MANUFACTURERS' ALLIANCE Policy Review

1200 EIGHTEENTH STREET, NW, WASHINGTON, DC 20036 • 202/331-8430 • FAX 202/331-7160

PR-129 April 1994

IS THE BUDGET DEFICIT STILL A PROBLEM?

Is the Budget Deficit Still a Problem?

was prepared by

Joseph V. Kennedy
Attorney/Economist

Further information on this subject may be obtained
by contacting him at 202/331-8430

Initial distribution of PR-129 is being made to presidents and financial officers of the Manufacturers' Alliance and to members of the Alliance's Strategic Planning and Development Council.

Is the Budget Deficit Still a Problem?

Administration's Budget for Fiscal Year 1995 Proposes Little Further Action on Deficit Other Than "Presumed Savings" From Health Care Reform; Deficit Remains a Serious Constraint on Long-Run Growth and Job Creation

Introduction

The Administration's fiscal year (FY) 1995 budget represents the second installment of President Clinton's economic vision for the country. Because it is also the first budget over which Administration officials have full control, it is an important statement of the direction in which they wish to move the nation.

This report examines the importance of budget deficit reduction both over the past year and over the next few years. Its central message is that the final FY 1995 budget is likely to be only marginally different from the one that Congress would have passed had the opposing political party been reelected. The long-run implications of failure to achieve additional deficit reduction are discussed. This analyses concludes that far from solving the problem, the budget deficit reduction of last year achieved only one-third to one-fourth of what is needed to fully balance the federal budget. Given the impact of demographic change on the government expenditures in the next decade, failure to continue on the path toward a balanced budget will have serious adverse effects on U.S. economic performance.

The General Outlook

The federal budget is both a political and a financial document. Each year, the budget presents the incumbent administration with its best opportunity to state in detail how the government should allocate its scarce resources to meet a wide range of economic and social policy goals. In order to complete the budget, the Administration must make hundreds of explicit and implicit decisions about the relative importance of specific expenditure programs and tax policies.

Yet, increasingly, many of these important decisions are being withdrawn from the control of succeeding Administrations. Since 1980, the percentage of the budget over which the Administration and the Congress exert direct control each year has shrunk from 47 percent to an estimated 36 percent in FY 1995 (Table 1). The balance of expenditures—mandatory spending for entitlements and interest payments on the debt—is set by law. In entitlements, the government never makes a binding decision on how much money to spend. Instead, it enacts qualifying standards and lets spending fall where it may. Although the Congress and the President always can change the law governing mandatory entitlements, the power of interest groups and the fact that the checks keep coming if nothing is done give defenders of the status quo a powerful advantage. Even in the discretionary programs, which must be approved each year, the presence of long-term procurement contracts, obligations to existing employees, and the influence of vested interests limit the Administration's ability to make significant changes from year to year. As a result, the difference between the budgets submitted by different administrations often amounts to only a few tens of billions of dollars out of a total budget of $1.5 trillion.

Table 1
Composition of Government Spending, 1980-1995
(Percent)

	1980	1985	1990	1995*
Discretionary	46.8	44.0	40.1	35.7
Mandatory	44.3	42.3	45.2	50.3
Debt Service	8.9	13.7	14.7	14.0
TOTAL	100.0	100.0	100.0	100.0

*Estimate
Source: Office of Management and Budget.

Every incumbent administration normally avails itself of the political opportunity afforded by the budget. In reading the budget and its auxiliary reports, one typically learns that the economic and social failures to be corrected were due to the failed policies of prior administrations. In the current instance, there is no mention of the history of low inflation inherited from previous administrations or of the 1986 Tax Reform Act that eliminated numerous inefficiencies in the tax laws and took millions of lower income workers completely off the tax rolls. In rightly taking credit for completion of the NAFTA and GATT trade agreements, the current Administration ignores the arduous groundwork laid by its last

two predecessors. The budget also does not mention the impressive achievements in industrial productivity and competitiveness, nor the end of the Cold War that has made possible dramatic cuts in defense.

All administrations celebrate favorable results that occur on their watch and assign defeats to the legacy of past administrations or to the influence of forces beyond their control. Certainly, previous administrations committed serious errors that influence the current economic picture. The problems of the American economy today, however, cannot simply be assigned to past sins of omission or commission and then be dismissed. The growing disparity in wages and living standards among Americans has far more to do with increased global competition and much faster technological innovation than it does with choices made by past leaderships. Similarly, the rapid growth in entitlements has replaced the tax cuts and increases in defense expenditures in the early 1980s as the leading source of continuing large deficits. Many of these entitlement programs consume an increasing share of resources while failing to accomplish many of the goals that they were originally intended to achieve.

Structural Issues

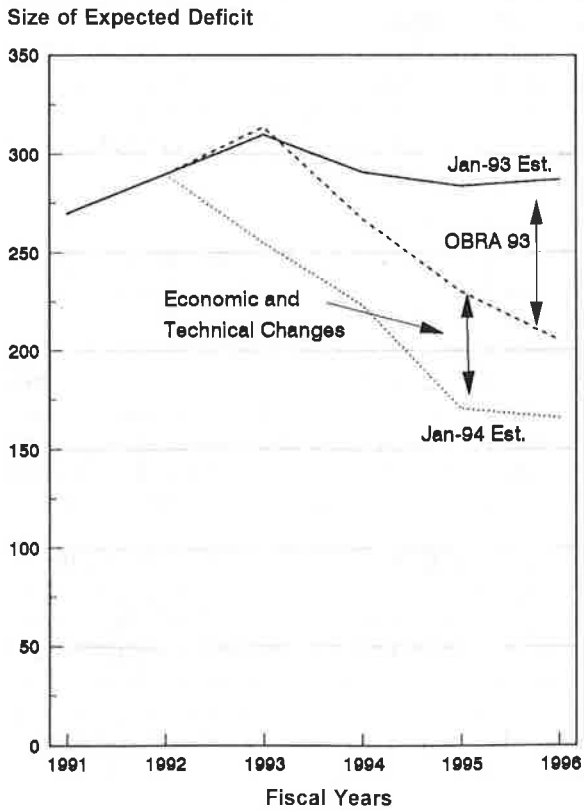
In some parts of the budget, the Administration recognizes that there are difficult structural problems. However, these challenges seem only to invoke marginal changes in existing programs. The Administration came into office promising to end the stalemate of divided government; a stalemate it attributed to partisan conflicts. In many respects, however, political conflicts were along institutional rather than party lines: between an administration arguing for change and a Congress institutionally wedded to the status quo by maintaining support for traditional programs developed in response to social and economic problems of the 1960s and 1970s. The current Administration may yet find that the penchant of the congressional leadership for ever more largesse continues to frustrate policy changes, especially in areas such as deregulation, welfare reform, crime, the streamlining of government, defense reengineering, and middle- and upper-income entitlements, where its views are closer to those of the preceding administration than to the Democratic leadership in the Congress. The central challenge facing the incumbent Administration is not to make marginal changes to existing programs, but to promote the structural reforms needed to lead the country into the future.

