UPDATE

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THE BUDGET SUMMIT AGREEMENT: SERIOUS DAMAGE TO THE ECONOMY, PART I

(Updating *Backgrounder* No. 787, "Rx for the Federal Deficit: The Four Percent Solution," September 4, 1990.)

George Bush and Congressional leaders at the budget summit have reached an agreement that will damage the economy very seriously. Among the most damaging aspects of the agreement:

♦ A huge tax increase that will lower living standards for most Americans. The increase in the gasoline tax is particularly harsh, adding to the hardship that Saddam Hussein has inflicted on the American consumers. The overall tax increase probably will push the United States into a full blown recession.

♦ Spending continues to rise, despite the misleading claims that spending has been cut drastically.

♦ The few tax credits for businesses, while not bad in themselves, follow the national industrial policy approach to the economy. Rather than cutting taxes across the board, the government targets particular kinds of investors for special privileges.

♦ No strong enforcement mechanism. The agreement, for example, does not contain a line-item veto. Where spending increases in popular programs are limited, Congress can (and will likely) restore funds after the full agreement is accepted.

The numbers released by Office of Management and Budget Director Richard Darman are so confusing that few Senators and Congressman can figure out exactly what it is they are being asked to vote on. The agreement is the most successful use of blue smoke and mirrors to date by the budget summiteers. However, a number of facts do stand out:

- In fiscal 1991, total federal spending will still increase by 4.5 percent, or $55 billion, over fiscal 1990 levels, excluding the costs of the S&L bailout.
- By fiscal 1995, total federal spending will be $222 billion higher than fiscal 1990 levels, an increase of 18.4 percent.
- In fiscal 1991, tax revenues were projected to grow by $77.7 billion over fiscal 1990 levels. With the summit agreement raising $16.2 billion in new taxes, total tax revenues in 1991 will be $93.6 billion higher than fiscal 1990 levels.
- Gross National Product is projected to grow by $1.8 trillion during the next five years. This assumption is highly questionable. Even if such growth occurs, the $133.4 billion tax increase will take 7.44 percent of every new dollar of economic growth over the next five years.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

- Defense spending bears 100 percent of the reductions in discretionary spending during the first three years of the agreement. During the first three years, domestic discretionary spending will rise by $23.6 billion, an increase of 12 percent.

MANDATORY SPENDING "CUTS"

A number of the so-called "spending cuts" are nothing of the kind. Examples:

1)**Agriculture Commodity Credit Corporation:** The supposed $1.3 billion cut still represents at least a $700 million increase over fiscal 1990 levels.

2)**Medicare:** Medicare spending will still grow by $4.4 billion in fiscal 1991 even with the $4.6 billion "cut."

3)**Civil Service Lump Sum Elimination:** This does save money in the first year or so, *but* it does little to reduce future liabilities of the Civil Service Retirement System.

4)**Guaranteed Student Loans (GSL):** The summit agreement hopes to accrue $2 billion in savings over five years. This pales in comparison with the $2 billion in GSL losses expected in 1991 alone.

MANDATORY SPENDING "USER FEES"

Most of the "user fees" agreed to in the summit are not user fees in the legitimate sense of the word. For instance, charging nuclear energy companies for the privilege of being regulated is not a user fee, it is a tax.

TAXES

The government currently projects that it will collect an additional $397.8 billion in revenues over the next five years. The budget agreement contains $133.8 billion in explicit tax increases, bringing total new revenues to $428.9 billion. The major new tax provisions include:

- A 12 cents per gallon increase in gasoline taxes (2 cents of which would be levied at the wholesale level);
- An increase in tobacco, beer, wine, and alcohol excise taxes;
- A 10 percent tax on so-called luxury items, which, in effect, is the first phase of a national sales tax;
- Changes in the tax code increasing taxes on American businesses;

Among the problems with the tax increases:

♦ The package destroys the insurance nature of Medicare. Specifically, it raises the cap on income subject to the payroll tax from $51,300 to $73,000. This is a direct tax on earnings. Nothing dampens an economy more than such a tax.

♦ The agreement undermines the protections in the tax code for home ownership, state and local taxation, and charitable deductions by restricting the use of itemized deductions.

There are many hidden tax increases in the agreement. Several of these are under the "spending cut" portion of the package. For example:

- The monthly tax that senior citizens pay to Medicare will be increased; yet the revenues generated by that change are counted as a spending cut.
- Seventeen different fees are to be increased, generating an additional $14.2 billion in revenue for the government over the next five years; yet the revenue is to be counted as a spending cut.
- Nearly $5.4 billion of the supposed spending cuts are actually revenues from the Postal Service, which is now off-budget, resulting in no real savings.
- The agreement contains an automatic tax increase provision. Thus every tax cut must be offset by tax increase. At the very least, this provision effectively eliminates any opportunity to pass tax-cut legislation to pull the economy out of the recession which the budget agreement will cause.

ECONOMIC ASSUMPTIONS

White House and congressional negotiators conspired to "cook the books" to minimize the obvious negative effects of the agreement. While most economists agree that the package will reduce economic growth, the budget summiteers somehow make the assumption that enactment of the package will nearly double the rate of growth next year (from 0.7 percent to 1.3 percent) and almost triple growth in 1992 (from 1.3 percent to 3.8 percent).

Negotiators have explicitly stated that they want the Federal Reserve Board to adopt an easy money policy in response to the agreement, yet they ignore the inflationary impact of such a policy by assuming that the inflation rate (as measured by the GNP deflator) will fall to 2.8 percent by 1995. Perhaps the most unrealistic element is the assumption that interest rates will decline. More than $25 billion of the alleged savings hinges on the interest rate on three-month Treasury bills falling to 4.2 percent and rates for 10-year Treasury notes dropping to 5.3 percent. Since interest rates normally rise and fall with changes in the inflation rate, this assumption has no credibility.

CONCLUSION

As it stands, the budget agreement is the same old blue smoke and mirrors that have blinded taxpayers for years. The American taxpayer should not shoulder the burden of higher spending just because Congress cannot control the budget. Before any decisions are made on this agreement, the summiteers and Congressman must be clear about the true nature of this proposal: It will damage the economy very seriously.

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