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The Budget Crisis:
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The Budget Crisis: Hard Choices in the Real World

The nation will soon begin the fourth year under the Gramm-Rudman-Hollings deficit-reduction law. The budget deficit continues to be a subject of continuing debate, especially in light of the Presidential campaign now under way, so it seems an appropriate time to take a look at what the future may hold with regard to our efforts to reduce the deficit and bring the federal budget closer to balance.

Not since the thirties, when the United States was in the midst of the Great Depression, has the state of the economy been debated more intensely than it is today.

There are very strong arguments on both sides of the issue.

Many political leaders and economists warn that continuing large budget and trade deficits are setting the stage for catastrophe.

On the other side, the President and his advisers point to a lengthy period of prosperity, to low inflation, and to lowered levels of unemployment as indicators that the significance of the deficit is overstated.

I admire these accomplishments, but I also believe that the federal budget deficit and our unprecedented level of national debt point toward major problems in the future. I highlighted my concern in the annual report I sent to the Congress last month when I said, "The consequences of our failures to control the budget have, in my view, become horrendous for our nation and indeed for the world....A bipartisan effort by the legislative and executive branches is essential to finding a workable solution."

Let's look at the facts.

Deficit Reduction Target Has Been Stretched Out and Delayed

The idea of Gramm-Rudman was that we would reduce the deficit from $221 billion in 1986 to $144 billion in 1987, to $108 billion in 1988, to $72 billion in 1989, and to $36 billion in 1990 and that we would balance the budget in 1991.

In 1987, we wound up with a deficit of about $150 billion. It would have been higher except that the 1986 tax reform law "front-loaded" revenue in the early years of its implementation, which was counted against the deficit. The deficit was also held down through liberal use of accounting gimmicks.

By last fall, it was clear we would never reach the original goal of $108 billion for 1988, so the Congress and the administration stretched out and delayed the targets as part of the compromise budget agreement last December. The new Gramm-Rudman targets are $144 billion in 1988, $136 billion in 1989, $100 billion in 1990, $64 billion in 1991, $28 billion in 1992, and a balanced budget by 1993.

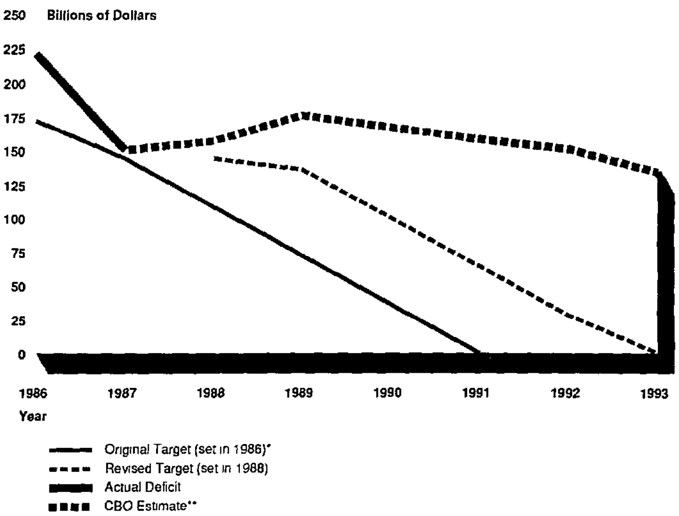
Clearly we will have grave problems meeting the targets. For 1989, for example, projections by the Office of Management and Budget (OMB) forecast a deficit of $130 billion—well within the target range. The Congressional Budget Office (CBO), however, places the "baseline" deficit in 1989 at $176 billion—some $40 billion higher than the new target. CBO estimates that even if the President's budget proposals were enacted, the deficit would be $165 billion. The new law, however, mandates that OMB projections prevail, so we've set the stage to pretend that we're meeting the target in 1989, only to face a virtually impossible goal in 1990.

The True Deficit Is Understated

The unified budget counts all receipts and expenditures of the federal government in tallying the deficit. But many of the trust funds—for highways, Social Security, and other purposes—are running a surplus. The surplus is loaned to the Treasury. This cuts down the amount of required federal borrowing on the open market, but it also disguises the size of the structural deficit as it affects all other government operations.

