Competitiveness: the Challenge of the Deficit

For the past 40 years, if anyone asked what was the primary issue facing the United States, the answer usually involved the cold war threat of the Soviet Union. Throughout the postwar period, both U.S. foreign and domestic policy revolved largely around the ups and downs of our relations with the Russian bear.

How quickly times change!

Events in Eastern Europe and in the Soviet Union have, with astonishing speed, altered our view of the world. What had been a basic organizing principle of American policy—the Soviet threat—is suddenly gone.

Where does that leave us in agreeing upon a new agenda of issues to focus upon?

Many thoughtful people cite U.S. competitiveness—or a lack thereof—as the predominant issue facing America in the 1990s and beyond. Others would add such contentious problems as the war on drugs, the quality of U.S. education, the viability and soundness of our banking system, the high and rising cost of our health care system, the environment, or a crumbling transportation infrastructure.

Personally, I believe our ability to compete with other nations is the primary issue facing the United States. But I would add one other problem: the deficit crisis and our growing national debt. Indeed, the issue of competitiveness is inseparable from our ability to deal with the deficit crisis and our growing national debt. Furthermore, our deficit and debt problems are an integral part of our ability to deal with the list of problems that others have mentioned and to which I just referred.

To understand the challenges that will confront us in the future, it is important to understand where we have come from, and that means we need to consider—at least briefly—how big a role our confrontation with the Soviet Union has played in setting the stage for where we find ourselves today.

Three times during the 20th century, the United States and the Soviet Union have faced great challenges.

The first of these occurred at the time of World War I. Russia, an exhausted and politically bankrupt state of the old order, experienced a revolution. The United States, a young country with considerably more promise than experience, played its first pivotal role in European politics that then dominated our world. The Soviets emerged after the 1917 Revolution as a country isolated and shunned by most of the rest of the world, its economy in tatters. The United States emerged from World War I with its economy intact and still growing. But we elected to pull back, to retreat to our distant shores, and to largely isolate ourselves from the tangled politics of Europe. Our rejection of membership in the League of Nations was symbolic of our distrust of foreign entanglements.

The second event that shaped both Americans and the Soviets was World War II. With very different political and economic systems, both nations emerged from the war as great military powers capable of dominating Europe from the Ural Mountains to the Atlantic. It was this rise of two superpowers that set the stage for the expensive and protracted conflict of the cold war of that past 45 years.

Since 1950, the United States has spent a cumulative total of more than $4 trillion on national defense. Measured in 1989 dollars, this comes to nearly $10 trillion. We have averaged 7.8 percent of the U.S. gross national product (GNP) for this purpose. The North Atlantic Treaty Organization allies have paid substantial, if smaller, costs. Japan paid very little, enjoying the luxury of the American nuclear shield as a greater share of its resources went into economic growth.

Determining whether the Soviets have spent more or less than we have on the arms race would involve such difficult conceptual and technical problems that they are probably not worth solving, if ever they could be. But we need no fancy analysis to tell us that the people of the Soviet Union and the other Warsaw Pact nations paid a tremendous price in terms of foregone economic growth and their own standards of living.

What is important to recognize, however, is that the race for military superiority in the postwar era between the Soviet Union and the United States—and the price we each paid—is in large part responsible for the position in which each nation now finds itself.

I am convinced that today, both countries are facing their third—and last—great challenge of this century: Both superpowers must now compete on the economic front with the rest of the world, rather than on the military front with each other. Whether that is because the arms race has become pointless or because it has become too expensive is almost beside the point. The fact is that there are other players on the scene—an economically integrated Europe; Japan, with an economy dominating the Pacific basin; and the growing number of fast-developing nations in Asia. With these other influential players at the table, the new competition is far more complex than the old.

The problems faced by the Soviet Union are much greater than our own. The Soviet economy, which has never been able to satisfy consumer demands for food and manufactured goods, is stagnating. The Soviet empire is in danger of collapse as the non-Russian republics assert newfound voices of autonomy, and even outright independence, from Moscow. The satellite nations of Eastern Europe have, one after another, rejected the Soviet model and have begun the exhilarating, if painful, transition to democracies driven by market forces.

