February 26, 1991

WASHINGTON'S NEW DOMESTIC SPENDING SPREE

INTRODUCTION

The fiscal 1992 budget submitted to Congress early this month by the Bush Administration is noteworthy, not because it lives up to the promises of last year's budget summit, but because it has opened the floodgates to record levels of domestic spending. George Bush may, as a result, be known as the biggest spending President in three decades rather than the President who finally balanced the federal budget.

The $166.5 billion[1] in new taxes agreed to in last year's budget summit did not result in deficit reduction. Rather, every new tax dollar raised has generated $1.83 in new domestic spending.[2] Thus, instead of a deficit of $155.5 billion, the number originally set by the budget agreement, or even of $64 billion, which would have resulted had automatic Gramm-Rudman-Hollings cuts been allowed to take effect, the deficit for fiscal 1991 will be at least $206.7 billion.

Huge GNP Bite. With the spending approved by last year's budget agreement, the federal government now consumes over 25 percent of gross national product, the highest level since 1946 and up from 22.3 percent in 1989. The federal government's bite of GNP has enormous impact on America's

1 The original budget agreement announced that it raised taxes by $137.2 billion over five years. In December, the Congressional Budget Office revised this total to $158 billion. The President's budget has reestimated the five-year tax increase at $166.5 billion.

2 Domestic spending here and below denotes all non-defense spending excluding net interest on the national debt and the costs of the savings and loan bailout.

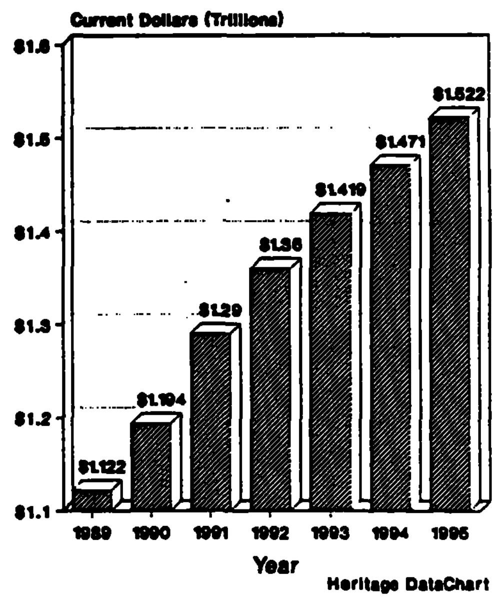
economy. The huge bite of this year takes out of the economy billions of dollars that could be used by consumers to make more purchases or business to make more investments and create more jobs. The current recession is in large part a result of the tax-and-spend policies of Bush and the Congress.

Bush promised in his State of the Union address in January to hold spending increases in fiscal 1992 below the level of inflation. This is not what his new budget does. When the one-time costs of the savings and loan bailout are removed from the current budget figures, aggregate spending rises at a 5.4 percent rate, 1.1 percentage points above inflation. What is more telling, non-defense domestic spending rises by 8.2 percent, 3.9 points above inflation. An increase of this pace signals that domestic spending again is out of control. Programs are growing and bureaucracies are expanding in ways that ensure higher base lines and constituencies for even bigger government programs in the future. As such, the Bush budget not only fails to keep domestic spending below the rate of inflation but nearly guarantees years of government spending increases and even deeper deficits.

Spending Caps. The fiscal 1992 budget need not be opening the sluices to new torrents of red ink. Just as strict limits have been placed on defense spending, such limits too could be placed on total domestic spending. The Bush budget should cap domestic spending at a firm four percent annual growth, a rate slightly above the projected rate of inflation. Capping domestic spending growth at four percent, enforced by an automatic sequester if Congress exceeds the spending targets, would still provide an additional, and predictable, $32 billion per year for new spending, while leading to a budget surplus by 1995. And by assuring the American people that federal spending is under control and that they will not be asked to turn over more of their paychecks for growing and wasteful programs, federal policy makers will help the country climb out of the recession that they helped to create.

