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THE REAGAN BUDGET: STILL TOO TIMID

INTRODUCTION

The press, Congress, and assorted interest groups have expressed outrage at President Reagan's recently released budget-cutting package. They have raised a loud chorus of complaints that the cuts are unjust, unacceptable, and inequitable. When not complaining about the magnitude of budget cuts, they are wringing their hands over the large expected deficit. The protest, however, seems to represent a vanguard without much of a following. National opinion polls indicate that solid majorities continue to favor additional budget cuts and fully support further reductions in the size of government along with a massive transfer of federal welfare, education, and health programs to state and local governments.

There is strong evidence, moreover, that the public may support cuts far beyond what Reagan has suggested in his recent package. In a January 1982 poll conducted for The Heritage Foundation by Sindlinger and Company, Inc. (see Appendix), over 40 percent of the respondents thought the budget had not been cut enough while only 19 percent thought the federal budget had been cut too much. The public favors additional cuts primarily in social programs, but not in the military budget. Of those sampled in the nationwide poll, only 23 percent want to cut defense spending while 53 percent favor cuts in social programs. There also appears to be strong support for maintaining the military build-up plans. Over 51 percent of the public favor current defense spending even if this requires running a budget deficit.

The public may also favor a more radical devolution of federal programs to the states and localities than even the President has recommended. Yet the President's relatively modest federalism proposal has raised a storm of protest from some of the nation's governors and mayors. They complain that the President is shirking national responsibilities and attempting to balance the federal budget on the backs of the states. The public, however, broadly supports returning social welfare programs to local governments where they can have more direct control. Nearly 80 percent of the public, for instance, feel that most welfare, education, and health programs should be administered at the local or state level. Only 14 percent feel that the federal government is best capable of providing these services. An impressive 50 percent say the local government provides needed government services most efficiently; 27 percent cite the state government and only 14 percent say that the federal government gives them the best value for their dollar.

The strong public support for additional budget cuts and a massive realignment of federal programs blunts much of the shrill criticism of the budget. Yet there is one valid criticism: Is this a "Reagan budget?" Is this a budget that fulfills the criteria set by Reagan himself at the outset of his Administration? Does it:

* reduce the level of taxation to encourage work, saving, and investing in order to stimulate economic growth and productivity;

* reduce the growth of government spending to eliminate unneeded programs, wasteful spending, duplicative services, and programs benefiting the non-needy;

* reduce the regulatory burden on business in areas where the competitive marketplace assures quality and safety;

* reduce inflation through a stable and de-accelerating money supply?

At least two more goals were implicitly set by the Administration:

* to determine which federal programs should be returned to local governments;

* to provide for a military defense budget that will protect U.S. security and vital interests abroad.

Are these criteria being met? Is this, in short, a budget document worthy of a self-proclaimed conservative administration dedicated to nothing less than the slowdown and then reversal of the longstanding trends of greater growth of government and the precipitous decline in the nation's military capability? The answer is at best a muted "yes." The budget strategy, bold as it is in some respects, fails to attack major economic problems. The President has suggested some $43 billion in new budget cuts, but these merely slow down the accumulated momentum of budgetary growth. They do not, as promised, reverse the trend. And while the federalism package touches a responsive chord in the American passion for local self-government it lacks theoretical coherence.

Perhaps in his speeches across the country, the President will develop a more coherent rationale why some programs belong at the local government level, but so far the federalism initiative is inconsistent.

While a few dozen major regulations have been repealed and many new regulations died aborning, little long-term regulatory reform has been proposed nor have there been many changes in enabling legislation governing the purview of regulatory agencies. The problem with regulation is not its burden on the budget but its burden on the economy. All regulatory agencies combined amount to only a few billion dollars in the budget, but their burden on the economy has been estimated as high as $100 billion. The President has recommended a reduction in the budgets of many regulatory agencies. What is disappointing is that this Administration does not seem to be taking the much more important step of limiting the legislative mandate of regulatory agencies and eliminating those which have outlived their usefulness -- not a budgetary matter but nonetheless essential.

