations might otherwise indicate by including figures in a category labeled "Revised Economic Assumptions." These numbers reflect assumptions about spending growth higher than indicated in initial outlay predictions and lower revenue receipts than is assumed in initial revenue predictions. Policy makers are not told what these numbers represent – they seem little more than a stealth spending agenda hidden in the agreement.

DEFICIT DOWN WITHOUT TAXES

The budget negotiators have added another twist on deficit calculation. The "consolidated" deficit includes the cost of the S&L bailout in total federal spending and the surpluses generated in the Social Security trust funds in total federal revenues (See Table 2).

Using this method to calculate the deficit, the summiteers' own data show that a tax increase is not needed. The deficit can be reduced, without introducing new taxes, to only $15.5 billion by fiscal 1994. A $36.4 billion surplus will be generated by 1995.

TABLE II DEFICIT REDUCTION WITHOUT TAX INCREASES (CONSOLIDATED DEFICIT CALCULATION METHOD)					
(Outlays in billions)	1991	1992	1993	1994	1995
Agreed Summit Outlays: S&L Costs Included	1360.8	1391.8	1380.6	1342.7	1385.4
Tax Revenues	1121.4	1194.2	1278.6	1363.0	1441.1
Summiteers' Adjusted Economic Assumptions	30.4	58.4	54.4	35.8	19.3
Consolidated Deficit	-269.8	-256.0	-156.4	-15.5	+36.4

Table 2 indicates the outlay levels agreed to by the summiteers. These levels reflect the defense spending freeze and the alleged savings in other programs, and they include the cost of the S&L bailout. The revenues cited are the projected revenues before the addition of any new taxes.

NON-DEFENSE SPENDING SOARS

Under the agreement, defense spending is practically frozen at nominal 1990 levels. It is this freeze that slows down the aggregate growth of spending. However, non-defense spending continues to increase rapidly. During the five-year period of the agreement, domestic spending will rise on average by 6.5 percent per year (See Table 3). Despite the so-called spending cuts, non-defense spending actually matches the pre-summit projected spending rates during the first three years of the agreement. There are no cuts in this segment of the budget.

The budget summit agreement also contains a hidden time bomb in the form of the "enforcement provisions," which could lead to even higher spending than the given 6.5 percent annual growth in the non-defense-domestic category. Although the enforcement mechanism "caps" spending increases in these categories at 6.5 percent per annum, these caps effectively could become null and void if the economic assumptions – primarily projected interest and inflation rates and entitlement spending – prove to be inaccurate.

This is likely to be the case. The tax increases in the budget summit plan will trigger a deep economic recession. This means that revenues will drop drastically, and the government will have to pay out more benefits such as unemployment insurance and food stamps. The spending caps will be adjusted upward automatically to absorb the extra spending. Thus with a tax increase stalling the economy, the real rate of growth of non-defense spending under the summit plan will exceed 6.5 percent and probably be closer to 8.5 percent.

TABLE III
SUMMIT AGREEMENT:
GROWTH IN NON-DEFENSE SPENDING

(Outlays in Billions)	1990	1991	1992	1993	1994	1995	Total Spending Increase
Discretionary Non-Defense Spending	185.3	198.1	2120.1	221.7	*	*	$80**
Growth Rate	–	6.9%	6.1%	5.5%	–	–	–
Mandatory Non-DefenseSpending Excluding Interest and S&L Costs	523.2	555.4	592.2	633.6	675.9	715.3	$557.4
Growth Rate	–	6.2%	6.6%	7.0%	6.7%	5.8%	–

*Spending Levels Unresolved by Budget Summit
**Three-Year Total

THE FOUR PERCENT SOLUTION

Congress and the Administration must deal with the budget deficit in a way that does not plunge the country into a recession. If the budget summit agreement outlay targets are enforced, the deficit can and should be reduced without new taxes.

Yet even greater deficit reduction than the summiteers envision can be achieved by controlling spending, without raising taxes, with a so-called Four Percent Solution. This approach would accomplish the goals of the budget negotiators, and would do so with a more even-handed approach to spending control. The three key elements in the solution are:

1) No new taxes;

2) A freeze on defense spending at the levels approved by the budget summiteers;

3) A four percent per year cap on the growth in non-defense spending.

By rejecting tax increases, the Four Percent Solution would avoid both the direct burden to individuals forced to shoulder the taxes and the tax-induced recession that would cause the budget deficit to balloon. The Four Percent Solution would reduce the deficit more rapidly than envisioned under the summit plan by bringing the non-defense spending under control. The Four Percent Solution, however, would not require any cuts in non-defense spending; instead it would allow this spending to increase at roughly the general rate of inflation.

TABLE IV DEFICIT REDUCTION UNDER THE FOUR PERCENT SOLUTION						
(Outlays in Billions)	1990	1991	1992	1993	1994	1995
Defense Spending/Nunn Levels	318.40	315.00	313.40	310.90	310.90	310.90
Discretionary Domestic Spending	185.30	192.71	200.42	208.44	216.77	225.45
Mandatory Spending	523.20	544.13	565.89	588.53	612.07	636.55
Interest	181.40	195.00	196.50	193.40	185.60	174.10
Total Outlays	1208.30	1246.84	1276.21	1301.27	1325.34	1347.00
Baseline Taxes		1121.40	1194.20	1278.60	1363.00	1441.10
Savings And Loan Costs	54.00	97.30	79.60	21.00	-53.60	-44.80
Summit Economic Assumptions		30.40	58.40	54.40	35.80	19.30
4 Percent Solution Consolidated Deficit		-253.14	-220.01	-98.07	+55.46	+119.60
Summit Consolidated Deficit		-253.60	-229.40	-129.40	+16.70	+68.30

Table 4 shows the impact of the Four Percent Solution on the budget deficit. By the third year of this plan, in 1993, total outlays would be $1,301 billion, while revenues – without any tax increase – would be at $1,278 billion. The cost of the S&L bailout and the summiteers' adjusted economic assumptions would bring the total deficit to $98 billion. This compares with a fiscal 1993 deficit of $129 billion under the summit budget plan.

In 1991, 1992, and 1993, the deficit would be lower with the Four Percent Solution than with the summit budget agreement. Thus, given the economic assumptions of the summiteers themselves, by 1994 the Four Percent Solution would produce a robust budget surplus of $55 billion compared to $16.7 billion under the summit budget agreement.

INCREASED ENFORCEMENT

The key to any successful budget agreement is the enforcement mechanism. If Congress can simply ignore its own agreement, then the budget will be out of control. The Four Percent Solution, however, would amend the Gramm-Rudman Deficit Reduction Act to provide a formidable barrier against runaway spending. Among the safeguards:

1) Spending targets would be incorporated into the Gramm-Rudman Act. The outlay targets established in the bill are four percent above the previous year's total outlays, starting with fiscal 1990 as the base year. If Congress exceeds the outlay target, then a sequester would be triggered to bring spending back in line. A sequester would continue to be triggered if the deficit target is not met.

2) A mid-year sequester would be added. The Four Percent Solution establishes a mid-year sequester on April 15, following a March 15 evaluation of the federal government's success or failure in meeting its spending targets. This guards against the introduction of new spending after the current October 15 sequester deadline and the "fudging" of expected revenues.

3) Current services budgeting would be eliminated. Under the four percent proposal, Congress will start the budget process using the last year's spending as the basis for deciding next year's spending. This will bring honesty to the budget process by defining spending increases as increases above the previous year's level, and spending decreases as reductions below the previous years's level.

4) A pay-as-you-go clause in the budget process would be established. Simply stated, this provision ensures that any spending increase is offset by a corresponding spending decrease. And any revenue cuts are offset by spending cuts or revenue increases.

CONCLUSION

The budget summit agreement offers the same old "business as usual" on non-defense spending which increases at a minimum of 6.5 percent per annum. If the growth in non-defense spending were limited to four percent per year and no new taxes were imposed on the economy, the deficit would be reduced even more rapidly and a large budget surplus would be generated by 1994.

The budget summiteers' own data show that a tax increase is not needed to produce deficit reduction. If the budget summit outlay targets were actively enforced without a tax increase, the result would be significant deficit reduction in future years. A tax increase would not lead to further deficit reduction but simply finance higher entitlement spending and, by slowing growth and tax revenue increases, would raise the deficit.

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10/2/90 Number 141

THE BUDGET SUMMIT AGREEMENT: SERIOUS DAMAGE TO THE ECONOMY, PART II

(Updating *Backgrounder Update* No. 140, "The Budget Summit Agreement: Serious Damage to the Economy, Part I," and *Backgrounder* No. 787, "Rx for the Federal Deficit: The Four Percent Solution," October 1, 1990.)

After five months of negotiations, congressional and Administration budget negotiators produced an agreement which can be only described as deplorable. The package combines the largest first-year tax increase in America's history, dubious economic assumptions, phony spending cuts, and inadequate enforcement provisions. At a time when annual economic growth has collapsed to less than one percent, enactment of the agreement surely would throw the nation into recession. Among the most damaging provisions in the agreement are:

NEW TAXES

Tax revenues are already projected to increase by $397.8 billion between 1990 and 1995, an average of $80 billion in new money each year. Apparently this flood of new tax revenues is not enough to quench Capitol Hill's thirst. Thus Congress has demanded and obtained from the budget agreement $133.8 billion in explicit tax increases over the next five years.

Major provisions include a 12 cents per gallon increase in gasoline taxes, 2 cents of which would be levied at the wholesale level, raising more than $50 billion over five years. To make matters much worse, rather than using gas tax revenues for repair and construction of highways and bridges, the agreement undermines the integrity of the Highway Trust Fund by using half of the money for general government spending. This thus opens the sluice gates for future gas tax hikes simply to fund general revenue outlays. Not only is this bad economics, it raises the cost of travel for every American and undermines one of the nation's most prized characteristics: the easy mobility of Americans.

In addition, there are higher taxes on aviation. The air passenger ticket will jump by 25 percent. Domestic air cargo taxes and aviation fuel taxes also will increase by 25 percent. These taxes will take nearly $12 billion from the travelling public. America is a large country with a highly mobile population. Increasing transportation costs has a particularly detrimental impact on the American economy because of the long distances goods are shipped. Consumers will be particularly hard hit, making it more expensive to visit family members and make business trips.

The package also increases tobacco, beer, wine, and alcohol excise taxes, raising $10 billion over five years. What is most alarming about the kind of taxes being raised is that the agreement sets the precedent for a national sales tax by imposing a 10 percent tax on so-called luxury items, raising

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nearly $2 billion. Exactly what constitutes a luxury is defined by Congress. It is certain that Congress will add new items to this list over time. The negotiators pulled a tried and true budget gimmick out of the hat. They claim that through stricter enforcement, the Internal Revenue Service can collect $9.4 billion in new revenues.

In addition to a wide range of taxes on American businesses, the package also destroys the insurance nature of Medicare by raising the cap on income subject to the payroll tax from $51,300 to $73,000. Furthermore, the agreement undermines the protections in the tax code for home ownership, state and local taxation, and charitable deductions by restricting the use of itemized deductions.

The agreement contains more tax increases than meet the eye. In what surely must be a deliberate attempt by the White House and Congress to deceive the public, they are including several tax increases in the "spending cut" portion of the package. The monthly tax that senior citizens pay to Medicare will be increased, but the revenues generated by that change are counted as a spending cut. Seventeen different "fees" are to be increased, generating an additional $14.2 billion in revenue for the government over the next five years, yet this money is to be counted as a spending cut. Nearly $5.4 billion of the supposed five-year spending cuts are actually revenues being transferred to the general budget from the Postal Service, which is now off-budget, resulting in no real savings.

Worse still, the agreement contains an automatic tax increase provision by requiring that any future tax cuts be offset by tax increases. Had it been in effect, this provision would have prevented the enactment of Ronald Reagan's Economic Recovery and Tax Act in 1981. At the very least, this provision effectively eliminates any opportunity to pass tax-cut legislation to pull the economy out of the recession which the budget agreement will cause.

DUBIOUS ECONOMIC ASSUMPTIONS

White House and congressional negotiators agreed to "cook the books" to minimize the obvious negative effects of the agreement. While most economists agree that the package will reduce economic growth, the budget summiteers somehow make the assumption that enactment of the package will nearly double the rate of economic growth next year, from 0.7 percent to 1.3 percent, and almost triple growth in 1992, from 1.3 percent to 3.8 percent.

Herbert Hoover thought tax increases would strengthen the economy in 1930. He was wrong; a recession became a depression. More ominously, the budget agreement would push taxes to nearly 20 percent of Gross National Product (GNP). The only two occasions in peacetime that taxes reached 20 percent of GNP, in 1969 and 1981, the economy fell into recession the following year. A recession is the biggest enemy of the budget deficit: The Congressional Budget Office estimates that the deficit would increase by $32 billion for each percentage point that the unemployment rate is higher than projected.

Negotiators have stated explicitly that they want the Federal Reserve Board to adopt an easy money policy in response to the agreement. Yet they ignore the inflationary impact of such a policy by assuming that the inflation rate, as measured by the GNP deflator, will fall to 2.8 percent by 1995. Since government spending is often tied to the price level, a more realistic inflation estimate would expose how much spending will actually increase compared to what is claimed in the agreement.

Perhaps the most unrealistic element of the package is the assumption that interest rates will decline. More than $64 billion of the alleged savings hinges on the interest rate on three-month Treasury bills falling to 4.2 percent and rates for 10-year Treasury notes dropping to 5.3 percent. Since interest rates normally rise and fall with changes in the inflation rate, this assumption has no credibility.

PHONY SPENDING CUTS

Negotiators are trying to sell the agreement as one of "shared pain." Other than the fact that the defense budget is projected to decline by $8 billion, from $300 billion this year to $292 billion in 1993, there are absolutely no cuts in spending. Even excluding the costs of the deposit insurance bailout, total spending under the agreement will rise by more than $220 billion over the next five years.

Since Congress has violated the spending limits in every previous budget agreement, it is a sure bet that spending actually will climb considerably more than the $220 billion already projected. Once realistic interest rate and inflation rate projections are included, any hope of limiting spending increases to $220 billion disappears. Furthermore, if a recession occurs, as many economists predict, spending on welfare and unemployment programs automatically will rise beyond currently projected levels.

INADEQUATE ENFORCEMENT

If history serves as a guide, the meager budget process reforms included in the agreement will fail to break the chronic cycle of tax and spend. Major reforms were completely rejected.

The package does not include a balanced budget amendment. The President was not granted a line-item veto. The current services budget, the feature that allows the negotiators to pretend they are cutting spending when outlays are actually rising, remains untouched. Minor revisions are made by the agreement to strengthen the Gramm-Rudman Deficit Reduction Act. Yet even with these changes, the law can still be waived by the Rules Committee in the House and by 60 votes in the Senate.

CONCLUSION

In 1982, the Tax Equity and Fiscal Responsibility Act (TEFRA) was enacted with the promise that every dollar of higher taxes would be accompanied by three dollars of spending cuts. The higher taxes became law, but spending actually increased by more than $200 billion over the following three years. This week's proposed budget agreement makes TEFRA look good by comparison.

If enacted, the current agreement is almost certain to push the economy into a recession. What few savings exist on the spending side are almost wholly dependent on unrealistic economic assumptions. The budget agreement effectively repeals Reaganomics and will put an end to the economic prosperity America experienced during the 1980s.

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Backgrounder UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

10/1/90 | Number 140

THE BUDGET SUMMIT AGREEMENT: SERIOUS DAMAGE TO THE ECONOMY, PART I

(Updating *Backgrounder* No. 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

George Bush and Congressional leaders at the budget summit have reached an agreement that will damage the economy very seriously. Among the most damaging aspects of the agreement:

- A huge tax increase that will lower living standards for most Americans. The increase in the gasoline tax is particularly harsh, adding to the hardship that Saddam Hussein has inflicted on the American consumers. The overall tax increase probably will push the United States into a full blown recession.
- Spending continues to rise, despite the misleading claims that spending has been cut drastically.
- The few tax credits for businesses, while not bad in themselves, follow the national industrial policy approach to the economy. Rather than cutting taxes across the board, the government targets particular kinds of investors for special privileges.
- No strong enforcement mechanism. The agreement, for example, does not contain a line-item veto. Where spending increases in popular programs are limited, Congress can (and will likely) restore funds after the full agreement is accepted.

The numbers released by Office of Management and Budget Director Richard Darman are so confusing that few Senators and Congressman can figure out exactly what it is they are being asked to vote on. The agreement is the most successful use of blue smoke and mirrors to date by the budget summiteers. However, a number of facts do stand out:

- In fiscal 1991, total federal spending will still increase by 4.5 percent, or $55 billion, over fiscal 1990 levels, excluding the costs of the S&L bailout.
- By fiscal 1995, total federal spending will be $222 billion higher than fiscal 1990 levels, an increase of 18.4 percent.
- In fiscal 1991, tax revenues were projected to grow by $77.7 billion over fiscal 1990 levels. With the summit agreement raising $16.2 billion in new taxes, total tax revenues in 1991 will be $93.6 billion higher than fiscal 1990 levels.
- Gross National Product is projected to grow by $1.8 trillion during the next five years. This assumption is highly questionable. Even if such growth occurs, the $133.4 billion tax increase will take 7.44 percent of every new dollar of economic growth over the next five years.

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- Defense spending bears 100 percent of the reductions in discretionary spending during the first three years of the agreement. During the first three years, domestic discretionary spending will rise by $23.6 billion, an increase of 12 percent.

MANDATORY SPENDING "CUTS"

A number of the so-called "spending cuts" are nothing of the kind. Examples:

1)**Agriculture Commodity Credit Corporation:** The supposed $1.3 billion cut still represents at least a $700 million increase over fiscal 1990 levels.

2)**Medicare:** Medicare spending will still grow by $4.4 billion in fiscal 1991 even with the $4.6 billion "cut."

3)**Civil Service Lump Sum Elimination:** This does save money in the first year or so, *but* it does little to reduce future liabilities of the Civil Service Retirement System.

4)**Guaranteed Student Loans (GSL):** The summit agreement hopes to accrue $2 billion in savings over five years. This pales in comparison with the $2 billion in GSL losses expected in 1991 alone.

MANDATORY SPENDING "USER FEES"

Most of the "user fees" agreed to in the summit are not user fees in the legitimate sense of the word. For instance, charging nuclear energy companies for the privilege of being regulated is not a user fee, it is a tax.

TAXES

The government currently projects that it will collect an additional $397.8 billion in revenues over the next five years. The budget agreement contains $133.8 billion in explicit tax increases, bringing total new revenues to $428.9 billion. The major new tax provisions include:

- A 12 cents per gallon increase in gasoline taxes (2 cents of which would be levied at the wholesale level);
- An increase in tobacco, beer, wine, and alcohol excise taxes;
- A 10 percent tax on so-called luxury items, which, in effect, is the first phase of a national sales tax;
- Changes in the tax code increasing taxes on American businesses;

Among the problems with the tax increases:

- The package destroys the insurance nature of Medicare. Specifically, it raises the cap on income subject to the payroll tax from $51,300 to $73,000. This is a direct tax on earnings. Nothing dampens an economy more than such a tax.

- The agreement undermines the protections in the tax code for home ownership, state and local taxation, and charitable deductions by restricting the use of itemized deductions.

There are many hidden tax increases in the agreement. Several of these are under the "spending cut" portion of the package. For example:

- The monthly tax that senior citizens pay to Medicare will be increased; yet the revenues generated by that change are counted as a spending cut.
- Seventeen different fees are to be increased, generating an additional $14.2 billion in revenue for the government over the next five years; yet the revenue is to be counted as a spending cut.
- Nearly $5.4 billion of the supposed spending cuts are actually revenues from the Postal Service, which is now off-budget, resulting in no real savings.
- The agreement contains an automatic tax increase provision. Thus every tax cut must be offset by tax increase. At the very least, this provision effectively eliminates any opportunity to pass tax-cut legislation to pull the economy out of the recession which the budget agreement will cause.

ECONOMIC ASSUMPTIONS

White House and congressional negotiators conspired to "cook the books" to minimize the obvious negative effects of the agreement. While most economists agree that the package will reduce economic growth, the budget summiteers somehow make the assumption that enactment of the package will nearly double the rate of growth next year (from 0.7 percent to 1.3 percent) and almost triple growth in 1992 (from 1.3 percent to 3.8 percent).

Negotiators have explicitly stated that they want the Federal Reserve Board to adopt an easy money policy in response to the agreement, yet they ignore the inflationary impact of such a policy by assuming that the inflation rate (as measured by the GNP deflator) will fall to 2.8 percent by 1995. Perhaps the most unrealistic element is the assumption that interest rates will decline. More than $25 billion of the alleged savings hinges on the interest rate on three-month Treasury bills falling to 4.2 percent and rates for 10-year Treasury notes dropping to 5.3 percent. Since interest rates normally rise and fall with changes in the inflation rate, this assumption has no credibility.

CONCLUSION

As it stands, the budget agreement is the same old blue smoke and mirrors that have blinded taxpayers for years. The American taxpayer should not shoulder the burden of higher spending just because Congress cannot control the budget. Before any decisions are made on this agreement, the summiteers and Congressman must be clear about the true nature of this proposal: It will damage the economy very seriously.

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RUSH!

Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

9/21/90 Number 281

THE FOUR PERCENT SOLUTION TO THE DEFICIT IMPASSE

Whether the current budget summit yields an agreement on the federal budget deficit or not, the negotiations graphically demonstrate that the federal government's budget process has broken down completely. Congress currently is set to spend the $79 billion it will receive next year in new revenues—and more—rather than using these funds to reduce the budget deficit. Indeed, over the last decade, every dollar in new revenues has been accompanied by more than a dollar of new spending. And the budget summit, which was meant to bring congressional and Bush Administration leaders together behind closed doors to work out an agreement to cut the deficit, has yielded almost nothing but calls for higher taxes. Now the economy is showing disturbing signs of a possible recession, due in part to the spectacle of a government unable to control its spending but eager to raise taxes.

Rather than taking more money out of productive enterprises and the pockets of American consumers, which could guarantee a recession, many policy makers are rallying around a proposal that rejects higher taxes and instead reduces the budget deficit by limiting total annual spending increases to 4 percent.

With federal revenues already projected to climb by $79 billion next year, and by $373 billion over the next five years, this "Four Percent Solution" would reduce the budget deficit to only $33 billion by 1995, and produce a balanced budget soon after (see table).

THE FOUR PERCENT SOLUTION
(in $billions)

Year	1990	1991	1992	1993	1994	1995
Spending*	1,192	1,240	1,289	1,341	1,394	1,450
Revenues	1,044	1,123	1,188	1,260	1,337	1,417
Deficit	148	117	101	81	57	33

*Assumes Congress will take the costs of the Savings and Loan deposit insurance bailout off-budget.
Source: Congressional Budget Office

This cap on spending growth still would allow policy makers to spend more on all programs—or even increase spending well over 4 percent for some programs if they cut back or terminate others.

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And perhaps more important, by precluding higher taxes, the Four Percent Solution will leave more resources in the productive private sector of the economy, making a recession less likely.

Yet this, or any other budget proposal, still will fail unless there are stronger enforcement mechanisms to prevent Congress from violating spending limits – as it has done routinely. The Four Percent Solution thus should include tough major budget process reforms. In particular, Congress should:

1) **Establish Gramm-Rudman Outlay Targets.** Under the Gramm-Rudman Deficit Reduction Act, spending automatically is cut across the board, or "sequestered," if the projected deficit exceeds the Gramm-Rudman target deficit. Lawmakers, however, can evade the law's intent simply by over-estimating projected revenues, thereby permitting even larger spending increases. Once it becomes apparent that the revenue projections were inaccurate, the sequester has already passed.

Establishing outlay or spending targets should eliminate this loophole. Under this approach, the current deficit targets would be augmented by outlay targets. Whenever projected spending in any fiscal year was above the target level permitted in the law, sequestration would be triggered to bring outlays back down to the legally required level.

2) **Create a Second, Mid-Year Sequester.** Even with outlay targets, however, politicians still would have an incentive to underestimate future spending in order to make program expansions and new spending legally possible. Congress could also continue its practice of waiting until after the October 15 sequester deadline passes to enact expensive spending bills.

These loopholes could in large part be closed by creating a second sequester in the middle of the fiscal year. If a mid-year estimate showed that spending was exceeding the new outlay target, automatic cuts would reduce spending by the necessary amount. Such a reform would give Congress less leeway to exceed its own targets.

3) **Abolish Current Services Budgeting.** Much of the public confusion surrounding the entire budget debate is caused by Congress's bizarre definition of a budget "cut" – legislating a reduction in a projected increase. Thus according to Congress's version of a cut, if a businessman raised his prices 15 percent instead of the 25 percent he had intended, that would be a price cut of 10 percent. This phony accounting system, known as the "current services budget," distorts honest debate and builds political pressure for higher spending.

Other proposals before Congress would further tighten the budget process. Among them: "pay-as-you-go budgeting," which would require new spending increases to be offset by reductions elsewhere in the budget; super-majority votes to raise taxes or violate Gramm-Rudman targets; a line-item veto; and a constitutional amendment to limit taxes and maintain a balanced budget. After tightening the Gramm-Rudman law, Congress should give urgent attention to such proposals.

The Four Percent Solution, enforced by budget process reforms, would help reignite strong economic growth by bringing the stubborn budget deficit finally under control. Spending control is the tool to curb the deficit. Tax increases are not. Tax increases approved by budget summits were tried in 1982, 1984, 1987, and 1989. In each case, the budget deficit increased the following year. Tax revenues now consume almost 20 percent of America's gross national product (GNP) – a near-record high for peacetime. Ominously, the only two times outside of World War II that tax collections have exceeded 20 percent of GNP, in 1969 and 1981, the economy fell into a recession the following year. The Four Percent Solution, backed up with reforms to tighten the budget process, would avoid the recession tripwire, allowing Americans to look forward to declining federal deficits and robust economic growth.

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The Heritage Foundation Backgrounder

No. 788 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

The Thomas A. Roe Institute for Economic Policy Studies

September 5, 1990

A SIX-PLANK PLATFORM TO SAVE THE ECONOMY FROM RECESSION

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INTRODUCTION

Many economists, political analysts, and media commentators are now telling Americans that the economy is heading for a recession. Although the current economic expansion is the longest in America's peacetime history, the economy has struggled with anemic growth of just over one percent in the past nine months. While politicians will try to blame everything and everyone from Saddam Hussein to the business cycle for the looming economic hard times, any recession that occurs should be stamped with the label, "Made in Washington, D.C."

The lesson that policy makers should have learned from the last two decades is that bad economic conditions are mainly the result of bad government policies. In the 1970s, high taxes, wasteful spending, inflation, and excessive regulation combined to produce stagflation. As a result of the weak economy, fewer jobs were created, many businesses went bankrupt, and families suffered. In the 1980s, by contrast, tax cuts, an improved monetary policy, and deregulation helped spark the current economic expansion and the greatest burst of job creation in American history.

Deadly Economic Mix. So far, the 1990s have resembled the 1970s with regard to government economic policy. In the current session of Congress, legislators have increased the minimum wage, enacted new regulations that enormously increase the costs of doing business, and appropriated huge increases in domestic spending. Still to come is the so-called Clean Air Act, a

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new bill to promote racial quotas, a massive child care entitlement program, and a record tax increase – a deadly mix even to a strong economy.

America's longest peacetime period of economic growth need not come to an end. The right combination of policies could restore and extend the expansion. To stave off recession and boost economic growth, George Bush and Congress should adopt a Six-Plank Platform.

Plank #1: Encourage more savings and investment by reducing the capital gains tax to 15 percent;

Plank #2: Increase incentives for working Americans by reducing the Social Security payroll tax burden;

Plank #3: Leave more financial resources in the productive sector of the economy by strictly limiting annual increases in federal spending to four percent;

Plank #4: Restore economic confidence immediately by announcing that tax increases are "off the table";

Plank #5: Strengthen American competitiveness by removing barriers to savings and investment in the tax code; and

Plank #6: Ease the regulatory burden on business and spur more job creation by eliminating those provisions of the Clean Air Act and the Civil Rights Act that retard economic growth.

STUMBLING TOWARD RECESSION

The economy indeed is weakening. The annual rate of growth was only 0.3 percent in the last quarter of 1989, 1.7 percent the first quarter of 1990, and an estimated 1.2 percent for second quarter of 1990. The Index of Leading Economic Indicators, used by forecasters to predict future economic performance, has risen only 0.7 percent since January. After flirting with the 3000 level in early June, the stock market has steadily declined, beginning even before the Persian Gulf crisis. Other economic indicators show similar sluggishness.

Despite the mounting evidence of impending recession, the Administration appears reluctant to support a comprehensive pro-growth agenda. Indeed, on fiscal policy issues, the Bush Administration has become part of the problem. Largely at the urging of Budget Director Richard Darman and Treasury Secretary Nicholas Brady, the White House is calling for a combination of high-tax austerity and an inflationary easy money policy on the part of the Federal Reserve Board. Eerily, this is the formula Jimmy Carter used to create the stagflation of the late 1970s.

DEFICIT HYSTERIA LEADING TO WRONG CONCLUSIONS

Notwithstanding the evidence of the past ten years, Brady in particular apparently believes the economy's performance is inextricably tied to the budget deficit. As a result, he and Darman are urging Bush to accept a tax increase even though there is no evidence or reason to believe Congress would use the money for deficit reduction.

Deficit spending is an important concern, but it is just one of many variables that influence economic growth. The deficit, moreover, is a symptom, not the disease. Federal spending is the problem. Regardless of whether it is financed by taxes or borrowing, federal spending consumes resources that could be better used by the productive sector of the economy. While it may shift the burden, replacing spending financed by borrowing with spending financed by taxes does not help the economy.

Nor is the deficit as much of a crisis as the Administration and some members of Congress suggest. Even under a worst-case scenario, it is unlikely that the deficit will be more than 3 percent of gross national product (GNP) this year and next. This is considerably below the 1983 deficit of 6.3 percent of GNP, the 1985 deficit of 5.4 percent of GNP, and the 1987 deficit of 3.4 percent of GNP. If a budget deficit equalling 3 percent of GNP threatens the economy today, the economy should have collapsed in those previous years when the deficit was a much larger share of GNP. Obviously, the deficit by itself does not determine the health of the economy.

TOO MUCH GOVERNMENT EQUALS RECESSION

It is not just a coincidence that the economy's slide is occurring as policy makers are increasing government intervention in the economy. If government takes an ever greater amount of resources out of the productive sector of the economy and adds numerous additional costs and regulations, economic growth inevitably is reduced. Consumers will have less after-tax income to spend. Because they may fear unemployment, many consumers are reluctant to make big-ticket purchases like houses, automobiles, and major appliances. Companies postpone investments in new plant and equipment. Reduced consumer spending may force businesses to lay off employees, and it is almost certain that few new jobs will be created.

Just as unwise economic policies produced recession and stagflation in the late 1970s and early 1980s, the recent enactment of unsound policies and the consideration of additional anti-growth policies has increased the possibility of a recession in the near future.

INFLATION IS NOT THE ANSWER TO RECESSION

Treasury Secretary Brady apparently believes rekindling the inflationary policies of the late 1970s is the best way to save the economy from recession. He seems to forget that Carter's high tax and inflation recipe in the late 1970s produced 18 percent inflation, 21 percent interest rates, record drops in inflation-adjusted family incomes, and recession.

Brady has been especially active in urging the Federal Reserve Board to lower the value of the dollar, apparently in the belief that inflation will reduce interest rates. Lower interest rates would help the economy, but the only way to lower interest rates permanently is for the Federal Reserve Board to eliminate inflation entirely so that lenders no longer feel a need to add an "inflation premium" to the interest rate they charge borrowers. Devaluing the dollar, as Brady is demanding, would push interest rates higher in the medium and long term by sparking a resurgence of inflation.

The Administration's pro-inflation policy could not come at a worse time. After hovering around 4 percent for a number of years, inflation has jumped to nearly 6 percent. Mainly due to fears of higher inflation, interest rates on 30-year bonds have climbed about one-half of a percentage point in the past two months alone. If the Federal Reserve Board succumbs to White House pressure and adopts an easy money policy, interest rates will rise dramatically, choking off economic growth and opportunity. If there is a recession, truth in labelling would require that it be called the "Brady Recession."

A PRO-GROWTH AGENDA FOR AMERICA'S FUTURE

What does affect the health of an economy is the overall level of government spending and the full extent and nature of government intervention. Understanding this, the recent slowdown in the economy is no mystery. The good news is that this understanding also means that a recession need not occur. With the right policies, robust economic growth can be restored. Or, if a recession already exists, the right policies can end it quickly. These policies comprise a Six-Plank Platform for Economic Growth.

Plank #1: Cut the Capital Gains Tax.

Senator Robert Kasten of Wisconsin and Representative Mickey Edwards of Oklahoma, both Republicans, have introduced legislation to reduce the capital gains tax to 15 percent for all assets. Their legislation also would index this rate for inflation, protecting savers and investors from paying taxes on purely nominal gains. According to Allen Sinai, Chief Economist for the Boston Company, reducing the capital gains tax to this level would raise GNP by 0.4 percent annually through 1995, add 2.5 million new jobs, and generate an additional $30 billion to $40 billion of new tax revenues over the next five years. Business investment would increase by 1.3 percent annually if the capi-

tal gains tax were reduced, and the after-tax cost of capital for American firms would fall by more than 4 percent per year.

Plank #2: Reduce the Social Security Payroll Tax.

Several legislators have introduced legislation to reduce the burden of Social Security taxes. The two most promising bills have been introduced in the Senate by Daniel Patrick Moynihan, the New York Democrat, and by Wisconsin's Kasten. The federal government now collects over $50 billion more in Social Security taxes annually than is being paid out in benefits. This surplus is being spent on other government programs. Rather than using Social Security taxes to pay for other programs, the tax should be reduced. Perhaps more than any other tax, the payroll tax is a direct levy on jobs. According to Fiscal Associates, Inc., a Washington-based consulting firm specializing in the economic effects of tax policy, cutting the Social Security payroll tax by 2.2 percentage points would spur GNP growth by an additional 0.3 percent by 1993, and create 500,000 new jobs. By the end of the decade, Fiscal Associates project that real economic growth would be 0.6 percent higher annually and the economy would create a total of 900,000 more jobs.

Plank #3: Cap Government Spending Growth.

While deficit spending by itself will not throw the economy into recession, ever-increasing federal spending consumes too much of the nation's resources. After increasing by nearly 10 percent annually the first half of the 1980s, spending growth slowed to about 4 percent annually after the enactment of Gramm-Rudman-Hollings Deficit Reduction Act in 1985. This modest achievement of fiscal responsibility, however, has seemingly evaporated. For the first nine months of the 1990 fiscal year, federal spending has been more than 10 percent higher than it was in the same period last year. This spending jump is the cause of the current deficit problem. The best way to solve the problem thus is to limit the future growth of federal spending. The Office of Management and Budget estimates federal tax collections will rise by nearly $400 billion over the next five years under current law. Limiting the growth of spending to 4 percent would allow a significant amount of those new tax revenues to be used for deficit reduction.[1]

Plank #4: Take All Tax Increases "Off the Table."

With the economy already teetering, a tax increase would push it off the edge. The budget summit, supposedly initiated to restore economic confidence actually is undermining the economy by raising the specter of higher taxes. Like a Sword of Damocles hanging over the economy's head, the threat of tax increases is eroding business confidence and throwing financial markets into uncertainty. A strong announcement by the President and other

1 See Scott A. Hodge, "Rx for the Federal Deficit: The Four Percent Solution," Heritage Foundation *Backgrounder* No. 787, September 4, 1990.

political leaders that tax increases are unacceptable would send the positive message to consumers and businesses that Washington is not going to deprive them of any more of their earnings.

Plank #5: Remove Tax Barriers to Savings and Investment.

Reducing the capital gains tax will increase savings and investment. So will expansion of the once very popular Individual Retirement Accounts (IRAs). All working Americans should be allowed to contribute up to $2,000 per year for themselves and $2,000 for their spouse into an IRA; their taxable incomes would be reduced by the amount of these contributions. The maximum contribution that is allowed should be increased annually at the rate of inflation. To increase IRA flexibility, Americans should be allowed to borrow against their IRAs to buy homes for themselves or their children.

Also prompting more investment will be elimination of the tax code's bias against spending on new plant and equipment. Properly defined, taxable profits should be the difference between total costs and total revenues. One of the costs for businesses is new investment. Under the current tax code, however, a business cannot subtract the full cost of investments greater than $10,000 from total revenues to determine yearly profits. Representative Nancy Johnson, the Connecticut Republican, has proposed legislation to raise the amount of investment that can be deducted from a business's tax liability annually from $10,000 to $250,000. By lowering the cost of investment, Johnson's legislation would spur business expansion and job creation.

Plank #6: Drop Consideration of Costly Regulatory Legislation.

Congress and the Administration already have added a heavy regulatory burden to the economy in the past two years. This will be increased greatly by the pending Clean Air Act and the Civil Rights Act. Both would impose heavy costs on the economy. The Clean Air Act makes no effort to balance costs and benefits and relies on centralized government dictates rather than market incentives to improve air quality. The Civil Rights Act, rather than promote equality, would force businesses to adopt racial quotas under the threat of costly litigation. The President should announce unambiguously that both bills will be vetoed if they reach his desk.

BUDGET IMPACT OF A PRO-GROWTH PACKAGE

The main goal of an anti-recession, pro-growth tax cut package is economic growth, not deficit reduction. Nonetheless, the revenue loss from reducing payroll tax rates will be offset by already projected increases in tax revenues, new monies generated by the capital gains tax cut, and the budgetary savings realized by capping spending growth at 4 percent.

Most important, this pro-growth package would prevent or cut short the biggest budget-buster of all: a recession. Even a mild recession could push the deficit above $300 billion.