Chart 1

Growth in Total Federal Spending



Excludes S&L costs, the costs of Operations Desert Shield and Desert Storm, and entitlement policy changes recommended by the Bush Administration.

SPENDING IS OUT OF CONTROL

Last year's budget summit originally was convened to solve a short-term problem. The deficit for fiscal 1991, which began last October 1, was growing so large that the ax of the automatic sequester, required by the Gramm-Rudman-Hollings deficit reduction law, was about to fall. This would have lowered the deficit to the $64 billion level specified in law. Blanching from this, the White House and congressional leaders began looking for new ways to raise revenues to match the higher level of spending.

While budget summiteers last year toiled for six months to find new revenues, they ignored the fact that Congress was raising total spending for fiscal 1991 by a record $96 billion, or 8.1 percent, over fiscal 1990. This increase did not include the Savings and Loan (S&L) bailout costs.[3] This spending spree is built into last year's budget accord. If unchecked, it will result in an annual average growth in aggregate spending of 5 percent per year through fiscal 1995, almost one point above the inflation rate.

Supporters of higher taxes defended the 1990 budget agreement by insisting that it would result in about $2.05 in spending cuts for every new dollar of taxes raised. These cuts, they claimed, combined with strict enforcement rules against new spending, would lead to a $155.5 billion deficit in fiscal 1991, a $150 billion deficit in fiscal 1992, and a $23 billion budget surplus by fiscal 1995.

Broken Promises. As critics of the budget accord predicted, the promises of spending cuts have been broken almost immediately. As the proposed 1992 budget released by the Bush Administration reveals, aggregate federal spending, not including the one-time costs of the S&L bailout, increases $1.97 for every new tax dollar raised. This is not obvious from a quick reading of the budget. This is because the fiscal 1992 budget, like the summit agreement, employs a series of budgetary gimmicks to mask the aggregate spending increases. In large part because of these increases, the fiscal 1992 deficit is estimated at $193 billion.

Domestic spending is entirely responsible for the rapid growth in the deficit. In fiscal 1995 alone, nearly $1 trillion of the nation's resources will be dedicated just to domestic spending, not counting the net interest on the national debt. The only thing holding down overall federal spending at all is the budget summit's reduction, in nominal terms, of defense spending by 3 per-

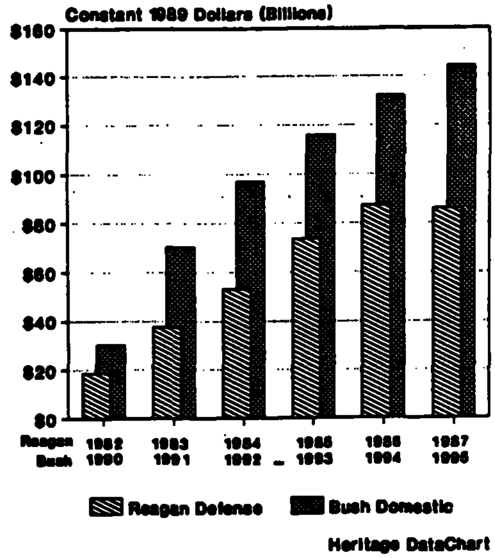
3 Unless otherwise noted, all totals of spending and deficits in the remainder of this study do not include the highly fluctuating one-time costs of the Savings and Loan bailout. Estimates of these costs have varied far too widely to reliably be included in aggregate totals. The confusion generated by the inclusion in budget figures of the S&L numbers will be discussed below.

cent per year. This defense rollback masks a 7.6 percent annual increase in non-defense domestic spending through fiscal 1995, an average of 3.4 points above the inflation rate.