Massive as are the problems facing the Soviets, however, we would be wise to remember that they possess enormous potential and a rich treasury of natural resources. There was a time in our recent history when the United States tended to overstate Soviet advances in science and in military proficiency. It would be equally unwise, now, to understate Soviet capabilities. Freed of the smothering inefficiency and corruption of central planning and a stifling Marxist ideology, the Soviets could well surprise the world at some point in the future, especially if Western technology becomes readily available, if they are able to adapt to a market-driven economy, and if their leaders are flexible enough politically to adapt their system to democratic reforms.

Competitiveness: The American Challenge

If the Soviet Union, in dealing with its political crisis, is being forced to turn inward and scale back its international commitments, at least temporarily, the United States is being forced to confront challenges on both the foreign and domestic fronts. They are not insubstantial.

Abroad, we face no letup in the increasingly stiff competition we've encountered in recent years:

- In Europe we will face, by 1992, a unified market, a productive system, and a set of financial institutions larger than our own—and this does not include the long-term potential of Eastern Europe. It should come as no surprise to us that what Western Europe has been able to accomplish in the past 45 years is more than comparable to the economic growth of the United States in the first 45 years of this century.
- In Asia in general, and particularly in the Pacific rim countries of Japan, Taiwan, Singapore, Hong Kong, and Korea, economic growth has been astonishing. Inflation-adjusted rates of 7 to 12 percent are typical. This growth has been based upon superbly competitive export strategies, which in turn have relied upon long-term domestic policies emphasizing savings, investment, and education. Korea—to take one example—has an industrial base that produced one-third of the world's shipping in 1988 and a domestic economy that has improved nutrition by 50 percent in 25 years and provides virtually all families with TV sets. Taiwan, to take another example, now equals Canada and Holland in exports of manufactured goods.

For the United States, the massive trade deficit that we have accumulated over the past decade offers explicit evidence of how complacent we have become in the face of competitive forces building during the post-war era and how ill-prepared we were to deal with them.

Yet even if we've come to recognize the seriousness of the challenge we face—and I believe we now have—we will still find it difficult to rebuild our competitive position in the world and to meet the additional challenges posed by such events as the integration of European economies if we are unprepared to deal with our budget deficit and our growing level of debt.

The General Accounting Office has long taken the position that the deficit is a major impediment to our own competitive position in the world. In the first of our 26 transition reports sent to President Bush and to the Congress in November 1988, for example, we identified the deficit as the primary problem facing the new administration.

But we have hardly been alone in this assessment. Other organizations reaching the same conclusion have included the Council for Competitiveness, chaired by Jack Young, the Chief Executive Officer of Hewlett-Packard; the Committee for Economic Development, whose 250 trustees are mostly presidents or board chairpersons of corporations or presidents of universities; and the American Agenda, chaired by former Presidents Ford and Carter.

The Worsening Deficit Crisis

Conventional wisdom held, at least until recently, that the deficit crisis was easing, thanks to the Gramm-Rudman-Hollings law that is supposed to force yearly reductions in the deficit.

In fact, the deficit is a worsening crisis. There are a number of reasons why this is so:

- First, the operating part of the government is underfunded, and this problem is growing worse. The unified budget deficit, which includes the surpluses of the social security and other trust funds and is used to calculate the Gramm-Rudman-Hollings deficit limits, has declined from its high of $221 billion in 1986 but seems to be stuck at about $150 billion. However, if you take out social security and the other trust fund surpluses that mask the true operating deficit, there is no improvement; things are only getting worse. Last year the operating deficit was $275 billion, and the Congressional Budget Office (CBO) projects it may approach $300 billion by 1995 if current policies are not changed.
- Second, the cost of solving problems the federal government must pay for, but has not, is becoming larger. That means even CBO projections—usually

considered realistic—are too low. In 1988, for example, GAO estimated the huge costs of cleaning up the nuclear weapons complex would reach between $100 and $150 billion. Now the administration acknowledges the problem but has requested an increase of only $800 million in its 1991 budget request. Meanwhile, to take another example, the costs of resolving the savings and loan (S&L) crisis continue to escalate by billions of dollars.