The Office of Management and Budget estimates tax collections over the next five years, under current law, as follows (in $ trillions):

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues	1.044	1.122	1.195	1.279	1.363	1.441

Cutting the capital gains tax rate to 15 percent would increase tax revenues by $30 billion to $40 billion over five years according to Allen Sinai's thorough estimates. Assuming the legislation would generate $35 billion, spread evenly over five years, federal tax collections would be (in $ trillions):

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues	1.044	1.129	1.202	1.286	1.370	1.448

According to the Congressional Budget Office's static revenue estimates, both the Moynihan and Kasten Social Security payroll tax cuts would reduce revenues. Some of the revenue loss doubtless would be offset by higher economic growth, as predicted by Fiscal Associates, Inc. Assuming, however, no offset, the impact on future tax collections from both the Moynihan and Kasten legislation are (in $ billions):

Fiscal Year	1991	1992	1993	1994	1995
Moynihan	-6.6	-16.7	-28.1	-40.9	-55.3
Kasten	-9.2	-23.2	-39.1	-45.8	-48.8

If the Moynihan legislation passes, actual tax collections over the next five years, including the reduction in the capital gains tax, would be (in $ trillions):

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues	1.044	1.122	1.185	1.258	1.329	1.393

The Office of Management and Budget estimates total fiscal 1990 spending, excluding the one-time expense of purchasing insolvent Savings and Loans, will be $1.2077 trillion. A complete spending freeze at this level combined with Social Security and capital gains tax cuts would produce a budget surplus of $50 billion by 1993. A complete spending freeze, however, probably is politically impossible. The more modest approach would be to cap federal spending at four percent annual growth. While this Four Percent Solution would not balance the budget until sometime between 1995 and 2000, the deficit would certainly cease to exist as an economic problem in just a few years.

Pro-Growth Four Percent Solution
($ billion)

Fiscal Year	1990	1991	1992	1993	1994	1995
Revenues $	1044	1122	1185	1258	1329	1393
Spending	1208	1256	1306	1358	1413	1469
Deficit	164	134	121	100	84	76

To accomodate the "Four Percent Solution," the Gramm-Rudman-Hollings targets would be charged to reflect the projections above. Policy makers already have agreed to revise current deficit targets. Changing them to reflect a package that could save the economy from recession as well as put the country on a path to a balanced budget would be the soundest approach.

The budget figures also would have to be changed to accomodate legislation expanding IRAs and increasing the amount of investment expenditures that businesses can expense deduct from their income for tax purposes. The magnitude of the change would depend on the extent of the final legislation. Policy makers could choose to offset the revenue loss by reducing how fast federal spending could increase, thus balancing the budget on the same schedule. Alternatively, they could simply adjust the new Gramm-Rudman-Hollings targets by the appropriate amount and reach a balanced budget one or two years later.

CONCLUSION

With the American economy possibly heading for recession, lawmakers must set aside traditional special-interest politics. The record economic growth that began in 1982 is no accident. It is the result of tax cuts, stabilized monetary policy, and reduced government intervention in the economy. It is also no accident that the economy is softening as policy makers retreat from the market-oriented policies that characterized the 1980s.

The way to stop a recession or to reduce its severity is to return to policies that promote economic growth. America needs tax cuts, not tax increases. Rather than return to the fiscal policies of the 1970s, federal spending growth must be limited to 4 percent. Instead of punishing new investment, the tax code should reward expenditures on new plant and equipment. Similarly, the anti-savings bias in the tax code should be eliminated. Expensive new regulations need to be shelved in favor of legislation that strengthens American competitiveness.

People, Not Numbers. The stakes are enormous. The economy is not numbers, it is people. When growth falters, people lose their jobs. When the economy slows, entrepreneurs see their businesses fail. When the stock market falls, millions of people's pensions lose value. More than any other group, it is the poor who suffer most. The record job creation of the 1980s disproportionately benefitted women, minorities, and the poor. They would be the ones who bear the brunt of a recession.

For that reason, if no other, policy makers must put aside their traditional differences and enact a bi-partisan Six-Plank Economic Growth Package.

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The Heritage Foundation Backgrounder

No. 787 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

September 4, 1990

Rx FOR THE FEDERAL DEFICIT: THE FOUR PERCENT SOLUTION

INTRODUCTION

George Bush has lost the first round of the budget summit negotiations with congressional leaders. After five months of negotiations and even his offer to renege on his no-new-tax pledge, the President has expressed his frustration at the failure of Democrats to offer a serious plan and says he will veto budget-busting spending bills.

Bush need not lose the second round of budget talks when Congress returns from its summer recess. At the summit table Bush should offer congressional negotiators a choice: accept a "Four Percent Solution" budget plan that would lead to a balanced budget by 1997 by limiting spending increases to four percent per year, or face the "sequester" cuts imposed by the Gramm-Rudman-Hollings budget law to bring the deficit down to next year's required $74 billion target. Bush must let Congress and the American people know that the country can survive with a budget sequester and not let big spenders use scare stories about the danger of such an action as an excuse for higher taxes.

Calling Congress's Bluff. With the crisis in the Persian Gulf and with congressional elections only a few months away, Bush holds all the trump cards. If he is willing to play them and to call Congress's bluff, he can win a budget deficit reduction agreement and still keep his pledge not to raise taxes.

As negotiations to reduce the budget deficit failed to produce an agreement during the spring, the White House attempted a three-part strategy to break the stalemate. First, Bush accepted the advice of Budget Director

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Richard Darman and Treasury Secretary Nicholas Brady to reverse his campaign pledge of "no new taxes." The result: No budget deal, and a succession of spending bills passed by the House of Representatives that will send fiscal 1991 spending levels more than 11 percent over fiscal 1990 levels.

Second, the Bush team crafted a package to increase excise taxes on beer and other items. The result: No budget deal, and no comparable budget proposal from the liberal congressional negotiators. Instead, Bush was criticized by the scores of groups that would be hit by the new taxes.

Third, in his mid-session review of the budget, Darman turned to scare tactics. He warned that a $100 billion sequester would cut off essential services to the American people. The result: Still no budget deal, nervous tremors rippled through financial markets, and many people began to talk seriously of an impending recession.

Return to Basics. To gain the upper hand in the second round of negotiations, Bush must recognize that the Darman/Brady strategy has failed. In place of it, Bush should return to the conservative basics: reducing the tax burden on Americans and limiting the growth of government.

He should tell the American people that for the past decade members of Congress have been talking about "solving" the deficit problem while, at the same time, going on a spending spree which has consumed the hundreds of billion of dollars in new tax revenues which were being collected.

He should tell the American people that now is the time to slow this spending binge.

He should propose that starting in fiscal 1991, which begins this October 1, Congress be allowed to increase total federal spending by only four percent over the previous year's levels. He should explain that by limiting congressional spending increases to a generous four percent a year for the next six years, the budget will be balanced by fiscal 1997.

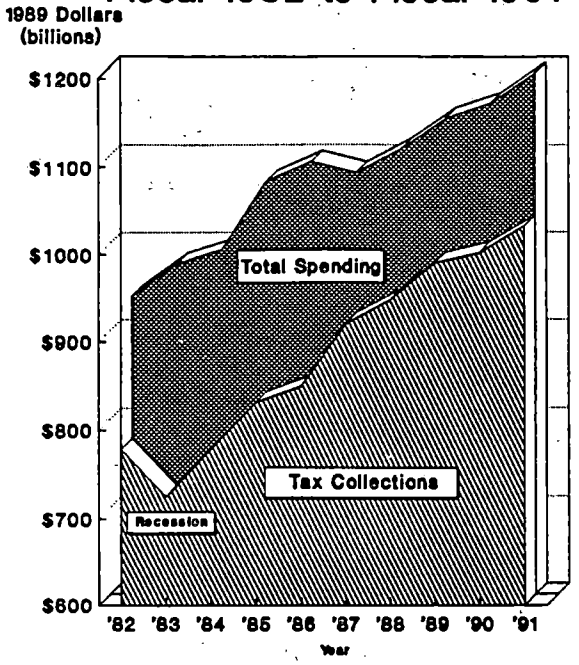
Essential Services Secure. He should announce that if Congress does not accept this Four Percent Solution, then he will allow the budget-cutting ax of the Gramm-Rudman-Hollings sequester to fall on all spending, cutting $100 billion from the budget. He should assure Americans that this will not cut essential services such as Social Security. But it will fall hard on government workers and big-spending liberals who will have to explain to the voters why they cannot hold spending increases to four percent per year.

Bush's message to America, as the budget summit reconvenes, should be unambiguous: The time for budget games is over, the time for the federal government to live with a four percent annual spending increase has come, and if the time comes for Bush to invoke the automatic cuts of a sequester, he will not flinch.

SPENDING IS OUT OF CONTROL

Advocates of higher taxes maintain that only new revenues can reduce the budget deficit. Experience teaches, however, that new revenues do not reduce deficits. From fiscal 1982 to fiscal 1991, for example, aggregate federal tax revenues grew annually by roughly 3.3 percent above the rate of inflation. Over this period, this brought in an extra $254 billion in revenues, after adjusting for inflation. What happened to this quarter-trillion dollars? Congress did not use it to reduce the deficit; Congress spent it dollar-for-dollar. During fiscal years 1982 to 1991, aggregate federal spending grew annually by roughly 2.7 percent over the inflation rate, or an inflation-adjusted total of $255 billion.

Spending and Tax Collections Fiscal 1982 to Fiscal 1991



1990-1991 does not include S&L Bailout HeritageDataChart

Fiscal Year	Total Spending	Change/ Previous Year	Total Revenues	Change/ Previous Year	Deficit
1982	939.35	-----	778.24	-----	161.11
1983*	976.18	36.83	725.34	-52.90	250.84
1984**	992.77	16.59	776.80	51.46	215.97
1985**	1070.17	77.40	830.19	53.39	239.98
1986	1093.48	23.31	849.24	19.05	244.24
1987	1080.79	-12.69	919.60	70.36	161.19
1988	1107.94	27.15	946.50	26.94	161.40
1989	1142.60	34.66	990.70	44.16	151.90
1990***	1159.50	16.90	1002.03	11.33	157.47
1991***	1194.06	34.56-	1031.96	29.93	162.10
	Total	$254.71	Total	253.72	

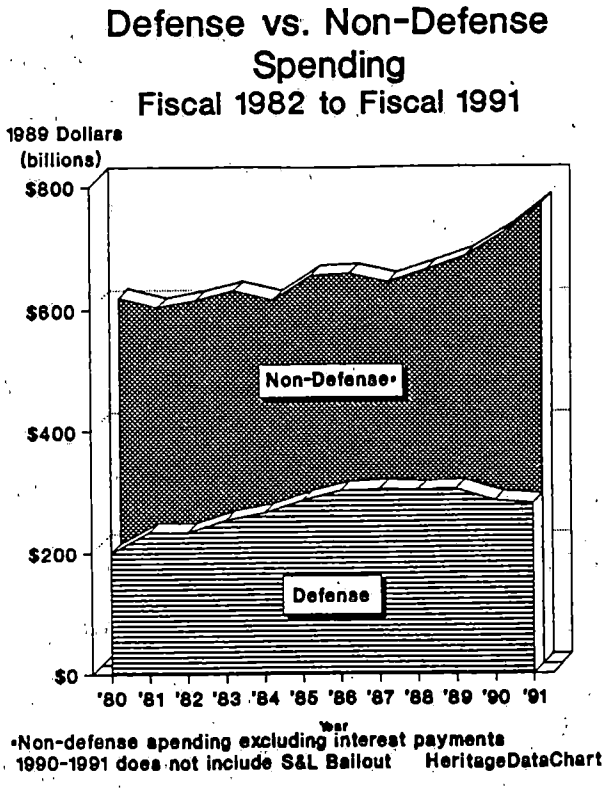
* Fiscal 1983: Recession Lowers GNP.
** Fiscal 1984 and 1985: The tax cuts of 1981-1984 boost the economy.
*** Fiscal 1990 and 1991: Does not include the S&L Bailout.

Some critics charge that the budget deficit is the result of Ronald Reagan's rebuilding of the American arsenal, a policy now vindicated by the speed with which the U.S. is deploying massive forces to the Persian Gulf. Yet, defense spending accounts for only 18 percent, or $45 billion, of the ten-year, $255 billion real increase in spending. Since 1988, moreover, defense spending actually has gone down in real terms by 7.7 percent, a reduction of $23 billion. These savings were more than offset by real increases in non-defense spending. (See chart on page 4.) Excluding interest payments on the national debt, non-defense spending has risen in inflation-adjusted terms by $106 billion since 1988, an increase of nearly 17 percent.

The budget deficit thus has not been due to lack of revenue nor to high defense spending. New revenues have been rolling in for a decade. The problem has been that Congress spends every new dollar. And most of this is on wasteful pork barrel programs.

MISSED OPPORTUNITIES

With the economy deep in a recession, the federal deficit jumped to $127 billion in fiscal 1982. This was 4.1 percent of gross national product (GNP), the greatest post-World War II share except for the 4.8 percent in 1948 and the 4.3 percent in 1976. Worse yet, total federal spending in fiscal 1982 was at 23.8 percent of GNP, the highest level since 1944, and federal taxes were at 19.7 percent of GNP, the third highest level since 1945.



As bad as that was, the U.S. could have lived with the 1982 level of spending. If Congress had controlled its spending habits that year, and simply kept annual growth of federal spending to the rate of inflation, the subsequent growth in tax revenues would have eliminated the deficit by fiscal 1988 and created a $92 billion surplus by fiscal 1991. Obviously, the deficit was not erased by 1988. Instead, the deficit was $161 billion – the same inflation-adjusted deficit level it was in 1982.

Second Chance Wasted. Though Congress missed the opportunity in 1982 to cap spending at the rate of inflation, it had a second chance in fiscal 1988. Increased tax revenues since then would have reduced the deficit to $75 billion by fiscal 1991 – only $1 billion above the Gramm-Rudman-Hollings deficit reduction target. And this would have created a $13 billion surplus by fiscal 1994. Instead, the inflation-adjusted fiscal 1991 deficit is expected to be about $162 billion – again, roughly the same as the 1982 deficit and the 1988 deficit.

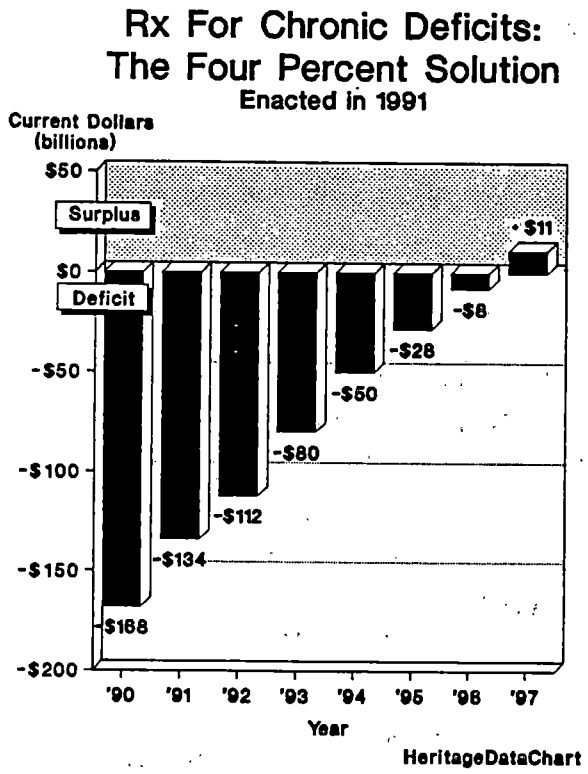
The hundreds of hours that budget negotiators have been spending in their "summit" deliberations this year could have been avoided had Congress not spent every new dollar of tax revenues generated by economic expansion resulting from the Reagan tax cuts of 1981 through 1984. The only check on this ten-year spending spree has been the Gramm-Rudman-Hollings budget law, which sets deficit targets each year and mandates automatic cuts if the

targets are not met. According to Heritage Foundation Economist Daniel J. Mitchell, federal spending today would be $300 billion greater than it is had Gramm-Rudman-Hollings not slowed the nominal 9.9 percent increase of congressional spending from 1980 to 1985.[1] The annual pace of spending increases slowed to 4.8 percent after Gramm-Rudman-Hollings went into effect in 1986.

THE FOUR PERCENT SOLUTION

The past ten years demonstrate that raising taxes does not eliminate the federal budget deficit. Raising taxes merely prompts Congress to raise government spending. What is required to eliminate the federal deficit is to hold the growth in overall federal spending at, or near, the rate of inflation. Bush should offer just such a plan at the budget summit as the most effective and reasonable way to reduce the deficit.

To be sure, it is difficult to predict future inflation rates. But since inflation in recent years has been averaging roughly four percent, it is reasonable to assume that aggregate federal spending would keep up with inflation if the spending grew annually at four percent. Among other things, this would create an incentive for the federal government to hold down inflation. If inflation goes above four percent but spending is held at that level, the government will find that its revenue buys less and will be forced to cut programs.



From Deficit to Surplus. If a "Four Percent Solution" is prescribed for fiscal 1991 and beyond, this medicine will eliminate the deficit by the end of fiscal 1996, and create an $11 billion surplus at the beginning of fiscal 1997. (This does not include the cost of paying for the S & L cleanup nor does it account for changes in tax policies.)

This "Four Percent Solution" requires more time than envisioned by the original Gramm-Rudman-Hollings timetable. Thus the timetable will have to be revised as follows:

1 Daniel J. Mitchell, "Save the Gramm-Rudman Sequester," Heritage Foundation *Backgrounder* No. 763, April 3, 1990.

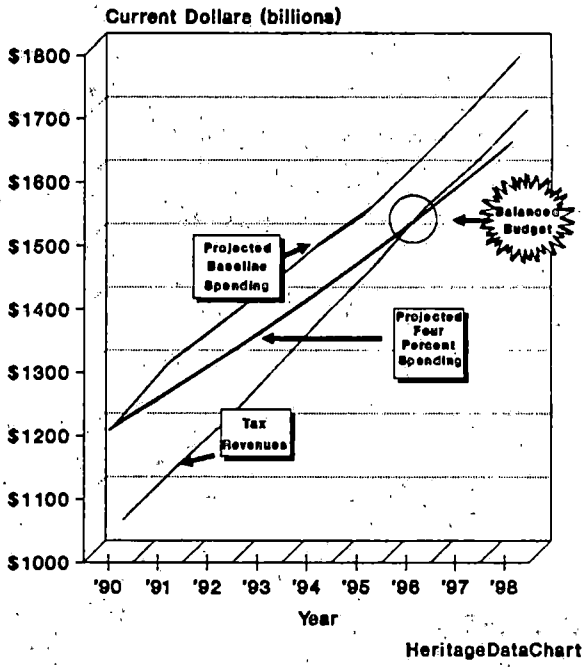
The Four Percent Solution Timetable

	1991	1992	1993	1994	1995	1996	1997
Current Dollars (billions)							
Deficit	-$134	-$112	-$80	-$50	-$28	-$8	+$11
% GNP	2.25%	1.7%	1.16%	0.68%	0.36%	0.09%	-----
Constant 1989 Dollars (billions)							
Deficit	-$124	-$99	-$68	-$41	-$23	-$6	+$28
% GNP	2.25%	1.7%	1.16%	0.68%	0.36%	0.09%	-----

Because the economy generates increased tax revenues just about all the time, the "Four Percent Solution" allows about $50 billion in new spending each year. Lawmakers can distribute this "pool" of money throughout the budget as they wish to offset inflation, to fund new programs, or increase spending for different programs. This would have the healthy effect of forcing members of Congress to set budget priorities.

This approach would require the federal government to abandon its present method of "baseline budgeting." Under this approach, introduced in the 1974 Budget Act, spending for each program automatically increases by a projected rate of inflation and projected program growth. This automatic increase creates the new baseline for the program. So doing, it enormously distorts budget calculations and confuses the public discussion of spending. Example: a program that costs $100 million in one year might be projected by the baseline budgeting method to receive $110 billion the following year. If Congress appropriates $105 million for the program, this is recorded as a $5 million "cut" by the baseline method. In fact, of course, this is a $5 million dollar increase.

The Four Percent Solution Compared to Baseline Spending



The baseline budgeting charade is the reason why federal spending soared in the 1980s despite all the claims of spending cuts. Congress, and lately the President's Office of Management and Budget, uses baseline budgeting to disguise their failure to cut spending. The baseline budgeting method should be

dropped. A commonsense method should replace it. The word "cut" should be used only if a program costs less than it did in the previous year. The word "increase" should be used any time a program costs more than it did in the previous year. This is the method and vocabulary used by Americans to run their household budgets and by corporations to run their business budgets.

Like the Average Taxpayer. While an absolute freeze in federal spending would eliminate the deficit very rapidly, it probably is politically unpalatable and too inflexible. A "Four Percent Solution" has the virtue of allowing the federal government to have about the same rate of spending growth as that enjoyed by the average taxpayer.

To the average taxpayer, a four percent annual growth in spending, which matches the increases in general cost of living, probably seems very reasonable. Anyone advocating higher levels of federal spending should be seen for what he or she is: a big spender.

HOW TO LIVE WITH A SEQUESTER

To win congressional approval for the "Four Percent Solution" on government spending, Bush will need substantial bargaining leverage with Congress. If the President believes that the government cannot function with a Gramm-Rudman-Hollings sequester – for even a short time – his bargaining position with Congress is greatly weakened. Bush therefore must understand and make clear to budget summit participants and to the American people that it is possible for the federal government to cope with sequestration for even several months without disrupting major services and without significant inconveniences to the public. Even a full-year sequester, though painful and requiring creative solutions, would be manageable for domestic programs.

According to the current baseline budget projections, federal spending in fiscal 1991 will grow by 7.46 percent, or $90 billion over this year's spending level. Thus, a $100 billion sequester for fiscal 1991 actually is no more painful than living with all of fiscal 1990's $1.2 trillion in federal spending less $10 billion. Moreover, a full sequester for fiscal 1991 merely would bring federal spending back to fiscal 1988 inflation-adjusted levels.

Summit Scare Stories. Budget summiteers who favor higher taxes and higher spending are using scare stories about the effects of a sequester. They want Bush to bow to their pressure and accept their policies. They claim that a sequester would shut essential federal services and cause severe economic hardship for the American people. They are wrong. The fact is, a sequester need not do anything of the sort. Bush already has said that if a sequester comes, he will manage it as best he can. To this he should add that he finds that he could manage a sequester quite well.

Then Bush should give the budget negotiators a choice: 1) accept the four percent cap on spending increases or 2) face a sequester.

In telling Congress that he can manage a sequester, Bush should make two points especially clear:

First, major federal programs are exempt from the sequester. Most government services that directly and immediately affect the public are exempt from sequestration. Continuing as usual would be Social Security, Medicaid, Food Stamps, and the Women, Infants, and Children (WIC) program. The sequester only affects $125.3 billion of the roughly $900 billion in non-defense spending.

Second, staffing reductions and cutbacks in work hours in most cases will be adequate to meet sequester targets. In most agencies and departments affected by a two- or three-month sequestration, the major cuts would be in personnel payroll. Most non-defense agencies and departments could meet sequestration targets for several months merely by putting their work force on a three day schedule. Key staff could be kept on a full work week while workers in non-essential staff positions were furloughed for the entire period.

HOW TO MANAGE A TEMPORARY SEQUESTER

If a stalemate develops in the budget negotiations, Bush can and should accept a sequester. In the budget negotiations, while a sequester is in effect, he will have the upper hand. There are four steps to managing a sequester.

Step #1: On the day that the sequester goes into effect, the President should request that personnel in key defense and non-defense positions, listed below, volunteer to continue operations full-time even though their pay officially is reduced to part-time levels. The President would promise full retroactive compensation for their volunteer services as soon as emergency appropriations legislation is passed.

Step #2: The President should require Congress to remain in emergency session until it passes legislation to exempt a few vital domestic functions from sequester for the approximately three months until Congress reconvenes in January 1991. While the public would not feel any pain from a sequester for most of the affected programs, such as the American Battle Monuments Commission and the Christopher Columbus Quincentenary Jubilee Commission, it would from several vital domestic government operations like:

1) Meat and Poultry Inspection;

2) Quarantine and Inspection Functions;

3) Some FBI functions;

4) Many Federal Prison System functions;

5) Some Postal Service functions;

6) Air Traffic Control functions.

To fund these continuing operations, deeper cuts could be made in the remaining programs subject to the Gramm-Rudman-Hollings targets. In the case of the Postal Service, it is possible that the effects of a temporary sequester could be entirely offset by suspending delivery of all non-solicited third class mail, or "junk mail." Otherwise, three days-per-week mail delivery would accomplish the same goal. The President might ask Congress to allow private carriers to deliver First Class mail to help take up the slack in the system.

Step #3: The President should ask Congress to exempt from sequester Persian Gulf military operations and other Pentagon and State Department functions directly related to Persian Gulf operations. In essence, the President would be daring Congress to leave American forces in the Gulf stranded without adequate supplies and support.

Step #4: As for other Pentagon operations, the Gramm-Rudman-Hollings law allows the White House to exempt salaries and benefits to military personnel. For the rest of its functions, the Pentagon would manage by cutting training and practice time for forces not involved in the Persian Gulf deployment, delaying maintenance of facilities, and furloughing civilian personnel. There are very many non-vital military functions that could manage through a sequester. For example, the Pentagon could: furlough civilian Defense Department workers involved in facilities maintenance, procurement, and research and development activities; halt research, development and production of submarines and other expensive projects that will not come on line for many months or even years; and close many non-essential military facilities such as commissaries and the War College.

MAKING THE MOST OF THE SEQUESTER

Once the emergency legislation is passed to exempt vital functions, the President can release members of Congress to go back to their districts. There they will have to explain: 1) why they reject the President's "Four Percent Solution"; 2) why they want a tax increase rather than control their spending habits; and, 3) why they refuse to reach a negotiated budget with the President and, thus, force the government into an sequester during the midst of an international military crisis. In such as situation, pressure will mount on Congress to approve the Four Percent Solution. In reality, therefore, the sequester probably would last no more than a month or two.

CONCLUSION

For ten years Congress has pushed federal spending to record levels, all the while crying that the White House was slashing spending to the bone. Now Washington faces what it calls a deficit crisis. Perhaps the crisis is only an inside-Washington political game designed to fool the public into thinking that something is being done about the deficit. If so, George Bush should not be part of this game.

Taking the Lead. Perhaps, however, Washington – this time – really wants to reduce the federal deficit. If so, then new taxes are not the answer; they will lead only to new spending. Drastic spending cuts also are not the answer. They will be too distasteful politically. What may be an answer is a "Four Percent Solution." This prescription raises no taxes. It need cut no programs. It gives the federal government an increase in allowance every year – an increase that is about the same as that received by American households. It tells Congress that it must live with this increase. And if it does, the federal budget will balance by the end of fiscal 1996 and show an $11 billion dollar surplus the following fiscal year.

Congress, throughout the budget summit process, has been demonstrating that it will not take the lead in solving the budget crisis. George Bush thus must lead. He must be willing to confront Congress by giving lawmakers a choice: the Four Percent Solution or a sequester. Congress has everything to lose if it forces a sequester. All the cards are in the President's hands.

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Heritage Foundation Policy Analyst Robert Rector contributed recommendations on managing federal programs during a sequester.

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The Heritage Foundation
Backgrounder UPDATE
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

8/3/90 Number 137

WHAT DEFICIT CRISIS? CONGRESS CONTINUES ITS PORK-LADEN SPENDING SPREE

(Updating *Backgrounder* No.780, "While Talking About A Deficit Crisis, Congress Proposes Billions in New Spending," July 25,1990.)

How is Congress responding to George Bush's broken no-new-tax pledge? With visions of new revenues dancing in its head, Congress has gone on a spending spree that will push the federal budget and the tax burden on the American people to record highs. While many in Congress thus publicly wring their hands and gnash their teeth about what they call the deficit crisis, what they really seem to care about is only more spending. Examples: On July 18, the House of Representatives passed a $50.34 billion Rural Development/Agriculture appropriations bill, which is $5.18 billion or 11.46 percent higher than the 1990 amount. On July 19 the House approved a $170.44 billion Labor/Health and Human Services appropriations bill, which increases spending by $17.31 billion or 11.3 percent over last year's level.

With only eight of the thirteen appropriations bills passed so far, the House already has spent $403.09 billion, or $41 billion over 1990 levels, an increase of 11.4 percent. This is $68 billion over 1989 levels, an increase of 20 percent.

Table 1
Appropriations Bills
($billions for Fiscal Year)

BILL	1989 Approps.	1990 Approps.	1991 Bush Proposal	1991 Approps.	$ Change 90 - 91	% Change 89 - 91	% Change 90 - 91
Commerce/ Justice	14.85	11.70	11.10	10.50	-1.20	-29.30	-10.20
Energy/Water	17.83	18.43	20.20	20.77	+2.40	+16.52	+12.70
Foreign Operations	14.29	15.52	15.52	15.78	+0.30	+10.46	+1.69
VA/HUD	59.39	71.28	78.78	83.57	+12.30	+40.72	+17.25
Transportation	25.67	28.17	26.73	30.94	+2.70	+20.54	+9.50
Treasury/P.O.	16.02	18.45	20.71	20.72	+2.27	+29.34	+12.30
Labor/HHS	140.37	153.13	166.23	170.44	+17.31	+21.42	+11.30
Agriculture	46.61	45.17	50.43	50.35	+5.18	+8.00	+11.46
TOTALS	335.03	361.85	390.00	403.09	+41.24	+20.00	+11.40

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

If the House continues at this record pace in the remaining five appropriations bills and if both the Senate and President approve, spending will rise by nearly $75 billion over similar fiscal year 1990 levels. This dramatic increase is of particular concern because the 13 appropriations bills represent only about 60 percent of all federal spending. When combined with the automatic increases in unappropriated entitlement programs such as Social Security as well as interest on the national debt, which comprise the remaining 40 percent of the budget, fiscal 1991 spending could top last year's levels by nearly $110.

George Bush is partly to blame for this spending spree. He ignited it by bowing to pressure from Budget Director Richard Darman and Treasury Secretary Nicholas Brady to agree to a budget summit with Congressional leaders in which all issues, including taxes, were on the table. And taking the cue from Darman and Brady again, Bush threw open the floodgates on June 26 when he announced that it was clear to him that "tax revenue increases" would be needed to bring the deficit in line. Smelling blood in the water, the liberal-dominated House of Representatives went on a feeding frenzy. It rejected proposals by some House members to reduce the rate of spending increases on the Agriculture appropriations bill and the Labor/HHS appropriations bill. It defeated eleven such amendments by wide margins. Six amendments that would have slowed spending across the board were offered by Republican representatives William Dannemeyer, from California, and Bill Frenzel, from Minnesota, in addition to Timothy Penny, the Minnesota Democrat. The House even rejected the symbolic amendment by Robert S. Walker, the Pennsylvania Republican; it would have trimmed the overall level of spending in the Agriculture bill by just $19.90 – a piddling 0.0000000002 percent.

Table 2
($ billions for Fiscal Year)

Bill	1990 Approps.	Penny[1] (9.5%)	Frenzel[2]	Dannemeyer[3]	Penny[4] (2%)	1991 Approps.
Agriculture	45.17	46.01	46.65	47.95	49.39	50.35
Labor/HHS	153.13	N/A	163.74	N/A	169.90	170.44

1. There were two amendments offered by Representative Penny to the Agriculture Bill. The first was an across-the-board 9.5 percent cut on the proposed 1991 appropriations, which was actually an amendment to Frenzel's 7.7 percent cut. This amendment contained an exemption to the cut, the Women and Infant Children program, which was not cut at all.

2. The Frenzel amendments were an across-the-board 7.7 percent cut on the Agriculture bill, and an across-the-board 15.2 percent cut on proposed HHS spending bill. This cut on the HHS bill amounts to only a little over 3 percent of the total bill when the unauthorized funds are added in.

3. The Dannemeyer amendment to the Agriculture bill was an across-the-board cut of 5 percent, but again, this percentage only would have an effect on discretionary spending. The percentage of the total bill was much less.

4. The second Penny amendment to the Agriculture bill was an across-the-board 2 percent cut. The Penny amendment to the HHS bill was also a 2 percent across-the-board cut, but it excluded certain programs such as Chapter 1 Compensatory Education, Education for the Handicapped, and Higher Education.

Other amendments were offered to prevent spending increasing above fiscal 1990 levels on specific programs. Walker proposed four amendments to test the House's resolve for holding the line on spending increases. The first amendment would have prevented a $65,000 increase for the $4,935,000 Law School Clinical Experience program; the second would have prevented $10,000,000 from being spent on a new "Education Summit Follow-Up" study; the third would have prevented a $65,000 increase in the $3,806,000 Physician Payment Review Commission; and the fourth would

have prevented a $450,000 increase for the $7,550,000 United States Institute of Peace. As could have been expected by that time, all of these proposed cuts were defeated.

Lastly, an amendment offered by Representative George Miller, the California Democrat, would have reduced salaries and expenses in the Department of Labor by $2 million, reduced funds for general departmental management in the Department of Health and Human Services by $2.8 million, and cut by $2 million funds for program administration in the Department of Education. This too was defeated. The result: the entire measly $6.8 million in cuts was defeated.

Congress went "hog wild" when George Bush was convinced by Richard Darman and Nicholas Brady to betray the "no-new-tax" pledge and put the issue of "new tax revenues" on the budget summit table. The House is now on track to spend any new taxes before the money even reaches the Treasury. This follows the decades-old pattern of Congress spending $1.50 for each new dollar of taxes collected. If Bush needs any more evidence of how Congress will never use a tax increase toward deficit reduction, he need look no further than how the House of Representatives reacted when he put taxes "on the table."

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Heritage Foundation research interns Angela J. Hulsey, Geoffrey Manne, and Matt Rawlinson assisted in the preparation of this study.

APPENDIX

Rural Development, Agriculture, and Related Agencies

The appropriations levels in the 1991 Rural Development/Agriculture bill are 11.46 percent, or $5.2 billion, higher than fiscal 1990 levels. The big gainers in the bill are Agriculture programs, increased by $846.7 million; Rural Development Programs, increased by $1.43 billion; and, Domestic Food Programs, increased by $2.77 billion.

Of the thirteen appropriations bills, the agriculture appropriations bill is by far laden with the most pork barrel projects. There is not a county in the nation that does not in some fashion benefit from this bill, and nearly every university in the nation receives "research" funds from this bill. Congress should begin trimming the fat from this bill by looking at the following programs:

Department of Agriculture

Economic Research Service: $54,400,000

National Agricultural Statistics Service: $76,451,000

World Agricultural Outlook Board: $2,196,000

Advisory Committees: $1,407,000

Examples:

National Advisory Council on Commodity Distribution: $81,428

National Arboretum Advisory Council: $13,654

Committee of Nine: $39,300

Federal Grain Inspection Service Advisory Committee: $65,586

Nat.Ad.Comm. on Microbiological Qual.Standards for Food: $50,252

Advisory Comm. on Foreign Animal and Poultry Diseases: $26,503

National Advisory Committee on Animal Damage Control: $38,950

Scrappie Negotiated Rulemaking Advisory Committee: $45,220

Agricultural Research Service: $633,708,000

Examples:

Plant germ plasma: $30,304,000

Plant genome research: $3,773,000

Narcotic plants: $6,484,000

Animal germ plasma: $6,501,000

Renovation of the Beltsville Agriculture Research center: $7,250,000

Dwarf bunt research: $130,000

Potato scab research: $190,000

Hawaii fruit fly research: $2,667,000

National Sedimentation Laboratory: $44,891,000

Kenaf: $1,106,000

Soybean-based ink: $426,000

Aflatoxin research: $5,849,000

Turkey ostemyelitis: $200,000

Agricultural Research Service Buildings and Facilities: $26,039,000
Examples:

National Seed Storage Lab, CO: $2,000,000

Salinity Lab, Riverside, CA: $5,050,000

Plant Stress Lab, Texas Tech, TX: $600,000

National Animal Disease Center, Incinerator, Ames, IA (post mortem facility): $300,000

Special Research Grants: $56,909,000
Examples:

Cool season legume research (IA, WA): $250,000

Animal waste disposal (MI): $75,000

Blueberry shoestring virus (MI): $92,000

Broom snakeweed (NM): $150,000

Grasshopper biocontrol (ND): $71,000

Nematode resistance through genetic engineering (NM): $150,000

Cooperative state research service buildings and facilities at over thirty U.S. universities: $45,361,000

Packers and Stockyard Administration: $10,687,000

Rural water and waste disposal grants: $300,000,000

Delta Commission (proposal for prison expansion in the Mississippi delta): $50,000

Rural Electrification Administration
Budget authority: $266,603,000

Loan authorization: $1,794,375,000

River basin surveys and investigations: $12,783,000

Great Plains Conservation Program: $24,637,000

Foreign Agricultural Service: $105,048,000

Ameri Flora '92 Exposition: $500,000

Departments of Labor, HHS, Education and Related Agencies

The House has appropriated $17.31 billion more for 1991 in Labor/HHS bill than in 1990, an increase of 11.3 percent; and $30 billion more than in 1989, an increase of 21.42 percent. The big winners in this bill are the Department of Health and Human Services with an increase of $13.23 billion, and the Department of Education with an increase of $3.0 billion. Specifically, the failed Job Corps will receive an additional $101 million in fiscal 1991, and the National Institute of Health's budget will increase by $1.04 billion.