Some critics charge that today's budget deficit is the result of Ronald Reagan's determination to rebuild and modernize America's defense arsenal. This is not correct and the figures do not support it. It is, moreover, instructive to note that the Bush build-up in domestic spending will dwarf Reagan's defense build-up. Chart 2 shows the constant dollar comparison of the first six years of defense growth under Reagan with six years of projected domestic spending under Bush.[4] Cumulatively over six years, the Bush domestic spending spree is $590 billion, two-thirds more growth than the $356 billion, six-year cumulative growth of defense spending under Reagan. If the critics of the Reagan budgets were concerned about high defense spending, they should be even more concerned about the Bush domestic spending build-up.

Chart 2

The Bush Domestic Build-Up vs The Reagan Defense Build-Up



Note: The base year for comparing Reagan defense build-up is Carter's fiscal 1981 defense budget. This is held constant for the subsequent six years and any increases above this level are assumed to be the result of Reagan policy. The base year for comparing Bush's build-up is the level of domestic spending in Reagan's last budget, fiscal 1989. Any significant increases during the next six years are assumed to be the result of Bush policy.

4 The base year for comparing each president's build-up is the constant dollar level of the last year of the previous administration. For example, Carter's last defense budget in fiscal 1981 is held constant for the subsequent six years. Any real growth above this level each year is assumed to be the result of Reagan policy. Cumulatively over six years, this build-up is $356 billion in constant 1989 dollars.
The Bush domestic spending build-up is likewise compared to the constant dollar level of domestic spending in Reagan's last year, fiscal 1989. This sum is held constant for the subsequent six years and any growth above that level is assumed to be the result of Bush policy.

REJECTING THE REAGAN SPENDING RATES

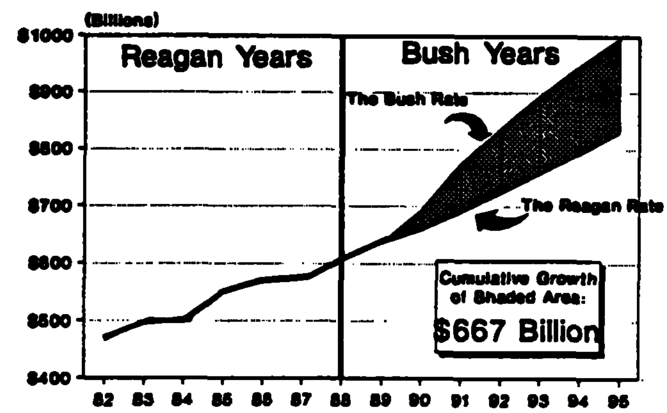
The growth trends for domestic spending now projected by the Bush Administration will repeal thoroughly the spending restraint established by Reagan. Domestic spending rose in nominal terms by 4.75 percent annually during Reagan's eight years, well above the average rate of inflation. Had Bush continued domestic spending at the Reagan growth rate, total federal spending for fiscal 1991, the current fiscal year, would stand at $1.2 trillion, not $1.3 trillion, and the deficit would be no more than $118 billion, not the minimum $206 billion now projected.[5]

Had Bush stuck to Reagan domestic spending growth levels from fiscal 1990, the first Bush budget, through fiscal 1995, the federal budget would have been balanced by early 1994 and shown a $107 billion surplus by 1995, even with the lower revenue estimates. But Bush abandoned the Reagan course. At the present rate of domestic spending growth, Bush will spend a cumulative $667 billion above the Reagan growth rate through fiscal 1995. (See Chart 3)[6] This massive increase amounts to $4.00 in new domestic spending for every new dollar of taxes raised by last year's budget agreement.

Even after the fast spending pace set by Bush in fiscal 1990, his first budget, he could have reversed the trend and gone back to the Reagan growth rate. Yet it is now clear that the budget summit quickened the spending spree in-

Chart 3

Domestic Spending Growth



Domestic spending trends exclude net interest and the S&L bailout costs.