- Third, the Gramm-Rudman-Hollings process is missing its targets by ever-larger amounts. We now know that formula budgeting is a very poor substitute for political responsibility. As I just mentioned, the targets include the social security and other trust fund surpluses that mask the true deficit. Even so the record is dismal. The original deficit target for 1989 (later revised) was $72 billion. The actual deficit was $152 billion, $16 billion over the revised target. For the current fiscal year, 1990, the deficit target is $100 billion. CBO projects the actual deficit will reach $159 billion and even the Office of Management and Budget (OMB) admits to $124 billion—and the OMB estimate was made only a few weeks after completing legislative action on the budget that was supposed to ensure that we would meet the target. If you add off-budget borrowing for the S&L bailout and trust fund surpluses, you get $310 billion. David Stockman's statement about $200 billion deficits as far as the

Masking the Federal Deficits With Trust Funds

	Actual		
	FY 1985	FY 1986	FY 1989
Revenues	$734	$769	$991
Outlays	946	990	1,143
Total deficit	**$−212**	**$−221**	**$−152**
Federal funds deficit	−266	−283	−276
Trust fund surpluses:			
Social Security	9	17	52
Other trust funds	45	45	71
Subtotal, trust fund surpluses	**54**	**62**	**123**
Total deficit	**$−212**	**$−221**	**$−152**
Total federal debt	**$1,817**	**$2,120**	**$2,866**

Note Totals may not add due to rounding

eye can see is now out of date. It's $300 billion!

- Fourth, our national savings rate continues to be the lowest of the large industrial democracies and is too small to sustain the investment we need for a strong and healthy economy in the next century. This problem is exacerbated by the fact that federal budget deficits have taken an average of three-quarters of net private savings over the past 8 years. Very recently there have been some hopeful signs that the domestic savings rate may be picking up, but these trends, such as they are, could be dwarfed by the possible shifts in capital from the high savings nations (principally Japan and

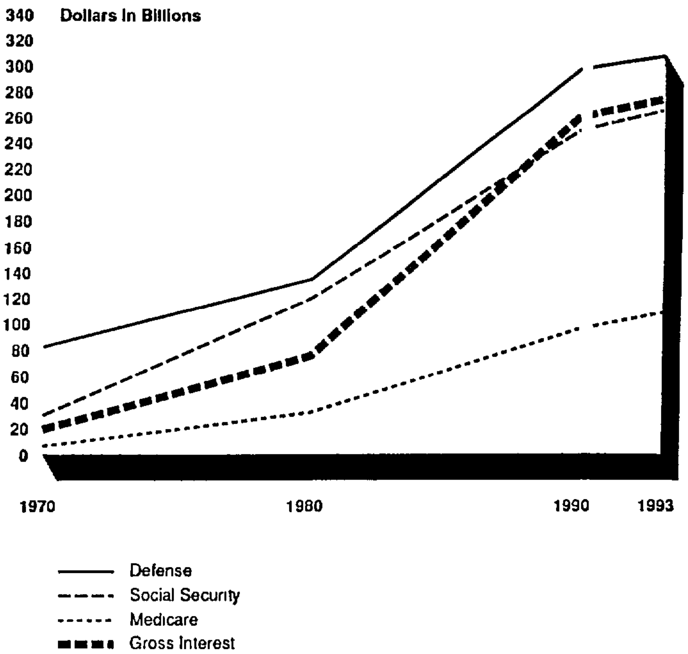
CBO estimate			
FY 1990	FY 1991	FY 1993	FY 1995
$1,067	$1,137	$1,277	$1,438
1,226	1,298	1,409	1,548
$-159	**$-161**	**$-132**	**$-110**
−290	−298	−289	−298
66	74	98	128
65	64	60	60
131	**138**	**158**	**188**
$-159	**$-161**	**$-132**	**$-110**
$3,156	**$3,454**	**$4,012**	**$4,603**

Germany) away from the United States into Eastern Europe and other parts of the world. It has been this foreign capital that has allowed us to sustain domestic investment despite our low savings rates, but we cannot continue to count on the rest of the world supplying the capital to support our investment needs.