While the appropriations committee reports that $126 billion, or 74 percent, of this bill's total appropriations is dedicated toward entitlement programs, Congress should look seriously at reforming or terminating the following discretionary programs:

Department of Labor

Job Training Partnership Act: $4,210,687,000

Community Service Employment for Older Americans: $400,000,000

Employment Standards Administration:
- Salaries and expenses: $222,388,000
- Longshore and Harbor Workers' Compensation Act: $1,016,000

Occupational Safety and Health Administration: $291,243,000

Mine Safety and Health Administation: $177,767,000

Bureau of Labor Statistics: $207,274,000

Assistant Secretary for Veterans Employment and Training: $172,031,000

Department of Health and Human Services

Health Resources and Services: $1,627,375,000

Examples:
- General Dentistry Residencies: $3,929,000
- Physician Assistants Program: $4,789,000
- Health Professions Data Analysis: $1,846,000
- Geriatric Training and Research: $14,047,000
- Native Hawaiian Health Care: $1,283,000
- Nurse Practitioners: $13,432,000
- Nurse Anesthetists:$1,130,000
- Nurse Disadvantaged Assistance: $4,000,000
- Organ Transplantation: $4,257,000
- Rural Health Research: $4,380,000
- Adult Health Care Demonstrations: $27,200,000

Centers of Disease Control: $997,701,000
Examples:

Lead Poisoning Prevention: $8,000,000

Sexually Transmitted Diseases: $90,000,000

Injury Control Program: $25,000,000

Occupational Safety and Health: $87,020,000

Epidemic Services: $70,000,000

National Institutes of Health: $8,317,654,000
Examples:

Dental Research: $134,000,000

Allergy and Infectious Diseases: $869,000,000

Environmental Health Sciences: $244,842,000

John E. Fogarty International Center: $18,682,000

President's Council on Physical Fitness and Sports: $1,499,000

Health Care Financing Administration

Research and Demonstration Projects: $69,000,000

Rural Hospital Transition Grant Program: $23,000,000

Social Security Administration

Special Benefits for Disabled Coal Miners: $841,081,000

Department of Education

Compensatory Eduction for the Disadvantaged: $6,225,250,000
Examples:

Administrative Assistance to State Agencies: $60,000,000

Evaluation and Technical Assistance: $15,000,000

Rural Technical Assistance Centers: $4,500,000

Impact Aid: $800,000,000

School Improvements Programs: $1,474,745,000
Examples:

National Diffusion Network: $14,000,000

Arts in Education: $4,500,000

Law-Related Education: $5,000,000

Blue Ribbon Schools Program: $900,000

Leadership in Education Administration: $3,845,000

Mid-career Teacher Training: $1,000,000

Fund for Innovation in Education: $25,000,000

Dropout Prevention Demonstration: $30,000,000

Education for Native Hawaiians: $6,400,000

Bilingual and Immigrant Education: $205,000,000

Student Financial Assistance: $6,777,000,000

Examples:

Work-Study: $600,000,000

Income Contingent Loans: $10,000,000

State Student Incentive Grant: $60,000,000

(Loan Defaults: $2 billion)

Grant to Gallaudet University: $74,047,000

Higher Education: $763,616,000

Examples:

Strengthening Developing Institutions: $87,500,000

Strengthening Historically Black Colleges and Universites: $87,500,000

Strengthening Historically Black Graduate Institutions: $12,000,000

Innovative Projects for Community Services: $1,481,000

International Education and Foreign Language Studies: $46,000,000

Law School Clinical Experience: $5,000,000

Interest Subsidy Grants: $20,900,000

Grant to Howard University: $200,036,000

Grant to Howard University Hospital: $29,000,000

College Housing and Academic Facilities Loans: $38,449,000

Independent Agencies

Corporation for Public Broadcasting: $259,565,000

Federal Mediation and Conciliation Service: $27,705,000

National Mediation Board: $6,675,000

United States Institute of Peace: $8,000,0000

The Heritage Foundation

FEDERAL BUDGET REPORTER

Analyzing the Process of Government Spending

No. 6 **August 3, 1990**

WASHINGTON WATCH

The Sky Is Not Falling: Facts About the Deficit. By breaking his promise not to raise taxes, George Bush has joined those doomsayers in Washington who maintain that the sky is falling, that the budget deficit is so great a danger to the economy that any means, including a tax hike, is justified to deal with it. Yet as Daniel Mitchell, Heritage's John M. Olin Fellow, points out, the fiscal 1991 budget deficit as a percent of the Gross National Product (GNP), is expected to be only 2.7 percent, its lowest level since 1981. "If the deficit truly is about to cause the economy to collapse...it seems curious that the economy did not fall apart in 1985, when the deficit was 5.4 percent of GNP."

If the deficit is $168.8 billion as the Administration predicts, the automatic across-the-board budget cuts, known as sequestration, mandated by the 1985 Gramm-Rudman-Hollings budget law will bring it down to the $74 billion top permitted limit. If policy makers at the current deficit reduction summit truly wish to avoid this sequestration and deal with the deficit, means other than higher taxes will be required. The most important moves: Eliminate wasteful existing programs, sell unneeded government assets and cut taxes that hinder economic activity. Scott Hodge, Grover M. Hermann Fellow at The Heritage Foundation, calculates that this will cut $130 billion from the budget. Among other means needed to deal with the deficit:

- **Freeze 1991 spending at the 1990 level.** Even though the Treasury will collect $70 billion more next year than this year, spending will go up by far more than this. A spending freeze will bring the deficit close to the Gramm-Rudman-Hollings target.
- **Impose a moratorium on new programs.** A $4.3 billion "Dire Emergency" appropriations bill meant to aid Nicaragua and Panama, which passed Congress in May, includes $6 million for a Iowa wildlife refuge, $6.8 million for grasshopper control and $750,000 for a cargo and passage boat for American Samoa. If the budget deficit is a dire emergency, new pork barrel spending must be stopped.
- **Reform the current services budget.** Currently, even though spending on a federal program increases, the spending officially is tallied as a cut if it increases less than projected in what is called the current services budget. This budget gimmickry is what allowed liberals to complain that Ronald Reagan was cutting welfare programs to the bone even though outlays for the programs were increasing. The "current services budget" should be repealed in favor of a budget process that honestly reflects real spending changes.
- **Introduce a second sequester.** Currently, Congress need merely meet the Gramm-Rudman-Hollings deficit target by October 15, only two weeks into the fiscal year. After that, the target can be violated – and it has been. Requiring a second, midyear sequester would prevent much of this.

(See Daniel J. Mitchell, "Bush's Deplorable Flip-Flop on Taxes," Heritage Foundation *Executive Memorandum* No. 271, June 28, 1990, and Scott A. Hodge, "A $130 Billion No-Tax Prescription for the Budget Deficit," Heritage Foundation *Backgrounder* No. 772, May 31 1990.)

House Republicans Repudiate Bush. George Bush should read the House Republicans' lips. Led by Texas Republican Representatives Richard Armey and Tom DeLay, the House Republican Conference passed a resolution on July 18 stating officially that its members oppose any new taxes as a means to cut the budget deficit. The Armey Resolution notes that Democrats consistently have supported tax hikes as the only solution to the deficit and that Democrats have not kept their promise to cut spending once Republicans agreed to new taxes. The resolution endorses Bush's position to reduce the deficit through spending cuts and growth incentives, but maintains that higher taxes will have "a detrimental impact on families, business, and the American economy."

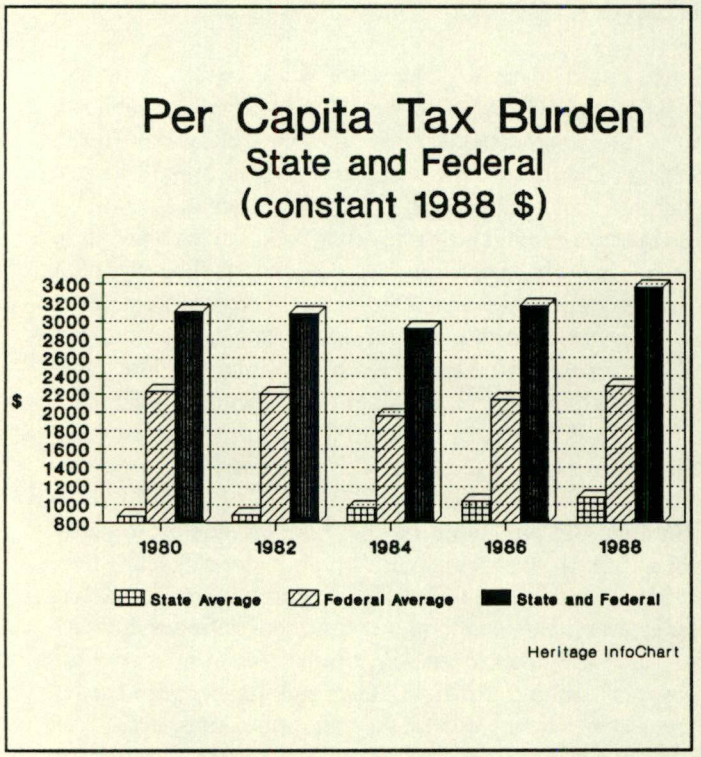
Economic Growth Continues. Despite chronic press warnings of an imminent recession, the numbers for this year's first quarter released by the Council of Economic Advisers tell a different story: the economic expansion continues into its eighth year. Writes *Fortune's* senior economist Vivian Brownstein in a June 18 article, "Give your fingernails a break. [Despite slow growth], overall the expansion continues." *Fortune* also reports that, based on the results of a recent survey, the business community in general is optimistic about the economy. The survey shows that most respondents are not concerned by the budget deficit, but are worried about "irresponsible" government fiscal policy and higher taxes. Signs of

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growth are particularly evident in the nation's major cities. In the fourth quarter of 1989, all but one of the 24 largest metropolitan areas enjoyed an expanding economy. And 75 percent of the 24 cities showed the highest levels of economic growth since January 1985.

The Road to Recession. The business community is correct to fear a tax hike. The last two times federal tax revenues surpassed 20 percent of GNP, in 1969 and 1981, the following years saw recessions. Even without another tax increase this year (Social Security payroll taxes already have jumped), revenues are expected to consume 19.6 percent of GNP.

Congress Approves New Spending. The public may expect that a budget deficit serious enough to prompt Bush to break his no-new-taxes promise would prompt immediate and deep spending cuts. No way. As in 1982, new taxes, it appears, will be used for new spending and not to reduce the budget deficit. The six appropriations bills recently approved by Congress are cases in point. Collectively, they raise spending from last year's levels by more than $18 billion or nearly 12 percent. Appropriations for the Departments of Veteran's Affairs and Housing and Urban Development alone is 17 percent over the fiscal 1990 level. For each of the bills, repeated attempts to cut discretionary spending were easily defeated. Taxpayers can expect similar action on the remaining seven annual appropriations bills to be passed before the new fiscal year.



STATE WATCH

Proposition 111, Not a National Trend. Tax-and-spend proponents claim that the passage of California's Proposition 111 to raise the gasoline tax reflects the nation's sentiment on taxation. This is far from the truth. The narrowly passed initiative will double the tax on gasoline over the next five years. It also will increase state spending by weakening the "Gann spending limit," a change few California voters were aware of. Proposition 111 was a special-interest piece of legislation backed heavily by a unified coalition of highway construction workers, lobbyists, and the political establishment. Supporters spent more than $5 million selling voters on the argument that their state needs to raise the gasoline tax, currently one of the lowest in the nation, to pay for desperately-needed new roads. Despite the absence of an organized opposition, little money spent against the initiative, and a low voter turnout, the initiative passed by only 52 to 48 percent.

State Tax Revolts on 1990 Ballots. Anti-tax fervor is most apparent in the states. Not since 1980 have there been as many potential state tax revolts shaping up for an election. In more than a dozen states, anti-tax organizations are seeking to place tax reduction measures on ballots this fall. In Massachusetts, Nevada, Oregon, and Utah, more than the required number of signatures have been obtained to put the tax issue to the voters. At least three other states are likely to qualify. Nevadans will vote a second time on an initiative to ban the personal income tax. Under state law, such a constitutional amendment must be approved in two successive elections for ratification. In 1988, voters passed the initiative by 82 percent. Residents of Michigan may have a chance to roll back the property tax, as well as to limit state and local spending. Residents of Utah will vote to repeal the sales tax on food.

The rising opposition to taxes in the states is not surprising. State and local taxes have escalated over the last decade (see graph), surpassing both the inflation rate and the rise in personal income, and now consume almost 9.2 percent of GNP. Currently 21 governors want to increase the tax burden by a total of $4.9 billion to fund further state spending for fiscal year 1991.

New Jersey especially stands to suffer. That state's new Governor, James J. Florio, wants to raise the state sales tax from 6 percent to 7 percent and double the top marginal income tax rate from 3.5 percent to 7 percent. He wants to reduce or phase out state education funds for middle class or "wealthy" localities to give more to poorer inner cities. But since schools are financed both from state and local taxes, many districts will have to raise taxes or cut back radically on education. Rather than helping pupils in poorer districts, the transferred funds will aid education unions and public school bureaucracy.

The Heritage Foundation Federal Budget Reporter, Dana C. Joel, Editor; Stuart M. Butler, Publisher. The Heritage Foundation, 214 Massachusetts Ave., N.E., Washington, D.C. 20002; (202) 546-4400. CABLE: HERITAGE WASHINGTONDC; TELEX 440235. Nothing herein is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

The Heritage Foundation Backgrounder

No. 780 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

July 25, 1990

WHILE TALKING ABOUT A DEFICIT CRISIS, CONGRESS PROPOSES BILLIONS IN NEW SPENDING

INTRODUCTION

The Bush Administration and congressional leaders involved in the current budget deficit reduction summit claim that the deficit is such a crisis that American taxpayers must give even more of their money to help pay Uncle Sam's bills. Some taxpayers may assume that before policy makers decided on a tax hike, they did everything possible to cut wasteful spending, to eliminate pork barrel projects and to shut down programs that serve no overriding national interest.

Such an assumption would be wrong.

Neither Congress nor the Bush White House has tried seriously to cut spending. Quite the contrary. At this very moment, while they wring their hands about a "budget deficit crisis," policy makers are proposing to spend more money on existing programs and to launch costly new programs. They are pushing federal spending to record high levels. As Washington veterans of the budget process could have predicted, the convening of the budget summit and Bush's broken no-new-taxes promise have opened the floodgates for this spending spree.

Congress's Bad Faith. George Bush betrayed his campaign pledge of no new taxes reportedly as a good-faith measure to convince congressional leaders of his sincere desire to reach an agreement in the budget summit. In the four weeks since then, the liberal-dominated House of Representatives has responded to Bush's gesture by passing six appropriations bills totalling $182.3 billion. This is $18.75 billion over 1990 appropriations levels, a 11.47 percent increase.

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If the House continues this trend for the remaining seven appropriations bills required by the Budget Act of 1974, and if these spending levels are matched by the Senate and accepted by the President, total appropriated spending will increase by $75 billion in fiscal 1991. At the same time, the House soundly defeated a series of amendments that would have reduced these proposed spending increases, in some cases reducing these huge increases by as little as 2 percent.

Costly New Programs. The House has not merely increased current spending in appropriations bills. With members smelling blood in the water, the House Ways and Means Committee okayed a new foster care entitlement program which will cost taxpayers more than $4 billion over the next five years. The House Agriculture Committee has approved legislation to expand Food Stamp and nutrition entitlement programs by $7.5 billion over five years.

At the same time that many House members have been congratulating Bush for his "statesman-like" betrayal of his no-tax pledge, they have been quietly adding spending to the budget that could cost every American household $750. Yet, nowhere in any of these bills have members of Congress attempted to cut spending.

The message is clear.

Congress does not want new taxes for deficit reduction.

Congress wants new taxes for new spending.

CONGRESSIONAL BETRAYAL

In April, Bush invited congressional leaders to a "budget summit" to negotiate a good-faith deal to bring the projected fiscal year 1991 deficit of $168 billion down to the $74 billion level[1] required by the 1985 Gramm-Rudman-Hollings deficit reduction act, a level that does not include the cost of bailing out ailing savings and loans.

Rather than trying to cut wasteful spending, many congressional leaders pressured Bush to betray his no-tax pledge. On June 26, he obliged by stating that it was clear to him that "tax revenue increases" would be needed to bring the deficit in line. What followed has been a spurt of new federal spending in the first six appropriations bills.

Table 1 compares the first six FY 1991 appropriation levels with totals from previous years.

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1 The Gramm-Rudman-Hollings deficit target for FY 1991 is $64 billion plus a $10 billion "margin for error."

Table 1
Appropriations Bills
($billions)

BILL	FY '89 Approps.	FY '90 Approps.	FY '91 Bush Proposal	FY '91 Approps.	$ Change '90-'91	% Change '89-'91	% Change '90-'91
Commerce/ Justice	14.85	11.70	11.10	10.50	-1.20	-29.30	-10.20
Energy/Water	17.83	18.43	20.20	20.77	+2.40	+16.52	+12.70
Foreign Operations	14.29	15.52	15.52	15.78	+0.30	+10.46	+1.69
VA/HUD	59.39	71.28	78.78	83.57	+12.30	+40.72	+17.25
Transportation	25.67	28.17	26.73	30.94	+2.70	+20.54	+9.50
Treasury/P.O.	16.02	18.45	20.71	20.72	+2.27	+29.34	+12.30
TOTALS	148.05	163.55	173.34	182.31	+18.75	+23.14	+11.47

CONGRESS REFUSES TO TRIM INCREASES

When some lawmakers attempted to slow the proposed increase in spending, Congress ignored them. By substantial majorities, the House of Representatives soundly defeated a series of amendments that would have rolled back proposed spending increases at various levels. Defeated were amendments to the Energy and Water Appropriations bill as well the Housing and Urban Development-Veterans Administration (HUD-VA) Appropriations bill offered by Representative Bill Frenzel, the Minnesota Republican, that would have nullified the proposed increases and returned spending to inflation-adjusted 1990 levels. The HUD-VA bill, just passed by the House, contains $12.6 billion in new spending.

Congress also has been averse to amendments that would roll back the appropriated increases by much smaller amounts. Representative William Dannemeyer, the California Republican, for instance, unsuccessfully offered amendments for 5 percent across-the-board reductions in appropriations for the Energy and Water bill, Commerce and Justice bill, and the HUD-Veterans Administration bill. And of the five attempts by Representative Timothy Penny, the Minnesota Democrat, simply to reduce appropriated levels 2 percent across-the-board all but one, which amended the Treasury/Post Office bill, were defeated. Even had these amendments passed, however, spending would have increased over fiscal 1990 levels (Table 2).

Table 2
($ billions)

BILL	FY '90 Appros.	Frenzel Amendment[1]	Dannemeyer Amendment[2]	Penny Amendment[3]	FY '91 Approps.
Energy	18.43	18.54	19.74	20.36	20.77
HUD/VA	71.28	71.46	79.39	81.90	83.57
Commerce/Justice	11.10	N/A	9.97	10.29	10.50
Transportation	28.17	N/A	N/A	30.33	30.94
Treasury	18.45	N/A	N/A	20.31	20.72
TOTALS	147.43	152.16	160.77	163.18	166.51

1. Representative Frenzel introduced two amendments. One would have cut Energy and Water appropriations by 10.53 percent across the board. The other would have cut HUD/VA appropriations by 14.5 percent across the board, except for VA medical benefits.
2. A 5 percent across-the-board cut.
3. A 2 percent across-the-board cut, except for VA medical benefits and HUD Section 8 housing.

BIG SPENDERS AT THE WHITE HOUSE

Bush cannot blame Congress solely for the alleged need for new taxes. His Administration also has been seeking higher federal spending. Table 3 shows a sample of higher spending requested for current programs.

The Bush Administration is seeking spending authorization for new programs as well. Table 4 offers a sample of these requests.

For years critics of high government spending have pointed to the need to cut or eliminate programs. Yet as Congress looks for ways to increase taxes, it refuses to address the $424 billion in government waste reported by the "Grace Commission" six years ago or the more than $150 billion in program waste, fraud, and financial mismanagement found earlier this year by Congress's own General Accounting Office (GAO). Moreover, nowhere is there evidence that members of Congress attempted to enact the roughly $60 billion in program saving measures recommended this year by the Congressional Budget Office or the $130 billion in program savings recommended by analysts at The Heritage Foundation.

Table 3
Bush Administration Proposals for Spending Increases

Program	1991 Request	Increase over 1990
National Endowment for the Arts	$175 million	$ 4 million
National Endowment for the Humanities	$165 million	$ 8 million
Smithsonian Institution	$308 million	$41 million
Institute for Museum Services	$ 24 million	$ 1 million
National Gallery of Art	$ 49 million	$ 7 million
Historical Preservation Fund	$ 34 million	$1.4 million

Table 4 Bush Administration New Authorization Requests	
Program	**Requested Amount**
Magnetic Levitation Techology	$10 million
Airport Grants	$1.5 million
Global Change Research	$1 billion
Environmental Protection Agency Operating Budget	$230 million
Goverment Research and Development	$4.5 billion
Manned Missions to the Moon and Mars	$408 million

PROSPECTS OF ENTITLEMENT EXPANSIONS

The serious economic damage that could result from Congress's spending increases is exacerbated by the fact that these 13 appropriations bills represent only about 60 percent of federal budgetary spending. The remainder of the budget is driven by interest on the national debt and, more important, by "automatic" spending such as entitlement programs, which congressmen rarely consider as targets for spending cuts. These programs are expected to grow in 1991 by roughly 6 percent, or $33 billion, to $606 billion. There is the possibility, moreover, that overall entitlement programs will balloon to even higher levels. Since the President broke his no-new-taxes promise, Congress has voted out of committee new entitlements: A Foster Care bill, the Congressional Budget Office (CBO) estimates, will cost $4.2 billion over five years, and expanding the Food Stamp and Nutrition programs will cost $7.5 billion over five years, according to CBO.

The six appropriations bills that the House already has passed are not "bare bones" programs. They are larded with wasteful spending, pork barrel programs, and outdated agencies. If the pork and fat were eliminated and if a spending freeze were imposed on the remaining spending, the budget would be near the $74 billion Gramm-Rudman-Hollings deficit target without harming entitlements.

Congress should analyze each program and spending item by asking:

1) Does the program serve the nation as a whole? If it does not, then Congress must ask if the program supersedes the responsibilities of state and local officials. Filling potholes on Main Street and fixing a railroad crossing in Springfield are not roles for Congress.

2) Does the program or service have an identifiable user? If so, then the user should be charged a sum equal to the cost of the service, or the service should be "shed" to the private sector as a competitive enterprise. In reality, this means that landlubbers should not have to subsidize Coast Guard services to wealthy yacht owners or that folks in rural America should not have to subsidize the mass transit costs of urban dwellers.

3) Has the program failed, fulfilled its mission, outlived its usefulness, or simply become irrelevant? If so, then these programs should be abolished. Too often Congress continues to fund a program even when Congress's own research groups determine that a program is a failure. If a program has outlived its usefulness or even fulfilled its mission Congress finds new activities for the program to do. Congress hates to abolish programs.

4) Is Congress engaging in central planning or attempting to set "national priorities" that should be left to communities or individuals? Example: the more than $1 million appropriated in this year's Transportation bill to establish a national bicycle program and to encourage safe bicycle riding. Certainly the decision to commute by bicycle or car is an individual one. Moreover, most local park districts already conduct classes for children in bicycle safety.

Before Congress makes another move toward higher levels of spending it owes it to American taxpayers to take a critical look at its spending habits. If Congress simply answers the four questions outlined here it will go a long way toward streamlining federal spending and freeing up sufficient funds to solve today's problems.

CONCLUSION

Congress has sent a clear message to American taxpayers that it wants more money for new spending, not for serious deficit reduction. After passing just the first six of the required 13 appropriations bills, Congress is exceeding last year's spending levels by nearly 12 percent. If this pace continues for the remaining seven appropriations bills, the "controllable" portion of the federal budget will balloon by at least $75 billion over fiscal 1990 levels.

Congress also is sending a clear message to Bush by enacting these increases in addition to the more than $11 billion in entitlement program expansions it has approved. This message is: Spending cuts have been taken "off the table" at the budget summit. Congress will accept nothing less than higher taxes. If Bush needs additional evidence of Congress's intentions, he need but look the fact that Congress refused nine of the ten opportunities it had to simply roll back the proposed increases in the appropriations bills.

Congressional action leads to only one conclusion: The only way to reduce the deficit is for Congress to reject new spending and to trim some existing programs. New taxes will not reduce the deficit. As Congress demonstrates almost every week, new revenues will be used for new spending.

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APPENDIX
THE FIRST SIX 1991 APPROPRIATIONS BILLS

DEPARTMENTS OF COMMERCE, JUSTICE, AND STATE, THE JUDICIARY, AND RELATED AGENCIES

As this appropriations bill is not yet complete, it is difficult to compare to previous spending levels. Nearly $9 billion in authorized program spending remaining to be appropriated by the House Appropriations Committee. But if the spending levels for Commerce Department technology programs recently appropriated by the House are any guide, spending for the finished appropriations bill will outpace last year's levels. For fiscal 1991, the House approved $290 million in spending for these programs and $468 million in fiscal year 1992. The fiscal 1991 spending level marks an 82 percent increase over the $159 million spent this year.

Congress and the budget summiteers should give serious consideration to terminating or reforming the following spending programs within this bill; this list is far from complete.

Department of Commerce

Programs for which funds have not yet been authorized: The Economic Development Administration, the Export Administration, the International Trade Administration, the U.S. Travel and Tourism Administration, the Minority Business Development Agency, and the Technology Administration.

National Oceanic and Atmospheric Administration (NOAA)

Fishing Vessel and Gear Damage Fund: $1,202,000

Fisherman's Contingency Fund: $1,000,000

Zebra Mussel Research: $1,000,000

Stuttgart, Arkansas Fish Farm: $2,850,000

National Telecommunication and Info. Administration

Grants for public TV & radio: $20,833,000

Department of State

Contributions to 52 International Organizations: $787,605,000

Examples:International Jute Organization: $69,000

International Lead and Zinc Study group: $36,000

International Office of Epizootics: $62,000

World Meteorological Organization: $6.6 million

International Sugar Organization: $261,000

Fisherman's Protective Fund: $500,000

Related Agencies

Total Spending: $1,901,419,000

Board for International Broadcasting: $192,586,000

Christopher Columbus Quincentenary Jubilee Commission: $214,000

Commission on Agricultural Workers: $1,457,000

Commission on the Bicentennial of the Constitution: $14,973,000

Federal Maritime Commission: $15,894,000

Marine Mammal Commission: $1,003,000

Small Business Administration: $437,700,000

ENERGY AND WATER DEVELOPMENT APPROPRIATIONS

Appropriations levels for 1991 Energy and Water programs are $2.4 billion more than fiscal 1990 levels, an increase of 12.7 percent. By comparison, fiscal 1990 levels were only $600 million over fiscal 1989 levels, an increase of 3.4 percent.

The Energy and Water Appropriations bill is a case study in pork barrel spending, federal involvement in local affairs, and federal involvement in activities that should be entirely left to the private sector. Congress should consider terminating many programs in this bill, such as the following:

Army Corps of Engineers

* General Investigations: $167,847,000

Examples of Feasibility Studies and Investigations:

Red River Basin Comprehensive Study: $425,000

Red River Waterway, Index, Arkansas: $500,000

Red River Waterway, LA: $1,900,000

Rancho Palos Verdes Landslide, CA.: $500,000

Beaver Creek, Floyd County, Kentucky: $200,000

Clinton River Spillway, Michigan: $225,000

Howard Hansen Dam, Water Storage, Washington: $200,000

Waikiki Beach, Hawaii: $100,000

* General Construction: $1,362,025,000

Examples:

McClellan-Kerr, AR, River Navigation System, Locks and Dams:

1991 Cost: $9,900,000

Total Federal Cost: $584,800,000

Santa Ana River Mainstem, CA:

1991 cost: $65,000,000

Total Federal Cost: $908,000,000

Melvin Price Lock and Dam, IL & MO:

1991 Cost: $29,000,000

Total Federal Cost: $742,400,000

Melvin Price Lock and Dam, Second Lock, IL & MO:

1991 Cost: $75,000,000

Total Federal Cost: $230,000,000

Red River Waterway, Mississippi River to Shreveport, LA:

1991 Cost: $61,636,000

Total Federal Cost: $1,724,000,000

* General Operation and Maintenance: $1,457,488,000

Examples:Beaver Lake, AR: $14,718,000

Tennessee-Tombigbee Waterway, AL & MS: $18,000,000

McClellan-Kerr Arkansas River Navigation System, AR: $22,403,000

Ohio River Locks and Dams, KY, IL, IN, OH, PA, WV: $41,060,000

Keweenan Waterway, MI.: $664,000

East River, NY: $1,410,000

Bureau of Reclamation

General Investigations: $12,926,000

Examples:American River Folsom South Optimization Study, CA: $50,000

Upper Gunnison-Uncompahgre Basin Project, CO: $280,000

Josephine Co. Water Management Improvement Study, OR: $200,000

Technical Assistance to States: $1,350,000

Construction Program: $649,697,000

Examples:Colorado River Basin Project: $201,966,000

Ogden River Project, Utah: $1,954,000

Operation and Maintenance: $231,516,000

Department of Energy Supply, Research and Development Activities: $2,703,272,000

Examples:Solar Energy Programs: $130,430,000

Geothermal and Hydropower: $23,600,000

Electric Energy Systems and Storage: $41,253,000

Nuclear Energy Programs: $313,490,000

Biological and Environmental research: $371,394,000

Magnetic Fusion: $325,300,000

Super Conducting Super Collider: $317,866,000 (Total Estimated Cost of the Program: $5 billion to $8 billion)

Uranium Enrichment Facilities: $1,406,018,000 (Could be sold to the private sector for $1.8 billion.)

The Five Power Marketing Administrations: $326,387,000 (Each could be sold to the private sector for over $1 billion.)

Appalachian Regional Commission: $150,000,000

Delaware River Basin Commission: $681,000

Interstate Commission on the Potomac River Basin: $200,000

Susquehana River Basin Commission: $501,000

Tennessee Valley Authority: $135,000,000 (Could be sold to the private sector for over $5 billion.)

TREASURY, POSTAL SERVICE, AND GENERAL GOVERNMENT APPROPRIATIONS

Appropriations for the Treasury and the Postal Service are $2.27 billion higher than 1990 levels, a 12.3 percent increase.

Postal Service: Although the U.S. Postal Service is technically "off budget," the taxpayer will nonetheless spend over $522,734,000 to subsidize the Postal Service.

National Critical Materials Council: $235,000

Advisory Committee on Federal Pay: $207,000

Administrative Conference of the United States: $2,079,000

DEPARTMENT OF TRANSPORTATION AND RELATED AGENCIES

Appropriations for the Department of Transportation and Related Agencies will climb $2.7 billion in fiscal 1991 to a total of $30.9 billion, a 9.5 percent increase.

This bill provides an excellent example of how the federal government subsidizes "gold-plated" local projects, fails to require those who use services to pay for what they receive, and pays for projects which clearly are the responsibility of local governments. Among the many spending items that should be terminated, Congress should consider the following:

Department of Transportation

Office of Small and Disadvantaged Business Utilization: $3,500,000

Transportation Policy and Planning: $6,748,000

Including:$50,000 for a national bicycle program manager

Research on sleep and fatigue in transportation

Coast Guard

Boat Safety: $35,000,000

Federal Aviation Administration

Grants-in-Aid for Airports: $1.4 billion

New Denver Airport: $25,000,000

Dallas/Ft. Worth Airport: $12,500,000

L.A. Basin Facility Consolidation: $76,100,000

$117,509,900 total for airport grants

Federal Highway Administration

Research Programs:

Intelligent vehicle/highway systems: $12,000,000

National bicycling and walking study: $1,000,000

University Transportation Centers: $5,000,000

Railroad-Highway Crossings Demonstration Projects: $14,845,000 Including projects in: Elko, NV, Wheeling, WV, Matamoros, Mexico.

Federal Funds to complete Substitute Highway Projects: $1,646,832,472. Including: San Francisco, Washington, Atlanta, Chicago, New York City, New York City-Trenton, New York City (New Jersey).

Baltimore-Washington Parkway.: $9,900,000

Intermodal Urban Demonstration Projects: $10,000,000

Indiana Industrial Corridor Safety Demo. Project: $3,000,000

Alabama Highway Bypass Demonstration Project: $10,000,000

Kentucky Bridge Demonstration Project: $4,000,000

Virginia HOV Safety Demonstration Project: $8,500,000

Bicycle Transportation Demonstration Project, Macomb County, MI: $1,000,000

Local Rail Service Assistance: $7,000,000

Orange County, CA Monorail System: $1,000,000

Long Island Railroad Intermodal Project: $250,000

Amtrak: $482,000,000

MAGLEV/High Speed Rail: $12,000,000

Urban Mass Transit Administration:

Local Construction Projects: $440,000,000

Including, Los Angeles, Jacksonville, Honolulu, and Atlanta.

Washington, D.C. Metro: $108,000,000

Washington Metro Interest Payments: $51,663,000

St. Lawrence Seaway Development Corp.: $10,500,000

Interstate Commerce Commission: $45,844,000

DEPARTMENTS OF VETERANS AFFAIRS AND HOUSING AND URBAN DEVELOPMENT, AND INDEPENDENT AGENCIES

The $83.58 billion appropriated in this bill represents a massive 17.25 percent increase over 1990 levels and a 40.72 percent increase over 1989 levels. Programs within this bill too often duplicate private sector services, prevent the private sector from operating efficiently, or simply compensate for restrictive regulatory policies at the local level. Congress should consider terminating the following programs:

Department of Veterans Affairs

Construction, Major Projects: $575,456,000, an increase of $45,456,000 above budget estimate

Examples:$7,000,000 new hospital at Detroit

$8,900,000 for nursing home care unit at Lake City, FL

$3,400,000 for a laundry and warehouse at Mountain Home, TN

$8,000,000 for a clinical, outpatient, research, parking and central air conditioning project at Ann Arbor, MI

$800,000 for the advanced planning of a modernization project at Wilkes-Barre, PA

$4,800,000 for the contract documents of a replacement for the ambulatory care facility in El Paso.

$3,100,000 for the design of a psychiatric and outpatient facilities modernization project at Northport, NY

$3,200,000 for the design and site preparation of a clinical addition project at Wilmington

$1,450,000 for planning and site acquisition for a new national cemetery at Albany, NY

$1,506,000 for planning and site acquisition for a new national cemetery in the Chicago area.

$1,690,000 for planning and site acquisition for a new national cemetery in the Cleveland area.

$2,385,000 for planning and site acquisition for a new national cemetery in the Seattle area.

Parking Garage Revolving Fund: Total '91 $28,900,000

Department of Housing and Urban Development

Management and Administration Salaries and Expenses: $816,466,000 Including:

$10,000,000 more staff – FHA

$2,000,000 more staff – In-house Program Evaluation and monitoring

$1,750,000 more staff – Public and Indian Housing programs

Public Housing Reconstruction/New Development: $550,320,000

Independent Agencies

American Battle Monuments Commission: $15,900,000

Consumer Product Safety Commission: $37,109,000

Including:

$950,000 for transfer to the National Institute on Standards and Technology for the Technical Study Group on Cigarette and Little Cigar Safety to design and implement a study to collect data about the characteristics of those cigarettes, ignited products, and smokers that are involved in fires.

$50,000 for travel expenses of individuals in the above mentioned study by the Technical Study Group on Cigarette and Little Cigar Safety.

Environmental Protection Agency: $6,012,175,000

Research and Development: $254,900,00

Including:$1,500,000 to establish solar and renewable energy demonstration projects

$250,000 for research on control of the "Zebra mussel"

Abatement, Control, and Compliance: $1,006,525,000

Including:$1,000,000 for the Rouge River basin non-point source control demonstration

$3,000,000 for lead-based paint studies and support

$1,225,000 for continued work on the Spokane Aquifer

$200,000 for a Southwest Arkansas/Southeast Oklahoma Millwood Basin Water Quality Study.

$1,000,000 for the EPA National Training Center at West Virginia University

$275,000 for the Lake Pontchartrain new wetlands creation demonstration project

Construction Grants/State Revolving Funds: $2,000,000,000

National Aeronautics and Space Administration

Research and Development $6,458,625,000

Including: Space Station: $1705,000,000

Search for Extraterrestrial Life: $6,100,000

National Aerospace Plane: $114,000,000

Consumer Information Center: $1,540,000

National Science Foundation: $2,337,000,000

National Institute of Building Sciences: $250,000

FOREIGN OPERATIONS APPROPRIATIONS

Fiscal 1991 appropriations for Foreign Operations inched up by 1.69 percent over 1990 levels, but were 10.46 percent higher than 1989 appropriated levels.

Even though last year saw discussions in both the Administration and Congress about the failures of U.S. foreign aid, appropriations are up again for 1991. This is due in part to a desire to help the emerging Eastern European and Central American democracies. The U.S. agreed, for example, to contribute $70 million to a new development bank for Eastern Europe despite the failures of similar institutions such as the World Bank and the Inter-American Development Bank.

Multilateral Aid: $1.95 billion

Examples: Inter-American Development Bank: $78,000,000

Inter-American Investment Corporation: $13,000,000

World Bank: $50,000,000

International Development Association: $1.06 billion

Asian Development Fund: $243,900,000

African Development Fund: $105,452,000

European Development Bank: $70,021,000

Bilateral Aid: $7.7 billion

Examples: Agricultural Aid: $491,635,000

Private Sector, Energy, Selected Development Aid: $152,223,000

Sub-Saharan African Development Aid: $800,000,000

Agency for International Development (AID) Operating Expenses: $435,000,000

Economic Support Fund: $3.46 billion

Anglo-Irish Accord: $20,000,000

Multilateral Assistance Initiative:
Philippines: $160,000,000
Eastern Europe: $418,675,000

Other:Export-Import Bank: $785,000,000

Trade and Development Program: $35,000,000

Overseas Private Investment Corporation:

Direct Loan Limitation: $40,000,000

Guaranteed Loan Limitation: $250,000,000

The Heritage Foundation Backgrounder

No.779 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

The Thomas A. Roe Institute for Economic Policy Studies

July 23, 1990

ELEVEN CONDITIONS FOR A BUDGET SUMMIT

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INTRODUCTION

If the current White House-Capitol Hill budget negotiations follow the pattern established by previous summits, the result will not be a balanced budget. It will be higher taxes, more spending, and a larger deficit. This is made all the more likely because of George Bush's recent assertion that "tax revenue increases" must be part of any summit agreement – a deplorable flip-flop which simply relieves the pressure on Congress to control runaway spending.

Compounding Bush's strategic blunder, the Administration also has failed to frame properly the fiscal debate to give budget negotiators a clear picture of what specific items must and must not be included in an acceptable deficit reduction agreement. Not only has the Administration failed to list specific components of an agreement, the White House repudiated Senate Minority Leader Robert Dole's comment that the President would not accept an increase in personal income tax rates.