The Administration has not mustered the political courage to begin reforming entitlement programs--Medicaid, Medicare, and Social Security--which have ballooned in cost while benefiting large segments of the middle- and upper-income classes. While most of the President's advisors have lobbied him to increase taxes, a truly effective remedy for the recession and eventually even the deficit has been ignored: acceleration to the start of this year of the personal tax cut reductions scheduled for July 1. If the Administration were truly courageous, it would pare the federal budget much further, reform major entitlement programs, and accelerate the tax reductions to give supply-side economics a fair chance to stimulate production and reduce unemployment.

BREAKING THE MOLD

In some areas the Reagan budget clearly breaks with the past. For years the defense budget has been underfunded to finance the massive social welfare build-up of the 1970s. By calling for an 18.1 percent increase in defense expenditures in 1983, the budget clearly takes a crucial step toward ending the deterioration of the U.S. arsenal. While critics seem to blame the deficit on the defense build-up, the military budget in 1962 -- before the Vietnam involvement -- claimed a larger share of the gross national product than in any year of the projected Reagan budget. Congressmen who worry that the U.S. cannot bear its defense burden need to be reminded that the nation's military budget could increase at an <u>annual</u> rate of 24.4 percent until 1985 before it would equal 8.67 percent of GNP, the share in 1962. The high level of defense spending in that year did not dampen economic prosperity. The U.S. had 7.7 percent economic growth, an unemployment rate of 5.5 percent and an annual inflation rate of about 1 percent. It is not defense spending that has burdened the economy and caused the budget deficit; it is the burgeoning social welfare expenditures which increased by 4.7 percent yearly after inflation from 1975 to 1981. The real increase in defense expenditures during the same period amounted to only 1.8 percent, while the Soviets continued their largest military build-up in peacetime history. The President wants to reverse those priorities and has proposed increasing defense expenditures an average of 7.9 percent after inflation for 1981 to 1987 and still increase entitlement programs by an annual rate of 1.5 percent after inflation. The shift in priorities will steadily raise the national defense share of total outlays from 24.3 percent in 1981 to 29.2 percent by 1983 and 37.2 percent by 1987.

ANNUAL RATES OF INCREASE IN REAL FEDERAL SPENDING

(percent)

	1975 to 1981	1981 to 1987
National defense	1.8	7.9
Nondefense:		
Entitlements	4.7	1.5
Other	4.3	-7.6
Subtotal, Nondefense	4.6	-1.7
Total	3.9	1.0

Source: Budget of the United States, Fiscal Year 1983

The President's new budget also breaks the mold and fulfills his campaign promise to reduce the growth in government expenditures, although even after adjusting for inflation many social programs will continue to grow sharply. Under the President's budget, the growth of government outlays should fall from 17.4 percent in 1980 to 10.4 percent in 1982 to 4.5 percent in 1983. After having reached 23 percent of the GNP in 1981, federal expenditures will represent 22.1 percent in 1983 and 20.9 percent in 1985 -- if the Reagan program is enacted. Most of this decline, however, is not the result of expenditure cuts but of sharp increases in the estimates of future GNP.

The President's seemingly drastic $43 billion in budget cuts, in fact, only amounts to about 5 percent of the 1983 budget and only reduces the year-to-year growth in government expenditures by about half. The President is attacked for allegedly shredding the social safety net programs. Yet major health, welfare, and retirement programs have increased sharply since Reagan took office. Even accounting for the FY 1983 proposals, medical care outlays have increased by over 13 percent a year since Reagan took office, Social Security is up by 12 percent a year, unemployment compensation outlays are increasing by 7 percent yearly, and housing assistance is up 13 percent a year. While some specific social welfare programs are being cut, the entire entitlement budget is increasing over 5 percent in 1983 to a yearly total of $341.5 billion. That social programs will increase at all after growing by a staggering rate of almost 15 percent yearly since 1973 is potent evidence that the Reagan budget knife is still too dull.