Take Social Security as an example. The Social Security Trust Fund is financed by payroll taxes, and those taxes are being used to build up a surplus that will be needed to pay retirement benefits for the "baby boom" generation in the next century. We lend those reserves to the Treasury, which uses the cash to pay for other government programs. This means that Treasury will have to borrow money or raise taxes to repay those loans when Social Security must start drawing down its reserves to provide benefits as people now in their thirties and forties begin to retire.

Figure 1: The Gramm-Rudman-Hollings Deficit Stretch



*The original Gramm-Rudman-Hollings target limited the 1986 "sequester" of spending to a maximum of $11.7 billion.

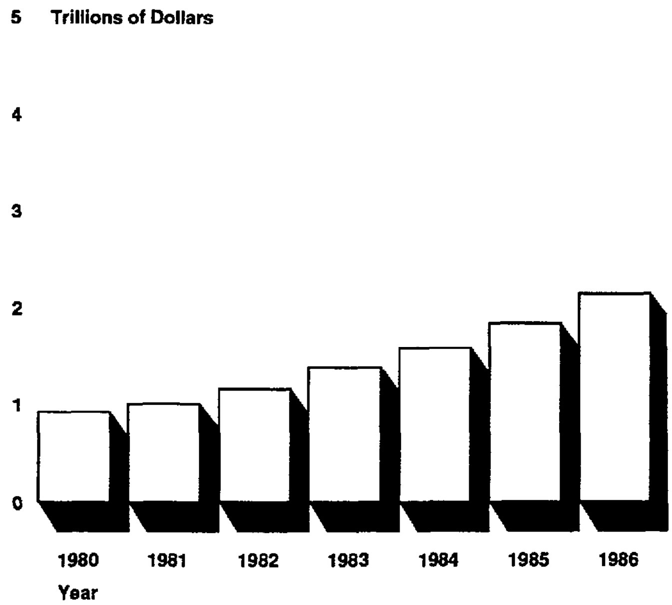
**Source: The Economic and Budget Outlook: Fiscal Years 1989 - 1993, (Feb. 1988).

If you disregard the trust fund surplus, the deficit in 1986 was $283 billion and $223 billion in 1987 and will continue at that magnitude for many years to come. The bottom line is that the revenues from corporate and personal income taxes and excise levies are more than $200 billion short of paying for the regular operations of government.

Debt Service Is Growing at a Rapid Rate

When we talk about cutting government spending, we normally focus on items most people clearly understand—defense, education, social programs, law enforcement, air traffic controllers, health care, agriculture programs, and all the other things government helps pay for. But we are spending more and more each year off the top on an item we cannot control—interest on the debt. With a total national debt that will soon top $3 trillion—triple what it was at the start of this decade—we are spending $150 billion this year on interest. We are headed toward $200 billion, and if interest rates should rise, it would be a great deal more.

Figure 2.1: The Debt Burden 1980-1993



*Estimates

Source: Historical Tables - Budget of the United States Government, Office of Management and Budget (1988) (for years 1980-87); The Economic and Budget Outlook: Fiscal Years 1989-1993, Congressional Budget Office (Feb. 1988) (for estimates, 1988-93).