Finally, it is unclear whether the Administration still regards the budget deficit as an important constraint on economic growth. This reflects a split within the Administration and the Democratic party over the importance of the budget deficit as a political and economic issue. The message one gets from the FY 1995 budget and from the congressional majority's opposition to attempts to cut the budget further is that the current Administration has done its share of heavy lifting and that further efforts to reduce the budget deficit in FY 1995 should be largely confined to health care reform—which, incidentally, is likely to prove elusive as a source of budget savings.

The Improved Budget Picture

The FY 1995 budget correctly states that the deficit picture is much improved from one year ago. Chart 1 compares the forecasts made by the Congressional Budget Office (CBO) in January 1993 and in January 1994. Chart 1 also shows how much of the total decrease in estimated deficits is due to the passage of OBRA '93 as opposed to economic and technical changes. Approximately half of the improvement through FY 1996 comes from passage of OBRA '93. The other half results mainly from a combination of lower interest rates, improved economic growth, and changes in the estimated cost of insuring bank deposits. Almost all the improvement in FY

Chart 1
Sources of Deficit Reduction
(Billions of dollars)



Source: Congressional Budget Office, Economic and Budget Outlooks and Midsession Updates.

1994 is due to economic and technical changes rather than new policy. As also shown in Chart 1, policy changes actually ***increased*** the deficit last year, and the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) is not expected to produce major budget savings until FY 1995.

Interest Rates

In the first 12 months following the election, long-term interest rates dropped by 159 basis points. The FY 1995 budget attributes most of this decline to successful deficit reduction efforts. Nevertheless, interest rates already were dropping by fall 1992, several months before the current Administration presented its FY 1994 economic program and almost a year before passage of OBRA '93. Moreover, as shown in Chart 2, the fall in interest rates was a global event. Although lower deficits no doubt helped sustain it, much of this drop is due to slow economic growth or recession in other industrialized nations and a continuation of low rates of inflation in the United States. This point is not academic. If falling interest rates were due largely to global forces rather than to the Administration's budget efforts, then rising interest rates are likely to accompany economic recovery overseas and to foster fears of rising inflation. This would cause the budget deficit to rise above current projections. The yield on long-term U.S. government bonds has risen 69 basis points since the Administration introduced its FY 1995 budget.

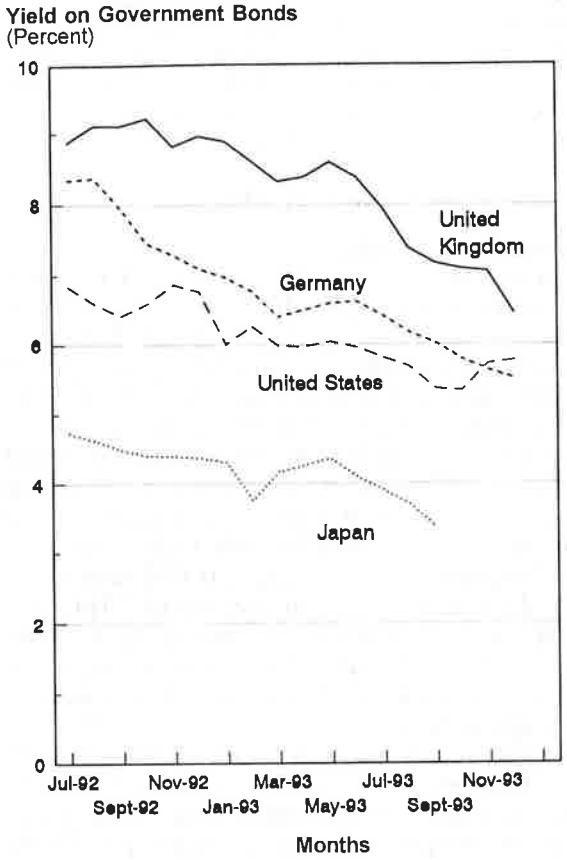
Economic Growth

Higher economic growth reduces the deficit by increasing tax revenues and reducing spending on income support and unemployment programs. Over the past year, the economy has continued to rebound from the last recession. Although the Administration claims credit for this recovery, its policies only made marginal changes in the overall economy, and its initiative to boost the economy by increasing government spending was defeated early in the year. The budget reduction effort is likely to continue to benefit from economic growth. Economic recovery overseas could improve matters even further by boosting U.S. exports and income.

OBRA '93

The Administration points with pride to the passage of its deficit reduction bill last fall. However, a glance at recent history puts this legislation in a slightly different perspective. Although neither Bill Clinton nor George Bush made deficit reduction a priority early in the election campaign, the sheer size of impending deficits would have forced the next President to engage in another round of deficit reduction. The decision of presidential candidates Paul Tsongas and Ross Perot to press this issue as the 1992 presidential campaign progressed forced deficit reduction to the front of the political agenda facing the eventual winner in November.