THE GROWTH IN BUDGET OUTLAYS, 1973-1981

(In billions of current dollars)

	1973	1981	Average rate of growth
Budget component:			
National defense	74.5	159.8	9.7%
Entitlements:			
Social Security	48.2	138.0	13.6
Medicare and Medicaid	14.1	59.3	19.0
Other	32.2	94.8	14.0
Subtotal, Entitlements	94.6	292.0	14.6
Net Interest	17.3	68.7	18.2
Other nondefense:			
Education, training, employment, and social services	12.7	29.1	10.6
Energy	1.2	10.3	30.0
Transportation	9.0	23.1	12.1
Community and regional development	4.6	9.4	9.1
All other	31.7	64.7	9.0
Subtotal, other nondefense	59.2	136.7	10.7
Total budget	245.6	657.2	12.7

Source: Budget of the United States, Fiscal Year 1983

Food stamps, Medicaid, Medicare, AFDC and other social welfare programs all have undergone scrutiny in this budget and are being trimmed to exclude some recipients who do not require sustenance from the taxpayers. But the Administration has yet to articulate a long-term strategy aimed at reform of the welfare system. Nibbling at the growth of a few programs will not achieve the needed fundamental changes in the outmoded and initiative-numbing anti-poverty efforts, nor will it achieve permanent reductions in the social welfare budget. Eventually, the federal government could return tax sources to the states to finance programs for the needy, leaving Washington to supplement state welfare budgets only in cases of severe fiscal need.

All levels of government now combine to spend over $200 billion on welfare for the poor. With 25 million Americans below the poverty line to some degree or another, each theoretically could receive $8,000 or about $32,000 per family of four. Obviously, much of the social welfare money never gets to the poor but ends up supporting an enormous professional bureaucracy of social workers, caseworkers, administrators and other interest groups charged with "taking care" of the poor. Reagan's budget initiatives do not fundamentally revise the system that allows such a large share of each welfare dollar to go to the welfare industry.

The 1983 budget initiatives also envision dissolution of the Cabinet level departments of education and energy. By cutting the Department of Energy budget by one-third and calling for its reorganization, the Administration is on the right track, but it needs to go much further. It should eliminate energy commercialization projects in which even industry has little or no interest, such as the $232 million Clinch River Breeder Reactor, where industry's support has never been more than 9 percent. The reactor's design has long been eclipsed by the French, who are looking forward to selling their technology. The budget also should curtail research where the product objective, completion date, and foreseeable benefits are vague at best -- such as magnetic fusions projects ($444 million) or the high energy and nuclear physics programs ($601 million). The 1983 budget increases expenditures for these questionable projects at a time when the U.S. should rely on private competition to meet energy needs.

THE PROBLEM OF RED INK

Although the budget deficits are slated to decline both absolutely and as a percentage of GNP after 1982, business leaders and economists are worried that government borrowing could increase interest rates, divert capital from expanding business needs, cause the Federal Reserve to increase the money supply, and perhaps abort the economic recovery expected in the spring. Even with the planned budget cuts and revenue-raisers, the deficit will go from $98.6 billion in 1982, or 3.2 percent of the GNP, to $91.5 billion in 1983, 2.7 percent of GNP, to $82.9 billion in 1984, 2.2 percent of GNP, and to $71.9 billion, or 1.7 percent of the GNP in 1985.

The solution to the gushing red ink, however, is not to raise taxes, especially in the current recession. Tax hikes crowd out private sector growth as much, if not more, than does government borrowing to finance the deficit. The relevant measure of the government burden on the economy is the level of government spending. Whether spending is financed by explicit taxes, government borrowing, or inflationary increases in the money supply to finance government debt, all are "taxes" on productive activity. Of course, the kind of tax imposed makes important differences to productivity, saving, and work effort. A consumption-based tax, for example, is much less harmful to the economy than progressive income taxes; and each tax affects groups in society differently. But the relative burden on the economy is not lessened by raising one tax -- say excise taxes -- in order to lower the implicit taxes of government borrowing or inflation. The Reagan budget cuts represent the economically sound approach to reducing the budget deficit.

