

Address by
Bruce K. MacLaury, President
Federal Reserve Bank of Minneapolis
To the Lake Superior Chapter, BAI
Duluth, Minnesota, February 15, 1973

The president of the Federal Reserve Bank of Minneapolis has a great privilege in representing an institution that serves a vast geographic region. Yet, I suppose some people might visualize the job of the Fed president as sitting in Minneapolis pondering monetary policy, pure and simple. But to do that would, in my opinion, be to miss most of the fun of the job. For what other kind of job can give you responsibilities in an area that spans from Montana to Michigan. Most important, part of those responsibilities dictate that I should try to become acquainted with the territory and its economy. Where else can you get paid for that kind of interesting education, and this trip to Duluth is an informative and pleasurable part of my education. I can't represent you as bankers and as people without knowing something about you, and I know it is trite to say, but it is indeed a privilege to have a chance to come, shake hands, get acquainted and learn.

I hope you will indulge me if I look upon this group as, in a sense, part of the family. The Bank Administration Institute is a great institution; I have had a chance to talk to a number of chapters in the past. I applaud the efforts that are put into these meetings to make them go; the education derived from them makes them and the organization very worthwhile indeed.

I'd like to talk about the trouble with the federal budget. It might be a trite old subject, but we're hearing a lot about it these days.

We are having a good deal of political acrimony, or at least dialogue between Congress on the one hand and the President on the other, as to who can do what to whom so far as expenditures are concerned.

Charlie Schultz, Director of the Budget during the Kennedy-Johnson Administration and now at the Brookings Institution in Washington, is, I suppose, one of my heroes. He publishes a book, or he oversees publication of a book each year dealing with the federal budget. The current issue is called National Priorities, the 1973-1974 Budget. It's not easy reading, but it is an awfully well analyzed work and is non-partisan. It represents a lot of work by Schultz and he brings a lot of first-hand budget experience to the analysis. He has quite probably devoted more attention to the subject than any other person. I recently heard him repeat something from last year's issue of this document, and I'd like to relate a few of the thoughts because I think they add up to--in my view--an explanation you don't see everyday in the newspapers.

First of all, if the budget is in trouble there are usually a number of reasons. One of them is that the United States can no longer count on a perpetual economic upswing (such as we are now in) to generate income tax receipts for the government sufficient to cover increases in expenditures. In effect, in the past we had it easy (insofar as paying taxes is ever easy). We had increases in budget receipts year after year without increases in tax rates. We could finance existing programs and also could, in fact, add programs year by year, and not increase taxes.

We have run out of those happy, good times, and one of the chief reasons for this change of circumstance (no longer a free ride, if you will, from the upswing in the economy) is that the very size of federal programs

has increased so much over recent years. I don't want to bore you with a lot of numbers--but I'd like to try to give you some sense of the dimensions of the problem without confounding you with statistics.

It's mainly been the growth of social programs, the so-called Great Society programs (I use that phrase not in a partisan sense). The defense component of our federal budget has in fact been declining, not in dollar terms but as a proportion of the total federal budget. In 1963--ten years ago--the defense budget was a little over half of total federal outlays. This fiscal year, it's down to about a third of the total federal budget. Thus, defense outlays, for all our outcries (and perhaps legitimate outcries) have been declining as a proportion of total federal expenditures over this period.

On the other hand, Great Society programs, the social programs so to speak, have been rising rapidly. Again, using the ten-year period 1963-1973--they rose from two percent of the total budget, which in 1963 was \$2 billion, to about 14 percent this year, or some \$35 billion. Now where did all that money go? About \$20 billion of that \$35 billion was spent on goods and services, primarily for low-income groups including expenditures for housing subsidies, Medicare-Medicaid, food stamps, student loans, etc. You can name your own programs; you are familiar with them. But they were programs to deliver goods and services to the people. The other \$15 to \$16 billion of the total \$35 billion was made up of grant programs, primarily to state and local governments--waste treatment plants, community health development plans, mental health, urban planning, manpower training, etc. You name it, it was there.

Costs of these programs have risen rapidly, not just as a proportion of the budget but also as a proportion of our total GNP output. How much? Well, in the last three years (fiscal years 1971-1973) civilian-type programs, including the Great Society programs already mentioned, have been growing twice as fast--more than twice as fast--as they were as little as ten years ago. There was a nine percent year-by-year rate of growth in social programs during the last three years, compared with a four percent rate of growth in social programs ten years ago, so that as of today these social programs (so-called nondefense) constitute about 13-1/2 percent of our total GNP output, as opposed to nine percent as little as seven years ago.

I cite these numbers simply to illustrate the fact that these social programs, which we have bought for ourselves, now bulk much larger in the total of our budget, in the total of our economic output. As you can see, a rate of growth of let's say even five percent in these kinds of outlays means much more in the way of dollars today than it meant ten years ago.

Our tax receipts have not kept pace with this kind of increase. In fact, federal taxes of all sorts have been reduced markedly over the last ten years--I'm talking about corporate taxes, personal income taxes, federal excise taxes. If we had the same tax rates at the federal level today as we had in 1963, federal revenues would be up \$45 billion. Our total tax bite has been going up because state and local taxes have been going up, filling in the gap as federal tax rates decline. It's not as though

we as citizens are paying less of our income for taxes--we're probably paying more--but federal taxes have in fact declined over this ten-year base. Not only have our programs grown, but our tax base in this sense has declined. No more free rides.

