FRBSF WEEKLY LETTER

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Of Mice and Men

After months of painful deliberation, the House and Senate on August 1 adopted S. Concurrent Resolution 92 expressing their nominal agreement on a budget for fiscal year (FY) 1986 and spending targets for the following two years. If implemented, the targets ostensibly would reduce spending over the next three years by $276 billion; that is, aggregate outlays (as distinguished from spending authority) would be $276 billion *less* than if no cuts are made. However, the term "cuts" is somewhat imprecise; while various individual programs are targeted for actual reductions, total spending (for 1986-88) at a prospective level of about $3.1 trillion would still exceed spending during the last three years (FY 1983-85) by almost $500 billion.

It also would be accompanied by additional deficits totaling about $440 billion, some $50 billion less than the deficits projected for this period by the President in his budget message last February. Nevertheless, the Congressional Budget Office (CBO) believes the magnitude of the projected deficits through FY 1988 has been underestimated by about $40 billion. Moreover, following adoption of the budget resolution, Senate Majority Leader Robert Dole (R-Kansas) conceded that "We really haven't cut Federal spending (and) reduced the deficit that much. . . and the deficit will really be much larger." House Budget Committee Chairman William Gray III (D-PA) declared that "savings" over the next three years probably would be about $76 billion less than estimated and that an economic crisis probably would have to occur before the Congress and the Administration would consider tax increases or cuts in Social Security.

For his part, recently resigned director of the Office of Management and the Budget (OMB), David Stockman, characterized the budget resolution as a "limp rag," and, in remarkably blunt comments, recently asserted that "we have increasingly resorted to squaring the circle with accounting gimmicks, evasions and half truths and downright dishonesty in our budget numbers, debate and advocacy."

This *Letter* reviews the changing dimensions and structure of the budget over the last five years, including the Administration's initial game plan and the more recent (1983) recommendations of the Grace Commission (The President's Private Sector Survey on Cost Control). A future *Letter* will discuss current Congressional efforts such as the recent Senate passed and White House endorsed Gramm-Rudman proposal to reduce the deficit to zero by 1991.

Through the looking glass

In July, 1981, the Vice Chairman of the Congressional Joint Economic Committee issued a study which, he noted, "demonstrates that the Reagan (Kemp-Roth) tax cuts will produce more than enough savings to finance any short-term increase in the budget deficit." Notwithstanding a prospective $496 billion loss of revenues as a result of a cut in tax *rates* and other tax reductions, the new Administration's "Program for Economic Recovery" estimated that total revenues, bolstered by an expanding economy (real growth was estimated to average 4.5 percent a year), even with tax cuts, would rise by about $250 billion from FY 1981 through FY 1985, surpassing a $190 billion *rise* in expenditures and resulting in a budget surplus of $7 billion in 1985. *Without* implementation of the new program, total spending was projected to reach $911 billion by FY 1985 and receipts $1,033 billion, resulting in a budget surplus of $122 billion — a prospect which the Administration viewed as unacceptable because of the increase which it would entail (from 21.4 percent to 23.5 percent) in the government's share of GNP.

But as Robert Burns noted 200 years ago (he may have been struggling with his household accounts at the time), "The best laid schemes o' mice and men gang aft a gley; an' lea'e us nought but grief and pain for promis'd joy." According to the recent mid-year (August) estimates of the OMB, FY 1985 will close in October with receipts of $741 billion, outlays of $951 billion (24 percent of GNP) and a deficit of $210 billion, raising the total of deficits incurred since 1981 to $734 billion. In the process, the outstanding debt held by the public has more than doubled. The larger than expected net rise in spending over the period ($320 billion) clearly has been a significant factor contributing to the soaring deficits. However, so has a $435 billion overall loss in revenues from the 1981 tax cuts, even though the net impact of the latter has been modified by $125 billion in new funds derived from various "revenue enhancements" enacted in 1982-1984 to help stem the rising deficits.