- Fifth, the peace dividend, while important and reflecting major changes in world politics, is not going to bail us out of the deficit problem any time in the near future. We cannot reverse our military commitments overnight, and we need to take the time to select prudently the force structure and weapons systems that will serve us best given new world political relationships. The Pentagon is only beginning to adjust its planning to the new realities, and changes in spending patterns will lag well behind the decision process.

- Finally, in addition to the obligations the federal government must face, there is a long list of unmet national needs awaiting action, many of which are likely to involve calls on the Treasury. These issues include the drug

Figure 1: Budget Outlays for Major Programs, 1970-1993*



*Figures for 1970-1989 are actual Figures for 1990 and 1993 are CBO estimates.

war, education, health care, the environment, transportation, and a growing concern over the U.S. financial services sector. There are different views of what is important and what is not and what is a federal responsibility and what is not. But the notion that our democratic process will reject all of them as either not critical or not a federal responsibility is inconsistent with history.

Facing up to the facts of these problems is crucial to any understanding of the future implications of the deficit, for this is where foreign and domestic policy considerations meet. These are issues that not only have a bearing, large or small, on our ability to compete effectively in world markets but that also go to the heart of our ability to satisfy expectations of the American public.

Alice Rivlin, the former head of CBO and cochair of the economic panel put together by former Presidents Ford and Carter as part of their group, the American Agenda, put it this way:

"We cannot address the other issues facing the country effectively unless and until we get the budget deficit under control. The budget deficit has become a defense issue, a foreign policy issue, a health care issue, an education issue. We must put our fiscal house in order so that we can address the other problems which are important to us as a nation. Getting the budget deficit under control is a test of our ability to govern."[1]

Traditionally, in times of need, the federal government has been able to respond. It found the resources for the recovery of Western Europe through the Marshall Plan. It financed the interstate highway system beginning in the 1950s. It has supported the National Institutes of Health in a quest for the cure of disease. It implemented Medicare and Medicaid to meet the health care needs of the elderly and the poor. It built an air traffic control system, sent astronauts to the moon, and funded the National Science Foundation when we deemed such expenditures essential to the national agenda. Today, however, it has become increasingly difficult, thanks to the deficit, to undertake new efforts as they come to the fore.

It is worth considering some of these issues and the challenges they pose for our future.

Education

It is increasingly evident that we are falling behind other nations in the quality of the education provided to our future work force and that this will have profound implications for

[1] Ms. Rivlin is now Senior Fellow in the Economics Studies Program of the Brookings Institution. The quote is from testimony before the National Economic Commission, November 16, 1988.

our productivity and international competitiveness. In considering this problem, we need to look beyond school systems, and how much we spend on them, for two reasons. First, it is not just performance in schools that is important; we need also to be concerned about students' transition into the labor force. Second, successful school performance is not just a matter of formal schooling. Many factors—social, cultural, and economic—are involved. Such problems as teenage pregnancy, welfare dependency, crime, and drug abuse both hamper students and reflect the consequences of poor schooling. Albert Shanker, president of the American Federation of Teachers, points out that the education of poor children is often affected by housing, transportation, and health care. Shanker also notes that schools restructured to be run by teams of teachers, administrators, parents, and other community representatives would make them more responsive to student needs and would foster community support.

The question of technology also enters the equation. How well we adapt computers to the classroom (and ensure that such technology is available to poor as well as wealthy schools) will certainly play a role in improving education and preparing young people for better performance in the work force.

These factors, as well as the quality of teaching itself, are all part of the educational context.

We can also learn from others. GAO has been studying education and training in four countries: England, Japan, Sweden, and Germany. We have found that young adults in foreign countries have higher literacy rates than we do. Foreign countries also emphasize the obligation of educating all students, rather than accepting the notion that many will lag behind. In Japan, for example, schools stress student effort for all rather than only for the gifted.