Tough Safeguards. If there is an acceptable agreement, it will need glue to hold it together. This must be budget process reform. Such reform is the equivalent of what verification and compliance guarantees are for international arms treaties. The wide disparity between the promises of budget agreements and the reality of budget outcomes shows that verification and compliance mechanisms are necessary for any domestic summit "treaty."

Without powerful safeguards to make a budget pact enforceable on Congress, it will not be worth the paper it is written on. Unless such safeguards are in the pact, in the form of tough budget control procedures, including a re-

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peal of the current services budget, creation of a second sequester, and a line-item veto, Bush should declare it in principle unacceptable, and lawmakers genuinely concerned about deficit control should not accept it.

As a result of Bush's political blunders, the current budget summit could well become a replay of the mistitled Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). Best known for the infamous and unfulfilled promise of "three dollars of spending cuts for every dollar of taxes," the legislation actually resulted in higher taxes, more spending, and a larger deficit. It is well known that Ronald Reagan personally regards TEFRA as one of his most serious mistakes while President. Unless Bush demands and gets budget process reform, his grand Budget Compromise will fare no better than TEFRA. The only question will be, "How much will taxes be raised, and who will pay them," and the deficit will not be brought under control.

A tax increase, meanwhile, likely will spur additional spending rather than deficit reduction. Already Congress is planning tens of billions of dollars in new spending. A tax-and-spend cycle would slow economic growth or even cause a recession. This will result in less government revenue and higher budget deficits.

Alternative Agenda. Rather than watch the accomplishments of the last eight years unravel, fiscally responsible legislators should advance an alternative agenda to fill the leadership vacuum created by the White House. They should insist on a budget agreement that promotes rather than retards economic growth. Such an agreement should include:

1) No new taxes;

2) Elimination of at least ten programs;

3) A spending freeze;

4) A moratorium on new programs

5) A tax limitation/balanced budget amendment

6) A line-item veto for the President;

7) Reform of the current services budget;

8) A second sequester to stop excessive spending;

9) A supermajority requirement for tax increases;

10) Linking taxes to deficit reduction;

11) A Common sense sequester.

LESSONS OF THE PAST

If the history of past budget summits is any indication, the current negotiations will result in higher taxes with little or no deficit reduction. A recent

study by the Tax Foundation, a non-partisan research group, on past budget summits demonstrates the desperate need for procedural safeguards. Under the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA), Ronald Reagan accepted a $98 billion tax increase which supporters claimed would reduce the deficit from $128 billion in 1982 to $104 billion in 1983. Spending restraints never materialized, however, and the actual deficit jumped to $208 billion.

Failing to Learn. The Administration apparently failed to learn from TEFRA. In 1984 it was seduced into raising taxes again, this time by $49 billion to lower the deficit from $185 billion in 1984 down to $181 billion in 1985. The actual deficit, after Congress went on a spending spree, rose to $212 billion.

The 1987 budget summit followed this sorry pattern. Reagan acquiesced to a $28 billion tax increase. The deficit, which was supposed to remain at $150 billion, jumped to $155 billion in 1988.

George Bush witnessed these debacles as Vice President. Even so, last year he accepted a $14.2 billion tax bill which was supposed to help lower the deficit from $152 billion in 1989 to $100 billion this year. The actual deficit this year, however, will probably exceed $150 billion.

The track record of budget summits certainly leaves much to be desired. The big problem, of course, is that Congress has never been willing to follow through on promises to restrain spending growth. As a result, changes need to be instituted that would bind legislators to produce what they promise.

A DEFICIT REDUCTION AGENDA

Some policy makers see deficits as the problem, with higher taxes and spending restraints as equally desirable ways to reduce the deficit. This ignores sound economic principles. In reality, spending is the problem; taxes and borrowing are simply alternative ways of taking money out of the pockets of taxpayers, of transferring resources from the productive sector of the economy to the government.

Unless the summiteers recognize this fundamental truth, a budget summit is unlikely to produce good results. If, on the other hand, budget negotiators wish to promote economic growth, they should adopt the following:

Condition #1: No New Taxes

The most important budget goal for responsible lawmakers remains: no new taxes. Higher taxes are not needed. In both nominal and inflation-adjusted dollars, tax revenues are at an all-time high. Federal taxes are expected to consume 19.6 percent of the Gross National Product (GNP) this year – the fourth highest level in peacetime history. Only twice have federal taxes ex-

ceeded 20 percent of GNP – in 1969 and 1981; in each case the economy fell into a recession the following year.

Increasing Red Ink. With the U.S. economy already somewhat weak, a tax hike almost certainly would trip the country into a recession. This would increase the deficit substantially. Unemployed Americans do not generate as much tax revenue for the government as those with jobs. Consumers with fewer after-tax dollars can afford fewer goods and services, and have less money to invest. And corporations with fewer sales do not pay as much in taxes as do those earning healthy profits. Even a modest slowdown would mean a great deal of red ink. The Congressional Budget Office (CBO) estimates that the deficit would rise by $52 billion next year if the unemployment rate increased by just one percentage point. The CBO also projects that if real economic growth is just one percentage point lower than projected, the deficit would climb by $26 billion.

A tax increase thus could increase the deficit by reducing economic growth. To make matters worse, a tax hike's revenues surely will not be used to trim the deficit. The political reality of the congressional budget process all but guarantees that a tax increase simply would trigger increases in federal spending. The deficit level is already statutorily determined by the Gramm-Rudman-Hollings Deficit Reduction Act. Higher taxes simply would allow Congress to comply with the deficit target at a higher level of spending.

Condition #2: Eliminate Programs

A necessary condition for a pro-growth budget summit agreement is the termination of federal programs. If there truly is a deficit crisis, as tax-hike supporters contend, then surely some of the more egregious examples of ineffective, wasteful, or pork barrel federal programs should be eliminated entirely. The budget negotiators should, at the very least, target a minimum of ten federal programs for termination to demonstrate that they are serious about trimming spending.

The ten should be chosen from:

Program	1990 Funding Level
Amtrak subsidies, which allow middle-class rail passengers to travel inexpensively.	$578.4 million
The National Endowment for the Arts, which gives handouts to artists and often sponsors controversial projects.	$167.5 million

The Legal Services Corporation, which often uses funds for political advocacy rather than to help poor clients.	$306.3 million
Economic Development Administration, which funds state and local pork barrel public works and other projects.	$ 23.7 million
Urban Mass Transportation Administration, which subsidizes forms of public transportation that usually are too costly and inefficient to run on their own.	$3.2 billion
Community Development Block Grants, which passes out funds to local governments.	$3.0 billion
Rural Electrification Administration, an obsolete program since 99 percent of rural residences have electricity.	$31.5 million
Agricultural Subsidies, cash payments, primarily to wealthy farmers.	$6.9 billion
Direct Foreign Aid, welfare for less developed countries.	$11.0 billion
Multilateral International Organizations, which funds organizations such as the United Nations.	$720 million
Low-Income Energy Assistance, which provides subsidies to people living in colder climates.	$1.4 billion
The National Endowment for the Humanities, which subsidizes writers, poets, and scholars.	$159.3 million
Alternative Energy Programs, which subsidize energy production that is too inefficient and costly to be sold to customers.	$138 million
Small Business Administration loans to small enterprises with low credit ratings.	$341.9 million
Appalachian Regional Commission, which subsidizes pork barrel public works projects in thirteen Eastern states.	$108.4 million
Job Training Partnership Act, a failed training program at a time when the mar-	

ket and private firms succeed in this task without public funds.	$4.5 billion
Superconducting Supercollider, an expensive scientific project with little practical application.	$217.8 million
Peace Corps, which provides social workers for less developed countries.	$168.3 million
Agency for International Development — Population Planning, which tries to limit the number of children born in less developed countries.	$34.1 million
Interstate Commerce Commission, an obsolete regulatory agency that restricts business activities, lowering American competitiveness.	$43.7 million
Corporation for Public Broadcasting, which funds T.V. programs aimed at upper class viewers, even though private cable channels provide the same service.	$229.4 million
Job Corps, another failed government jobs program	$767.1 million
Community Services Block Grants, which provides subsidies to local governments.	$390.0 million
Food for Peace Program, which dumps surplus American food into less developed countries, usually inducing local farmers not to produce.	$1.0 billion

Sources: Office of Management and Budget, Congressional Budget Office.

Condition #3: Freeze Spending

In addition to program terminations, budget summiteers should limit total fiscal 1991 spending to the 1990 level. This alone would cut the deficit almost in half in just one year, since tax revenues already are projected to increase by approximately $70 billion next year. Under a freeze, lawmakers would have the option to increase spending for politically sensitive items, such as Social Security Cost Of Living Adjustments (COLAs), but they would have to "pay" for these increases by reducing spending in other areas. If overall spending did not increase, all of the projected increase in tax collections under existing tax rates could be used for deficit reduction.

Some critics maintain that a spending freeze is unrealistic and would harm the economy. Yet between 1986 and 1987 the total growth of federal spend-

ing was held to $13.5 billion, an increase of less than 1.4 percent. This virtual freeze in spending resulted in a record $71.5 billion one-year reduction in the deficit. As a result, federal borrowing to cover budget deficits dropped from 5.3 percent of GNP to 3.4 percent in just one year. While old-fashioned economic theories predicted that the economy would contract because of the cutback in government spending, real GNP grew that year at a healthy 3.4 percent rate.

Forcing Choices. Another advantage of a spending freeze is that legislators finally would be forced to choose between different programs and to determine priorities. Under the current budget process, there is scarcely the pretense of priority-setting as higher taxes permit across-the-board increases in almost all programs, regardless of their relative merit.

A spending freeze also should apply to reauthorizations of existing programs, which almost always receive a congressional funding hike. Congress is now considering major reauthorization bills for housing programs, farm programs, and other programs. The participants in the budget summit should agree that spending levels in these bills will be capped at current levels.

Condition #4: A Moratorium on New Programs and Additional Spending

Congress should pledge no new programs until the budget is balanced. To consider an increase in the tax burden while continuing to create new programs and expand existing ones is deficit hypocrisy. Yet that is precisely what Congress has been doing. This is clear from the special interest pork-barrel projects tacked on to the recently-enacted $4.3 billion "Dire Emergency" Supplemental Appropriation which originally was designed to funnel foreign aid to Nicaragua and Panama. Included in this "Dire Emergency" legislation:

- $6 million for a wildlife refuge in Iowa
- $750,000 for a cargo and passenger boat for American Samoa
- $300,000 for a fishery resources study in Wisconsin
- $5 million for the United Nation's Environment Fund
- $6.8 million for grasshopper control
- $10 million in aid for Haiti
- $1 million in travel expenses for the Veterans Administration

Many of the legislators who voted for these special interest projects are the same ones who say the deficit problem is so severe that taxpayers should ante up more of their paychecks.

Congress also has thrown fiscal responsibility to the winds by considering legislation establishing a host of new entitlement programs for such things as child care. Legislators should demonstrate their commitment to deficit reduction by withdrawing the child care bill and other new programs from consideration.

MAKING A BUDGET DEAL STICK

The fact that the budget has been balanced only one year in the past three decades suggests that the budget process is fundamentally flawed. If a budget agreement this year is to mean anything, it must contain a good-faith package of reforms designed to assure Americans that legislators live up to whatever commitment they make to control spending. A litmus test for deficit reducers is whether they support the powerful safeguards needed to turn an agreement into reality. If responsible lawmakers cannot win support for key budget process reforms, they should refuse to support a budget summit deal that can be nothing other than a sham.

Reforming the process admittedly is not a panacea. Congress has shown remarkable creativity when it comes to wiggling out of deficit-reduction deals. But a better process would lead to better decisions. And certain major reforms would limit the wiggle room. The essential reforms:

Condition #5: Tax Limitation/Balanced Budget Amendment

The recent rejection of a balanced budget amendment by the House of Representatives clearly illustrates that Congress is more interested in taxing and spending than in fiscal responsibility. Yet a tax limitation/balanced budget amendment is precisely what is needed to restore balance to the budget process.

Politicians have an incentive to spend money since the beneficiaries of federal largesse tend to be concentrated, politically active, and able to reward politicians with votes, contributions, and other types of support. The victims of federal spending, by contrast, are ordinary workers and other taxpayers who are unlikely to calculate the costs imposed on them due to particular programs. Even if they are aware of how federal spending on various programs burdens them, they are unlikely to be in a position to counter the politically-sophisticated and well-financed lobbying efforts of the special interests who benefit from federal spending. A tax limitation/balanced budget amendment would force lawmakers to take into account the interests of the general public by limiting the amount of resources politicians could extract from the productive section of the economy.

Condition #6: A Line-Item Veto

Powerful legislators often attach pork barrel projects and special interest spending to larger, unrelated pieces of legislation knowing that the President may be reluctant to veto the underlying bill. This practice adds billions of dollars of wasteful spending to the budget. Some 43 state governors have line-item veto authority. This has achieved major savings at the state level. A President with line-item veto power, which would allow him to cross out irrelevant sections of legislation without rejecting the entire bill, could cut deficit spending by billions of dollars.

Condition #7: Current Services Budget Reform

One of the biggest obstacles to sound fiscal policy is the political manipulation of budget numbers. The federal government uses a budget device known as the "current services budget." This automatically assumes that federal spending will increase in future years according to the expected inflation rate, projected increases in program beneficiaries, and program expansions already built into the law. Such assumed increases are not, officially, treated as spending increases. Thus if spending for any particular program did not increase as fast as the current services budget estimates, this is treated as a "budget cut." In fact, of course, this is a spending increase. This through-the-looking-glass re-definition of a budget cut has significant political consequences, since special interest groups can build public opposition to fiscally responsible spending limitation measures by painting them as severe cutbacks when, actually, outlays have increased – though not at the rate originally presumed. Ten years of newspaper stories and news reports about "cruel and draconian" budget cuts have convinced many Americans that spending actually has been "cut to the bone." In reality, federal spending has more than doubled since 1980. The only thing that has been cut is the rate of increase. Responsible budget making thus requires that the gimmick of the "current services budget" be scrapped and replaced with a budget process that honestly measures changes in annual spending.

Condition #8: A Second Sequester

One of the few bright spots in budget policy is the 1985 Gramm-Rudman-Hollings Deficit Reduction Act. Adjusted for inflation, federal spending is growing less than half as fast now as it was before the law's enactment. The key to Gramm-Rudman-Hollings is the automatic spending control mechanism known as sequestration. Under sequestration, if Congress tries to spend more than Gramm-Rudman-Hollings allows, spending levels are automatically reduced by the amount needed to lower the deficit to the legally required level. A loophole in the law, however, is that the sequester takes place on October 15, barely two weeks into the fiscal year. Beginning October 16, Congress can add additional spending without the fear of sequestration. A budget agreement can close this loophole by adding a second sequester to Gramm-Rudman which would occur in the middle of the fiscal year. Congress would then have a choice either to forego back door spending or run the risk of sequestration.

Condition #9: Supermajority Tax Increase Vote

In addition to the sequester, Gramm-Rudman has tightened the budget process by requiring 60 votes before the Senate can consider legislation that would increase the deficit. This provision should be strengthened by a similar, supermajority requirement for any tax increase.

Condition #10: Taxes Dedicated to Deficit Reduction

Higher taxes are not needed and would damage the economy. So lawmakers should not support any tax increase proposed by the summiteers. If a tax increase appears inevitable, however, Congress should mandate that revenues be used for deficit reduction.

Under current law, any tax increase almost surely will lead to a dollar-for-dollar increase in federal spending. The reason for this is that Gramm-Rudman-Hollings limits total spending to the sum of projected tax revenues plus the allowable deficit target. The 1991 deficit target, for instance, is $64 billion. This target will not change if taxes are raised by, say, $20 billion. All that changes is that Congress can now meet that target at a higher level of overall spending. The actual deficit, in other words, remains that set by the Gramm-Rudman-Hollings law. Raising taxes merely permits higher spending.

The summiteers supporting a tax increase claim, of course, that a tax hike would be used for deficit reduction anyway and so it is not necessary to reform the budget process. Previous experience suggests, however, that this is like the kleptomaniac assuring the store manager that security guards are unnecessary. If lawmakers truly intend to use new taxes only for deficit reduction, they should not be reluctant to support a requirement to ensure that is actually what happens.

The only way to ensure that higher taxes do not get spent is to tie taxes to automatic reductions in the Gramm-Rudman-Hollings deficit target. Under this proposal a $20 billion tax increase would reduce the Gramm-Rudman-Hollings deficit target by $20 billion – in 1991 that means it would be reduced from $64 billion to $44 billion. Even if the Gramm-Rudman 1991 deficit target were to be moved to $100 billion, a $20 billion tax increase would drop the target to $80 billion. Only an undertaking of this kind, built into budget law, would assure what the summiteers profess to desire – a rise in taxes to cut the deficit.

Condition #11: A "Common Sense" Sequester

Many analysts believe that the White House is capitulating on taxes, not because the President really believes in a tax increase, but because he has no choice. According to this thesis, if the President were to stick to his promise, and Congress refused to exercise the fiscal restraint needed to meet the Gramm-Rudman-Hollings deficit target, the stalemate would mean a sequester. Failure to control this year's spending, combined with a relatively sluggish economy, means that the potential 1991 sequester could be in the $50 billion-$100 billion range. The assumption is that a sequester of this magnitude is unacceptable, especially since the defense budget must bear 50 percent of the total sequester.

The probable reason why a sequester is so unpalatable to the Administration is that there is relatively little managerial discretion available under Gramm-Rudman-Hollings. With total federal spending next year expected to

approach $1.3 trillion, a cut of $50 billion or even $100 billion is hardly draconian. The rigid formula which determines how a sequester is applied, however, makes sequestration extremely painful politically. But if Congress were to allow the Administration even a modest amount of authority to manage the sequester, shielding some programs and subjecting less important parts of the budget to a larger percentage of the total cut, sequestration would become much more acceptable.

CONCLUSION

Budget summits historically have resulted in higher spending, more taxes, and bigger deficits. This need not be the case this year. A combination of no new taxes, program terminations, a cap on overall spending, locked in with real budget process reform, would reduce deficit spending dramatically.

Avoiding Bad Policies. The White House so far has allowed the budget summit to evolve into a tax summit. Before bad discussions are allowed to become bad policies, fiscally responsible participants in the summit process should insist on a pro-growth agenda for the negotiations. Smart politics, as well as sound economics, dictates that these positive proposals must be part of any final agreement. Should Congress refuse to accept such a package, the sequester can be utilized to achieve real deficit reduction. And even as currently structured, sequestration would be a preferable alternative to a repeat of the 1982 TEFRA tax hike debacle.

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RUSH!

Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

7/11/90 Number 273

SOLVING THE DEFICIT PROBLEM: A TAX LIMITATION/BALANCED BUDGET AMENDMENT

The House of Representatives soon will vote on a balanced budget amendment (H.J.R. 268, S. 183) which would require the President to submit, and the Congress to approve, a balanced budget each year. The amendment also would prohibit Congress from raising the debt ceiling unless this would be supported in each House by a three-fifths vote; currently it takes only a majority to hike the debt ceiling. To become part of the Constitution, this amendment must be approved by a two-thirds vote in each chamber of Congress and be ratified by three-fourths of the state legislatures. The problem is that there are a variety of possible balanced budget amendments. A measure simply requiring a balanced budget could be used to justify higher taxes to fund greater spending. What is needed, therefore, is a balanced budget amendment containing a provision restricting the ability of Congress to raise taxes.

In the past three decades, Congress only once has produced a balanced budget. That was in 1969. Since then, 21 straight years of deficit spending have added more than $2 trillion to the national debt. While many observers discount the economic impact of the national debt, asserting that it is "just money we owe ourselves," deficit spending does in fact harm the economy. The reason is that every dollar that the Treasury Department borrows to finance excessive government spending is a dollar that is not being spent more productively by the private sector. Money that is loaned to the federal government is money that is lost to private borrowers. The borrower may be a young worker seeking a car loan, a family searching for a mortgage for a first home, or a business trying to raise money to build a new factory and expand production. Whatever the purpose of the private borrower, federal deficit spending "crowds out" more valuable uses of funds.

Draining the Productive Sector. Deficits thus are bad. But they are the symptom, not the disease. Government borrows more only because it is spending more. Replacing deficit-financed government spending with spending financed by taxes simply substitutes one policy that harms the economy for another. Taxes, like borrowing, are funds transferred from the productive sector of the economy to the government. With this in mind, the single most important provision of a balanced budget amendment would be a clause restricting taxes.

A "Taxpayer Protection" clause should make it more difficult to raise taxes and should limit the total tax burden to be placed upon the American people. The simplest method of making it harder for the federal government to increase the tax burden would be the so-called super-majority requirement introduced by Representative Larry Craig, the Idaho Republican; it would require a three-fifths vote by each House. Currently, taxes can be raised by a simple majority of those voting. As important, a provision limiting total tax collections as a percentage of the GNP would keep Congress from using a balanced budget amendment as an excuse for annual tax hikes.

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Buying Popularity. The current budget debate demonstrates that a balanced budget amendment without a tax limitation provision surely would generate support for higher taxes. The statutory requirement in the 1985 Gramm-Rudman-Hollings deficit reduction law that the 1991 deficit not exceed $64 billion, combined with the refusal of Congress to cut spending sufficiently, seems to be what prompts George Bush to betray his "No New Taxes" promise and join with congressional big spenders in seeking more funds from already overtaxed Americans. Higher taxes, of course, allow more spending, and more spending allows many politicians to "buy" popularity.

It is this allure of buying popularity which prompts lawmakers to say "yes" to taxes even though this may threaten economic growth and impose heavy costs on individuals and businesses across America. This temptation would not be changed by a balanced budget amendment that did not include a provision making tax increases more difficult to enact.

Were such an amendment adopted, if taxes did not equal the amount lawmakers sought to spend, they could raise taxes to finance the spending rather than limit spending. Since the political system currently rewards big spending, a tax limitation provision is needed to restore balance to the political decision-making process.

Strong Tax Limits Needed. A proper balanced budget amendment would strengthen the economy by promoting responsible fiscal policy. This would not be the case with a balanced budget amendment that might spur higher spending and higher taxes. To ensure that a balanced budget amendment encourages sounder economic decisions and is a vehicle for economic growth, the strongest possible tax limitation language should be included.

Proponents of higher taxes and spending understandably have cheered George Bush's flip-flop decision to betray his no-tax pledge. These lawmakers may cloak their tax-and-spend agenda with rhetoric about the need for greater fiscal responsibility and for closing the budget deficit gap. But 21 straight years of fiscal responsibility rhetoric has not balanced the budget. A tax limitation and balanced budget amendment would. Until such an amendment is enacted and ratified by three-fourths of the states, all tax increases should be "off the table."

Daniel J. Mitchell
John M. Olin Fellow

For Further Information:

Daniel J. Mitchell, "Mr. President, Keep Your Promise: No New Taxes," Heritage Foundation *Backgrounder* No. 769, May 18, 1990.

Stephen Moore, "What the States Can Teach Congress About Balancing the Budget," Heritage Foundation *Backgrounder* No. 751, February 6, 1990.

Executive Memorandum
The Heritage Foundation
214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

RUSH!

6/28/90
Number 271

BUSH'S DEPLORABLE FLIP-FLOP ON TAXES

If George Bush had pardoned Willie Horton, or burned Old Glory on the lawn of the White House, it would hardly have rivalled the flip-flop he has committed on taxes. Few political figures have identified themselves in an election with a particular principle or position to the degree that George Bush pledged himself to protect the American voter from higher taxes.

Even the President's rationale for breaking his pledge does not stand up to scrutiny. Notwithstanding Bush's statement that, "...the size of the deficit problem and the need for a package that can be enacted require...tax revenue increases...", there is no need for higher taxes. While the deficit is a problem, it is not a crisis, and it should be addressed through budget cuts. Moreover, there is little doubt that the big spenders in Congress have been fanning deficit hysteria as a ruse to push through a tax increase with the aim of spending the money on new programs, not to reduce the red ink.

Both the Congressional Budget Office and the Office of Management and Budget estimate that the 1991 budget deficit will total about $160 billion if current spending trends continue unabated. Such a deficit would equal approximately 2.7 percent of Gross National Product (GNP), the lowest level since 1981. If the deficit truly is about to cause the economy to collapse, as some in the Administration and Congress would like Americans to believe, it seems curious that the economy did not fall apart in 1985, when the deficit was 5.4 percent of GNP. If a deficit of 2.7 percent of GNP is a crisis, why did the economy grow in 1987, when the deficit equalled 3.4 percent of GNP?

Deficits are not the issue; the real problem is excessive government spending. By allowing its attention to focus on the deficit, the Administration is treating the symptom and not the disease. Unfortunately, it appears that an unwillingness to offend special interest groups, or risk reducing the President's high popularity ratings, has precluded any serious effort to control the growth rate of government spending.

Battle Lines. The battle over taxes, however, is not one that can be decided simply by "splitting the difference" between the two sides. It is a fundamental conflict between two visions for America's future. On one side is the bureaucracy, the Washington establishment, and the special interests who feed at the public trough. For these groups, taxes are the lifeblood upon which their health depends. Because the Gramm-Rudman Deficit Reduction Act has as least partially restricted how much money politicians can spend, the big spenders desperately need more tax revenue if they are to increase spending. On the other side are the workers, consumers, and businesses of America who produce the country's wealth. These are the people who elected George Bush to the Presidency, and expected George Bush to protect them from higher taxes.

Some Administration figures claim that circumstances have changed since the President promised "No new taxes." Yet they fail to identify any convincing reason why taxes should be increased. At least no Administration official has been foolish enough to argue publicly that taxes should be in-

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creased to boost the economy, since both economic theory and real-world evidence suggest just the opposite. As the 1980s richly demonstrate, lower taxes increase incentives and promote economic growth by raising the rewards of savings, working, investing, and producing. The 1970s showed just the opposite: higher taxes result in economic stagnation. And the argument that Congress will use new tax revenue to cut deficits, not increase spending? That demonstrates a remarkable naivete about the facts of life in Washington.

Real Worry. Tax collections, in any case, are climbing back to the levels of the late 1970s. Federal tax collections this year are expected to consume 19.6 percent of GNP, the fourth-highest level in peacetime history and within range of the all-time peacetime record of 20.1 percent, reached in 1969 and 1981. But surging revenues are a cause for alarm – and hardly indicate a need to boost taxes. The record-high tax years of 1969 and 1981 were followed not by good economic times, but by deep recessions.

George Bush said, "There's no quicker way to kill prosperity than to raise taxes.[1]" He was right. He said, "I've been in government a long time, and I've seen what happens when the government raises a dollar in revenues – Congress spends a dollar fifty.[2]" He was right. He said, "The surest way to kill the recovery is to raise taxes. That will stifle everything from investment and personal savings to consumer spending. It will clamp down on growth. It will invite a recession.[3]" He was right.

Thus the battle over taxes is a battle not only for the economy; it is a battle for the integrity and character of the Bush Presidency.

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1 Boston, MA, April 15, 1987.
2 Pittsburgh, PA, April 29, 1988.
3 Chicago, IL, September 13, 1988.

The Heritage Foundation Backgrounder

No. 774 | The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-440(

The Thomas A. Roe Institute for Economic Policy Studies

June 28, 1990

THE SIX TRILLION DOLLAR DEBT ICEBERG
A REVIEW OF THE GOVERNMENT'S RISK EXPOSURE

INTRODUCTION

In a congressional floor speech last spring decrying the cost of the savings and loan (S&L) bailout, now estimated at between $150 billion and $300 billion, Representative Major Owens, the New York Democrat, declared that he believed there had never been a single item in peacetime that cost the government so much money. Owens raised an intriguing question, and research into federal budget history reveals that he was right. Only World War II cost more than the S&L bailout, at least in nominal dollars. But an examination of the finances of other government-backed agencies indicates that the bailout may be just the tip of a fiscal iceberg about to strike the American taxpayer. The total financial obligation of agencies underwritten by the federal government is now some $5.8 trillion – and much of that obligation is in bad shape.

The S&L disaster represents an staggering breakdown of government, and the hidden costs to Americans likely will turn out to be several times the amount that the hapless taxpayer is scheduled to pay directly in extra taxes. It will take years to unravel what really happened and why. But one thing is clear: the government's mega-billion dollar commitment to guarantee the deposits of the savings and loans insured by the Federal Savings and Loan Insurance Corporation (FSLIC) was grossly mismanaged. This and the perverse incentives offered by the insurance program led to the wholesale looting of hundreds of thrift institutions.

Worsening Daily. As the S&L bailout legislation went through Congress, most lawmakers tried to convince Americans that the crisis was just an isolated incident, however costly, and that the vast bulk of the government credit programs are well-managed and pose little risk to the taxpayer. While

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taxpayers may wish for this to be so, a cursory examination of the federal government's vast credit empire actually reveals repeated instances of huge financial risks that are worsening by the day. In fact, the $958.9 billion in S&L deposits insured by the FSLIC at the end of 1989 represents just a small fraction of the financial liabilities the federal government has assumed through its many direct lending, loan guarantee, and insurance programs. The $4.2 billion loss at the Federal Housing Administration revealed in May 1989 in a General Accounting Office (GAO) audit and the Office of Management and Budget's (OMB) projection that the losses continue, are just among the latest hint of a vast liability that could land in the lap of taxpayers. The government's total risk exposure of nearly $6 trillion dollars is more than twice the national debt held by the public and more than five times the annual federal budget.

Comprehensive Effort Needed. A number of these programs already are encountering serious financial problems. Others could join them over the next year, depending upon how the economy performs. Like the FSLIC, some of these programs require immediate attention to stanch enormous losses and limit potential future claims on the taxpayer. Unfortunately, no such comprehensive effort is under way in Congress or the White House. Worse still, to the extent that credit-related legislation is being considered by Congress, some of it would make the situation even worse.

Because the potential costs of ignoring these problems are so huge, it is essential that steps be undertaken immediately to place the government's vast array of financial activities on a sound basis. This requires enactment of an Omnibus Credit Solvency Act that would fundamentally restructure these many programs to reduce the taxpayers' exposure to costly program failures. Such an act would improve underwriting standards and financial controls, tighten management, and eliminate or reform the most costly programs.

THE RISKS FACED BY TAXPAYERS

The $6 trillion risk exposure is spread among deposit insurance programs, loan and pension guarantees, direct loans, other forms of insurance, and the debt of the five multi-billion dollar government-sponsored enterprises.

1) Deposit Insurance

In addition to the $958.9 billion in savings and loan deposits insured by the FSLIC, another $1.806 trillion of deposits at commercial banks and savings banks are insured by the Federal Deposit Insurance Corporation (FDIC). In addition, approximately $161 billion in credit union deposits are insured by the National Credit Union Administration. Total deposit guarantees amounted to $2.9 trillion in 1989.

2) Loans and Guarantees

The federal government stands behind nearly half a billion dollars in guaranteed Veteran's Administration (VA) and Federal Housing Administra-

tion (FHA) mortgages, $48 billion in guaranteed student loans, and a host of other guarantees ranging from rural electrification to ship building loans, and from small business disaster loans to loans for building plants to convert grain to ethanol. Altogether, the contingent liability associated with the government's loan and deposit guarantees total approximately $3.5 trillion at the end of fiscal 1988. Other insurance programs, such as flood insurance, add about another half-trillion dollars to this liability.

3) Pension Programs

Added to these loan and insurance risks are 105,000 single-employer pension plans, and 2,300 multi-employer pension plans protected by the federal government's Pension Benefit Guaranty Corporation. The government's potential obligation for these pension programs is estimated at $819 billion for 1989.

4) Direct Loan Programs

The government also acts as a financial institution, extending loans to eligible borrowers. Major direct loan programs include the Export-Import Bank, the Small Business Administration, College Housing, and the Rural Telephone Bank. The portfolio of outstanding loans held by the federal government as of the end of fiscal 1989 amounted to $207 billion.

5) Government-Sponsored Enterprises

The government has created a number of "off-budget" enterprises and is responsible for their finances. These government-sponsored enterprises (GSEs) technically are private organizations, but in practice are treated and act as extensions of the federal government. Several of these enterprises add to the real estate exposure due the troubled mortgage insurance schemes. One of the GSEs, the Federal National Mortgage Association (FNMA), for instance, held $110 billion in mortgage loans and guaranteed another $208 billion in outstanding mortgage-backed securities at the end of 1989. Its companion, the Federal Home Loan Mortgage Corporation (FHLMC), holds few mortgages but guarantees $257 billion in mortgage-backed securities. Collectively, the five government-sponsored enterprises had an outstanding debt obligation of $763 billion at the end of 1989,[1] and they are the fastest growing source of federal credit exposure.

Although these privately-owned but government-sponsored enterprises maintain the fiction that they are independent of government and thus pose no liability to the taxpayer if they fail, recent experience suggests that the government will in fact bail them out to maintain their solvency during periods of adversity. The fiction of independence, for instance, did not

1 These GSEs are the Student Loan Marketing Association, the Federal National Mortgage Association, the Farm Credit System, the Federal Home Loan Bank System, and the Federal Home Loan Mortgage Corporation.

prevent the 1987 bailout of the "independent" Farm Credit Administration, with an estimated final cost of between $2 billion and $3 billion.

THE RISING TIDE OF RISK EXPOSURE

As the $958.9 billion pool of insured savings and loan deposits has unraveled, Americans have become painfully aware of the risks associated with such programs, and the enormous potential cost of mismanagement and failure to correct emerging problems. Yet the FSLIC is by no means the only federal credit program confronted with staggering losses. Default rates in many of the government direct loan and loan guarantee programs are rising at an alarming rate and could lead to huge losses which will have to be met by the taxpayer. The FDIC and the FHA posted their first-ever losses in 1988 and repeated that performance in 1989. With the residential and commercial real estate markets still weak, this trend could continue through 1990.

Many of the government-sponsored enterprises and insurance programs, moreover, have inadequate net worth and reserves to support the risks to which they are exposed. The FHA, for example, has seen the level of claims against its shrinking reserves rise nearly three-fold over the last three years. Further, half of the farm loans made by the Farmers Home Administration are in default, and half of these defaulted loans have been in that condition for more than three years. Yet even that dismal performance appears almost praiseworthy when compared to the 100 percent default rate experienced by the Economic Development Administration's loan guarantees for the steel industry and the equally disastrous performance of the ethanol production loan guarantees issued by the Departments of Agriculture and Interior.

Has Congress learned any lessons from these and the many other troubled loan programs? The answer appears to be, it seems, "no," judging from recent legislative initiatives. Indeed, some proposed congressional legislation actually would aggravate the problem. Example: Some in Congress would expand FHA exposure to markets already served by the private sector and on terms leading to a greater likelihood of default. And although the Bush Administration has proposed many valuable reforms in its 1991 budget to reduce the total risk to the taxpayer, much more needs to be done.

WHAT NEEDS TO BE DONE

The savings and loan fiasco could be just the beginning of a costly stream of financial disasters that will end up in the lap of the American taxpayer. Urgent action must be taken to reduce the potential price tag. Fortunately, it is not too late to avoid several potential collapses. But a comprehensive legislative package is needed soon. The appendix to this paper details the principal federal financial programs and lays out a reform strategy for groups of similar programs that should be included in an Omnibus Credit Solvency Act. Among its necessary provisions:

♦ **Establish premium incentives and operational practices to encourage both government providers and private sector users to act in a fiscally prudent fashion and to rebuild reserves.**

Many of the credit programs most in trouble cannot help but lose money because of poorly conceived, yet congressionally required, underwriting standards that actually forbid federal program managers from rejecting poor credit risks. Indeed, some programs, such as the Farmers Home Administration, are designed specifically to serve poor credit risks. For the same reason, many of the programs cannot charge premiums that correspond to likely (or actual) losses, and so are required to run at a deficit, such as the Pension Benefit Guarantee Corporation or the Federal Housing Administration.

♦ **Eliminate costly programs that have outlived their usefulness, such as many of those created during the Depression of the 1930s.**

Another source of the problem is the continued operation of programs that have long since outlived their usefulness and now expose the government and the taxpayer to needless risk. Many of the Depression-era programs – created to meet a national emergency – long ago have completed their job and should be retired gracefully. The Rural Electrification Administration, which met its goal in the mid-1950s, nonetheless continues to expand at ever-rising costs. Thus an omnibus bill should provide for a thorough review of the need of each program and an assessment of the potential for private sector alternatives.

The review also should consider the extent to which federal credit programs and government-sponsored enterprises have come to dominate and monopolize certain segments of the economy. The U.S. has a long tradition of concern over excessive concentration of market power, and several of the GSEs now dominate the market in degrees of concentration seldom seen in the private market. Government intrusion into the housing finance market, for instance, is very extensive. This exposes the taxpayers to risk and discourages private entities from offering the same service; this concentration in the mortgage market, for example, was a contributor to the weakening of the S&L industry. An omnibus credit bill thus should consider ways in which this responsibility and risk can be decentralized and returned to the private sector where it belongs.

♦ **Establish uniform accounting and financial controls that would quickly and accurately reveal program losses.**

Also exacerbating the structural weakness of these programs are a series of management, information, and control problems that make it difficult or impossible to properly supervise these programs. As the GAO audits have revealed, many of these programs have primitive accounting systems that hide more than they reveal. Moreover, standards of accounting between agencies also differ, making it difficult to make comparisons between programs. Any omnibus credit reform bill thus should include the requirement that accounting and financial control systems be overhauled and standardized. It should also include the requirement for accurate quarterly reporting so that

public officials can have timely and understandable information on program status.

CONCLUSION

The vast system of federal credit programs, with their $5.8 trillion in outstanding obligations, is in serious trouble. It costs the taxpayers billions of dollars a year in bailouts, defaults, and unneeded subsidies. Beyond these direct costs to American taxpayers is a host of indirect costs due to the disruption they cause to U.S. financial markets and the country's ability to deploy its capital resources in an efficient and productive fashion.

Facing the Fact. This national embarrassment and potential catastrophe must be brought under control as swiftly as possible through an Omnibus Credit Reform Bill that makes fundamental changes in the way these programs are structured and operated. Many of the reforms that should be contained in such a measure already have the support of the Administration and in Congress. Unfortunately, the reform approach to this date has been piecemeal, and thus misses the opportunity to achieve comprehensive reform, dealing with problems before they worsen. Congress must at last face up to the fact that the savings and loan crisis, and the other emerging problems associated with federal credit and guarantee programs, are not isolated and unconnected. Rather, they indicate systemic flaws. The solution is system-wide reform.