Chart 2
Long-Term Interest Rates in Selected Countries



Source: International Monetary Fund, *International Financial Statistics, various issues.*

Deficit reduction bills have become a regular event in domestic politics. Over the last decade, a series of these bills has been passed every two to three years. None has solved the underlying problems causing the deficits. The primary concern of each attempt has been to contain the deficit while postponing most of the tough decisions until later years. Since the last deficit reduction effort in 1990 claimed $492 billion in deficit reduction over the normal five-year budget horizon, this amount was the logical starting point for the next administration. Despite claims that OBRA '93 will save $508 billion over five years, the CBO estimates that the legislation will reduce the deficit by $433 billion.[1]

[1]CBO, *The Economic and Budget Outlook: An Update*, September 1993, p. 29.

The real difference between the budget bill that was passed in August 1993 and the one that would have been passed had George Bush been reelected is probably less in the magnitude of deficit reduction than in the mixture of tax increases and spending reductions used to achieve that total. Since any proposal still would have had to pass a Democratic Congress, even that difference may have been marginal.

A Review of the Administration's 1995 Budget

Discretionary Spending

As stated above, only 35.7 percent of the total budget requires action by the Administration and Congress this year (see Table 1). Table 2 lists the major categories of discretionary programs. There are several points worth noting in this category. The 1990 Budget Agreement required the Administration and the Congress to hold total discretionary spending in 1995 to roughly the same absolute level as last year. Last year's budget agreement extended these caps on total spending out through 1998. As a result, total spending in these programs will remain flat in nominal terms for the next four years. This will force cuts in real spending of roughly 12 percent. Over the past two decades, the Congress has never shown the discipline needed to budget within constraints such as these.

Defense.—In its first budget, the Clinton Administration finessed its projection of future defense spending reductions by borrowing numbers proposed a year earlier by then-Congressman Les Aspin without explaining the exact spending reductions needed to attain the goals. Since then the Administration has conducted a bottom-up review of defense requirements in the post-Cold War world. The projections contained in this year's budget represent the Administration's view of those requirements.

In his State of the Union address, President Clinton stated that further defense cuts would be unwise. Having supported the Administration's original attempts to cut defense from the last recommendations of the Bush Administration in 1992, conservative Democrats also have indicated their discomfort with proposals for additional cuts. Together with most Republicans, they now probably represent the majority within the Congress. Nevertheless, a number of liberal Democrats believe larger defense cuts are both possible and necessary in order to fund domestic priorities. These include the new Chairman of the House Armed Services Committee, Ronald Dellums (D-CA). Defense spending will therefore remain a point of contention. Note, however, that the disputes are now reduced to several billions of dollars per year. Since 1989 defense spending has fallen by 29 percent in real terms.

Within the defense budget, the Administration is stressing operations and maintenance over weapons procurement. This means that existing stocks of weapons are being drawn down, presumably to levels that reflect the reduced strategic threat. Beginning in 1997, however, procurement will have to rise again to fulfill current needs. The Administration finesses the issue of where this extra money will come from. There are two possible sources—apart from higher taxes and/or more borrowing. The first is lower-than-expected inflation, which would reduce procurement and personnel costs. The second is through significant improvements in defense efficiency, including procurement reform. If neither of these savings materialize, there is real doubt as to whether the Administration's projections can support its own assessment of the nation's security needs.

Table 2
Major Discretionary Spending Programs
(Billions of dollars)

	Constant (1987) Dollars					Current Dollars		
	1980	1985	1990	1995*	1999*	1994*	1995*	Percent of Increase or Decrease
Defense	187.9	261.5	273.2	206.9	175.2	280.6	271.1	-3.4
International	18.0	18.2	16.9	16.1	14.7	21.8	20.8	-4.6
Education	17.3	14.5	16.3	20.0	19.9	26.1	25.9	-0.8
Transportation	29.4	26.7	26.0	29.8	28.0	37.1	37.9	2.2
Health	13.5	11.9	15.2	20.0	20.7	22.4	24.7	10.3
Housing Assistance	7.8	12.2	13.5	18.8	17.9	23.7	25.3	6.8
Natural Resources	21.7	15.9	15.8	16.9	15.4	22.3	21.8	-2.2
Other	91.3	73.0	75.1	88.3	90.9	116.1	116.0	-0.1
TOTAL	386.9	433.9	452.0	416.8	382.7	550.1	543.5	-1.2

* Estimate (excludes Health Security Act and other allowances).
Source: Office of Management and Budget, *Budget of the United States Government Fiscal Year 1995*, Historical Tables.

The political and economic impact of *past* decisions to cut defense spending also will continue to be felt. A number of major military bases will be closed this year and next as a result of the first round of decisions of the Base Closure Commission in 1991. Last year, the Commission voted to close or realign an additional 32 bases. The Administration's projections virtually guarantee that it will recommend an even larger number of base closings when the Commission makes its final round of cuts in 1995. In addition, continuing cuts in weapons purchases and manpower levels will produce a further downsizing within the defense industry. Even the most liberal members of the Congress have resisted the impact of such cuts when they occur in their districts.

Emergency exceptions.—The Administration recently requested $11 billion in additional spending to cover a variety of emergency needs, including the earthquake in California and peacekeeping in Bosnia and Somalia, and firmly resisted efforts to offset the increased spending with cuts in other programs. The Administration also refused to count this money against the total cap on discretionary spending, adding it directly to the deficit. Although the budget law allows such exceptions, their use indicates that the Administration is willing to ignore budget constraints when meeting them becomes too difficult. It also demonstrates a reluctance to engage in further deficit reduction at this time.

