The Heritage Foundation Issue Bulletin

No 91 | The Heritage Foundation • 513 C Street • N.E. • Washington, D.C. • 20002 • (202) 546-4400

May 5, 1983

THE HATCH—GRAMM BALANCED BUDGET—SPENDING FREEZE PROPOSAL

INTRODUCTION

The House and Senate Budget Committees apparently have short memories. They have produced budgets that are tired reruns of the 1970s--calling once again for more spending and more taxes. This is precisely the bitter brew that created the nation's painfully high inflation and high unemployment. The 1970s should teach us that high taxes and unrestrained spending are not the means to a healthy and stable economy. This end is promised by the Balanced Budget-Spending Freeze advocated by conservatives Senator Orrin Hatch (R-Utah) and Congressman Phil Gramm (R-Texas). The Hatch-Gramm budget would lead to a balanced budget by 1989.

The proposal calls for $836 billion in outlays in FY 1984--$13 billion less than the Senate Budget Committee (SBC), $31 billion less than the House Budget Committee (HBC), and $8 billion less than the President's budget. The proposal would freeze income taxes over the next five years--compared with the $30 billion in new taxes in 1984 alone, favored by the House and Senate Budget Committees.

The budget freeze requires compromise from all Americans and interest groups for the sake of fiscal austerity necessary for continued economic recovery. The budget would freeze non-defense discretionary spending at nominal levels for three years, allow entitlements to grow at the rate of inflation, leave untouched the new Social Security package, and allow for only a 7 percent increase in defense budget authority in FY 1984, tapering down to 4 percent in the following years.

The proposal faces rough going on the Hill and in the White House. Many congressional Democrats would prefer to balance the budget on the backs of the taxpayers by repealing the third year of the tax cut and tax indexing. Moderate Republicans, on the other hand, are wary of the proposal because they fear that Congress will not deliver the fiscal austerity necessary to achieve the plan's spending and projected growth levels.

The Hatch-Gramm proposal is the only budget which recognizes the true danger in the federal budget--that total federal spending, not deficits, is responsible for low economic growth. Raising taxes will reduce individual incentives and encourage further wasteful spending, killing the economic recovery now under way.

HOW THE BALANCED BUDGET-SPENDING FREEZE WOULD WORK

The proposal is a modified spending freeze. Rather than attempting a freeze in nominal (or current) dollars, the proposal aims to achieve a freeze in "real" terms. Allowing for growth in defense and entitlements programs, aggregate spending under the plan will increase about 5 percent annually during the next five years, roughly equal inflation.

The budget makes few programmatic assumptions. Instead, it sets specific growth rates for groups of programs, such as non-defense discretionary spending, entitlements, and defense. This leaves spending priorities to congressional discretion, so long as they remain within the guidelines.

Total Federal Outlays
(in billions of dollars)

	FY 1984	85	86	87	88
SBC	851	913	969	1,040	1,109
Hatch-Gramm	836	877	922	976	1,037
President	843	907	973	1,044	1,112

Source: Senate Budget Committee

Note: These figures are based on the latest CBO computer analysis. They are subject to change. SBC is Senate Budget Committee, Hatch-Gramm is budget freeze, and President is President Reagan.

Non-defense discretionary spending would be frozen at current nominal levels for three years, then allowed 3 percent nominal growth per year. This would save $8 billion in FY 1984 and $101 billion over five years. Several Heritage Foundation studies have demonstrated that this target is reasonable since large spending cuts could be accomplished by reducing subsidies to businesses and wealthy individuals, restructuring the delivery of public services through privatization and devolving functions to the states.[1]

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1 See, for example, John Palffy, "Saving $111 Billion: How To Do It," Heritage Foundation Backgrounders No. 240, 241, 242, January 24, 25, 26, 1983.

Two of the most sensitive entitlement programs, unemployment insurance and social security (the single largest program in the budget) would not be frozen. Aggregate spending for other entitlement programs would grow at the rate of inflation for three years, then at the rate of inflation plus 3 percent.

While keeping pace with inflation, however, a "real" entitlements freeze, of the type proposed, would mean $2 billion in aggregate program cuts from the FY 1984 Congressional Budget Office baseline (the budget resulting from a continuation of current policy) and $79 billion in cuts over the next five years, since new beneficiaries meeting the eligibility criteria would otherwise boost the budget total.