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APPENDIX

THE FEDERAL GOVERNMENT'S CREDIT OBLIGATIONS

GROUP I: THE HOUSING CREDIT PROGRAMS

Despite the prevailing popular view that the 1980s was a decade of government retrenchment, there was in fact a rapid growth of government credit programs, often at the expense of private financial institutions unable to compete with generous government subsidies. Indeed, one factor in the S&L collapse was aggressive government mortgage lending activity that depressed the earnings generated from traditional savings and loan lending activities. In the residential housing mortgage market, for example, expanding government programs led to the effective "federalization" of much of the nation's housing finance market, and to the assumption of multi-billion dollar liabilities by the taxpayer. Federal and federally-sponsored mortgage credit support accounted for just 17 percent of outstanding mortgages in 1980, but by the end of 1989, 41 percent of outstanding home mortgages had been guaranteed by federal agencies or securitized by GSEs as the Federal National Mortgage Association, the Federal Housing Administration, the Government National Mortgage Association, and the Federal Home Loan Mortgage Association widened their activities and displaced private providers of mortgage credit and insurance. There has been similar growth in the agriculture sector, with a vast array of subsidized federal credit support programs for farmers adding momentum to the agriculture debt crisis that first emerged in the middle of the decade.

What is ironic about this rapid growth in credit programs during the economically buoyant 1980s is that the vast majority of the programs were created during the Great Depression to help revive a struggling economy. But credit programs were not dissolved once the apparent need for them had passed. Instead, in predictable bureaucratic fashion, their missions simply were redefined and they continued to grow well beyond the scope and purpose envisioned by their founders.

1) The Federal Housing Administration

The Program. The Federal Housing Administration (FHA) was created in 1934 to revive the badly battered residential housing market by insuring a new type of residential mortgage instrument: the long-term, fixed rate, level payment, fully amortized mortgage. The goal of injecting new life into the housing market largely was fulfilled in the early postwar era, when private lending institutions returned in force to the housing finance market. In the early 1970s, the need for a government-operated mortgage insurance enterprise was further diminished when a private mortgage insurance in-

dustry emerged and offered lenders and borrowers essentially the same services as government and at competitive fees.

The Problem. Despite the shrinking need for a government mortgage insurance industry, the FHA has attempted to remain in operation by redefining its mission and expanding its activities into risky ventures that serve little or no public purpose yet expose the taxpayer to ever-growing potential losses. Thanks to a policy of lax underwriting standards, low downpayments and excessive risk-taking, as well as weakening regional real estate markets, the FHA now is confronted with the very real prospect of financial insolvency.

Rapid increases in claims filed by lenders against the FHA insurance fund have jumped. Since 1987, the cost associated with the acquisition of property and the assignment of mortgages has risen from $4.3 billion to an estimated $6.9 billion in 1990. Delinquencies of more than sixty days accounted for 6 percent of FHA mortgages in early 1989, compared with 5 percent in the third quarter of 1988 and just 2 percent in 1979. In early 1990 the delinquency rate has been running at 3.3 percent, but because revenues from new insurance premiums are expected to decline with the current slowdown in the real estate market, the FHA's losses could rise at an accelerating rate. The agency is estimated to lose $99 million a month in 1990

Considerable light has been shed recently on the FHA's troubles by a GAO audit which found that FHA's equity, essentially its reserves against losses, had declined to a negative $2.9 billion in support of $303 billion of insurance-in-force at the end of 1988.[2] Since the agency's financial condition has been deteriorating, it is quite possible that even these tiny reserves and equity have been completely wiped out, leaving the taxpayer liable to cover all future net losses.[3] In his June 9, 1990, testimony to the Senate Banking Committee, Housing and Urban Development Secretary Jack Kemp told members that years of neglect and mismanagement have rendered FHA ill equipped to fulfill its mission of promoting homeownership. Kemp noted the rapid financial deterioration of the FHA's Mutual Mortgage Insurance Fund, the major program for insuring mortgages on single family dwellings. He stated that under the existing program's arrangements each year's new business will lose money for FHA at a rate of $200 million, and this ultimately will wipe out the fund's net worth unless major reforms are made.

2 "1988 Financial Audit: Federal Housing Adninistration," Testimony of Charles A. Bowsher, Comptroller General of the United States before the Housing and Urban Affairs Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, September 27, 1989, p. 1.

3 For further details on FHA's financial status see Ronald Utt, S. 565: Pushing the Federal Housing Administration Toward Insolvency," Heritage Foundation *Issue Bulletin* No. 148, June 12, 1989.

What Needs to be Done

First and foremost, congressional efforts to reduce FHA's required downpayment should be rejected. Study after study demonstrates that loan losses rise as downpayments are lowered. Congress and the Administration should work to construct a package of legislative reforms that would restore permanent financial solvency to the FHA program. Among the steps, first suggested by The Heritage Foundation in 1986, needed to bring the FHA's finances under control:[4]

- ♦ Restrict FHA insurance to first time buyers with modest incomes.
- ♦ Require a minimum downpayment of no less than 5 percent of the cost of the property.
- ♦ Hold mortgage insurance limits at their present level of $101,250, as recommended by Secretary Kemp.
- ♦ End the practice of allowing borrowers to finance their closing costs.
- ♦ Increase FHA reserves to 4 percent of FHA's contingent liabilities by way of increased premiums, higher coinsurance, and better underwriting standards. Charge higher premiums for riskier mortgages.

Last year, in response to the GAO's audit report, HUD proposed a series of important interim reforms that Congress adopted. Kemp recently unveiled a package of sensible reforms to reduce the risk associated with low downpayments and achieve a comprehensive overhaul of the program.

2) The Veterans Administration

The Program. In 1948 the Veterans Administration (VA), now the Department of Veterans Affairs, launched a mortgage guarantee program designed to help eligible veterans to become homeowners. While the FHA insures 100 percent of a mortgage only up to a certain dollar limit and requires a minimum downpayment of between 3 percent to 5 percent, a VA mortgage has no upper dollar limit. VA guarantees only the first 40 percent of principal up to a maximum of $36,000 for loans up to $144,000. For loans that exceed $144,000, VA will pay 25 percent of the loan up to $46,000. VA loans require no downpayment. The VA mortgages do experience higher default rates than the FHA because of the lack of a downpayment requirement,[5] but the government's financial exposure actually is less than with the FHA because the risk is shared with the lender.

The Problem. Like the FHA, mortgages insured by the VA are experiencing much higher default rates and losses than anticipated. In many cases, the

4 Stephen Moore, "How to Defuse the Federal Housing Administration Time Bomb," Heritage Foundation *Backgrounder* No. 528, July 29, 1986.

5 See Utt, *op. cit.* for an explanation of the relationship between downpayments and the risk of default.

losses exceed the government's guarantee, causing losses to the private lender – or to the Government National Mortgage Association (GNMA) which adds its own guarantee on top of VA's when the VA loans are "securitized" through the GNMA program, which provides 100 percent guarantees on its VA/FHA-backed securities.

Between 1981 and 1987, VA foreclosure actions increased by 215 percent. Over the same period, losses rose from $51 million to $615 million, but by 1990 the annual loss is expected to rise to $792 million. It is expected that VA mortgages written in 1990 eventually will experience a 10.4 percent foreclosure rate. In the past, VA often would cover all the loss on a defaulted mortgage – even that portion which exceeded its legal obligation. However, Congress in 1984 enacted legislation prohibiting the agency from paying out more than its legal obligation.

What Needs to be Done

Because the program was established to reward veterans for their service, and was not meant to be financially self-sufficient, a reform of the program should aim at bringing the taxpayer liability under control, not at an eventual elimination of taxpayer exposure. To accomplish this a package of reforms should:

♦ Undertake a thorough review of the VA's underwriting standards to determine whether too many risky borrowers are using the program. The program was never meant to be a blanket entitlement for all veterans – only those who could demonstrate an ability to repay the loan were deemed qualified for a VA guaranteed mortgage.

♦ Adopt the Bush Administration's most recent reform proposals that would require veterans to make a small downpayment of 4 percent of the amount of the loan above $25,000; charge a 1.75 percent loan fee; and, increase risk sharing with lenders.

3) The Federal National Mortgage Association

The Program. The Federal National Mortgage Association (FNMA), known as "Fannie Mae," is a privately-owned, government-sponsored enterprise (GSE), chartered and organized by the FHA in 1938 to provide secondary market support for the newly-devised FHA mortgages. In 1968 the FNMA was split into the newly-created Government National Mortgage (GNMA), or "Ginnie Mae," which took over those FNMA housing assistance programs that were largely targeted to moderate- and low-income households, and a new FNMA, which held onto to the profitable business of borrowing in capital markets to buy residential mortgages. The new FNMA became privately owned – its shares trade on the New York Stock Exchange – but retained several important links to the government including a line of credit with the U.S. Treasury, debt that is eligible for purchase by the Federal Reserve, and an exemption from registration with the Securities and Exchange Commission. Investors take these privileges to mean that the government will bail out FNMA if required. As a result, FNMA debt carries interest

rates just slightly higher than U.S. Treasury securities, and well below those available to its private sector counterparts. FNMA also issues mortgage-backed securities, which are sold to investors and secured by residential mortgages.

The Problem. By practicing a "savings and loan" investment strategy of borrowing short term to fund long-term investments in residential mortgages, FNMA is vulnerable to any rise in interest rates which would increase its borrowing costs and thus squeeze profits and reserves. The degree of risk facing FNMA is underscored by a report from the Department of Housing and Urban Development, which notes that the rise in interest rates between 1978 and 1981 reduced the FNMA's mark-to-market net worth from negative $387 million to a staggering negative $11 billion.[6] During this same period the FNMA also faced a growing default problem. The subsequent decline in interest rates and a massive expansion in its investment program helped reverse the deterioration through much of the 1980s. But by the end of 1987 the market value of its reserves still had risen to only $1.6 billion to support a portfolio of $97 billion of mortgages and $140 billion in mortgage-backed security guarantees.[7] According to the Bush Administration's FY 1991 Budget, "At the end of 1988 each held [FNMA and FHMLC] capital equal to less than 1.5 percent of assets including mortgage-backed securities.... With such a small margin, the taxpayers are more at risk."[8]

Recognizing the potential for trouble, HUD conducted a thorough investigation of the FNMA and released its report in January, 1989. The report concludes that FNMA's extensive operations "...creates serious risks to FNMA and...creates substantial risks of disruption to the housing market and possible calls for help from the Federal Government."[9] While the FNMA has made some progress in better matching the maturities of its assets and liabilities, it is still vulnerable to interest rate swings and its net worth is well below the level required of savings and loans under the 1989 bailout legislation. Compounding this is the potential risk associated with holding a portfolio of only one kind of asset – residential mortgages.

Even more disturbing is that while the FNMA continues to operate under conditions of a limited cushion of reserves, it does so as an increasingly important participant in the nation's residential mortgage market. In part, the growing federalization of the mortgage market, noted earlier, is due to the rapid growth of FNMA activities in the 1980s. Approximately 90 percent of all originated mortgages are eligible for support from the FNMA or its sister in-

6 *1987 Report to Congress on the Federal National Mortgage Association* (Office of Policy Development and Research, U.S. Department of Housing and Urban Development), unpublished draft dated January 19, 1989.
7 *Ibid.*
8 *Budget of the United States Government; Fiscal Year 1991* (Washington, D.C.: U.S. Government Printing Office, 1990), p. 236.
9 *Ibid.*, Chapter 1, p. 4.

stitution, the Federal Home Loan Mortgage Corporation (FHLMC). In 1986, these two institutions purchased loans equal to 82 percent of this eligible amount.[10] At the same time, virtually all of the FHA and VA loans originated that year were repackaged into GNMA's pass-through securities, which are 100 percent guaranteed by the government.

Given this commanding presence in the U.S. residential mortgage market – a presence that will increase because of the declining role of the savings and loan industry – any financial problems at the FNMA or its companion institutions could have devastating implications for the American housing market and the financial system, as well as for the hapless taxpayer who would no doubt be called upon to bail out the agencies.

What Needs to be Done

To avoid this, major reforms are needed to diminish the risk of insolvency. In particular, the FNMA's reserves need to be built up quickly. Studies for HUD by Standard and Poors, and Shearson Lehman, suggest that a capitalization level of about 5 percent of the FNMA's mortgage portfolio (compared with today's level of below 2 percent) and capitalization of 2 percent of its mortgage-backed securities obligation, would be appropriate for the risk assumed and would also allow the FNMA to become truly independent of the implicit government support that it now receives.[11]

According to the HUD report submitted to the OMB in the last days of the Reagan Administration, to achieve this ratio of reserves to liabilities, the FNMA should:

♦ Wind down its mortgage portfolio at a rate matching the maturation of its debt obligations. This would have the added benefit of beginning the process of defederalizing the mortgage market, permitting private lenders and secondary market participants to enter the market and compete with the FNMA.

♦ Cease payment of dividends to shareholders, so that all earnings can be applied to reserve accumulation.

♦ Increase fees to those mortgage originators (and borrowers) who utilize and benefit from FNMA support. President Bush's 1991 budget proposes a variation on this, recommending that fees be charged on all new debt and securities issued by the FNMA and the FHLMC.

Recently, the FNMA has acknowledged the existence of the problems and has begun to take significant actions. On May 8, 1990, the FNMA announced that it planned to set aside at least $2 billion over the next two years against

10 *Ibid.*, Chapter 4, p. 14.
11 *Ibid.*, Chapter 3, p. 8.

possible losses in its mortgage portfolio. Its chairman stated that it planned to spend most of its profits in this year and the next to meet this goal.[12]

4) The Government National Mortgage Association

The Program. The GNMA was created in 1988 to conduct activities previously carried out by the FNMA. Much of the agency's original low-income support activity has since been wound down to minimal levels, and the GNMA's major function today is to guarantee the payment of principal and interest on what are called GNMA mortgage-backed, pass-through securities. These securities were developed in the late 1960s as a way of tapping the capital markets for funds for housing. The idea was that those investors and institutions not willing to invest in residential mortgages would be willing to invest in government guaranteed securities collateralized by pools of residential mortgages that also were guaranteed by the government.

Only FHA-insured and VA-guaranteed mortgages can be used to back GNMA pass-through securities. Although the GNMA charges a nominal fee to those entities that issue the securities, it has been assumed that the organization is exposed to little risk because of the additional guarantee on the underlying collateral. By the end of fiscal 1990, the outstanding volume of GNMA-guaranteed securities is expected to reach $390 billion.

The Problem. The presumption of safety is now being questioned as past HUD management scandals continue to unfold. For one thing, the financial collapse of one GNMA security issuer revealed that the company had been skimming off borrower prepayments and not passing them through to the holders of the GNMA securities. The GNMA estimates that the losses associated with this issuer alone could cost GNMA as much as $125 million. Rising defaults in VA mortgages lead to another source of loss for GNMA. Whereas FHA insures 100 percent of the value of its mortgages, VA guarantees only 40 percent of the mortgage, up to a maximum amount of $36,000. Losses beyond this level must be born by the lender or mortgage holder – or ultimately by the GNMA when VA loans are used to back GNMA pass-through securities. Because of the rise in VA defaults, and a steady increase in losses exceeding the VA obligation, GNMA is facing heavy losses. With more than 10 percent of the VA mortgages written this year expected to go into foreclosure, the potential GNMA liability could be as high as $2 billion or more, an amount that exceeds the GNMA reserve fund of $1.7 billion.[13]

What Needs to be Done

To rectify these problems and avoid future losses, the GNMA should:

12 *Washington Post*, May 9, 1990, p. F1

13 "Rising VA Mortgage Losses Spell Trouble at Other Agency," *The New York Times*, June 29, 1989, p. 1.

- Review the capital standards required of its issuers and determine whether they should be raised as a result of the greater rate of mortgage defaults.

- Audit randomly chosen pass-through security issuers to determine that the existing standards are being met.

- Disqualify immediately those unable to meet the revised standards.

- Raise the guarantee fee, now set at only 6 basis points, to at least the 10 basis points recommended in Ronald Reagan's fiscal 1988 budget. As that budget noted, "This fee is closer to that charged other issuers of mortgage-backed securities and is part of a coordinated effort to increase opportunities for private sector activity in the secondary mortgage market for home mortgages."[14] Although Congress did not enact this proposal, Bush has included it in his 1991 budget.

5) The Federal Home Loan Operations

The Program. The government is even more deeply involved in mortgage finance, thanks to two other government-sponsored enterprises – the Federal Home Loan Bank System (FHLBS) and the Federal Home Loan Mortgage Corporation (FHLMC). The FHLBS was created in 1932 to provide a central credit facility for savings and loan institutions and to supervise and regulate the industry. As of the end of 1989, its outstanding loans were $151.1 billion, most of which were in the form of loans to savings and loan institutions. Although the FHLBS is better capitalized than some other government enterprises, the vast majority of its loans are concentrated entirely within the troubled savings and loan industry.

The Problem. The FHLMC was created in 1970 to stimulate the flow of capital into the housing market by establishing an active secondary market for conventional mortgages. While in some respects the corporation can be viewed as the conventional mortgage companion to the FNMA, it differs from the FNMA by largely relying on packaging its mortgages into a form of pass-through security and then reselling these securities in the open market. By securitizing the mortgages, much in the way that the GNMA does with FHA/VA mortgages, the FHLMC aims to attract additional funds to housing. As of the end of 1989, the FHLMC had $257 billion of these securities outstanding, and it is anticipated that this amount will increase by about $40 billion to $50 billion per year.[15]

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14 *The Budget of the United States Government, Fiscal Year 1988* (Washington, D.C.: U.S. Government Printing Office, 1988), pp. 5-61.

15 1991 Budget, p. A-140.

What Needs to Be Done

The FHLMC is in better financial condition than FNMA and its interest rate risk exposure is manageable by virtue of its limited portfolio of mortgages held for investment. It is, nevertheless, concentrated in one asset and, by virtue of its implicit government support, has a competitive advantage over its private sector competitors. One way to diminish the latter advantage would be to require it to pay a fee to the government on all securities it issues to the private market, as proposed by the Bush Administration.

GROUP II: AGRICULTURE CREDIT PROGRAMS

The agriculture sector of the U.S. economy also enjoys substantial federal credit support. As in many of the other federal credit programs, the government greatly expanded its agriculture finance business during the Depression, although the first major programs were created in 1917. Because a disproportionate share of the bank failures during the Depression were concentrated in rural banks, many farmers were left without any source of credit to finance spring plantings, storage, and general improvements. The federal government stepped into this gap with several programs and institutions to help get the farm economy back on its feet.

When the Depression ended, these programs did not wither away – they were expanded and new ones were added. By 1985, the federal government accounted for more than half of the farm sector's real estate debt and more than a third of the other agriculture-related debt.

But for many farmers, it was too much of a good thing. The generous lending policies of the federal government promoted an unsustainable rate of increase in the price of farm land during the 1970s and early 1980s and induced many farmers to take on more debt than they could ever hope to service or pay back unless land and crop prices continued to escalate. But land and crop prices fell in the 1980s. The end result was a collapse of the agriculture economy that ruined the lives of thousands of farmers, bankrupted hundreds of rural banks and other businesses, and cost the taxpayers billions of dollars.

1) The Farmers Home Administration

The Program. The Farmers Home Administration (FmHA), created in 1948, has as its chief objective the provision of temporary credit to farmers whose financial situations prevent them from obtaining credit elsewhere at affordable rates and terms. The FmHA operates two major programs: one makes loans to farmers to finance farm ownership and other agriculture-related credit needs, while the other provides mortgage credit to assist farmers and other residents of rural areas to buy their own homes. Unlike the FHA and VA, which insure or guarantee loans made by private lenders at interest rates approximating the market rate of interest, the FmHA makes loans directly to the borrower, at subsidized interest rates, with funds provided by the U.S. Treasury.

The Problem. A 1988 General Accounting Office (GAO) study has discovered serious deficiencies in the FmHA loan program. The report notes that whereas the outstanding volume of FmHA loans increased by 400 percent between 1976 and 1987, the amount of delinquent payments over that period increased by a staggering 4,300 percent, from $164 million to about $7 billion. Of the $26.2 billion of loans outstanding at the end of 1987, some $12.8 billion was in default. A disturbing $6.7 billion of this amount had been in default for more than three years.[16] The resulting losses are expected to be significantly more than this. According to the report:

> Although implementing regulations have not been finalized, FmHA has estimated that approximately 16,200 of its farm borrowers will be eligible for the loan write-down, with about $2.1 billion of debt being written off as a loss. In addition, loan losses from other borrowers who will be unable to show repayment of debt even after write-down are estimated at about $6.7 billion. As a result, FmHA estimates total potential losses to be about $8.7 billion by fiscal year 1990.[17]

As a result of these and other losses, the FmHA agriculture credit revolving fund is estimated to have a *negative* net worth of $28 billion.[18] Unfortunately, this is not the only taxpayer cost of the program. The same GAO report estimates that FmHA agriculture borrowers received interest rate subsidies valued at between $612 million to $1.6 billion over and above the direct costs associated with the high rate of defaults.

The situation in the FmHA housing loan program is marginally better than the farm program, but still substantially worse than any of the government's other housing programs. At the end of fiscal 1988, the FmHA had $26.9 billion in loans outstanding to finance homeownership and housing rental programs in rural areas. Section 502 of the 1949 Housing Act created the FmHA's largest subsidy program to finance the purchase of single family homes at deeply subsidized interest rates. Under the 502 program eligible households with incomes below 80 percent of the median area income may borrow from the FmHA to purchase a home. The risk associated with these loans is particularly high, since no downpayment is required and borrowers must demonstrate that they cannot get credit from another source. Loans typically are written for 33 years, although they may be as long as 38. The interest

16 "Farmers Home Administration: Farm Loan Programs Have Become a Continuous Source of Subsidized Credit," U.S. General Accounting Office, GAO/RCED-89-3, November 1988, p. 9.

17 *Ibid.*, p. 36.

18 1991 Budget, p. 240.

rate on the loan is subsidized through an interest "credit." This reduces the effective interest rate to as low as 1 percent. According to one sample survey, the average effective interest rate on outstanding FmHA home loans is 3.4 percent,[19] leading to an estimated subsidy cost of $98 million dollars for just those loans that will be made in fiscal 1990.[20]

What Needs to be Done

The high costs of this program suggest that homeownership programs are an inappropriate and costly method of assisting low-income rural residents. Thus no new FmHA loans should be originated and the existing portfolio should be allowed to wind down through repayments and loan amortization. In non-rural areas, such households are assisted through vouchers, rental certificates, and other forms of low-income rental assistance. Vouchers are a proven, cost-effective method of providing housing assistance to the poor, and the Reagan Administration proposed that a voucher program be substituted for the direct loan programs that have pushed too many of rural Americans deeply into debt, ruining their credit rating and costing the taxpayer billions. Regrettably, Congress has ignored this request and legislation to reauthorize the existing loan program is now before both the House and the Senate. The Bush Administration, by contrast, recommends vouchers as a substitute for many of the rural housing loan programs. This recommendation should be supported.

2) The Rural Electrification Administration

The Program. The Rural Electrification Administration (REA) was created in 1935 to provide loans and loan guarantees to rural cooperatives for the purpose of providing electrical service to farms. At that time only 12 percent of the farms had electricity. But by 1964, some 98.1 percent of farms had service. Nonetheless, the program has continued to grow, despite the fact that its Depression-era mission was largely accomplished a quarter of a century ago.

The REA offers two types of credit assistance to eligible borrowers: 100 percent government-guaranteed loans and direct loans with 5 percent interest rates. Guaranteed loans are provided to eligible cooperatives by the Federal Financing Bank (FFB), which is part of the U.S. Treasury, or from private lenders with the REA guaranteeing the full payment of principal and interest. The direct loans are made by the REA to eligible electric cooperatives at a 5 percent interest rate, which is well below that on the guaranteed loans or on the loans a co-op's for-profit competitors must pay in private capital markets. As of the end of 1987, the latest year for which accurate figures are available from OMB documents, there were $22.6 billion in outstanding

19 "A Home of Our Own: The Costs and Benefits of the Rural Homeownership Program," A Publication of the Housing Assistance Council, 1988, p. 39.
20 OMB, Special Analysis F, 1990, p. F-42.

guaranteed loans, most of which were held by the FFB. There were another $13.1 billion in direct loans held by the REA.

The Problem. In 1988, a special report prepared by the Reagan Administration estimated the cumulative cost of subsidies at about $18 billion between 1973 and 1986. In addition to this costly subsidy, REA loans have experienced a relatively high default rate. Of the more than $20 billion in guaranteed loans outstanding, between $8 billion and $9 billion have gone into default.

Beyond the usual problems associated with the bad credit risks typical of federal credit programs, the REA confronts a special challenge in the form of a required 1993 repayment of an interest-free loan from the U.S. Treasury. The REA revolving loan is drifting toward insolvency because of the sharply mounting costs of the deeply subsidized 2 percent and 5 percent loans. Without substantial reforms, and with this interest-free loan coming due, a major taxpayer bailout will be needed to allow REA to continue operations. This year, Congress has appropriated approximately $320 million to cover loan payment defaults.

What Needs to Be Done

Recognizing that the program has long since achieved its goals and that the continued federal assistance is both costly and unjustified, the Reagan Administration proposed reducing the level of taxpayer support by replacing the direct REA loans and the 100 percent guaranteed FFB loans with 70 percent and 80 percent guaranteed loans from private sector lenders.[21] The Bush Administration resubmitted the proposal, proposing 70 percent and 90 percent guarantees. Congress should enact legislation to accomplish these reforms, including other steps that ultimately make the co-ops entirely reliant on private sector sources of credit.

3) The Farm Credit System

The Program. The Farm Credit System (FCS) has its origins in the Farm Loan Act of 1916, and took on its current form in 1933. The FCS was substantially reorganized in 1987 in response to rising loan losses and the threat of insolvency. Until then it had comprised four major entities: the Farm Credit Administration (a federal agency) and three separate privately-owned but government-sponsored enterprises – Banks for Cooperatives, Federal Intermediate Credit Banks, and Federal Land Banks.

The Problem. Although they are privately-owned GSEs, government sponsorship bestowed significant benefits upon the three farm lending institutions within the Farm Credit System. As is generally the case with GSE's, FCS was provided with a line of credit at the Treasury, made exempt from federal, state and local taxes, made eligible for Federal Reserve open market pur-

21 *Ibid*, p. F-19.

chases, given equal standing with Treasury debt as qualified investments for banks, made exempt from Securities and Exchange Commission registration, and could be treated as collateral for public deposits. With these advantages, the banks of the FCS were able to offer below-market rates to their borrowers and attract business away from their private sector competitors. Thanks to the privileged and subsidized position of the banks, outstanding farm real estate loans held by federal land banks increased by a staggering 588 percent between 1970 and 1983, compared with only 272 percent for all farm real estate loans.

This surge in lending by the land banks displaced billions of dollars of privately-available credit and exposed the federal government to enormous risk. When crop prices fell in the early 1980s, so did farm incomes and the value of farm land, the collateral securing the land banks' loans. Losses began to mount at many of the Systems' banks, and a poorly conceived bailout in 1985 failed to stem the red ink. When the FCS lost $1.9 billion in 1986, emergency bailout legislation was prepared and signed into law in early 1988. A recent estimate places the total taxpayer cost of the bailout at about $2.9 billion.[22]

Although the bailout resolved the short-run problem facing the FCS by injecting substantial amounts of cash into the system, the structural "reforms" included in the measure could further weaken the agriculture credit market, exposing farmers, government, and taxpayers to even greater risks in the future. This is because the bailout legislation increased the government's explicit liability for the new loans extended to the system and created a new federal enterprise that requires the federal government to guarantee the payment of principal and interest on new loans extended to farmers by private lenders.

The 1988 legislation also created two new government-sponsored enterprises that will increase the federal government's involvement in agriculture lending and thus expose the taxpayer to larger losses. These institutions are the Farm Credit Assistance Financial Corporation (FAC) and the Federal Agriculture Mortgage Corporation (FAMC or "Farmer Mac").

The FAC will provide the financing mechanism through which the FCS can receive capital beyond what it can borrow on its own – particularly for those FCS institutions whose loss-ridden loan portfolios preclude them from borrowing in private capital markets. Obligations issued by the FAC will carry the guarantee of the federal government, and the U.S. Treasury will pay all or part of the interest cost on most of FAC's debt for the next ten years. For those System lenders not eligible for FAC loans because they maintained their financial integrity during the recent period of adversity, the Act will reward them by creating the Farm Credit System Insurance Corporation, a federal agency that will insure all of their debt obligations. Thus with one pro-

22 *Ibid*, p. F-23 to F-27.

gram or the other, the federal government can now guarantee explicitly all obligations issued by the many lending institutions that comprise the Farm Credit System.

As disturbing as this extension of coverage may be, the FAMC poses an even larger potential risk to the government, the farmer, and the taxpayer. The FAMC was established to guarantee the timely repayment of principal and interest on pools of farm mortgages and certain rural housing loans originated by the FCS banks, commercial banks, savings and loans, and insurance companies. But this will encourage private lenders to make more farm mortgage loans at lower credit standards, since the risk can be transferred to the taxpayer. The bailout legislation makes it possible for the vast majority of loans extended to farmers, regardless of source, to be insured or guaranteed by the federal government.

Although future risks pervade the new program, the agriculture credit system has improved markedly over the past few years. Farm debt has declined 30 percent since 1983, largely as a consequence of write-offs, and agriculture sector debt-to-equity ratios have declined from 31 percent in 1985 to 22 percent today.

What Needs to be Done

With the agriculture debt situation of the recent past now largely resolved, efforts should be undertaken to diminish gradually the federal role and to encourage more private sector involvement. The 1987 bailout should be viewed as a short-term expedient and the institutions it created should be reduced in scope or transferred to the private sector.

4) The Federal Crop Insurance Program

The Program. There are several other, smaller farm credit and insurance programs that also suffer from relatively high loss rates. For example, the federal crop insurance program (FCIC) was created in 1980 to allow farmers to insure their crops against a variety of natural hazards such as drought and hail.

The Problem. The FCIC is heavily subsidized with losses and administrative costs consistently exceeding income. Yet farmer participation has never exceeded 30 percent, in large part because Congress has always showed a willingness to bail out farmers regardless of whether they have made the effort to obtain insurance against such losses. In 1989 the insurance in force was $13 billion and this year's loss is expected to be as high as $250 million.

What Needs to be Done

Congress should either substantially reform the program so that premium income matches expected losses, or terminate the program and rely on the existing discretionary authority to compensate farmers for losses experienced as a consequence of natural disasters.

GROUP III: OTHER MAJOR INSURANCE AND GUARANTEE PROGRAMS

When large segments of the banking industry began to fail during the Great Depression, thousands of depositors lost their life's savings and credit became unavailable in many communities. Confronted with the risk that depositors throughout the country would panic and withdraw their funds from all banks and thrifts, thereby jeopardizing the entire financial system, the government responded by creating a system to provide federal insurance to depositors to eliminate the threat of a nationwide run on the banks.

As long as the insured institutions were confined to a narrow range of investments offering limited risk, the system worked reasonably well and all losses were more than covered by the insurance premiums paid by the depository institutions. However, when the deregulation process gave banks and S&Ls more freedom to choose their investments, the continued existence of federal deposit insurance encouraged the unscrupulous or incompetent managers to take irresponsible risks with the knowledge that the government would pick up the pieces and cover the losses. This asymmetry of responsibility was one of the key reasons for the S&L debacle.

1) The Federal Deposit Insurance Corporation

The Program. In an effort to stabilize America's financial system during the Depression and restore confidence in depository institutions, Congress enacted the Banking Act of 1933. Among its many provisions, the Act created the Federal Deposit Insurance Corporation (FDIC) to insure, up to a specified limit (now $100,000 per depositor), deposits held at commercial banks. In 1935, similar coverage was extended to deposits at the savings and loan associations by the creation of the Federal Savings and Loan Insurance Corporation (FSLIC). The National Credit Union Administration (NCUA) also was created to insure deposits at federally-insured credit unions.

As of the end of 1989, these three federal agencies had insured a total of nearly $2.9 trillion of deposits, with $1,806 billion of this amount at commercial banks covered by the FDIC, $958.9 billion at savings and loans covered by the FSLIC, and $161 billion at credit unions and insured by NCUA. The financial institutions pay the appropriate insuring agency a flat-rate fee representing a percentage of their deposits.

The Problem. Confidence in the federal deposit insurance system was shaken when the extensive failures in the savings and loan industry vastly exceeded the reserves of the FSLIC, causing it to seek huge infusions of cash from the U.S. Treasury, the remaining S&Ls, and the taxpayer. Between now

and 1999, the total cost of the bailout is estimated to fall somewhere in the range of $150 billion to $300 billion.[23]

Although the commercial banking system had at first managed to escape the problems confronting its sister industry, solvency problems are beginning to emerge and there is growing concern regarding the ability of the FDIC to fulfill its obligations during a sustained period of financial stress.

Although the number of problem banks dropped to 1,394 in 1988 from a peak of 1,575 in 1987, the 200 banks failing that year and the 22 that required financial assistance cost the FDIC $7.3 billion, leading to the first-ever loss experienced by the agency. Another 206 banks failed in 1989, costing the FDIC $4.1 billion. The FDIC's reserves fell from $18.3 billion in 1987 to $16.3 billion at the end of 1988 and to $14.3 billion by 1989. Reporting on its most recent audit of the FDIC, the GAO concludes that "[T]he ratio of the FDIC's insurance fund balance to insured deposits declined to the lowest level ever, estimated by the Corporation to be 0.83 percent."[24]

Recent reports by the GAO and the Office of Management and Budget (OMB) offer only qualified support for the view that the worst is behind the FDIC. In its April 1989 audit, the GAO notes that "The Corporation anticipates it will have net income in 1989. However, a downturn in the Northeast or Southeast or increasing interest rates could result in additional insurance costs to the Corporation." Although the GAO was accurate in its predictions, in the next paragraph the GAO notes that "In spite of the significant number of bank failures and the potentially adverse conditions which could affect the Corporation, we believe that it has sufficient funds to handle current and short-term identifiable needs."[25] Earlier in 1989, OMB had also expressed a cautious view, when it noted in the President's 1990 Budget that, "U.S. banks recorded healthy profits in 1988, after a year of extraordinary losses. Nevertheless, concerns remain. Increased levels of nonperforming bank assets in 1988 represent a potential future danger sign. In addition, the FDIC has become increasingly concerned as banks and other institutions appear to be increasing their concentration in high-yield, high-risk "junk" bonds...."[26]

Two reports by private analysts, however, express a less optimistic view than either of these two government agencies. The "Shadow Financial Regulatory Committee," an unofficial group of leading banking experts from business and academia, concluded in a late 1988 report that "...if the FDIC

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23 R. Dan Brumbaugh, Jr., Andrew S. Carron, and Robert E. Litan, "Cleaning Up the Depository Institutions Mess," *Brookings Papers on Economic Activity* I:1989, p. 261.

24 "Financial Audit: Federal Deposit Insurance Corporation's 1988 and 1987 Financial Statements," General Accounting Office, GAO/AFMD-89-63, April 1989, p. 6.

25 *Ibid.*, p. 7.

26 *Special Analysis, Budget of the United States Government, Fiscal Year 1990* (Washington, D.C.:U.S. Government Printing Office, January 1989), p. F-35.

were to experience losses that would not be unreasonable to anticipate in view of its recent loss experience and problem bank estimates, the FDIC's reserve balance would be exhausted at present."[27] Using historic failure rates for both problem and nonproblem banks, and relating these rates to the volume of bank assets at risk and the likely resolution costs, the Shadow Committee estimates the total of FDIC "booked" and "unbooked" losses at $21.3 billion, an amount exceeding current FDIC reserves.

Even more pessimistic than the Shadow Committee is "Cleaning Up the Deposit Mess," a 1989 report by three private sector economists. The economists question the view that the worst is behind the FDIC, contending that "Given the large number and asset size of weak banks, the extent to which GAAP accounting techniques (Generally Accepted Accounting Principles) hide market value losses, and the potential for rapid asset deterioration, it is possible that losses in the commercial banking industry could eclipse those of the thrift industry, especially if the economy enters a recession before the weak capitalization of many banks is corrected."[28]

The authors' conclusion is based on an analysis of the banking industry's balance sheet and their argument that many banks are very thinly capitalized, having actual reserves below 3 percent of assets. They note that in addition to the approximately 400 banks closed in 1987 and 1988, another 28 large banks with $22.5 billion in assets were still open and insolvent in late 1988, and a further 48 banks holding $43 billion in assets had capital ratios below 3 percent under GAAP.

Although the potential risk is considerable, any effort to estimate likely losses and costs are highly speculative and depend heavily upon the projected economic outlook over the next several years. Nonetheless, the risk is there and much of it follows directly from fundamental flaws in the way the government operates the deposit insurance system. Reviews of the issue by Heritage Foundation analysts[29] conclude that the problem stems from the fact that depository institutions, particularly the poorly supervised thrifts, have been able to engage in reckless business activities because the federal deposit insurance system takes no account of the riskiness of an institution's investments when setting premiums. In fact, because institutions making riskier investments generally offer higher deposit rates, depositors actually are encouraged to keep their money in them because they are secure in the knowledge that the government will bail them out if the institution fails. Indeed, this perverse incentive is one of the chief reasons why the cost of the S&L bailout grew so rapidly between 1987 and 1989.

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27 "Statement of the Shadow Financial Regulatory Committee on the Need to Estimate the True Economic Condition of the FDIC," Statement No. 36, December 5, 1988, p. 1.

28 Brumbaugh, *op. cit.*, p. 250.

29 James L. Gattuso and Dana Joel, "Only Structural Reform Can Solve the Long-Term Savings and Loan Crisis," Heritage Foundation *Backgrounder Update* No. 92, January 27, 1989. See also Bert Ely, "Confronting the Savings and Loan Industry Crisis," Heritage Foundation *Issue Bulletin* No. 126, August 13, 1986.