Heritage DataChart

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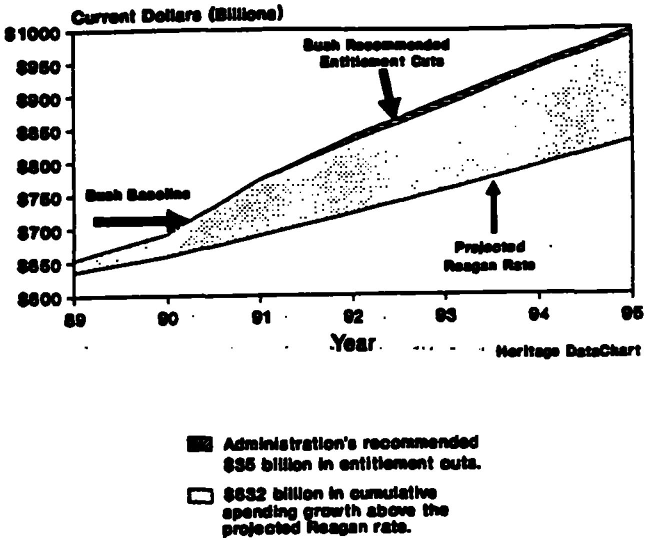
5 In fact, were the recession not causing a significant reduction in the estimates of future revenue growth, this year's deficit could have been as low as $87 billion, only $23 billion above the $64 billion deficit target required by Gramm-Rudman. Before the recession, $30 billion more revenues were expected to come into the Treasury for fiscal 1991 than is now projected. These projections have been torpedoed by last year's budget agreement's tax and spending hikes which are driving the economy deeper into a recession. As a result, estimates of future tax revenues have fallen considerably.

6 The shaded area represents the cumulative $667 billion difference between the two trends.

Chart 4

Bush Policy Recommendations



itiated in fiscal 1990. Belatedly, the Bush Administration acknowledges this rapid build-up in domestic spending, especially in mandatory programs. To offset in part what could have been prevented in total, the Administration now seeks to trim roughly $35 billion from the planned entitlement growth through 1995.

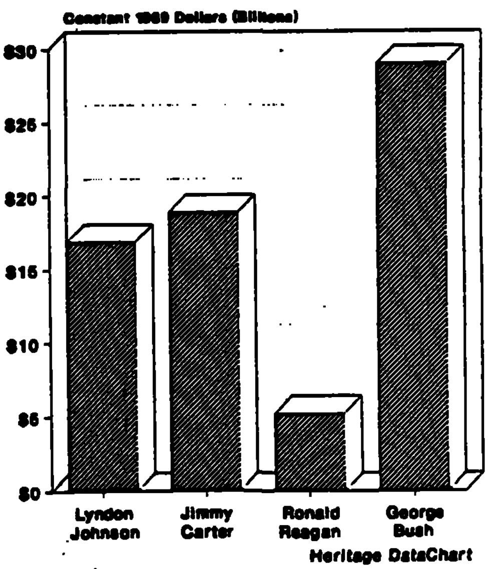
As Chart 4 shows, this tardy and meager attempt to stem the spending tide will have negligible results. Even if Congress gives Bush all the cuts he seeks, the cumulative six-year increase in domestic spending over the Reagan rate will still total $632 billion, $3.80 for every new dollar of taxes raised.

BUSH OUT-SPENDS FIVE PRESIDENTS

Unless the Bush Administration alters its furious domestic spending pace, it will be heading for the record books, outspending the first term domestic increases of the last five Presidents. Adjusting for inflation, the Bush Administration in its current term will boost domestic spending an average of $29 billion per year. Measured in constant dollars (ie: inflation-adjusted dollars), this average annual growth rate well exceeds the domestic spending of Richard Nixon,

Chart 5

Average Annual Growth in Domestic Spending



is twice the growth rate of John Kennedy, nearly twice the growth rates of Lyndon Johnson and Jimmy Carter, and a staggering five times the growth rate of Ronald Reagan.

BUDGET SLIGHT-OF-HAND

The Bush Administration claims that it is holding the fiscal 1992 budget growth of federal spending to 2.6 percent, well below the projected 4.3 percent rate of inflation. The budget summit negotiators similarly have claimed to cut over $280 billion in spending from the budget over the next five years. Both claims are false.