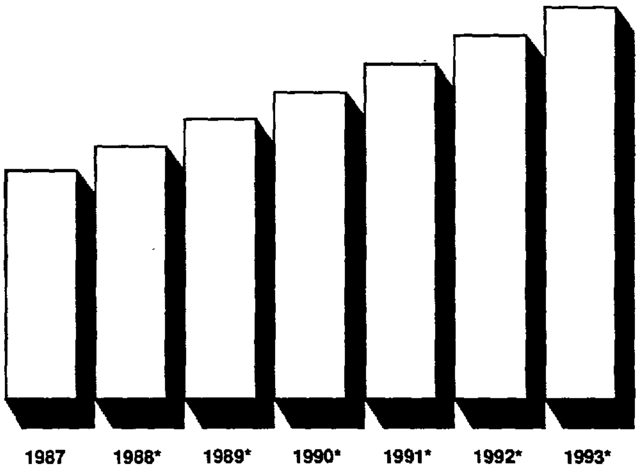

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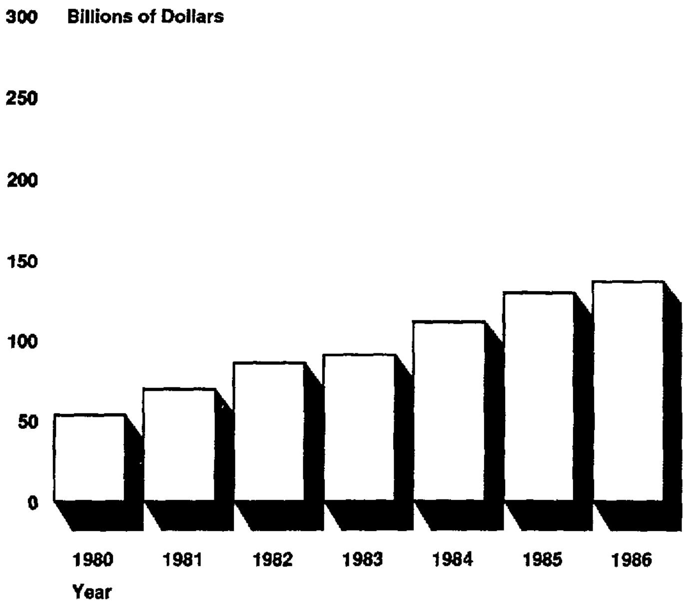
Figure 2.2: The Interest Burden 1980-1993



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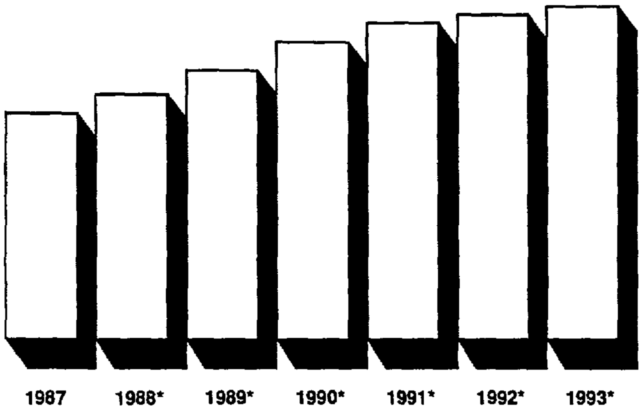
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This money does not pay for a single government service. It cannot be used to hire a single air traffic controller, to educate a disadvantaged young person, to hire law enforcement officers, or to buy a single tank or missile for national defense. Rather, the money goes to bond holders, many of them foreign. These costs may soon overshadow all but Social Security and defense as the biggest outlay in the budget. The only thing it buys us is the right to pay even more next year.

We Are the World's Largest Debtor Nation

Finally, there is the worrisome situation of our international accounts. In 4 short years, we have gone from being a creditor nation to being the world's largest debtor nation. It's hard to get exact figures, but a good guess is that we owe foreigners at least $400 billion more than they owe us.

Until recently, it was foreign insurance companies, pension funds, and wealthy investors who bought U.S. government securities. As the value of the dollar has fallen, however, so has the value of these holdings. So these traditional sources of foreign credit are drying up.

The current buyers of U.S. securities are now foreign central banks, which have intervened to help prop up the value of the dollar. In essence, we are relying upon central banks in Europe and Japan to spend billions of their own currency to buy dollars, which they then convert to U.S. securities. That costs them a lot of money, and it is not something they will be willing to do forever. Not only is this a new phenomenon, but it is also one that holds great danger for the future.

A New President and a New Congress: A Window of Opportunity

I am not sanguine about the many problems we face. However, I believe the public has begun to recognize that something must be done, and we may finally have reached the point where it will be possible to see some real action that will address this crisis. The best chance will come early next year, when a new President and a new Congress take office. Traditionally, a President's "honeymoon" period offers any new Chief Executive his best shot at fundamental policy changes.

It's helpful, I think, that the Presidential campaign has begun to focus on the budget as candidates line up to spell out their proposed solutions to the problem.

But other events have also coalesced to concentrate the attention of the American people on the danger we face. Chief among these was the stock market crash of Black Monday—October 19, 1987. Right after the crash, Wall Street looked around for a villain to blame for this debacle, and it settled on the federal deficit.

A number of people and organizations—including GAO—have studied the crash. The studies disagree on many issues, but there seems to be one point of agreement: The deficit was not the cause of Black Monday.