What Needs to be Done

Several important reforms have been proposed to reduce the taxpayers' exposure to deposit insurance risks.

Under one plan, deposit insurance premium rates would rise with the degree of risk associated with the loans and investments in an institution's portfolio. This would force institutions undertaking riskier investments to pay much higher insurance rates than those pursuing more conservative investment strategies. This would provide better protection for taxpayers and discourage reckless investment.

Another alternative proposes that the amount of deposit insurance available per depositor should be limited to something much less than $100,000. This would improve the current system both by diminishing the outstanding liability assumed by the government and by forcing larger individual depositors to pay more attention to the soundness of the institution where they keep their money, just as investors consider the quality of a mutual fund or individual stock when making an investment. For most Americans with only a few thousand dollars in bank deposits, there would be no change: they would be fully insured and would not have to worry about the quality of the management of their local bank. But even larger depositors would not have to check out each institution.

It would be unreasonable to expect a typical bank depositor to make independent judgments about his or her commercial bank. But in practice rating services such as Standard and Poors, and Moodys would do the work for each depositor in much the way they assess the risk associated with marketable debt instruments. Thus, depositors could select among triple A or double B banks much as they choose that combination of risk and reward most suitable for other investments.

A third alternative would place a much greater reliance on the resources of the banking system through a system of "cross-guarantees." Under this plan, the combined reserves of the banking system would serve as the first line of defense against the failure of any individual bank. FDIC insurance would serve as a back-up in the unlikely event that a credit crisis exhausted the reserves of the banking system.[30]

Although each of these plans could improve the system, the cross-guarantee proposal holds the greatest promise because it would greatly diminish the role of the federal government and create a powerful set of incentives to induce the banking system to move quickly against those banks whose inept lending practices jeopardize the collective resources of the system.

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30 Bert Ely, *Making Deposit Insurance Safe Through 100% Cross-Guarantees* (Washington, D.C.: National Chamber Foundation, May 1990).

2) The Guaranteed Student Loan Program

The Program. The Guaranteed Student Loan Program (GSL), now referred to in statute as the Stafford Student Loan Program, was created in 1965 to provide financial assistance for students seeking higher education. Students qualify for GSLs if they are enrolled at least half time in an eligible institution of higher education or a vocational school. Undergraduates may borrow up to $2,625 in their first two years of schools. Providing they have completed two years, they may borrow up to $4,000 for each succeeding year. But the maximum amount they may borrow for undergraduate education is $17,250. The actual loans are made by private lenders – mostly depository institutions – at interest rates subsidized by the federal government. The $12.6 billion in new GSLs expected to be granted in 1990 are projected to entail an interest rate subsidy of just over $3.7 billion over the life of the loans.

The Problem. By the early 1980s, the deep interest rate subsidy and the absence of any household income limits on eligibility made GSLs the most attractive method of financing a college education or vocational training. In 1980 the dollar volume of new student loans granted was equivalent to more than half the amount of tuition received by all colleges and universities.[31] Some income constraints have since been imposed and the new loan volume is now below 40 percent of total tuition revenues. Currently, there is $48 billion in outstanding GSLs.

The chief problem now confronting the program is an excessive default rate. Loan losses have been rising sharply in recent years. Realized losses reached $1.4 billion in 1988, soared to $1.9 billion for 1989 and losses are expected to exceed $2 billion in 1990.

There are a variety of reasons for this sharp increase. One is the advent of "fly-by-night" vocational schools that induce unsuspecting individuals to sign up for instructional programs of dubious value and excessive tuition costs by emphasizing that costs will be covered by the GSL program. Upon graduation, if they make it that far, many of these poorly-trained students often fail to find adequately-paid employment and default on their loans. At one technical school in Baltimore, Maryland, the default rate was a staggering 83 percent on the outstanding loans of its students. The former students of many community colleges experience default rates in excess of 50 percent. The for-profit trade schools have average default rates of 40 percent, compared with 9 percent at four-year institutions.[32]

What Needs to be Done

In response to the problem, the U.S. Department of Education released new regulations last year designed to force reforms at those schools with the highest default rates. These schools will be required to reduce their student

31 *Statistical Abstract*, Tables No. 257 and No. 259, p. 153 and 154.

32 "A Governmental 'F' Awaits Schools Lax on Student Loan Defaults," *The Washington Post*, June 2, 1989.

default rate gradually over several years or face restrictions on the availability of GSL loans to finance tuition.

This is an inadequate response to the problem; institutions with dismal records will continue to receive federal credit support while still providing an inadequate education to young Americans. Many of these schools are nothing more than taxpayer-financed scams that prey on the disadvantaged, leaving them with a poor education and thousands of dollars in debt.

To cut the default rate, save the taxpayer more than a billion dollars, and limit the harm to future students, the Department of Education should modify its existing regulations to require all schools with default rates in excess of 30 percent to post a bond equal to the dollar volume of defaulted loans in excess of the 30 percent cutoff. Without the bond, these schools would be ineligible to participate in the GSL program. As the school's default rate declined, portions of the bond would be returned to the school. But if there were to be no progress, the bond would be used to cover defaults in excess of the cutoff, and additional bonding would be required to maintain eligibility for GSLs. This potentially costly requirement quickly would force the sham schools out of business. Over time, the 30 percent rate could be reduced to 15 percent, ensuring that the schools that remain in operation are those with a demonstrably positive effect on the careers of their students.

3) The Pension Benefit Guarantee Corporation

The Program. The Pension Benefit Guaranty Corporation (PBGC) was established in 1974 under Title IV of the Employee Retirement Income Security Act (ERISA), to protect workers' pension plans when private pension trusts are terminated without sufficient assets to meet their commitments. The insurance program is funded by premiums paid by the defined benefit pension plans covered by the program. The PBGC's liability reached $820 million in 1989.

The Problem. Initially it was believed that a premium of $1.00 per participant per year would be sufficient to provide the revenue needed to build reserves and cover PBGC losses. This turned out to be wildly optimistic, and in 1986 the premium was hiked sharply to $8.50 per participant. But even this was insufficient, and the premium was raised yet again in 1987. Single-employer plans now can face premiums ranging from $8.50 to $16.00 but a variable charge of up to $34 per participant can be levied depending upon a plan's unfunded vested benefits.

This change in premium structure is an important precedent for federal insurance programs, because it marks the introduction of a risk-based premium structure in which higher risk participants have to pay higher premiums in order to remain eligible. This could have significant benefits if applied to other programs such as the federal deposit insurance systems.

Despite this important reform, and a June 18 ruling by the Supreme Court giving the PBGC the power to force certain employers to take back the responsibility for their troubled pension programs, the corporation still is in

trouble, and the taxpayer exposed to potentially huge bailout costs. By 1989 the cumulative PBGC deficit had risen to between $3 billion and $4 billion, although that is not reflected it its published reports.[33] Even more troubling is information contained in a 1989 report of the Inspector General at the Department of Labor.[34] According to this report, a series of administrative, management and supervisory failings on the part of Department's bureau has seriously jeopardized the well-being of the many pension plans for which the government has ultimate responsibility. The Inspector General made a series of recommendations for better reporting and greater reliance on independent public auditors to maintain close surveillance over the plans. In that report, the Inspector General stated that "... the burden of insuring and protecting failed benefit plans will fall upon all taxpayers, not just the plan beneficiaries and parties, since the PBGC in the final insurer of these plan assets. Unless steps are taken now, today's S&L bailouts may become tomorrow's ERISA nightmare."[35] These remarks were prophetic. In recent testimony to Congress, the PBGC's Executive Director stated that the insurance fund's deficit could rise to $8 billion in the near future as a result of looming corporate bankruptcies.[36]

What Needs to be Done

The Department of Labor should be instructed to hire an independent consultant to measure the risks and to determine whether the existing premium and supervisory system are sufficient to keep these risks at a minimum. Until such time as this comprehensive review is completed, the PBGC should follow the advice of the Department of Labor's Inspector General by establishing better and more comprehensive auditing procedures. The Inspector General recommends that this task be contracted out to experienced, independent audit firms. In addition, Congress should give the PBGC more flexibility in setting its premiums so that revenues cover losses and expenses on a sustained basis.

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33 The PBGC reported a cumulative deficit of $1.781 billion in 1986 but then reduced it to $1.480 billion in 1987 based on the attempt to shift the LTV pension obligation back to the company. LTV is a steel producer that filed for bankruptcy several years ago. LTV has refused to accept the obligation. The issue has gone to court twice and the PBGC has lost on both occasions. Unfunded liabilities of $2.2 billion is at stake and if the PBGC losses on appeal this amount would be added back to the accumulated deficit.

34 *Semiannual Report, Office of Inspector General, U.S. Department of Labor*: October 1, 1988 - March 31, 1989 (Washington, D.C., 1989).

35 *Ibid.*, p. 3.

36 Frank Swaboda, "Pension Fund Called Vulnerable," *The Washington Post*, June 14, 1990.

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The Thomas A. Roe Institute for Economic Policy Studies

May 31, 1990

A $130 BILLION NO-TAX PRESCRIPTION FOR THE BUDGET DEFICIT

George Bush and congressional leaders are engaged in negotiations to deal with the federal budget deficit, which is described by many policy makers as a "crisis" that threatens the health of the national economy. Many members of Congress are urging the President to "show leadership" by raising taxes. And Bush has announced that he might be willing to forsake his most solemn political pledge, to abandon his "no new taxes promise."

Behind calls for new taxes are the assumptions that the federal budget already has been cut to the "bare bones," that every program is running as efficiently as possible, and that every program serves vital national goals that cannot be accomplished by state and local governments or by the private sector. These assumptions are false. In fact, Heritage Foundation analysts have identified over $130 billion in spending cuts and budget savings that could be made without harming programs comprising the social "safety net."

Wasteful or unneeded spending in the budget is the real cause of the deficit. Before the President and Congress take one more dollar from Americans who are now paying record high levels of taxes, they must put every federal program on the table for critical review.

Ignoring Billions in Cuts. There is indeed a need for leadership on the problem of the budget deficit. The Bush Administration has failed even to go through the motions of requesting cuts or elimination of dozens of programs that aid only special interest groups or government bureaucrats. And Congress repeatedly has ignored reputable studies calling for hundreds of billions of dollars in spending cuts. In 1984, for instance, the President's Private Sector Survey on Cost Control, known as the "Grace Commission" after commission chairman J. Peter Grace, recommended spending reductions and efficiency measures totaling $424 billion over three years. The year following the

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

commission's report, Congress increased federal spending by $94.5 billion, an inflation-adjusted increase of 7.2 percent.

Congress repeatedly has ignored revelations of wasteful spending uncovered by its own respected research arms. Last November, for example, the General Accounting Office (GAO) released its fourth annual report on the implementation of the Federal Manager's Financial Integrity Act of 1982. This act was intended to control waste in Federal Financial Management Systems. GAO found over $150 billion in program waste, fraud, and financial mismanagement. Said Comptroller General Charles A. Bowsher before the Senate Governmental Affairs Committee, "The problems that exist are not limited to a few agencies or a few programs; rather, all of the major agencies have serious problems."[1]

Each year, the Congressional Budget Office (CBO) is required by the Congressional Budget Act of 1974 to produce a survey of recommended budgetary options for the Senate and House Budget Committees. This year's report, released in February, recommended program reforms that yield roughly $60 billion in savings in the first year of implementation.[2] And CBO is known for erring on the side of caution. Congress so far has ignored these recommendations.

Record Revenues, Record Taxes. Americans are paying a higher percentage of their income to the federal government than ever before. And the federal government is collecting record amounts of revenue. Rather than turning to more taxes to deal with the budget deficit, therefore, Congress must turn seriously to the task of cutting spending.

Legislators face a difficult task when spending reductions are necessary. Most government spending benefits some group of individuals or interests. If there were no limit to revenues, Congress could find many worthy projects to fund. But government spending is at the expense of the taxpayer. Helping one interest always harms another. Congress, therefore, must decide which expenditures truly serve the national interest and which, while not without merit, should be left to state and local governments or to the private sector.

In the face of the budget deficit, Congress and the Administration must justify to the American taxpayer why each new dollar of revenue is needed, why the last dollar did not accomplish what lawmakers promised, and why existing programs should continue.

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1 Judith Havemann, "OMB's 'High Risk List' Details Vulnerable Programs," *The Washington Post*, December 6, 1989.

2 Congressional Budget Office, *Reducing The Deficit: Spending and Revenue Options*, February 1990.

HOW CONGRESS FORCES UNCLE SAM TO WASTE MONEY

Lawmakers are always quick to argue that cuts in federal programs are impossible to achieve without significant reductions in the quality or quantity of essential services. They give the impression that all spending is necessary and relevant to the goals of government, and that they have taken all possible steps to permit the Executive Branch to use the most efficient means available to deliver services.

The reality is very different. In a number of ways, Congress consciously prevents the federal government from saving money without reducing necessary services. Thus billions of dollars must, by law, be wasted, rather than being used to reduce the deficit.

1) Congress makes it illegal to use privatization to reduce costs.

Congress constantly blocks attempts to inject market incentives into government. After years of academic analysis and successes at the local level, there is no longer any question that the private sector can provide many government services at greatly reduced costs. Yet during the Reagan Administration, Congress in many cases passed legislation explicitly blocking White House attempts to expand federal contracting and the sale of certain federal assets. In some cases laws were passed to prevent agencies even from studying ways to save money through privatization. Currently there are 37 laws blocking privatization, including measures that exempt 70 percent of federal commercial services from competition. In addition, Congress often micromanages programs, bypassing the normal chain of command, to require programs to serve certain constituencies. The total cost to taxpayers of these prohibitions: $5 billion per year.

Example: The General Services Administration is prohibited from contracting out guard, elevator operation, messenger, and custodial services.

Example: The Legal Services Corporation may not use vouchers or hire private legal clinics as an alternative to staff lawyers employed by a limited number of legal service agencies. Thus, it cannot employ the services of private for-profit legal clinics, such as Hyatt Legal Services, or private arbitration or mediation organizations, such as ENDispute Inc. and New York City's Dispute Center.

Example: Due to congressionally mandated employment levels, the Food and Drug Administration, the Veterans Administration, and the Coast Guard maintenance yard are effectively prohibited from reducing costs through privatization or eliminating duplicative staffing.

Example: The commission created in 1987 to explore the privatization of Amtrak was denied funding and future studies of privatizing Amtrak were prohibited.

2) Congress refuses to close down programs that have completed their purpose.

Once Congress creates a program it rarely lets it die. If the program succeeds, some new constituency is found that "needs" help from the program. Washington's bureaucrats are remarkably entrepreneurial, creating new missions for their programs and creating new political constituencies.

Some 35 states and many local governments avoid this problem by enacting "sunset" laws. These laws mandate that an agency or program must expire after a specified period of time, unless the legislature takes specific action to extend its life. But the federal government has yet to accept such a comprehensive system of automatic agency and program review. Failure to close down agencies and programs that have fulfilled their mission may cost taxpayers as much as $20 billion per year.

Example: The Davis-Bacon Act of 1931, which establishes inflated "prevailing wages" for federal construction contracts over $2,000, was enacted to protect unionized construction workers, the majority of whom were white, from competition from lower cost non-union labor, the majority of whom were black. For sixty years this law denied opportunities to black tradesmen and raised federal construction costs by $1.5 billion per year. Yet Congress refuses to abolish it.

Example: The military commissary system was created to provide foodstuffs to the cavalry on the Western plains in the 1800s. The program continues today, although over 80 percent of military commissaries are within ten miles of two or more commercial supermarkets.

Example: The Export-Import Bank was created in 1934 to finance exports to Russia. Sixty-five years later the Bank loses about $400 million a year financing exports for some of America's largest international corporations.

Example: The Rural Electrification Administration was created in 1935 to bring electricity, and later telephone service, to rural areas of the country. Today, 99 percent of rural Americans have electricity and 96 percent have telephones. Yet REA still exists at a cost to taxpayers of $2 billion per year.

3) Congress is addicted to creating programs.

Congress rarely designs just one program to solve a problem; rather, Congress tends to "spread out" a program over many agencies so that as many constituencies as possible become reliant on the program. If a program proves to be a failure, Congress never reforms or abolishes it. Rather, a new program is created to "solve" the problem or a new layer of bureaucracy is added onto the old one.

Example: There are roughly sixty anti-poverty programs administered by the federal government. Nearly every federal agency has its own anti-poverty program. This includes the military if certain veterans programs are counted.

Example: The Stewart B. McKinney Homeless Assistance Act of 1987, intended to help the homeless, created seventeen different programs adminis-

tered through seven federal agencies. Yet, there were already over sixty separate federal programs providing assistance to the homeless.

4) Congress does not trust people to help themselves.

With few exceptions, Congress designs programs to empower bureaucrats and private sector professionals, not those individuals that a program was intended to help. For instance, federal money for the poor reaches recipients only after it has trickled through a half million poverty-industry bureaucrats and untold numbers of private sector specialists, such as doctors, real estate developers, and social workers.

Example: Since the mid-sixties the federal government has spent about a quarter of a trillion dollars to build or subsidize the construction of over four million low-income housing units. The use of housing vouchers, like food stamps, would have allowed the government to help twice as many poor individuals, using market demand to stimulate construction of more low- and moderate-income housing. More important, vouchers give the poor a greater sense of efficacy because vouchers allow the poor to live where they choose, near the good schools and good jobs, for example.

5) Congress is addicted to "porkbarrel" spending.

The election process provides powerful incentives for each member of Congress to bring more federal money back to the home district than the voters in the district paid in federal taxes. This is the political equivalent of the "tragedy of the commons" problem found with limited natural resources. Because the resource does not have an identifiable owner, it is to everyone's advantage to obtain as much of the resource as possible before it runs out. The result of this situation is obvious; the resource is quickly destroyed by everyone's rush to "get their's." In budgetary terms, the result is "porkbarrel" spending and consistent budget deficits. The cost to the American taxpayers is difficult to calculate.

Some representative examples of porkbarrel spending are[3]:

♦♦ A $107,000 grant from the National Science Foundation and the National Institute of Mental Health for the study of "sexual looking, classical conditioning of sexual arousal, and improvement of copulatory performance with practice" of the Japanese quail. The conclusion: male quails prefer female quails over male quails and female ducks for mating purposes. Congress has renewed this study with a $100,000 grant.

♦♦ $2,500 to study the causes of rudeness, lying, and cheating on tennis courts.

♦♦ $84,000 to study why people fall in love.

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3 See: "Pork Barrel Items in the FY 1990 Appropriations Bills," Citizens Against Government Waste. March 27, 1990 and Walter Williams, "Your Tax Dollars at Work," *The Washington Times*, April 13, 1990.

♦♦ $500,000 to build a ten-story replica of the Great Pyramid of Cheops in Bedford, Indiana, and an additional $200,000 to the same city to build a 800-foot replica of the Great Wall of China.

♦♦ $46,000 to study how long it takes to cook breakfast eggs.

♦♦ $221,000 to send twenty-one members of Congress and their "officials" to the Paris Air Show.

♦♦ $68,000 to send officials of the Urban Mass Transit Administration to Disney World to study the secrets of the Disney transportation system.

♦♦ $150,000 for Broom Snakeweed research in New Mexico.

The burden is on Congress to change the way it does business. Taxpayers should no longer have to pinch pennies so that Congress can spend them with abandon.

SLASHING THE DEFICIT: FY 1991

Summary of Cost Savings by Budget Function

Budget Subsection	Total Savings ($ million)
(000) General Government Management	$25,540
(051) National Defense	$11,200
(150) International Affairs	$ 3,916
(250) Science, Space, and Technology	$ 2,068
(270) Energy	$ 18,276
(300) Natural Resources	$11,439
(350) Agriculture	$10,690
(370) Commerce and Housing Credit	$ 4,140
(400) Transportation	$ 9,443
(450) Community Development	$ 5,608
(500) Education	$ 7,326
(550) Health	$ 1,545
(600) Income Security	$15,200
(700) Veteran's Benefits	$ 3,000
(750) Justice	$ 406
(800) Legislative Branch	$ 270
(920) Federal Pay	$ 900
Total Savings	$130,967

Last year, in the monograph *Slashing the Deficit: FY 1990*, Heritage Foundation experts recommended $128 billion in budgetary spending cuts. The following recommendations are based in part on that monograph, though greatly summarized. Some new recommendations have been added and other recommendations to phase-out programs over many years have been modified. Heritage analysts suggest over $130 billion in cuts this year.

The three fastest growing programs in the budget, Social Security, Medicaid, and Medicare are not addressed here. These programs are in such serious need of reform that they deserve extensive attention elsewhere. Congress should, however, freeze spending for these programs for one year at 1990 levels. This one-year period should be used to develop long-term reform policies to bring the spiraling costs of these programs under control.

All suggested spending cuts are reductions from Fiscal Year 1990 outlays and are, therefore, real dollar cuts, not reductions in projected baseline increases.

LEGISLATIVE BRANCH

Legislative Branch Expenses:

Deficit Reduction: $220 million

Repeal the congressional payraise and reduce funding for Congress and Legislative Branch agencies and activities by 10 percent. Congress should not receive a pay raise until a balanced budget has been achieved without a tax increase.

Congressional Mail Privilege:

Deficit Reduction: $50 million

Reduce expenditures by 50 percent on congressional mailings, known as the "franking privilege." Members of Congress use this free mailing privilege to enhance their chances for reelection. In 1987, lawmakers sent out 12,000 pieces of mail for every piece received on Capitol Hill.

GENERAL GOVERNMENT MANAGEMENT

Contract Out Federal Services:

Deficit Reduction: $5 billion

Issue an executive order requiring federal agencies to contract out to private firms or groups of federal employees all functions that are not inherently governmental.

Merge the Department of Energy with the Departments of Interior, Commerce and Defense:

Deficit Reduction: $2 billion

Close the Department of Energy and transfer all defense related activities to the Department of Defense; place regulatory functions with the Department of Commerce; and, merge resource management functions with the Department of the Interior, creating a Department of Natural Resources.

Merge HUD and HHS:

Deficit Reduction: $2 billion

Move all low -income housing programs into the Department of Health and Human Services; replace all low-income housing assistance with vouchers; transfer HUD's economic development functions to the states and the Department of Commerce.

Streamline the Department of Agriculture:

Deficit Reduction: $1 billion

Move the Food Stamp and nutrition programs into the Department of Health and Human Services; move the Forest Service into the Department of Interior and the agricultural trade programs into the Department of Commerce; close the Farmers Home Administration and place all low-income housing programs in HHS.

Expand Federal Loan Sales and Include Revenues in Deficit Reduction Calculations:

Deficit Reduction: $4 billion

Initiate a comprehensive credit reform program requiring federal lending agencies to sell the existing $250 billion federal loan portfolio, plus sell all new loans to the private sector through competitive auctions.

Require Reinsurance on Federal Loan Guarantees:

Deficit Reduction: $3 billion

Require all federal lending agencies to purchase reinsurance from the private sector for all federally-guaranteed loans; establish a new federal loan guarantee policy prohibiting lending agencies from granting a guarantee of more than 90 percent of the face value of a loan.

Cut the Capital Gains Tax:

Deficit Reduction: $4 billion

Cut the capital gains tax from 33 percent to 15 percent.

Improve Federal Debt Collection:

Deficit Reduction: $2.5 billion

Adopt the standard debt collection procedures found in the private sector.

Modernize Federal Cash Management:

Deficit Reduction: $40 million

Charge states and cities interest on federal grant and loan money that is paid before the funds are actually spent. A Treasury Department revolving fund should be established to insure that the federal government is fully compensated for early payments to the states and cities, as recommended by the

Grace Commission. This revolving fund similarly should reimburse cities and states for late federal payments.

Repeal the Davis-Bacon Act:

Deficit Reduction: $1.5 billion

Repeal the 1931 Davis-Bacon Act, which establishes inflated "prevailing wages" for federal contracts over $2,000. This law was designed to protect white labor from competition from lower cost Black labor and has continued to have an adverse impact on minority labor.

Repeal the Service Contract Act:

Deficit Reduction: $500 million

Repeal the Service Contract Act of 1965, which establishes inflated "prevailing wages" for federal service contracts of more than $2,500. This law has been especially harmful to small, minority-owned businesses.

NATIONAL DEFENSE

Deficit Reduction: $11.2 Billion

Bush's proposed 1991 Pentagon budget already trims 2.1 percent from last year's defense outlays, for a saving (in 1991 dollars) of $6.2 billion. Bush accomplished the savings by terminating thirteen programs including the M-1 tank (saving $1.1 billion in 1991), Maverick missile (saving $367 million in 1991), and Sea Lance anti-submarine warfare missile (saving $156 million in 1991). Bush also proposed cutting two divisions from the Army for savings of $1.2 billion in 1991 and closed 35 military installations.

New Administration proposals will trim the budget by an additional $2.5 billion in 1991: a cutback in spending for the B-2 bomber, C-17 transport and Advanced Tactical Fighter aircraft programs, and termination of the Follow-on-to-Lance missile, a 280 mile-range nuclear missile designed primarily for use in Europe. These cuts were recommended last March in a Heritage Foundation *Backgrounder*, "Four Imperatives for Cutting the Defense Budget."[4]

On top of these savings, Bush can trim another percent or so from the budget by such measures as:

- **postponing production of the C-17 aircraft;**
- **putting the equivalent of another Army light division in the reserves;**

4 Jay P. Kosminsky, "Four Imperatives for Cutting the Defense Budget," The Heritage Foundation *Backgrounder* No. 757, March 2, 1990.

♦ **slowing down procurement plans for the Army Light Helicopter and other programs geared mainly to meet advanced Soviet forces.**

As important an issue as how the Pentagon budget is cut is the question of which programs are protected from the budget ax. Key areas of the budget which should be protected are: 1) strategic nuclear forces, particularly land- and sea-based intercontinental missile modernization programs; 2) the Strategic Defense Initiative (SDI); 3) Marines and Special Forces most likely to be engaged in combat; 4) research and development, and; 5) programs critical to armed forces morale and professionalism, such as training time and benefits for military personnel.

INTERNATIONAL AFFAIRS

Reduce U.S. Contributions to the World Bank:

Deficit Reduction: $110.6 million

U.S. taxpayers now are committed to $30 billion in loan guarantees to the World Bank, in addition to America's annual contribution. Yet the Bank repeatedly gives out loans contrary to U.S. interests. Funds go to governments in less developed countries that mismanage their economies and waste countless billions of dollars. Moreover, the World Bank continues to increase its loans to less developed countries that have little hope of repaying the loans.

P.L. 480 "Food for Peace" Program:

Deficit Reduction: $146.3 million

Eliminate Food for Peace funding except for temporary food shipments in emergencies like earthquakes, droughts, and famines. This program actually has harmed the economies of the Third World countries by depressing the market prices that local farmers can obtain for their crops.

Agency for International Development (AID) — Foreign Aid:

Deficit Reduction: $3.1 billion

Cut the overall AID budget by 50 percent and phase out the remainder of the program over three years. American economic development assistance has effectively rewarded wasteful and irresponsible economic policies in less developed nations. Any U.S. economic development aid should be given contingent on reforms toward free enterprise, free markets, and local entrepreneurship.

U.S. Contributions to the United Nations:

Deficit Reduction: $190 million

Cut U.S. contributions to those programs that clearly do not serve American interests, completely eliminating funding for those which are fundamentally hostile or ineffective. Specifically: U.N. Food and Agriculture Organization (FAO); U.N. Industrial Development Organization (UNIDO); World In-

tellectual Property Organization (WIPO); World Health Organization (WHO); World Heritage Fund; U.N. Relief and Works Agency (UNRWA); U.N. Education and Training Program for Southern Africa and the U.N. Trust Fund for South Africa; and the U.N. Development Program (UNDP).

International Monetary Fund (IMF):

Deficit Reduction: $5 million

End all U.S. direct funding of the IMF and prohibit any new U.S. commitments in contingent liabilities. The IMF is now requesting a $60 billion capitol increase which will bring its total operating assets to some $175 billion. It does not need expanded lending authority. Moreover, IMF lending policies actually have led to less economic development in recipient countries because IMF loans tend to cover up for bad economic policies and corrupt governments.

Export Import Bank (Eximbank):

Deficit Reduction: $364 million

Close the Export Import Bank. The Bank's existing loan guarantee commitments should be honored, but the Bank should be forbidden from insuring any new loans. The Bank was established in 1934 to finance U.S. exports to the Soviet Union. In recent years, the Bank loses an average of around $400 million a year financing exports for some of America's largest multinational companies.

SCIENCE, SPACE, AND TECHNOLOGY

NASA – Space Station:

Deficit Reduction: $1.7 billion

Delay federal funding of the planned Space Station Freedom for two years. This period should be used for further study of less expensive options such as encouraging privatization of commercial space activity, or sponsorship of a joint public-private venture.

NASA – Mars Project:

Deficit Reduction: $150 million

Delay federal funding of the proposed manned mission to Mars. The entire Mars program is estimated to cost as much as $400 billion, according to the Congressional Budget Office (CBO). While a manned landing on Mars is a noble goal further thought should be given toward less expensive priorities.

Superconducting Super Collider (SCS):

Deficit Reduction: $218 million

Cease funding of the SSC. The SSC would be the world's largest, and most powerful, high energy particle accelerator, with a projected total cost of $8

billion to construct and $270 million annually to operate. The SSC will drain funds from less exotic, and less costly, research projects with greater commercial potential.

ENERGY

Naval Petroleum Reserves (NPR):

Deficit Reduction: $1.6 billion

Sell the NPRs through a well-publicized public stock offering. For over seventy years the federal government has owned and operated commercial oil fields at Elk Hills, California, and Teapot Dome in Wyoming in case of a national emergency. Since these reserves account for about 1 percent of U.S. domestic output, the government has no reason to continue operating these sites.

Federal Dams: The Five Regional Power Marketing Administrations (PMA):

Deficit Reduction: $5 billion

Sell the Power Marketing Administrations through public stock offerings. With few exceptions, the government has not reviewed or revised its policy for pricing the electrical output of these dams since the 1930s, when many of them were built. Consumers of PMA electricity receive over $1.5 billion worth of subsidies yearly. The federal Treasury could be receiving more than $4 billion per year if the government let buyers bid for the electricity. Underpriced federal power even lights gambling casinos in Las Vegas.

The Tennessee Valley Authority (TVA):

Deficit Reduction $5 billion

Sell the TVA through a public stock offering after dividing it into three or four independent power generating companies. The TVA, which is a government-owned corporation created in 1933 to bring electricity to the Tennessee River Valley, is effectively bankrupt. Of TVA's $22 billion in assets, some $15 billion are inoperative. The only way to ensure service to this region is to sell it to the private sector.

Uranium Enrichment Enterprise:

Deficit Reduction: $1.8 billion

Sell the U.S. uranium enrichment facilities to the private sector. The logical buyers for this enterprise are current employees, in addition to the 108 commercial nuclear power plants located in the U.S. that purchase the uranium.

Fossil Energy Research and Development:

Deficit Reduction: $383.7 million

Eliminate the Fossil Energy Research and Development programs which support research and development for new technologies intended for commercial markets. Alternatively, the government should require private sector cost sharing for all federal energy research and development expenditures with commercial applications. The government should impose a 50 percent up-front cost-sharing charge before launching new research projects and recoup 100 percent of the federal investment if the technology is eventually commercialized.

Rural Electrification Administration (REA):

Deficit Reduction: $2 billion

Eliminate the REA by phasing out REA loans by 1993 and selling existing loans to private investors and commercial banks. The REA was created in 1935 to bring electricity, and later telephone service, to rural areas of the country. Today, 99 percent of rural residents have electricity and 96 percent have phone service. Yet REA still distributes $2 billion in below-market cost loans each year.

Clean Coal Technology Program (CCTP):

Deficit Reduction: $151.5 million

Eliminate funding for the CCTP, which was created to assist private industry in developing environmentally safer coal technologies. The federal government currently is funding 60 percent of the program's costs while private industry funds the remainder. Since private industry is the beneficiary of this program, it should bear the full costs. Alternatively, regulations should be changed to allow power companies to use cleaner fuels.

Energy Conservation Programs:

Deficit Reduction: $340.6 million

Eliminate funding for energy conservation programs which support research and development of technologies intended for future use by the private sector. Since private industry potentially may receive lucrative benenfits from this technology, it should bear the full costs.

Energy Supply, Research and Development Activities:

Deficit Reduction: $2 billion

Eliminate funding for Energy Supply, Research and Development Activities which support research and development on technologies ranging from solar power to magnetic fusion. Continue funding on "pure scientific research" projects. Over the last fifteen years, the government has spent billions on research projects that have brought little or no return to the government or the private sector. For instance, over $10 billion was spent on nuclear energy research even though ten years has passed since the last U.S. commercial reactor was built.

Bureau of Land Management (BLM):

Deficit Reduction: $3 billion

Sell the most marketable portions of the 340 million acres of Western land owned by the Bureau of Land Management and transfer ownership of the remaining land to the respective states. This should include the same 600,000 acres of land classified as "in urbanized areas or with residential, commercial, or industrial value," in addition to the 350,000 acres of federal property classified as "no longer needed for federal purposes." Private buyers could include: environmental groups, recreational associations, ranchers, mining interests, or individual citizens. Federal ownership of Western land is an historical anomaly with no environmental or economic purpose. These are lands that were not transferred to the private sector under the Homestead Act, state land grants, and similar means in the 19th and early 20th centuries.

Bureau of Reclamation – Water and Construction Projects:

Deficit Reduction: $665 million

Close down the Bureau of Reclamation, which was formed in 1902 to promote economic development in the arid West. Begin by withholding all appropriations for new water projects which the Bureau itself recommends. Also, transfer all water distribution and pricing responsibilities to the private sector, thus bringing market efficiencies to the very inefficient and inequitable Western water market.

Offshore Oil and Gas Leasing:

Deficit Reduction: $800 million

End current moratoria on exploration and drilling of the Outer Continental Shelf (OCS). Technology can prevent the oil spills that drilling restrictions are intended to prevent. Experience of the past two decades demonstrates that offshore drilling need not damage the environment. Most spills occur as a result of shipping oil over long distances, not from offshore drilling.

Arctic National Wildlife Refuge (ANWR) Leasing:

Deficit Reduction: $1 billion

Lease the Arctic National Wildlife Refuge (ANWR) tracks immediately through competitive bidding under standard Department of Interior leasing guidelines. According to a 1987 Department of Interior study, ANWR oil could bring $38 billion in new revenue to the federal Treasury.

Powder River Basin Coal:

Deficit Reduction: $2 billion

Sell the federally-owned coal that lies under the privately-owned surface land in the Powder River Basin in Wyoming. The sale should be accom-

plished through competitive auctions, or possibly through the public sale of stock in a newly created coal management corporation.

U.S. Forest Service – Road Building:

Deficit Reduction: $224 million

Discontinue subsidized road building for private timber companies. The U.S. Forest Service is the world's largest road builder. Under its direction over 342,000 miles of roads have been built, eight times the mileage of the U.S. Interstate Highway System. This program is extremely harmful to the environment, yet it continues only because the Forest Service claims that timber sales yield considerable revenues to the U.S. Treasury. According to the Wilderness Society, these claims are false: the Forest Service actually has averaged $406 million in annual losses since 1982.

Land Acquisition – U.S. Forest Service and National Park Service:

Deficit Reduction: $210 million

Cancel all new land purchases by the U.S. Forest Service and the National Park Service. The federal government already owns 727 million acres of property. Only the Soviet Union and China own more public land. The government should begin to facilitate the purchase and stewardship of existing federal holdings by private conservation organizations.

Recreational Lands – User Fees:

Deficit Reduction: $1 billion

Raise entrance fees for federal recreational lands to reflect the costs of maintenance and operations. Congress prevents federal land management agencies, such as the National Park Service, the Army Corps of Engineers, and the National Forest Service, from charging fees for use of most public lands and facilities. Minimal fees collected by the Park Service, about $55 million, do not come close to covering the agency's annual outlays of $729 million. Meanwhile, the fragile environment of these parks suffers near irreparable stress because there is no market mechanism to regulate visitorship.

Environmental Protection Agency (EPA) – Enforcement Activities:

Deficit Reduction: $200 million

Allow independent, private environmental auditors to take over the (EPA) monitoring of industry compliance with EPA standards. EPA currently spends nearly $800 million on the Abatement, Control, and Compliance program. Yet, much of this monitoring could be accomplished through the private markets, as is done with financial auditing.

EPA – Wastewater Treatment Construction Grants:

Deficit Reduction: $2 billion

Eliminate the wastewater treatment construction grants program; which provide initial capital to states' Revolving Funds for loans to local govern-

ments to construct treatment facilities. The $50 billion spent in this program since 1972 has encouraged local governments to build "gold-plated" treatment facilities rather than look for lower-cost and more environmentally safe alternatives.

National Oceanic and Atmospheric Administration (NOAA):

Deficit Reduction: $40 million

Impose a $100 annual licensing fee on fishermen for the right to fish in federal waters. Other fishing user fees should also be reviewed. The National Marine Fisheries Service spends over $100 million a year promoting fishing and conserving fishing resources in federal waters. Fishermen should pay for some of the benefit they receive.

Bureau of Mines:

Deficit Reduction: $180 million

Close the Bureau of Mines. The Bureau's important data gathering activities should be merged with other research agencies within the Department of Interior. The research and development facilities of the Bureau should be closed, or sold to the private sector which has a direct financial interest in conducting some of this research.

Federal Helium Reserves:

Deficit Reduction: $60 million

Sell the federal helium reserves and the Exell helium refining plant near Amarillo, Texas. Between 1929 and 1961 the federal government was virtually the sole supplier of helium. The private market now is flourishing and should not have to compete with subsidized government helium.

The National Weather Service (NWS):

Deficit Reduction: $60 million

Institute user fees that reflect the true cost of service. Additionally, close or contract out any activities that compete with the private sector. There are approximately 100 private companies in the U.S. preparing and disseminating weather forecasts to businesses and the public on a commercial basis.