The fiscal 1992 budget uses a variety of methods to trick the public into believing that Washington has become fiscally responsible. Most deceptive is the inclusion of the widely fluctuating one-time costs of the S&L bailout in the aggregate of total federal spending. This inclusion gives the false impression that aggregate federal spending will grow by a mere $61 billion between fiscal 1991 and fiscal 1995.

Since the time that the soaring costs of bailing out ailing S&Ls first made headlines, there has been considerable debate among policy makers over whether to include theses costs "on-budget" and account for them as any other program expenditure, or to exclude these costs from aggregate accounting because of their short-term, unpredictable nature.

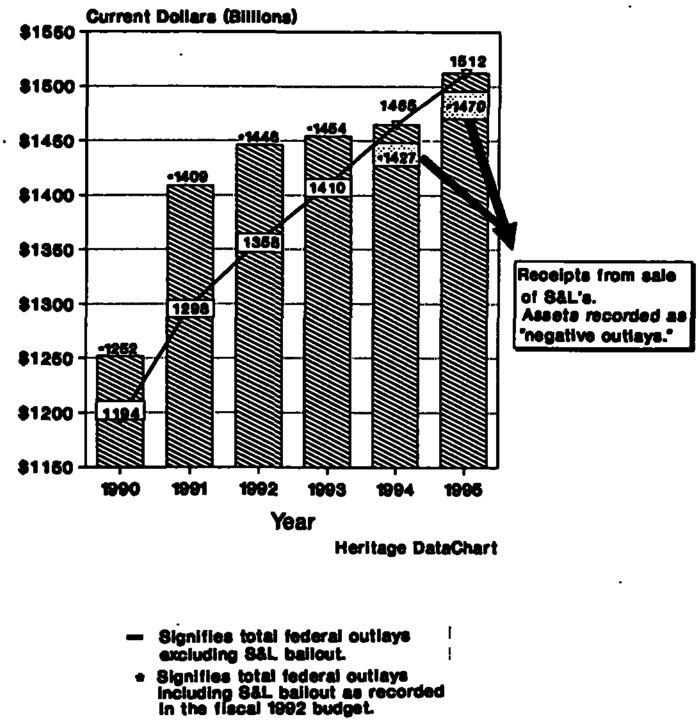
S&L Confusion. Those who favor the "on-budget" approach argue that failing to include these costs understates the true size of the federal deficit and, thus, the financial problems facing the federal government. Those who favor the "off-budget" approach argue that the S&L crisis is a short-term, one-time problem. To include this in an aggregate accounting of federal spending, continues the argument, would make it difficult for the public gauge the real growth trend of the federal government. Rather than choose between these two camps, last year's budget summit agreement and the fiscal 1992 budget use both methods. "Technically," the S&L costs are off-budget, but they are included in the aggregate totals of federal spending.

There are two characteristics of the S&L crisis that lead to the confusion when it is viewed in the light of total federal spending. First, the S&L crisis will have very high up-front costs in the first few years. These costs will shrink considerably in later years. In fiscal 1991, for instance, it is estimated that the bailout costs will total $111.5 billion. This will drop in fiscal 1992, according to the estimates, to $88 billion; in fiscal 1993 it will drop to $44 billion. As the costs of the bailout drop so will the growth rate of federal spending, even though almost all federal spending accounts may be increasing. Indeed, this is exactly what is happening. The Bush White House uses the drop in the cost of the S&L bailout to hide the growth in domestic spending. (See Chart 6) Such use of a one-time or short-term expenditure violates all accepted accounting practices.

The second problem is that the government, as it sells the assets that it has acquired from the failed S&Ls, eventually will realize, in some years, more money coming in than goes out in the S&L operation. In a sense, for that year, this is a "profit." But because of the peculiar accounting methods of the federal government, these profits will be recorded not in the revenue column but in the expenditure column as "negative outlays," or "off-setting receipts." The sale of S&L assets is projected to generate $38 billion in fiscal 1994 and $42 billion 1995. The government's accounting practices allow these "profits" to cover up billions in higher federal expenditures. This furthers the illusion that spending growth is slowing.