The United States tends to tilt its educational expenditures toward college, investing more than twice as much in those who go to college than those who do not. The four foreign countries we reviewed invest a higher proportion of their national income in precollege education and spend more to help young people enter the work force. The foreign countries we've studied also seek to systematically guide a student's transition from school to work, while many young people in our country drift aimlessly from job to job—or from job to unemployment—after leaving school.

For a variety of reasons reflecting different cultures and traditions, approaches that work in another nation may not be directly transferable to our own educational systems. But these are the nations with which we must compete. If they succeed where we fail, as they do in achieving near universal literacy and a successful transition from school to work, it will affect our ability to compete. If we are to be competitive, we must identify those differences and search out our own ways to match the successes of our competitors.

The quality of American education and the utilization of our work force have a tremendous impact upon our ability to meet the competitive challenges we face. What is important for the future, however, is to build on our strengths and successes and to overcome our failures. Head Start, for example, has been a demonstrated success. But we have yet to implement this program on a nationwide basis, an effort that would cost about $12 billion.

The Drug War

Drug use continues to be a national crisis, one that must be dealt with cooperatively at all levels of government. The cost of drug dependency in terms of lost productivity, health care, and law enforcement resources that could be better devoted to other problems is staggering.

At the federal level, top priority has been given to law enforcement. Yet, many experts believe that treatment and prevention are of equal or greater importance. With a whole generation of children at risk of growing up in drug-filled environments, we cannot afford a lengthy debate on who should do what. Without adequate federal support now, the future cost of dealing with this generation will be enormous. Moreover, the related cost associated with the spread of AIDS (acquired immune deficiency syndrone) is similarly disturbing.

Health Care

The United States spends over half a trillion dollars in health care—almost 12 percent of GNP and more than any other country. Over 41 percent is publicly financed. For this, many of us get the world's best medical care, but still the U.S. infant mortality rate is much higher than that in most industrialized societies, and our average life expectancy ranks 13th among these countries. Furthermore, more than 30 million Americans lack health insurance, public or private.

It is very hard to deal with these issues of quality and access because costs continue to escalate. By the year 2000, they are projected to absorb roughly 15 percent of GNP. Health care expenditures have grown at more than double the general inflation rate for nearly three decades.

Some of the expenditures reflect an aging population and advances in technology, but much of the increase reflects incentives for inefficiency that are built into the ways we pay for and deliver health care. If changes in our health care system could, by the year 2000, reduce the share of GNP spent on health from 15 percent to 14 percent, we would save nearly $70 billion a year, of which the Treasury could save about $15 billion a year.

Much has been tried to moderate these cost trends, but piecemeal efforts have failed. We need strong national leadership to achieve comprehensive reform.

The Transportation Infrastructure

Gridlock has threatened progress in the skies and highways. Airline passenger travel has nearly doubled in the past decade. According to Federal Aviation Administration (FAA) estimates, airline travel delays in 1986 created $1.8 billion in extra operating expenses for airlines and cost passengers $3.2 billion in lost time. U.S. motor vehicle travel reached nearly 2 trillion miles last year, racking up 722 million hours in delays. All this is costing the U.S. billions of dollars in lost productivity and wasted fuel.

CBO estimates that total federal spending on the transportation infrastructure amounted to $26.5 billion in 1988—yet we are falling far short of the needed investment. The Department of Transportation has estimated that between $25 billion and $39 billion is needed annually to restore and maintain the current federal-aid highway system through the year 2005. And at least $27 billion will be needed through the year 2000 to fund FAA's air traffic control modernization program.

The Environment

The federal government seems to have less capacity to deal with the environment than it did 20 years ago. We decided then, for example, to clean up the nation's waterways, and since 1973, the federal government has invested $50 billion in grants to states and localities to build sewage treatment plants. But although the Environmental Protection Agency has estimated that the country has additional water treatment needs that will cost $75 billion to meet, the federal government is now turning the program over to states and local governments, hoping that they will somehow find the money. The Congress also enacted additional requirements for safe drinking water supplies, but the costs will be borne by local government.