Domestic spending.—The budget proposes the elimination of 115 government programs and significant cuts in others. Most of these proposals were recommended by prior administrations and rejected out of hand by the Congress. The Administration hopes that it will have more luck by proposing to use any savings to increase spending in other programs rather than to reduce the deficit. In general, the Administration proposes to increase spending in programs dealing with technology, worker training, education, and the environment.

These proposals are likely to be controversial for two reasons. First, although many Republicans and conservative Democrats will support the program cuts on policy grounds, they will argue that the savings should go to deficit reduction rather than further spending. The Administration's claim that the lower interest rates and higher growth of the past year are largely due to its efforts to reduce the deficit suggests that the economy would benefit more from further deficit reduction than from increased spending on social programs. Second, the Democratic leadership in the Congress remains committed to most existing programs. Having spent the last two decades building these programs up and defending them from attacks questioning their cost-effectiveness, they are unlikely to view their sudden termination dispassionately. To its credit, the Administration generally has attempted to redirect this spending toward the poor and others in need. However, the Administration may have underestimated the degree to which legislators identify the pattern of existing spending with their own political interests.

In spite of the heat such disputes are likely to cause, they involve only a small portion of the total budget. The proposed terminated programs account for only $3.4 billion in government spending out of a total budget of over $1.5 trillion. They are marginal indicators of government's priorities and have a negligible impact on the deficit.

The caps on total discretionary spending will require even more pain next year. Past deficit reduction efforts demonstrate that the Congress has a low threshold for pain. Whenever making further spending cuts or revenue increases has become politically difficult, the Congress has struck a new deal with the Administration in power, resetting the goals and postponing the most difficult decisions.

Mandatory Spending

Last year's budget agreement, OBRA '93, did little to address the fundamental forces driving the deficits. Table 3 on page 6 lists the major entitlement programs. In spite of the agreement and the recent improvement in economic indicators, the budget deficit will continue to burden this Administration as well as its successors well into the future. For most of the nation's history, the moral aversion against running deficits, except in times of national emergency, and the absence of large entitlement programs implicitly linked the decision of how much to spend with the willingness of public officials to incur the public's wrath by raising revenue.

Over the last decade and a half these decisions increasingly have become separated. The separation is important because the natural desire of private interest groups for government largesse creates continuous pressure to increase government spending regardless of the effect on the budget deficit and/or whether such spending accomplishes any important public purpose. The general interest in economic efficiency and fairness has almost always been too weak to constrain calls for government growth. The movement toward large entitlement programs has further reduced the institutional barriers toward increased spending by absolving the Congress and the executive branch from any responsibility to make explicit decisions about the amount of resources devoted to these programs. Rather than decide how much to spend, the Congress determines the criteria for qualifying for government payments and then lets actual spending fall where it may. Of course, the pressure for expanding these criteria through legislation, regulation, administrative ruling, or court decision is always far greater than the pressure to reduce

Table 3
Major Mandatory Spending Programs
(Billions of dollars)

	Constant (1987) Dollars					Current Dollars		
	1980	1985	1990	1995*	1999*	1994*	1995*	Percent of Increase or Decrease
Social Security	166.0	200.1	215.0	246.9	265.7	317.6	334.5	5.3
Medicare	44.0	68.9	83.4	112.4	137.8	140.8	153.3	8.9
Medicaid	19.8	24.3	35.9	71.3	65.5	87.2	96.4	10.6
Federal Retirement	37.7	41.4	45.3	47.4	50.5	62.2	64.3	3.4
Unemployment	23.9	17.0	14.9	17.0	16.2	26.7	23.0	-13.9
Nutrition Assistance	18.6	17.9	18.6	25.4	26.5	34.4	34.5	0.3
Other	60.6	60.4	82.0	41.4	51.2	61.4	55.7	-9.3
TOTAL	370.6	430.0	495.1	561.8	613.4	730.3	761.7	4.3

* Estimate (excludes Health Security Act).

Source: Office of Management and Budget, *Budget of the United States Government Fiscal Year 1995*, Historical Tables.

them. It should be no surprise that these programs almost always exceed their projected costs.

Political pressure on the revenue side acts to restrain revenue. While reductions in the top marginal tax rates passed by the Congress early in the Reagan Administration entailed some cost, the indexing of tax brackets was much more significant. By stopping the bracket creep by which inflation pushed taxpayers into higher marginal tax brackets, indexing denied the federal government the ability to collect additional tax revenues without taking politically difficult votes. While occasional appeals to class warfare may result in increases in the marginal tax rate on the wealthiest Americans, the cost of rapidly growing entitlement spending can only be paid for by tax increases on the middle class.

Most lawmakers clearly no longer feel constrained to balance the budget. With most government spending dictated in advance by entitlement programs subject to continuing pressures to expand, and revenues limited by strong political resistance against tax increases, a continued and even growing worsening of the deficit picture seems likely. This is true even though the deficit may show occasional temporary improvement as the result of improving economic indicators or periodic deficit reduction agreements.

Health Care Costs

The Administration correctly focuses on the threat that rapidly expanding health care costs pose to the federal budget. Over the next decade, spending on Medicare and Medicaid will account for 46 percent of all increases in federal spending and for 226 percent of the expected increases in the deficit, contributing to deficits of over $350 billion by 2004. The Administration's decision to devote most of its efforts to health care reform makes sense as part of an overall strategy of deficit reduction. The Administration's approach of solving the problem through the enactment of a broad new entitlement and the creation of a new quasifederal bureaucracy is unlikely to restrain health care costs and threatens to increase the deficit dramatically.

Much of the debate about the cause of rising health care costs is similar to the debates about whether a glass is half full or half empty. The federal government already is responsible for approximately 45 percent of all spending on health care. Proponents of further government involvement, especially those in favor of a single-payer system, argue that costs are rising because no one entity is able to put a cap on overall health spending. They believe that giving the federal government this ability would enable it to impose restraints from the top. The failure of previous cost-control programs and the fact that other markets work fine without such a single payer do not bother them.