The White House has been less than consistent on this point. In the 1983 budget, the Administration has trotted out many of the same proposals to eliminate tax loopholes suggested by the Carter Administration. The proposed tax revisions include a minimum corporate tax and user fees which are estimated to raise nearly $9.7 billion in 1983. If past political history is any clue, these tax increases have little chance of enactment. That's just as well. The tax increases are too small to appreciably reduce the deficit, but large enough to discourage already over-taxed businesses and groups of workers and professionals. The Administration risks losing valuable political capital by fighting for these nuisance tax increases; a battle would only blur Reagan's popular and economically sound tax-cutting image. Are these measures included in the budget to prove the Administration's toughness to business and wealthy individuals? If so, they surely will fail to convert the opponents of economic growth and will send conflicting signals to business.

NEW FEDERALISM

The most innovative aspect of the new budget is President Reagan's New Federalism. The President has proposed to transfer more than forty programs -- as well as food stamps and Aid to Families With Dependent Children -- to state and local control. In return, Washington will take over Medicaid expenses and establish a $28 billion trust fund financed by federal excise taxes to compensate states for net increases in costs due to the swap. What vitally distinguishes this plan from past schemes, like revenue sharing and grants-in-aid, is that the states and localities will resume responsibility for financing the programs in 1988 as the federal trust fund and federal excise taxes are phased out. The proposal forces taxes to be raised for programs by the same level of government that runs the programs. This will cause taxpayers to associate taxes with services and make decisions more rationally about the appropriate level of government services.

While the Reagan federalism initiative generally provides a good blueprint for restructuring the federal government, the Administration seems unsure of the principles motivating it. The swap of AFDC and food stamps for Medicaid may please the big city mayors by removing the health program from their budgets, but it saddles the federal government with the complete cost of one of the budget's fastest growing programs. Federal health programs grew an astounding average of 19 percent between 1973 and 1981 and in 1981 alone soared 21 percent. The federalized Medicaid program is expected to rise 83 percent by 1987. Yet the total funding level for programs turned back to the states, AFDC and food stamps, is projected to decrease slightly from $26.5 billion in 1981 to $24.5 billion in 1987.

After 1987 when the states begin to finance the turnback programs, the federal government will assume over $25 billion in state Medicaid costs and will give to the states less than $18 billion in federal welfare programs. The swap, moreover, centralizes government further. The Administration has also suggested a turnback of some $31 billion in other programs to the states by 1987. Even if this additional turnback is approved by Congress, the Medicaid program will offset over 50 percent of the expenditure turnbacks. In sum, the federalism initiative so far is only a step -- a welcome step, to be sure -- toward decentralizing government. Federalizing health care programs, however, is a giant step towards the liberal goal of universal national health insurance.

What concept of federalism, it can be asked, justifies the return of the major poverty programs to the states, but not the major health program for the poor? Such an arbitrary distinction between federal and state responsibilities creates the impression that the Administration is confused in its theory of federalism. Yet the Administration should not have trouble developing a convincing and coherent theory of federalism. The underlying purpose of federalism is to establish local control of government programs. The American constitutional system was founded on the idea that a dispersal of power among states presents much less danger to liberty and representative government than concentration of power in one national government. At the local level, individuals also exert most influence over their own government. National opinion polls find large majorities of Americans believing that local and state governments are less wasteful of tax dollars, less corrupt, and more likely to reflect local wishes than the federal government.

Some critics contend that states cannot afford additional responsibilities and that inequities will result since some states have fewer resources than others. If there is a "fiscal mismatch," however, it favors the states. State and local revenue has risen 345 percent in constant dollars since World War II, while federal revenue has risen only 151 percent over the same time. Regional wealth differences have also declined by 40 percent since 1960, and will continue to narrow rapidly in the future. The federal government, however, does enjoy one major advantage over the states--the Bureau of Engraving and Printing. By running the printing presses, the federal government can pay for just about any program. In the process, it triggers inflation. The states, of course, cannot print money and thus must live within their means.

The issue is not whether states have sufficient wealth to provide for the needs of their citizens. If the federal government did not drain 22 percent of the nation's resources, states would have enough of an economic base to support services. The federal government could always provide emergency aid to needy states, but such intervention should be rare. The federal government now provides not only emergency aid, but funds for pothole repairs, sewers, milk for pregnant mothers and hundreds of other programs. It is not the federal government's role to equalize wealth between states or finance services which states can--but prefer not to--provide themselves.

