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

Daniel J. Mitchell
John M. Olin Fellow

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 repeal 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 exceeded 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 spending 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.

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.