Others argue that the way in which the government exercises its 45 percent of the purchasing power itself accounts for much of the growth in health care costs. By divorcing the decision of how much to use from the responsibility to pay, the government has encouraged a massive growth in demand, much of which is not related to actual need. When people do not have to pay for their own health care, their demand for services rises appreciably. Yet someone ultimately has to pay the costs. Rising demand is encouraged by suppliers whose contracts with the government are based on the amount of services they supply. In many cases, a service's value to the patient is far below what the government agrees to

pay. By proposing additional government programs and tax subsidies which hide the cost of health care from patients, the Clinton health care plan does nothing to stop this source of rising costs. Instead, it actually broadens the federal government's commitment to subsidize health care without regard to cost.

A true solution to health care costs must distinguish between public and, if it was possible to, private costs. The contribution of rising health care costs to the deficit could of course be solved by capping expenditures on these programs. This would solve the health care deficit problem but leave many problems in the private health care sector untouched. However, as long as government remains willing to pay for a given service but leaves to other interested parties the decision of when and how much of the service to demand, costs will always be driven upward. Administrative controls and tighter regulations may temporarily control these forces, but they will never conquer them. Setting a cap on total spending is the only sure way to control these expenditures. A cap, however, does little to ensure that funds are spent efficiently or go to those who need them most. It also does not prevent the incentives created by government spending from creating problems in the private market for health care.

Rising demand for medical services will never be moderated until individuals are forced to pay more of the costs of their own health care directly. For most individuals this would require eliminating or capping the exclusion of employer-paid premiums from taxable income. By obscuring the tradeoff between rising use of health care and rising wages, this regressive tax subsidy encourages the demand push behind rising cost. The taxation of employer-paid health insurance premiums above a cap also would contribute to deficit reduction.

Social Security

In spite of numerous statements to the contrary, balancing the deficit will require a restructuring of the Social Security system. The basic premise of Social Security, that each generation can receive more from the program than it pays in, is unsustainable. Eventually, the program must be amended because tax revenues financing the system are insufficient to generate the benefits that individuals have been promised.

The Social Security trust fund is projected to run a surplus of $63 billion in 1995,[2] roughly half of what CBO estimated that the FY 1995 surplus would be in 1990. These surpluses will rise over the next several years. As a result, under current law the Social Security trust funds will not be exhausted until well into the next century. These surpluses only are made possible by a payroll tax of over 13 percent on all wages earned up to a maximum salary of roughly $60,000.[3] This regressive tax applies to the first dollar earned and younger employees will contribute more in taxes than they will ultimately receive in benefits. The decision to steer these revenues to the trust fund rather than to the general treasury perpetuates the fiction that Social Security is an insurance program rather than an income transfer program. The government could have achieved the same effect by simply raising income taxes to generate an identical amount of revenues.[4] The Administration implicitly admitted as much last year when it raised the proportion of Social Security benefits subject to taxation from 50 percent to 85 percent and devoted the additional revenue to the general treasury rather than returning it to the trust fund.

There is good cause to doubt whether younger employees will remain willing to pay such a large portion of their income into a program which will run deficits by the time they retire in order to allow older Americans to continue receiving far more out of the system than they paid into it, regardless of income. Instead, the younger generation may press for legislation to reduce these taxes or to devote the revenues to government programs that meet their immediate needs. Proposals to solve this inequity between generations by raising the payroll tax even higher or by delaying the date at which these younger workers can receive Social Security benefits miss the point.

Unfunded Liabilities

The existence of large government programs promising citizens future cash payments regardless of whether the government raises the necessary revenues has produced large contingent liabilities for the federal government. The 1995 budget estimates that the net present value of future retirement benefits promised to government employees alone exceeds $1.5 trillion. The net present value of the Social Security trust funds over the next 75 years is negative $7 trillion. While present projections show that

[2]Social Security's Disability Insurance Trust Fund is expected to run out of money by the end of 1995 due to rapid increases in disability payments. The Administration's response thus far is largely limited to transferring $28 billion from the main Social Security trust fund over the next two years.

[3]This includes the employer's share for individuals who are not self-employed. Labor studies provide strong evidence that, although hidden from the employee, this share is ultimately paid for by workers in the form of lower wages.

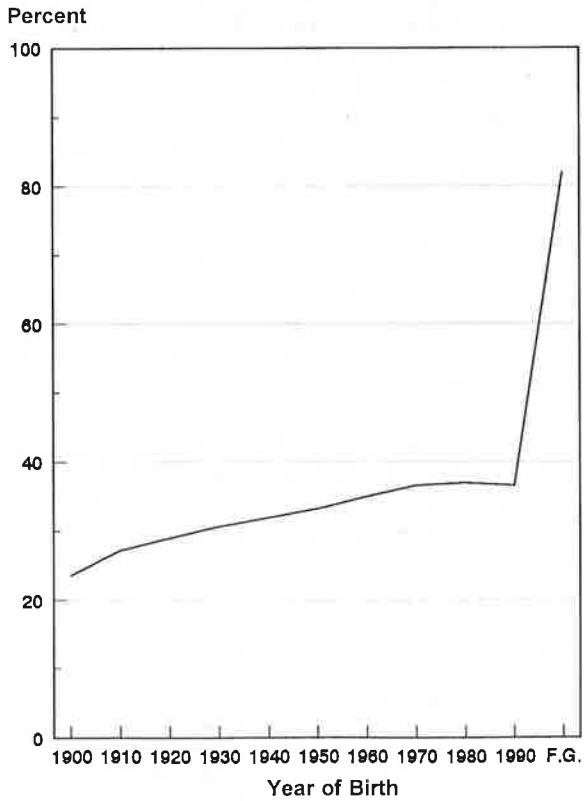
[4]The arbitrariness of raising revenue through a payroll tax also can be seen by the reverse example. If the Administration reduced everyone's marginal rates by 5 percent but then raised the payroll tax by an equal amount, the Social Security trust fund would run even larger "surpluses" and could "afford" to pay recipients even higher benefits. In reality, however, the fiscal position of the government would remain the same.

neither of these massive liabilities will pose problems for the next decade, at some point a reduction in spending or an increase in taxes seems inevitable. Because these programs comprise such a large portion of current and future spending, any effort to balance the budget will have to cut spending on them.