Chart 6

How the S&L Bail-Out Masks Real Budget Increases



Budget Gimmicks. Since the fiscal 1992 budget was released, Administration officials have said repeatedly – often in the same breath – that total federal spending growth will be kept below the inflation rate and that the costs of the S&L bailout are "off-budget." Those not familiar with federal accounting practices – and this includes, understandably, almost all Americans, including almost all journalists – will not see through this budget gimmick. The truth is that total federal spending is kept below the inflation rate only if the S&L bailout costs are included in aggregate spending totals. This means that the Administration is misleading the public when it claims that domestic spending growth now is under control.

Removing the gimmicks, and thus eliminating the S&L bailout costs and eventual profits, total federal spending is growing by an annual average of 5 percent between fiscal 1991 and 1995. As is shown by the growth line in Chart 6, the fiscal 1992 budget jumps roughly $70 billion over fiscal 1991 levels, an increase of 5.4 percent and a full point (or nearly 25 percent) above the inflation rate. This increase follows on the heels of a $96 billion total spending hike in fiscal 1991, an increase of 8.0 percent, nearly 3 points above the inflation rate.

Oddly enough, though, it is this use of the S&L bailout cost that Budget Director Richard Darman used during the budget summit last year to create the illusion of a budgetary crisis and, according to some observers, to force Bush to support higher taxes. When Darman's Office of Management and Budget released its *July 1990 Mid-Session Review of the Budget*, Darman had completely changed the terms of the debate up to that time by including the S&L costs in both the deficit and spending calculations. By doing this he depicted the estimated fiscal 1991 deficit as $232 billion, up from the January estimate of $100 billion. This gave the appearance of credence to his argument: a huge deficit suddenly has emerged and it can be reduced only by record high taxes.

DEFENSE CUTS

Changes in defense spending also disguise the true federal spending situation. Last year's budget agreement cuts defense spending considerably through 1995, calling for a 3 percent reduction in defense spending per year in nominal terms, that is, below the level spent in previous years. In Washington budget terms, a reduction below a prior year's level counts for much more than it may first appear to be. This is because of what is known as the current services baseline budgeting method.

The current services baseline method is very confusing. Some veterans of the federal budget process say that the method is deliberately confusing. The current services baseline method works as follows: Budgeteers project future spending levels for programs based upon such criteria as the requirements of current law, estimated inflation rates, and the expected growth in demand for the good or service provided. These projections, which are required by the 1974 Budget Act, become the baseline with which future real outlays or proposals for outlays are compared. Example: a program that costs $100 million this year could, using the current services system, be projected to cost $110 million next year. If the program does cost $110 million, it is said that the program has not increased at all – even though the program costs taxpayers an extra $10 million. And if the program goes from $100 million only to $105 million, instead of to the projected $110 million, it actually is said that the program is being cut – even though the program costs the taxpayers an extra $5 million.

Apparent Fiscal Responsibility. It is this "current services" system that allowed last year's summiteers to claim that they were "cutting" $178 billion from discretionary spending over the next five years. Discretionary spending includes most defense programs and any domestic programs for which Congress must appropriate funds each year. In reality, all they did was trim the discretionary defense spending slightly each year below the previous year. A slight trim over a previous year is a huge cut from what the projected outlays would be. It is this "savings" by keeping defense below projections that accounts for 36 percent of last year's summit's entire $492 billion deficit reduction plan. The reduction in defense spending, meanwhile, slows the aggregate growth of spending, which gives the further appearance of fiscal responsibility claimed by the summiteers.