Despite these imposing numbers, significant savings could be effected with minimal loss in essential services to the truly needy. Reducing the cost-of-living (COLA) benefits or lowering income eligibility requirements are two obvious methods of slowing benefits growth and limiting welfare to the truly needy. Heritage Foundation studies have presented other more efficient and less painful means of cutting entitlement spending. Among them: requiring workfare of welfare recipients and instituting higher co-payments on Medicare and Medicaid. Workfare would reduce welfare rolls and increase public service while co-payments would limit the incentive to abuse "free" health care, thus lowering the strain on the federal budget, the demand for health services in general, and the price of health care for all.[2]

Defense budget authority would grow at 7 percent in FY 1984 under the plan, then at 5, 5, 4, and 4 percent in four succeeding years. Initially, these are significantly higher rates than the 2.5 percent FY 1984 increase recommended by the House Budget Committee and the 5 percent proposed by the Senate Budget Committee, but lower than the President's request for 10 percent. It still translates into a cut of $1.6 billion from the Senate Budget Committee outlay target for FY 1984. In addition, it means an $88 billion reduction in nominal defense outlays from the Congressional Budget Office's baseline figure, and a reduction of $132 billion from the President's request, over the next five years.

Defense Spending Projections
(in billions of dollars)

	FY 84		85		86		87		88	
	BA	O	BA	O	BA	O	BA	O	BA	O
SBC	267	241	300	271	335	300	372	332	410	364
Hatch-Gramm	272	240	300	265	332	293	364	317	399	349
President	280	245	330	282	364	322	396	358	432	390

Source: Senate Budget Committee

Note: BA is budget authority, O is outlays, SBC is Senate Budget Committee, Hatch-Gramm is budget freeze, and President is President Reagan.

2 Palffy, op. cit., Peter Germanis, "Workfare," Heritage Foundation Backgrounder No. 195, July 9, 1982.

THE POLITICAL BENEFITS OF THE FREEZE BUDGET

The Hatch-Gramm proposal is the only budget resolution that addresses the twin objectives of reducing spending and holding the line on income taxes. Spending cuts must begin with a budget resolution that forces Congress to meets its targets. Cuts cannot come from the appropriations process, where many a special interest will line up to protest the cut. The Hatch-Gramm budget would discourage the special interest groups in two important ways.

First, it restructures the budget by replacing general tax financing with specific financing through user fees. This limits excess and inefficient use of "free" or subsidized goods such as navigational charts, deep water ports, airports, weather satellites, or highways. Politically, this is very important. Special interests would have to pay for more goods and services from their own pockets. This is likely to translate into less intensive lobbying and fewer special interest pork barrels. The Hatch-Gramm budget increases such fees in several program areas.

Secondly, it would result in a budget resolution demanding cuts in aggregate spending rather than in specific programs. This means that supporters of particular programs would have to compete with each other for a share of the total pie. At the moment, each special interest tries to entrench its own program and the budget is, in practice, the total of the successful demands.

WHY IS THIS PROPOSAL NECESSARY?

This budget proposal is essential to the economic recovery. Under the Senate Budget Committee budget, federal spending during the Reagan years (FY 1981-1984) will have increased at an annual rate of 9 percent. Spending as a percentage of GNP will have increased from 18 percent in 1965 and 19.4 percent in 1975 to 26 percent in 1984.

Clearly, the spending spiral has not been broken. In fact, spending is no longer viewed as the primary foe. Debate at both budget committee mark-ups centered on the size of recent and prospective deficits. Most Democrats, and some Republicans, argue that these deficits crowd out private economic activity, and that the budget gap must be bridged with new taxes (which, of course, would also crowd out private economic activity). The real goal of this strategy should be clearly understood; it is to use the bugaboo of deficits to convince the public to support an even bigger federal government. Explains economist Paul Craig Roberts, former Assistant Secretary of the Treasury for Economic Policy, "the deficit crisis applies only when it is time to derail the President's tax cuts and defense buildup."[3]

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3 Paul Craig Roberts, "The President's Men Will Do Anything to Cut a Deal," The Wall Street Journal, April 26, 1983, p. 34.

Many Republicans have mistakenly sought compromise by cutting spending a little and raising taxes a lot. The Republicans voted for a $98 billion tax increase in 1982 on the premise that they would receive $3 in spending cuts for $1 dollar in taxes. Secretary of the Treasury Donald Regan recently admitted that the Administration expects the final deal to work out to "slightly less" than a one-for-one tradeoff; that is, less than one-third of the cuts promised.

This concern with budget deficits deliberately ignores the economic reality that federal spending, not deficit size, is the true indicator of the government's drain on the economy. Discussions of taxes and deficits distract attention from the fundamental truth--all government expenditures must be financed by the nation's wage earners through some combination of higher taxes, higher inflation and higher interest rates. Each damages the economy and destroys jobs.

Proponents of tax increases overstate the correlation between government deficits and interest rates. In fact, most empirical analysis and historical evidence confirms that, if anything, there is a slight negative relationship between interest rates and deficits. Deficits skyrocketed in 1982, for instance, and this was supposed to fuel inflation and interest rates. In fact, interest rates and inflation have plummeted, and the economy is recovering robustly. And other countries, such as Japan, have managed for years to run much larger deficits than the United States as a percentage of GNP, while maintaining low inflation and a health economy.