The President should broaden his New Federalism to include regulatory agencies. The federal government should be regulating only when a national effort is required to remedy market imperfections and when the initiative cannot be undertaken by the states individually.

FAT ENTITLEMENTS

The Administration's 1983 budget fails to confront Social Security reform, even though Social Security consumes about one-fourth of the budget and has been rising at nearly 14 percent a year since 1973. Over the next five years Social Security outlays will climb an average of 8.5 percent yearly at a time when the budget as a whole (excluding Social Security) will increase only 5.5 percent. While any mention of Social Security change is politically explosive, major reform must be considered if budgetary growth is to be limited and a secure retirement provided for today's young Americans. Eventually, the Administration will have to consider restructuring Social Security into a true insurance program in which the retiree's pension is based on his contributions during working years plus accumulated interest.

The Administration's budget-cutting strategy is running into an inevitable dilemma. Apart from defense, Social Security, Medicare and Medicaid, very few areas of the budget can be cut substantially. These four areas represent 56.5 percent of the FY 1982 budget. Under the current round of cuts, the programs will claim almost 72 percent of the budget by 1987. If the President is to achieve sizable additional cuts, the fat entitlement programs--long sacrosanct--will have to come under the axe. Reform of basic entitlement programs is nearly impossible to avoid in the next few years if budget growth is to be restrained significantly. Yet the current Reagan budget for 1983 contemplates no substantial reform of Social Security, Medicare or Medicaid.

THE SUPPLY-SIDE PRESCRIPTION

Caught in the midst of a chilling recession that is not his doing, Ronald Reagan has fashioned a budget that must take account of rising unemployment and idle industry. It is a tribute to Reagan's integrity that he has not capitulated to his unrelenting critics. He has not, in short, abandoned the supply-side prescription for economic vitality. Yet he hesitates to administer the full supply-side dosage. Now is the moment to test the promises of the supply-siders. Thus, rather than delay the 10 percent cut now scheduled for July, he should accelerate it by six months, making it retroactive to January 1.

THE GROWTH IN BUDGET OUTLAYS, 1982-1987

(In billions of current dollars)

	1982	1983	1984	1985	1986	1987
Outlays:						
National defense	187.5	221.1	253.0	292.1	331.7	364.2
Social Security	154.6	173.5	188.5	202.3	216.5	232.0
Medicare and Medicaid	67.4	72.4	79.8	88.8	97.8	107.4
All other entitlements	102.9	95.6	93.7	95.3	96.6	98.5
Net interest	83.0	96.4	98.7	100.8	99.3	93.2
Other nondefense	129.9	98.7	92.3	89.2	85.2	83.5
Total budget outlays	725.3	757.6	805.9	868.5	927.0	978.9
Growth rate (percent):						
Defense, Social Security, Medicare and Medicare	14.7	14.0	11.6	11.9	10.8	8.9
All other	5.2	-8.0	-2.1	0.2	-1.5	-2.1
Total budget	10.4	4.5	6.4	7.8	6.7	5.6
Share of budget (percent):						
Defense, Social Security, Medicare and Medicaid	56.5	61.6	64.7	67.1	69.7	71.9
All other	43.5	38.4	35.3	32.9	30.3	28.1

Source: Budget of the United States, Fiscal Year 1983

This speed up, contend supply-siders, could quicken economic recovery and enhance the incentives for the saving, investing, and working essential for increasing productivity and employment. Supply-siders also urge immediate indexing of individual income taxes to halt inflation-induced tax bracket creep. Since economic growth powerfully reduces budget deficits, the supply-side remedies also should reduce and eventually eliminate the budget deficit. A 1.2 percent higher real GNP growth rate and an inflation rate 1.2 percent lower than the Administration's own scenario, for example, would cut the defict in half over 1982-1987. In turn, this would bring down the high interest rates plaguing the economy.

