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THE BUDGET, THE DEFICIT, AND GRAMM-RUDMAN

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Once again it is time for debate over the federal government's budget, and again Congress and the Reagan Administration are battling over how to reduce $200 billion deficits. The basic issues are not very different from last year (see LCR #145). The Reagan Administration continues to seek increases in military spending combined with cuts in most domestic programs, while adamantly opposing any tax increases. Congressional Democrats, on the other hand, would prefer to maintain most social programs, while holding the line on defense spending. What is new this year is that the universal sentiment calling for deficit reductions is embodied in the Gramm-Rudman bill mandating specific deficit targets between now and 1991. While the crucial implementing mechanism of Gramm-Rudman was recently declared unconstitutional by a federal court, it is still being implemented pending a final ruling, and in any case the political pressure to reduce the deficit remains.

What's So Bad About the Deficit? -- According to Keynesian economists there is nothing inherently wrong with deficits. When the economy is operating below full employment it is appropriate to run a deficit in order to stimulate the economy. Increased government spending contributes to output, and, along with higher transfer payments and lower taxes, puts greater purchasing power in the hands of the public. Since tax revenues increase with income, economic growth will reduce the size of the deficit. Ideally, according to the Keynesians, the budget should be written so as to be balanced if the economy were operating at full employment.

Today's deficit, however, does not fit the Keynesian prescription. The current deficit stems not so much from the absence of full employment, but rather from major policy decisions undertaken by the Reagan Administration. It is estimated that the 1981 tax cut has cost the government approximately $100 billion a year, while the defense budget has risen cumulatively by over $100 billion since 1981. In spite of this, the Administration is insisting on a further 11.9% increase in defense spending (or about 8% even after adjusting for inflation), while continuing to oppose any increase in taxes.

Most economists agree that the existence of a deficit causes interest rates to rise. This makes it more difficult for working Americans to buy houses, autos, and other durable items. It also increases the cost for businesses seeking to invest in new plant and equipment. In addition, high interest rates help to keep the dollar overvalued relative to foreign currencies. Many jobs have been lost in the auto and steel industries, among others, because the strong dollar has left them vulnerable to foreign competition. Whether or not interest rates are high depends largely on the actions of the Federal Reserve (see LCR #177), but large deficits make it more likely that the Fed will keep them high.

The Impact of Gramm-Rudman -- The Gramm-Rudman bill reflects a broad consensus that the present deficit is too large. It mandates a set of successively shrinking deficit targets beginning with $144 billion in fiscal 1987 and culminating in a balanced budget in 1991. If the budget proposed by Congress meets that year's target no further action is required, but if not, and if no alternative budget acceptable to the President and meeting the Gramm-Rudman targets can be worked out within 30 days, then automatic across-the-board cuts will go into effect. Cuts totaling $11.7 billion for fiscal 1986 have already been implemented, and current estimates suggest that $38 billion in additional cuts will be needed this fall should no compromise be reached. Since interest on the national debt (which has risen largely as a consequence of the Reagan deficits), Social Security, some antipoverty programs, and many defense contracts are specifically exempt from automatic cuts, this could mean reductions of as much as 15% in nonexempt programs.

The reason Gramm-Rudman exists in the first place is because nearly everyone agrees that the deficit is much too large, but that nobody agrees on how to eliminate it. By providing for automatic cuts, whereby no effort is made to sort out priorities, its supporters hope that it will force meaningful negotiations over budgets for 1987 and beyond. The automatic nature of these cuts means that, for instance, AIDS research would receive no greater priority than would subsidies to corporate farmers.

Supporters argue that this very feature will induce compromise, on the grounds that almost anything will seem preferable to the automatic spending cuts. This reasoning is rather dubious, as it may be easier for a Congressperson about to face the voters to reject specific cuts which might be unpopular among constituents, yet claim to have helped bring down the deficit by supporting Gramm-Rudman. Another difficulty with the bill is that its deficit reduction targets themselves are inflexible. If the economy were to fall into another recession we might like to see an increase in the actual deficit, yet adhering to specific targets will require smaller deficits, thus making the recession worse. The bill does permit the targets to be waived for one year in the event of a recession, but requires that any deviations be made up in the next year regardless of the state of the economy at that time.

A Federal court recently ruled the provision calling for automatic cuts unconstitutional, and the Supreme Court is expected to affirm this decision. A fallback provision calls for Congress to vote explicitly on the "automatic" cuts, but this effectively kills Gramm-Rudman. Ironically, though, Congress may be more likely to reach an acceptable compromise, including the possibility of a tax increase, given the pressure for some form of deficit reduction. The Reagan Administration's budget proposal, calling for $33 billion in increases for defense and $23 billion in domestic program cuts, with only minor revenue increases, is given no chance of passage.

Politically any increase in income taxes seems out of the question, given Reagan's opposition, but it may be possible to raise taxes through other means. For instance, there is some support for a proposal to take advantage of lower oil prices by imposing an oil import fee or increasing the gasoline tax. This would be a relatively painless way to cut the deficit, but will not by itself raise enough revenue to meet even this year's Gramm-Rudman target. A sort of national sales tax has also been proposed; it would raise much more revenue but have the disadvantage of increasing prices of all goods, hitting low income people particularly hard. Another proposal is for a one-time amnesty for tax evaders; this has the appeal of raising revenues (from those who pay back taxes) without penalizing honest taxpayers, but faces opposition on moral grounds and, in any case, would only postpone fundamental decisions on priorities.

The reality of the situation is that such decisions do have to be made this year. It is by now painfully obvious that Reagan's tax cut, his military buildup, and a balanced budget are mutually exclusive goals. Some workers have benefited from lower taxes, but at some point we will have to pay for the military buildup. A similar situation occurred in the 1960s when the Johnson Administration tried to conduct the Vietnam War and the War on Poverty without raising taxes. We ended up paying the price through higher inflation, and, later, high unemployment as the government tried to fight inflation. Today we are faced with a similar dilemma. There does not seem to be much room for further reductions in social programs, and Gramm-Rudman (or the underlying political pressure) may finally force the public to choose between a tax increase and a halt in Reagan's defense buildup.

-- *David Brauer*