"STRUCTURAL DEFICITS"

Office of Management and Budget (OMB) Director David Stockman has dipped into neo-Keynesian textbooks to revive the spurious concept of the "structural deficit." This theory claims to separate the deficit into two components--a cyclical deficit that is reduced through economic recovery, and a structural deficit which equals the remaining deficit after "full" or "potentially full" recovery. This concept focuses policy on reducing the structural deficit. As long as a structural deficit exists, economic recovery supposedly will be inhibited by public borrowing crowding out private borrowers in the financial markets.

Some Republicans, including Stockman, apparently have abandoned trying to cut spending to eliminate the structural deficit. This leaves tax increases as the only means of reducing the current "structural deficit"--as if tax increases somehow will accelerate economic recovery, and thereby reduce the cyclical deficit.

This argument fails to take into account the economic reality confirmed by distant and recent experience, that tax increases reduce rather than stimulate economic growth. Lower economic growth is reflected in lower levels of "full" recovery. So, less of the deficit would be reduced through economic growth. In other words, using tax hikes to tackle the deficit may actually increase the structural deficit, rather than reduce it. And the response of tax increase advocates to this unwelcome result is--increase taxes!

This theory is documented by the experience of past major tax increases which have so stifled economic activity that the deficit has increased rather than fallen. As Roberts notes, 1982 saw the largest tax increases in history, but the only impact it had on the deficit forecast was to raise it by $841 billion for FY 1983 to FY 1987.

THE SPENDING FREEZE AND THE PROSPECTS FOR "HIGH GROWTH"

The Hatch-Gramm proposal has been criticized because it requires the Congressional Budget Office's high growth projections of 4.4 percent growth in the economy over the next five years to balance the budget. If growth does not meet these projections, tax revenues would be lower and entitlement spending would be higher, leaving a significant, albeit declining, budget deficit in 1988.

Many legislators maintain that this rate of growth is unobtainable without first reducing current deficits which, they claim, can only be achieved through tax increases. Proponents of the Hatch-Gramm budget, however, contend that rapid economic growth can, and must, be reached with federal spending cuts no tax increases.

CBO's growth projections are predicated on a baseline budget, but the spending freeze critically alters the assumptions of these growth projections by cutting spending far below baseline figures, while holding the line on income taxes. This will stimulate economic growth not accounted for in the CBO model, because it reduces the government's financial burden on the economy. With these new fiscal assumptions, it is possible that the economy will grow faster than even the CBO projection--conceivably resulting in a budget surplus.

The CBO growth projections are indeed pessimistic by historical standards; they have been conditioned by the dismal performance of the economy in the 1970s. With the regrettable exception of the inflationary 1970s, every decade in this century has enjoyed a six-year period of growth higher than the supposedly optimistic CBO projection.

The period 1962-1967 is of particular interest because today's economic conditions are similar in many respects; prices were relatively stable, there was excess capacity in both the labor and capital markets, and also, as now, there were similar tax policies put into effect which were aimed at stimulating investment and economic growth. During that period the economy grew at an annual real rate of 6 percent, and unemployment fell by 43 percent, largely because of the tax cuts. In addition, deficits actually declined.

The Institute for Research on the Economics of Taxation has estimated that given a baseline budget and a similar 5 percent growth, the deficit could be reduced to 1.9 percent of GNP by 1988.[4] Under CBO's 4.4 percent growth assumptions, the baseline budget would equal 3.6 percent of GNP in 1988. According to the budget freeze proposal, the remaining deficits would be eliminated by spending cuts.

According to the most accurate among the economic forecasters during the past several years, Wainwright Economics, Inc., growth of 5.7 percent will occur in 1983, followed by 9 percent in 1984, and 4 percent thereafter.

In sum, given the stimulative policy of the Hatch-Gramm proposal, the original CBO growth projections should be revised upwards. And further, the CBO projections are overly pessimistic in light of historical experience.

CONCLUSION

Congress seems to worry about high deficits only when it wants to repeal the President's tax rate reductions or slash defense growth, and not when it wants to pass pork-barrel projects for the voters back home. If deficits and government spending are as out of control as the congressional rhetoric on tax and defense issues would claim, then the compromises inherent in the Hatch-Gramm proposal are essential.

Only the Hatch-Gramm Budget freeze tackles the exploding growth of entitlements, not by decimating assistance to the poor, but by ending the annual circus of special interest pleading and congressional vote buying. At the same time, it offers compromise on defense and assures the income security of the elderly. All it does not do is raise taxes--and that is something every American taxpayer and businessman should heavily endorse.

Most important, the Hatch-Gramm budget freeze gets the nation out of the degenerating cycle of taxes, recession, deficits, and more taxes, with a sound fiscal plan for economic recovery.

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4 Michael Schuyler, "Structural Defitits - The Big Scare," Economic Report No. 13, Institute for Research on the Economics of Taxation, April 5, 1983.