The Heritage Foundation Backgrounder

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Rx FOR THE FEDERAL DEFICIT: THE FOUR PERCENT SOLUTION

INTRODUCTION

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

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

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

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

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

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

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

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

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

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

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

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

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

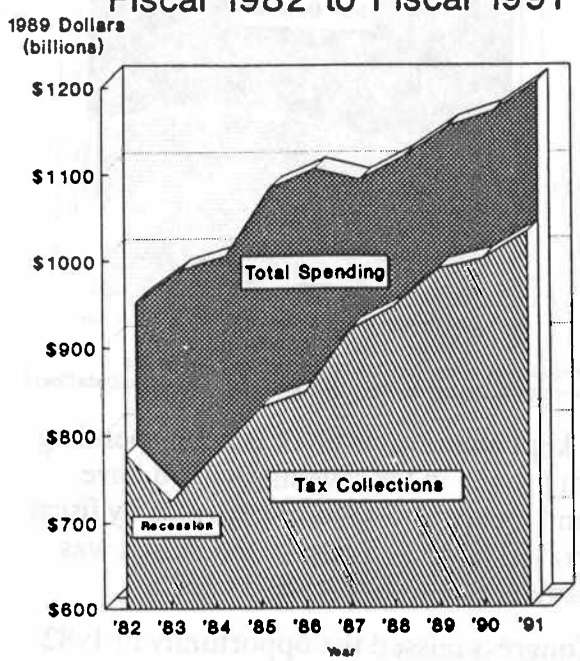
SPENDING IS OUT OF CONTROL

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

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

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

Spending and Tax Collections
Fiscal 1982 to Fiscal 1991

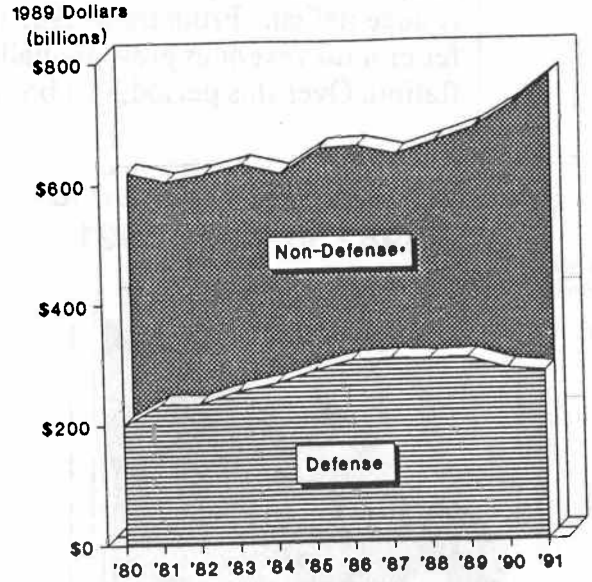


1990-1991 does not include S&L Bailout HeritageDataChart

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

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

MISSED OPPORTUNITIES



*Non-defense spending excluding interest payments
1990-1991 does not include S&L Ballout HeritageDataChart

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

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

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

The hundreds of hours that budget negotiators have been spending in their "summit" deliberations this year could have been avoided had Congress not spent every new dollar of tax revenues generated by economic expansion resulting from the Reagan tax cuts of 1981 through 1984. The only check on this ten-year spending spree has been the Gramm-Rudman-Hollings budget law, which sets deficit targets each year and mandates automatic cuts if the targets are not met. According to Heritage Foundation Economist Daniel J. Mitchell, federal spending today would be $300 billion greater than it is had Gramm-Rudman-Hollings not slowed the nominal 9.9 percent increase of congressional spending from 1980 to 1985.[1] The annual pace of spending increases slowed to 4.8 percent after Gramm-Rudman-Hollings went into effect in 1986.