CONCLUSION

The federal, state, and local governments combined currently dispose over 40 percent of our national income. For more than half a century ever increasing amounts of power and tax dollars have flowed to Washington, along with the interest groups prepared to defend their government-sponsored benefits and positions. It is hardly possible for Ronald Reagan to reverse that trend in the short time since his presidency began. Taken together with the budget cuts enacted last year, however, the 1983 budget represents an impressive achievement and a clear break with past policies that have brought our nation close to economic ruin.

It is now within the grasp of Congress to reassert control over poorly conceived government programs, to begin reform of the major entitlement programs which have long been financially out of control, and to restrict many social welfare programs which shower benefits on the non-needy. Just as important, the Reagan initiative makes a start at returning many programs to local governments -- which Americans most often cite as the most efficient, least corrupt system, and most in accord with their own wishes. With all the faults and oversights of the Reagan 1983 budget, it is still the only game in town. Congress can use the document as a foundation to launch a broader attack on many other programs which deserve closer scrutiny. Congress, for its own part, is getting off to a bad start by seriously considering proposals to increase taxes and reduce the defense budget, but mostly the Congressmen are wringing their hands over deficits and criticizing the only person who has formulated a viable budget: Ronald Reagan. One hopes that when all the political carping ends, Congress will tackle the unfinished task before it and begin reining in the rapidly expanding public sector.

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APPENDIX

Sindlinger and Company, Inc. for The Heritage Foundation
Special Study
Interview Dates: January 7, 1982 through January 26, 1982
Before the State of the Union Address

	Total %
QUESTION 1	
What should the Reagan Administration's defense budgetary policy be --	
1. Increase defense spending?	27.4
2. Decrease defense spending?	19.3
3. Leave defense spending intact?	40.2
4. Don't Know/Not Sure	13.0
QUESTION 2	
While President Reagan has stated that he can no longer balance the Federal budget by 1984, he is still committed to eventually ending the deficit that we now face. Given these alternatives, what should the primary means for achieving this be --	
1. Cut Social Programs?	52.6
2. Cut Defense Spending?	22.6
3. Increase Taxes?	17.8
4. Don't Know/Not Sure	7.0
QUESTION 3	
Are you in favor or opposed to budget cuts as a means for reducing the Federal deficit?	
1. Favor Budget Cuts	79.0
2. Oppose Budget Cuts	10.8
3. Don't Know/Not Sure	10.2

QUESTION 4

If it were possible to balance the budget only by decreasing defense spending, which policy would you favor --

	Total %
1. Balance the budget/Decrease defense spending?	38.4
2. Run a deficit/Maintain defense spending?	51.5
3. Don't Know/Not Sure	10.1

QUESTION 5

Do you think that the Federal budget has been cut too much -- too little -- about the right amount -- or what do you think?

1. Too Much	19.2
2. Too Little	40.1
3. About the Right Amount	27.9
4. Don't Know/Not Sure	12.9

QUESTION 6

Which level of Government delivers needed Government services most efficiently --

1. Federal?	13.7
2. State?	26.7
3. Local?	49.9
4. Don't Know/Not Sure	9.7

QUESTION 7

Should most welfare, education and health programs be administered at the Federal level -- state level -- local level -- or what do you think?

1. Federal Level	14.3
2. State Level	24.0
3. Local Level	54.8
4. Don't Know/Not Sure	6.9

QUESTION 8

President Reagan is attempting to combine many programs in health, education and social services into block grants to the states. The concept of block grants is to give each state a portion of the Federal funds and let the states decide what the best uses for the funds are. What is your opinion of this concept?

	Total %
1. Strongly Agree	43.4
2. Moderately Agree	34.3
3. Neutral	6.2
4. Moderately Disagree	2.6
5. Strongly Disagree	4.3
6. Don't Know/Not Sure	9.2

QUESTION 9

A major premise of the proponents of block grants is that each state has individual problems that can be handled more efficiently by states and municipalities than by the Federal Government. Do you agree or disagree with this statement?

	Total %
1. Agree	78.8
2. Disagree	8.1
3. Don't Know/Not Sure	13.1