Intergenerational Taxation

One indication of the imbalance of current spending programs can be seen by estimating the average marginal tax that the government would have to collect from future generations in order to pay for benefits that are currently promised and then comparing it to the average income tax rate paid by existing generations. Chart 3 shows the estimates contained in the 1995 Budget. While the tax rate on existing generations rises gradually from 30 percent to 35 percent, the rate on future generations is a stunning 82 percent of lifetime income. This indicates the presence of large future liabilities for which nothing has been set aside. Since future generations will never stand for such high tax rates it is likely that future benefits will have to be cut.

Chart 3
Lifetime Net Income Tax Rates on Current and Future Generations



Note: F.G. = Future Generations.
Source: Office of Management and Budget, Special Analyses.

Proposed Policy Initiatives

Missing Elements

In the coming year, the Administration will propose and work for a number of policy initiatives. Many of these would increase government spending. Under the terms of the 1990 Budget Agreement, this additional spending must be funded by raising revenues or by cutting spending in other entitlement programs. Although the Administration acknowledges that it will have to pay for these initiatives, the 1995 budget does not explain how it will do so. Whatever method the Administration proposes as payment is likely to be the subject of renewed controversy. Major policy initiatives yet to be financed include:

- ***Health care reform.*** The 1995 budget estimates that the Administration's health care proposal would ***save*** $26 billion over the next five years. However, CBO recently estimated that the ***cost*** of the Administration's bill would be $71 billion over the same period. Somehow, the Administration will have to come up with savings to offset this cost if health care reform is enacted in a form similar to the Administration's proposal.
- ***Welfare reform.*** The Administration has said it will introduce a bill to reform welfare programs. While the details of its proposal still are not clear, any serious effort would incur estimated costs of $4 to $7 billion annually for training and benefits even though reforms could reduce costs in the long run.
- ***The General Agreement on Tariffs and Trade.*** Last December, the Administration successfully concluded the GATT negotiations begun during the second term of the Reagan Administration. The final agreement is expected to boost trade and economic growth. It will, however, reduce the tariff revenue collected by the federal government, and the budget agreement requires that this lost revenue must be offset. The total cost over five years is almost $11 billion.
- A series of miscellaneous tax provisions will expire over the next two years. These include the tax deduction for health care purchased by the self-employed and the targeted jobs tax credit. The total cost of extending these provisions through 1999 is almost $20 billion. The budget does not indicate whether the Administration favors extending some or all of these provisions or, if it does, how it proposes to pay for them.

Although current budget rules clearly require that any new mandatory spending programs be offset by increased revenue or decreased spending elsewhere, there is a growing concern in the Congress that complying with this requirement may become too onerous. There is discussion that certain major bills

should not have to be financed, especially if they enjoy bipartisan support or if their passage is regarded as politically important. This discussion currently focuses on the GATT agreement because that legislation will have broad bipartisan support. However, the precedent of waiving the budget rules, once set, would quickly be applied to other legislation such as health care and welfare reform.

To its credit, the Administration has not explicitly endorsed this idea and has pledged to propose further savings to offset the cost of any legislation it supports—emergencies excepted. As with the caps on discretionary spending, the strain of keeping the deficit from growing is likely to result in political pressure by party leaders to rewrite the budget rules once again. This would automatically result in higher deficits.

The Medium-Term Budget Outlook

The Administration is justifiably pleased that the deficit picture is much better than it was a year ago. Only three years ago, however, sustained deficits of nearly $200 billion were considered so severe that they led to the 1990 Budget Agreement. Several times in the past, lawmakers have completed action they believed would keep the deficit under control only to see the problem worsen within the next year.

Despite progress, the deficit is vulnerable at several points. First, the vast majority of tax revenues predicted from OBRA '93 have yet to be collected. Private individuals and corporations have a continuing incentive to find ways to minimize these revenues. Consequently, the government may collect less money and the deficit picture could worsen. The same vulnerability to estimating assumptions threatens the projections of spending reductions. While actual spending sometimes comes in below estimates, the preponderant forces within government programs are working to increase benefits.

Second, if the analysis of interest rates presented earlier is correct, then interest rates fell less as a result of OBRA '93 passage and more as the result of broader economic forces. If these forces reverse themselves as the global economy recovers, interest rates could rise. CBO estimates that a rise of one percentage point in interest rates would increase the deficit by $16 billion in 1995.

Although the economic recovery appears self-sustaining, the business cycle has not been conquered. Sooner or later another recession will appear and bring with it dramatic increases in both the annual deficit and the total debt. While many policymakers favor running deficits during economic downturns, the wisdom of this philosophy assumes that the government saves (i.e., runs surpluses) during times of recovery. Much of the deficit growth during the Bush Administration stemmed from the economic recession. Most of this deficit growth will return when the economy takes another downturn.

Conclusion

The continuous call to reduce the budget deficit is motivated by a belief that it represents the single largest threat to long-run economic growth. This view is generally supported by most economists and political scientists. The federal government cannot control many things affecting economic prosperity, but the deficit is ***not*** one of them. While there is often a short-term tradeoff between lower deficits and economic growth, the size of this tradeoff is overestimated and cannot justify another decade of large deficits.

Unquestionably, current projections of the federal deficit are much improved from last year, and much of this improvement is due to the passage of spending reductions and tax increases last August. However, much of it also is due to broader improvements in the economy, including lower interest rates and higher employment. Satisfaction over lower deficits should be tempered by the realization that estimates of the budget savings from OBRA '93 are subject to the ability of people to avoid tax increases, the possibility of a reversal in the economic upswing, and the willingness of public officials to resist increasing expenditures on new social programs.