AGRICULTURE

Farm Subsidies:

Deficit Reduction: $10 billion

Discontinue direct subsidies to farmers and the federal crop price support programs managed by the Agricultural Stabilization and Conservation Service and the Commodity Credit Corporation. Farm subsidies are anti-consumer, and are especially burdensome for low-income families. Farm subsidies add as much as $10 billion to food prices for American households.

Moreover, according to Cato Institute scholar, James Bovard, "With the $260 billion that government and consumers have spent on farm subsidies since 1980, Uncle Sam could have bought every farm, barn, and tractor in thirty-three states."[5]

Federal Crop Insurance Corporation (FCIC):

Deficit Reduction: $500 million

Phase out FCIC, which insures farmers against crop losses resulting from natural disasters such as droughts, floods, hurricanes, fire, and insect infestation. The government should use measures to promote a more mature private crop insurance industry. While participation in FCIC currently is voluntary, farmers receiving any level of agricultural subsidies or loans should be required to purchase crop insurance from private insurers. The role of the FCIC should be relegated to that of a reinsurer of private insurance firms.

Agriculture Extension Service:

Deficit Reduction: $190 million

Reduce the Agriculture Extension Service budget by half and phase out the remainder of the program over three years. The County Cooperative Extension Program was established in 1914, at a time when 35 percent of Americans lived on farms. Though only 2.2 percent now reside on farms, the program continues. The training, education, and marketing assistance activities of the Extension are duplicated by dozens of other state and local programs in addition to private groups such as the American Farm Bureau Association.

COMMERCE AND HOUSING CREDIT

Federal National Mortgage Association ("Fannie Mae") and Federal Home Loan Mortgage Corporation ("Freddie Mac"):

Deficit Reduction: $500 million

Begin the process to phase out over ten years all special government benefits enjoyed by FNMA and FHLMC. Place a temporary annual fee of 0.25 percent on all single-family and multifamily mortgages sold to or guaranteed by FNMA or FHLMC. This fee should be paid by borrowers, collected by lenders, and passed through to the Treasury. Reduce the cap on the maximum mortgage amount that can be held or traded by FNMA or FHLMC to 150 percent of local conventional home loan values. Remove the exemption from Securities and Exchange Commission reporting requirements that each enjoy.

5 James Bovard, *The Farm Fiasco* (San Francisco: Institute for Contemporary Studies Press, 1989), p 1.

Federal Housing Administration (FHA):

Deficit Reduction: $1 billion

The FHA may soon become the next Savings and Loan Crisis. The FHA must be held to the same capital requirements as private mortgage insurers: 4 percent. Also, require a minimum downpayment of 5 percent of the mortgage amount from homebuyers obtaining FHA insurance. Default rates are exceedingly high for loans with less than 5 percent downpayments. Impose on lenders a 5 percent coinsurance requirement on all FHA-insured loans, and discontinue FHA mortgage insurance on second homes or investor properties.

Small Business Administration (SBA):

Deficit Reduction: $340 million

Close the SBA and sell all outstanding loans to the private sector. The SBA has been a dismal failure, with around 12 percent lost each year on the $3 billion of loan guarantees it issues. As many as 20 percent of SBA direct loans default. Only two-tenths of 1 percent of all small businesses in the nation receive SBA loans. To be eligible for SBA direct and guaranteed loans small businesses must have been rejected by two previous banks. As a result, SBA loans divert venture capital away from enterprises that seem likely to succeed to those with are more likely to fail.

Federal Communications Commission Auctioning of the Electromagnetic Spectrum:

Deficit Reduction: $2.3 billion

Auction licenses for unassigned frequencies of the electromagnetic spectrum to the highest bidder, with the revenues from the auction going to the U.S. Treasury. Auctioning is a more efficient and equitable method of assigning frequencies.

TRANSPORTATION

Interstate Commerce Commission (ICC):

Deficit Reduction: $43 million

Complete the deregulation of the trucking industry, and abolish the ICC. Remaining ICC functions should be distributed to other agencies. The ICC's rail regulatory functions, for instance, should be moved to the Department of Transportation, while its consumer protection functions could be handled by the Federal Trade Commission.

Urban Mass Transportation Administration (UMTA):

Deficit Reduction: $2 billion

Eliminate all federal transit operating subsidies immediately, since they subsidize inefficiency in transit operations. Cost-sharing by local governments

should be raised to 50 percent from 25 percent on all new projects. Despite a $40 billion investment in urban transit projects over the past quarter century, 10 percent fewer transit trips were taken in 1986 than in 1963, the year before the program began. Much of the $40 billion in federal aid has been spent on gold-plated transit projects which attract few riders.

Amtrak:

Deficit Reduction: $500 million

Sell Amtrak to the private sector in the same manner as the sale of Conrail. While Amtrak is becoming more self-sufficient than in the past, federal subsidies to Amtrak average about $25 per passenger trip.

Federal Highway Administration:

Deficit Reduction: $4 billion

Declare the interstate highway system complete. Over 98 percent has been completed, any further construction should be done by the states or by private companies using toll road arrangements. Eliminate funding for all highway "demonstration" projects. Allow states to impose tolls to cover the cost of maintaining and extending roads that have received no more than 75 percent federal funding. This would lift the current ban on direct user fees for primary and urban roads, but continue the ban on tolls on portions of the interstate highway system.

Federal Aviation Administration (FAA):

Deficit Reduction: $2 billion

Eliminate payments for aviation from the general treasury, except for the estimated 15 percent of FAA costs due to military use. The success of airline "in-air" deregulation should be extended to "on-the-ground" operations. The Department of Transportation should be more aggressive in selling airports to private firms or contracting out a greater portion of airport management.

Maritime Administration:

Deficit Reduction: $400

Repeal the "cargo preference" requirement for exports shipped and financed by the U.S. government. Although the Maritime Administration's activities originally were designed to promote U.S. national security interests, today many of its programs – particularly the "cargo preference" law – are little more than protectionist measures intended to shield the U.S. shipping industry from foreign competition. Protectionism for U.S. shipping interests adds to the costs of U.S. exporters and thus harms America's competitiveness.

United States Coast Guard:

Deficit Reduction: $500 million

Charge fees for Coast Guard services, such as aids to navigation, boat towing, and ice breaking, which benefit easily identifiable users. Conduct a com-

prehensive inventory of Coast Guard property holdings and begin to sell unnecessary land and facilities.

COMMUNITY DEVELOPMENT

Community Development Block Grants (CDBGs):

Deficit Reduction: $2.5 billion

End the Community Development Block Grant program, and apply $500 million of the program's funding toward tax abatement in federal enterprise zones in blighted areas.

Farmers Home Administration (FmHA):

Deficit Reduction: $3 billion

Close the FmHA and shift all low-income housing programs to the Department of Housing and Urban Development. Repeal the 1987 congressional prohibition on further sales of FmHA loans to the private sector. Sell off the mounting inventories of defaulted properties as FmHA accumulates them. FmHA has been a disaster. The General Accounting Office estimated that 1987 losses totaled $13 billion, pushing FmHA's accumulated deficit to a staggering $42 billion. The situation is getting worse each year.

Appalachian Regional Commission (ARC):

Deficit Reduction: $108 million

Abolish the Appalachian Regional Commission. Since this program was enacted in 1965, the federal government has spent nearly $6 billion in this economically distressed region, two-thirds of that investment on roads. The ARC duplicates fourteen federal rural aid programs provided by the Departments of Transportation, Labor, and Agriculture.

EDUCATION

Impact Aid:

Deficit Reduction: $764 million

Eliminate the Impact Aid program which is intended to compensate local governments for the ostensible cost of educating school children of federal employees. This program was established during World War II based on the erroneous premise that military bases and other federal facilities are a "cost" for local communities.

Bilingual Eduction Programs:

Deficit Reduction: $100 million

Cut federal funding for bilingual eduction by 50 percent and remove all restrictions on the instructional methods adopted by local schools. The remain-

ing funds should be given to local school districts to develop the programs they deem most appropriate and effective.

Stafford Student Loan Program:

Deficit Reduction: $1 billion

Reform the Stafford Student Loan program by eliminating all federal interest rate subsidies to students after they leave school. Serious study should be given to imposing a 10 percent to 15 percent co-insurance requirement on lenders. Default rates on student loans are nearing 15 percent, and nearly 3 million Americans now hold delinquent loans, worth $5.5 billion to the federal Treasury.

Howard University:

Deficit Reduction: $100 million

Reduce total federal support for Howard University by 50 percent. Although Howard University, in Washington, D.C., is a private institution, it receives nearly $200 million annually in federal support. Howard should be required to develop a plan for self-sufficiency over ten years using a graduated matching grant system.

College Work Study Program (CWS):

Deficit Reduction: $606 million

End the federal role in the College Work-Study program, which makes grants to participating institutions that provide part-time jobs for disadvantaged graduate and undergraduate students. Nearly all of the students who take advantage of this program already collect student aid in other forms. The federal government should not have to pay for both a student's education and his or her part-time job.

Corporation for Public Broadcasting:

Deficit Reduction: $150 million

Reduce funding for the Corporation for Public Broadcasting to $80 million and phase out support over the next three years. With today's boom in cable television and the rental movie market, taxpayer supported television and radio, if it was ever justified, is now unnecessary and should be ended.

National Foundation on the Arts and the Humanities:

Deficit Reduction: $210 million

Reduce by two-thirds federal funding for the National Foundation on the Arts and Humanities which gives grants to the National Endowment for the Arts and the National Endowment for the Humanities; then expand the Challenge Grants program currently operated by the National Endowment for the Arts. Funding would be phased out over three years. There is no shortage of private financial support devoted to the arts and humanities. The American

Association of Fund-Raising Councils calculates that in 1987 private donations to "arts, culture, and the humanities" was $6.41 billion.

Job Training Partnership Act (JTPA):

Deficit Reduction: $3.9 billion

Terminate the Job Training Partnership Act, which is designed to provide job training for poor youth through block grants to the states, in addition to federally managed programs, such as the Job Corps. Government directed job training programs have a long history of failure. More often than not, job training programs have simply been a boondoggle for private operators and bureaucrats. There are other methods of achieving the same end that should be tried, such as: the Earned Income Tax Credit, lowering the minimum wage, repealing occupational licensing laws at the local level, or, perhaps, eliminating any tax burden on individuals below the poverty line.

Job Corps:

Deficit Reduction: $767 Million

If JTPA is not eliminated, Congress should at least terminate the Job Corps program which is intended to provide training for disadvantaged, unemployed youth. It should discontinue the construction of all new centers, and sell off the remaining centers under government control. Job Corps has a twenty-five year record of failure. According to the Office of Management and Budget, the Job Corps is the most expensive job training program administered by the Department of Labor. Training costs per youth average between $15,000 (privately managed facilities) and $21,000 (federally managed centers) for an eight month session.

Trade Adjustment Assistance:

Deficit Reduction: $196 million

Eliminate all funding for Trade Adjustment Assistance, which is intended to aid workers whose jobs have been lost due to import competition. Workers who lose their jobs as a result of foreign competition should not receive government benefits that exceed the assistance available to those laid off due to domestic competition.

Community Services Block Grants (CSBGs):

Deficit Reduction: $300 million

End the Community Services Block Grant (CSBG) program, created in 1981 by consolidating several federally-funded community action programs that had been part of Lyndon Johnson's Great Society efforts. The $90 million remaining in this program's $390 million budget should be directed toward federal tax abatement in enterprise zones in blighted areas. A recent General Accounting Office (GAO) study found that more than 30 percent of CSBG funds are used to defray the administrative costs incurred by local social service agencies as a result of local and federal regulations. The Davis-Bacon wage-setting law can add 25 percent to administrative costs, and local

building and zoning codes can add 15 percent to 25 percent to the cost of building low-income housing.

HEALTH CARE

National Institutes of Health (NIH):

Deficit Reduction: $1.14 billion

Reduce by 30 percent funding for the NIH, which fund biomedical research in a variety of health care areas. During the 1980s, as much as 30 percent of NIH extramural grant funds went to recipients' indirect overhead costs rather than basic research. Institute a graduated matching-grant program which would require recipients to find additional sources of support for their work. This would also act as a check on the validity of the research conducted.

Health Resources and Services Administration (HRSA):

Deficit Reduction: $370 million

Reduce by 20 percent funding for the HRSA. Transfer control of community health centers, migrant centers, and black lung clinics to the states by transforming HRSA funds into a Primary Care Block Grant. Reducing the strings attached to this block grant would allow each state to tailor assistance to meet unique local primary care needs.

Consumer Product Safety Commission (CPSC):

Deficit Reduction: $35 million

Abolish the CPSC. Consumers and firms do not need the CPSC. The legal system has more than adequate protection against defective products. Moreover, product monitoring is handled very capably by private firms, such as Underwriters Laboratory, Inc., and publications, such as *Consumer Reports*.

INCOME SECURITY

Civil Service Employee Retirement:

Deficit Reduction $3 billion

Bring Civil Service Retirement benefits in line with private sector packages. Such reforms should include: raising the federal retirement age from 55 to 65; eliminating the lump-sum retirement option; calculating retirement benefits based on an average of the five highest annual salaries in an employee's earnings history, rather than the current top three years earnings base; and reducing cost-of-living adjustments (COLAs) from the full Consumer Price Index to the CPI less 1 percent. The government pays out over $30 billion a year to two million civil service retirees. The unfunded liabilities of the civil service retirement system are mushrooming to potentially catastrophic levels, $1 trillion by some accounts.

Unemployment Insurance:

Deficit Reduction: $2 billion

Reform the Federal-State Unemployment Insurance program, which will pay out $19.5 billion to unemployed workers this year. Initial reforms should include delaying the 26 weeks of unemployment benefits for unemployed workers for two weeks, and allowing firms to opt out of the program if instead they establish and make payments to Personal Unemployment Insurance and Training Accounts for all employees. Another long-term reform is to give workers tax incentives for purchasing individual unemployment insurance.

Privatize Public Housing:

Deficit Reduction: $1.3 billion

Take steps to begin privatizing public housing. There are approximately 1.4 million public housing units nationwide, managed by 3,300 local public housing authorities. Federal expenditures now total over $6.5 billion a year.

1) Offer all public housing developments nationwide for sale to the highest bidder. An estimated 20 percent would be purchased in the first year, yielding immediate savings to the federal government (as well as income from sales).

2) Require purchasers to maintain the properties sold as privately-managed public housing for five years. Purchasers would underwrite all maintenance and operating costs and freeze rents at pre-sale levels, with annual increases for inflation. After five years, purchasers would own property free and clear, with the option to convert to other uses or retain as low-income housing.

3) Use the proceeds from the sale of public housing units to fund housing vouchers for displaced tenants, and apply the balance to deficit reduction. Twice as many poor can be assisted with vouchers than is possible with public housing.

Child Nutrition Programs:

Deficit Reduction: $1 billion

Eliminate $1 billion of the $4.9 billion in federal grants to states which compensate for families with incomes over 130 percent of the poverty level who participate in School Lunch programs, School Breakfast programs, and Child Care Feeding programs. Families with incomes below 130 percent of the poverty level with children in schools that do not participate in the meals program should be given additional food stamps or government cash assistance equal to the amount of subsidy in the child nutrition program.

Aid to Families With Dependent Children (AFDC), MEDICAID, and Related Welfare Benefits:

Deficit Reduction: $6.5 billion

Limit to seven years the time that a family can remain on the Aid to Families with Dependent Children assistance rolls. This will reduce the current welfare rolls by roughly one-third and reduce total state and federal spending by $10.2 billion. There are 3.7 million families currently receiving AFDC assistance; and, these families will, on average, stay on the program 11.5 years. Two million of the current beneficiaries will receive benefits over ten years, with an on-average stay of 16.5 years. This prolonged welfare dependence provides an unsuitable environment for raising young children.

Low Income Home Energy Assistance:

Deficit Reduction: $1.4 billion

Immediately end the Low Income Home Energy Assistance program and replace it with a scaled-back program to provide only emergency and temporary energy aid to very low-income families facing disconnection of their utilities.

VETERANS BENEFITS

Veterans Medical Benefits:

Deficit Reduction: $3 billion

Convert veterans' health benefits to a reimbursement system, paying for treatment by private doctors, hospitals, and nursing homes, with full coverage provided for treatment of service-related disabilities and tapered coinsurance charges for treatment of nonservice-related disabilities. Also, reduce VA medical staff levels over several years in areas where adequate alternative treatment facilities exist. VA health care equipment and buildings located in these areas should be sold to the private sector or closed. .

JUSTICE

Legal Services Corporation:

Deficit Reduction: $306 million

Eliminate funding for the Legal Services Corporation which is intended to provide legal assistance to low-income individuals. Encourage the use of private-non profit dispute resolution organizations and give vouchers to those who need other legal assistance. The Legal Services Corporation has betrayed its mission by involving itself in political advocacy work, not legal aid to the poor.

The Bureau of Prisons:

Deficit Reduction: $100 million

Begin gradually to contract with private corrections firms to administer and operate prison facilities, including the "special need" facilities, such as juve-

nile institutions and illegal immigration facilities as well as the minimum security. Also, finance the construction and expansion of federal prisons through lease-purchase arrangements.

FEDERAL PAY

Federal Blue Collar Salaries:

Deficit Reduction: $900 million

Reevaluate the pay rates for non-key jobs. Reform the step classification system within each occupational grade level to bring federal pay into line with private sector pay rates.

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FEDERAL BUDGET REPORTER

Analyzing the Process of Government Spending

#5 May 31, 1990

WASHINGTON WATCH

Read Bush's Quivering Lips. "My opponent won't rule out raising taxes. But I will. The Congress will push me to raise taxes, and I'll say no, and they'll push, and I'll say no, and they'll push again, and I'll say to them, 'Read my lips: no new taxes.'" So went then-Vice President George Bush's famous campaign pledge at the Republican National Convention in 1988. But now, as Congress pushes him to raise taxes, Bush's lips are quivering. In negotiations with congressional leaders on budget deficit reduction, the President refuses to rule out a tax hike.

Yet the budget deficit is not caused by a shortfall in revenue. The federal government is expected to collect a record $1.073 trillion this year, which is $82.8 billion more than last year and an 8.4 percent annual increase. The tax burden on Americans, moreover, is heavier than ever. The average taxpayer must work two hours and forty-five minutes of each eight-hour day just to pay taxes.

What is worse, a tax increase would not reduce the budget deficit. The Gramm-Rudman law sets the budget deficit this year at no higher than $74 billion. Additional revenues only would allow Congress to meet this target at a higher rate of spending.

Just How Committed Is Congress to Reducing the Deficit? While Bush has assured Congress that "no preconditions" exist – meaning tax hikes for the fiscal 1991 budget are on the bargaining table – Congress has assured no one of its commitment to cut spending. Just how concerned over the deficit is Congress? The *Washington Post* reports that the Senate Budget Committee's spending proposal for fiscal 1991 would add at least $3.5 billion in new outlays for highway construction, air traffic control systems, child care, anti-drug programs, environmental initiatives, and veterans' health care.

The House Budget Resolution is worse. Most so-called "cuts" are nothing more than reductions from initially proposed spending increases. For example, spending for Medicare is to be "cut" by $1.7 billion. This only means that outlays are $1.7 billion less than the proposed increase in the previous budget baseline. Expenditures for Medicare will actually rise by at least $8 billion over last year. (Available from Citizens for a Sound Economy, *Capitol Comment*, April 25, 1990, 202/488-8200.)

The Inappropriate Appropriations Bill. This spring's supplemental Appropriations Bill, which gives new government funds to programs deemed "emergencies," indicates the lack of seriousness that many legislators bring to the budget problem. Examples of "emergency" spending, which total more than $100 million, include: $1.9 million for a fish farm in Arkansas; $900,000 for cotton ginning research in Michigan, New Mexico, and Texas; $1.3 million to research fruit flies in Hawaii; $285,000 to study the effect of advertising on milk consumption; $1.3 million to research uses for fish oil; and $185 million for an FBI finger-printing center in West Virginia. To garner votes on Election Day, Members of Congress purchase these generous gifts for their constituents using the taxpayers' hard-earned dollars. And now they want to raise taxes even higher.

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Wide Bipartisan Support for a Line-Item Veto. Some observers speculate that President Bush may accept a tax hike in exchange for budget reform. The Administration is justifiably eager to restore the President's prerogative to reject specific spending items appropriated by Congress. However, raising taxes to obtain it clearly is not the solution. There are more than seven separate line-item veto proposals, including one to amend the Constitution sponsored by Illinois Democrat Senators Paul Simon and Alan Dixon. Both were reported out of the powerful Senate Judiciary Committee in April by an 8 to 6 vote.

One bill that has generated substantial bipartisan support and would not require a constitutional amendment, is the "enhanced rescission" or "legislative" line-item veto reintroduced from last year by Republican Senators Dan Coats of Indiana and John McCain of Arizona. The legislation, S. 1553, would give the President the power to rescind spending items appropriated by Congress.

Even liberal Democrat Senator Paul Simon says: "The reality is that we have demonstrated year after year after year that Congress simply doesn't have the discipline [to control spending on its own]."

STATE WATCH

Bush Should Read the Taxpayers' Lips. Americans clearly do not approve of any tax increases. This overly poll-conscious Administration should look at the latest numbers. According to a recent *USA Today* poll, six out of ten respondents said they are opposed to new taxes. Similarly, a poll conducted by the Wirthlin Group found that 89 percent of the respondents favored cutting spending over raising taxes to reduce the deficit. Only 6 percent preferred higher taxes.

If Bush is still not convinced of public disapproval, he should hear what the taxpayers are saying to their state legislators. In response to growing taxpayer revolts against spendthrift fiscal policies, voters in more than a dozen states will have the opportunity to vote for tax reform initiatives on ballots this fall. Most initiatives would limit tax increases by requiring either statewide voter approval or a legislative super majority vote in order to raise taxes. A Massachusetts initiative, for example, would give taxpayers a direct role in the budgetary process by allowing voters to reject the Legislature-approved tax hikes for fiscal 1989-90.

A pathbreaking initiative in Illinois would mandate that any proposals to raise taxes be approved by a special legislative committee, as well as 60 percent of the state legislature. The brainchild of the National Taxpayers United of Illinois, the initiative is backed by 470,292 signatures, including those of gubernatorial candidates Republican Jim Edgar (who campaigned for tax increases in his campaign for the Republican nomination against fiscal conservative Steve Baer) and Democrat Neil Hartigan. (See Patrick B. McGuigan, "Grassroots to Bush: 'No More Taxes,'" *Wall Street Journal*, May 9, 1990. Also contact David Keating, Executive Vice President, National Taxpayers Union, (202) 543-1300.)

The Heritage Foundation Backgrounder

No. 769

The Heritage Foundation 214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202) 546-4400

May 18, 1990

MR. PRESIDENT, KEEP YOUR PROMISE: NO NEW TAXES

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The policy most strongly associated with George Bush is best summarized in his now-famous statement, "Read my lips: No new taxes." Now, notwithstanding his 1988 election promise to oppose any tax increase, Bush has announced that he enters budget deficit reduction negotiations with congressional leaders with "no preconditions." Administration representatives have made it clear that a tax hike is "on the table."

It was not without reason that Bush won the 1988 election on a "no new taxes" platform. The American people understand that they are not undertaxed but, rather, that the federal government overspends and is unable to get its fiscal house in order. The federal government currently is collecting and spending record amounts of revenue. Herein lies the cause of the budget deficit. Yet rather than restraining the growth of government spending, many policy makers urge higher taxes. A tax increase, however, almost certainly would slow economic growth and could lead to a recession. This would mean less revenues for the federal government and a higher budget deficit. If he breaks his most solemn political pledge, Bush forgets the lessons of his own victory over tax hike advocates Walter Mondale in 1984 and Michael Dukakis in 1988.

Federal Spending Increase. Advocates of a tax hike insist that the additional revenue would go to reduce the budget deficit. But contrary to this contention, additional revenue almost certainly will mean dollar-for-dollar increases in federal spending. The Gramm-Rudman Deficit Reduction Act dictates that total federal spending can be no greater than the sum of projected tax revenues plus the allowable deficit. Since the deficit target is already deter-

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mined by law, higher taxes simply would permit Congress to meet that target at a proportionately higher level of spending.

Some critics argue that deficit reduction is so important that the President should renege on his election pledge and accept higher taxes. Yet as a percentage of the Gross National Product, the budget deficit is less than half the size that it was just five years ago. In any case, if Congress and the White House are seriously interested in reducing government borrowing, Gramm-Rudman's deficit reduction mechanism known as sequestration will automatically reduce the deficit to the legally required level.

Damaging Concession. Other critics assert that the President should capitulate on taxes in order to win acceptance of a line-item veto, lower capital gains taxes, or some other budget reform. Yet the damage done to the economy as a result of higher taxes all but certainly would more than wipe out any gains from such concessions.

President Bush repeatedly promised the American people that he would not raise taxes. This was the economically and politically correct thing to do. The Bush Administration's integrity and commitment to economic prosperity are now on the line. The President should fulfill his pledge and refuse to raise taxes. Candidate Bush correctly promised to veto any tax increase; President Bush should follow through on that commitment.

THE PEOPLE SPEAK

Some political commentators maintain that the American people do not mind paying higher taxes. When policy makers propose tax hikes, some pundits instantly congratulate them for their "wisdom" and hail them for having the "courage" to come to the only "realistic" solution to the budget deficit problem. And, prior to his recent announcement opening the door for new taxes, President Bush was condemned for his "unrealistic" approach to fiscal matters.

Yet the current budget summit reflects an inside-the-Beltway perspective, not the beliefs of the vast majority of the American people. There should be no question concerning the public's attitude towards taxes. In election after election the American people unambiguously have said "no" to higher taxes. Bush's 1988 victory certainly is due in great part to his strong opposition to any tax increase. Polls indicate that the President's no-tax pledge is the most remembered feature of the campaign. Numerous states, including Michigan, Wisconsin, Washington, North Dakota, Oregon, Louisiana, and Pennsylvania have held referenda and initiatives on tax issues in the last two years. In every case, the voters rejected higher taxes. Tax revolts are currently under way in many states and localities, including the California, Illinois, Massachusetts, Michigan, Montana, Nebraska, Nevada, North Dakota, Oklahoma, and South Dakota.

Public opinion polls confirm the public's strong opposition to higher taxes. A comprehensive poll on fiscal policy released by the Roper Organization,

Inc., last year found that, by a margin of more than six to one, Americans blame the deficit on higher spending rather than inadequate revenues. When asked about the best means to reduce the deficit, the same poll found that people prefer spending restraint over higher taxes by a margin of nearly fifteen to one. By a margin of nearly six to one, the public believes that if taxes are raised Congress will spend the additional money rather than use it to reduce the deficit. The Roper poll also found that people believe higher taxes will slow economic growth, make America less competitive, and reduce savings.

Polls conducted this year show that popular opinion has not changed. A poll by the Wirthlin Group asked the following question:

> Federal tax revenues are expected to rise by an average of 74 billion dollars a year through 1995. At the present rate, government spending will also increase about that fast, leaving the deficit above 100 billion dollars. What would you do to reduce the budget deficit – raise taxes so that they would equal spending, or hold down spending so that it fits tax revenues?

Only 6 percent of the respondents prefer higher taxes. Some 89 percent of the public, on the other hand, believe spending restraint is the best way to reduce the deficit. A *USA Today* poll of May 11 found that citizens opposed higher taxes by a margin of 62 percent to 31 percent. What the public wants concerning taxes is quite clear. If budget summit participants want to accommodate the wishes of the American people, they should say "no" to higher taxes.

FEDERAL TAX RECEIPTS: NOW AT RECORD LEVELS

Advocates of higher taxes often suggest that the federal government is starved of revenues. They maintain that the Reagan tax cuts deprived the U.S. Treasury of money, resulting in persistently large deficits. Since, they claim, federal spending has already been "cut to the bone," the only solution to the deficit is higher taxes.

These contentions in no way match the facts. As Table 1 illustrates, federal tax revenues doubled over the last decade, up from $517 billion in 1980 to an estimated $1.073.5 trillion this year. This was a 106 percent increase. Further, the Congressional Budget Office (CBO) predicts that federal tax revenues will jump by more than $370 billion over the next five years. Some tax-increase advocates argue that these figures are misleading. When the numbers are adjusted for inflation, they contend, actual tax revenues are seen to decline. Yet in constant, inflation-adjusted 1982 dollars, federal government tax receipts climbed from $612 billion in 1980 to approximately $820 billion this year, an increase of more than 34 percent.

Table 1

Annual Tax Increase During The 1980s
($ Billions)

Year	Taxes	Yearly $ Increase	Annual Growth Percent
1980	517.1	—-	—-
1981	599.3	82.2	15.9
1982	617.7	18.4	3.1
1983	600.6	-17.1	-2.8
1984	666.5	65.9	11.0
1985	734.1	67.6	10.1
1986	769.1	35.0	4.8
1987	854.1	85.0	11.1
1988	909.0	54.9	6.4
1989	990.7	81.7	9.0
1990 est.	1073.5	82.8	8.4

In both nominal and inflation-adjusted dollars, taxes are at the highest level in U.S. history. Had nominal tax revenues simply kept pace with inflation, tax collections this year would total only about $802 billion rather than $1.073.5 trillion. In other words, actual tax collections outstripped the amount needed to keep pace with inflation by more than $250 billion.

Other measures confirm that the tax burden is at a record high. The Tax Foundation, a Washington-based research organization, each year computes "Tax Freedom Day," the time of the year that citizens stop working to pay taxes and start earning money to support their families. Tax Freedom Day this year was May 5, the latest it has ever occurred. Put in other terms, the average American works two hours and forty-five minutes out of every eight hour day just to pay taxes. The American people clearly are not undertaxed.

Finally, federal taxes are consuming near-record amounts of the nation's Gross National Product (GNP). Tax revenues averaged 17.6 percent of GNP in the 1950s, 18.2 percent of GNP in the 1960s, 18.3 percent of GNP in the 1970s, and an all-time high of 19.0 percent in the 1980s. Tax revenues are expected to reach 19.6 percent of GNP this year, the fourth-highest single-year level in peacetime history. It is instructive to note that 1969 and 1981, when the tax burden reached peacetime highs of 20.1 percent of GNP, were followed by recessions in 1970 and 1982 respectively.

A DEFICIT DUE TO EXCESSIVE SPENDING

The all-time high levels of tax receipts suggests the real source of the budget deficit: Congress overspends. The dramatic growth in federal spending over the last ten years clearly makes this point. As Table 2 shows, federal spending doubled in the 1980s. Total federal spending increased well beyond the amounts needed to keep pace with inflation.

Table 2

Annual Federal Spending Increases During the 1980s
($ Billions)

Year	Spending	Yearly $ Increase	Annual Growth Percent
1980	590.9	--	--
1981	678.2	87.3	14.8
1982	745.7	67.5	10.0
1983	808.3	62.6	8.4
1984	851.8	43.5	5.4
1985	946.3	94.5	11.1
1986	990.3	44.0	4.6
1987	1003.8	13.5	1.6
1988	1064.0	60.2	6.0
1989	1142.6	78.6	7.4
1990 est.	1197.2	54.6	4.8

Thus, even though tax revenues have climbed $540 billion since 1980, the deficit is higher today than ten years ago because of the approximately $610 billion-plus increase in federal spending during that period. It is easy to see that the budget would be balanced today if Congress had simply limited total spending increases last decade. Rather than exercise even this modest level of fiscal responsibility, however, Congress is spending every penny of the $540 billion in additional tax revenue, borrowing and spending at least an extra $70 billion just for good measure.

In the area of spending, both Congress and the White House have failed to exercise leadership. The Bush Administration has not even bothered to list the tens of billions of dollars in wasteful government spending that should be cut, fearing perhaps to offend special interest groups. The White House has been overly generous in seeking new spending, for everything from the National Endowment for the Arts to a manned mission to Mars. Failure to attack wasteful spending gives the illusion that the budget has been cut to the bare bones and that a tax increase is the only way to deal with the deficit.

MORE TAXES MEAN MORE SPENDING

The current budget summit has many observers thinking, "This is *deja vu* all over again." The decade of the 1980s witnessed the collapse of a normal budget process. High-level negotiations between the executive and legislative branches replaced regular congressional procedures. The history of these summits does not bolster confidence that the current negotiations will produce a pro-growth deficit reduction package.

The most noted fiscal failure of the last decade was the 1982 Tax Equity and Fiscal Responsibility Act (TEFRA) which promised $3 of spending restraint for every $1 in higher taxes. The taxes materialized, but instead of

reducing spending, legislators increased the budget. Tax increase packages in 1983 and 1984 also promised spending restraint. Once again, however, both taxes and spending continued their relentless rise. The budget summit of 1987 followed true to form. Taxes were raised with the promise that the deficit would be reduced by about $75 billion over the following two years. The deficit in 1987 was approximately $150 billion; two years later, it was still about $150 billion.

Proponents of higher taxes would like the American people to believe that times are different, that Congress would not use additional taxes for more spending. Yet the current budget situation in Congress virtually guarantees that any additional revenue raised by higher taxes will go towards more spending. The 1985 Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Reduction Act, better known as Gramm-Rudman, requires Congress to enact a budget each year with a projected deficit no greater than a specific mandated level.[1] If the projected deficit exceeds the legally required target, Gramm-Rudman has a spending restraint mechanism known as sequestration. This mechanism automatically reduces spending levels in each program in the budget by the percentage necessary to bring the projected deficit down to the target.

Less understood about Gramm-Rudman is the fact that placing a cap on each year's deficit also has the effect of placing a limit on each year's total spending. Congress can spend no more than the sum of projected tax revenues plus the allowable deficit target. Should legislators attempt to exceed that target, sequestration would occur, bringing total spending back down to the legally required level. The budget can be expressed as the following equation:

Total Spending = Projected Tax Revenue + Deficit Target

What happens if Congress wishes to spend more than the sum of projected tax revenues and the deficit target? There are three ways this can be accomplished. First, legislators could repeal the Gramm-Rudman law. Some policy makers have proposed this, but repeal appears unlikely. Second, legislators could change the deficit targets. If the 1991 deficit target were raised from $64 billion to $84 billion, for instance, Congress legally could spend an extra $20 billion. Since the targets were increased once already, in 1987, changing them a second time would subject lawmakers to charges of cheating on their own rules.

The third option left to lawmakers who want to increase spending is higher taxes. The oft-repeated claim that higher taxes would be used to reduce the deficit is not true. Higher taxes simply make it possible to meet the deficit target at a proportionately higher level of spending.

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1 The maximum deficit for 1991 is $64 billion, falling to $28 billion in 1992, and $0 in 1993. For all years other than 1993, Congress is only actually required to come within a $10 billion "margin of error" of the deficit target.

Consider the following example. Tax revenues for fiscal year 1991 are projected to total $1.156 trillion. Since next year's deficit target is $64 billion, Congress can spend no more than $1.220 trillion. In other words:

Total Spending = Projected Tax Revenue + Deficit Target, or:

$1.220 trillion = $1.156 trillion + $64 billion.

What would happen if taxes were raised, say, by $20 billion? Allowing the improbable assumption that the economy continues to grow despite higher taxes, the budget formula changes to:

$1.240 trillion = $1.176 trillion + $64 billion.

Every dollar of higher taxes leads to a dollar of higher spending. The only way to dedicate a tax increase to deficit reduction is to require the Gramm-Rudman targets to be lowered by the same amount that taxes are raised. Therefore, if taxes are raised $20 billion next year, the $64 billion target would be reduced to $44 billion. Spending would remain the same while the deficit would fall. The budget formula changes to:

$1.220 trillion = $1.156 trillion + $44 billion.

If supporters of tax increases were truly serious about deficit reduction, they would support legislation tying higher taxes to lower deficit targets. The fact that no prominent tax increase advocates have adopted this position speaks volumes about their true intentions.

A DEFICIT PROBLEM, NOT A CRISIS

Advocates of higher taxes maintain that the U.S. budget deficit has reached crisis proportions, threatening the health of the economy. Recent estimates do suggest that the deficit this year and next will be somewhat higher than projected due in part to slower economic growth, the cost of bailing out the Savings and Loans, and higher interest rates. Yet the budget deficit is not out of control.

Even under a worse case scenario, the deficit for 1990 and 1991 would not climb much higher than $150 billion, where it has been stuck since 1987. Such a deficit certainly is too high and should be reduced. But policy makers should not be panicked into making decisions that would undermine economic growth and in the end lead to even higher deficits. A deficit of $150 billion would equal about 2.5 percent of GNP, around the 1979 level. As Table 3 shows, the deficit as a percent of GNP reached a high of 6.3 percent in 1983 and averaged more than 4.0 percent of GNP between 1980 and 1989.

Nor should policy makers be fooled into thinking a tax increase would result in lower interest rates. During the 1980s, as Table 4 shows, there was no strong correlation between budget deficits and high interest rates. Indeed, in six of the past eight years, deficits and interest rates moved in opposite directions.

Table 3

Deficits During the 1980s

Year	Deficit ($ billions)	Deficit as % of GNP
1980	73.8	2.8
1981	78.9	2.6
1982	127.9	4.1
1983	207.8	6.3
1984	185.3	5.0
1985	212.3	5.4
1986	221.2	5.3
1987	149.7	3.4
1988	155.1	3.2
1989	152.0	2.9
1990	123.8	2.3

Table 4

Interest Rates and the Deficit

Year	Prime Rate	Change	Deficit as % of GNP	Change
1981	18.87	–	2.6	–
1982	14.86	Down	4.1	Up
1983	10.79	Down	6.3	Up
1984	12.04	Up	5.0	Down
1985	9.93	Down	5.4	Up
1986	8.33	Down	5.3	Down
1987	8.22	Down	3.4	Down
1988	9.32	Up	3.2	Down
1989	10.50	Up	2.9	Down

Source: *Budget of the United States, FY 1991,* historical tables; Joint Economic Committee, *Economic Indicators,* January 1990.

If the deficit, in and of itself, prevents economic growth, advocates of higher taxes fail to explain why the economy was experiencing its longest period of peacetime economic growth during the 1980s. In reality, the budget deficit is just one of the many factors which inhibit economic growth. High taxes are another. The deficit is not a crisis. Policy makers should not replace a bad policy with a worse one; the cure would be worse than the disease.