Some costs simply cannot be shifted to other levels of government. The federal government will be forced to bear the costs of cleaning scores of federally owned facilities, where toxic and radioactive wastes have seeped into soil and groundwater. Cleaning up these facilities, including the nuclear weapons plants, and bringing them into compliance with environmental laws could cost some $200 billion. Even if we could continue to devote

$4.5 billion a year toward these problems, as the administration has proposed for next year, it would take at least 40 years to correct existing problems at this rate of expenditure.

Banking and Capital Markets

From the Great Depression until the 1980s, we had a strong and growing financial system. The flexibility of that system and the efficiency and stability of our capital markets were the envy of the rest of the world. The federal government has traditionally been an important player in this sector of our economy. Not only has it provided deposit insurance for banking and thrift institutions and ensured the integrity of our financial markets, but it has also promoted all kinds of financial innovations through such devices as loan guarantees, secondary markets, and the establishment of autonomous government-sponsored enterprises. Generally, federal participation in financial markets was either self-sustaining or profitable. But deregulation, combined with the 1982 recession and the collapse of oil prices, changed the equation.

The first visible patient was the farm credit system, which required several billion dollars in assistance to keep alive. This was, of course, merely spring training for the savings and loan crisis, which will take years to accomplish. The $50 billion provided by the Congress is just the beginning—we really do not yet know the full price tag. The latest estimates of the total cost is over $300 billion.

What happened? Well, we learned one basic lesson: deregulation permits people to take risks. In the case of the S&L crisis, many thrift owners, faced with insolvency, gambled with taxpayers' dollars—not their own—and lost!

More generally, the 1980s marked a period of financial excess. Computer technology combined with the ingenuity of money managers to create an endless variety of marketable financial instruments. From mortgage-backed securities to zero coupon treasury bonds (that the Treasury itself never issued), it seemed that anything with a dollar value could be turned into a security and sold. Junk bonds were only the most dramatic manifestation of this, and even the government got involved. The Navy leased ships to avoid paying the full costs up front. The National Aeronautics and Space Administration guaranteed lease payments for a Western Union communications satellite. Most recently one investment banking firm floated a special security on behalf of the National Archives to finance a new building at the University of Maryland.

Of course, I recognize that there is value in having sophisticated, efficient, and innovative financial markets. But I worry that we have put so much of our creative energy into innovative financing mechanisms that we are neglecting production innovations. No matter how efficient we are at raising capital, our wealth depends on the value of what we produce. Leveraged buyouts financed with high cost money may keep managers on their toes, but surely we need to worry when vast sums are made from purely financial manipulation and corporate leaders worry more about hostile takeovers than they do about technology and the productivity of their work forces. These are issues that go to the heart of our ability to compete in world markets.

Conclusion

The long-term opportunities for the United States and the Soviet Union are potentially enormous. But just recognizing these opportunities does not mean that either country will automatically be able to deal with the challenges that each must confront.

The future of the Soviet Union is problematic. It is still very much uncertain whether the Soviet empire will disintegrate in the chaos of civil strife as individual republics seek to break away from Moscow's rule or whether it will manage to find unity in a new or modified form of confederation based upon democratic principles. What is clear is that if the Soviet Union ceases to challenge the United States for military superiority, it is hardly in a position to challenge us economically—yet.

But other nations—notably Japan and an economically unified Europe incorporating the enormously productive German economy—are in such a position, or soon will be. The question is whether we are willing, and able, to put our own financial house in order in such a way that we can sustain the political and economic leadership we've come to exercise within the non-Communist world for the past 45 years and to extend that leadership to encompass those nations that have traditionally been our adversaries.