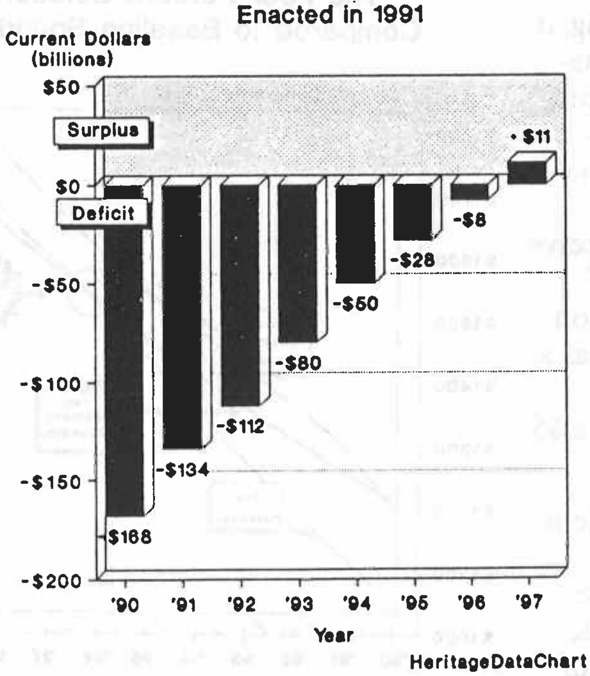
THE FOUR PERCENT SOLUTION

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

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

Rx For Chronic Deficits: The Four Percent Solution

Enacted in 1991



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

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

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

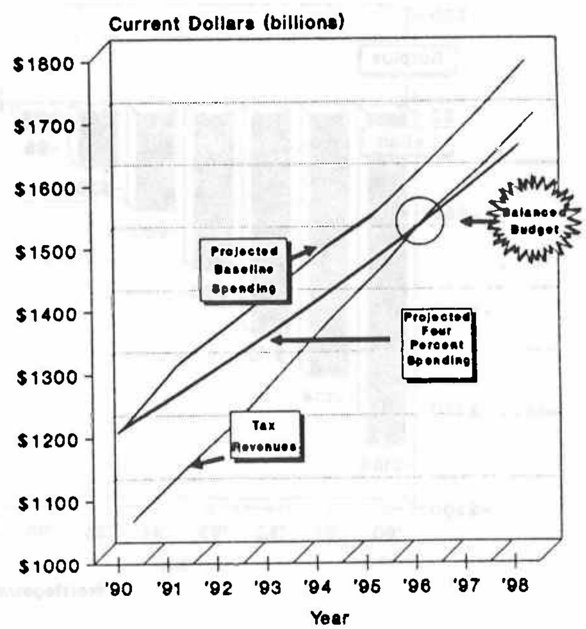
The Four Percent Solution Timetable

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

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

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

The Four Percent Solution
Compared to Baseline Spending



HeritageDataChart

The baseline budgeting charade is the reason why federal spending soared in the 1980s despite all the claims of spending cuts. Congress, and lately the President's Office of Management and Budget, uses baseline budgeting to disguise their failure to cut spending. The baseline budgeting method should be dropped. A commonsense method should replace it. The word "cut" should be used only if a program costs less than it did in the previous year. The word "increase" should be used any time a program costs more than it did in the previous year. This is the method and vocabulary used by Americans to run their household budgets and by corporations to run their business budgets.

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

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

HOW TO LIVE WITH A SEQUESTER

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

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

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

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

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

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

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

HOW TO MANAGE A TEMPORARY SEQUESTER

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

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

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

1) Meat and Poultry Inspection;

2) Quarantine and Inspection Functions;

3) Some FBI functions;

4) Many Federal Prison System functions;

5) Some Postal Service functions;

6) Air Traffic Control functions.

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

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

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

MAKING THE MOST OF THE SEQUESTER

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

CONCLUSION

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

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

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

Scott A. Hodge
Grover M. Hermann Fellow in
Federal Budgetary Affairs

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