HIGHER TAXES COULD MEAN RECESSION

Advocates of higher taxes often overlook the most probable result of their policy: An economic slowdown or a recession. The only two times since World War II that federal tax revenues surpassed 20 percent of GNP, the economy dipped into a recession the following year. This should give pause to policy makers considering a tax increase.

Even if a tax increase results in only slightly less economic growth, the budget deficit could rise rather than fall. The CBO projects that the deficit will increase by $26 billion next year if real economic growth is just one percentage point lower than currently projected. Further, CBO estimates that the deficit would jump by $52 billion next year if the unemployment rate rises by one percentage point.

A tax increase would remove from the pockets of Americans more of their money, the results of their hard work and productive efforts. As consumers, they would purchase less. As providers of goods and services, they would find fewer customers. Economic activity would slow. Unemployment would rise. The government would collect less revenue. The budget deficit would increase.

SEQUESTRATION: A VIABLE DEFICIT REDUCTION OPTION

Some policy makers state that they do not want to raise taxes, but that they have no choice since Congress refuses to enact a budget that meets the Gramm-Rudman target by restraining the growth of federal spending. They believe doing nothing would leave the deficit unchecked.

Fortunately, "doing nothing" is the one option that would result in the greatest deficit reduction. If the President and Congress fail to meet this year's deficit target by restraining spending, the automatic sequester of Gramm-Rudman would go into effect. The only way to prevent sequestration is to repeal the entire Gramm-Rudman law, repeal the sequester provision, raise the allowable level of the deficit, or enact a budget which would meet the current deficit targets.

Sequestration would not represent a high water mark in political responsibility. Politicians presumably are elected to make spending choices and to set priorities among various programs, not to have the budget determined by an automatic procedure. Nonetheless, there are benefits to sequestration. First and foremost, a sequester reduces the deficit without a tax increase. Rather than threatening the economy by raising taxes, a sequester promotes

economic growth by slowing the rise of federal spending and leaving more resources in the productive sector of the economy.

Even though a sequester would not affect Social Security or programs designed to help the poor, critics charge that a sequester would be an arbitrary, "meat-ax" approach to the budget that might tear holes in the social "safety net." All programs would be cut by the same percentage, regardless of their merits.

Adjusting the Formula. Yet if legislators are unhappy with the distribution of the savings under a sequester, they have the power to adjust the formula that determines cuts. Alternatively, Gramm-Rudman allows Congress to rearrange spending priorities after a sequester goes into effect. Thus, if Congress is concerned about the sequester's effect on air traffic control or AIDS research, for instance, legislators can take money from less important programs and increase spending in those more important or politically sensitive parts of the budget.

Some critics point out that a Gramm-Rudman sequester falls disproportionately on the defense budget; 50 percent of the cuts must come out of defense even though defense accounts for only a quarter of federal spending. Yet, it is not entirely certain that the defense budget will be any worse off with a sequester than it would be otherwise. The budgets being considered in the House and Senate both reduce defense spending more over five years than would a sequester. Furthermore, since Congress is likely to focus defense cuts on weapons systems, a sequester might better protect defense preparedness by at least ensuring that a portion of the cuts come out of the manpower budget.

George Bush has the power to make real reductions in the deficit and fulfill his promise of no new taxes. He can simply inform Congress that he will take a sequester if legislators fail to produce an otherwise acceptable budget. And if Congress attempts to raise taxes, Bush can exercise his veto power. Never in the history of the United States has a tax increase become law over a presidential veto.[2] There is nothing to suggest that the current Congress would fail to sustain a veto today.

BEWARE THE DEAL

Tax hike advocates no doubt will try to give the White House some minor concession that would be used as an excuse for breaking the no-tax pledge. Among the likely candidates are a line-item veto, some sort of reduction in the capital gains tax, and an up-or-down vote on the balanced budget amendment.

2 President Franklin D. Roosevelt did veto a tax increase that he believed was *too small*. Rather than enact a larger tax increase, the Congress overrode his veto.

Positive Steps. Yet, the Bush Administration should avoid a political trap which requires surrender on the tax issue. As long as Gramm-Rudman is the law of the land, controlling taxes is the only sure way to control spending. Sticking to Gramm-Rudman and no-new taxes guarantees that tens of billions of dollars will be saved. A line-item veto and lower capital gains tax would be positive steps and could reduce the deficit by billions of dollars. A tax increase, however, would lead to increased spending that would wipe out such reductions. There is no face-saving gesture which can make up for a capitulation on the tax issue.

CONCLUSION

The importance of averting tax increases cannot be overstated. In 1988, Candidate Bush understood the importance of holding the line on taxes. He understood that higher taxes would open the floodgates for a torrent of new spending that could trigger an economic slowdown or recession, and in the end lead to higher rather than lower deficits. He understood that the American people already turn over entirely too much of their pay to the federal government, that if anything, the tax burden should be reduced further.

George Bush has distinguished himself first and foremost by his anti-tax hike policy. Now his credibility, integrity, commitment to principles, and political and economic wisdom are put to the test. Bush was not elected to adopt the policies of his losing opponents. This is a make-or-break decision for the Bush Administration. If Bush expects to keep the support of the people who put him in office, he must read their lips. They are saying: "Mr. President, keep your promise: No new taxes."

RUSH!

Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue N.E. Washington, D.C. 20002 (202)546-4400

5/8/90

Number 266

IN THE BATTLE OF THE BUDGET, BUSH SHOULD READ HIS OWN LIPS

George Bush is being pressured to renege on his promise to oppose higher taxes, notwithstanding his famous "Read my lips: No new taxes" pledge at the 1988 Republican convention. In meetings with congressional leaders last weekend, White House officials left open the door to inclusion of a tax increase in any new budget package.

If the President were to abandon his hitherto firm resolve to stand by his tax pledge, it would be a political and economic disaster. A concession by Bush would indicate to American voters that his most solemn election promise meant nothing, and it would indicate to Congress that the door to a massive tax increase finally is ajar. It would also be a body blow to the American economy. Before falling victim to the siren song of tax-and-spend, the President should heed the following sound advice:

> There's no quicker way to kill prosperity than to raise taxes.
> —George Bush, Boston, Massachusetts, April 15, 1987
>
> There are those who say we must balance the budget on the backs of the workers—and raise taxes again. But they are wrong. I am not going to raise your taxes—period.
> —George Bush, Houston, Texas, October 12, 1987
>
> Some people on the other side say, "Raise Taxes." Well, I've been in government a long time, and I've seen what happens when the government raises a dollar in revenues—Congress spends a dollar fifty. You know, I've yet to have anyone walk up to me and say, "Mr. Vice President, we're not taxed enough. I hope you'll be the President to raise my taxes." I will not raise your taxes, period.
> —George Bush, Pittsburgh, Pennsylvania, April 29, 1988
>
> I'm the one who won't raise taxes. My opponent now says he'll raise them as a last resort, or a third resort. When a politician talks like that, you know that's one resort he'll be checking into. My opponent won't rule out raising taxes. But I will. The Congress will push me to raise taxes, and I'll say no, and they'll push, and I'll say no, and they'll push again, and I'll say to them, "Read my lips: no new taxes."
> —George Bush, Republican National Convention, August 18, 1988
>
> The Republican Party restates the unequivocal promise we made in 1984: *We oppose any attempts to increase taxes*. Tax increases harm the economic expansion and reverse the trend to restoring control of the economy to individual Americans.
> —Republican Party Platform, 1988

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The first principle is the most important: No Tax Increases... The surest way to kill the recovery is to raise taxes. That will stifle everything from investment and personal savings to consumer spending. It will clamp down on growth. It will invite a recession.

—George Bush, Chicago, Illinois, September 13, 1988

As the world's largest economy, we have been the leaders in the movement toward economic freedom. So my first principle is, let's not reverse course with a tax increase and big dose of central government planning.

—George Bush, Bensalem, Pennsylvania, September 19, 1988

And I am not going to betray that trust. I am not going to raise taxes. Period.

—George Bush, Seattle, Washington, October 16, 1988

The foundation of that growing America is low taxes. That's why the first part of my plan is simple: No new taxes.

—George Bush, Waterbury, Connecticut, October 24, 1988

I am opposed to tax increases. In the past several years, tax increases have been used to feed congressional spending, not for true deficit reduction. This should be a warning to all future Presidents *against* tax hikes — unless you can control Congress's spending, increased revenues will go to increased spending. The most important action we need to take on the budget deficit is to hold the line on taxing and spending. Raising taxes would only hurt the tremendous economic recovery we have had in our Administration.

—George Bush, "Leadership on the Issues," pp. 82-83

♦ ♦ ♦

Some self-appointed experts and congressional leaders say, of course, that the budget deficit can only be reduced with additional taxes. This is not so. The Congressional Budget Office projects that tax revenues will rise by an average of $74 billion annually between now and 1995. Reducing the deficit simply means limiting annual spending growth to less than $74 billion.

Taxes also still are too high. Federal taxes this year will consume 19.6 percent of the Gross National Product, the fourth highest level in peacetime history. Tax revenues, in both nominal and inflation-adjusted dollars, are at record highs. Tax Freedom Day this year, the day an average American stops working to pay taxes and begins to work to support himself and his family, was May 5. This is the latest it has ever occurred. By transferring money from the productive sector of the economy to government, a tax increase would impair economic growth and could lead to a recession. Restraining the growth rate of federal spending would be a more responsible approach.

Fortunately, if Congress is unwilling to enact a fiscally responsible budget, the President can bring deficit spending under control by using Gramm-Rudman's automatic spending control mechanism known as sequestration. Hence, there is absolutely no reason to accept a tax increase that would damage the economy, open the door to a torrent of new spending, and increase cynicism among American voters. George Bush should end any White House discussion by telling his budget negotiators: "Read my lips again: No new taxes."

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RUSH!

Executive Memorandum

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3/22/90 Number 263

ROSTENKOWSKI'S BUDGET PROPOSAL: THE GOOD, THE BAD, AND THE UGLY

In election after election and poll after poll, Americans have made it clear that they do not want to pay more taxes. Despite public opinion, the Chairman of the House Ways and Means Committee, Illinois Democrat Dan Rostenkowski, has proposed a budget plan raising taxes. On the positive side, the package does correctly call for some long-overdue limits on the growth of federal spending. But its proposed repeal of the Gramm-Rudman-Hollings deficit reduction law could mean that the deficit will rise rather than fall.

Curiously, rather than denouncing this plan, the White House welcomes it as a positive contribution to the budget debate. Further, Office of Management and Budget Director Richard Darman told a congressional committee that some new taxes, those that allegedly contribute to economic growth, are good. Like the unicorn, however, pro-growth taxes are more imaginary than real. Giving Congress more money to spend would inhibit economic growth by taking resources out of the productive sector of the economy. George Bush therefore should announce quickly that he has no intention of agreeing to a tax increase.

The Good: The Rostenkowski plan addresses in part the true source of the budget deficit: excessive government spending. The plan calls for a one-year across-the-board freeze on domestic discretionary spending. It also would freeze for one year such non-means tested entitlement programs as Social Security. It would require a 3 percent annual cut in defense spending. And the plan would require that any new spending must be "paid for" by reductions in existing programs.

This approach probably is not as effective as the current Gramm-Rudman-Hollings system, which puts a cap on the total spending and leaves to legislators the responsibility of dividing that fixed amount of money between various programs. It is, nonetheless, a step in the right direction.

The Bad: The centerpiece of Rostenkowski's proposal is higher taxes. His plan would tamper with the 1986 Tax Reform Act and ignore the world-wide revolution toward lower tax rates by increasing the top personal income tax rate from 28 percent to 33 percent. One of the major achievements of the past decade was to protect citizens from having their taxes raised because the government inflates the currency. This was done in 1985 by indexing tax brackets and the personal exemption to inflation. Rostenkowski's plan would restore the inflation tax for one year. Finally, the Rostenkowski proposal would mean higher taxes on oil, alcohol, and tobacco. Besides taking more money out of the pockets of American consumers and giving it

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to the government, taxes on energy in particular will raise costs for American industry, making it less competitive in world markets.

A tax increase would almost certainly result in a higher budget deficit if it leads to a recession. Even if higher taxes have only a mild impact on the economy, the deficit could rise. The Congressional Budget Office estimates that the taxes proposed by Rostenkowski would raise $29 billion in revenue next year. The same group points out, however, that a one percentage point decline in annual gross national product growth would increase the deficit by $26 billion in 1991 while a one percentage point rise in unemployment would boost the deficit by $52 billion that year.

The Ugly: A particularly grotesque aspect of the Rostenkowski plan is its call for the repeal of the Gramm-Rudman-Hollings (GRH) "sequester" mechanism, which requires automatic budget cuts if Congress fails to meet deficit reduction targets. While GRH has by no means been perfect, it has led to substantial reductions in the deficit. The growth of federal spending, in both nominal and inflation-adjusted dollars, has fallen by more than 50 percent since GRH was enacted in 1985. The budget deficit as a percent of gross national product, after peaking at 6.3 percent in 1983, is projected to fall this year to only 2.3 percent, its lowest level in more than a decade.

Rostenkowski's call for repeal of the automatic sequester is especially strange since he claims that his approach to deficit reduction will more than match the GRH requirements. If he is correct, there is little urgency to repeal the deficit reduction law. It makes more sense to leave the sequester as a back-up mechanism, just in case Congress decides to use the higher taxes for additional spending rather than deficit reduction. Indeed, Rostenkowski is just one of several prominent legislators to propose the end of Gramm-Rudman, suggesting that Congress is unhappy with the degree of fiscal responsibility the law requires.

More important, undermining Gramm-Rudman-Hollings would send dangerous signals to financial markets, suggesting that Congress is giving up on deficit reduction. Indeed, rather than weakening the deficit reduction law, Congress should strengthen it. For example, the adoption of a second sequester, to occur in the middle of the fiscal year if the projected deficit exceeded the target, would help control the kinds of budget gimmicks and back door spending that Congress uses to evade GRH strictures.

Gramm-Rudman Alternative. The reaction to Rostenkowski's proposal has been mixed. While few have endorsed the specifics of the package, many commentators and policy makers have expressed general support for Rostenkowski because they feel that no acceptable alternative has been offered. Yet Gramm-Rudman-Hollings is an alternative. Under it, real deficit reduction will occur automatically if Congress fails to produce an acceptable budget. The Congressional Budget Office projects that a $37 billion sequester this year, the amount necessary to reach the $64 billion target for 1991, would lower projected deficits by $311 billion over the next five years.

The Bush Administration's initial positive reaction to the Rostenkowski plan sends the wrong signal to Congress and the nation. George Bush was right to promise never to raise taxes. He should loudly reaffirm this promise with respect to Rostenkowski's plan. Whether by sequester or regular budget, the deficit can and should be reduced without a tax increase. The Rostenkowski plan fails this test.

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The Heritage Foundation Backgrounder

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April 3, 1990

SAVE THE GRAMM-RUDMAN SEQUESTER

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Washington should be celebrating the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Reduction Act of 1985, popularly known as Gramm-Rudman. Since it was enacted, inflation-adjusted federal spending has grown by only 1.4 percent annually, a dramatic reversal of the runaway federal spending increases of previous periods when it jumped 3.6 percent annually in the 1970s and 4 percent annually between 1980 and 1985. At the same time, the federal budget deficit has fallen from $212 billion in fiscal year 1985 to an estimated $123.8 billion this year. Adjusted for inflation, the deficit today is less than half the size it was just five years ago.

Instead of celebrating the success of Gramm-Rudman, many in Washington are claiming that it has failed. Thus, while two of the measure's principal sponsors, Republican Senators Phil Gramm of Texas and Warren Rudman of New Hampshire, still support the Act, South Carolina's Democratic Senator Ernest Hollings openly disassociates himself from it. Newspaper articles and political commentators routinely assert that Gramm-Rudman is a flop. Despite the facts that say the opposite, the sheer volume of criticism directed at Gramm-Rudman suggests that federal spending and budget deficits continue to grow uncontrollably.

Vast Improvement. Many of those who assert that Gramm-Rudman does not work are mounting a campaign to repeal the law or eliminate its enforcement mechanism, known as sequestration. If Congress fails to produce a budget that controls deficit spending, sequestration takes effect, automatically reducing spending by the amount needed to bring the deficit down to the legally-required level. This is a vast and proven improvement over earlier congressional efforts to control deficit spending. The fact that now a sequester occurs automatically if Congress fails to comply with the deficit-cutting law guarantees deficit reduction will actually happen. Without the sequester, Gramm-Rudman is almost completely emasculated.

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Rather then discussing ways to weaken Gramm-Rudman, Congress should examine proposals to strengthen the law. One reform would be to introduce a second sequester, occurring in mid-year. This would help prevent Congress from increasing spending after the October 15 sequester deadline, which occurs just two weeks into the new fiscal year. Another reform, mentioned in the Bush Administration's budget this year, would require a "super-majority" vote by each House of Congress to rescind a sequester once it goes into effect; currently, a sequester can be rescinded by legislation passed by simple majority. Another reform would limit such budget gimmicks as taking programs "off budget" or moving government paydays from one fiscal year to another. These gimmicks do not cut spending but merely hide the size of the deficit.

THE GRAMM-RUDMAN APPROACH TO DEFICIT REDUCTION

In the 1970s, the proponents of higher federal government spending usually had their way. Since there were no objective limits on spending or deficits, they could enact new spending programs and increase funding for existing programs with little difficulty. Fiscally-responsible legislators then often had to raise taxes to contain deficits. This pattern of fiscal conservatives raising taxes so advocates of big government could raise spending did little to promote economic growth – or to control the federal debt.

In 1981 Ronald Reagan, with Republicans controlling the Senate, broke with tradition and pushed through comprehensive legislation to lower America's tax burden. Supporters of tax cuts hoped that reducing disincentives to work, save, and invest would lead to higher levels of economic growth. This in fact happened. A by-product of cutting tax rates and of the record 88-month economic expansion is that annual federal revenues have increased by more than $473 billion since 1983, a jump of 79 percent. The problem was that the combination of the 1982 recession and continued congressional overspending pushed the deficit to record high levels. Some thought higher taxes were the only way to lower the deficit; this resulted in large tax increases in 1982, 1983, and 1984. As in the past, however, these tax increases were not used for deficit reduction; they simply were excuses for more government spending.

Frustrated Congress. The Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Reduction Act of 1985 changed all this. Enacted by a Congress frustrated with persistently high deficits, the Act set progressively smaller maximum budget deficits for each fiscal year. The original targets sought to balance the budget by fiscal 1991. Subsequently, Congress shifted the timetable to 1993 (see Table 1).[1]

1 Note: The fiscal year begins October 1 and ends September 30 of the following year. The 1990 fiscal year, for instance, began October 1, 1989, and will end September 30, 1990.

Table 1

Gramm-Rudman Deficit Targets
($ billions)

Year	1990	1991	1992	1993	1994
Target	$100*	$64*	$28*	-0-	?

* There is a $10 billion margin of error for all years other than 1993, raising the effective targets by that amount.
Source: Budget of the United States Government

Gramm-Rudman requires that the Office of Management and Budget (OMB) prepare a "snapshot" estimate of the upcoming fiscal year's deficit each August based upon assumptions about economic performance and congressional actions on that year's budget. Since the August snapshot will almost certainly show that the projected deficit is higher than the Gramm-Rudman target, Congress will know how much additional deficit reduction is required before the new budget takes effect on October 1.

Automatic Reductions. OMB takes a final deficit snapshot on October 15. If the projected deficit on that day is more than $10 billion over the Gramm-Rudman target, spending for federal programs subject to sequestration is automatically reduced by the percentage necessary to lower the deficit to the required level. Under Gramm-Rudman, 50 percent of the sequester comes from defense and 50 percent from domestic spending. Most entitlement programs are exempt from sequestration.

Should a sequester occur, Congress can simply accept the results, or it may choose to substitute an alternative deficit reduction package. A full sequester has never happened, although partial year sequesters did occur in fiscal 1986 and 1990.

DYNAMICS OF THE GRAMM-RUDMAN PROCESS

Gramm-Rudman sharply curtails Congress's ability to increase spending. Under Gramm-Rudman, total spending in any year cannot exceed the sum of anticipated tax revenues plus the maximum allowable deficit. To introduce new programs or to increase spending for existing ones, legislators must either raise taxes or cut spending elsewhere in the budget. This deficit-neutral requirement forces policy makers to make trade offs. This, more than anything else, fundamentally has altered the dynamics of the budget process.

In the case of catastrophic care, for example, Congress had to include a large tax increase as part of the legislation to "pay" for the spending provisions of the bill. This sparked a revolt by the elderly asked to pay the higher taxes, leading Congress last year to repeal the catastrophic care program. The lesson: beneficiaries of spending are much less enthusiastic about big government if they have to pay for the programs.

Congress, of course, could trim some existing programs to free up money for new programs. This is a commendable process, for it would require lawmakers to set priorities. Politically, however, it has been difficult to find off-

setting spending reductions. An attempt to comply with Gramm-Rudman's deficit neutrality requirement, for example, resulted in bitter warfare in the Senate last year over legislation to fund anti-drug programs.

GRAMM-RUDMAN SUCCESS IN CONTROLLING SPENDING

As shown in Table 2, federal spending in current dollars increased by an average of more than 9.9 percent annually between 1980 and 1985. Since Gramm-Rudman was adopted, however, annual spending increases have averaged about 4.8 percent. If federal spending had continued to grow at the 9.9 percent annual rate, both the budget and the deficit for 1990 would be more than $300 billion higher than currently projected.

Table 2

Annual Spending Increase During the 1980s

Year	Spending ($ billions)	Annual Growth Percent	
1980	590.9	–	
1981	678.2	14.8	Five Year Average Growth = 9.9 %
1982	745.7	10.0	
1983	808.3	8.4	
1984	851.8	5.4	
1985	946.3	11.1	
1986	990.3	4.6	Five Year Average Growth = 4.8 %
1987	1003.8	1.4	
1988	1064.0	6.0	
1989	1142.6	7.4	
1990*	1197.2	4.8	

*Estimate

Source: Budget of the United States Government

Table 3 shows that after adjusting for inflation, the impact of Gramm-Rudman is even more striking. Federal spending in real terms grew almost three times faster before Gramm-Rudman than it has since Gramm-Rudman.

More important, Gramm-Rudman has helped reduce the size of government relative to the size of the productive sector of the economy. In every year but one between 1980 and 1985, government spending as a percentage of Gross National Product (GNP) was higher than the previous year, with annual increases averaging 0.36 percentage points. Yet as Table 4 shows, government spending as a percentage of GNP has fallen or remained stable every year since Gramm-Rudman was adopted, declining by an average of more than 0.4 percentage points each year.

GRAMM-RUDMAN'S SUCCESS IN SLASHING THE DEFICIT

Gramm-Rudman also has reduced the budget deficit. In four of the five years before Gramm-Rudman, the deficit increased. As Table 5 shows, of the five years since Gramm-Rudman was enacted, the deficit has fallen three years. As a percent of GNP, the budget deficit increased in three of the five years before Gramm-Rudman; since enactment, the deficit as a percent of GNP has fallen every year. According to current projections, the deficit as a percent of GNP will be at its lowest level in more than a decade. As recently

Table 3

Annual Spending Increases During the 1980s (1982 dollars)

Year	Spending ($billions)	Annual Growth Percent	
1980	699.1	—	
1981	726.5	3.9	Five Year
1982	745.7	2.6	Average
1983	775.0	3.9	Growth =
1984	788.1	1.7	4.0 percent
1985	849.6	7.8	
1986	867.5	2.1	Five Year
1987	857.8	-1.1	Average
1988	879.6	2.5	Growth =
1989	907.1	3.1	1.4 percent
1990	912.2	0.6	

*Estimate

Source: Budget of the United States Government

Table 4

Federal Government Spending as a Percent of GNP

Year	Spending Percent of GNP	Change	
1980	22.1	—	
1981	22.7	+0.6	Five Year
1982	23.8	+0.9	Average
1983	24.3	+0.5	Growth =
1984	23.1	-1.2	+0.36%
1985	23.9	+0.8	
1986	23.7	-0.2	Five Year
1987	22.7	-1.0	Average
1988	22.2	-0.5	Shrinkage =
1989	22.2	—	-0.42%
1990	21.8	-0.4	

Source: Budget of the United States Government

as 1988, total government deficits in the U.S. as a percent of GNP were the same as West Germany's (though West Germany was in better shape than the U.S. last year), and for at least the past half-dozen years, the annual U.S. government deficit as a percent of GNP was below the average for all West European countries.

Table 5
Deficits During the 1980s

Year	Deficit ($ billions)	Deficit as % of GNP
1980	73.8	2.8
1981	78.9	2.6
1982	127.9	4.1
1983	207.8	6.3
1984	185.3	5.0
1985	212.3	5.4
1986	221.2	5.3
1987	149.7	3.4
1988	155.1	3.2
1989	152.0	2.9
1990	123.8	2.3

Source: Budget of the United States Government, Historical Tables

Another way to illustrate how Gramm-Rudman has reduced the budget deficit is to compare what the Congressional Budget Office (CBO) projected the deficit would be in 1989 and 1990 before Gramm-Rudman was enacted. In 1985, CBO estimated that the 1989 deficit would be $272 billion and consume 5.2 percent of GNP. For 1990, CBO also predicted in 1985 that the 1990 deficit would climb to $296 billion and 5.3 percent of GNP. In reality, owing largely to the Gramm-Rudman law, the 1989 deficit was $152 billion, $120 billion below the estimate. If the 1990 budget deficit estimate of $123.8 billion is even close, the deficit will be less than half the amount CBO projected.

THE FLAWED CASE AGAINST GRAMM-RUDMAN

Opponents raise several arguments against the Gramm-Rudman approach to fiscal policy. If the case were that Gramm-Rudman is far from perfect, then the critics would be correct. Gramm-Rudman offers considerable room for improvement. But this is not where the congressional critics focus.

Slipping Targets. Opponents point out that Gramm-Rudman originally called for a balanced budget for fiscal 1991. Now the target is fiscal 1993. Thus, it might be said the law lacks credibility. But this is an indictment not of Gramm-Rudman but of Congress, which pushed the target forward two years. Congress was unwilling to reduce the deficit as quickly as Gramm-Rudman originally demanded. The weakness of Congress in dealing with overspending underscores the importance of preserving the automatic Gramm-Rudman mechanism for meeting deficit targets.

Gramm-Rudman's critics claim that the law does not work because actual deficits at the end of each fiscal year consistently have exceeded the Gramm-Rudman target. The deficit in fiscal 1989, for instance, was $152 billion, $16 billion above the $136 billion target. Furthermore, the Bush Administration

projects that the fiscal 1990 budget deficit will be $123 billion, $23 billion over target.

Loopholes. This overshooting of the target results from loopholes in the Gramm-Rudman law. One loophole is that Gramm-Rudman does not require that the actual deficit equal the deficit target. Instead, it mandates that the deficit projected as of October 15, two weeks into the new fiscal year, be no more than $10 billion over the target.

If the economic assumptions underlying the deficit projection are too optimistic (for example, projecting a stronger economy and more resulting tax revenues), the actual deficit will be higher than the target. And it is Congress, not the White House, which typically usually adopts the rosiest forecasts because better economic assumptions mean that less spending restraint is needed to meet projected deficit targets.

A second loophole is that once the October 15 sequester deadline passes, Congress can increase spending for that fiscal year without triggering a subsequent sequester. The only significant barrier against such midyear spending increases is the 60 votes required in the Senate to waive the budget act and consider legislation which would increase the deficit. While the 60-vote requirement makes it more difficult to increase spending, it is still possible for Congress to approve such increases. Every dollar of added spending after October 15 causes the actual deficit to be that much higher than the deficit target.

Meat-Ax Budgeting. Critics assert that Gramm-Rudman is an arbitrary meat-ax approach to budget cutting, since those programs vulnerable to sequester all are penalized, while almost all entitlement programs are exempt from automatic cuts. Indeed, there is no doubt that Gramm-Rudman discriminates. The defense budget, for instance, must account for 50 percent of the total sequester even though defense is barely one-fourth of the total budget. If Congress finds the current sequester formula unfair, however, legislators can change the law to increase the number of programs which are affected.

THE PROBLEM OF BUDGET GIMMICKS

Congress, often in cooperation with the Administration, can get around Gramm-Rudman restrictions with budgetary gimmicks and sleights of hand. Congress, for example, has shifted government paydays and Medicare and farm-price-support payment dates from one fiscal year to another. Thus, if projected spending for 1991 appears too high, Congress could move a payday from October 1, the first day of the 1991 fiscal year, back to September 30, the last day of the 1990 fiscal year. Spending will increase for the current year, but Congress will not be subject to sanctions since the sequester deadline passed nearly a year before, on October 15, 1989.

Another gimmick used by Congress to evade deficit limits is to take programs off budget. Last year, for instance, Congress took the Postal Service

off budget so that its deficit no longer is counted in the general federal deficit calculation. Congress claimed to "save" $1.7 billion by doing this, even though the Treasury Department still must borrow just as much money to cover off-budget as on-budget debts. And once the Postal Service was off budget and its deficits no longer counted, Congress required the Postal Service to make a one-time $400 million payment to an on-budget part of the government. This created the illusion of an additional $400 million of deficit reduction. The Farm Credit system was also taken off budget, a move that generated another $400 million of phony savings.

SOCIAL SECURITY AND THE BUDGET DEFICIT

The issue of deficit reduction has been confused by constant claims that the Social Security "surplus" masks the true size of the deficit. It is true that Social Security tax revenues have begun exceeding Social Security outlays. The overall federal budget deficit, however, is supposed to measure how much money the government will borrow from private credit markets. As such, all government spending and taxes, including Social Security, should be counted. Any other measurement would misrepresent the true extent of government borrowing. The Social Security system thus belongs where it is, in the unified budget.

When Social Security tax revenues exceed outlays, the Social Security system takes its excess to the Treasury and exchanges the cash for U.S. government bonds or IOUs; these are "deposited" in the Trust Fund. When Social Security outlays begin to exceed revenues, as they will early next century, the Social Security system will return to the Treasury to redeem these bonds for the cash to pay retirement benefits. At that time, to get the cash to redeem the Social Security system's bonds, the Treasury either will have to raise taxes, or issue new debt, just as would be the case with a pay-as-you-go system. If it does not do so, then it will not be able to redeem the bonds; the Social Security system then will have to reduce benefits to retired Americans.

RECOMMENDATIONS

Gramm-Rudman has helped slow federal spending and reduce the budget deficit. Legislators concerned about its weaknesses should strengthen the law rather than repeal it. Among the changes that would bolster Gramm-Rudman's ability to control deficit spending are:

1) Adding a second sequester. To discourage budget gimmicks and back-door spending, a second sequester should be adopted in the middle of the fiscal year. As with the present sequester, it would be triggered only if the projected deficit exceeded the target by more than $10 billion.

2) Requiring a super-majority to rescind a sequester. Since Gramm-Rudman is a law rather than a constitutional requirement, Congress can cancel a sequester. Requiring a three-fifths or two-thirds vote to rescind sequester would make it very difficult for Congress to avoid the law's discipline.

3) Prohibiting payday shifts and other budget gimmicks. Both Congress and the Administration often use various loopholes in the law, such as taking programs off budget or shifting paydays or days for disbursing other government payments from one year to the next. Limits should be placed on these mechanisms to force Congress to adopt measures that restrain real spending rather than create the illusion of dealing with the problem.

CONCLUSION

Even with its weaknesses, Gramm-Rudman has slowed the growth of federal spending and reduced the budget deficit. If critics complain that Gramm-Rudman is not tough enough, the answer would be to plug the loopholes. But most critics seek to repeal the Act or at least to eliminate its automatic sequester, which is the Act's most effective curb on spending.

In reality, many of Gramm-Rudman's critics object to the law because it has worked. Many legislators resent having to choose which programs will receive scarce funds. Special interest groups are having a much harder time getting access to taxpayers' wallets, forcing them to compete against one another.

Change for the Better. The passage of Gramm-Rudman thus marked a turning point in the battle of the budget. With the right strategy, refusal to capitulate on taxes and willingness to use the sequester if necessary, George Bush can assure that spending and deficits are brought under control. These benefits, however, will vanish if the Gramm-Rudman sequester is repealed. The deficit reduction law has dramatically changed the way Congress budgets —for the better.

Indeed, the only shortcoming is that Gramm-Rudman will end in 1993. There is always a possibility that politicians will "slip" the targets again and extend the balanced budget goal forward a year or two, but at some point Gramm-Rudman will accomplish its immediate goal of balancing the budget. At that point, advocates of economic growth need to be ready with tax-cut proposals, accompanied by new deficit reduction requirements. Gramm-Rudman has succeeded in reducing the relative size of government, but only constant vigilance will keep leviathan under control.

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THE HERITAGE FOUNDATION FEDERAL BUDGET REPORTER

#4 January 18, 1990 *Analyzing the Process of Government Spending*

WASHINGTON WATCH

Congress Resorts to Budget Tricks and New Taxes to Meet Deficit Target. On November 22, eleven months after George Bush sent his fiscal 1990 budget proposal to the Hill, Congress finally passed the reconciliation bill and adjourned for the holidays. The lawmakers now are returning and must face a new budget cycle based on 1989 legislation that provides a very uncertain foundation for reducing the budget deficit. For while the end-of-session legislation technically meets the $110 billion budget deficit target required under the 1985 Gramm-Rudman-Hollings law, the exact amount of the deficit reduction is not clear. The reconciliation package purports to cut $17.8 billion from the deficit during 1990. The Bush Administration and some members of Congress, however, claim that $14.7 billion may be a more accurate figure.

Had Congress left in place for the entire 1990 fiscal year the automatic across-the-board spending cuts (technically known as sequestration) triggered by Gramm-Rudman-Hollings on October 16, that no-gimmicks measure would have reduced spending precisely by $16.2 billion without a tax increase. Instead, Congress passed its own budget bill which extends the sequester only until early February, some 130 days, saving only $4.6 billion. Congress also raised $5.6 billion in new taxes.

Explicit spending cuts in the budget legislation were modest. Approximately $2.8 billion was cut from Medicare, for example, by reducing payments to doctors and hospitals, and $521 million was cut from farm programs. Many of these savings are offset by expanding other programs, like $148 million more for Medicaid.

The budget also includes its share of accounting gimmicks. Example: placing off-budget the Postal Service's deficit of almost $2 billion and the Farm Credit Financial Assistance Corporation's deficit of $420 million.

On the revenue side, Congress forfeited an estimated $4.8 billion in new revenue by rejecting Bush's request for a cut in the capital gains tax. The revenues would have been generated by the taxes paid on the sale of assets by investors taking advantage of the tax reduction. Instead, Congress approved almost $5.6 billion in new revenues, including increased taxes on international airline flights and ocean cruises that depart from the U.S., a tax on chemical emissions that purportedly deplete the ozone layer, and extension of airport and airway taxes.

If a "User Fee" Looks Like a Duck and Quacks Like a Duck... Adding the final touches to the fiscal 1991 budget, to be unveiled before Congress on January 29, the Bush Administration seems to have devised a clever way to impose new taxes without appearing to do so. Knowing that taxpayers continue to read Bush's lips very carefully, Budget Director Richard Darman is considering raising approximately $1 billion through so-called "user fees." *The Wall Street Journal* reports that the budget will include fees levied on the manufacturers of certain foods and drugs which require government inspections. These "user fees" are imposed on

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private industry to finance the expansion of government regulations that industries neither want nor need.

STATE WATCH

State legislators are reading the taxpayers' lips. Voters on Election Day 1989 in St. Louis, Missouri; Orange County, California; Michigan and Washington state were unequivocal on one issue: All said no to new taxes. Most of the rejected ballot proposals called for raising the sales tax by a small percentage to fund increased spending for social programs.

In Massachusetts, which recently posted a budget deficit of $1.2 billion, the highest deficit in that state's history, the state House of Representatives rejected by 94 to 64 legislation that would have raised taxes significantly on capital gains, sales, and gasoline. As the *New York Times* reported, many legislators wondered why Massachusetts House Speaker George Keverian was introducing a tax bill when they had not yet passed a spending-reduction bill. It is clear that Massachusetts legislators and voters realize that after several years of excessive state government spending and tax increases, the Dukakis statehouse should not expect a taxpayer bailout.

Neighboring states do not see eye to eye on tax policy. Dartmouth economist Colin Campbell and his wife Rosemary Campbell recently conducted a study comparing the tax structures in New Hampshire and Vermont. The study was particularly compelling, given the two neighboring states' widely contrasting economies. While Vermont's per capita personal income rose by 30.6 percent between 1975 and 1987, per capita personal income rose by as much as 53.2 percent in New Hampshire. The Campbells attribute Vermont's more sluggish economy to heavier taxation, as well as to government "centralization and its effect on government efficiency." While Vermont's individual income tax and general sales tax accounted for 22 percent of total revenues in 1987, New Hampshire's dependence on revenue from these sources was very small. Individual income taxes in the state accounted for only 8.7 percent of total revenues in 1987, and New Hampshire does not have a sales tax. (Available from The Henley Group, Liberty Lane, Hampton, New Hampshire, (603) 926-5911.)

Successful, innovative policies in New Hampshire Do Not Go Unnoticed. A small New England state must be doing good things if it can attract the attention and win praise from ABC-TV host and commentator David Brinkley. In the closing remarks on "This Week with David Brinkley" last October, Brinkley commented on the positive effects of New Hampshire's low taxes and limited spending: "Every presidential election year, New Hampshire has the first primary, and the politicians pour into the state, and the press along with them. Pretty soon there will be the familiar news report that New Hampshire has (a low) state income tax and no sales tax, and so spends less money on its schools than some other states. It is taken for granted, of course, that this is bad.

"But in talking to the teachers, it appears it is not all that bad. For one reason, the state keeps its educational bureaucracy quite small, while in some other states, such as New York, the administrators threaten to outnumber the students. For another, a teacher said they didn't need so much money because they get help from home....That kind of help and support may be worth more than money."

The Heritage Foundation Federal Budget Reporter, Kate Walsh O'Beirne, Editor; Stuart M. Butler, Publisher.
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