A SPENDING FREEZE, NOT NEW TAXES, WILL SOLVE THE BUDGET CRISIS

Guessing that the stock market's October 19th collapse was triggered by the federal budget deficit, the Reagan Administration and Congress rushed to the budget summit table to signal, as they put it, the world financial markets that the U.S. can reach a budget compromise. The negotiators believed that by fashioning a budget agreement, thereby avoiding automatic spending cuts under the Gramm-Rudman-Hollings Deficit Reduction Act, they would be demonstrating the leadership necessary to calm jittery stock markets.

The summiteers erred on two counts. First, the deficit in and of itself did not cause the stock market to collapse. In fact, the deficit has fallen from 5.0 percent of the Gross National Product (GNP) to 3.4 percent over the past fiscal year. It is the proposed solutions to the deficit that have shaken Wall Street's confidence. Second, a budget compromise which promises $23 billion in new taxes, no program cuts, and only $6 billion in unspecified domestic spending cuts can hardly be described as reassuring to the financial markets. Rather than embracing the compromise, Wall Street reacted with a shrug as stocks traded in a narrow range in days following the announcement and then plummeted this week as investors took a closer look at the "compromise."

By substituting taxes for spending cuts, the budget negotiators failed in their task. A tax increase will have very negative effects on an economy that may not be able to withstand many more bad legislative ideas. A recent *Newsweek* poll found that Americans prefer spending cuts to taxes by a six to one margin. Congress must assert leadership and craft a budget that narrows the deficit without resorting to taxes. If a taxless budget cannot be devised, then the Gramm-Rudman-Hollings automatic spending cuts should take effect.

Illusory Cuts. The spending cuts included in the budget reduction plan are weak and illusory; the taxes are a drain on the private economy. The agreement pledges to raise $5 billion for the 1988 fiscal year through selling federal assets. The "asset sale" most often mentioned is that of allowing rural electric cooperatives to prepay outstanding federal loans. By prepaying these loan obligations--without penalty--the rural co-ops escape the high interest rates to which they agreed under the original loan contracts. To finance the loans, the federal government had to issue long-term debt at the high rates of the 1970s. Hence, if the rural co-ops are allowed to prepay without penalty, the Treasury will no longer receive interest

payments on these loans, while the taxpayer will be stuck with paying off the long-term debt at double-digit rates. The budget negotiators should have looked at sales of other federal assets which would be a real gain for the Treasury. These include sale of the Naval Petroleum Reserves, the federal uranium enrichment plant, and Amtrak.

The "compromise" promises to cut $6 billion in discretionary domestic spending over two years. This is only a flimsy promise; Congress has a track record of breaking such promises. Where these cuts will take place has yet to be spelled out. In 1982 Reagan agreed to a tax increase with the proviso that Congress would pare $3 in spending for every $1 in new taxes. When all the dust had settled, it turned out that Congress actually increased spending--and the budget soared 63 percent between 1982 and 1985.

Using New Taxes for New Spending. The $9 billion in unspecified new taxes represents the most onerous provision of the budget "compromise." Taxes drain private capital and thus slow economic growth. Empirical studies find that taxes do not reduce the deficit. In fact taxes may increase the deficit, as every dollar in increased taxes historically has been offset by further spending. Tax increases simply provide Congress with incentive to increase spending. Unlike spending cuts, moreover, tax increases have a notorious habit of becoming permanent.

Except for the Gramm-Rudman-Hollings automatic spending cuts, the simplest, most effective and most understandable method of reducing the federal deficit would be an across-the-board spending freeze. By holding spending in check, natural growth in tax revenues resulting from economic expansion would be sufficient to meet the Gramm-Rudman-Hollings deficit target. For fiscal year 1987, the federal government spent $1,002 billion. The Office of Management and Budget expects to receive approximately $916.6 billion in tax revenues for fiscal 1988. By limiting 1988 discretionary domestic and defense program funding to 1987 levels, the budget deficit will fall to approximately $85.5 billion, well under the $125 billion Gramm-Rudman-Hollings target. Such a large margin allows a degree of flexibility.

Short-Term Expedient. In the shortest run, defense may fare better with the $285.4 billion the Pentagon would receive under the "compromise" compared to the $282.2 billion it would get under a freeze. But the enormous damage which new taxes will inflict on the economy will soon catch up with the Pentagon anyway. Those responsible Americans determined to continue to modernize the U.S. arsenal should view the $3 billion in lower defense spending in a freeze as a short-term expedient to sustain more vigorous defense spending well into the 1990s.

Reagan Administration compromisers and Members of Congress must bear in mind that the deficit is the result of excessive spending, not undertaxation. As a result of economic growth stimulated by the Reagan tax reductions, tax revenues are at near record highs. The problem is that Congress has assured that spending growth has outstripped revenue growth. A budget freeze at least would inject the discipline into spending necessary to get the deficit under control. To be sure, a freeze is an abdication of leadership. But that is preferable to the terrible leadership provided by those who arranged the budget "compromise." If Congress cannot enact a freeze or a budget without taxes, sequestration under Gramm-Rudman-Hollings should take effect.

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