FAILED ENFORCEMENT PROCEDURES

Supporters of last year's budget agreement claim that they have established tough procedures to enforce the terms of the accord. These enforcement mechanisms are in the form of caps on discretionary spending and pay-as-you-go provisions on entitlement spending. Ostensibly these check federal spending growth and force spending priorities to be set by requiring agencies to compete for resources. But the spending spree of the Bush fiscal 1992 budget reveals that these enforcement mechanisms do not check spending growth. The main reason is that the spending caps on domestic discretionary spending were set very high: 9.5 percent growth in fiscal 1991; 6.1 percent growth in fiscal 1992; and 5.3 percent growth in fiscal 1993. Each of these rates is well

Chart 7
Domestic Discretionary Spending

	1989	1990	1991	1992	1993	1994	1995
Total (billions)	$169.00	$182.50	$199.80	$212.00	$223.20	$228.90	$231.70
Annual Change		7.99%	9.48%	6.11%	5.28%	2.55%	1.22%
Points Above Inflation		3.19	3.78	2.01	1.48	-.95	-2.28

Note: Only fiscal years 1991 to 1993 were agreed to during the summit. Fiscal years 1994 and 1995 have been estimated by OMB.

Chart 8
Mandatory Spending

	1989	1990	1991	1992	1993	1993	1995
Total (billions)	$459.3	$510.3	$574.8	$626.3	$671.00	$718.3	$765.1
Annual Change		11.1%	12.66%	8.96%	7.14%	7.05%	6.52%
Points Above Inflation		6.95	7.3	4.65	3.18	3.35	2.81

Note: Totals exclude net interest on the national debt and S&L bailout costs.

above the inflation rate and, in fact, above the existing pre-summit baseline. The result: last year's budget agreement actually permits vast boosts in discretionary spending.

Another result: the caps will prompt no reordering of program priorities. Any trade-off of funding forced by the spending caps is likely only at the margins. The high aggregate level of the caps would suggest that there will be plenty of funding for everyone's favorite programs.

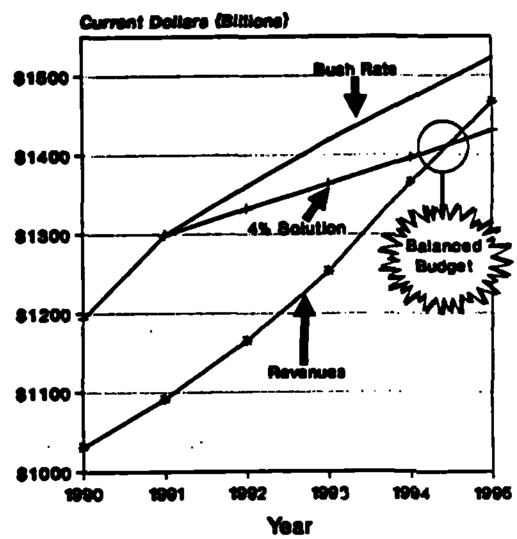
"Savings" Washed Away. Since last year's summit, the costs of entitlement program growth have been revised and reestimated. The resulting new figures completely wash away the "savings" promised by the summiteers. Entitlements are now projected to grow by over 8.5 percent per year on average through 1995, a cumulative increase of $183 billion over the levels agreed to by the summiteers. Even if Bush's recommended policy changes in this area are adopted by Congress, they only will slow entitlement growth to an average 8.2 percent per year. Moreover, the pay-as-you-go provisions to stem new entitlement spending, which require that any new spending proposal be matched by an equal reduction in spending elsewhere or a tax increase, have yet to be tested but this rapid rate of growth may make them irrelevant.

THE FOUR PERCENT SOLUTION

The budget summit's enforcement provisions and spending caps have not slowed domestic spending. This is because they do not force policy makers to weigh the relative value of every program and, thus, trade off low priority programs for more important programs. The most effective method for reducing federal spending and forcing such trade offs is to put a single cap on total domestic spending, excluding net interest on the federal debt and the S&L costs. This cap should be fixed at four percent, roughly the rate of inflation. Such a Four Percent Solution initiated in fiscal 1992, and enforced by an automatic sequester if Congress exceeds the established spending caps, would save the taxpayers $255 billion by 1995.