What about the programs themselves? In the last few weeks since the President's budget message we've heard a lot about the ineffectiveness of federal programs. Well, Charlie Schultz makes the following point, and I think it's valid: that we have come to expect a whole lot more from our federal expenditures in terms of the kinds of programs we are asking for today than we did as little as ten or twenty years ago. What do I mean? Well, if you go back to the 1930s, you're talking about security--minimal programs where the federal government doled out dollars and that was the end of it.

What about today? We are asking our federal government to provide us a whole new range of programs for which it was not conceived and for which it has not done a very great job. The point that Schultz makes is that if we judge these programs to be a failure we have got to understand that we are judging them by standards we never before applied to the federal budget. I'm not trying to argue that they are successes. On the contrary, many of the programs the President is at the moment trying to cut are ineffective. But I want to emphasize that we are using a whole new set of standards to judge what we expect of the federal government.

If we say that these programs are not great successes, one and all, then what can the federal government do well? As in the 1930s the one thing that it can do well is pass out money. It started out in that business with veterans' benefits and social security, and it still can

with the increased social security benefits, and with some welfare payments pass out money efficiently. You just sign the checks, they go through the mail, they arrive and, by golly, the money is in the hands, hopefully, of the right people. Another kind of thing the federal government can do is to provide essential kinds of services; here I'm thinking of health insurance, for example, realizing as I say the word, that is it not without controversy in itself. The government can provide, for example, supplementary financing for education in the form of student loans--again passing out money, if you will. It can pass out money in the form of revenue sharing and it can do this efficiently. It can give out the money and the money gets spent, and by that kind of criterion it does the job well. In another area it can compensate for failures of the market pricing system. While we still believe the marketplace is the best allocator of resources, whether it's credit from your bank or goods and services, we've come more and more to focus on its deficiencies. For example, costs of pollution control are not acknowledged by the pricing system; effluents from a manufacturing plant have not in the past been charged to that plant, but rather to society as a whole, in terms of reduced water quality. We're changing that, and the federal government can do something about it with effluent taxes. It can improve the allocation of resources where in some instances the market price system has failed.

What can be done if we are in this kind of financial bind and we know, or think we know, what the federal government can do well? Schultz describes three alternatives (1) He describes the "Nixon approach" as cutting and cutting sharply the growth of programs or even whole programs in the

social area, and that's it. (2) The second approach is what he calls Congressional reaction--that is to march right back to the White House and say "put all those same programs right back; they are the programs we need and you, Mr. President, are impounding these funds without the right to do so and we're going to insist that you spend that money." This approach takes us right back to where we were; it disregards the fact that some of these programs were not achieving their objectives. (3) The epitome of the Schultz approach (and you can guess that this is the best one from his point of view) is neither of the first two alternatives; you don't cut social programs and let it go at that; nor do you put them all back the way they were. Instead, Schultz would take a three-pronged approach--first, make most of the cuts the President is advocating in his budget in these social programs. As a former budget director for a Democratic Administration he hazards the guess that perhaps 80 percent of those cuts ought to be made. (I think that is an interesting nonpartisan, or bipartisan if you will, commentary on the issue.) Second, don't stop there, he would argue. He suggests there is \$5 billion or so in the defense budget that can be cut without hurting the defense posture of the United States. Third, Schultz would press for tax reform, which, he argues, would yield some new revenue dollars. All right, if we can get dollars by cutting social programs, by cutting the defense budget and by increasing revenues through tax reform, what are we going to do with them? Schultz suggests that you focus these saved dollars on things the government can do well. It's all very well to list as national priorities those things which we need most, says Schultz, but we also need to but draw up a parallel list of what things government--at various levels--can do well.

It doesn't make much sense to address all our budget resources to priority number one if the federal government does a miserable job accomplishing priority number one, whatever that particular priority is. Rather, we should concentrate resources on the national priorities we think the federal government can accomplish well.

Schultz lists those national priorities that he and, incidentally, I think the federal government can accomplish well:

(1) Health insurance--including a viable system for poverty-level people combined with a new and more effective system of delivery of health care. Also included is disaster health insurance for all people--rich, poor, middle-income. We all know of extreme instances in which families have been forced to sell their homes to pay medical expenses. There ought to be--and the Nixon Administration has proposed--some sort of relief for this family disaster.

(2) Welfare reform. I won't pursue this in detail, but I think there has been enough bipartisan argument on the issue to believe there is a case for radically changing the present system.

(3) Educational opportunity--expenditures on equalization of opportunity in education.

(4) Central cities--not particular programs, says Schultz, because the federal government shouldn't decide which particular program a particular central city needs, but the government does need to target general revenue sharing funds into these central city areas more than is presently done.

These kinds of priorities for our federal budget resources offer promise of greater effectiveness and efficiency.

There is another worry in this whole area of troubles with the federal budget--the Congress itself and its budgeting process. A lot of the dialogue we're getting--mutual recrimination between the executive and the legislative branches--is a reflection of the fact that Congress itself is not in control of its own house, so to speak. That condition appears to be recognized by Congress and they are attempting reforms. You've probably read that there is a joint committee at work to set up budget committees in both the Senate and the House, to oversee the total of expenditures rather than having authorization committees and appropriations committees approving cost-incurring programs one after another sequentially and never bothering to add up the total until it's too late. To describe it is, I hope, to point out the absurdity of that approach. Yet if one is head of an appropriations committee or particular Congressional committee and sees his power being eroded by an overall look, it's obvious why reform doesn't come easy.

One final point: federal budget cutting can hit home. As I recently read through the annual report of the Arrowhead Regional Development Commission, I was struck by the number of programs the Nixon Administration is proposing to not fund in the coming year that are the mainstay of Commission work in northeastern Minnesota. We are forced to recognize that what they in Washington are doing to the budget they are also doing to us as well as to others.