Executive Memorandum

The Heritage Foundation

214 Massachusetts Avenue, N.E. Washington, D.C. 20002-4999 (202) 546-4400

RUSH!

9/21/90

Number 281

THE FOUR PERCENT SOLUTION TO THE DEFICIT IMPASSE

Whether the current budget summit yields an agreement on the federal budget deficit or not, the negotiations graphically demonstrate that the federal government's budget process has broken down completely. Congress currently is set to spend the $79 billion it will receive next year in new revenues—and more—rather than using these funds to reduce the budget deficit. Indeed, over the last decade, every dollar in new revenues has been accompanied by more than a dollar of new spending. And the budget summit, which was meant to bring congressional and Bush Administration leaders together behind closed doors to work out an agreement to cut the deficit, has yielded almost nothing but calls for higher taxes. Now the economy is showing disturbing signs of a possible recession, due in part to the spectacle of a government unable to control its spending but eager to raise taxes.

Rather than taking more money out of productive enterprises and the pockets of American consumers, which could guarantee a recession, many policy makers are rallying around a proposal that rejects higher taxes and instead reduces the budget deficit by limiting total annual spending increases to 4 percent.

With federal revenues already projected to climb by $79 billion next year, and by $373 billion over the next five years, this "Four Percent Solution" would reduce the budget deficit to only $33 billion by 1995, and produce a balanced budget soon after (see table).

THE FOUR PERCENT SOLUTION
(in $billions)

Year	1990	1991	1992	1993	1994	1995
Spending*	1,192	1,240	1,289	1,341	1,394	1,450
Revenues	1,044	1,123	1,188	1,260	1,337	1,417
Deficit	148	117	101	81	57	33

*Assumes Congress will take the costs of the Savings and Loan deposit insurance bailout off-budget.
Source: Congressional Budget Office

This cap on spending growth still would allow policy makers to spend more on all programs—or even increase spending well over 4 percent for some programs if they cut back or terminate others.

And perhaps more important, by precluding higher taxes, the Four Percent Solution will leave more resources in the productive private sector of the economy, making a recession less likely.

Yet this, or any other budget proposal, still will fail unless there are stronger enforcement mechanisms to prevent Congress from violating spending limits — as it has done routinely. The Four Percent Solution thus should include tough major budget process reforms. In particular, Congress should:

1) **Establish Gramm-Rudman Outlay Targets.** Under the Gramm-Rudman Deficit Reduction Act, spending automatically is cut across the board, or "sequestered," if the projected deficit exceeds the Gramm-Rudman target deficit. Lawmakers, however, can evade the law's intent simply by over-estimating projected revenues, thereby permitting even larger spending increases. Once it becomes apparent that the revenue projections were inaccurate, the sequester has already passed.

Establishing outlay or spending targets should eliminate this loophole. Under this approach, the current deficit targets would be augmented by outlay targets. Whenever projected spending in any fiscal year was above the target level permitted in the law, sequestration would be triggered to bring outlays back down to the legally required level.

2) **Create a Second, Mid-Year Sequester.** Even with outlay targets, however, politicians still would have an incentive to underestimate future spending in order to make program expansions and new spending legally possible. Congress could also continue its practice of waiting until after the October 15 sequester deadline passes to enact expensive spending bills.

These loopholes could in large part be closed by creating a second sequester in the middle of the fiscal year. If a mid-year estimate showed that spending was exceeding the new outlay target, automatic cuts would reduce spending by the necessary amount. Such a reform would give Congress less leeway to exceed its own targets.

3) **Abolish Current Services Budgeting.** Much of the public confusion surrounding the entire budget debate is caused by Congress's bizarre definition of a budget "cut" — legislating a reduction in a projected increase. Thus according to Congress's version of a cut, if a businessman raised his prices 15 percent instead of the 25 percent he had intended, that would be a price cut of 10 percent. This phony accounting system, known as the "current services budget," distorts honest debate and builds political pressure for higher spending.

Other proposals before Congress would further tighten the budget process. Among them: "pay-as-you-go budgeting," which would require new spending increases to be offset by reductions elsewhere in the budget; super-majority votes to raise taxes or violate Gramm-Rudman targets; a line-item veto; and a constitutional amendment to limit taxes and maintain a balanced budget. After tightening the Gramm-Rudman law, Congress should give urgent attention to such proposals.

The Four Percent Solution, enforced by budget process reforms, would help reignite strong economic growth by bringing the stubborn budget deficit finally under control. Spending control is the tool to curb the deficit. Tax increases are not. Tax increases approved by budget summits were tried in 1982, 1984, 1987, and 1989. In each case, the budget deficit increased the following year. Tax revenues now consume almost 20 percent of America's gross national product (GNP) — a near-record high for peacetime. Ominously, the only two times outside of World War II that tax collections have exceeded 20 percent of GNP, in 1969 and 1981, the economy fell into a recession the following year. The Four Percent Solution, backed up with reforms to tighten the budget process, would avoid the recession tripwire, allowing Americans to look forward to declining federal deficits and robust economic growth.

Daniel J. Mitchell
John M. Olin Fellow