Nevertheless, if the crash was not caused by the deficit, the crisis of confidence that ensued highlighted many of the problems we face. It galvanized action and forced the President and the Congress to come to terms on a short-term effort to lower the deficit by $76 billion in 1988 and 1989 through a combination of spending cuts and new taxes. It is true that the compromise significantly stretched out the Gramm-Rudman targets. And some of the budget "savings" were only accounting gimmicks. But it was at least a start.

The National Economic Commission

Potentially, one of the most promising developments that came out of the budget compromise legislation last December was the creation of a National Economic Commission.

The bipartisan Commission is composed of a number of very influential leaders, with Bob Strauss and Drew Lewis as cochairmen. The credibility and talent of the Commission mean its recommendations will carry great weight.

The Commission faces a number of problems, not the least of which is gathering basic facts. As GAO has long pointed out, federal financial systems are antiquated, making it difficult to track the way money is budgeted and spent.

I hope that the Commission, as it makes its way through this labyrinth, will point out the evils of gimmickry. We've already had far too much blue smoke and mirrors and it doesn't work. It did not work for New York City before its crisis in the 1970s; it didn't work for the Penn Central Railroad; it will not work for the federal government.

In recent years, to meet budget targets, the Congress and the administration have been equally guilty of gimmickry. Payrolls have been moved from one fiscal year to another; receipts have been rearranged to show lower deficits; and we've sold loan assets, which yield short-term revenue at the expense of long-term income.

Beyond avoiding blue smoke and mirrors, what should the National Commission be looking at? Let me list some of the issues.

)efense

The next administration, whether Democratic or Republican, will have to wrestle with defense spending. The Commission could pave the way for stability in defense outlays so that we avoid the wasteful roller coaster ride of the past several decades, where we've seen huge buildups followed by periods of austerity, followed by another buildup.

The ultimate question is affordability The country cannot afford to buy everything on every general's and admiral's wish list. We can afford a strong, effective, and efficient nation defense, but only if the Congress and the administration are willing to impose the kind of controls necessary to avoid cost overruns, to plan weapons systems that do the job right, an to eliminate those that do not work or are not essential.

It is time we took a new look at soaring manpower costs. We spend billion of dollars to recruit, train, and retain highly skilled people—then retire them in middle age at the peak of thei careers. This policy is long overdue fo change.

Similarly, the area of burden-sharing between the United States and its major allies needs a close look as part of a reexamination of U.S. commitments worldwide. We need to relate those commitments to the force structure we can afford.

Unmet Needs

In our concern over the deficit, we often fail to recognize that in many areas, demand is building for increased federal outlays to meet unmet needs, both present and future.

For example, many of our financial institutions are in deep financial difficulty. Over the next several years, federal assistance for the thrift industry will cost at least $15 billion and may reach a staggering $60 billion. That makes the other federal bailouts—New York City, Lockheed, Chrysler, the Penn Central—pale by comparison. Today over 500 thrifts are under water, yet we keep them open. Every month they lose more money, yet they attract deposits because they pay a little higher interest rate than others and they have that "insured deposit" sign in the window. Every month of delay means the problem gets worse, but eventually the bill will have to be paid.

Large commercial banks face their own difficulties, most notably with foreign debt owed by lesser-developed countries and risky loans to such depressed sectors as energy and agriculture. We just put $1 billion into a Texas bank, and that is only the start. The total is hard to quantify, but it could ultimately cost several billion dollars, and the taxpayers may be forced to bear a major portion of that.

Other examples of unmet needs range from demands for more funds for AIDS (acquired immune deficiency syndrome) research and treatment to modernization of nuclear weapons plants and nuclear waste disposal.

The point is that the Commission mu: concentrate not only on where we c.. save money, but also on how we can deal with new demands on federal resources that will continue to grow.

Entitlements

A growing percentage of federal outlays goes to entitlements—programs that allow any citizen who meets the benefit criteria to receive payments o assistance. Appropriations are automatic, and these programs can be changed only by changing eligibility requirements or reducing benefits.

The most explosive growth in entitlement expenditures has resulted from automatic cost-of-living adjustments-COLAS. One of the reasons for our budget bind was the high inflation of decade ago, which dramatically d... up costs just after transfer payments, such as Social Security, had been indexed in the early 1970s.