In addition, as the CBO has noted, the chronic propensity to overestimate revenues and underestimate spending and deficits is attributable to excessively optimistic assumptions about the real growth of the economy, which the Administration has estimated at about a steady 4 percent per annum.

Deja vu?

The budget resolution adopted by the Congress on August 1, while actually fairly close to the Administration's budget in terms of its overall spending and deficit magnitude, differs significantly from the Administration's proposals in various particulars. White House Chief of Staff and former Treasury Secretary Donald Regan, for example, stated that Congress cut "too much in defense and not enough in non-defense," and that the Administration would concentrate more in obtaining cuts in domestic programs in the FY 1987 budget (to be submitted next February). These programs presumably include some twenty whose elimination the Administration recommended earlier this year but which the Congress (except for General Revenue Sharing — about $5 billion in FY 1985) thus far has refused to approve. Among them are Amtrak and Conrail subsidies, the Small Business Administration, general revenue sharing, the Job Corps, national employment and training programs, and urban mass transit.

On balance, the Congress' August budget resolution and spending targets contemplate about a $20 billion (2 percent) net rise in total spending in FY 1986 to $968 billion, and, including FY 1986, a $127 billion (13 percent) increase to $1,073 billion in FY 1988 — about $20 billion less than proposed by the Administration. In setting this target, the Congress shaved about $110 billion off the Administration's proposed level of defense spending *during* the three year period to $856 billion. However, at this level, military outlays would still exceed those of the last three years by $165 billion. By 1988, when defense spending will reach a $304 billion annual rate, it would account for 28 percent of total budget outlays. In "real" terms, that is, after allowance for inflation (estimated by the Administration at about 12½ percent over the period), defense spending would register a net increase of 8 percent.

In the area of health and income support (Social Security, Medicare, food and nutrition, housing assistance, unemployment compensation and general retirement and disability programs) total spending is targeted to rise by about $61 billion (15 percent) to a $479 billion annual rate in FY 1988, about $10 billion higher than proposed by the Administration and representing 44 percent of total budget outlays. In real terms, spending would increase by a nominal 2 percent. Interest outlays in support of servicing the rising debt are projected to rise by as much as $20 billion (to $150 billion) by 1988, and all other expenditures (net of offsetting receipts) to *decline* by about $10 billion to $140 billion in 1988.

This "residual" category of programs runs the gamut from international affairs to science, energy, transportation, agriculture, natural resources and the environment, education, training, employment and social services, community and regional development, and community and housing credit. In recent years, they have been a major focus of spending cuts — including actual reductions as compared with just reduced rates of increase. Between 1980 and the current fiscal year, for example, aggregate outlays for those programs rose very slightly in current dollars (from $143 billion to $149 billion), but due to a 30 percent increase in the price level (as measured by the GNP deflator), registered a *decline* of 20 percent in *real* terms. In real terms, the proposed level of aggregate spending on these programs in FY 1988 would entail a further reduction of almost 20 percent.

However, as noted previously, the Congress refused to terminate completely several programs whose phase-out has been recommended by the Administration. For example, agricultural price supports, targeted by the Administration for a reduction from about $20 billion this year to $8 billion by FY 1988 (and subsequent elimination), have been tentatively set by the Congress at $14 billion in 1988. Partly because of its potential assistance to American farmers, the Congress also refused to terminate funding for the Export-Import Bank.

Grace for today?

In the face of these developments many observers have wondered: "Whatever happened to the recommendations of the Grace Commission?" The Commission was established by President Reagan in 1982 and headed by J. Peter Grace to determine ways of reducing the costs of running the federal government. It advanced some 2,498 proposals aimed at reducing waste, improving management and rectifying "structure failures" in government programs. These recommendations, according to its estimates, would involve savings of $424 billion over a three-year period when finally implemented. (In some cases, such as suggested changes and potential savings of $58 billion in military retirement programs, full implementation would not occur until 2001-03). A considerable number of the recommendations, including the elimination of various programs, already have been incorporated into the Administration's budget proposals.