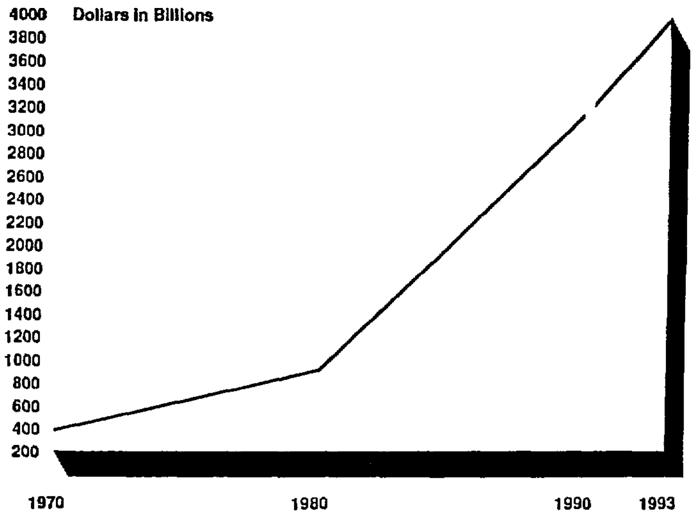
Thus, the challenge we confront is much easier to spell out than is that of the Soviet Union. Internationally, we must be able to compete. Internally, we must be able to provide the services and meet all the other needs that Americans expect of their national government. Both challenges are inevitably linked to the folly of continued reliance upon huge deficits.

We need action.

To begin with, we must cease competing with the future. By continuing to borrow money to meet present obligations, we are robbing the future of the resources that our children and grandchildren will need in their generations to sustain a position of American leadership.

In 1980, our gross federal debt, which includes the debt held by the social security and other trust funds, was $800 billion. This year, it will top $3 trillion, and CBO projects that by 1993, without policy changes, it will reach $4 trillion. Interest on that debt is now costing us $260 billion a year and has become the second largest item in the federal budget. It has now surpassed social security and is gaining steadily on defense for the largest annual expenditure of the federal government. Debt service buys us nothing except the right to pay even more next year.

Figure 2: Total Gross Public Debt, 1970-1993*



*Figures for 1970-1989 are actual. Figures for 1990-1993 are CBO estimates.

Fundamentally, the debt and deficit crisis is as much a political issue as it is an economic problem. But however defined, it is a solvable problem. It will take bipartisan compromise and a sustained, multiyear commitment to get the job done. That compromise—as a matter of politics, equity, and simple arithmetic—must involve both sides of the ledger, revenues as well as expenditures; both sides of the aisle in the Congress; and both ends of Pennsylvania Avenue—the Congress and the White House.

Despite the severity of the numbers—and perhaps because of them—I remain optimistic.

When all is said and done, Americans have traditionally risen to great challenges. We undertook vast reforms to cope with the Great Depression of the 1930s We shook off our innate isolationism and built the greatest military force in the history of the world to fight World War II—and sustained that military superiority at great cost through the depths of the cold war. We rejected the notion of revenge and dealt fairly with Japan and Germany after the war, setting each on the road to recovery as the democratically governed economic powerhouses they are today. If we could deal with the political and economic ramifications of such trials, we can surely deal with this one.

Indeed, there are signs that attention is being refocused on the budget debate. Senator Moynihan focused the debate with his proposal to roll back social security payroll taxes rather than continuing to allow the social security surplus to cover spending on other government operations. Even the press, which has appeared bored over the deficit debate, paid attention.

There are also signs of recognition that there is not an inexhaustible source of foreign money to continue borrowing to fund the deficit. The Europeans, especially the West Germans, may find it lucrative to begin shifting investment toward Eastern Europe and away from the United States.

But ultimately, I think we'll find the will and the way to work our way out of this crisis simply because Americans know that it is a problem they must confront. Average citizens may not understand the intricacies of the debate, but they do sense that something is amiss when suddenly the most popular car sold in America bears a Japanese nameplate or when they read about highly publicized foreign purchases of American corporations or of symbolic structures, such as Rockefeller Center. The merits of these events aside, they are symptomatic of the fact that our fiscal house is not in order. They strike a responsive chord among Americans who sense that our debt and deficit crisis is at the heart of the problem.

So in the final analysis, I believe we'll devise the political compromises that are needed to deal with the budget deficit. It may yet take time and it will not be easy, but we'll get there if only because we must.

We have little other choice if we want to enter the 21st century enjoying the same position of leadership in the world we've exercised for the past 45 years.