It is worth noting that not all entitlements are on the spending side: The tax code is now just as indexed to inflation as is Social Security. The result is that we must spend more money on indexed entitlements to protect people from inflation at the same time revenues go down because we've protected taxpayers against "bracket creep."

Another round of double-digit inflation might well "break the bank" once and for all if changes are not made.

In one area of entitlement spending—health care—we see costs being driven up at a rate much higher than inflation. The explosive costs of Medicare and Medicaid, coupled with calls to expand these programs to meet the costs of catastrophic illness and long-term nursing care, are imposing enormous demands on federal resources. We desperately need a way to keep costs down while ensuring quality care, but no one yet knows how to do that.

Clearly, restraining entitlements will be one of the most contentious issues facing the Commission. But if we are going to solve the deficit problem, all citizens must bear an equitable share of the burden. There can be no exemptions.

griculture

The cost of our farm programs has grown from $5 billion a few years ago to $22 billion today. It's time to ask ourselves whether we can go on spending this much.

The list of issues could be much larger, but these examples demonstrate the problems facing the Commission and future administrations on the spending side of the budget.

'hat About evenues?

Let me turn now to the other side of the equation—to revenues. It is clear to me that we will never bring our budget anywhere near balance unless we are willing to admit that taxes must be raised.

The question, I think, is not whether to raise taxes, but when and how.

On the question of when, I believe the sooner the better. We ought to begin the process of bringing revenues into line with the needs we face while times are good.

The really tough question is how.

The Congress has just enacted the most sweeping change in federal tax policy in the postwar era, so I doubt that we can tinker with income tax rates. The tendency will be to give the new tax law a chance to work as it was written.

Against this backdrop, there are three other areas where revenue could be gained—from stepped-up tax enforcement activities, from increases in excise taxes, or by imposition of a broad-based consumption tax.

Enforcement might gain some additional revenue. However, the Congress has already increased the IRS (Internal Revenue Service) budget substantially to finance heightened collection efforts. Most experts seem to agree that gaining additional revenue from enforcement will take time and that it will not produce dramatic results in terms of revenue.

The problem with most excise taxes—levies on cigarettes, alcohol, gasoline, telephone service, and the like—is that they do not raise much money. For example, doubling the tax on cigarettes would yield only about $3 billion a year, and adding 12 cents a gallon to the federal gasoline tax would yield about $11 billion a year. This would hardly put a large dent in the deficit.

Broad-based consumption taxes, such as a value-added tax, may be the only available way to raise revenues and lower the deficit.

Consumption taxes are generally regressive but can be tailored in a way that avoids harm to lower-income groups. Certain items, such as food and medicine, could be exempted, and provision could be made to allow offsetting income tax credits or rebates for low-income persons. Even with such limits, a broad-based consumption tax would raise a lot of money. A 5-percent value-added tax with exemptions for food, housing, and medical care could raise $65 billion a year over the 4 years beginning in 1990.

There are many unanswered questions about consumption taxes to which the Congress and the American people will want answers before proceeding to impose them. Clearly the money would go primarily to reduce the deficit, not for vastly increased social services.

Nevertheless, the success of other countries in raising a major portion of their national revenue through such taxes indicates that they are worth a close look, especially if the Congress declines to raise income tax rates because of the new tax law.

Conclusion

I hope that the National Economic Commission, which is bipartisan, can make a real contribution, much as the Greenspan Commission did a few years ago with Social Security. Sometimes it takes an outside group to help in a situation like this.

But it is also going to take a great deal of courage by the next President. He probably has only a few months—a window of opportunity—where he will be able to get a lot done when he first takes office. My hope is that the report from the Commission might serve as the spark for the leadership and action that are needed.

I hate to say it, but if we don't use this window of opportunity effectively, then it will take a crisis to force action—and it is always more difficult to act wisely in a crisis atmosphere. We've been through one crisis in this past year—the stock market crash—and I hope we do not have to go through another before action is taken.

So, time is running out. We delude ourselves if we think there are any easy solutions. We've lived beyond our means on borrowed money and borrowed time for so long that pulling back and putting our economic house in order will require major readjustments in the way we go about our business.

It is time to get on with the work we all know must be done.