Chart 9

The Four Percent Solution



Note: Aggregate Spending Totals Exclude the S&L Costs, and the Costs of Operations Desert Shield and Desert Storm

Heritage DataChart

The Four Percent Solution is much like a long-term union contract in which the worker can count on a specific percentage pay increase every year of the contract. Beginning in fiscal 1992, the Four Percent Solution provides the domestic spending pool with an additional $32 billion each year for new spending. This new money can be allocated throughout domestic programs as policy makers see fit.

This is not possible under the current system. Last year's budget summiteers were right to put "firewalls" between domestic discretionary spending and defense spending. Each of these areas is protected by a distinct spending cap so that Congress could not cut defense to increase domestic spending. While this is wise, it was not wise to erect a firewall between domestic discretionary spending and domestic mandatory spending as the budget agreement has done. Just as all of the programs that comprise the nation's defense interests should compete equally for the available funds dedicated toward that purpose, so too should all of the programs that comprise the domestic interests compete equally for the available domestic resources.

Policy Fiefdoms. The current enforcement system effectively has created two distinct domestic policy fiefdoms in Congress; one fiefdom gets to pass out perks through projects and pork, while the other fiefdom gets to pass out perks through benefits to all who are eligible, be they welfare recipients or large agribusinesses. A single Four Percent Solution cap on total domestic spending would force all of the nation's domestic interests to be appraised within a predetermined pool of money.

Because the Four Percent Solution prevents runaway domestic spending growth, it allows the current pace of revenue growth to catch up with spending. The Four Percent Solution, thus, honestly balances the budget by 1995. If tax revenues continue to grow at the current projected rate, the budget could show a surplus by the end of that year. Chart 9 shows the growth of tax revenues compared to both total federal spending under the Four Percent Solution and the current Bush rate of growth.

CONCLUSION

Last year the American people witnessed their federal government in fiscal crisis, struggling within a budget process that had broken down, unable to define spending priorities, and uncertain from day to day whether or not it would stay open for business. Both supporters and critics of the final budget agreement hoped that this experience never would be repeated, that Congress and the Administration had learned their lessons and that this year they would strive to avoid past mistakes.

These hopes are to be dashed. The White House and Congress are heading for a tragic replay of last year's tragic budget fiasco. Budget negotiators assured taxpayers last year that spending would be cut in exchange for higher taxes. They claimed that the budget agreement would control the future growth of spending. And they claimed that all of this was necessary to avoid a higher budget deficit. This year, the Bush Administration is pledging that fiscal 1992 spending growth is held below the rate of inflation.

Tragic Replay. Last year's promises already have been proved hollow. This year's promises are no better. The truth already is that the federal deficit again is heading for record levels because domestic spending is growing at unprecedented rates. The record-high tax increase levied by last year's summit already has been squandered on new spending. In fact, for every dollar raised by the new Bush-Congress tax hike, domestic spending will increase by at least $1.83 through 1995. None of the tax hike has been used to trim the deficit. In fiscal 1991 domestic spending rose by 12 percent over fiscal 1990 levels, 6.5 points (or about 95 percent) above inflation. The 1992 budget submitted by the White House projects a domestic spending increase of 8.2 percent, 4 points (or about 100 percent) above inflation. If this growth continues, the federal budget cannot be balanced in the foreseeable future.

Reversing the Trend. Washington's insatiable big-spenders, as is their habit, will want only higher spending and bigger government once they taste this new money. Before it is too late, Bush should admit that negotiating with these big spenders did not work. The Washington Establishment got everything it wanted, higher taxes and much higher spending. Bush can reverse this trend only by confronting Congress with the truth and then submitting a budget plan, like the Four Percent Solution, that slows the rate of government spending growth enough to allow a growing economy to generate the taxes, as was happening at the end of the 1980s, to balance the budget.

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