However, early in 1984, the General Accounting Office (GAO) together with the CBO did a lengthy analysis of some 396 of the Commission's proposals, which together account for 90 percent ($380 billion) of the Commission's estimated savings. The report was highly laudatory of the Commission's efforts and noted that two-thirds of the proposals it analyzed "have some merit" (including 150 which previously had been advanced by the CBO itself, and 50 of which were in the process of implementation). But the report also concluded that, on balance, potential savings would be "much smaller" than estimated by the Commission — perhaps only one third as much.

It also noted that the bulk of estimated savings involve recommendations that would require "significant changes in current laws" and that the estimated savings are "much too large" to be attributed to waste and inefficiency. The analysis also identified a number of cases that involved double counting, and several key recommendations that, if implemented, actually would result in added costs. For example, making federal pay "comparable" to that of the private sector could result in a net *increase* in federal salary costs of about $2 billion rather than the $11 billion in savings claimed by the Commission, inasmuch as the differential in favor of federal pay scales which existed in 1976, and which apparently was assumed by the Grace Commission still to exist, no longer prevails.

In summary, the CBO/GAO concluded that the Commission had not found an easy solution to resolve the problem of soaring costs and budget deficits. Moreover, it concluded, it is questionable whether the Commission's recommendations could be achieved, as the Commission contends, "without raising taxes, without weakening America's defense buildup and without harming in any way necessary social welfare programs." (However, to those appalled at documented revelations of overcharging in military procurement programs, for example, the Commission's "assumption" that 5-7½ percent of procurement costs can be reduced *a priori* appears entirely credible.)

On balance, the spending targets for the next three years, embraced in Concurrent Resolution 92 adopted last August, envision an increase in total spending in current dollars of about 12 percent, but an increase in "real" terms of only about one percent. In the Resolution, there is roughly an 8 percent "real" increase in defense spending and a 2 percent increase in health and income support that are largely offset by a further substantial (20 percent) decline in outlays for a gamut of social infrastructure programs.

In the face of prospective continued large deficits and what many observers increasingly have viewed as a potential crisis, the Senate, by a substantial majority early in October, adopted the Gramm-Rudman proposal to reduce deficits to zero by 1991. Together with proposals to amend the Constitution to require a balanced budget, the proposal, including its implications for monetary policy, will be the subject of a future *Letter.*

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 10/2/85	Change from 9/25/85	Change from 10/3/84 Dollar	Change from 10/3/84 Percent[7]
Loans, Leases and Investments[1] [2]	196,194	1,896	12,759	6.9
Loans and Leases[1] [6]	176,960	1,910	12,168	7.3
Commercial and Industrial	51,549	727	1,155	2.2
Real estate	64,995	449	3,738	6.1
Loans to Individuals	36,012	97	5,826	19.3
Leases	5,411	– 3	370	7.3
U.S. Treasury and Agency Securities[2]	11,992	– 83	266	2.2
Other Securities[2]	7,242	69	326	4.7
Total Deposits	202,566	5,757	10,431	5.4
Demand Deposits	50,343	4,730	4,199	9.0
Demand Deposits Adjusted[3]	32,962	1,836	3,802	13.0
Other Transaction Balances[4]	14,106	673	1,454	11.4
Total Non-Transaction Balances[6]	138,117	354	4,777	3.5
Money Market Deposit Accounts—Total	45,023	50	7,231	19.1
Time Deposits in Amounts of $100,000 or more	38,259	– 377	– 2,965	– 7.1
Other Liabilities for Borrowed Money[5]	21,631	– 1,818	1,293	6.3

Two Week Averages of Daily Figures	Period ended 9/23/85	Period ended 9/9/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	61	– 2
Borrowings	39	16
Net free reserves (+)/Net borrowed(–)	23	– 18

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change