Although the economic outlook appears very favorable, the deficit remains a major issue. The deficit is the single largest source of misallocation of resources in the economy. And like so many other examples of inefficiency, its cost does not show up as a dramatic decline in economic welfare but instead represents a reduction in the rate of increase of living standards from what they otherwise could have been. According to the latest projections, the Clinton Administration will add almost $840 billion to the federal debt during its term in office. This is more than either of the Reagan Administrations and almost as much as the Bush Administration. Although the Clinton Administration inherited the problem from its predecessors, at some point continuing deficits become its responsibility. After reading the 1995 budget, one comes away with the impression that this moment has yet to arrive.

The Administration's decision to focus on health care makes sense as part of a multiyear plan to balance the federal budget. However, past history does not justify optimism about the ability of complex government programs to constrain spending. By committing the federal government to pay for a significant increase in health benefits, the Administration risks seeing the future cost of those benefits rise beyond all expectations. Even if legislation this year

solves the threat that future increases in health care costs pose to the deficit, the economy will still be left with ongoing deficits in the range of $170 billion. Another deficit reduction effort will be needed before this Administration's term ends. The 1995 budget provides no indication that the Administration recognizes this.

Finally, there is a growing danger that the Congress again will decide to scrap or reschedule the budget restraints in order to increase federal spending. Already the Administration has increased the deficit by $11 billion to pay for the earthquake in California and other programs. It also may agree to exempt the GATT agreement from the budget requirement, raising the deficit by another $11 billion. There are several procedures the Congress and the Administration can use to evade the budget law. The simplest is just to change it. The argument for doing so is always the same: that deficit reduction, as important as it is to the nation's long-term economic and political health, cannot stand in the way of short-term needs. Yet nothing the Congress can do will spur long-run growth and job creation more than further deficit reduction.

MANUFACTURERS' ALLIANCE
FOR PRODUCTIVITY AND INNOVATION, INC.

For further information on the services of the Manufacturers' Alliance, please write or call:

Fred E. Shand, Vice President-Membership Relations
1200 18th Street, NW, Washington, DC 20036
Phone 202/331-8430 • Fax 202/331-7160

The Manufacturers' Alliance is a policy research organization whose some 500 member companies include leaders in machinery and components, primary metals, automotive, chemicals, oil and gas, electronics, precision instruments, telecommunications, computers, office systems, aerospace, and similar high-technology industries.

Acting as the national spokesman for policies which stimulate technological advancement and economic growth for the benefit of U.S. industry and the public interest, the Manufacturers' Alliance provides its member companies with timely, professional analyses of issues critical to the economic performance of the private sector. Annually, the Alliance's professional staff prepares close to 75 reports on a wide variety of topics which are distributed to officials in the Alliance's member companies. This unique and valuable professional service is one of several distinguishing activities offered by the Manufacturers' Alliance to the business community.

Another unique service available to the Alliance's member companies is the system of peer-discussion groups known as councils and an annual seminar series, the Conference on Business and Economic Policies. The papers and following discussions at the meetings of these councils and the annual seminar series frequently lead to improvements in business management practice.

The Manufacturers' Alliance also performs a broad, educational function for the business community and public policy officials by sponsoring conferences that bring together representatives of government and the private sector to exchange information and discuss significant policy problems facing industry and the nation.

DESCRIPTION OF COUNCILS

Presidents Council—A peer group of presidents-CEOs of small- to medium-size industrial companies in seminar-like discussions on the special problems encountered as a chief executive officer in rapidly changing domestic and international markets.

General Managers Councils I and II—Promotes an interchange among a peer group of senior executives in industry—those whose task it is to plan, organize, direct, control, and coordinate the resources of the division (business) in accordance with corporate policies to achieve long-term profit and growth goals of the organization.

Council on Engineering and Technology—A peer group of senior engineering executives—those who have the responsibility for providing engineering leadership, planning and controlling engineering tasks, and monitoring engineering practices—which serves as a clearinghouse for state-of-the-art information and data affecting basic technologies and practices that further engineering excellence.

Financial Councils I, II, and III—Programs are devoted to the study and discussion of internal company financial problems. Emphasis is on policy and operating plans.

Government Contracts Council—A forum for discussion by experienced executives of common problems and opportunities in doing government business in the light of contract administration, legal, financial, marketing, and other considerations.

Hazardous Materials Management Council—Provides for the discussion of all aspects of the very serious problem of hazardous materials. Council members represent all disciplines involved in the management process.

Human Resources Councils I and II—Seminars in industrial and personnel relations for the senior executive. Provides a forum for the discussion of operating problems and the exchange of information in this field.

Information Systems Management Councils I and II—A forum where information systems executives explore information management as an element of strategy, productivity, and quality; the efficient delivery of data and telecommunications solutions to all areas of the enterprise; the safeguarding of data from damage or misuse; and all facets of ISM organization and administration.

International Operations Council—Seminar in foreign operations on organization and management of international operations, international marketing, finance, taxation, and government regulation of international business.

Investor Relations Forum—Operated under the auspices of the Institute for Technological Advancement, Inc., the Manufacturers' Alliance affiliate, the Forum is an information-exchange for investor relations specialists, and concerns itself with all aspects of enterprise presence, performance, communciations, and competition in the global markets for financial capital.

Law Councils I and II—Forums for the exchange of ideas and experiences among a group of senior corporate counsel who are involved both in providing legal advice and counsel to top corporate management and also in the operation and administration of corporate legal departments.

Manufacturing Council—A forum for the exchange of experiences and consideration of the policy and operating problems of senior manufacturing executives.

Marketing Council—Provides a focal point for the study of industrial marketing (at home and abroad) through the interchange of case studies and experience among marketing and sales executives.

Products Liability Council—Examines the problems resulting from the liability of a manufacturer for injury to persons or property alleged to have been caused by defective products of its manufacture. The Council also considers the liability of a manufacturer for the failure of its product to perform in accordance with warranties, etc.

Public Affairs Council—A forum for an interchange of ideas and experiences with the objective of improving the role of American business in public affairs. Subject matter includes relationships between business and all of the "publics" with which it interacts—government, shareholders, employees, customers, and the general public.

Purchasing Council—Concerned principally with the policy and operating problems involved in procurement at the senior executive level with discussion of such related subjects as the organization of purchasing in a multinational corporation, supplier quality assurance programs, materials and energy shortages, evaluating purchasing performance, and cost reduction.

Council on Quality—A forum in which senior executives explore all aspects of quality requirements, including the quality process as a critical source of productivity improvement, management leadership, process/product excellence, employee participation, supplier involvement, and customer needs.

Risk Management Councils I and II—Forums for discussion of corporate risk and insurance management as well as certain employee benefit issues, including: integrating the quality concept into risk management function; analyzing changes in the property and casualty insurance markets; developing effective liability programs; establishing and administering global insurance programs; and controlling workers' compensation costs.

Strategic Planning and Development Council—A forum in which senior corporate planning executives can exchange views on all parts of their function.

Tax Councils I and II—Forums for informal discussion by experienced tax executives of federal tax policy and operating problems of common concern to manufacturers in the industrial sector with special emphasis on capital recovery allowances, foreign earnings taxation, tax accounting problems, etc.

GENERAL AUDITORS COUNCIL

The Manufacturers' Alliance currently is forming for startup in fall 1994 a General Auditors Council. The Council will be a network of top-level internal and operational auditors from major transnational enterprises engaged in manufacturing and/or related business services. With primary activities consisting of two meetings per annum, the Council will explore all aspects of managing and conducting audit to ensure control, compliance, and cost-effectiveness. For more information, please call Frank Holman at 202/331-8430.

MANUFACTUERS' ALLIANCE CONFERENCE ON BUSINESS AND ECONOMIC POLICIES

The Manufacturer' Alliance Conference on Business and Economic Policies has a long tradition (currently in its 46th year) of providing business executives with a useful and significant forum for analyzing crucial questions such as those concerning international competitiveness; productivity; quality; personnel development; global procurement; strategic planning; and cost effectiveness. Problems and opportunities concerning the national interest are other broad areas of equal importance that are less susceptible to scientific analysis. Here the need for broad-gauged business leaders—familiar with national and international problems affecting industry and capable of statesmanlike judgment on public policy considerations—is paramount.

Objectives of the Conference

Held annually, the seminar-like Conference has the following objectives:

- First, to generate fuller understanding of the problems and opportunities now facing manufacturers in the U.S. industrial sector;
- Second, to give executives a deeper awareness of broad public problems and a fuller appreciation of the favorable and adverse impacts of public policy on society and in their industries;
- Third, to explore innovative and economically sound means of achieving increased investment, higher productivity, and greater profits in manufacturing; and
- Fourth, to broaden the general knowledge of participants and provide them with opportunities to discuss and debate issues with executives from a wide range of industries.

A number of companies utilize the Conference series each year as an integral part of their training programs for younger executives. Many companies also select senior executives to participate for whom the Conference experience is equally beneficial.

The alumni of the Conference number more than 2,600 executives from many industries.

Course of Study

The Conference provides participants with a varied and comprehensive agenda. Manufacturers' Alliance President Ken McLennan is assisted by outstanding guest speakers invited from government, industry, and academe who make presentations and lead discussions on subjects relevant to business executives. Speakers during the current Conference series of meetings include the following:

Sam M. Gibbons
Chairman, Ways and Means
Subcommittee on Trade
U.S. House of Representatives

Robert D. Reischauer
Director
Congressional Budget Office

Alice M. Rivlin
Deputy Director
Office of Management and Budget

Edward W. Kelley, Jr.
Governor
Federal Reserve System

Kent Hughes
Associate Deputy Secretary
for Competitiveness
U.S. Department of Commerce

Douglas Ross
Assistant Secretary for Employment
and Training
U.S. Department of Labor

Lynn R. Williams
International President
United Steelworkers
of America

James C. Chapman
Chairman, President and
Chief Executive Officer
Outboard Marine Corporation

Ernest L. Daman
Chairman Emeritus
Foster Wheeler Development
Corporation

Edson I. Gaylord
Chairman of the Board
The Ingersoll Milling
Machine Company

James E. Marley
Chairman
AMP Incorporated

James E. Perrella
Chairman, President and
Chief Executive Officer
Ingersoll-Rand Company

Robert L. Qualls
President and Chief
Executive Officer
Baldor Electric Company

Richard F. Teerlink
President and Chief
Executive Officer
Harley-Davidson, Inc.

Alan Fraser
Senior Vice President,
Corporate Services
Northern Telecom Limited

Robert E. Sullivan
Senior Vice President-Administration
Harris Corporation

Thomas G. DeOrio
Vice President and General Manager
Ryder Services Corporation

Warren W. Dettinger
Vice President & General Counsel
Diebold, Incorporated

Roger E. Levien
Vice President, Technology
and Market Development
Xerox Corporation

William E. Nettles
Group Vice President and General Manager
Chemical Catalysts
Engelhard Corporation

John Ruckert
General Manager
Electronic Information Systems Division
McDermott Incorporated

Joseph D. Blackburn
Professor, Owens Graduate
School of Management
Vanderbilt University

Edmund B. Fitzgerald
Managing Director
Woodmont Associates

William Lovett
Professor, School of Law
Tulane University

Richard W. Oliver
Professor
Owen Graduate School of Management

Roger W. Werne
Associate Director for Engineering
Lawrence Livermore National Laboratory

For additional information concerning the Conference on Business and Economic Policies, please contact the Manufacturers' Alliance at:

1200 Eighteenth Street, NW
Washington, DC 20036
202/331-8430 • fax 202/331-7160